FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

# Regulatory Impact Statement

Published November 2015

## Guidance on risk indicators and description of managed funds

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# Executive summary

1. This Regulatory Impact Statement (RIS) considers the FMA's proposed guidance on risk indicators and description of managed funds.
2. Before deciding on the proposed guidance, we analysed various options, and considered the regulatory and financial impacts of the alternative solutions provided by those who made submissions. Our assessments were made based on:
    a. the likely compliance cost
    b. the likely effect on competition
    c. other impacts, costs and benefits.
3. Our intention is to provide guidance that includes information on the legislative framework that applies to managed funds and how we expect risk indicators to be calculated. Our guidance also covers when the product disclosure statement (PDS) should be updated when a fund's risk category changes; how the volatility of managed funds should be described; and how to approach naming conventions for funds.
4. Our guidance note for those managing funds includes guidance about our expectations that:
    a. managers use the European Union guidelines (CESR Guidelines)[1] for details on how to calculate risk indicators, or for when they are looking for alternative methodologies to use (when what's set out in regulations is not appropriate)
    b. when choosing to describe a fund's volatility risk in words, managers use the standardised descriptions set out in the guidance note for the seven numerical risk indicators categories set by the regulations
    c. a PDS is updated when a fund's risk indicator:
        - moves by two categories
        - moves as a result of a change in investment policy
        - when there is a consistent change away from the risk indicators in the PDS.
5. Our guidance note also provides guidance on matters to consider when naming a fund to ensure the name selected is not misleading.

[1] Guidelines produced by the Committee of European Securities Regulators (CESR) for the calculation of a 'synthetic risk and reward indicator' for key disclosure documents (CESR Guidelines). The CESR has now been replaced by the European Securities and Markets Authority (ESMA) and the intention is that the CESR Guidelines will become enforceable technical standards for the European Union. The CESR Guidelines are available here: http://www.esma.europa.eu/system/files/10_673.pdf

# Background

1. This RIS is a result of our consultation on our proposed guidance for fund managers and other market participants. The guidance is consistent with our Statement of Intent to promote a fair, efficient and transparent financial market while balancing the cost and benefits of our proposals. The guidance note does not impose new reporting requirements or add to the burden of compliance. However, some of our expectations contained in the guidance note may require a change in practice that may incur some costs.
2. The proposed guidance highlights four matters we have identified as issues that need clarification and guidelines. They are:
    a. how to calculate a risk indicator
    b. describing the volatility of managed funds
    c. updating a PDS to reflect a change in risk category
    d. the naming conventions for funds.
3. Our analysis of the guidance's potential impact is intended to provide non-technical information to help explain:
    a. why some issues need addressing
    b. what our objectives are
    c. the range of alternatives considered that could meet the desired policy options
    d. the impact (identified costs and benefits) of the preferred option
    e. the preferred position and reasons.
4. The specific issues and proposed approach are set out in the following sections. The impact analysis and the preferred solutions are discussed in the context of specific issues.

## Reasons and objectives

5. Managed funds must provide information about the general risk profile of funds and meet specific requirements when calculating a fund's risk indicator under the Financial Markets Conduct Act 2013 (FMC Act) and the Financial Markets Conduct Regulations 2014 (the regulations) regime.
6. The guidance is to ensure confident and informed participation in the market, and to meet the overall objective of a fair, efficient, and transparent market. Both the FMA and the industry's participants consider the guidance a necessity.
7. The guidance is for managers and supervisors when they are calculating, describing and reporting on the risks related to the fund. Our other aim is to lay out the criteria and parameters for different aspects of risk. This ensures a consistent and comparable disclosure so investors can make informed decisions and provides confidence to managers and supervisors in meeting the legal requirements.

## About the consultation

### Who was consulted

8. We undertook two rounds of consultation, targeted at managed funds, their supervisors and investors. The first was in December 2014 where we consulted on proposed guidance for calculating risk indicators along with a proposed fund update template (initial consultation).

9. Feedback on the initial consultation and our subsequent discussions with industry participants raised additional issues that we could address through our guidance. We extended the consultation process to cover additional related matters, including clarifying when a change in the risk indicator becomes 'material' and ensuring there is consistent description of the risk indicator in the PDS, the register and the fund update.

10. We developed proposed guidance to address these issues. A second consultation paper was published in July, with submissions closing in August (August consultation). In the August consultation, we asked stakeholders some key questions to find out how the proposed guidance is likely to affect them. Specific questions were asked about the costs, benefits and other impacts of the proposals. The submissions on the revised and expanded guidance are analysed and reported in this RIS.

### Who made submissions

11. We received 13 submissions during the initial consultation and 25 submissions for the August consultation. Please see appendix 1 for a list of submitters.

# Section 1: Calculating risk indicators

## The problem and the options

### The issues and options to address

12. The Act and regulations require managed funds to disclose a risk indicator and a risk indicator diagram. Managers are required to include the risk indicator in:
    - the PDS[2]
    - the Disclose register, as an entry when the PDS is lodged[3]
    - in each fund update[4]
    - the corresponding Disclose register update[5].

13. Schedule 4 of the regulations sets out how the risk indicator diagram should look[6], how the indicator should be calculated[7], and when alternative methods must be used to determine risk indicators[8]. The overarching requirement is that managers must calculate and present a risk indicator that the manager reasonably considers will reflect the potential future volatility of the fund.

14. The risk indicator provides investors with a simple tool that shows the historical volatility of a fund's returns. The risk indicator is intended to help investors make decisions by providing them with a way to compare the volatility among various managed investment scheme (MIS) products.

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[2] Clauses 25-29 of schedule 4 of the FMC Regulations
[3] Clause 53(1)(c) (ii) of schedule 4 of the FMC Regulations
[4] Clause 58(1) of schedule 4 of the FMC Regulations
[5] Clause 54(1)(a)(i) of schedule 4 of the FMC Regulations
[6] Clause 5 of schedule 4 of the FMC Regulations
[7] Clauses 6-7 of schedule 4 of the FMC Regulations
[8] Clause 8 of schedule 4 of the FMC Regulations

15. One of the issues identified is the lack of detail on the calculation of risk indicators. Feedback showed that participants wanted more information about how to meet what the law requires.
16. To address the issues raised, our initial consultation was focused on the methodology for calculating the risk indicator. The New Zealand legislative requirements on risk indicators are based on the guidelines produced by the Committee of European Securities Regulators (CESR) for the calculation of a 'synthetic risk and reward indicator' for key disclosure documents (CESR guidelines). The link to the CESR Guidelines is http://www.esma.europa.eu/system/files/10_673.pdf.
17. The initial guidance used the CESR guidelines as a 'how-to guide' to provide technical detail on how to calculate the risk indicator to meet what the law requires, and as a resource for alternative methodologies for those who need them. The initial consultation gathered stakeholder feedback about whether the guidance adequately addresses their perceived need for more direction on calculating the indicator.

## Results of consultation and impact analysis

### What did the submissions say?

18. Submissions from the initial consultation indicated strong support for having the risk indicator calculation guide. Submitters felt it was important to have a consistent calculation for the risk indicator information.
19. Those who submitted on the revised guidance in the August consultation confirmed the need for guidance on calculating risk indicators. They also raised concerns related to the risk indicator and the general risk disclosure requirements in the legislation. In particular, concerns about calculating a risk indicator built around volatility focused on the following themes:
    a. The returns used for the calculation. The view was that the returns used for the risk indicator are not always consistent with what's required of other returns reporting (for example the fund update). Also, the different definitions for 'return' (for example, pre-tax and post-tax) can introduce bias for, and against, particular funds.
    b. The return volatility is not by itself a full or true reflection of risk. There is a danger that investors may assume the same risk indicator for two different types of funds (an example being a conservative versus balanced) would mean the same level of risk. Different investments can have the same level of volatility but very different risk profiles.
    c. The period of time over which volatility was measured. Several submissions pointed out that a five-year period is very short, and is not in line with the average economic cycles.
20. All these issues relate to the current legislative requirements and addressing them will require future legislative changes. We have noted the issues for discussion with the Ministry of Business, Innovation and Employment (MBIE) over the next stages of regulatory change. In the meantime, the key message to the investment community is take care when explaining the risk indicator. The emphasis should be that the risk indicator is a measure of historical volatility of past returns, over a specific period – in this case over five years. The risk indicator is not in itself a complete picture of the future risk of an investment.
21. We considered whether it was appropriate or not to issue guidance. The options were:

### *Option 1: Introduce standardised risk descriptions*

22. This option would see the draft guidance confirmed. Fund managers would be required to adopt the methodologies for calculating risk indicators as set out in the guidance note providing a consistent way for managers to calculate the measure.

#### *Impact assessment*

23. Submissions indicated that the preference is for guidance for risk indicator calculations. The calculation of the risk indicator is a highly technical area. Providing guidance may reduce costs for managers as it increases

clarity around how the legislative requirements can be satisfied. References to the appropriate sections of the CESR guidelines may be useful in increasing understanding of managers in this area.

***Option 2: Provide no guidance (status quo)***

24. This option would leave it up to each fund manager to adopt appropriate calculation methodologies.

***Impact assessment***

25. The New Zealand legislative requirements are based on the CESR guidelines. Managers would need to adopt methodologies for calculating a risk indicator which are largely consistent with those set out in the guidance. However, without guidance it is possible that managers could use slightly differing approaches to the calculations resulting in inconsistency of results across the market. This will make comparison between like or similar products difficult for investors.

## Conclusions and preferred option

26. The guidance should be adopted with no substantial changes to the initial guidance on the risk indicator. The proposed guidance has details on how to use the prescribed methodology to calculate the indicator, and what to consider if an alternative methodology is needed.
27. The submissions confirmed that participants needed the guidance and supported its introduction. The key issues raised in submissions are about the legislative requirements. Although the FMA has no power to change legislation, we will share the feedback we have received from the consultation with MBIE for review when legislative change is for considered in the future.

# Section 2: Describing the volatility of managed funds

## The problem and the options

### The issues and options to address

28. The regulations require all funds to be allocated a numerical risk indicator, from 1 to 7.[9] The scale represents the levels of volatility risk, from the lowest to the highest. Fund managers may describe the numerical risk value in words. However, there is no prescribed wording for each value. A fund with a risk category of 4 could be described by one fund manager as having a 'medium to high level' of volatility. A different fund manager may describe the same category 4 as having a 'low to medium' level of volatility.
29. The potential use of different descriptions for the same risk category may be confusing and misleading for investors. The use of different descriptions will also interfere with the comparability of risk categories between funds. To address these concerns, we proposed a set of standardised descriptions, set out in the table below.

[9] Schedule 4 of Regulation 6(1)(a)

| Risk category | Annualised standard deviation[10] | Description of volatility |
|---|---|---|
| 1 | 0% to less than 0.5% | very low |
| 2 | 0.5% or more, but less than 2% | low |
| 3 | 2% or more, but less than 5% | medium |
| 4 | 5% or more, but less than 10% | medium to high |
| 5 | 10% or more, but less than 15% | high |
| 6 | 15% or more, but less than 25% | very high |
| 7 | 25% or more | very high |

## Results of consultation and impact analysis

### What did the submissions say?

30. Submitters felt it was generally desirable for managers to describe the numerical risk indicator in words and welcomed the introduction of consistent descriptions they could use.
31. Some concerns were raised on the overlap in category 6 and 7 where both categories' volatility were described as 'very high'. Most submitters felt it was important to make a clear distinction between categories. They suggested that category 7 risk should be renamed as 'extremely high' or 'highest'.
32. A number of submitters also felt that the classification of category 3 as 'medium' overstated the risk of an investment which fell within the lower end of the category range (2% standardised deviation). They suggested the description 'low to medium' would more appropriately reflect the range of risk within this category.
33. We considered whether it was appropriate or not to issue guidance. The options were:

### *Option 1: Introduce standardised risk descriptions*

34. This option would see the introduction of a set of standardised descriptions for each of the prescribed risk indicator categories. We would not require the volatility risk to be described in words, but if a manager chooses to include a description, then the standardised descriptions should be used.

#### *Impact assessment*

35. The cost to industry of implementing this guidance is likely to be minimal. Some updates to existing PDS documentation may be required. However, no submitters raised this as a potential problem.

### *Option 2: Provide no guidance (status quo)*

36. This option would leave it up to each fund manager to adopt appropriate descriptions, which are not misleading, for each category of risk indicator.

#### *Impact assessment*

37. As each category contains a range of standard deviations, there is potential for managers to adopt varying descriptions for each risk category, depending upon where they feel their fund lies. While most managers are likely to adopt suitable terminology, there remains a risk that some managers may attempt to understate a fund's perceived level of risk.

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[10] Clause 6(1)(b) of schedule 4 of the FMC Regulations

38. When making an investment decision some investors may find the words describing the risk indicator to be more understandable than the numerical figure. Using varying descriptions will therefore reduce the value of risk indicators to provide a useful measure of comparing risk between funds.

### Conclusions and preferred option

39. It is not compulsory for managers to describe the risk indicator in words. However, submissions indicated most managers were likely to do so. Having considered the submissions, which supported standardisation of descriptions, we think there would be significant benefit in recommending a set of standardised descriptions to be used by industry. Consistent terminology will enhance the value of risk indicators to investors.

40. Taking into account submissions the categories will be described as follows:

| Risk category | Annualised standard deviation[11] | Description of volatility |
|---|---|---|
| 1 | 0% to less than 0.5% | very low |
| 2 | 0.5% or more, but less than 2% | low |
| 3 | 2% or more, but less than 5% | low to medium |
| 4 | 5% or more, but less than 10% | medium to high |
| 5 | 10% or more, but less than 15% | high |
| 6 | 15% or more, but less than 25% | very high |
| 7 | 25% or more | extremely high |

# Section 3: Updating a PDS to reflect a change in risk category

### The problem and the options

#### The issues and options to address

41. Managers must not offer, or continue to offer, interests in a managed fund if information in the PDS has become false, misleading, or is likely to mislead.[12] In general, a change in the risk category of a fund is unlikely, on its own, to cause the PDS to be misleading. However, the risk indicator might have changed significantly. This would make information in the PDS potentially misleading and the PDS would need to be updated.

42. We proposed four situations where a change in a fund's risk indicator would likely be significant enough to warrant an update of the PDS. They are, if:

    a. the risk indicator has moved by two or more categories, for example from risk category 3 to risk category 5

    b. the risk category shown in the PDS has been inconsistent with the risk category in two or more consecutive quarterly fund updates (for a fund that has to provide quarterly fund updates under reg 56(1) of the Regulations)

11 Clause 6(1)(b) of schedule 4 of the FMC Regulations
12 Section 82 of the FMC Act

c. the risk category shown in the PDS has been inconsistent with the fund's actual risk category for the majority of the weekly or monthly data reference points during any 12-month period after the date of the PDS (for a fund having to produce annual fund updates required by reg 56(2) of the Regulations)

d. the change in a risk category is the result of the manager's decision to change the fund's investment policy or strategy.

## Results of consultation and impact analysis

### What did submissions say?

43. Submitters agreed that it was important for prospective investors to receive up-to-date information about the volatility of a fund. However, this concern needed to be balanced against the costs involved in updating the PDS. The majority of submitters felt that the guidance proposed generally struck the right balance between these competing objectives.

44. All submitters agreed that a change in the risk indicator by two or more categories warranted an update of the PDS. Similarly, most felt that the PDS should be updated where the risk category changed due to an underlying change in the investment strategy of the fund. The submitters suggested that this should only apply to the long-term strategy of the fund, as outlined in the statement of investment policy and objectives (SIPO), and not as a result of short-term tactical investment decisions.

45. Some raised concerns over the requirement to update a PDS where the risk indicator varied by only one risk category. Submissions on this point suggested that fluctuations between categories could be common in certain situations, and was not likely to be material to the decision-making process of investors. The view is that investors are sufficiently warned and informed by the caveat (required in every PDS) which states that risk indicators do shift from time to time, and the most-recent risk indicator can be found in the latest fund update.[13] Investors are also told they should look for up-to-date information about the risk indicator, should they wish to do so. Some submissions suggested the introduction of a buffer which would apply when a risk indicator changed by only one category.

### *Option 1: Introduce guidance*

46. This option would see the requirements outlined in the draft guidance confirmed. Fund managers would be required to amend a PDS when a fund's risk indicator changes in the manner set out in paragraph 41 above.

#### *Impact assessment*

47. The requirement to update a PDS will always carry with it a level of compliance costs. Submissions were mixed on the likely cost involved here. Some submissions stated it would be an expensive process (requiring various levels of sign off, redistribution and staff training). Others felt that a fund's risk indicator could be corrected quite simply if required.

48. Given the significance the Act places on volatility risks and risk indicators, it is important that investors receive up-to-date information about the risk of a fund. Most submitters felt that the circumstances set out in the draft guidance represented a sufficiently material change to warrant a PDS update. Under the guidance an update is only required where the new risk indicator is significantly different to the risk indicator stated in the PDS. For funds susceptible to multiple movements, a PDS would need to be updated only where a difference has existed for most of the reference period.

49. There is a real potential for inconsistent action in the market if each manager is left to determine when a change in a fund's risk indicator warrants a change to the PDS. Providing guidance in this area will increase consistency and increase investor confidence in the accuracy of the information they receive.

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[13] Clause 26(2)(c) of schedule 4 of the FMC Regulations

***Option 2: Provide no guidance (status quo)***

50. This option would leave each fund manager to decide whether they consider it necessary to update a PDS when there is a change in a fund's risk indicator.

***Impact assessment***

51. The purpose of a PDS disclosure is to help investors compare products and make informed choices. It is therefore important that information in a PDS accurately reflects the related product. As circumstances change, information contained within a PDS will become out of date. Managers need to assess whether a change alters the information contained within a PDS to the extent the information may be misleading or deceptive.
52. As noted above there is potential for inconsistent action if each manager is left to determine when a change in a fund's risk indicator warrants a change to the PDS. As there are costs involved in updating a PDS, there is a real risk that some managers will be reluctant to update a PDS in all but exceptional circumstances. Providing no guidance may increase costs for managers due to uncertainty and the need to obtain advice about whether they need to update a PDS or not.

***Option 3: Amend guidance to include a buffer before PDS update is required***

53. This option would see no change to the majority of the draft guidance. However, where a risk indicator has moved by only one category, fund managers would only need to update a PDS where the change represents a movement of more than $1/10^{th}$ of the difference between the top and bottom boundaries of the new category.

***Impact assessment***

54. This option has the potential to reduce the compliance burden for funds which sit on the boundary between two risk categories. These funds may be susceptible to small changes which repeatedly move them between categories. However, it also introduces a further complexity for applying the guidance which will be irrelevant in the majority of cases.

## Conclusions and preferred option

55. A fund's risk indicator should be relatively stable. It should only be changed in situations which make the volatility of fund different from what it was initially. In general, those who submitted agreed that the situations outlined in the guidance provide an appropriate balance of situations which justify when investors need to be told of the change. Some minor amendments have been made to the wording of the situations outlined to clarify the guidance.

# Section 4: Naming conventions for funds

## The problem and the options

### What are the issues and options to address?

56. Funds are often given names to reflect the types of assets they invest in. These names need not reflect the fund's risk category because the volatility of a fund's investments may change over time. However, managers who use names that suggest certain fund characteristics should not call their funds by names that misrepresent the types of products the fund may invest in. This has the potential to cause some investors to be misled about the nature of the fund.
57. Broadly speaking, funds allocate investments between income and growth assets. Our proposed guidance, which outlines what we expect funds to normally allocate their investments into, is based on the following common naming conventions:

| | |
|---|---|
| Defensive | Funds using the word 'defensive' in their name would usually be expected to hold 0% to 9.9% of their value in growth assets. The remainder would be income assets. |
| Conservative | Funds using the word 'conservative' in their name would usually be expected to hold 10% to 34.9% of their value in growth assets. The remainder would be income assets. |
| Balanced | Funds using the word 'balanced' in their name would usually be expected to hold 35% to 62.9% of their value in growth assets. The remainder would be income assets. |
| Growth | Funds using the word 'growth' in their name would usually be expected to hold 63% to 89.9% of their value in growth assets. The remainder would be income assets. |
| Aggressive | Funds using the word 'aggressive' in their name would usually be expected to hold 90% to 100% of their value in growth assets. The remainder would be income assets. |

## Results of consultation and impact analysis

### What did submissions say?

58. Submitters agreed, generally, that in principle there should be a degree of consistency between funds with a similar name. However, substantial objections were raised to any attempt to mandate:
    - the range of assets managers were required to hold for each fund type, and/or
    - the types of names managers could choose to adopt for their funds.
59. The submissions highlighted the need for managers to have flexibility around what exposure range they should be allowed for each asset type. Some questioned how the proposed guidance would apply to tactical positions adopted outside of the benchmarks. Others feared guidance on naming conventions would stifle either fund differentiation or market innovation.
60. Some submissions noted that the conventions outlined in the guidance did not wholly correspond with industry practice. Other submissions noted that there was no single industry interpretation. Some submissions drew attention to the use of different terms such as 'moderate', 'cash' and 'high growth' to name funds. Hybrid categories that bridge the listed categories were also noted.

### *Option 1: Confirm proposed guidance*

61. Under this option the proposed guidance would be confirmed. Some alterations would be made to the text of the guidance note to ensure it was clear we were not intending to prescribe naming conventions which must be adopted by all fund managers.

#### *Impact assessment*

62. Providing a benchmark for the assets which funds with certain common names should hold ensures some consistency across the industry. The variation which exists in practice indicates the need for some level of guidance to drive consistency for investors.
63. However, some submissions indicated the potential for confusion on how much fund managers may deviate from the recommendations, particularly in the short term. We will make sure the guidance is drafted so it is clear our recommendations are only benchmarks.

### *Option 2: Provide no guidance (status quo)*

64. Under this option there will be no guidance around our expectations. The industry would be left to ensure that their naming conventions for funds were appropriate.

#### *Impact assessment*

65. While it would appear that most managers adopt names consistent with our recommendations, there remain a number who do not. Investors are likely to compare funds with similar names and expect them to have a similar asset mix. Providing guidance in this area should help to ensure that the market has a consistent approach for funds with certain common names.

### *Option 3: Provide more prescriptive guidance*

66. Under this option more prescriptive guidance would be given around the types of asset and asset mix we would expect funds with certain names to hold.

**_Impact assessment_**

67. Prescribing the features that funds with certain names must have would potentially create a high level of consistency across the market and improve comparability for investors. However, it is likely that those funds which fall outside of the recommendations would adopt an alternative but similar name, rather than comply with the requirements. It would not be possible, under the current legislation to prescribe a limited set of naming conventions that a fund must use.

## Conclusions and preferred option

68. There are a number of factors to consider in determining whether a fund's name is misleading. An important aspect is whether the name tends to suggest a certain investment strategy or asset mix.
69. It is not appropriate to prescribe naming conventions which would be applied to all fund managers. Nor is it realistic to prescribe strict asset ranges managers must hold. Our view is, it is sufficient to provide general guidance of what type of assets we expect to see in common fund names. This will ensure that funds which significantly differ from this position will be on notice of their potentially misleading effect.

# Where to from here?

70. The guidance will be published on our website and participants notified. We will assess whether the information provided has helped fund managers and investors by monitoring the new FMC Act risk- related disclosure they provide, and through our ongoing communications.
71. The more substantial issues raised in the submissions that will require legislative change will be included by us in the list of matters to be considered by the Government for future legislative change.

# Appendix 1: List of submitters

| First consultation | Second consultation |
|---|---|
| New Zealand Bankers Association (NZBA) | Accordia (ACC) |
| Pathfinder Asset Management (PAM) | Guardians of NZ Superannuation (GNZS) |
| ANZ Bank New Zealand Limited (ANZ) | Russell Investments |
| Workplace Savings NZ (WSNZ) | BNZ |
| Gareth Morgan Investments Limited Partnership (GMI) | Grosvenor Financial Services Group Ltd |
| Peter Long (PL) | Civic Assurance |
| Smartshare Limited (SS) | Forsyth Barr |
| Carl Chenery (CC) | ANZ |
| Westpac BT Funds Management (NZ) Limited (Westpac BT) | AMP Services |
| Civic Assurance (Civic) | AMP Capital |
| Grosvenor Investment Management Limited (GIM) | Workplace Savings NZ |
| Mint Asset Management (MAM) | RiskIQ Limited |
| Guardian Trust (GT) | ASB |
| | New Zealand Bankers' Association |
| | BNZ |
| | MAS |

| | |
|---|---|
| | BT Funds Management (NZ) Ltd |
| | Fisher Funds Management Limited |
| | Mercer (N.Z.) Limited |
| | Aon Hewitt |
| | CFA Society of New Zealand |
| | NZX Limited |
| | Gareth Morgan Investments |
| | Kensington Swan |
| | Craigs Investment Partners |