

25 January 2017

Regulatory Impact Statement – Property schemes

This document is for:
managers, supervisors, custodians
and investors in property schemes

It discusses exemptions granted to property schemes.

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Executive summary

This Regulatory Impact Statement (RIS) discusses the exemptions we have granted to property schemes from custody requirements under the Financial Markets Conduct Act 2013 (FMC Act).

The FMC Act applies to all managed investment schemes. Most schemes are managed funds, but the FMC Act also applies to single asset-type schemes, such as property schemes. Property schemes have some unique characteristics, and we have considered these in reaching a view on whether the important protections the regime brings to investors are all appropriate when measured against the compliance burden and associated costs.

In this RIS we provide an analysis of the exemption options considered, their impact and the reasons for our decisions. Assessments were made based on the purposes of the FMC Act, including whether compliance costs are unreasonable.

Exemptions granted

After carefully considering both regulatory and non-regulatory impacts, we decided to grant the following exemptions:

- **Independent custody:** managers and supervisors of existing closed property schemes are exempt from the requirement that the scheme's supervisor or an independent person holds real property assets. However, there needs to be a registered encumbrance or mortgage over that property in favour of the supervisor.
- **Cash reconciliation:** custodians of existing or new property schemes are exempt from the requirement to reconcile scheme cash records daily. Instead cash must be reconciled at a frequency suited to the level of transactions for the scheme.
- **Annual assurance engagement:** custodians of existing or new property schemes, except those managed by a 'large' manager (managers with \$200 million or more total assets under management), are exempt from the requirement to have an annual assurance engagement with a qualified auditor that checks the custodian's processes for holding scheme property. The exemption is granted on the condition that an annual assurance engagement is obtained when required by the supervisor.

Objectives

Where market participants encounter difficulties offering financial products under the standard FMC Act regime exemption relief from a regulatory requirement may sometimes be appropriate. Any exemption granted must promote one or more of the purposes of the FMC Act regime, which are to:

- promote confident and informed participation in financial markets by businesses, investors, and consumers
- promote and facilitate the development of fair, efficient and transparent financial markets
- provide for timely, accurate, and understandable information to assist the making of decisions on financial products or services
- ensure appropriate governance arrangements apply to financial products and services that allow for effective monitoring and reduce governance risks
- avoid unnecessary compliance costs
- promote innovation and flexibility in the financial markets.

Additionally, an exemption must not be broader than necessary to address the matters that gave rise to it.

In applying our exemption powers we have considered the possible exemptions against the following objectives (which are the purposes of the FMC Act which we consider most relevant in this case):

- promote confident and informed participation in financial markets by businesses, investors, and consumers
- ensure appropriate governance arrangements apply to financial products and services that allow for effective monitoring and reduce governance risks
- avoid unnecessary compliance costs
- promote innovation and flexibility in the financial markets.

We have also considered whether the scope of the possible exemptions is not broader than necessary to address the problem.

In conducting this analysis, we compared the exemption options against the status quo (no exemption).

We considered the following stakeholders' interests:

- investors in property schemes
- property scheme managers
- licensed supervisors
- custodians.

Exemption relief considered

Independent custody of real property

Exemption considered

The FMC Act requires that a scheme's property is held by the supervisor or by an independent custodian. Submitters told us that the real property of many existing property schemes is not held by the supervisor or an independent custodian. They said it would be costly to transfer that property to comply with the independent custody requirements. This is particularly the case in Australia where stamp duty applies on transfers of real property.

We have considered whether property schemes should be exempt from the independent custody requirements for their real property assets where custody of the real property is protected by a registered encumbrance or mortgage in favour of the supervisor.

Impact analysis

The exemption would give property schemes the option of either registering an encumbrance or mortgage or transferring the real property to the supervisor or an independent custodian.

We have been told that the cost for a scheme of transferring real property to the supervisor or an independent custodian would be prohibitive, particularly where there are a number of titles and other encumbrances or bank debts secured over the property. The estimated cost of transfer ranged from \$1,200 to \$6,000 per scheme under management.

A further reason for an exemption is that some liabilities relating to the land may fall on the supervisor, if the supervisor holds the land. Submitters said that these liabilities relate to health and safety and resource management law.

Decision and reasons

A custodian of scheme property holds the property on trust for the investors (section 157 of the FMC Act). If the obligations of the custodian to the supervisor and the scheme participants are secured by a registered encumbrance or mortgage over the real property in favour of the supervisor, then investors will have a level of protection against a subsequent purchaser or security holder.

The terms of an encumbrance, typically, require the scheme's manager to obtain the supervisor's prior consent before dealing with the property. While we understand that an encumbrance may not actually prevent registration of a transfer or subsequent mortgage where the supervisor's consent has not been obtained, the subsequent purchaser or security holder will take their interest in the property subject to the encumbrance and the trust in favour of the scheme. In practical terms, the existence of a registered encumbrance over the real property assets is likely to deter any dealing with the property because it provides notice of the scheme's interest in the property.

The special features of real property contribute to the effectiveness of an encumbrance or mortgage in sufficiently protecting investors' interests. Its immovable nature and the land registration system mean it is difficult for the property to be dealt with contrary to investors' interests without the supervisor's knowledge.

If scheme real property is secured by a registered encumbrance or mortgage in favour of the supervisor, schemes are likely to avoid some unnecessary compliance costs. These options will also promote flexibility in the financial markets by enabling existing property schemes to retain existing custody arrangements while still providing adequate protection for investors. We therefore consider that property schemes should be exempt from the independent custody requirements for their real property assets where custody of the real property is protected by a registered encumbrance or mortgage in favour of the supervisor.

Limited scope of independent custody exemption

The independent custody exemption will only apply to real property of existing closed property schemes, and not to other schemes¹ or assets. There is also a condition requiring that a registered encumbrance or mortgage is in place in favour of the supervisor as an alternative protection for scheme participants. Given these limitations and conditions, we consider that the exemption proposed is not broader than reasonably necessary to address the matters that gave rise to it.

Annual assurance engagement

Exemption considered

The custodian of a registered scheme is obliged to obtain an annual assurance engagement. The assurance engagement is a check by a qualified auditor on the custodian's processes, procedures and controls to ensure, amongst other matters that:

- transactions are authorised, processed and recorded in an appropriate, accurate and timely manner
- scheme property is held in accordance with the FMC Act
- records are accurate
- there are safeguards against loss of scheme property.

We have considered whether an assurance engagement needs to be carried out annually for property schemes where most of the assets are real property and where transactions are infrequent.

Impact analysis

One supervisor has obtained quotes for assurance engagements from auditing firms, ranging from \$15,000 to \$40,000 per manager. These annual costs will ultimately be passed on to investors, and will be a significant burden, particularly for investors in small to medium-sized schemes. We note existing schemes did not factor in this annual cost when they were set up.

Decision and reasons

It is important that custodial systems and processes for managed investment schemes are regularly checked by an assurance engagement with a qualified auditor. It is appropriate that this check is annual for managed funds and other schemes which have frequent transactions involving scheme property. However, we consider that generally checks can be less frequent for property schemes because:

¹ We note, however, that we have also decided to grant an exemption from independent custody requirements in relation to real property and carbon credits of forestry schemes where similar characteristics apply.

- the nature of the property held by these schemes means a custodian's processes for looking after it will be relatively simple, and risks of any material misstatement in the custodian's records low. Most of the property held by a property scheme is real property, with a small amount of cash and other assets. Any real property transfers are dealt with through registration of an instrument under the Land Transfer Act 1952.
- the volume and frequency of transactions for property schemes is lower than for managed funds and many other schemes. There is little, if any, turnover of real property assets. Again, this is likely to reduce the risks of material misstatement in the custodian's records.

There are other factors that also mitigate risks around custody of scheme property:

- schemes will be overseen by an independent licensed supervisor with statutory duties that include acting honestly, in the best interests of scheme participants; and to a professional standard of care.
- as real property is typically not traded, the audit of the scheme's financial statements will provide some assurance it is still held
- some audits of the scheme's, or manager's financial statements, may include a check of controls in relation to the scheme's bank account
- managers are required to be licensed and have statutory duties that include being honest and acting in the best interests of investors, and with a professional standard of care.

However, we consider it appropriate to place an upper limit on application of the exemption. We think the exemption should not apply for a property scheme if the manager of that scheme is 'large' (i.e., has \$200 million or more total property scheme assets under management for all the property schemes). Large managers manage a significant amount of cash across the various schemes they manage. In addition, they will be better able to absorb compliance costs across their portfolio of schemes. We therefore consider it is appropriate to apply an upper limit on the exemption.

Although we do not consider annual assurance engagements are necessarily required annually throughout a property scheme's life (subject to the upper limit discussed above), there may be periods where an assurance engagement is needed due to increased risks. Examples are where significant cash or other liquid assets are held; where the volume of transactions is increased (e.g. on start-up or where a property is being developed or renovated); or where there have been compliance or other issues related to the management of the scheme or custody of its assets.

We therefore consider that an exemption should apply on the condition that an assurance engagement is obtained when the supervisor considers the value to investors outweighs the costs. We think it is appropriate for supervisors to make this decision given they are licensed, independent from the manager and have statutory duties that require them to act honestly, in the best interests of scheme participants and to a professional standard of care.

Cash reconciliation

Exemption considered

The Financial Markets Conduct Regulations 2014 require property scheme custodians to reconcile cash records daily. We considered whether daily reconciliation is appropriate for a property scheme and whether cash could instead be reconciled at a frequency appropriate in the circumstances.

Impact analysis

For much of a property scheme's life there is typically a low volume and frequency of cash transactions. The volume and frequency of transactions may be greater in the start-up period or where a property is developed, renovated or realised and the scheme is wound up.

Decision and reasons

In these circumstances, for much of a property scheme's life daily cash reconciliation would be unlikely to provide any useful information. It would also result in unnecessary compliance costs. At some stages of a scheme's life, daily cash reconciliations would provide protection for investors. What is required may vary from scheme to scheme and change during the life span of a scheme.

We therefore consider that cash reconciliations should be done at a frequency that is appropriate to ensure that the records accurately state the scheme money held and all related transactions. This discretion should be left with the custodian, acting as a professional and prudent custodian.

Summary assessment of options against objectives

	Option 1: Exemption	Option 2: No exemption (status quo)
Promotes confident and informed participation of businesses, investors, and consumers in the financial markets	Property schemes and investors will be able to confidently transition and operate under the FMC Act regime with governance obligations and compliance costs that are commensurate with the risks to investors. ✓✓	Unnecessary compliance costs (that are not anticipated for existing schemes) may affect whether schemes transition to and operate under the FMC Act regime. ✘
Ensures appropriate governance arrangements apply to allow effective monitoring and reduce governance risks	Property schemes will have tailored governance obligations that suit their unique characteristics and the risks to investors. ✓✓	Some standard governance obligations will be burdensome for property schemes without leading to effective monitoring or reducing risks to investors. ✘
Avoids unnecessary compliance costs	Property schemes and investors will avoid unnecessary compliance costs from governance obligations that do not lead to effective monitoring or reduce risks to investors. ✓✓	Property schemes and investors will incur unnecessary compliance costs complying with governance obligations that do not lead to effective monitoring or reduce risks to investors. ✘
Promotes flexibility in the financial markets	Property schemes will have flexibility to retain some existing governance arrangements where they provide adequate protection for investors. ✓✓	Property schemes will have to comply with standard governance obligations. ✘
Not broader than reasonably necessary to address the problem	The exemptions only apply to property schemes and are subject to appropriate thresholds and alternative requirements. ✓✓	n/a

Key

- ✓✓ Meets the policy objectives
- ✓ Partially meets the policy objectives
- ✘ Does not meet the policy objectives

Consultation

Consultation process

In December 2015, we published a [Consultation Paper: Proposed exemptions for existing property schemes](#) to seek feedback on proposals for relief. The submissions received are summarised below.²

We also carried out further extensive consultation with submitters, and other market participants (including property managers and supervisors and their advisers), as we further developed the proposals and settled a notice to give effect to them. During this process, we identified new issues including the need for further relief from the custodian's obligation to obtain an annual assurance engagement and from the requirement for daily cash reconciliation.

Consultation Paper submissions - independent custody exemptions

We received written submissions on our consultation paper in relation to the independent custody exemption from:

Chapman Tripp;

Covenant Trustees;

BDO New Zealand Limited.

² While we consulted on additional class relief for property schemes in wind-up this did not result in a class exemption and therefore submissions on this aspect of the consultation paper are not summarised in this RIS.

Summary of submissions

Independent custody exemption proposal

Requiring existing schemes to transfer property to an independent licensed supervisor or custodian would likely impose additional costs that are not warranted if alternative safeguards can be put in place to protect investors' interests.

An encumbrance or caveat would provide adequate protection in the context of real property assets

Do not want liabilities under other legislation (health and safety, resource consent) to potentially transfer to the supervisor

For some Australian-based property schemes the supervisor already holds mortgage security over the properties. If the scheme property is required to be transferred to a supervisor or custodian there will be significant costs and the potential to adversely impact on the financial benefits of the scheme (i.e. potential tax consequences). Continued holding of mortgage security only would provide adequate safeguards.
