Consultation – 6 July 2015

Draft guidance on risk indicators and descriptions of managed funds

In December 2014 we consulted on guidance for calculating risk indicators. After consultations, feedback and subsequent discussions with businesses who have been involved in producing draft product disclosure statements, we believe it would be useful to extend that guidance note to cover additional related matters. There is no material change to the earlier guidance but we have added three sections. They are: ‘Describing the volatility of managed funds’, ‘Updating a PDS for a change in risk category’ and ‘Naming conventions for funds’. We are now consulting on this revised guidance on risk indicators and descriptions of managed funds.

We invite you to review our proposed guidance and share your feedback with us. We welcome general comments and have also included a number of questions seeking specific feedback. Your response will be used to consider whether further guidance may be useful or necessary, and inform the final guidance note. It may also highlight further areas where guidance may be useful or necessary.

Submissions close on Friday, 14 August 2015. The form at the back provides more details.

About this consultation:

This consultation is for: market participants who manage funds, their supervisors and investors.	It aims to: provide additional guidance related to risk indicators and the description of managed funds following our December 2014 consultation.

Document history

This version was issued in July 2015 and is based on legislation and regulations as at the date of issue.

It incorporates additional guidance into the original consultation paper issued in December 2014 by providing guidelines for the description of risk and managed funds .

FMA document reference code 2627773

Contents

About this guidance note

1. This guidance note is primarily for managers and supervisors. It gives guidance on your statutory obligations when you provide a risk indicator for your fund.
2. It also gives guidance on our expectation of the approach you use in any product disclosure statement (PDS), Disclose register entry, or fund update to:
   a. calculate and present the risk indicator
   b. describe your fund's volatility
   c. update a PDS when there is a change in the risk category
   d. name your fund

Background

3. Risk indicators and risk indicator diagrams are an important element of the disclosure requirements for managed funds under the Financial Markets Conduct Act 2013 (FMC Act) and the Financial Markets Conduct Regulations 2014 (the regulations). Managers are required to include the risk indicator for a managed fund in the PDS[1] and as an entry in the Disclose register when the PDS is lodged[2]. This information must also be provided in each fund update[3] and in the corresponding Disclose register update[4].
4. The purpose of the risk indicator is to provide investors with a simple tool that shows the historical volatility of returns of the fund. The risk indicator is intended to help investors make decisions by providing them with a way to compare the volatility between various managed investment scheme (MIS) products. Inappropriate naming conventions for a fund or descriptions of the fund's volatility could undermine the benefits of the risk indicator.
5. The regulations allow us to issue frameworks or methodologies (FM) for risk indicators. Our view, however, is that a guidance note is more appropriate at this time. The risk indicator requirements are based on European standards. This guidance explains how you can use the European standards to help prepare the risk indicator for your fund.
6. The guidance also addresses how to approach the description of risk categories and how to avoid confusing or misleading investors when naming your funds. The guidance also sets out our expectations on when managers should update the PDS when there are changes to the risk indicator.

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[1] FMC Regulations schedule 4, cl 25-29
[2] FMC Regulations schedule 4, cl 53(1)(c)(ii)
[3] FMC Regulations schedule 4, cl 58(1)
[4] FMC Regulations schedule 4, cl 54(1)(a)(i)

Your obligations related to risk indicators

7. Schedule 4 of the regulations (schedule 4) provides the legislative requirements for how the risk indicator diagram should look[5], how the indicator should be calculated[6], and when alternative methods must be used to determine risk indicators[7]. Each time the risk indicator is included in the PDS, fund update or on Disclose, the presentation should be consistent and in line with the legislation.

8. This part of the guidance focuses on the methodology for calculating the risk indicator. The FMA will specify the format and presentation of the risk indicator in more detail when we provide a template for fund updates. The fund update template is expected to be available once the new regulations have been made at the end of 2015. Managers who are required to provide a fund update under the FMC Act before that time should set out the information as prescribed in the regulations. If you have concerns about your fund update, contact the FMA to discuss your proposed approach.

9. The regulations require you to calculate a risk indicator that is relevant for your fund, using different approaches for different situations. The methodologies include:

    a. a general methodology for calculating the volatility for a managed fund using the standard deviation for past changes in weekly or monthly returns (clause 6 methodology):

        i for funds with a performance history of at least five years, the calculation is based on the latest five years of fund returns (full history funds)[8]; and

        ii for funds that do not have a sufficient return history (short history funds), either because their investment policy is now significantly different, or because the fund is less than five years old, the calculation is based partly on fund returns, and partly on the returns of a relevant market index (index)[9]

    b. an alternative methodology for calculating volatility when the cl 6 methodology results in an inappropriate risk indicator. This applies when a risk indicator calculated using the cl 6 methodology is likely to mislead or deceive investors. The risk indicator calculated by an alternative method must accurately reflect the future volatility of the fund[10].

10. The New Zealand legislative requirements related to risk indicators are based on 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). [11] 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

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[5] FMC Regulations schedule 4, cl 5
[6] FMC Regulations schedule 4, cl 6-7
[7] FMC Regulations schedule 4, cl 8
[8] FMC Regulations schedule 4, cl 6(1)
[9] FMC Regulations schedule 4, cl 6(2)
[10] FMC Regulations schedule 4, cl 8
[11] CESR's guidelines on the methodology for the calculation of the synthetic risk and reward indicator in the Key Investor Information Document, Committee of European Securities Regulators, 1 July 2010, CESR/10-673

Clause 6 methodology will apply to most managed funds

11. The regulations require the risk indicator to be based on annualised standard deviations calculated using the change in returns from week to week or (if not available) from month to month over five years. This is essentially a measure of how volatile the returns have been over the relevant period. The more the actual weekly or monthly return differs from the average weekly or monthly return, the higher the standard deviation and the higher the volatility. This clause 6 methodology will result in a reasonable indication of volatility for most managed funds and you must use this method unless it results in an indicator that is likely to mislead or deceive investors.
12. The CESR Guidelines are useful to help you meet your FMC Regulations requirements. They provide additional details for managers, including setting a standard deviation formula and defining the variables that will produce a risk indicator as required by the cl 6[12] methodology. The CESR Guidelines show a diagram[13] that meets the requirements and description of the risk indicator diagram required by cl 5 of schedule 4 of the regulations. The CESR Guidelines[14] also use the same risk categories as those listed by the regulations (from 1-7) to determine a fund's volatility, or risk.
13. The regulations require adjustments to the risk indicator calculations when the fund is not a full history fund or when there is insufficient relevant performance history for calculating five years of returns. The adjustment involves identifying an index that is appropriate for assessing the type of assets relevant to the fund. This index needs to either be widely recognised or used, or administered by a person not connected with the scheme.[15] The index returns are then used as a proxy for the returns of the short history fund given its lack of performance history or to reflect a period of significant difference in investment policy.[16]
14. Although the CESR Guidelines have different requirements for the choice of index, they are useful for their detailed description of the reasons and methods behind the 'short history adjustments'[17].

If clause 6 methodology is likely to mislead, use an alternative

15. If the nature of your managed fund is such that the clause 6 methodology is likely to result in a misleading or deceptive risk indicator, you are required to use a method that you consider will produce a risk indicator that accurately reflects the potential future volatility of the fund[18]. In other words, you have an obligation to assess whether the clause 6 methodology will work for your fund and if not, to make a reasonable choice of alternative methodology when calculating your risk indicator.
16. The regulations do not prescribe alternative methodologies if the clause 6 methodology is not appropriate for your fund. In contrast, the CESR Guidelines do provide specific alternative methodologies for certain categories of fund. We recommend you use the Guidelines as a resource when you are looking for a reasonable method to calculate the risk indicator if your fund is one of the identified categories.

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[12] FMC Regulations schedule 4, cl 6(1)(a) and the CESR Guidelines (box 1), page 5
[13] CESR Guidelines (Box 1), page 5
[14] FMC Regulations schedule 4, cl 6(1)(b) and the CESR Guidelines (box 2) page 7
[15] FMC Regulations schedule 4, cl 61
[16] FMC Regulations schedule 4, cl 5(2) and the CESR Guidelines (box 4), page 9
[17] CESR Guidelines (Box 4), page 9
[18] FMC Regulations schedule 4, cl 8

17. The CESR Guidelines set out four alternative methodologies for funds that may require adjustments to the risk indicator calculation because of the nature of the fund:

    a. Absolute return funds[19]: funds managed according to investment policies or strategies based on a variable allocation of the portfolio of the fund across asset classes. They have constraints of a predetermined risk limit.

    b. Total return funds[20]: funds managed according to investment policies or strategies focused on certain reward objectives by participating (through flexible investment) in different financial asset classes.

    c. Life cycle funds[21]: funds managed according to investment policies or strategies. Over time, their portfolio allocation might shift from equity to fixed-income assets, based on some pre-determined rules, or as a target maturity date approaches.

    d. Structured funds[22]: managed funds that provide investors, at certain predetermined dates, with algorithm-based payoffs that are linked to the performance, or when price changes provide gains, or when there are changes to the financial assets, indices or reference portfolios.

18. In our view, the CESR's methodologies are appropriate alternatives for calculating risk indicators for funds in the identified categories. We expect managers of these funds to use the CESR Guidelines when they need alternative methods to calculate a risk indicator of the fund. Risk indicators that are widely used and based on the same methodology will provide investors with a consistent comparison between funds.

Calculating risk indicators when prescribed or identified methodologies are likely to mislead

19. It is possible that you might not be able to find an acceptable risk indicator for your particular fund from the methodologies set out in the regulations and the CESR Guidelines. All the methodologies may result in a misleading or deceptive risk indicator. This could happen if your fund is not a typical market fund, or is not one of those identified for a CESR methodology. In some cases, the methodologies might be unacceptable even if your fund is a type anticipated under the regulations or specified in the CESR Guidelines.

20. In every case, your overriding obligation under the legislation is to determine a risk indicator that reflects the potential future volatility of the fund. If the clause 6 methodology and the CESR alternative methodologies do not work for your fund, you must use a different method to calculate your fund's volatility. If you have concerns about the methodology to use or the resulting calculations, it is important to talk to us to present and explain your proposals. We will be happy to discuss the options and the issues with you.

[19] CESR Guidelines (Box 5), page 10
[20] CESR Guidelines (Box 6), page 11
[21] CESR Guidelines (Box 7), page 12
[22] CESR Guidelines (Box 8), page 13

Describing the volatility of managed funds

21. The regulations prescribe certain wording which must be used in a PDS and fund update to help investors understand the risk indicator. Currently the seven compulsory risk categories that are assigned a numerical value in the regulations can also be described in words. For example, a fund with a risk category of 4 could include a description in its Key Information Summary (KIS) saying 'this fund has a medium to high level of volatility.' In contrast, a different fund may describe the same 4 category as having a 'low to medium' level of volatility. As the examples show, the same numerical risk category can potentially be described differently for different funds. This is because there are no standard risk category descriptions prescribed by the regulations.
22. The regulations do not require managers to describe the risk ranking of their fund in words. In our view, different descriptions for the same risk category may be confusing and misleading for investors. Different descriptions will also interfere with the comparability of risk categories between funds.
23. To address these concerns, we have developed a standardised description of risk categories set out in the table below. If a manager chooses to use words to describe a fund's volatility, they should use this consistent terminology in their ratings description to facilitate risk comparisons between funds, and to ensure investors are not misled.

Risk category	Annualised standard deviation[23]	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

Questions:

Q1: Do you think the suggested Descriptions of volatility accurately reflect the Risk category numbers?

Q2: If your answer to Q1 is no, please explain why and describe the alternative risk descriptions that you consider would be more appropriate.

[23] FMC Regulations schedule 4, cl 6(1)(b)

Updating a PDS for a change in risk category

24. You must not offer, or continue to offer, interests in a managed fund if information in the PDS has become false or misleading, or is likely to mislead[24]. A change in the risk category of the fund is, however, unlikely on its own, to cause the PDS to be misleading. One reason for this is the regulations anticipate that the risk indicator may change. The PDS is required to contain language saying: '*While risk indicators are usually relatively stable, they do shift from time to time. You can see the most recent risk indicator in the latest fund update for this fund.*'[25]

25. Although not every change in the risk indicator will mean a change to the PDS, there may be cases when changes in the risk indicator are significant. This would make the information in the PDS potentially misleading and the PDS would need to be updated before further interests in the fund are issued. In our view, the PDS would need to be updated if:

    a. the risk category 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 regulation 56(1) of the regulations)

    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 reg56(2) of the regulations)

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

26. The Ministry of Business, Innovation & Employment is considering amendments to the regulations to allow for different formats of PDS for managed funds. This may include provisions to allow fund updates to be used to satisfy requirements for fund-level information at the point of sale, either as a separate supplement to the PDS, or as part of the PDS. If the information delivered to an investor at the point of sale was to include an updated risk indicator in a fund update, then we would treat this as if that risk indicator was contained in the PDS itself.

Questions

Q3: Do you agree that a PDS needs to be updated in the above circumstances? If not, when do you think a PDS should be updated to reflect a change in risk category, and why?

We are also interested in comments related to the balance between the cost of providing PDS updates against the benefits of ensuring investors are likely to make investment decisions based on up-to-date risk information.

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[24] FMC Act section 82

[25] FMC Regulations schedule 4, cl 26(2)(c)

Naming conventions for funds

27. 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 fund characteristics are not permitted to call funds by a name that is misleading, for example, if it misrepresents the types of products that the fund may invest in.

28. When there is already a consistent market approach for certain names such as 'conservative fund' or 'balanced fund', managers should take extra care to ensure their use of such names is not misleading. We encourage managers to avoid using the following names if their investment policy doesn't match the usual characteristics of such funds:

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.

29. The descriptions in the table provide a guide on what's normally expected of a fund based on its given name. Other factors, however, must be taken into account to ensure the names are not misleading. For example, managers should be careful in interpreting whether an asset is a growth asset (generally shares and property) or an income asset (generally cash and bonds), and whether the use of such terms is in line with the general understanding of those terms. This ensures the name of the fund is not misleading when the actual asset mix is taken into account.

30. We cannot give definitive guidance on all names that might be misleading, but we would be happy to hear from managers, as they move into the FMC Act regime, if they have any concerns about their naming conventions.

Questions

Q4: Do you agree with our approach to the naming conventions for funds? If not, why, and what approach would you suggest?

Q5: Would this guidance cause you to change the names of any of your funds when you make a transition to the FMC Act regime? If so, what are the costs associated with this?

Terms used

CESR	Committee of European Securities Regulators CESR provided technical advice on securities markets to the European Commission until it was replaced by the ESMA as the European regulatory authority
Disclose Register	The register administered by the Companies Office that contains two registers established under the FMC Act: the register of offers of financial products and the register for managed investment schemes: http://www.business.govt.nz/disclose
ESMA	European Securities and Markets Authority ESMA is the regulator for the EU that has a role similar to the FMA's role in New Zealand
FM	Frameworks or methodologies are notices issued by FMA under subpart 4 of part 9 of the FMC Act
FMA	Financial Markets Authority
FMC Act	Financial Markets Conduct Act 2013
Fund update	A fund update prepared under reg56-61 of the regulations
Managed funds MIS	A managed fund MIS as defined in reg5 of the regulations
Manager	Manager of a registered managed investment scheme, including in the case of a restricted scheme, the trustees of that scheme
MIS	A managed investment scheme that is registered on the MIS register and defined in section 9 of the FMC Act
PDS	Product Disclosure Statement for a regulated offer as defined in section 41 of the FMC Act
Registered scheme	A managed investment scheme registered on the register of managed investment schemes under the FMC Act
Regulations	Financial Markets Conduct Regulations 2014
Restricted scheme	A KiwiSaver, superannuation, or workplace savings scheme that has restricted membership, is closed to new members, and registered as a restricted scheme A restricted scheme does not need a licensed manager or a licensed supervisor, but must instead have a licensed independent trustee All restricted schemes are managed investment schemes
Risk Indicator	The value calculated under cl 5-8 of schedule 4 of the regulations
Synthetic risk and reward indicator (SRRI)	The term used in the CESR Guidelines that is equivalent to the term risk indicator in New Zealand legislation
Supervisor	Supervisor of managed investment schemes as defined in section 6(1) of the FMC Act

Feedback form

Feedback: Guidance on risk indicators and description of managed funds	
Please submit this feedback form electronically in both PDF and MS Word formats and email it to us at consultation@fma.govt.nz with '**Feedback re guidance on risk indicators and description of managed funds: [Your entity name]**' in the subject line. Thank you. We seek comments by **14 August 2015**.	
Date: Number of pages: Name of submitter: Company or entity: Organisation type: Contact name (if different): Contact email and Phone:	
Question #	**Comment**
1.	
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5.	
Any other comments	
Feedback Summary – if you wish to highlight anything in particular	
Please note: Feedback received is subject to the Official Information Act 1982. We may make submissions available on our website, compile a summary of submissions, or draw attention to individual submissions in internal or external reports. If you want us to withhold any commercially sensitive or proprietary information in your submission, please clearly state this and note the specific section. We will consider your request in line with our obligations under the Official Information Act.	
Thank you for your feedback – we appreciate your time and input.	

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July 2015

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