

25 January 2017

# Regulatory Impact Statement – Forestry schemes

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

It discusses exemptions granted to forestry schemes.

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# Executive summary

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This Regulatory Impact Statement (RIS) discusses exemptions we have granted to forestry schemes from governance and some other 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 forestry schemes. Forestry 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 weighed against the compliance burden and associated costs.

This document analyses the exemption options considered, their impacts and the reasons for our decisions. Assessments were made based on the purposes of the FMC Act, including whether compliance costs are unreasonable.

After careful consideration of both regulatory and non-regulatory impacts, we decided to grant the following exemptions:

## Managers and supervisors

- Licensing and updating governing documents: managers of existing closed forestry schemes (where the manager has less than \$40 million registered forestry schemes assets under management) are exempt from the requirement to be licensed, and to update governing documents.
- Custody: managers and supervisors of existing closed forestry schemes are also exempt from the requirement that the scheme's supervisor or an independent person holds real property assets and carbon credits. However there needs to be a registered security interest over that property in favour of the supervisor.
- Routine reports: managers of existing and new forestry schemes are exempt from routine quarterly limit break reporting during dormant periods.
- Corporate general partner: corporate general partners of some forestry schemes that are limited partnerships are exempt from disclosure, governance and financial reporting obligations relating to shares in the general partner held or offered to scheme participants.

## Custodians

- Cash reconciliation: custodians of existing or new forestry 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 forestry schemes 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 an annual assurance engagement is obtained when required by the supervisor.

# Objectives

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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 exemptions we grant must promote one or more of the purposes of the FMC Act regime. These 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, the extent of the 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 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 have compared the exemption options against the status quo (no exemption).

We considered the following stakeholders' interests:

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



# Exemption relief considered

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## Licensing and governing documents

### Exemption considered

The licensing regime enables us to assess and ensure that minimum standards appropriate for managers are met, and helps us to consider whether managers are competent and have good systems and processes in place. Governing documents that conform with the standards set out in the FMC Act provide for good governance and hold managers to account.

We have considered whether for existing small closed forestry schemes the compliance costs of licensing and updating governing documents outweigh the benefits for investors. We looked at the following factors to identify the impact on stakeholders:

- level of manager activity
- value of assets under management
- impact of compliance costs.

The starting point is that the FMC Act applies to all managed investment schemes, and not just managed funds. We consider that an exemption will only be appropriate if there are features of forestry schemes that distinguish them from other types of managed investment schemes, and therefore support an exemption from manager licensing and requirements to update governing documents.

### Impact analysis

#### *Level of manager activity*

As licensing is an assessment of manager competence, we considered the level of manager activity required of forestry scheme managers. Forestry schemes have very little activity for much of their lives. They are typically dormant after pruning and thinning work is completed, and before harvest. In contrast, property and agricultural schemes, while having less activity than a typical managed fund, will have some on-going activity to manage.

Forestry schemes also have a lower volume and less frequent transactions than some other managed investment schemes. Typically transactions occur quarterly or less frequently for schemes with dormant forests. This compares with monthly transactions for many property schemes, and daily transactions for managed funds. Forestry schemes, like property schemes, also have little, if any, turnover of real property assets (which make up the majority of the scheme property).

#### *Value of assets under management*

As the number of schemes a forestry manager manages increases, the level of activity required by the manager also increases. Risk increases with increased scheme assets under management and the increased level of risk means investors benefit more from manager licensing. It is, therefore, more important that a manager with significant assets under management has been assessed through the licensing process; is subject to monitoring; and that the scheme has updated governance documents to meet the new requirements.

### *Current population*

Forestry schemes are a limited group, and there is a natural divide in the current population between several large managers, and the managers of small closed schemes. A feature of these smaller forestry managers is that they are part of a 'sunset industry' for retail investment. These schemes were generally set up in the 1980s and 90s, and there have been very few, if any, small retail forestry schemes set up since. The existing schemes are closed to new investors, and their managers are not offering new schemes. These managers manage no more than eight schemes, and most commonly between two and four.

Harvest for these existing small forestry schemes will occur, with one exception, in 10 years' time or sooner. This is relevant when balancing the benefits of compliance against the impact of costs. For schemes close to harvest and winding up, there is a shorter period when investors in the schemes will be subject to the risks raised where the manager is not licensed, and where governing documents are not updated.

We have also taken into account the impact that harvest planning and management has on likely investor returns. Harvest management requires significant expertise to address timing, transport and land management challenges. Managers will often contract in technical expertise; however, the manager will be responsible for selecting competent contractors and overseeing the process.

### *Protections remain in place*

We have also considered that providing an exemption from manager licensing obligations will not relieve managers from the governance obligations and duties under the FMC Act. Managers will still have a duty to act honestly and in the best interests of investors. They must exercise the care, diligence and skill that a prudent person engaged in that profession would exercise in the same circumstances. Managers will also be subject to oversight by the independent licensed supervisor and bound by the provisions of the governing document.

### *Impact of compliance costs*

Manager licence applicants must pay an application fee and licensed managers must pay annual levies. Applicants also need to review systems and processes, and may need to implement new systems or improve existing ones. They may also need to pay for advice to complete their application.

Some managers have raised concerns that they will have serious difficulty sourcing funds to pay these compliance costs. They have told us that the cost of complying with the new licensing and governing document obligations is likely to have the greatest impact on small schemes. In particular, some schemes were set up with no expectation that investors would be called upon to contribute further funding. Another concern is that as forests under management are harvested and schemes wound up, compliance costs will need to be spread between fewer schemes and will therefore have a greater impact on investor returns.

We acknowledge concerns about compliance costs are serious. We note however that:

*In some cases, costs may be warranted and lead to important improvements:* Costs may vary significantly and depend on existing systems and competencies. If systems and competence are poor, it is important these issues are addressed. We accept, and expect, higher costs will be necessary and appropriate.

*Costs of licensing will be commensurate with the size of the scheme and the risk the manager poses:* The licensing process is designed to be flexible and not 'one size fits all'. What is required to meet the minimum standards necessary to obtain a licence is scaled according to the size of the scheme the applicant manages, and the degree of risk raised by the application. Extensive legal advice should not be required to apply for a

licence. We expect managers will generally be able to provide information on why their systems and process are appropriate without significant professional assistance.

Levies for managers are also scaled, based on the amount under management, starting at \$2,000. The FMC Act therefore anticipates that even managers with smaller amounts under management (nil to \$20 million) must get licensed, and pay levies and scales these levies appropriately. We note that levies will reduce as forests are harvested and wound up, and the manager drops a levy category in terms of total assets under management.

*We are helping the industry to keep costs as low as possible:* We have produced a licensing guide to help forestry scheme managers understand licensing requirements, and thereby reduce the need for professional advice.

### ***Updating governing documents***

We have considered the requirement to update governing documents along with manager licensing. The FMC Act requires governing documents to prescribe rules for certain key management and governance activities. These include:

- rules about acquiring, disposing of and redeeming investors' interests
- what contributions investors have to pay
- how scheme benefits are calculated, allocated and paid to investors
- the fees and expenses that are payable to the manager
- the appointment and removal of the supervisor and the manager
- the process for winding up.

These rules provide investors with important protections by limiting the manager's discretion to manage. The supervisor is also able to monitor the manager's performance against these rules.

These requirements are broadly similar to the requirements which have already been incorporated in the deeds of participation for existing forestry schemes (as required by the Securities Act regime). However, we recognise that even though some of the FMC Act content may be already contained in schemes' governing documents, reviewing and updating the documents where necessary comes at a cost that may be disproportionate to the benefits for small schemes with a finite life.

The exemption means smaller schemes will avoid the costs of reviewing and updating governing documents in circumstances where the majority of the benefits of the new requirements for governing documents are already in place.

### **Decision and reasons**

We think, generally, managers of managed investment schemes, including forestry scheme managers, should be licensed. This is because the purpose of the licensing regime is to enable us to assess and ensure that minimum standards appropriate for managers are met to protect investors' interests. Similarly, we think that in most cases, schemes should have governing documents that conform with the standards set out in the FMC Act because they will provide for good governance and ensure managers are accountable.

However, we consider exemptions from these requirements are appropriate for managers of closed schemes where the combined value of assets under management for that manager for all registered forestry schemes is \$40 million or less. The exemption takes into account the low level of manager activity for much of the schemes' lives, and the fact the schemes are closed to new members.

We consider an exemption is not appropriate for managers where the total value under management is more than \$40m. These managers are likely to manage a high number of schemes, and have a high level of manager activity with resulting increased risk.

In reviewing the level where we consider costs outweigh benefits, we have focused on the forest value and period under management, and the level of manager activity. The fact schemes are closed to new members, and there is a finite time to run until harvest and wind up is also relevant.

There are several managers who have only a small number of schemes under management that are closed to new investors. Little manager activity is required for these schemes for much of their remaining lives, apart from harvest. In addition, schemes will harvest their forests progressively, and in time this will further reduce manager activity and the value of assets under management.

## Custody of real property and carbon credits

### 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 forestry schemes is not held by the supervisor or an independent custodian. Instead that property is subject to a registered encumbrance in favour of the supervisor which secures custody of the property. A forestry scheme's real property includes its land and standing timber.

We have considered whether forestry schemes should be exempted from the independent custody requirement for their real property assets, if custody of the real property can be protected by a registered encumbrance in favour of the supervisor.

Submitters have told us that if this exemption is granted, similar relief is also required for carbon credits, which must be held by the owner of the forest.

### Impact analysis

Many forestry schemes have a registered encumbrance in place in favour of the supervisor, and so would not need to transfer their real property assets to the supervisor or independent custodian if the exemption was granted. Other schemes that do not have an encumbrance in favour of the supervisor would have the option of registering an encumbrance or transferring the real property to an independent custodian.

Some submitters said the cost of transferring real property to an independent custodian would be prohibitive, particularly where there are a number of titles and other encumbrances, or bank debts secured over the property. Estimates 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 emissions trading units, and health and safety, and resource management law.

### Decision and reasons

A person who is 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 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 include a requirement that the manager of the scheme 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. Similar protection will apply to carbon credits that are subject to a registered security interest created under the Personal Property Securities Act 1999.

The special features of real property contribute to the effectiveness of an encumbrance 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 knowing. Carbon credits are also recorded on a register, which allows the interests of a security holder to be recorded.

If scheme real property and carbon credits are secured by a registered encumbrance, or security interest in favour of the supervisor, schemes are likely to avoid some unnecessary one-off and ongoing compliance costs. These options will also promote flexibility in the financial markets by enabling existing forest schemes to retain existing custody arrangements while still providing adequate protection for investors.

We therefore consider on balance that an exemption from independent custody of real property and carbon credits should apply on the condition that custody of those assets is protected by a registered encumbrance or mortgage in favour of the supervisor.

#### *Consideration of the breadth of exemption*

The independent custody exemption will only apply to real property and carbon credits of existing closed forestry schemes, and not to other schemes<sup>1</sup> or assets. There is also a condition requiring that a registered encumbrance or security interest 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 forestry schemes where most of the assets are real property and where transactions are minimal.

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<sup>1</sup> We note, however, that we have also decided to grant an exemption from independent custody requirements in relation to real property of property schemes where similar characteristics apply.

## Impact analysis

One forestry supervisor has obtained quotes for assurance engagements from auditing firms. These range 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 size schemes. We note existing schemes did not take this annual cost into the account when the schemes 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 for this check to be annual for managed funds which have frequent transactions involving scheme property. However, we consider that generally checks can be less frequent for forestry schemes because:

- 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 property records low. Most of the property held by a forestry scheme is real property, with the remaining assets mostly being carbon credits and cash. Any real property transfers are dealt with through registration of an instrument under the Land Transfer Act 1952. Carbon credits are also recorded on a public register. In addition, industry has also told us it is not in forestry schemes' interests to trade in carbon credits because they need to have a balance of credits at harvest equal to credits earned during the life of the forest. If they do not have a sufficient balance, they will need to buy extra credits. The government recently closed a loophole that enabled purchase of cheap international credits to be used to replace sale of NZ credits.
- the volume and frequency of transactions for forestry schemes is lower than for a managed fund. There is little, if any, turnover of real property assets. Forestry schemes have very little activity for much of their lives. Again, this is likely to reduce the risks of material misstatement in property records.

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

- schemes will be overseen by an independent licensed supervisor with statutory duties that include acting honestly, and 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 financial statements will provide some assurance it is still held
- some audits of the scheme, or manager's financial statements, may include a check of controls in relation to the scheme's bank account
- managers have statutory duties that include being honest and acting in the best interests of investors, and to a professional standard of care; managers must also be licensed (unless an exemption applies).

Although we do not consider that annual assurance engagements are required annually throughout a forestry scheme's life, there are likely to 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 (eg, on start-up or at harvest); 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 but that this should be on the condition that an assurance engagement is obtained when required by the supervisor (ie, where the supervisor considers the value to investors outweighs the costs). We think it is appropriate for the supervisor to make this decision given they are licensed,

independent from the manager, and have statutory duties that require them to act honestly and in the best interests of scheme participants, and to act to a professional standard of care.

## Cash reconciliation

### Exemption considered

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

### Impact analysis

For much of a forestry scheme's life, as discussed above, there is typically a very low volume and frequency of cash transactions. The volume and frequency of transactions is greater in the start-up period when planting, pruning and thinning work is done. In the period in-between, which extends over many years, there is typically a very low volume and frequency of transactions. During harvest, the volume will increase, and the frequency during harvest may vary as well depending on the stage of harvest.

### Decision and reasons

In these circumstances, for much of a forestry scheme's life, daily cash reconciliation would not provide any useful information and would impose unnecessary compliance costs. At some stages of a scheme's life, more frequent cash reconciliations would provide protection for investors, but this will vary over its life, and between schemes. We consider, therefore, that cash reconciliation should be done at a frequency that is appropriate. This discretion should be left with the custodian, acting as a professional and prudent custodian, to ensure that the custodian's records accurately state its holdings of scheme's money and all transactions relating to that money.

## Other technical exemptions

### Exemptions considered

We have also considered various technical compliance issues raised by the industry, and have identified two further exemptions for forestry schemes managers from:

- the obligation to report quarterly on statement of investment policies and objectives (SIPO) limit breaks (see below) in dormant periods
- disclosure and financial reporting obligations for corporate general partners of a limited partnership.

#### *SIPO limit break reporting*

A manager must report on any departures from the SIPO. The SIPO describes how the manager will manage the scheme and sets out the investment objectives and parameters for the scheme. It enables a supervisor to ensure a manager is managing investments within established parameters.

Departures from the SIPO are referred to as 'limit breaks'. If a material limit break is not corrected within five days, managers are obliged to report these to the supervisor immediately. Managers must also report quarterly to the supervisor about any material limit breaks (including any that were remedied within five days). It is these quarterly reports that our exemption proposal addresses.

It is likely there will be minimal activity in some years of a forest's life. Given this, there may often be nothing to report in the quarterly limit break reports, with the result that there are likely to be many 'nil reports'. We consider it appropriate to provide an exemption from quarterly limit break reporting.

#### *Corporate general partner reporting*

Under the Act, issuers of regulated products have disclosure and financial reporting obligations. Under the structure used by one large forestry manager, there will be two issuers of regulated products, although in substance investors only invest in one scheme. This structure involves use of a limited partnership which has a company as the general partner. Investors in the limited partnership are issued shares in the general partner, along with the interests in the scheme. The purpose of the structure is to give investors decision-making rights through their shareholding in the general partner.

The general partner does not hold any assets or carry on any business. Notwithstanding this, the general partner would have product disclosure statement (PDS), and register disclosure obligations as an issuer of equity securities. In addition, if the general partner has 50 or more shareholders then it will be an FMC reporting entity, and so have financial reporting obligations.

#### *Impact analysis and decision*

Nil limit break reports have very little value for the supervisor and investors in times when schemes are dormant. They create unnecessary compliance costs.

As the manager must still report on any material limit breaks that are not corrected within five days, the supervisor will be informed if major compliance problems exist. Routine quarterly limit break reports that are nil reports do not add any extra value.

Similarly, a PDS and ongoing disclosure and financial reports on the general partner and its shares are unlikely to provide any useful information. This is especially so where the general partner has no assets, and no business or activities, other than acting as general partner of the limited partnership. Investors will still receive disclosure and financial reporting information about the scheme.

We therefore consider on balance that exemptions should be granted in respect of SIPO limit break reporting and corporate general partner reporting.

## Summary assessment of options against objectives

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

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## Consultation process

We published a consultation paper seeking feedback on proposals for relief for forestry schemes in December 2015: see [Consultation Paper: Forestry scheme issues and exemption proposals](#). Submissions received are summarised below.

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

## Initial consultation document submissions

We received written submissions on our initial consultation paper from:

Forest Enterprises Limited

Franklin Rural Management Limited

Ogle Consulting Ltd/ Southern Forestry Ltd

Warren Forestry Ltd

Arbor Management Limited

Silverwood Corporation Limited

Clout Forests Limited

DLA Piper

BDO New Zealand Limited

# Summary of submissions

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Issue	Summary of various submissions
<p>Licensing and governing document updates are not required for managers of smaller schemes</p>	<p>This is a sunset industry</p> <p>These schemes have sufficient governance and other protections in place and have operated without any problems for a long time</p> <p>Compliance costs will be disproportionate and will have a significant impact on investors' returns</p> <p>Thresholds suggested were all closed schemes, schemes with fewer than 25 and 35 investors, and less than \$4 million accumulated cost. Do not limit to schemes within a year of wind up, as very few schemes are in that position</p> <p>No exemption – there is a risk of mismanagement</p>
<p>Custody of real property</p>	<p>Unnecessary to transfer custody of real property to a custodian if there is a registered encumbrance in favour of the custodian or supervisor</p> <p>Do not want liabilities under other legislation (health and safety, emissions trading, resource consent) to potentially transfer to the supervisor</p>
<p>Statement of investment policy and objectives and limit break reporting</p>	<p>SIPO and routine limit break reporting will not provide any useful information</p>
<p>Disclosure and financial reporting for a general partner</p>	<p>Investors will receive disclosure and financial statements for their interest in the partnership, and there will be no value in also providing information on the general partner</p>