NEW ZEALAND BANKERS ASSOCIATION

Submission

to the

Financial Markets Authority

on the

Consultation Paper: Draft guidance on disclosure of certain fees and returns by managed funds

27 November 2015

NEW ZEALAND BANKERS ASSOCIATION
Level 15, 80 The Terrace, PO Box 3043, Wellington 6140, New Zealand
TELEPHONE +64 4 802 3358 FACSIMILE +64 4 473 1698 EMAIL nzba@nzba.org.nz WEB www.nzba.org.nz

Submission by the New Zealand Bankers' Association to the Financial Markets Authority on the Consultation Paper: Draft guidance on disclosure of certain fees and returns by managed funds

About NZBA

1. NZBA works on behalf of the New Zealand banking industry in conjunction with its member banks. NZBA develops and promotes policy outcomes which contribute to a strong and stable banking system that benefits New Zealanders and the New Zealand economy.

2. The following fifteen registered banks in New Zealand are members of NZBA:
   - ANZ Bank New Zealand Limited
   - ASB Bank Limited
   - Bank of China (NZ) Limited
   - Bank of New Zealand
   - Bank of Tokyo-Mitsubishi, UFJ
   - Citibank, N.A.
   - The Co-operative Bank Limited
   - Heartland Bank Limited
   - The Hongkong and Shanghai Banking Corporation Limited
   - JPMorgan Chase Bank, N.A.
   - Kiwibank Limited
   - Rabobank New Zealand Limited
   - SBS Bank
   - TSB Bank Limited
   - Westpac New Zealand Limited.

Background

3. NZBA is grateful for the opportunity to submit to the Financial Markets Authority (**FMA**) on the Consultation Paper: Draft guidance on disclosure of certain fees and returns by managed funds (**the Guidance**) in relation to the Financial Markets Conduct Act 2013 and the Financial Markets Conduct Regulations 2014 (**the FMC Act regime**).

4. The process around the development of the FMC Act regime has been a good example of policy development that has actively involved the industry. NZBA commends the ongoing commitment to meaningful consultation and engagement and appreciates the invitation to participate in this consultation.

5. The following submission provides responses to the questions posed in the Guidance.

6. If you would like to discuss any aspect of the submission further, please contact:

Antony Buick-Constable
Policy Director & Legal Counsel
04 802 3351 / 021 255 4043
antony.buick-contsable@nzba.org.nz

Executive summary

7. NZBA and its members generally support the Guidance, as it should promote consistency in application by the market and therefore comparability for investors.

8. In order for the Guidance to actually achieve consistent market practice, it should either stipulate a formula for how returns must be calculated, or specify an industry standard (e.g. Morningstar) be followed. Otherwise, it runs the risk of participants applying their own formula and returns being calculated differently, and ultimately no consistency/comparability.

9. A further characteristic which generally indicates investment in an underlying fund should be added to the list under paragraph 14 of the Guidance, namely wholesale funds (where not already picked up by other characteristics in the list, for the avoidance of doubt). Furthermore, the inclusion of subparagraph (e) "an investment in a listed or unlisted property fund", should be deleted, and subparagraph (g) should not be linked to PIEs.

10. The sample wording proposed to disclose there is no high water mark, and to disclose a different performance fee hurdle rate, should be reworded to better aid investor understanding.

Question 1: Do you agree with our interpretation of 'accrued tax'? If not, please provide your interpretation and give your reasons.

11. Yes.

Question 2: Do you agree that 0% PIR returns should 'add back' the value of tax credits? If you disagree, please state why 0% PIR returns should reflect the returns net of tax credits?

12. In general, yes, provided that the calculation methodology for the performance of the portfolio, and any market benchmark that portfolio is compared to, are the same.[1]

13. To achieve true comparability across providers for the calculation of returns, the guidance should disclose the formula for calculating returns for PIE managed funds as:

[1] Where the calculation methodology for the market benchmark is not the same, managers should include a note to this effect in their disclosures.

(current day unit price – (Taxable income * PIR) + tax credits)/Prior unit price -1)

14. It should be noted that this is a simplified formula which is appropriate for PIEs that were newly created on/after 1 October 2007. The Guidance should cross reference the Morningstar guidance on calculating returns which is more exhaustive and considers a wider range of scenarios. Please see the response to Question 6 below.

Question 3: Are you aware of any other methods for accounting for accrued tax that are not captured under methods A, B, and C? If so, please provide details.

15. No.

Question 4: If you currently calculate 0% PIR returns using a methodology other than method A:

a) will you incur any significant expense if you change your systems and processes to be aligned with the guidance? (if possible, please quantify the initial expense and any material ongoing additional cost)

b) will the returns information that you calculate materially change if you adopt this guidance?

16. Not relevant for NZBA.

Question 5: Do you think this guidance will help investors compare 0% PIR returns and their investment decision-making?

17. It may assist to enhance comparability across providers for investors, provided the formula to calculate returns is disclosed (see the response to Question 2 above).

Question 6: For non-PIE managed funds, do you think it is necessary for us to provide guidance for methods used to calculate returns? If yes, please explain which areas you need guidance for.

18. NZBA and its members believe guidance – such as Morningstar guidance on calculating non-PIE returns – is helpful as it standardises approach the across the industry.

19. The Morningstar guidance we refer to can be found here:

Pre-tax methodology:
http://corporate.morningstar.com/au/documents/MethodologyDocuments/MethodologyPapers/NZ_PIE_Methodology.pdf

After tax methodology: http://www.mbie.govt.nz/info-services/business/business-law/past-work-older-topics/changes-to-kiwisaver/periodic-disclosure-requirements/documents-image-library/draft-regulations-list-of-submissions/Morningstar.pdf

Question 7: What other guidance do you need on the calculation of returns in fund updates or disclosure statements?

20. NZBA and its members do not believe that any further guidance is necessary.

21. However, any guidance/calculation methodology should apply industry-wide to help enable all investors to have a clear understanding of how returns are calculated (e.g. all calculations are after fees and before tax; or after tax calculated at the highest PIR) and to help ensure true comparability between funds and providers.

Question 8: Do you agree with the characteristics we have identified as being highly indicative of an underlying fund? If not, please outline your reasons.

22. NZBA and its members query whether the characteristics should include wholesale funds where not already picked up by other characteristics, for the avoidance of doubt. NZBA believes that most wholesale funds would be picked up through other designations (e.g. being a unit trust, a PIE or eligible to be a PIE), but it is possible some wholesale funds will fall outside of any other categorisation.

23. NZBA and its members submit that the inclusion of subparagraph (e) “an investment in a listed or unlisted property fund” should be deleted as it has the potential to make the scope of what is captured by the definition of “underlying fund” too broad. Property vehicles, whether trusts or companies, should not be considered underlying funds because they are not funds but property businesses that invest in direct property assets, i.e. they are not funds investing in listed companies (e.g. ETFs or passive index fund).

24. Further, we submit that subparagraph (g) should not be linked to PIEs. The characteristics listed in subparagraphs (g)(i) and (ii) will be sufficient to identify an underlying fund irrespective of whether or not it is a PIE and to link these will create confusion.

Question 9: Are there any other characteristics of an underlying fund that we have not identified?

25. No, but NZBA and its members submit that the guidance should make it clear that the listed characteristics are not an exhaustive list.

26. In addition, some flexibility will need to be applied in the interpretation of this list. Although the circumstances listed at paragraph 14 of the Guidance will generally identify an underlying fund, there will be circumstances which will be caught due to the broad terms used (for example, subparagraph (h)) which will not be an underlying fund. Provided a degree of flexibility is taken to the application of this list, NZBA and its members think it is appropriate.

Question 10: Would you have to incur any significant expense to change systems and processes to be aligned with the guidance on determining underlying funds? If possible, please quantify the initial expense and any ongoing additional cost.

27. Not relevant for NZBA.

Question 11: Do you agree with our views on when underlying fund fees should be disclosed? If not, please outline your reasons.

28. NZBA and its members are not clear on what this section is trying to achieve and consider that the granularity may be more than what the law requires. Please see the response to Question 8 above.

29. Furthermore, in relation to performance-based fees generally, NZBA and its members submit that the Guidance does not correctly reflect the definition of performance-based fees from the Financial Markets Conduct Regulations 2014 (**Regulations**). Paragraph 15 of the Guidance, and the diagram at paragraph 22, suggest that it is sufficient if there is a fee in relation to performance charged by a related underlying fund. However, Schedule 4 of the Regulations defines performance-based fees as "fees charged by the manager, or any *manager* of a related underlying fund …." (emphasis added). In accordance with this definition, specific disclosures in relation to performance fees are only required where the fees are charged by the manager, or any manager of a related underlying fund. Under the Regulations all other performance related fees (whether in a related underlying fund or otherwise) are included as part of the annual fund charges. Even where the fees are captured by the definition of performance-based fees and require the disclosures prescribed under clause 33 of the Schedule 4 of the Regulations, we question the need for this when the presence of that performance fee is immaterial. The necessary disclosures in the relevant Product Disclosure Statement (**PDS**) would appear to give undue emphasis to the fee in those circumstances.

Question 12: Would you have to incur any significant expense in changing systems and processes to be aligned with the guidance on when underlying fund fees affect a fund? If possible, please quantify the initial expense and any ongoing additional cost.

30. Not relevant for NZBA.

Question 13: Do you agree a PDS should highlight to investors that no high water mark applies to the respective fund's performance fee?

31. NZBA and its members agree with this approach. NZBA and its members expect all funds that have performance fees factor those into both historical and projected fees that they report.

32. In addition, the PDS should also highlight to investors if their fund has a high water mark that resets after a certain period of time. Certain funds apply a high water mark that can reset, allowing them to charge performance fees following a period of poor performance.

Question 14: Do you agree the wording example provided above clearly explains the effect of not having a high water mark?

33. NZBA and its members submit the wording proposed under paragraph 33 of the Guidance could be made clearer by rewording the statement as follows to better reflect this concept for investor understanding. NZBA and its members would also like to highlight that basing the high water mark on the value of the fund is not appropriate, as this value is affected by other factors such as member contributions. Using cumulative performance for each investor would be a more appropriate measure.

34. NZBA's suggested wording is:

> **Sample wording to disclose there is no high water mark**
>
> You should be aware that this fund does not apply a high water mark, which may be applied by other funds who charge performance fees. A high water mark is designed to prevent performance fees being charged following poor performance.
>
> A 'high water mark' is the value the fund must reach before the manager can charge performance fees. Managers who apply a high water mark must ensure the fund's value is at least equal to the last time they charged performance fees.
>
> If a fund loses value, the manager must ensure the value of the fund increases above the high water mark before being able to charge further performance fees.
>
> The impact of this fund not applying a high water market is that if this fund drops in value and then recovers, you may be paying a performance fee twice for the same return, once for the recovered growth, as well as the original growth.

Question 15: Do you agree the wording example provided above clearly explains the effect of using an inappropriate market index performance as the hurdle rate of return?

35. NZBA and its members submit the wording proposed under paragraph 38 could be made clearer by rewording the statement as follows to better reflect this concept for investor understanding.

36. NZBA's suggested wording is:

> **Sample wording to disclose different performance fee hurdle rate**
>
> Our performance fees are based on a hurdle rate of return. The 'hurdle rate' is the minimum return the fund must achieve before being able to charge a performance fee, and is determined by a market index.
>
> In our fund update, we compare the fund's performance against the [insert market index]. Our view is this index provides the best comparison of how the fund should perform.
>
> However the hurdle rate of return for the performance fee is based on [insert market index].
>
> This means you may be paying a performance fee even if the fund's performance does not match or beat the performance of what we believe to be the most appropriate market index.

37. Further, while we consider that this warning statement addresses disclosure of the impact of the hurdle rate, we submit that more regulation around the use of performance-based fees generally would be appropriate.