Consultation Paper: Proposed exemption from the market index requirement

Purpose of this consultation paper

The Financial Market Conduct Regulations 2014 (FMC Regulations) require managers to disclose the return of a 'market index' in quarterly fund updates. The market index must be a 'broad-based securities market index' that is 'appropriate in terms of assessing movements in the market in relation to the returns from the assets in which the specified fund directly or indirectly invests'.

During the FMC Act transition period some fund managers signalled to us that they were experiencing difficulty complying with this requirement. These managers believe there is no market index available (for one or more of their funds) that complies with the FMC Regulations.

Proposed exemption

We agree that that the market index requirement creates challenges for certain types of funds.

In our view, the market index acts as a benchmark. Where managers are unable to find a compliant market index, we propose to allow managers to provide another form of benchmark (a peer group) as an alternative.

We seek feedback on this proposal from managers, their advisers, supervisors, investors and other market participants. We also welcome information and views on the operation of the market index requirement in general.

Submissions close on 1 September 2017.

After this date, we will finalise our policy proposals. We aim to have any exemption in force by late 2017.

This consultation is for MIS managers, advisers, supervisors, investors and other interested parties.

It seeks feedback on a proposed exemption from the market index requirement.

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Overview

Disclosing past performance

The FMC Regulations require managers to disclose information on the past performance of their funds. This information is made available in quarterly fund updates under the heading *'How has the fund performed'*.

The past performance of a fund must be disclosed in both a table and a graph over a number of prescribed periods:

- The table sets out the performance of the fund over both the past year and the average of the past 5 years[1]
- The graph sets out the performance of the fund in each of the past 10 years, as well as the average of the past 10 years.[2]

The FMC Regulations specify the approach a manager should take if the fund has not been in existence for all or part of one of these prescribed periods.

The fund's returns must be presented in the graph on a net basis (ie after deductions for charges and trading expenses) and after tax.[3] In the table returns are also presented on a net basis, both before and after tax.

Market index requirement

The table and graph must also include the past performance of a 'market index'. This market index must meet certain criteria. The market index must be a 'broad-based securities index' that is:[4]

- widely recognised and widely used in the financial markets; or
- administered by a person other than the MIS manager or their associated persons.

In selecting a market index, the manager must ensure the market index is 'appropriate in terms of assessing the movements in the market in relation to the returns from the assets in which the specified fund directly or indirectly invests'.[5]

The market index must also take into account the following assumptions:[6]

- That all income is reinvested
- That there are no charges
- Any other reasonable assumptions that reflect the operation of the specified fund.

[1] Clause 59 of schedule 4 of the FMC Regulations
[2] Clause 62 of schedule 4 of the FMC Regulations
[3] Clause 59 of schedule 4 of the FMC Regulations
[4] Clause 61(3)(a) of schedule 4 of the FMC Regulations
[5] Clause 61(3)(b) of schedule 4 of the FMC Regulations
[6] Clause 61(2) of schedule 4 of the FMC Regulations

Policy rationale

New Zealand's market index requirement is based on a similar obligation that applies to mutual funds in the US.[7]

While not explicitly labelled as such, in our view the market index requirement serves as a 'benchmark' for a fund. A benchmark is a standard against which the performance of a fund can be measured, and forms part of the relationship between the manager and investors. The market index is intended to help investors make an informed decision by providing contextual information on the performance of the fund, relative to the market. In line with the way the requirement has been constructed, the market index should be independent of the manager, and representative of the risk characteristics and investment strategy of the fund.

Difficulties encountered with the market index requirement

Challenges faced by certain types of funds

During the FMC Act transition (particularly during late 2016) we became aware that managers of certain types of funds were finding it difficult to identify market indices that complied with the FMC Regulations.

Alternative funds

The challenges have been most acute for funds with an allocation to alternative asset classes, or that follow an alternative investment strategy ('alternative funds'). Alternative asset classes include real estate, infrastructure and hedge funds.

The difficulties faced by managers in selecting appropriate benchmarks for alternative funds are well-known, and have been acknowledged by both regulators and the industry.[8]

At a high-level, market indices have many of the characteristics associated with good quality benchmarks. Nonetheless there are notable difficulties associated with using a market index as a benchmark for some alternative funds. There may be no available index or indices that reflect the risk characteristics and investment strategy of the fund. This may be because the fund:

- invests in asset classes with no identifiable index available, for example because the underlying assets are illiquid and have no readily available market price
- does not invest in particular assets or markets, but instead follows a particular strategy or style, or
- uses investment strategies or structures (such as derivative instruments) that materially alter the return profile of the underlying assets.

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[7] MBIE, FMC Regulations: *Third Exposure Draft – Commentary and request for submissions*, May 2014 (available here). For the US approach, see SEC, *Final Rule: Registration Statement of Open-End Management Investment Companies*, 13 March 1998 (available here)

[8] See for example 2.5.3 of the CFA Institute's, *Global Investment Performance Standards: Guidance Statement on Alternative Investment Strategies and Structures*, 18 May 2012 (available here).

Industry practice has been for managers to work around these difficulties by disclosing other forms of benchmark as a substitute for a market index. The most common are:

- *peer groups:* A peer group index provides a return based on the performance of a universe of funds following a similar approach or investment style (for example HFRX for hedge funds)
- *absolute returns:* An absolute return is most commonly expressed as an index and a spread (for example OCR + 500bps). This approach is predominantly associated with funds seeking to provide performance not closely correlated to broader market conditions.

For single sector funds such as hedge funds, the manager may use a peer group or absolute return as the entire benchmark. For multi-sector funds (funds that invest into a number of different asset classes or geographies) the manager may use a peer group or absolute return for a portion of the benchmark, namely where the fund has an allocation to alternatives for diversification.

We understand the rationale behind the use of peer groups and absolute returns. However we think they are unlikely to comply with the current settings of the market index requirement in the FMC Regulations.

- Peer groups are typically prepared net of fees, while the market index must be presented on a gross basis.
- Absolute returns are often based on a non-securities index, such as a cash rate or CPI, and will not qualify as a 'broad-based securities index'. Where the discretionary component of an absolute return is determined by the manager, we are also concerned at the degree to which the measure can be seen as independent of the manager.

Both peer groups and absolute returns are also likely to be non-compliant on the basis that movements in the benchmark do not reflect movements in the market the fund invests in. For example, a peer group that tracks a strategy such as 'global macro' may comprise a group of funds that have very divergent asset holdings.

Multi-sector funds

In addition to alternative funds, we have also had some engagement with managers of multi-sector funds that have expressed concern about their ability to comply with the market index requirement.

Provided the multi-sector fund does not have an allocation to alternatives, we do not think managers of these funds should find compliance with the market index requirement challenging. The FMC Regulations allow a 'composite' market index to be used for funds investing in more than one asset class or geography. For multi-sector funds, a market index can be constructed using a series of individually compliant market indices. For example, a fund with a 50 percent allocation to New Zealand listed equities and a 50 percent allocation to Australian listed equities could use a composite of the NZX50G and the ASX200 accumulation index.

Where a composite market index appropriately reflects the neutral asset weighting of a fund, a manager cannot be said to be 'administering' the market index. Indices constructed in this way are consistent with the policy intent - that the information provided to investors is both representative and independent.

Restricted schemes

Due to their operating model, restricted schemes have faced particular difficulties complying with the market index requirement. Restricted schemes commonly outsource their investment management function to a single wholesale manager. Some wholesale managers consider a non-compliant market index best represents the performance of one of the funds within the scheme, and report on that basis (noting there are no specific requirements for performance reporting in the wholesale space). This creates difficulties later on for the trustees when they have to comply with the FMC Regulations.

Market index is a mandatory requirement

Where a manager has a fund with alternative assets or following an alternative investment strategy, and there is no compliant market index available, they are in an unenviable position. There is no explicit opt-out mechanism for managers of an alternative fund - even if they are concerned that any market index they provide would either mislead or confuse investors.

We also consider there is no scope to opt-out on the basis of the preliminary provisions in the FMC Regulations. The FMC Regulations provide that a PDS or register entry is not required to refer to a matter that is 'not applicable to the offer'.[9] We think this carve-out is irrelevant in this case. Rather it is intended to remove the need to disclose to investors that certain information is excluded for a particular fund.[10]

International context

While the market index requirement borrows heavily from the US mutual fund disclosure regime, we understand US managers have found compliance with their requirement to be less problematic. This is mainly because the requirement is applied differently in the two jurisdictions.

In contrast to New Zealand, the US securities regulator, the Securities and Exchange Commission (SEC) has interpreted the market index requirement as requiring managers to disclose a market index that allows investors to evaluate a fund's risks and returns relative to 'the market', rather than the risks and returns for the assets 'in which the specified fund directly or indirectly invests'. 'The market' is a more amorphous concept. We understand that in practice many mutual funds exposed to alternative assets or following an alternative investment strategy have satisfied the US requirement by providing a market index indicative of general market conditions (such as the S&P500).

The SEC also allows managers to provide additional market indices in their prospectus. Under US requirements, a fund 'is encouraged to compare its performance not only to the required broad-based index, but also to other more narrowly-based indexes that reflect the market sectors in which the fund invests'. For example, a fund may compare its performance to a peer group, if the comparison is not misleading'.[11]

Australian and European comparative performance reporting requirements are more limited. Australia has no directly equivalent market index requirement. For funds offered under the Undertaking for Collective Investment in Transferable Securities (UCITS) regime there is a requirement to show the past performance of a market index, but only in limited circumstances. That is, where the fund refers to the market index as a benchmark in its investment objectives and policies, and the manager intends to measure the fund's performance against that benchmark.[12]

[9] Regulation 12 of the FMC Regulations

[10] For example, a fund that does not charge performance, contribution or withdrawal fees does not have to state this to comply with clause 12(2) (d) of schedule 4 of the FMC Regulations

[11] Form N1-A, Instruction 6 to Item 27(b)(7) (available here)

[12] European Commission, Article 18, Commission Regulation No 583/2010, 1 July 2010 (available here)

Current market position

When the FMA engaged with managers affected by these issues in late 2016, we were aware the time to consider potential options, consult and secure decisions would extend into 2017 - leaving managers unable to comply with the FMC Regulations for several fund updates.

To allow us time to reach a substantive policy decision, we have decided not to prevent offers proceeding where managers unable to comply with the market index requirement have elected to either use another form of benchmark (such as a peer group) or not to provide a benchmark – provided this approach has been disclosed clearly in fund updates.

Proposed solution

Options considered

If there is no readily identifiable market index for a fund, a manager cannot in practice comply with the FMC Regulations. We do not think this is appropriate, so we are proposing to provide an exemption to allow managers greater flexibility in how they can comply with the market index requirement.

We set out our preferred exemption approach and the other options we have considered below. We seek feedback on both.

Beyond this exemption proposal, we are aware that some managers may have views on the broader policy settings for performance reporting in the FMC Regulations. Broad changes to current legislative settings are outside the scope of our exemption powers. These should be addressed by way of law reform, which is led by the Ministry of Business, Innovation and Employment (MBIE). While not within the scope of this project, any comments we receive on broader policy settings for performance reporting, and any comments you may have about how the market index concept has been operating in practice, could be considered as part of any future review of the fund update concept that we may work on with MBIE.

Class exemption proposal

Our preferred approach is to put in place a class exemption that would allow managers to use a peer group for part or all of a benchmark if they decide there is no available broad-based market index compliant with the FMC Regulations. We view a peer group as a second order benchmark, and propose that managers are only able to use the exemption after making reasonable efforts to find a compliant market index.

We are aware that a majority of managers impacted by the market index issue have already adopted these types of benchmarks, or indicated that they would be prepared to do so. Therefore the proposed exemption would address the issue faced by managers in a relatively efficient manner.

Peer groups have weaknesses when compared to the characteristics associated with high-quality benchmarks. Peer groups may have technical deficiencies, including survivorship or self-reporting bias. Categorisation of funds by style may not be transparent. While we acknowledge these limitations, we do not think they outweigh the benefits to investors of providing useful benchmark information. Market indices can themselves be imperfect, and may not always precisely capture the assets or markets in which the fund invests. We nonetheless consider that, where appropriately and carefully selected, market indices and peer groups are consistent with the underlying policy rationale of the current requirement. That is, providing investors with a benchmark that is independent, and representative of the investment strategy of the fund.

We are not proposing to provide restricted schemes with differential treatment. The issues faced by restricted schemes relate to their reliance on the performance reporting of alternative funds by the wholesale manager. We consider they will be appropriately addressed by allowing greater flexibility in the use of benchmarks at the retail level.

Scope of the exemption

Under the proposed exemption, managers would not be required to satisfy the assumption that there are no charges. Further, in allowing the use of peer groups we are also proposing to relax the requirement that the measure chosen by the manager is 'appropriate in assessing the movements in the market in relation to the returns from the assets in which the specified fund directly or indirectly invests'. Neither requirement reflects the manner in which peer groups are constructed.

We do not propose to remove the requirement that the peer group be widely recognised, widely used or independently administered. We consider this is an important element of the underlying policy rationale for the market index requirement.

Proposed disclosure condition

The proposed exemption would be conditional on the manager including an explanatory note in the fund update:

a) briefly stating that peer group returns have been used to calculate the market index in the table and graph

b) briefly explaining the reason why a peer group return has been used in calculating the market index, including why the peer group appropriately reflects the risk profile and investment strategy of the fund

c) briefly explaining that, as a result of a peer group being used, the market index may be a less reliable indicator of the performance of the markets in which the fund directly or indirectly invests.

Peer groups are typically prepared net of fees. This represents a change from current settings, where the performance of the market index is presented on a gross basis in both the table and the graph. To the extent adjustments for fees and tax are material to the market index, managers should make this clear in both their labelling of the market index and/or as part of their explanatory note. Where a manager considers it is appropriate to provide more detailed information around the construction of the market index, this information can be disclosed on the register. Managers retain the ability under the FMC Regulations to modify any prescribed wording to ensure it accurately reflects the circumstances of a particular fund.[13]

Risk indicator

Under the FMC Regulations, the product disclosure statement (PDS) for a fund must include a 'risk indicator'. The risk indicator is intended to help investors make decisions, by providing them with a way to compare the volatility between various funds.

[13] Regulation 9 of the FMC Regulations

As a starting point the risk indicator is calculated on the basis of the previous five years' returns. However, in some circumstances, for example if the fund is less than five years old, or where a fund's investment policy has been significantly transformed, the market index may also be used to calculate the risk indicator.[14]

In calculating the risk indicator, the returns used must be net of fees - meaning peer group indexes can be used for these calculations. In line with our guidance, where a manager has any concerns the risk indicator would deceive or mislead investors, they may elect to use an alternative method set out in the CESR Guidelines.[15]

Performance fee estimates

A PDS must state the total annual fund charges as a percentage of the net asset value of each fund. If a fund charges a performance fee, managers must estimate the level of the fee they expect to charge.

The FMC Regulations allow managers to use the average return of the market index in making this calculation. This method of calculation cannot be used if a peer group is used, as this return will be net of fees. We do not think this is likely to have a significant impact on managers, as they retain their broader ability to prepare an estimate based 'on the basis of reasonable assumptions'.[16]

Alternative options considered

We are also seeking comment on three further options we have considered, and do not propose to take forward. These options are to allow managers:

- to use an absolute return benchmark
- to opt-out of the market index requirement in circumstances where no compliant market index is available
- to have the flexibility to provide more than one benchmark.

Allow for the use of an absolute return

While we acknowledge that absolute returns are used by some managers, we do not currently think they are an appropriate alternative to the market index. While an absolute return provides information on performance against an objective, it does not provide contextual information about the performance of the assets or markets in which a fund invests, or the performance of similar strategies. Similarly an absolute return based on a cash rate or CPI is unlikely to reflect the risk characteristics of alternatives funds. Absolute returns rely on a discretionary component set by the manager. We think this raises concerns around the independence of these benchmarks, and increases the risk that managers select an arbitrarily low market index that overstates comparative fund performance.

Opting-out of market index requirement

Another option we have considered is to allow managers to 'opt-out' of providing a market index if they think an appropriate measure is not available. This approach would be similar to the ability of equity issuers to opt-out of providing prospective financial information for an IPO.[17]

This is not our preferred approach. We think the issues faced by funds impacted by the design of the current market index requirement (such as 'go-anywhere' funds) are better addressed through the flexibility to provide peer groups.

[14] Clause 6(2) of schedule 4 of the FMC Regulations
[15] FMA, Guidance note on risks indicators and description of managed funds, November 2015 (available here)
[16] Clause 32(3)(b) of schedule 4 of the FMC Regulations
[17] Clause 39(c) of schedule 3 of the FMC Regulations

We are also concerned that any opt-out mechanism will increase the risk that managers will opt-out if they are underperforming their market index.

Allow flexibility to provide more than one benchmark

We do not think it is desirable to allow managers to disclose more than one benchmark in their fund updates. While this is a feature of the US approach, we think this practice has developed in an environment where:

- managers consider the application of the market index provision has required the disclosure of unrepresentative indices for alternative funds.
- the disclosure regime remains oriented around lengthy prospectuses, rather than the more tightly prescribed framework of the FMC Act.

Our preference is to address the current issues faced by managers of alternative funds by allowing them to provide what they consider to be the most appropriate benchmark.

If we allow the disclosure of additional benchmarks, we think there is no valid reason to restrict this flexibility to only a sub-set of funds. This suggests that, to the extent that change of this nature might be desirable, it would need to be considered in the context of broader law reform.

Questions

Market index requirement

Q1. Do you agree with our view on the policy rationale for the market index? Do you consider current settings for the market index requirement are effectively achieving that policy aim?

Difficulties encountered with the market index requirement

Q2. Do you agree with our view that alternative funds may not be able to comply with the market index requirement?

Q3. Are there any other types of funds that are also likely to have difficulty with the market index requirement? If yes, please describe the issues faced by these funds.

Q4. Do you agree with our assessment that the market index is a mandatory requirement? If not, what implications does this have for managers that cannot produce a compliant market index?

Proposed solution

Q5. Do you think the best option to solve the issue faced by alternative funds is to allow for the use of other types of benchmarks? If not, what response do you consider to be preferable?

Q6. We have proposed to allow for the use of peer groups. Do you think our approach will resolve the difficulty faced by managers of alternative funds?

Q7. Do you think that we have made an appropriate distinction in allowing for the use of peer groups but not absolute returns or other forms of benchmark?

Q8. Are there any risks for investors from allowing the use of peer groups? How do you think these risks should best be managed?

Q9. We have proposed a condition that requires the manager to disclose that they have elected to use a peer group for a particular fund, and the reasons they consider the peer group they have selected to be appropriate. Do you think this condition ensures investors have access to sufficient relevant information about the benchmark?

Alternative options considered

Q10. In the paper we consider whether it would be appropriate to provide managers with the ability to opt-out of the market index or to disclose more than one benchmark. Do you agree with the risks we have identified with these approaches? Do you think it would be appropriate to provide either of these options to managers, either in addition or as an alternative to our proposed exemption?

Q11. Where a manager uses a peer group, either on its own or as part of a composite, the treatment of fees may diverge from the existing market index requirement. Do you think that our proposed disclosures and the ability of managers to modify prescribed statements mean investors will be provided with understandable information about how the market index factors in fees? If not, what approach do you think would be preferable?

Technical and cost considerations

Q12. What would be the cost implications for your managed fund of providing a peer group or absolute returns? To what extent are these costs different or incrementally higher than for funds that disclose a market index?

Q13. Do you think the proposed class exemption raises any issues with how a fund would calculate its risk indicator or performance fee estimate? Do the current FMC Regulations offer enough flexibility for fund managers to work around these issues?

Q14. Where fund updates are included in a PDS, what is the best way to allow managers to transition between market indices, if the proposed exemption is granted?

Other

Q15. Do you have any additional information not already covered in this consultation paper that you believe is relevant to us in considering this issue? We have a specific interest in any views informed by your experiences disclosing and explaining market indices to investors under the FMC Act regime.

Feedback form: Proposed exemption from the market index requirement’

Please submit this feedback form electronically in both PDF and MS Word formats and email it to us at consultation@fma.govt.nz with ‘Proposed exemption from the market index requirement’: [your organisation’s name]’ in the subject line. Thank you.

Submissions close on 1 September 2017.

Date: Number of pages:

Name of submitter:

Company or entity:

Organisation type:

Contact name (if different):

Contact email and phone:

Question or paragraph number	Response
You don’t need to quote from the consultation document if you note the paragraph or question number.	

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.