FINANSTILSYNET
THE FINANCIAL SUPERVISORY AUTHORITY OF NORWAY

DNB Asset Management AS
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c/o Board chair

OUR REFERENCE	YOUR REFERENCE		DATE
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This translation is for information purposes only.

Management of equity fund – corrective order

1. Introduction

DNB Asset Management AS (the Company) manages the securities fund Verdipapirfondet DNB Norge[1] (DNB Norge). DNB Norge has substantial assets under management, approaching NOK 8 billion. The fund is marketed mainly to non-professional investors.

Finanstilsynet has analysed how DNB Norge has been managed over the last five years. The results of the analysis show that DNB Norge has performed virtually identically to its benchmark. In Finanstilsynet's assessment the actual management of the fund has deviated for a long time from the premises set out in DNB Norge's fund rules and prospectus, and from what the investors were led to expect. In Finanstilsynet's view the Company has failed to adequately safeguard the unit holders' interests in as much as the unit holders, in light of the costs associated with being a unit holder in the fund, have not been given a genuine possibility of excess return. In this connection Finanstilsynet refers to the fact that the Company also has a securities fund under passive management, DNB Norge Index, which up until May 2013 made use of the same index, and which is marketed at a significantly lower management fee (0.3% p.a. compared with 1.8% p.a. in the case of DNB Norge).

Finanstilsynet gave notice of a corrective order by letter of 28 November 2014. The Company disputes that the actual management of DNB Norge has been in violation of the fund rules and prospectus, and that the unit holders' interests have not been safeguarded. Finanstilsynet has considered the Company's arguments, but cannot see that they provide a basis for a different

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outcome. Finanstilsynet accordingly orders the Company to take corrective action as required by the letter of notice. This broadly requires the Company to either bring the management of the fund in line with the characteristics of active management, as reflected in the fund's prospectus and the management fee, or to adjust the pricing of the fund to the management strategy that has in fact been applied, and at the same time to make changes to the fund rules and prospectus to ensure that the management strategy is clearly evident. See point 4 in this regard.

Attention is also drawn to other correspondence in the matter, including Finanstilsynet's analysis and preliminary assessments of 12 June 2014 and the Company's comments of 15 August 2014. Further, reference is made to the Company's letters of 25 August and 1 September 2014 giving details of DNB Norge's active share.

2. Further details of DNB Norge – Finanstilsynet's observations

DNB Norge was in May 2013 converted from a domestic securities fund into a UCITS, and the fund's benchmark index, Oslo Børs Benchmark Index (OSEBX), was replaced with Oslo Børs Mutual Fund Index (OSEFX). DNB Norge is a feeder fund authorised to place all its assets in one other Ucits fund (a master fund). DNB Norge's master fund is DNB Norge (IV). Based on information in annual reports for DNB Norge, Finanstilsynet's presumption is that DNB Norge has placed more than 99 per cent of its assets in DNB Norge (IV).

DNB Norge has a minimum subscription amount of NOK 100 and an annual management fee of 1.8 per cent. According to DNB Norge's fund rules, DNB Norge IV invests mainly in Norwegian companies domiciled in Norway or listed on Norwegian-regulated markets. DNB Norge's fund rules state that the fund's investment mandate is described in greater detail in the prospectus.As the fund invests its assets in DNB Norge (IV), it is that master fund's investment mandate that is described in the prospectus. The fund rules make clear that the fund is characterised by relatively high fluctuation risk (volatility). The fund rules refer to key investor information for further details of the risk profile.

The fund's investment objective is described as follows in the prospectus:

"DNB Norge's objective – relative to the fund's benchmark index – is to achieve the highest possible return on the fund's investments. The fund's investment index: Oslo Børs Mutual Fund (OSEFX). The index is dividend adjusted. The fund is suitable for businesses and individuals wishing to invest in Norwegian equities and preferring high risk and a high level of freedom in fund management. DNB Asset Management AS recommends an investment horizon of five (5) years or more."

DNB Norge's investment strategy is described as follows in the prospectus:

"DNB Norge is an equity fund that invests mainly in equities (securities representing an ownership share in a company) domiciled in Norway or listed on Norwegian-regulated markets.In addition,

the fund can invest up to 20 per cent in foreign companies that are not listed or whose shares are not traded on a Norwegian market. The investments are diversified across companies and sectors.

Investment decisions are made with a basis in the managers' own analyses of equities that have a potential to rise in value over time. The fund is managed by a skilled group of analysts with specialised competence in the Norwegian market."

The linkage between risk and potential return is described as follows in the prospectus:

"To illustrate the linkage between risk and potential return on investments in the fund, the fund is classified at 6 on a scale from 1 to 7 where 7 is the highest possible potential return and risk."

Key investor information expresses the fund's objective as follows:

"…maximum return on the fund's investments in the medium to long term without taking more risk than necessary."

The fund's investment objective and strategy, and risk taking, are imprecise and little clarification is added in the fund documentation. The key investor information's formulation of the investment mission gives no guidance, nor does it reflect the statement in the prospectus to the effect that the objective is to achieve as high a return as possible relative to the benchmark index.

The descriptions in the prospectus give the clear impression that the fund is to be actively managed. Finanstilsynet points in particular to the management objective which is to achieve the highest possible return relative to the fund's benchmark index, and to the wording regarding a high level of freedom whereby investments are based on the manager's own analyses in equities that have a potential to rise in value. Moreover, the fact that the fund is priced as an actively managed fund means that the fund is to be managed actively.

The Company does not dispute that the fund is to be actively managed. It points out that the fund targets the consumer market, and that the intention was to offer an actively managed fund that provides a sound excess return above that of the fund's benchmark index, but with a relatively low tracking error. The Company argues that the information on its website to the effect that the managers have wide freedom to continuously make active choices of companies with a high potential for value increase does not contradict this, and that the fund's risk relative to its benchmark index is in accordance with the marketing of the fund. The Company further states that its management is in accordance with the key investor information and investment profile as presented on the home page, and that the unit holders get the risk they pay for through the management fee.

The Company states that the fund is managed by a management team of four persons who take decisions regarding investment of the fund's portfolio based on their own assessments of companies. It states that these are dedicated managers who have neither mandate nor incentive to pursue a passive strategy. Finanstilsynet underlines that it is the fund's actual investments that are relevant to the assessment of whether the fund has been managed as intended, and not the number of managers involved or the Company's costs of managing the fund.

The specific targets indicating how actively the fund is managed show, in Finanstilsynet’s view, that the fund, by investing its assets in DNB (IV), is not managed actively, but virtually identically to the fund’s benchmark over the past five years. Attention is drawn to the data and to Finanstilsynet’s comments on the following pages.

Finanstilsynet's analysis of DNB Norge is based on the following figures:

Management fee 1.8%

DNB Norge	%		Size of the fund NOK 7.9bn			
Figures as of 03.06.2014		Last 5 yrs	Last 4 yrs	Last 3 yrs	Last 2 yrs	Last 1 yr
Return[2]		13.12%	12.68%	8.81%	23.27%	19.51 %
Diff. return[3]		-1.86 %	-2.12%	-1.86%	-4.50%	-2.25%
Information Ratio[4]		-58.47	-70.33	-62.16	-161.97	-130,49
Tracking Error[5]		3.18 %	3.01%	2.99%	2.78%	1.72%
R-squared[6]	98.21					

The figures are taken from Oslo Børs and Morningstar, 3 June 2014.

As shown, Finanstilsynet’s analysis is based on a five-year period, reckoned backwards from 3 June 2014. Finanstilsynet wanted to base the analysis on publicly available figures, and has therefore used official figures from Oslo Børs to compute the differential return against OSEFX (Mutual Funds). The Company contends that this does not give a correct picture since the fund utilised the OSEBX (Benchmark Index) up to 22 May 2013.

The Company has not presented any calculation of tracking error in relation to the actual index against which the fund has measured its performance. Finanstilsynet obtained a tracking error calculation based on OSEBX for the period to 22 May 2013 from the investment analysis platform Morningstar Direct. When the change of index is taken into account, the tracking error is somewhat lower than Finanstilsynet stated in its notice. The low levels of tracking error support the view that DNB Norge has been managed as a close-to-index fund.

'Active share' is based on the following figures (including cash) at given points in time (supplied by the Company):

	31.03.2014	31.12.2013	31.12.2012	31.12.2011
Active share	16.9%	16.8%	11.9%	9.2%

The fund has for a long period shown a low tracking error and a very low active share. Such low levels are a clear indication that the fund is not managed in line with its active profile, and it is statistically very unlikely that the fund would achieve an excess return justifying a management fee

2 Annualised return – source Oslo Børs
3 Differential return is measured against the mutual fund index (OSEFX)
4 Source: Oslo Børs
5 Tracking errror (TE) is calculated as (TE=Diff. Return / IR)
6 Source Morningstar **–** R shows the co-variation with OSEBX which is here 99.1% (correlation rate)

of 1.8%. An active share over time of 17% would require the fund to achieve a substantial excess return (10.6 percentage points) on the share of the portfolio that deviates from the index in order to achieve a return equal to the fund's benchmark index, and an excess return of 8.8 percentage points to achieve a return equal to the benchmark index less the index fund's management fee of 0.3% per annum.

The Company refers to a master's degree dissertation by Smørgrav and Næss on active shares in Norwegian mutual fund management, dated 16.12.2011. This dissertation refers to DNB Norge IV as the best performing close-to-index fund with 11% excess return on the fund's active portfolio (p. 55). The Company comments as follows:

"While it is true that the commission in this fund is lower than for DNB Norge, we do not agree with Finanstilsynet's assertion that the fund is highly unlikely to achieve a return that justifies the commission."

The period to which the dissertation refers is 2003 – 2010, i.e. not the period (the last 5 years) analysed by Finanstilsynet. Finanstilsynet also notes that the dissertation refers to DNB Norge as the fond with the lowest active share (15%), when index funds are disregarded (diagram on page 54), and that the dissertation states that: *"It should be noted that DNB Norge has a low tracking error for an actively managed fund" (page 42).* According to the dissertation, DNB Norge is classified as an index fund or close-to-index fund (tracking error < 2.0%, active share 20%). The dissertation's conclusion is in accordance with Finanstilsynet's previous observations; see Finanstilsynet's letter to the Company of 28 August 2007 drawing attention to the issue of DNB Norge IV's low tracking error.

The Company argues that the fund's differential return over a long period of time is an equally reliable indication of a fund's historical risk-taking and hence also a good indicator of the degree of active management. The Company states that a fund with a constant excess return favours unit holders even if tracking error is very low. It points out that risk and return should be evaluated collectively and that neither active share nor tracking error alone indicates whether a fund is actively managed. The Company states that active share is encumbered with weaknesses in a market like Norway's, and that it is difficult, based on funds' active share, to compare the degree of active management of funds invested in different regions.

Finanstilsynet agrees that a fund with a constant excess return favours the unit holders even if tracking error is very low, but points out that differential return at DNB Norge has been negative throughout the five-year period. The fact that the return achieved by the fund has been virtually identical to the return achieved by the benchmark index in the period less the management fee indicates that the fund has been managed close to index.

Finanstilsynet also agrees that tracking error and active share should be evaluated collectively. Finanstilsynet therefore bases its analysis on an overall assessment taking both tracking error and active share into account. Finanstilsynet's analysis also takes into account the R-squared value which shows very high covariation with the benchmark index.

The Company states that achieving a high active share in a market such as the Norwegian market presents a challenge. This is not, in Finanstilsynet's view, an argument against using active share as one of several measures when assessing how the fund has been managed. Finanstilsynet also points out that it has the Company's responsibility for ensuring that DNB Norge is aligned such that unit holders have a realistic possibility of achieving excess return. The actual management of the fund in recent years, with such a low tracking error and active share, does not justify a management fee of 1.8% per annum.

Column 1 below shows figures stated by the Company for DNB Norge's differential return after management fees over the past 11 years (net asset value less benchmark index). Column 2 shows the differential return if the management fee of 1.8% per annum is disregarded (gross asset value less benchmark index).

Deviation from benchmark index

Year	Column 1		Column 2
2014	-2.74		-0.94
2013	-0.32		1.48
2012	-2.76		-0.96
2011	-1.81		-0.01
2010	-0.26		1.54
2009	5.67		7.47
2008	1.77		3.57
2007	1.81		3.61
2006	1.27		3.07
2005	-0.16		1.64
2004	-2.24		-0.44

In the last five years the deviation from the benchmark index has shown little variation, in the interval from minus 0.96 to plus 1.54 (Column 2)). The actively managed share of the portfolio has produced a differential return below the management fee over the last five years.

DNB Norge's deviation from the benchmark index over the last five calendar years also shows that the fund has been managed close to index in the analysed period. Where Finanstilsynet's assessment of the fund's return is concerned, the Company argues that it is more relevant to apply a longer time horizon, and that an examination of the fund over a 10-year period shows that it has not been managed virtually identically to an index fund. Finanstilsynet considers that the fund must at all times be managed in accordance with the fund rules and prospectus. Finanstilsynet has analysed the fund's results over the last five years. It is Finanstilsynet's assessment that a period substantially shorter than five years could have served as a basis for deciding whether the management has been in accordance with intentions.

Finanstilsynet agrees that results achieved by an actively managed fund should be assessed over a long period of time (possibly an economic cycle), but would point out that it is not in accordance with the intentions underlying actively managed funds to be managed virtually as index funds.

Based on an overall assessment of various target figures used in the actual management of DNB Norge, Finanstilsynet's view is that the fund has been managed virtually identically to its benchmark index, and that the Company has not managed the fund as intended.

Finanstilsynet finds it appropriate in this connection to remark that it wrote to the Company in 2007, pointing out that the master fund was managed virtually identically to the benchmark index. Further, DNB's group audit gave the Company the following recommendation in the second half-yearly report for 2013:

"We also recommend DAM to check that there is a reasonable connection between degrees of freedom applied in the management of the respective funds and the client's commission costs. Now that DNB is offering cheap index funds, the costs in the case of actively managed funds should be in proportion to how actively the risk mandates are utilised."

3. Legal basis and Finanstilsynet's closer assessments

The rules governing how the individual fund is to be managed must be established in the fund rules and prospectus. The fund's key investor information must contain assembled and easily comprehensible information about the fund. The documents must contain information necessary to make a well-informed assessment of the fund.

Securities funds must be managed in accordance with the investment strategy described in the fund rules, prospectus, key investor information and any other marketing material. Investors who subscribe units in a securities fund to be managed actively, and pay the appropriate management fee, must be able to do so with confidence that the fund is in practice managed as intended and not virtually as an index fund (close-to-index management). The fund's investments must be selected based on the manager's own assessments and analyses and not shadow or track an index, as is the strategy for passively managed securities funds. The management must give the unit holders a genuine possibility to achieve a return above the benchmark index.

Compliance with the investment strategy is highlighted in the Securities Fund Regulations section 2-9(2) as a key aspect of senior executives' responsibility in a fund management company. It is the top management that is responsible for ensuring that the general investment strategy for each individual securities fund is carried out in accordance with fund rules and prospectus. The top management must see to it that the investment strategy for each fund is monitored and they shall ensure, and regularly check, that the general investment policy, investments strategy and risk limits for each securities fund are complied with. Moreover, the top management must approve and regularly check that the internal procedures for investment decisions are adequate for each securities fund with a view to ensuring compliance with investment strategies.

A key aspect of the conduct of business rules of the Securities Funds Act section 2-15 is to ensure that the interests of securities funds and unit holders are safeguarded in the best possible manner by ensuring that the management company acts in an orderly and correct manner in running the business. It is important to avoid conflicts of interest inter alia by ensuring that the interests of the unit holders and the funds take precedence over the interests of the management company. Portfolio management is the core business of management companies and is the central aspect of their licensed activity. Managing securities funds in accordance with the fund rules, and as specified in the fund’s prospectus and other fund documentation, is required according to the conduct of business requirement. Management companies are not safeguarding unit holders’ interests properly if the funds are managed so close to index that the unit holders, in light of the costs associated with being a unit holder in the fund, are not given a genuine possibility to achieve excess return.

In Finanstilsynet’s view the actual management of DNB Norge has for a long time deviated substantially from the intentions set out in the fund’s rules and prospectus, and which the investors have been led to expect. The fund is managed close to index, but is marketed and priced by the Company as an actively managed fund. The Company has by this means received payment for a product it has not delivered. Based on the way the Company has aligned the management of DNB Norge, the Company has failed to safeguard the unit holders’ interests in the manner required by the conduct of business rules of the Securities Funds Act.

4. Choice of penalty - corrective order

The fact that the Company has for a long time aligned the management of DNB Norge so that it is in effect managed close to index is censurable. The performance of the fund has accordingly shadowed the fund’s benchmark index when adjusted for the fixed management fee. The criticism is compounded by the fund’s substantial size, the fact that it targets non-professional investors and the fact that the Company has maintained an annual fixed management fee that is not justified by the way the fund has in real terms been managed and marketed.

After considering various penalties, Finanstilsynet has decided to issue the Company with a corrective order under the Securities Funds Act section 11-4, cf. 2-15(1) and (2) no. 1 and 4, whereby the Company is ordered

(1) To either:

(i) organise the management of DNB Norge in accordance with the characteristics of active management, as reflected in the fund’s prospectus and management fee, or

(ii) adjust the management fee of the fund to the management strategy that in actual fact is applied, and at the same time to make changes to fund rules and prospectus so that the management strategy is clearly evident. This alternative requires the unit holders’ consent.

(2) to inform the unit holders of Finanstilsynet’s conclusions and corrective order, and of what course of action the Company intends to take.

(3) to send Finanstilsynet by 26 March 2015 a concrete plan for how the Company intends to act to safeguard the unit holders' interests.

This order can be appealed to the Ministry of Finance, see the Public Administration Act section 28 et seq. The appeal should be sent to Finanstilsynet. The deadline for appeal is three weeks from receipt of this order. The appeal must state the order that is being appealed against and what result the appellant considers to be correct. The appeal should also cite the grounds on which the appeal is based.

On behalf of Finanstilsynet

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