

June 2013

Guidance Note: Monitoring by Securities Trustees and Statutory Supervisors

Purpose of this guidance note

This guidance note is for licensed securities trustees and statutory supervisors. It sets out the Financial Market Authority's (FMA) expectations of how they will carry out their monitoring functions effectively.

Licensed securities trustees and statutory supervisors (licensees) play an important role in monitoring the activities of the supervised entities on behalf of investors and residents of retirement villages. This guidance note focuses on factors licensees should consider in designing and carrying out monitoring plans for the entities they supervise, and the qualities they should demonstrate when doing this.

Issuing guidance is just one of the ways FMA is transparent and shares our intended approach with the market. Guidance helps market participants to be confident they understand our approach and how we interpret, and intend to apply, the law relating to licensees' responsibilities.

This guidance note will also be of interest to entities supervised by licensees, as it explains how their securities trustee or statutory supervisor may undertake its monitoring functions.

This guidance note is based on regulatory requirements as at June 2013.

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Overview

Background

1. Licensees play an important role as front-line supervisors of issuers of securities (for example finance companies and managed funds) and retirement village operators (supervised entities). The licensee role includes monitoring the activities of the supervised entities on behalf of investors and residents of retirement villages (investors). For example, for securities issuers, this includes ensuring that the activities are in line with those disclosed to investors or that additional disclosures are made if the circumstances of the supervised entity change.
2. A failure by one or more licensees to perform its functions effectively is likely to have serious consequences for investors who place reliance on the licensee role. Many of these investors are inexperienced in investment matters and as a result vulnerable. Therefore, any serious consequence for investors in one supervised entity can result in wider loss of investor confidence and serious adverse consequences for our financial markets.
3. As a result, the Securities Trustees and Statutory Supervisors Act 2011 (the Act) requires licensees to perform their functions effectively. The Act explicitly focuses on protecting the interests of investors and on enhancing investor confidence. FMA licenses securities trustees and statutory supervisors, and monitors the performance of their functions.
4. FMA and the market have high expectations of licensees. Licensees have been entrusted with a vital role. They must conduct themselves in a manner deserving of that trust.

What is this guidance note for?

5. Issuing guidance is one of the ways FMA can be transparent and share our intended approach with the market. Guidance helps market participants be confident and understand our approach and how we interpret and intend to apply the law relating to FMA's responsibilities.
6. This guidance note is intended to assist licensees in carrying out their functions effectively. It concentrates on FMA's expectations of:
 - the culture and qualities that licensees will demonstrate (section A)
 - the monitoring activities that they will undertake to ensure that supervised entities are complying with their relevant obligations (section B).
7. Licensees can also refer to FMA's Guidance Note: Securities Trustees and Statutory Supervisor Licensing, which sets out our expectations in other areas, for example in respect of governance and experience, skills and qualifications.
8. This guidance note does not specify the processes and procedures each licensee must undertake to effectively perform its functions, but rather sets out FMA's general expectations. Licensees should use the principle of protecting the interests of investors as a guide when monitoring supervised entities.

9. While FMA's expectations of licensees are high, the success of licensees as front line supervisors also depends on the development of a productive relationship with us. FMA wishes to develop a mutually supportive relationship, with an emphasis on our joint role of investor protection. This guidance note forms part of that relationship.

Summary

How the licensee fulfils its functions (Section A)

10. To be successful in its role, a licensee must be aware that it acts as a front line supervisor on behalf of investors. Its activities should have an investor focus. It should demonstrate qualities such as professional scepticism and a pro-active approach. A licensee should ensure that its actions and decisions are not influenced by its own commercial interests.
11. A licensee should demonstrate critical self-awareness. It should monitor its own processes and seek to continually improve them, not only in response to changes in legislation, but as part of an ongoing review process.

Monitoring supervised entities (Section B)

12. FMA accepts that licensees cannot offer a 100 percent guarantee of investor protection and we do not expect licensees to take all risk out of the market place. Licensees should, however:
 - identify and assess the risks each supervised entity poses to investors, beyond the level accepted in making the investment. Licensees should monitor changes in the entity's risk profile
 - understand and assess how the supervised entity mitigates these risks through its governance, processes and controls
 - plan their supervision and monitoring to determine whether risks are being appropriately mitigated by the entity
 - act to require an entity to take additional steps in any areas where risks are not sufficiently mitigated, as these become apparent to them through their supervision. This may include requiring additional disclosure to investors.
13. Licensees should take a pro-active approach to their role and should use a variety of monitoring tools. Their activities will include approaches beyond the desk-based evaluation of reports from the supervised entity. Licensees should also interview the supervised entity's management, review and challenge its key processes, controls and management information and consider the supervised entity's own compliance assurance.

Implications for supervised entities

14. This guidance note will also be of interest to issuers of securities and retirement village operators, as it explains how their securities trustee or statutory supervisor is likely to undertake its monitoring functions.
15. Whilst supervised entities may view the licensee's role as a cost, ongoing access to investor funding is dependent on investor confidence, which in turn depends upon the robust

performance by licensees. Supervised entities should bear this in mind when choosing or dealing with licensees.

16. A licensee that is actively fulfilling its role on behalf of investors is likely to seek ongoing interaction with its supervised entity to understand its business, its risks, and its governance, controls and processes. The areas of focus will change as the risks in the entity's business change. The licensee will seek to identify issues of concern at an early stage and will expect the supervised entity to move quickly to address these.

17. In practice, this may mean:

- increased visits from the securities trustee or statutory supervisor
- further questioning around regular reports, including how they are prepared and what they show
- increased or more wide ranging reporting
- more difficult or uncomfortable conversations.

18. In dealing with the licensee, a supervised entity may find it useful to bear in mind the licensee's investor protection focus.

Section A – How the licensee fulfils its functions

Recognition of role as a front line supervisor

19. FMA expects each licensee to fully appreciate its role as a supervisor of its supervised entities. This recognition should form part of the culture of the licensee organisation.
20. The task of monitoring the supervised entity, identifying issues and poor practice and challenging these on behalf of investors is a significant responsibility. FMA expects the relationship between the licensee and the supervised entity to exhibit tension or push back at times, managed within the professional relationship.
21. FMA expects the governance bodies and management of licensees to support the culture of investor protection and front line regulation through:
 - messages to supervised entities
 - messages to staff, including acceptance that it is appropriate to disagree with supervised entities
 - allowing enough time and resources for training and quality checking
 - steps to manage conflicts of interest or perceived conflicts, at all levels of the organisation.

Pro-activity

22. FMA expects each licensee to carry out its monitoring pro-actively. It is not acceptable simply to receive regular reports and to react when an issue becomes manifest. FMA expects licensees to understand the supervised entity's sector and business and to work with each supervised entity to pro-actively pre-empt problems rather than respond to them once they have occurred.
23. FMA expects a licensee's pro-active approach to evidence:
 - a strong investor protection focus
 - demonstrable energy and curiosity
 - adequate staff resources, in terms of numbers, expertise and training
 - the creation of a strong investor protection culture within the licensee and the promotion of a similar culture within each supervised entity.

Section B gives further guidance on components of pro-active monitoring.

A healthy dose of scepticism

24. FMA expects all of a licensee's interactions with a supervised entity to be undertaken with an appropriate level of professional scepticism. In particular, where information is presented to a licensee by a supervised entity, FMA expects a licensee to:
 - form its own view on the validity of that information
 - be alert for evidence that contradicts or brings into question the reliability of documents or representations

- regularly test information provided.

25. FMA does not consider it sufficient for information to be simply accepted as presented. We expect there to be evidence of independent checking and analysis on each file.

Senior management engagement

26. FMA expects the senior management of a licensee to have confidence that decisions made by its management and staff, are effective, because senior management know:

- the policy that informs these decisions
- how that policy is formed, reviewed and assessed
- the controls over those decisions
- that its processes and systems, including decision processes and controls, are followed by all staff.

27. FMA expects that senior management will ask themselves on a regular basis “How do I know our approach works and how do I know it works well?” They should ensure that they receive management information tracking key decisions and controls, and on any significant non-compliance with processes. Senior management should test their assumptions about the robustness of the approach against day to day practice.

A culture of continuous improvement

28. FMA assessed each licensee’s processes for monitoring its supervised entities as part of licensing. These processes should not stagnate. The licensee should subject these monitoring processes to regular reviews and updates, to ensure they reflect not only legislative changes, but also best practice, to promote the highest levels of investor protection.

29. FMA expects each licensee to demonstrate critical self-awareness. A licensee should apply the same questioning mind-set and pro-activity that it applies to its supervised entities to its own internal systems. These systems include both its systems for dealing with supervised entities (referred to above) and those for dealing with compliance with its own obligations.

30. We expect the governance bodies and management of each licensee to implement a culture of continuous improvement through:

- encouraging staff to raise areas of potential improvement
- challenging and testing of the monitoring and compliance, including through management review, spot checking and peer review processes
- a regular review programme of all monitoring and compliance procedures
- reporting of significant findings from reviews to the governing body, and prompt remedial action to follow up on the findings
- where appropriate, use of risk and compliance staff to assess procedures independently from day to day operational staff carrying out the review work.

Management of conflicts of interest

31. A licensee derives its income from the entities it monitors. The licensee model is therefore subject to an inherent conflict between the licensee's own commercial interests in maintaining a client relationship, and the interests of the investors for whom it acts.
32. In dealing with supervised entities, licensees must ensure that investor protection is paramount. In some cases, this will include taking actions detrimental to the licensee's own short term commercial interests. A robust approach is likely to advance the licensee's long term commercial interests.
33. FMA expects licensees to have policies and procedures for the identification of conflicts and their avoidance, mitigation or management. Management of conflicts is likely to include segregation of activities, for example:
 - separate staff carrying out any fee negotiations from those carrying out day to day monitoring
 - clear policies separating relevant parts of the licensee's wider business from its licensed activity, if those parts also carry out back office functions for supervised entities.

We expect to see clearly documented evidence of conflicts management in respect of each appointment.

34. Additionally, FMA expects to see examples in the day to day operations of the licensee that show constructive disagreement between the licensee and its supervised entities. As part of FMA's monitoring of licensees, it will talk directly to supervised entities to ascertain whether they have had "hard discussions" with their licensee.
35. FMA expects all licensees to apply a high standard of supervision and monitoring. FMA will not tolerate licensees seeking commercial advantage by being less rigorous in their approach than their competitors.

Relationship with FMA

36. FMA will work with licensees to foster a culture of open communication, both formal and informal, to further our joint role of investor protection. Communications from licensees about supervised entities will not always result in intervention by us. FMA is keen to receive market intelligence from participants, and licensees also have a statutory obligation to advise their own intended course of action in some cases (section 46).
37. In addition, as with all financial market participants, FMA expects licensees to willingly share information about their own compliance with FMA on a formal and informal basis. A relationship of 'constructive tension' with participants allows us to bring about high standards of conduct and compliance, whilst taking a proportionate approach to its role as supervisor.

Section B – Monitoring supervised entities

38. Monitoring a supervised entity requires a licensee to:

- understand the entity's business and its business environment
- identify key risks to investors posed by that entity and its business
- consider if and how the entity mitigates these risks
- determine an appropriate monitoring plan, based on its understanding of the risks and controls - this may include actions that the entity or trustee will take where risks are not sufficiently mitigated by the supervised entity.

39. The licensee may need to ask the supervised entity to take action to address issues revealed by its consideration of risk or its monitoring activity.

40. As part of conducting its due diligence prior to taking on a new appointment, a licensee should ensure it understands the appointment and how it will monitor the supervised entity (including the points in this section).

Understanding the supervised business

41. A licensee can only effectively supervise a business that it understands. This includes an understanding of the:

- **type of business** the supervised entity undertakes
- **specific business** of that entity, including an ongoing familiarity with its strategy and business plan, for example including its target markets, distribution channels and any outsourcing
- **external environment** in which it operates now and how this environment is likely to change - this might include economic factors, market and competitor developments and regulatory factors
- **key drivers** of the performance and success of that business as well as any constraints
- **obligations** of the entity, including its obligation to investors and under regulatory requirements. This will include the varying nature of the investor exposure according to the type of investment it is.

42. FMA expects the licensee to regularly review its understanding of each supervised entity, and to keep up to date with changes in the external environment and proposed changes to the supervised business. The licensee's approach is likely to include both ongoing updating of its understanding and a regular formal review.

43. A licensee should use information from both the supervised entity and external parties, as well as information gained from discussions and desk-based research. For example, the licensee might maintain informal contacts with other participants or commentators in a relevant market, or compare market information provided by different supervised entities in the same market.

44. Licensees should be prepared to discuss business pressure points with the supervised entity's governance body and management, and how these are being addressed.

45. FMA expects that the monitoring will not be carried out in a vacuum or based on general assumptions about a particular market. Instead monitoring should be tailored based on an understanding of the specific business of the supervised entity.

Evaluating key risks

46. The understanding of the supervised entity's business allows the licensee to consider what risks exist to the entity's achievement of investors' objectives and to the entity's compliance with its regulatory obligations.
47. A supervised entity is responsible for identifying and disclosing the risks to its own objectives. A licensee might consider the supervised entity's view of risks, but will also need to be able to challenge this, and form its own view. The licensee should assess the relative importance of these risks by considering the potential size and impact of each risk and the likelihood of it occurring.
48. In many cases the risks to the supervised entity's objectives may coincide with risks which are relevant to the licensee's oversight, but this will not always be the case. For example:
- threats to profitability or key person risk will impact the supervised entity and any investors in a finance company
 - in a managed fund, the risk that assets are not invested in accordance with the mandate might pose more direct risks to an investor than to the supervised fund manager, who might report better returns as a result
 - delays in the publication of financial statements or other information may be viewed as presenting more direct risk to investors than it would to the management of the supervised entity.
49. In addition, a licensee might place more emphasis than the supervised entity's management on high impact risks with low likelihood, given the nature of its front-line supervisor role.
50. A licensee should also consider how the risks are likely to change over the short to medium term.

Considering the supervised entity's controls over the risks

51. A supervised entity must put in place governance, processes and controls to mitigate the risks to its own objectives and to ensure that it complies with its regulatory obligations. As part of its monitoring, a licensee should understand and assess these arrangements.
52. Understanding how each supervised entity mitigates relevant risks is likely to include considering:
- the entity's governance and culture
 - the entity's processes
 - the entity's key controls over these processes
 - the management information that the entity uses to monitor the risks and the operation of its controls, including both financial and non-financial information

- whether specific personnel are key to the entity's business or its controls
- the way in which management assures itself that the processes and controls are properly designed to mitigate the risks and are operating effectively. For example, through an independent compliance monitoring or internal audit function.

53. The licensee's assessment of these arrangements should include whether they are likely to mitigate key risks to investors and to result in compliance, both in the way that they are designed and the way that they operate in practice.

The culture of an entity will change over time. The way in which the processes and controls mitigate the risks and the extent of that mitigation will vary. The licensee will need to keep its understanding and assessment up to date, for example, by being aware of:

- changes in the governance, processes or controls
- changes in key personnel or resourcing levels.

54. In assessing a supervised entity's governance, processes and controls, a licensee can make comparisons to those seen at other supervised entities, to build a picture of good practice.

Determining the monitoring approach

Risk based plan

55. A licensee's monitoring approach should aim to detect changes in the risk to investors at an early stage, and should deter non-compliance with the supervised entity's obligations. Monitoring enables the licensee to encourage the supervised entity to take appropriate mitigating steps. Monitoring puts the licensee in a position to take appropriate action on behalf of investors, if necessary.

56. The licensee therefore uses the information gathered about the entity's business, risks and controls to formulate a monitoring plan. The plan should be risk-based and pro-active. It should focus on activities to monitor the key risks to investors identified, and whether it appears that the controls mitigate these risks sufficiently in practice. A risk-based plan will not necessarily mean that only the highest risk areas are addressed, more that these areas are given higher priority.

57. A plan is likely to list the key risks for the particular entity, and provide a calendar of activities and tools that will be used to target each key risk. It is useful to consider how the key risk areas will be covered on a cyclical basis over a number of years.

58. As a result, a monitoring plan might look similar to plans produced by compliance monitoring or internal audit functions. Whilst these functions might invest several people for days or weeks in an area, a licensee would not necessarily plan to carry out as much work or detailed testing. For example, for a large managed scheme a monitoring plan might include:

- monthly – assessment of reports submitted against asset limits
- in month six - a substantial visit to check understanding, observe and test investment risk processes (but a similar visit might not be undertaken again for two years)

- in month nine - a short visit to understand and assess unit pricing, with a view to a more substantial review of processes in year two
- quarterly - meetings to cover risks and issues, including risks identified by the licensee, as well as receiving updates on processes and personnel.

59. The monitoring plan will also include activities to:

- keep the licensee's understanding of the entity's business up to date
- monitor changes in the key risks identified
- monitor changes in the controls over risks.

Use of pro-active monitoring tools

60. A licensee should use a number of tools in its plan for a supervised entity, including a balance of both desk-based and more pro-active tools:

- assessment of information from the entity designed to highlight risks
- assessment of required information such as annual financial statements or returns against other information available regarding a supervised entity
- interviews with the supervised entity's management to assess and challenge on a particular risk or control area
- desk-based assessment of the adequacy of information used by the entity's management to manage the risks and assessment of steps management have taken as a result of the information
- consideration of the entity's own compliance reviews (such as internal audit or external assurance reports), including assessment of the scope, the methodology (including working files), the findings and the actions taken
- on-site detailed discussions with staff carrying out the entity's key controls or processes
- visits to the entity to 'walk through' and observe processes and controls in operation
- some testing of the entity's practices and controls in key areas.

61. In setting the monitoring plans, the licensee should not have a culture of 'one size fits all'. As work is carried out, the depth of review required may be adjusted and the plan for future activities adapted to take account of the results.

62. FMA will review the licensee's consideration of supervised entity risks and how these are reflected in the monitoring plan, when conducting its on-site inspections of the licensee.

Use of information from the supervised entity

63. Where a licensee requests that the supervised entity prepares certificates or reports specifically for the licensee, these should be tailored to address risk areas. For example, what key financial indicators or triggers can be best used to monitor the entity's performance? Asset/liability ratios may not be the most relevant for all business types.

64. Licensees should move away from a practice of having unchanging reports as set out in the trust deed or governing document, to a practice of regularly updating the reports and certificates requested as the risk factors associated with a supervised entity change.

65. A licensee should apply professional scepticism when using reports from the supervised entity. This includes considering the robustness of the reporting. This is particularly important where information is prepared specifically for the licensee and is not relied upon in the day to day management of the supervised entity. For example, depending on nature and impact of the related risk, the licensee should understand the entity's process for preparing or checking the reports, consider whether its accuracy has been the subject of review, test its extraction from source documents or consider the report against other sources.
66. Similarly, having understood the entity's processes and controls, it is likely that the licensee will take into account the entity's own controls in determining the priority areas for monitoring. So the licensee will consider the likelihood that a risk will occur, given the controls. In doing this, the licensee should consider whether there is evidence that the controls are operating robustly. For example, whether the entity's own compliance monitoring or internal audit has reviewed the control processes. Alternatively, the licensee might undertake some monitoring on key controls.

Other aspects of the entity monitoring plan

67. The monitoring plan should consider the resource that the licensee will need to devote to the entity, and any specific skills or experience needed. Resource should be prioritised to the areas of highest risk to investors. In some cases, external expertise may be needed, for example particular business or IT expertise. The planned resource should also allow time for dealing with issues identified by the supervised entity or through monitoring.
68. The monitoring plan should be reviewed when there are changes in the entity's business, governance, processes or controls which affect risk to investors. The licensee should consider how it will adapt its monitoring both after the change has been made and during the change period. The licensee may need to undertake additional work during the change period, for example, considering whether the supervised entity:
- has considered the impact of external changes on its business strategy
 - has appropriately informed investors about relevant significant change
 - will maintain controls and oversight of existing business during the change
 - has ensured that appropriate controls and oversight are designed into new businesses or internal change
 - implements change only when it is satisfied that it will not adversely affect the overall business or controls.
69. Progress against the monitoring plan should be tracked to ensure that the activities have been undertaken, additional resource allocated if activities are behind, or the delay escalated for the licensee's management to consider an appropriate response.
70. The monitoring plan must continue to address the evolving risks of the supervised entity and to ask the right questions to see if they are mitigated. The plan should be continuously improved to ensure that it works. The plan should state the frequency with which it will be formally reviewed. This is likely to be at least annually for most supervised entities.

An overarching view of supervised entities

71. A licensee is also likely to have an aggregate plan of its activities. This allows management to take a holistic view of the entities supervised (or a segment of similar entities) to consider whether skills and experience are appropriately targeted and to allow comparisons to be made.

Dealing with issues

72. Monitoring of a supervised entity is likely to identify issues that need to be addressed. Other issues may be notified by the entity, or come to light through other interactions with industry or investors.

73. The licensee should use its understanding of the supervised business when dealing with issues in the supervised entity, such as breaches of the obligations. This will include considering the potential impact of the issue on investors.

74. When presented with a breach notification or other issue, FMA expects licensees to consider, not only the detail of the specific breach, but also:

- the purpose of the provision breached
- the likely repercussions, bearing in mind investor protection
- the timing of any repercussions going forward
- the broader history of the supervised entity.

75. In reviewing an entity's remedial actions or in putting in place steps to address the issue, the licensee should consider:

- changes the entity will put in place to prevent the issue from arising in future
- whether other arrangements need to be put in place until the desired changes can be made
- how the entity will address any investors who have been disadvantaged by the issue
- whether the issue needs to be communicated to investors.

76. When considering remedial actions, the licensee should draw on its understanding of the entity's processes and controls.