In Confidence

OFFICE OF THE MINISTER OF COMMERCE

The Chair
Cabinet Business Committee

Financial Market Conduct Regulations Paper 3: Governance

Proposal

1 This is the third in a series of four Cabinet papers in which I am seeking policy decisions for the regulations to be made under the Financial Markets Conduct Bill (FMC Bill). In this paper, I seek decisions on the governance requirements for debt products, managed investment schemes and other products and schemes.

Executive Summary

2 The FMC Bill introduces a step-change for the governance of managed investment schemes, and consolidates governance obligations for other publicly offered financial products. In doing so, it seeks to promote the confident and informed participation of businesses and investors in financial markets.

3 Managed investment schemes are KiwiSaver schemes, managed funds, property schemes, and other pooled investment schemes. All publicly offered ('retail') schemes will be required to register on an online register. Other schemes can register voluntarily.

4 Part 4 of the FMC Bill sets common governance obligations for all registered schemes. Unlike the current law, these apply consistently irrespective of the scheme's legal form. The obligations include independent supervision of managers, independent custody of scheme property and duties for managers and supervisors to act in the best interests of investors.

5 Regulations need to set the detailed requirements to support these governance obligations. They also need to provide exceptions, so that obligations do not apply where they are unnecessary, and are proportionate to risks.

6 This paper seeks decisions on regulations to:

- define managed funds as a distinct type of scheme to help differentiate disclosure and governance and aid investors' use of the online register
- set clear rules applying to withdrawals for some superannuation schemes
- set controls over content of governing documents
- determine a default set of meeting procedures and minimum notice and quorum requirements
- set issuer reporting obligations
- set the detail of, and exceptions for, the controls on limit breaks or pricing errors
- determine supporting requirements, and exceptions, for related party transactions
- set the detailed requirements for custodians and issuer registers and records.

Context

7 Part 4 of the FMC Bill sets governance rules for debt products, managed investment schemes, and other publicly offered financial products.

8 In a managed investment scheme (for example, a KiwiSaver scheme or unit trust), investors rely heavily on the fund manager's specialist investment skills. A wide group of investors each owns a small portion of the fund. The investors have incomplete information about the risks and returns of the fund. The fund manager is both in control of the fund and information flows to investors. Investors often have limited means of assessing whether the fund manager can meet its promises and claims.

9 The current law tries to address this by applying governance rules for managed investment schemes. However, managed investment schemes come in many legal forms: trusts, partnerships, limited partnerships, or contractual schemes. Many of the issues identified with the current regulatory framework relate to the patchwork of different Acts that apply to schemes with layers of regulations and exemption notices resulting in inconsistent obligations.

10 Part 4 of the FMC Bill addresses these issues with one common set of governance rules for managed investment schemes. These governance rules apply to schemes according to their function not legal form. Obligations are tiered: reduced where there is less governance risk but otherwise imposed consistently on funds of a particular type.

11 Part 4 also rolls over the existing governance obligations for other publicly offered financial products with some changes.

Types of managed investment schemes, registration requirements and process

Recognition of 'managed funds' on register of managed investment schemes

12 The register of managed investment schemes established under the FMC Bill provides a publicly searchable database of managed investment schemes.

13 Some distinct types of schemes are separately identified on the register by the FMC Bill: KiwiSaver schemes, superannuation schemes, workplace savings schemes, and other sub-categories (for example, that a KiwiSaver scheme is a default scheme). The other schemes however are a broad group. Regulations may recognise other types or features of schemes.

14 The benefit of doing so is two-fold. It enables the disclosure and governance requirements set by the regulations to differ according to the type, or features, of schemes. It will also assist investors to select and compare like schemes on the online register when making investment decisions.

15 I consider that the register should identify another key distinction: the difference between 'managed funds' and other more complex schemes.

16 Managed funds are investment vehicles (for example, unit trusts) where there is a fund invested according to an investment mandate. They are characterised by investments into relatively liquid assets (for example, cash and listed securities) and regular valuations. This is often used to facilitate both continuous entry and exit by members and ongoing investment decision-making by fund managers.

17 This is in contrast to schemes that invest largely in illiquid assets – for example, forestry schemes or property syndicates. These often have more in common with equity (for example, company shares) than with managed funds. Investors in these more complex schemes may not have a low-cost means of exit if they are unhappy with scheme performance and need a greater level of engagement with the scheme's manager. I propose below different governance requirements for complex schemes in the form of an annual meeting requirement.

18 I also consider that disclosure requirements should differ between managed funds and complex schemes. Paper 2, on disclosure, discusses the proposal that the product disclosure statement (PDS) for managed funds be subject to a higher level of prescription to improve comparability between schemes.

19 The exact criteria for what is a 'managed fund' still need to be determined in consultation with stakeholders and through developing the detailed disclosure requirements. I propose to base them on whether a scheme meets either or both of the following:

- holds a high percentage of liquid assets (the equivalent Australian definition turns on whether the scheme holds 80 per cent of its assets in cash or other liquid assets), or
- is continuously offered and redeemed on a basis calculated wholly or mainly on the underlying value of the scheme property (ie, net asset value).

Employer-related schemes

20 The FMC Bill recognises 'employer-related' KiwiSaver or superannuation schemes as a particular subcategory of schemes. Where an employer-related scheme enters into a transaction with a contributing employer, this is treated as a related-party transaction and the scheme must comply with related party transaction requirements. These include requirements for supervisor consent or certificates.

21 Criteria for what is an 'employer-related' KiwiSaver or superannuation scheme need to be set by regulations. The FMC Bill's related party transaction controls are not needed for employers contributing to master trust schemes. I propose that a scheme should be 'employer-related' only if the employer contributor is closely involved in running the scheme.

FMA ability to classify schemes

22 Schemes will be identified on their transition to the register or on registration as being a 'managed fund', 'employer-related' or being another 'scheme-type' on the register. The criteria for the scheme type are set by the FMC Bill, other legislation, or the regulations. However, it may not always be clear cut whether or not the criteria apply. The Financial Markets Authority (FMA) is better placed than the Registrar to exercise judgement on whether a scheme comes within a particular scheme-type or not.

23 I consider that regulations should future-proof the register by enabling FMA to direct that it be amended if FMA is satisfied that a scheme does, or does not, come within a particular scheme-type. There need to be procedural safeguards that give adequate prior notice and opportunity to object to the scheme classification.

Registration requirements for superannuation schemes and workplace savings schemes

24 Under the FMC Bill, schemes that are registered as 'superannuation schemes' and open to new members must have, as their sole purpose, to provide retirement benefits to members. Regulations are needed to set the registration requirements for these schemes.

25 The new superannuation scheme category in the FMC Bill has been designed as an opportunity to create a brand of 'sole purpose' superannuation, for which there may be regulatory benefits or overseas recognition (for example, for pension transfers) in the future. This category is not intended to cater for existing schemes (for which there are other options discussed below) or workplace superannuation (for which there is more flexibility).

26 The registration requirements for superannuation schemes will be set out in the regulations. They will set clear rules that 'lock in' members' savings until retirement and permit the trust deed to allow withdrawals on other limited grounds. The question is how much flexibility to allow members of these schemes while still ensuring that the schemes are consistent with the 'sole purpose of retirement' test.

27 Ideally the new withdrawal rules should allow more flexibility for retirement than KiwiSaver schemes. Accordingly, I propose that funds be accessible in full as of right after the age of eligibility for New Zealand superannuation. To add flexibility, early retirement withdrawals should be permitted, if the trust deed allows, after reaching age 60 and retiring. This is a realistic early retirement age that is not out of step with other jurisdictions.

28 I also propose permitting the trust deed to allow partial withdrawals by workers who decrease their working hours after age 55 and need to supplement their income. Australia caters for this need through 'transition to retirement' rules. I propose that the regulations allow phased withdrawals before retirement, if capped annually, so as to ensure the full amount is not withdrawn before the age of eligibility for New Zealand superannuation.

29 Outside of this, I propose that rules on limited withdrawals (for example, on death, serious illness and in the case of significant financial hardship) and use of funds for new members match those for KiwiSaver schemes with two exceptions:

- The first home withdrawal is not justified where there is no default registration in the scheme.
- Permanent emigration should be dealt with through requiring the scheme to permit funds to be transferred to overseas superannuation schemes (where allowed by that overseas scheme). Unlike KiwiSaver schemes, there is no requirement that members of these schemes be New Zealand citizens. Withdrawal on permanent emigration would risk misuse of the schemes by overseas residents.

30 The equivalence criteria for overseas schemes will need to ensure that there is no substantial risk of undermining the lock-in requirements, but not require exact equivalence. I propose that the rules also require schemes to enable funds to be transferred to other superannuation schemes and KiwiSaver schemes (when allowed by those schemes) to enable members to change providers within New Zealand.

31 Existing schemes have a wide range of retirement ages and different withdrawal benefits. As noted above these new withdrawal rules apply only if a scheme chooses to register as a superannuation scheme. They will not automatically change conditions for existing schemes or existing members. Existing superannuation schemes have three other options:

- They may close to new members and continue as 'legacy' schemes with their current withdrawal rules.
- They may register as workplace savings schemes (and continue to allow withdrawals on leaving a workplace as well as on retirement).

- They may register in the general 'managed fund' category. The new withdrawal rules do not apply to these schemes.

32 Some additional flexibility may be needed to allow existing members to continue to make withdrawals under their existing terms, to the extent that existing schemes register in this category.

33 Workplace savings schemes are another category of retirement schemes under the FMC Bill. They differ from superannuation schemes in that they allow withdrawals on leaving a workplace as well as on retirement. I propose that these also be required to permit the transfer of retirement funds to other workplace savings schemes, KiwiSaver schemes, superannuation schemes, or equivalent overseas workplace or superannuation schemes. Funds in workplace savings schemes are not locked in to the same extent. But requiring schemes to allow funds to be transferred to other retirement schemes increases the likelihood that savings are moved to other retirement vehicles on leaving a workplace, rather than used pre-retirement.

Registration process for managed investment schemes

34 Schemes will register under Part 4 on an online register. The main concern of submitters on the discussion document on the proposals for the regulations was that the process be streamlined and simple, and minimise compliance costs.

35 I propose that regulations require the application to be made electronically on the register. In addition, the regulations should set the minimum information and process that is necessary and enable FMA to determine other information or process requirements. This will enable the application process to fully integrate with the final register design and ensure regulations do not impose unintended compliance costs.

Schedule 3 schemes (single-person superannuation schemes)

36 The FMC Bill recognises single-person superannuation schemes (currently registered under the Superannuation Schemes Act 1989). These single-person superannuation schemes are mainly used as vehicles for retirement payments made under other legislation (for example, the Remuneration Authority Act 1977 authorises payments to these schemes for members of parliament).

37 These schemes do not raise the same governance issues as retail managed investment schemes. Accordingly, they are not registered under Part 4 of the FMC Bill. Instead they are recognised under Schedule 3. Regulations under Schedule 3 may require schemes to report to FMA and may imply terms into the trust deeds for the schemes.

38 Because these schemes are intended to be vehicles for retirement payments and receive public money for this purpose, a key issue is what accountability arrangements are imposed on them, and by whom, to ensure that this purpose is met.

39 Accountability requirements can either be set by regulations under the FMC Bill and monitored by FMA, or required under another law – for example, a determination of the Remuneration Authority.

40 I propose that regulations require that schemes have properly prepared annual financial statements that are provided in an annual report to FMA, with other relevant information currently required under the Superannuation Schemes Act 1989. Financial statements will give FMA an oversight of the position of these schemes.

41 Currently the Superannuation Schemes Act 1989 requires these schemes to be audited. Audit gives a level of comfort to the regulator that the assets of the scheme and the contribution flows are correct. However, there are fewer risks where funds are self-managed. In view of the limited use of these schemes at present, I propose that the regulations not impose an auditing obligation on all schemes. But if an audit is performed due to another law, the auditor's report should also be provided to FMA. As these requirements are imposed by regulations, they could be reassessed should use of these schemes and the risks they pose change over time.

42 I also consider that terms should be implied in the scheme trust deed to limit the use of scheme funds for non-retirement purposes. The FMC Bill tightens the purpose of these schemes so that they must be for the sole purpose of retirement, not only the 'principal purpose' as at present.

43 But some prescription is desirable to clarify the effect of the sole purpose test for members and trustees (for example, to clarify the ability to loan to the member or purchase significant assets used by the member to his or her benefit). I propose to limit the use of retirement funds for the member to derive external financial benefits except on arm's length terms. This would match KiwiSaver scheme rules.

Reference to retirement schemes in other legislation

44 The FMC Bill creates an overarching term of 'retirement schemes' to replace references in other legislation to superannuation schemes registered under the Superannuation Schemes Act 1989. Retirement schemes are superannuation schemes, KiwiSaver schemes, workplace savings schemes, and Schedule 3 schemes. Transitional regulations can exclude workplace savings schemes and Schedule 3 schemes where the term is used in other legislation. I consider that, in consultation with Ministers responsible for that legislation, transitional regulations should do the following on a case by case basis:

- workplace savings schemes should be excluded if the legislation's policy is not met by allowing retirement funds to be withdrawn in full on leaving a workplace,
- Schedule 3 schemes should be excluded if the legislation's policy is not met by covering schemes that are not registered schemes, but
- rights to continue to make current payments to existing schemes should not be affected.

Contents of governing documents

45 Issuers and supervisors negotiate the trust deed for debt products or the governing document for a managed investment scheme. This document sets the terms on which the supervisor takes on the supervisory role. Regulations may regulate the content of these documents by requiring particular matters to be covered or by implying terms into the documents.

To what matters procedural protections should be applied

46 Governing documents have procedural protections: they must be publicly disclosed on the online register, must be legally binding, and can be amended only by following procedural steps in the FMC Bill. Requiring matters to be covered by the governing document (rather than in side-agreements) gives them these procedural protections. It is important to note that requiring these matters to be negotiated by the supervisor and issuer and included in the governing document does not prescribe a particular approach. But it does go one step further to protect investors than can be achieved by disclosure.

47 I consider that these procedural protections should apply to matters that materially affect credit risk or governance risk. For debt products, I propose the following matters be covered:

- any financial covenants given by the issuer in favour of the holders of the debt products or the supervisor
- any prohibition or restrictions on related party transactions
- provisions governing the appointment and removal of the supervisor, [and for ensuring transfer of rights and obligations on a change of supervisor]
- the frequency and content of reports by the issuer to the supervisor: while some submitters considered that this should be a matter for side-agreement between the issuer and supervisor, I consider the quality of these reporting requirements are critical to the oversight of the regime and should be publicly disclosed
- changes to the prescribed meeting procedures for product holders
- any other matters that materially affect the rights and duties of holders of the debt product or the powers, rights, and duties of the issuer or supervisor.

48 The FMC Bill already sets most content matters for managed investment schemes. I consider, however, that the frequency and content of reports by the manager to the supervisor and changes to prescribed meeting procedures should be also required by regulations.

Substantive protections through implied terms

49 Implied terms go a step further again. They set minimum rights or duties. Currently they are used to require half-yearly audits and for auditors to report for the benefit of supervisors of deposit takers.

50 Submissions on the discussion document reflected a long-standing tension between auditors and supervisors. Supervisors consider that auditors do not accept their statutory responsibilities and identify specific limitations with current requirements. Auditors are concerned about liability for statutory responsibilities that are unclear in scope or inconsistent with auditing and assurance standards.

51 The FMC Bill already imposes whistle-blowing obligations on auditors for debt products and managed investment schemes. The question is how much further to go in the regulations, particularly for deposit takers. The issue is complicated by two further developments.

52 The New Zealand Institute of Chartered Accountants has begun an initiative to develop an industry-wide solution to this tension. This initiative is only in its early stages. The Reserve Bank is undertaking a review of the prudential regime for deposit takers. If the Reserve Bank were to cease to rely on supervisors of deposit takers as a result of the review, in the prudential context, the auditor's obligations to report to supervisors may become redundant.

53 These implied terms will ultimately need to be aligned with the outcome of these projects. I propose, in the interim, to rollover the existing implied terms for deposit takers relating to auditors and their reporting to supervisors (other than those superseded by the FMC Bill).

54 I propose one change: to require consultation with supervisors on the nature and scope of the audit as well as on the appointment. This enables the auditor and supervisor to clarify audit scope and its consistency with auditing and assurance standards. It would also give supervisors an opportunity to engage auditors directly. This implied term should apply to both debt products and managed investment schemes.

55 There is one further category of implied terms required. Where supervisors are replaced by FMA under the Securities Trustees and Statutory Supervisors Act 2011 (rather than by the issuer), the appointment may not be made in the usual way contemplated by the governing document. I consider terms should be implied to ensure the appointment of a replacement supervisor is effective to transfer rights and obligations of the previous supervisor, including title to any scheme property and access to bank accounts.

Procedures and requirements for meetings of product holders

Requirement for annual meetings

56 Participation rates in meetings by holders of debt products and managed investment scheme participants are generally low. The ability to exit through redemption or transfer of interests is the primary recourse for dissatisfied investors. Regular meetings of product holders are of little relevance to, and would impose significant costs on, KiwiSaver schemes and other managed funds.

57 In the case of equity-like managed investment schemes, investors' interests are more akin to an ownership interest. Consequently, investors will have an interest in the strategic direction of the scheme and an expectation of being more actively engaged. Meetings are an opportunity to comment on the annual report and financial statements. They require the manager to be answerable to investors in an open forum. Accordingly, I consider there is sufficient benefit to justify an annual meeting requirement for these schemes akin to those for companies.

Meeting procedures

58 Approval by product holders is also required for particular matters under the FMC Bill. Those matters are few, but may be value-critical (for example, approval of a related party transaction). It is important that all product holders have an equal opportunity to participate in meetings to approve these matters.

59 I propose that the regulations provide a default set of meeting procedures that establish minimum notice and quorum requirements to ensure equal participation. I also propose other default meeting procedures be set, but that they be able to be varied by the scheme's governing document. Default meeting procedures help to lower transaction costs for those schemes that may never or very rarely hold meetings.

60 I propose that the notice and meeting procedures be set along the lines of section 122 and Schedule 1 of the Companies Act 1993. The market is familiar with these procedures and they allow for electronic voting and written resolutions, which may improve participation rates. Some changes will be needed to:

- ensure the governing document can vary more procedures than Schedule 1 permits
- set the quorum at an appropriate level for these product holders. It can be very difficult to get a quorum. I consider that 25 per cent is an appropriate quorum for meetings at which a special resolution is proposed. Procedures should provide that if the quorum is not met at the first meeting, the number of product holders that are present at the second meeting forms the quorum

- take account of the nature of managed investment schemes and debt products.

61 Voting by the scheme manager or its associated person is generally prohibited, except in the case of a listed scheme. Listing rules impose voting restrictions in these cases. Submitters have argued that unlisted wholesale schemes should be excluded to prevent one or two large institutional investors from removing the manager. I consider that an exclusion of this nature is justifiable only if there are no retail investors, the manager's ability to vote was disclosed in the PDS or register entry and that the manager certifies that voting is in the scheme participants' best interests.

Reporting by issuers to supervisors

62 The FMC Bill mandates compliance reporting by issuers on key events (for example, pricing errors). In general, I consider that supervisors are best placed to negotiate and determine other reporting required by issuers. Supervisors negotiate the governing document and are familiar with the product design and the risks it poses. In addition, FMA is able to monitor and control the level of supervision through the supervisor licensing regime (for example, through licence conditions).

63 The current law mandates particular minimum reports being made by deposit takers to supervisors. Submitters did not raise any concerns with them. Deposit takers pose particular risks. I propose to continue the current minimum reports, subject to the outcome of the Reserve Bank's review of deposit takers' supervisory arrangements.

Controls on risks around limit breaks and pricing errors

64 The FMC Bill controls the risks around breaches of limits on asset allocations and pricing errors by requiring there to be a statement of investment policy and objectives (SIPO) publicly available on the online register, and also requiring the reporting of material limit breaks of the SIPO and the reporting and rectification of material pricing errors.

Exception from the obligation to make SIPO publicly available

65 The SIPO contains the investment policy and objectives and limits on asset allocations. It sets the risk profile of a fund and aids investment decision-making by prospective investors. Where there is no regulated offer I consider that there is little benefit in it being publicly available. I propose that the regulations should instead require the SIPO be made available to product holders and FMA on request and that the issuer notify the existence of the SIPO and any changes to the online register.

Reporting of material limit breaks

66 A scheme must report material breaches of the limits on asset proportions in its SIPO in accordance with regulations. FMA will determine through its frameworks and methodologies when a limit break is material. Not every material limit break has the same compliance significance. I consider it important that reporting requirements are meaningful for the action that the supervisor or FMA may need to take in response to it.

67 A limit break needs immediate supervisory action if it is not quickly rectified. Otherwise periodic reporting better enables the supervisor or FMA to see trends in compliance and analyse causes. I propose requiring quarterly reporting if a limit break is rectified within 5 working days after the issuer becomes aware, or should reasonably have become aware, of the limit break. Other limit breaks should be reported as soon as reasonably practicable.

68 The limit break report should be required to state basic details to enable the supervisor or FMA to assess its significance and what steps have been or will be taken to rectify and improve compliance. FMA should also be able to require other information.

Remedying and reporting of pricing errors

69 Pricing errors are errors in the pricing of a unit issued under a scheme, or non-compliance with the scheme's pricing methodology. Errors may be caused by incorrect valuations by managers, administrative recording errors, and the application of incorrect accounting or tax policies. In many cases, these errors may occur in sub-schemes that hold assets with complex valuation methods or tax treatment.

70 Pricing errors are a risk to investors, especially when they are entering or exiting a managed investment scheme. The effect on scheme participants (both on exit/entry and on ongoing scheme participants) may be large, particularly if the discovery of the pricing error is delayed. Early discovery and prompt rectification of pricing errors are critical to minimising their impact on investors.

71 A number of schemes apply the guide to good practice in unit pricing issued jointly by the Australian securities and prudential regulators. However, this is guidance only. The FMC Bill goes further and mandates the correction of the pricing error, its reporting to the supervisor or FMA, and the taking of the prescribed steps (for example, to compensate for the pricing error and inform scheme participants).

72 These mandated steps apply to material pricing errors. FMA will set the materiality threshold. It may choose to measure materiality on percentage of unit price affected, on the nature of the error, or on whether adequate pricing policies have been followed. I propose that the regulations impose steps be taken to assess and give effect to any obligation to compensate on the principle that former and current scheme participants should be returned to the position they would have been in if there had been no material error or non-compliance.. In designing those steps, I propose to recognise that the cost of compensation may in some cases exceed the benefit to the scheme participant.

73 Reimbursement may be made by issuing more units or adjusting the pricing of units for on-going scheme participants. The regulations will require the manager to take all reasonable steps to pay any monetary compensation to former scheme participants (recognising that in some cases it may be very difficult to find former scheme participants).I propose to set requirements for reporting to both FMA and scheme participants and provide for FMA to require other information.

Related party transactions

74 Related party transactions create particular risks for scheme participants. While there are good reasons why related party transactions occur, they may also be improperly influenced by interests of the related party. The FMC Bill controls these risks by requiring the manager to positively demonstrate that the transaction is on arms' length terms or meets scheme participant or supervisor consent requirements.

Certificate requirements

75 To rely on the permissions for related party transactions that meet the arms' length or consent requirements, the manager or supervisor must give a certificate stating the grounds on which the transaction is permitted and the basis for their reliance. The certificate requirement requires the manager or supervisor to justify this reliance and gives visibility and oversight of the permitted transactions.

76 General certificates are permitted, but certificates still risk adding large compliance costs for many routine transactions. Requiring too much supporting evidence may be problematic, particularly for institutions such as banks that enter into many related party transactions. I consider that the certificate should provide the information needed to assess whether transactions need further investigation.

77 On that basis, I propose that regulations require that certificates state the nature of the benefit given to the related party under the transaction and quantify (if quantifiable) or describe the extent of the benefit. The manager should also be required to report to the supervisor on related party transactions in a periodic compliance report.

Requirements for scheme participant approval

78 The rationale for permitting related party transactions approved by scheme participants is that the potential conflict of interest is disclosed to, and approved by, those affected. This disclosure needs to be adequate for this rationale to be met.

79 I consider that regulations should require an explanatory memorandum be included in the notice for a meeting to approve a related party transaction. The memorandum should be provided to the supervisor for its comment before the meeting and the supervisor's comments also included. The explanatory memorandum should include all information known to the manager or its directors that scheme participants would reasonably require to decide whether it is in the scheme's interests to pass the resolution. At a minimum this should include the nature and monetary value of the benefit (if it is quantifiable) or the extent of the benefit, the relevant related party and the nature of the related party relationship.

Other permitted related party transactions

80 I consider that regulations should permit three additional classes of related party transactions:

81 *Sale of first property into a scheme:* Investors sometimes subscribe on the basis of an initial, or initial series of, transactions. Requiring further consent is unnecessary. There is some risk in how widely this exemption could be applied and so I consider it should be limited to the sale of the 'first property' into the scheme. I propose that any first property over a minimal value must be specifically identified in appropriate disclosures and its value must be supported by evidence (for example, by a suitably qualified independent valuer or the latest market price of quoted financial products).

82 *Listed scheme exclusion:* I also propose that listed schemes transactions be excluded where appropriate listing rules apply and are complied with. There are significant overlaps between the FMC Bill's requirements for related party transactions and those in the NZX listing rules. The listing rules provide established alternative means of dealing with the same policy objectives. The overlap creates compliance inefficiencies for listed schemes of dealing with dual regimes, dual regulators, and overlapping requirements. For example, a listed scheme may need to obtain approval from an ordinary resolution of participants to any material related party transaction (or obtain a waiver from NZX) under the NZX listing rules, and need supervisor consent under the FMC Bill.

83 I do not consider that the same exclusion should apply to all licensed markets automatically. Not all licensed markets may have related party controls and not all related party controls may be adequate for schemes. On that basis I propose that the exclusion apply only to those markets with sufficient related party controls in the listing rules.

84 *Investments in Australian registered schemes:* I consider that acquisitions or disposals of products in managed investment schemes registered under the Australian Corporations Act 2001 should also be permitted transactions. Investments in other registered schemes are already permitted by the FMC Bill on the basis that related party transactions between registered schemes are sufficiently controlled by the duties to comply with the SIPO and the professional standard of care. Australian registered schemes have equivalent safeguards and the same rationale applies.

85 This last exclusion is also relevant to the related party prohibitions for discretionary investment management services under Part 6, and I propose that it apply there also.

Custodial duties, registers, and document obligations

Custodial duties

86 Custody of scheme property is a significant issue for managed investment schemes. The FMC Bill requires scheme property to be held on trust by an independent custodian, requires the scheme property to be held separately from the custodian's own property and requires custodial records to be kept. Regulations may add more detailed requirements.

87 The duties applying to managed investment scheme custodians should be consistent with those applying to other custodians under the Financial Advisers Act 2008. Wrap platforms, custodians for discretionary investment management services, and other custodians are covered by equivalent high-level obligations under the Financial Advisers Act. Officials will be consulting on regulations to set the detailed requirements under the Financial Advisers Act. I intend to seek policy decisions on custodial duties applying to both custodians under the Financial Advisers Act and custodians for managed investment schemes following public consultation over the next few months.

Registers

88 Issuers are required to keep registers of financial products. These registers form the basis of title to a financial product and enable the public to ascertain ownership of financial products. These register obligations need to be adjusted in places to address the following:

- There are other equivalent publicly available registers required by other legislation (for example, credit unions and building societies) and the information need can be met in other ways.
- In some cases the need for publicly available information is outweighed by privacy concerns about some details.
- There are limitations currently on register obligations for debt products and modifications for unit trusts.

89 These issues are already addressed to a certain extent by the FMC Bill. I propose to continue the effect of current exemptions under the existing law that address these issues (to the extent still relevant under the FMC Bill) with any necessary improvements or updates.

90 The regularity and scope of audit or assurance of the registers must also be prescribed by regulations. I propose that generally the current obligation to have the registers annually audited within five months after the issuer's balance date be continued with one change.

91 Superannuation schemes do not need to comply with the obligation to audit each register currently if the scheme is fully managed by an administration manager whose business, and business systems, is audited as a whole. I consider that a similar approach should apply to other issuers who appoint a register-keeping company to keep their registers. I consider that having each register separately audited is an unnecessary compliance cost if the register company has an annual audit of the registers in general. This audit should provide assurance that its register systems are adequate.

Document-keeping obligations

92 Issuers must keep all certificates, notices, and other documents required by the FMC Bill for seven years. Many of these documents will also be on the online register and this should be the primary means of accessing, for free, those documents. Existing investors should also be able to obtain copies of these documents from the issuer or offeror. I propose that this obligation be imposed by regulations, subject to payment of a reasonable fee for the cost of providing the document.

Consultation

93 The Financial Markets Authority, Treasury, Reserve Bank, Ministry of Justice, and the Inland Revenue Department were consulted on this paper. The Department of Prime Minister and Cabinet has been informed.

94 The proposals in this series of papers have been subject to public consultation, both during the development of the FMC Bill and via a public discussion document on the regulations.

Financial Implications

95 This paper has no financial implications.

Human Rights

96 There are no human rights implications from this series of papers.

Legislative Implications

97 The proposals in this series of papers will require the making of regulations under the Financial Markets Conduct Bill once it is passed.

Regulatory Impact Analysis

98 The Regulatory Impact Analysis requirements apply to the proposal in this series of papers. A Regulatory Impact Statement for all of the papers has been prepared and is attached.

Quality of the Impact Analysis

99 The General Manager, Strategic Policy Branch and the Ministry of Business, Innovation and Employment Regulatory Impact Analysis Review Panel have reviewed the attached Regulatory Impact Statement (RIS) prepared by the Ministry of Business, Innovation and Employment, and consider that the information and analysis summarised in the RIS meets the criteria necessary for ministers to fairly compare the available policy options and take informed decisions on the proposals in this paper. Publicity

100 The Ministry of Business, Innovation and Employment will post a copy of this paper on its website.

Recommendations

It is recommended that the Committee:

1 **note** that Part 4 of the Financial Markets Conduct Bill (FMC Bill) implements a step-change for managed investment schemes, and consolidates existing governance obligations for other financial products

Types of managed investment schemes and registration requirements and process

2 **agree** that regulations recognise 'managed funds' as a distinct type of managed investment scheme to assist differentiation in disclosure and governance requirements and investor use of the online register

3 **agree** that a scheme should be a 'managed fund' if it is a scheme that has high liquidity or is continuously offered and redeemed on the basis of net asset value

4 **agree** that a scheme should be 'employer-related' if the employer is closely involved in running the scheme

5 **agree** that regulations should enable the Financial Markets Authority (FMA) to direct that the register be amended if FMA is satisfied that a scheme does, or does not, come within a particular scheme-type or does not have particular features recognised on the register (subject to prior notice and an opportunity to comment)

6 **agree** that registration requirements for superannuation schemes enable these schemes to be a more flexible alternative retirement vehicle to KiwiSaver schemes with the following features

6.1 full withdrawal to be permitted after reaching the age of eligibility for New Zealand superannuation or, if the trust deed allows, on reaching 60 years and being retired

6.2 partial withdrawals be permitted in the trust deed before retirement from the age of 55 if those amounts are capped on an annual basis that ensures the full amount is not withdrawn before the age of eligibility for New Zealand superannuation

6.3 other limited withdrawals or use of funds be permitted only on equivalent grounds to those applying to KiwiSaver schemes (but excluding first home purchase or permanent emigration)

6.4 current withdrawal benefits be permitted for existing members of existing schemes

6.5 schemes be required to permit the transfer of retirement funds to other superannuation schemes, KiwiSaver schemes, and substantially equivalent overseas superannuation schemes (but must not transfer funds to other schemes)

7 **agree** that workplace savings schemes be required to permit the transfer of retirement funds to other workplace savings schemes, superannuation schemes, KiwiSaver schemes, and substantially equivalent overseas retirement schemes

8 **agree** that equivalent overseas retirement schemes be defined in the regulations for the purposes of recommendation 6.5 and 7 on criteria that ensure that there is no substantial risk of undermining the relevant registration requirements for those schemes, but without requiring exact equivalence

9 **agree** that, to enable the online register design to provide for a simple and least compliance cost application process, regulations prescribe the minimum application process and information necessary and otherwise provide for FMA to determine additional information or process

10 **agree** that the following requirements apply to Schedule 3 schemes:

10.1 requirements for properly prepared annual financial statements and an annual report to be provided to FMA containing other relevant information consistent with the current annual report obligations under the Superannuation Schemes Act 1989

10.2 the regulations should not impose an audit requirement, but if audit is performed due to another law the auditor's report must be provided to FMA

10.3 an implied term preventing members from deriving external financial benefits from the retirement funds in the scheme except on an arm's length basis

11 **agree** that regulations exclude workplace savings schemes and Schedule 3 schemes from references to retirement schemes in other legislation on a case by case basis according to the following criteria:

11.1 workplace savings schemes should be excluded if the legislation's policy is not met by allowing retirement funds to be withdrawn in full on leaving a workplace

11.2 Schedule 3 schemes should be excluded if the legislation's policy is not met by covering schemes that are not registered schemes

11.3 rights to continue to make current payments to existing schemes are continued

Contents of governing documents

12 **agree** to require debt trust deeds to cover any financial covenants given, any prohibitions or restrictions on related party transactions, the frequency and content of issuer reports to the supervisor, the appointment and removal of the supervisor, and any other matters that materially affect the rights and duties of holders of the debt product or the powers, rights, and duties of the issuer or supervisor

13 **agree** to require governing documents of registered schemes and debt trust deeds to cover the frequency and content of issuer reports to the supervisor and any changes to the prescribed meeting procedures for product holders

14 **note** that the New Zealand Institute of Chartered Accountants has begun an initiative to develop an industry-wide solution to the conflict between supervisors and auditors over their respective roles and responsibilities and the Reserve Bank is also reviewing the prudential regime for deposit takers, including the role of supervisors

15 **agree**, in the interim, to rollover the current implied terms for deposit takers relating to auditors and their reporting to supervisors (to the extent not superseded by the FMC Bill)

16 **invite** the Minister of Commerce to report to Cabinet on the outcome of the NZICA initiative and Reserve Bank review and any effect on these implied terms

17 **agree** to imply terms in governing documents to ensure that an appointment by FMA of a replacement supervisor is effective to transfer rights and obligations of the previous supervisor (including title to scheme property)

Meetings of product holders

18 **agree** to set annual meeting requirements for equity-like schemes akin to the annual meeting requirements applying to companies

19 **agree** to set meeting procedures along the lines of section 122 and Schedule 1 of the Companies Act 1993 (adjusted where appropriate to take account of the nature of schemes or debt issues and to set the initial quorum for a meeting at 25 percent) and to allow the governing document to vary those procedures (except as to minimum notice and quorum requirements)

20 **agree** to permit a manager of an unlisted wholesale scheme (or its associates) to vote their interests at meetings against a resolution to remove the manager, if there are no retail investors in the scheme, the ability to vote was disclosed, and the manager certifies that doing so is in the best interests of scheme participants

Reporting of issuers to supervisors

21 **agree** to continue current reporting requirements for deposit takers, subject to the outcome of the Reserve Bank's review of the prudential regime for deposit takers

SIPO, limit breaks and pricing errors

22 **agree** to exclude managed investment schemes for which there is no regulated offer from the obligation to make the SIPO publicly available on the online register and instead require notice of the SIPO and any changes to be lodged on the online register and that the SIPO be made available on request to product holders and FMA

23 **agree** to impose immediate reporting for material limit breaks not rectified within a specified period, periodic reporting for other material limit breaks, and set reporting details in the regulations (with a discretion for FMA to require other relevant information)

24 **agree** to mandate steps to assess and give effect to any obligation to compensate for material pricing errors and non-compliance (but allow flexibility to deal with cases where the cost of taking action exceeds the benefit) and to require appropriate reporting (or enable FMA to require this)

Related party transactions

25 **agree** that regulations require certificates given in support of related party transactions to state the nature of the benefit given and quantify (if quantifiable) or describe the extent of the benefit

26 **agree** to set explanatory memorandum requirements for notices of meetings at which scheme participant approval is sought for a related party transaction (including an opportunity for supervisor comment and input)

27 **agree** to permit related party transactions involving the sale of 'first property' into a scheme, listed schemes acting in compliance with sufficient related party listing rule requirements, and (under both Parts 4 and 6) acquisitions and disposals of interests in schemes registered under the Australian Corporations Act 2001

Custodial duties, registers, and document obligations

28 **note** that the Minister of Commerce intends to seek policy decisions on custodial duties applying to custodians under the Financial Advisers Act 2008 and custodians for managed investment schemes following public consultation over the next few months

29 **agree** to continue the effect of current exemptions and exclusions from register obligations for debt securities issued by credit unions, building societies, companies, and other issuers under the Securities Act 1978 to the extent still relevant

30 **agree** to rollover the current requirements for auditing of registers of financial products, with the exception that where the register is kept by an administration manager or other register-keeping company, it is sufficient if the register business of that entity as a whole is audited and given an assurance review

31 **agree** to require issuers and offerors to provide copies of documents kept for seven years under the FMC Bill to existing investors on request, subject to payment of the reasonable costs of doing so

Publicity

32 **note** that the Ministry of Business, Innovation and Employment will post a copy of this paper on its website.

Hon Craig Foss
Commerce

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