Consultation Paper – October 2015

Draft guidance on disclosure of certain fees and returns by managed funds

About this consultation paper

This consultation paper is designed to help managers, supervisors, and their professional advisers understand certain disclosure obligations under the Financial Markets Conduct Regulations 2014. These obligations cover certain information in fund updates and product disclosure statements (PDSs).

The guidance may also be useful for managers of KiwiSaver schemes that have not transitioned into the Financial Markets Conduct Act (FMC Act) regime and still need to produce disclosure statements under the KiwiSaver (Periodic Disclosure) Regulations 2013.

Our proposed guidance covers these areas:

1. calculation of returns applying a 0% prescribed investor rate (PIR)
2. classifying underlying fund charges
3. calculation and disclosure of performance-based fees in managed funds.

We invite your feedback on the proposal. **Submissions close on Friday, 27 November 2015.** The form at the back has more details.

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About this consultation:

This consultation is for: managers, supervisors, and their advisers.	It aims to: help the industry comply with FMC Regulations for their fund updates and PDSs.

Document history

FMA document reference code 2723687

Contents

Background

Many managers are currently preparing their first PDSs and fund updates as they make their transition to the FMC Act regime.

In a recent review of funds' offer documents and disclosure statements under the Securities Act regime, we saw some inconsistencies in how performance-based fees were disclosed and how managers were calculating 0% PIR returns and fund charges.

This guidance highlights some of the lessons that can be learnt from disclosures produced under the Securities Act regime.

Section 1: Calculation of 0% PIR returns

1. Managers of a fund that is a portfolio investment entity (PIE) must calculate and disclose 0% PIR returns, and returns at the highest PIR in their fund updates[1]. This is similar to the obligation that managers of KiwiSaver schemes have had in the periodic disclosure regulations[2].
2. For PIE funds, we understand the unit price or the market value of the fund will not include the value of accrued tax and are 'off balance sheet' from an accounting perspective. This is the formula we expect managers to use for calculating the returns of a fund:

   > the change in the fund's unit price or market value for the relevant period (net of all fund fees) *less* accrued tax

3. Accrued tax is not a defined term in either the FMC Regulations or the periodic disclosure regulations.

Defining accrued tax

4. Our interpretation of the term accrued tax is summarised as follows:

   > (the fund's total taxable income or loss for the relevant period x PIR) *less* tax credits)

5. Tax credits are made up of resident withholding tax (RWT), foreign tax credits (FTC) and imputation credits (IC) deducted from income received by a fund during the relevant period.
6. Inconsistent interpretations of accrued tax can have a material impact on the calculation of 0% PIR returns. This can result in users of this information not being able to accurately assess a fund's past returns to make fully informed decisions or conclusions.

[1] Clause 59(1)(b)(i) of schedule 4 of the FMC Regulations.
[2] The 0% PIR returns under regulations 16(3) of the periodic disclosure regulations are only disclosed in the csv data file.

Different methods used to account for accrued tax in 0% PIR returns

7. Our monitoring of disclosure statements showed that there are generally three methods of accounting for accrued tax when calculating 0% PIR returns.

Method A

The PIR component of the accrued tax formula was set to 0% whilst the tax credits component reflected the total tax credits attributed to members during the return period. This effectively 'added back' any tax credits to the change in the fund's unit price or market value for the relevant period. Or put another way, it presents the returns of the fund as if tax credits had not been deducted.

Method B

The PIR component of the accrued tax formula was 0% whilst the tax credits component reflected some of the tax credits attributed to members during the return period. The tax credits not reflected in the returns related to some FTCs, the rationale for this exclusion being the tax legislation doesn't allow FTCs to be passed where the fund/member has made a tax loss for the year. This effectively 'added back' some of the tax credits to the change in the fund's unit price or market value for the relevant period. Or put another way, it presents the returns of the fund as if some tax credits had not been deducted.

Method C

The accrued tax component of the returns formula was set to nil. This resulted in the returns of the fund reflecting the full deduction of any tax credits.

8. We consider method A to be the most appropriate method for calculating 0% PIR returns. This is because, in our view, the 0% PIR returns of a fund should reflect the fund's investment returns held during the period, before any tax credits were withheld from income generated by the fund's investments.

Questions

Q1: Do you agree with our interpretation of 'accrued tax'? If not, please provide your interpretation and give your reasons.

Q2: Do you agree that 0% PIR returns should 'add back' the value of tax credits? If you disagree, please state why 0% PIR returns should reflect the returns net of tax credits?

Q3: Are you aware of any other methods for accounting for accrued tax that are not captured under methods A, B, and C? If so, please provide details.

Q4: If you currently calculate 0% PIR returns using a methodology other than method A:

a) will you incur any significant expense if you change your systems and processes to be aligned with the guidance? (if possible, please quantify the initial expense and any material ongoing additional cost)

b) will the returns information that you calculate materially change if you adopt this guidance?

Q5: Do you think this guidance will help investors compare 0% PIR returns and their investment decision-making?

Q6: For non-PIE managed funds, do you think it is necessary for us to provide guidance for methods used to calculate returns? If yes, please explain which areas you need guidance for.

Q7: What other guidance do you need on the calculation of returns in fund updates or disclosure statements?

Section 2: Classifying underlying fund charges

9. Managers must disclose their total fund charges in the PDS[3], fund updates[4] and periodic disclosure statements.[5] Incorrectly classifying the charges, which must be disclosed, can have a material impact on the information provided to investors. This can result in investors not being able to accurately assess the total cost of investing in a fund, and therefore not being able to make fully informed decisions.

10. This section of the guidance is intended to help managers determine:
    - when an investment asset is an underlying fund
    - whether a fee is a performance-based fee
    - whether a fee is a management and administration charge
    - what to do when relying on third party information.

What fees must be disclosed

11. Fund charges include management and administration charges, as well performance-based fees. Other than fees incurred or charged by the fund itself, managers must also include fees and charges incurred by underlying funds in which the fund invests.

Determining when an investment asset is an underlying fund

12. An underlying fund is a fund in which a fund invests, whether directly or indirectly. A fund is a pool of assets held for the benefit of a group of investors and managed under a single investment mandate.[6]

13. We acknowledge that the definition of a fund (and therefore underlying fund) is very broad in nature.[7] This can lead to different interpretations as to what investment assets constitute a fund, and therefore an underlying fund.

14. To help managers determine whether an investment asset is an underlying fund, we outline below a non-exhaustive list of investments, which generally indicate an investment in an underlying fund.
    a. A unit in a unit trust established under the Unit Trust Act 1960.
    b. Membership of a superannuation scheme established under the Superannuation Schemes Act 1989.
    c. A unit in a group investment fund established under the Trustee Companies Act 1967.
    d. Membership of a managed investment scheme registered under the Financial Markets Conduct Act 2013.

[3] Clause 32 of schedule 4 of the FMC Regulations
[4] Clause 63(1) of schedule 4 of the FMC Regulations
[5] Regulation 21(3) of the period disclosure regulations require total fund fees to be disclosed
[6] Regulation 5(1) of the FMC Regulations and regulation 4(1) of the periodic disclosure regulations
[7] The FMC regulations and the periodic disclosure regulations have the same definition of what's a 'fund'.

e. An investment in a listed or unlisted property fund whose primary purpose is to pool money from a group of investors in order to generate capital gains and/or rental income from owning real property and/or land.

f. An investment in an exchange traded fund (ETF). Typically, this may be in the form of a listed unit trust or a company that provides investors with exposure to a wide range of asset classes such as shares or commodities.

g. An investment in a listed or unlisted entity which is a PIE, or likely to be eligible as a PIE[8] [9]. For example the entity:

   i. is widely held by many investors and, generally, has no single major investor; and

   ii. derives most of its income from passive sources such as interest, dividends, and capital gains.

h. Regulated investment funds in foreign jurisdictions such as an investment company under the Investment Companies Act of 1940 (USA) or an investment fund with UCITS status (undertakings for the collective investment in transferable securities) in the European Union.

Questions

Q8: Do you agree with the characteristics we have identified as being highly indicative of an underlying fund? If not, please outline your reasons.

Q9: Are there any other characteristics of an underlying fund that we have not identified?

Q10: Would you have to incur any significant expense to change systems and processes to be aligned with the guidance on determining underlying funds? If possible, please quantify the initial expense and any ongoing additional cost.

Performance-based fees

15. Managers must disclose any fees charged by the manager related to the performance of the fund. Fees charged by a related underlying fund (in relation to the performance of that fund) also need to be included in the performance fee disclosures.

16. A related underlying fund is:

- an underlying fund managed by the manager of fund A or by an associated person of the manager of fund A; or
- if fund A's assets are managed as a whole by a person other than the manager, an underlying fund managed by that person or that person's associated persons.

[8] http://www.ird.govt.nz/industry-guidelines/pie/becoming/gen-requirements/

[9] For a non-New Zealand resident entity, the principles of the PIE eligibility rules still apply to determine whether an entity is an underlying fund.

Example

A KiwiSaver scheme is managed by ABC Investment Limited and provides an option for members to select XYZ Balanced Fund, whose assets are managed by XYZ Investment Ltd.

All underlying funds managed by ABC Investment Limited, XYZ Investment Ltd, an associated person of ABC Investment Limited; or an associated person of XYZ Investment Ltd, are related underlying funds.

17. Based on how performance-based fees are defined under the FMC Regulations, fees charged for the performance of non-related underlying funds are not considered performance-based fees for the purposes of disclosures. However, these fees will generally have an effect on investors' interests in the fund, so they must be disclosed as management and administration fees. Further information on this point is provided below.

Management and administration charges

18. Managers must disclose any fees and costs charged by any person for a fund, or an underlying fund, which affect investors in proportion to their interest in the fund. This definition is quite broad. It includes any fees or charges incurred which reduce the member's balance.
19. Our monitoring of disclosure statements showed that many managers do not think fees and costs incurred by listed investments need to be disclosed. Their view is these costs are similar to management costs (such as wages, rent, etc) of listed companies. We do not agree with this interpretation. Where fees and costs flow through to an investor, they must be disclosed.
20. We have summarised our views on how to determine when underlying fund fees need to be included in a fund's annual fund charges. Check table 1 in the next page for descriptions of fees and costs charged to a fund.

Table 1

Investment Vehicles	Description of fees and costs charged to a fund	Disclosure required?
Unlisted funds	Interests in unlisted funds are generally acquired and disposed at a price that is based on the underlying net asset value. Fees and costs charged to an unlisted fund are generally reflected in the unit price/market value. Therefore underlying fund fees would affect members of a fund via a reduction in the market value of the fund.	Yes
Exchange traded funds (ETFs)	Interests in ETFs are acquired and disposed based on a quoted price on a listed exchanged, driven by supply and demand. All ETFs generally incur fees and costs related to the management and administration of them. The net asset value (NAV) per share[10] of an ETF represents the value of each share's portion of the underlying ETFs. However, the quoted price of an ETF may not always reflect the underlying value of the fund. Generally, there is significant correlation between movements in the NAV per share and the market price. Our view is that the stronger the correlation between the NAV and the market price, the higher the likelihood that the underlying fund fees need to be disclosed as they are likely to affect the fund's members. This is irrespective of whether the ETF is trading at a premium or discount.	Highly likely
Other listed funds a) Listed investment companies (LICs) b) Property funds	Generally, LICs and property funds and similar investments (closed-ended funds) are vehicles that initially seek to raise a set amount of funds from investors to invest in long-term assets. Subsequent to listing, interests in closed-ended funds are acquired and disposed of on a listed exchange based on supply and demand, without affecting the fund's capital base. The listed price of a closed-ended fund may trade at a premium or a discount to NAV.	Highly likely

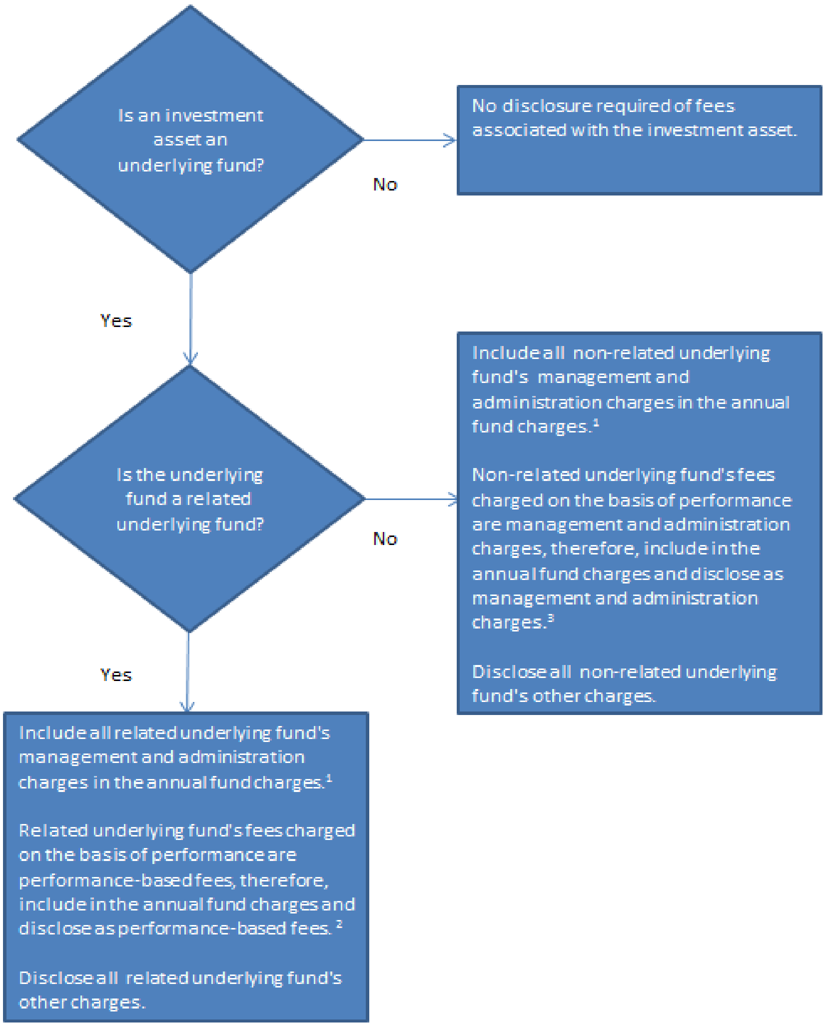
21. Managers should also take into account whether fees and costs charged to the underlying fund affect the amount of income or capital distributions made to the fund. If the amount for distribution is reduced due to fees and costs, we consider these fees and costs to have affected members, and therefore need to be disclosed.

[10] ETFs can be companies or other legal structures. For the purposes of this guidance, 'share' means ordinary shares or other forms of ownership.

Example

An underlying fund may have a fixed unit price and a policy of distributing all net income on a monthly basis. Members of the fund receiving the net income would be affected if fees and costs charged to the underlying fund reduced the net income available for members.

22. The diagram below illustrates the process for determining an underlying fund's annual charges.



[1] apply all Clause 32, schedule 4 of the FMC Regulations' disclosure requirements

[2] apply all Clause 33, schedule 4 of the FMC Regulations' disclosure requirements

[3] Clause 33, schedule 4 of the FMC Regulations does not apply to unrelated underlying fund fees charged on the basis of performance

Questions

Q11: Do you agree with our views on when underlying fund fees should be disclosed? If not, please outline your reasons.

Q12: Would you have to incur any significant expense in changing systems and processes to be aligned with the guidance on when underlying fund fees affect a fund? If possible, please quantify the initial expense and any ongoing additional cost.

Reliance on third-party information

23. Where a fund has invested in an underlying fund, we understand that is often necessary for managers to get information from third parties to determine the underlying fund's charges.

24. It is common for third-party funds to publish a total expense ratio (TER), or an equivalent, that managers will use to incorporate into a fund's total fund fees.

25. You should have policies and processes in place to determine whether a third party TER was calculated based on what's required by the FMC Regulations or periodic disclosure regulations. If you are unsure, you are likely to be estimating the underlying fund charges, therefore you need to make the appropriate disclosures to say that the fees are estimated.[11]

Section 3: Calculation and disclosure of performance-based fees in managed funds

26. Schedule 4 of the FMC Regulations sets out how performance-based fees should be disclosed within a PDS. The PDS must state how the performance-based fee is charged.[12] The PDS must at least disclose:
    a. the hurdle rate of return[13]
    b. the proportion of the return above the hurdle rate that is paid[14]
    c. whether the fee has a maximum limit and if so, what that is[15]
    d. the frequency of calculating and paying the fee.[16]

27. When applicable, the FMC Regulations require the PDS to include additional statements saying the fund does not need to achieve a hurdle rate before a performance fee applies.[17] The PDS also needs to say if a fee can be paid when the return of the market index is not achieved.[18]

28. Managers of KiwiSaver schemes must ensure any performance-based fees are reasonable. We have previously provided guidance on KiwiSaver performance-based fees at http://fma.govt.nz/assets/Guidance/_versions/3216/120501-kiwisaver-performance-fee-guidance-note.1.pdf. We encourage non-KiwiSaver schemes to also take note of this guidance. We are particularly concerned about the effect of performance-based fees without a high water mark, and fees being linked to an inappropriate benchmark. Whether the schemes are KiwiSaver or not, the FMC Regulations require managers to provide an example of how fees apply to investors. Within the example, managers must disclose the effect of any applicable performance fee.[19]

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[11] Clause 32(3) of schedule 4 of the FMC Regulations
[12] Clause 33(1) of schedule 4 of the FMC Regulations
[13] Clause 33(2)(a) of schedule 4 of the FMC Regulations
[14] Clause 33(2)(b) of schedule 4 of the FMC Regulations
[15] Clause 33(2)(c) of schedule 4 of the FMC Regulations
[16] Clause 33(2)(d) of schedule 4 of the FMC Regulations
[17] Clause 33(3) of schedule 4 of the FMC Regulations
[18] Clause 33(4) of schedule 4 of the FMC Regulations
[19] Clause 38(1) of schedule 4 of the FMC Regulations

The effect of having no high water mark

29. The term 'high water mark' means the highest value that an investment fund has achieved on previous performance fee calculation dates. Performance-based fees are often only payable if a fund's performance exceeds the high water mark. A high water mark ensures that if a manager loses money over a period, they must get the fund above the high water mark before receiving a performance fee.

30. Of the Securities Act documents that we have reviewed, a high water mark was not always disclosed by funds that charged a performance fee. Neither the KiwiSaver Act nor the FMC Act requires a high water mark although investors will be affected by the absence of one, or by a high water mark that works differently to the one described above.

31. The PDS should clearly disclose when there is no high water mark that needs to be achieved for a performance fee to be charged, or where the high water mark can be reset. Failure to do so would most likely result in a fee description that is misleading.

32. The absence of a high water mark means the fund manager may be rewarded for the same performance, and this must be clearly explained to an investor.

33. Where no high water mark applies, here is an example of how a manager could word the PDS to explain the absence.[20]

Sample wording to disclose there is no high water mark

The fund does not apply a high water mark it must achieve before it charges a performance fee. A 'high water mark' is the highest value that a fund has achieved on previous performance fee calculation dates. If a fund loses value over a period, the manager must get the fund back above the high water mark before receiving a performance fee.

The impact of this fund not applying a high water mark is that if this fund drops in value and then recovers, you may be paying a performance fee for the recovered growth as well as the original growth.

Questions

Q13: Do you agree a PDS should highlight to investors that no high water mark applies to the respective fund's performance fee?

Q14: Do you agree the wording example provided above clearly explains the effect of not having a high water mark?

Using an inappropriate benchmark to calculate performance fees

34. Some funds currently base their performance fee on a hurdle rate of return linked to a market index that does not fairly reflect the asset class and risks of the underlying investments. An example is equity-based funds that use a 90-day bank bill index as the hurdle rate of return.

35. The impact of the above is that a fund could underperform against the appropriate market index but will still be paid a performance fee.

36. Under the FMC Regulations all managed funds are required to report their performance against the returns of an appropriate market index.[21] The market index used must appropriately reflect market

[20] This is not prescribed language. Alternative wording may be used. Managers must determine what's the most appropriate wording based on how they charge a particular fee.

[21] Clause 61 of schedule 4 of the FMC Regulations

movements in the types of assets that the fund invests in. Although not a legal requirement, it is reasonable to link the hurdle rate for any performance fee to the returns on this market index.

37. Where a fund's hurdle rate of return is linked to the performance of an inappropriate market index, it should be clearly disclosed in the offer documents so that prospective investors can understand the implication of this.

38. The following is an example of the language that can be used in a PDS for the above scenario.[22]

Sample wording to disclose different performance fee hurdle rate

In our fund update we will report the fund's performance against the [insert market index]. Our view is this index provides the best comparison of how the fund should perform.

However the hurdle rate of return for the performance-based fee payable to us is based on [insert market index].

This means you may be paying a performance fee even if the fund's performance does not match or beat the performance of what we have determined to be most appropriate market index.

Question

Q15: Do you agree the wording example provided above clearly explains the effect of using an inappropriate market index performance as the hurdle rate of return?

Applying this guidance

39. We expect managers, who have transitioned funds to the FMC Act, to align their PDS (including any related information on the Disclose register) and fund updates with this guidance.

40. We encourage managers who are required to prepare offer documents and disclosure statements to align them with this guidance if practical, before transitioning to the FMC Act.

41. We do not expect managers to revise older disclosure statements to bring them in line with this guidance, although managers may choose to do so if they wish.

42. We have previously issued guidance notes on a range of topics for both managers and supervisors of managed investment schemes. These are available at our guidance library for managed investments and KiwiSaver/superannuation. We intend consolidate these guidance notes, where applicable, at the end of the consultation.

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[22] This is not prescribed language. Alternative wording may be used. Managers must determine what's the most appropriate wording based on how they charge a particular fee.

Terms used

0% PIR returns	Returns calculated under regulation 16(3) of the periodic disclosure regulations and clause 59(1)(b)(i) of Schedule 4 of the FMC Regulations
Disclosure statement	Disclosure statements (annual and quarterly) prepared under the periodic disclosure regulations
Disclose register	The register of offers of financial products and the register for managed investment schemes at http://www.business.govt.nz/disclose
FMC Act	Financial Markets Conduct Act 2013
FMC Regulations	Financial Markets Conduct Regulations 2014
Fund fees	Fund fees defined in 21(1) of the periodic disclosure regulations
Fund charges	Fund charges defined in clause 2(1) of Schedule 4 of the FMC Regulations
Fund update	A fund update prepared under regulations 55-74 of the FMC Regulations
Managed fund	A managed fund as defined in regulation 5(1) of the FMC Regulations
Manager	Manager of a registered managed investment scheme, and for a restricted scheme, the trustees of that scheme
Offer document	Investment statements, prospectuses or both (as the case may be) that is prepared under the Securities Act
Periodic disclosure regulations	KiwiSaver (Periodic Disclosure) Regulations 2013
PDS	Product disclosure statement for a regulated offer as defined in section 41 of the FMC Act
PIE	Portfolio investment entity has the same meaning as section YA 1 of the Income Tax Act 2007
PIR	Prescribed investor rate has the same meaning as section YA 1 of the Income Tax Act 2007
Registered scheme	A managed investment scheme registered on the register of managed investment schemes under the FMC Act
Related underlying fund	A related underlying fund as defined in regulation 5(1) of the FMC Regulations
Restricted scheme	A KiwiSaver, superannuation, or workplace savings scheme that either has restricted membership, or is closed to new members, and registered as a restricted scheme A restricted scheme does not need a licensed manager or a licensed supervisor, but must instead have a licensed independent trustee All restricted schemes are managed investment schemes
Securities Act	Securities Act 1978
Supervisor	Supervisor of managed investment schemes defined in section 6(1) of the FMC Act
UCITS	Undertakings for the collective investment in transferable securities are investment funds regulated at the European Union level under directive 2014/91/EU
Underlying fund	Underlying fund defined by regulation 5(1) of the FMC Regulations and regulation 4(1) of the periodic disclosure regulations
Underlying fund fee	Fees and costs charged for an underlying fund

Feedback: Draft guidance on disclosure of certain fees and returns by managed funds	
Please submit this feedback form electronically in both PDF and MS Word formats and email it to us at consultation@fma.govt.nz with **'Feedback re draft guidance on disclosure of certain fees and returns by managed funds': [Your entity name]**' in the subject line. Thank you. We seek comments by **27 November 2015**.	
Date: Number of pages: Name of submitter: Company or entity: Organisation type: Contact name (if different): Contact email and Phone:	
Question #	**Comment**
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Any other comments	
Feedback summary – if you wish to highlight anything in particular	
Please note: Feedback received is subject to the Official Information Act 1982. We may make submissions available on our website, compile a summary of submissions, or draw attention to individual submissions in internal or external reports. If you want us to withhold any commercially sensitive or proprietary information in your submission, please clearly state this and note the specific section. We will consider your request in line with our obligations under the Official Information Act.	
Thank you for your feedback – we appreciate your time and input.	