KensingtonSwan
*LAWYERS

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Financial Markets Authority
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## Draft Guidance Note: KiwiSaver Performance Fees

### 1 About Kensington Swan

1.1 Kensington Swan is one of New Zealand's leading full-service commercial law firms with a legal team comprising over 100 lawyers acting on government, commercial, and financial market projects from our offices in Wellington and Auckland.

1.2 As Financial Markets Authority ('FMA') will be aware, we have acted on behalf of a number of KiwiSaver providers in relation to compliance obligations under the KiwiSaver Act 2006 ('Act'), including advising managers in relation to their performance fee obligations under the Act.

1.3 We have considered the draft guidance note issued by the FMA in November 2011 in relation to KiwiSaver performance fees ('Guidance Note') and we set out in this letter our response to some of the principles set out in the note.

### 2 Overview of our response

2.1 We support FMA providing guidance notes that clarify its approach to interpreting and fulfilling its obligations under the law. In our view, as much certainty as is reasonably practicable should be provided for all KiwiSaver scheme managers, providers, investors, and advisers to those parties, to ensure a greater consistency of approach.

2.2 We also support the general overall objectives and headline principles as presented in the Guidance Note. However, whilst we support a majority of the comments put forward by FMA, we have concerns with some aspects of the Guidance Note, and these are outlined below. In particular, we believe stated requirements for disclosure go beyond the provisions of the Act and the Securities Regulations in relation to determining the reasonableness of fees, and should be removed from the Guidance Note.

## 3 Principle 2: Performance fees should adequately reflect the risks taken by both the investment manager and the investor.

3.1 Principle 2 includes the bullet point comment that:

> Fee structures should be based on an appropriate extended timeframe. They should avoid situations where large fees are paid for a single year immediately preceding or following periods of low returns.

3.2 In our view, it is unnecessary to address this perceived concern given the high water mark concept outline in the Guidance Note. In addition, requiring performance fee structures to be calculated over an extended timeframe introduces an unwarranted complication that will cause difficulties when reporting, and is likely to cause inequity between investors. It is just as valid to say that a performance fee should not be charged if returns fall after (say) a five year period of strong performance, as it is to say that such fees should not be charged after a single quarter of strong performance when the following quarter involves a negative return.

3.3 We do not believe it is practicable or appropriate to endeavour to avoid a situation where a performance fee has been accrued and paid for a period immediately preceding a period of low return. Low return periods cannot be accurately anticipated, meaning that to avoid the situation identified performance fees would need to be accrued on a contingent basis. This is a concept we strongly oppose due to the complexities and potential inequities this would cause.

3.4 In our view, requiring a high water mark, coupled with an appropriate hurdle rate of return being adopted, is the only appropriate mechanism that should be imposed to restrict the charging of performance fees. We are entirely comfortable with the notion of a performance fee being calculated and charged on an annual basis. We would not support any proposal to require performance fees to be calculated over any longer period, although appreciate that some managers may choose to structure their fees in this way.

3.5 A further bullet point under Principle 2 is that:

> Fee structures should share the 'downside' of performance between manager and investor as well as the 'upside'.

3.6 Reference to sharing the 'downside' of performance is ambiguous. If it is intended that managers should be required to refund performance fees previously paid in the event of a subsequent downturn, we strongly oppose the idea. With the prospect of investors moving in and out of funds, we believe that requiring a refund is impractical, and would give rise to inequities between investors and to reporting issues. In particular, it is unclear how such a concept would fit within proposals for periodic disclosures, which may need to be constantly revised under this proposal.

3.7 If the intention of this bullet point comment is that performance fees should be taken into account in determining the reasonableness of the base fee, then we support the concept, but ask that it be rewritten in more precise terms to overcome the ambiguity of using colloquial references to 'downside' and 'upside'.

## 4 Performance fee elements

4.1 Under the second bullet point of the commentary in the Guidance Note under the 'Performance fee elements' heading, there is comment that:

> The Hurdle Rate of Return should reflect:
>
> …
>
> - If appropriate, an allowance in the minimum Hurdle Rate of Return where there are active management fees already implicit in any fixed base fee.

4.2 The reference to 'an allowance' in this context is unclear. In our view, the comment would be better expressed by simply referring to a requirement that in determining an appropriate minimum hurdle rate of return, regard would be had to any active management fees already implicit in any fixed base fee (assuming this is the intention).

4.3 The fourth bullet point under this heading provides as follows:

> An appropriate multi-year assessment period. This might include either deferred payment or claw-back provisions in the event that good performance reverses within that period (with corresponding adjustments to any High Water Marks if appropriate). While performance fee calculations are normally fixed annually (and accrued within that period), longer multi-year assessment periods may be appropriate to mitigate the impact of strong performance periods being immediately followed by poor outcomes.

4.4 As previously indicated, we strongly oppose the concept of including a deferred payment or claw back arrangement to address the situation of good performances reversing within a multi year assessment period. We believe this is impractical and introduces undue complexity, as well as creating issues for reporting. If nothing else, the risk of investors in a fund for the early part of a multi-year assessment period effectively 'freeloading' by exiting the Fund prior to the conclusion of the period, and the performance fee being imposed, would need to be managed.

4.5 Again, the appropriate way to manage the risk of poor performance following strong performance is the locking in of a high water mark requirement coupled with an appropriate minimum hurdle rate of return within any performance fee structure. If nothing else, insisting upon multi-year assessment or claw back provisions runs contrary to the modern drive for simplicity, and clarity of disclosure: multi-year assessments and claw back provisions are inherently complex, with a high risk of investor confusion arising through attempts to explain them.

4.6 The second to last bullet point under this heading proposes imposition of an annual cap, as follows:

> An annual cap on the performance fee. This will ensure a fair and reasonable total investment fee is payable for the services provided.

4.7 In our view, imposing a cap on performance fees is inconsistent with the concept of fairness, and the principle that a manager should be appropriately rewarded for skill and performance, which underpins performance fees. It also produces a perverse disincentive for managers to strongly outperform: if a performance fee cap is proposed, managers are placed in the odd position of any outperformance leading to a rise in the high water mark, for which they are not rewarded.

4.8 Even though this will impact on their ability to generate performance fees in future periods, imposing an annual cap means that the performance fee will become a lower percentage of the overall return in periods of super performance, compared with periods where the fee cap is not met. This will lead to undue complication in reporting fees on a percentage basis. It also sends the wrong signal to investors by indicating that the manager will limit its horizons, and rest on its laurels once a certain level of performance has been achieved.

4.9 The final bullet point under this heading provides as follows:

> 'Reset' provisions, where the investment manager has the opportunity to re-establish either the Hurdle Rate or Return or High Water Mark, should be approached with caution and shouldn't be considered where the investment manager can make such adjustments without approval by investors or someone charged to act in their best interests. (Note: any such change would, in any event, need to be referred to the FMA on the basis of a change in fee arrangement).

4.10 In our view, insisting on obtaining the approval of investors or the trustee where hurdle rates of return or high water marks are re-established is inappropriate. Whilst we agree that such a reestablishment should be approached with caution, the appropriate party to assess reasonableness of such a reestablishment is FMA, consistent with FMA's powers under the Act.

4.11 In our view, the only requirement that should be included here is for investors to be given reasonable notice in advance of a hurdle rate of return or high water mark being re-established, so that they have opportunity to 'vote with their feet' if they don't like the change. Often, there will be complex commercial reasons why a reestablishment is appropriate, and the party best placed to assess the reasonableness of that is FMA. Requiring a reestablishment to be put to investors will simply add to the cost of the exercise. Those costs will ultimately be borne by the investors this concept is intended to protect.

## 5 Disclosure of Performance Fees

5.1 The opening paragraph under this heading provides as follows:

> Where the performance fee payable to the Manager (or an investment manager affiliate), is in respect of a material proportion of the assets of the Fund, or may have a material impact on the total fee payable by the investor, then the Manager will be expected to clearly articulate the basis, rationale and reasonableness for each element listed above for performance fee structures in disclosure material. This would include an explanation as to why an element may not be present.

5.2 In our view, there is no regulatory authority under the Act or the Securities Regulations for FMA to require a manager to disclose the 'basis, rationale, and reasonableness for each element listed… for performance fee structures in disclosure material'. Doing so introduces an undesirable additional layer of complexity and length to disclosure material, which will only serve to mask the key information required to be disclosed to investors regarding fees.

5.3 It is a given that managers will need to clearly articulate (and justify) the basis, rationale and reasonableness for each element of their performance fee structures when seeking confirmation from FMA as to the reasonableness of the scheme fees. However, justifying the reasonableness of fees to members and prospective investors is neither a regulatory requirement nor should it be. For marketing purposes, managers may well choose to explain or justify their performance fees in greater detail than is required under relevant disclosure obligations, but this should be a matter for the manager concerned. In doing so, they will need to be very careful that they are not detracting from the key information required to be disclosed.

5.4 In our view, if such an obligation is to be imposed, the appropriate mechanism for doing so is through an amendment to the Securities Regulations 2009.

5.5 The final substantive paragraph under this heading provides as follows:

> Where a performance fee is payable to a third party investment manager unrelated to the Manager, and:
>
> - Has been entered into on an arm's length basis,
> - Has none of the fee payable to the Manager,
> - Is in respect of only a portion of the investments of the Fund,
>
> Then, disclosure of the key elements of the performance arrangements will be required. Such disclosure should demonstrate that any performance fee is not expected to be a material element (generally less than 10%) of any total fee payable by the investor.

5.6 Again, we believe that if such a disclosure obligation is to be imposed, the appropriate mechanism for doing so is through an amendment to the Securities Regulations 2009. Imposing disclosure obligations in the Guidance Note as proposed is inappropriate.

5.7 At a conceptual level, irrespective of the above, it is unclear why this particular type of performance fee has been singled out as warranting specific treatment. Performance fees paid to unrelated parties that have been determined on an arm's length basis in respect of a portion of the investment of the fund may well be a legitimate consideration for FMA in assessing the reasonableness of the overall fee structure for a KiwiSaver scheme. However, this should not be singled out as a priority for disclosure. Again, such disclosure risks masking the key information to which investor's attention should be drawn in disclosure material.

5.8 Regardless, requiring disclosure to demonstrate that any performance fee is not expected to be a material element of any total fee payable is inappropriate. If that is a factor that FMA will take into account in assessing the reasonableness of the overall fee structure, then that is something for the manager to work through with FMA. Disclosure should be focused solely on the appropriate disclosure of relevant fees. It is not the function of a disclosure obligation to create rules as to how fees may be determined.

## 6 Conclusion

6.1 As stated in our opening response overview, and notwithstanding the comments we have raised above in relation to particular aspects of the Guidance Note, Kensington Swan is generally supportive of the Guidance Note proposals. We welcome this initiative from FMA, and look forward to the Guidance Note being finalised, with the points we have raised in this response having been taken into account.

6.2 We would be happy to further discuss any aspect of our comments with the FMA if that would assist.

Yours faithfully
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