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Financial Markets Authority

By email: [consultation@fma.govt.nz](mailto:consultation@fma.govt.nz)

**Consultation Paper: Proposed exemption from the market index requirement**

Thank you for the opportunity to provide feedback on the proposed exemption from the market index requirement where managers determine there is no available broad-based market index compliant with the Financial Markets Conduct Regulations 2014 (**Regulations**).

We thank the FMA for recognising:

- the difficult position in which the strict interpretation of the Regulations places managers; and
- the genuine efforts being made by managers both to comply with the Regulations and to provide investors with the most meaningful disclosure possible about the performance of their investments.

To more fully represent the voice of the managed investment schemes community, this submission is made jointly by the Financial Services Council of New Zealand Incorporated and Workplace Savings New Zealand Incorporated.

Please contact me on 021 0233 5414 to discuss our submission.

Yours sincerely

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# Table of Contents

Table of Contents.....	2
Who we are – Financial Services Council.....	3
Who we are – Workplace Savings NZ .....	4
Our submissions .....	5
Market index requirement.....	5
Difficulties encountered with the market index requirement.....	5
Emerging asset classes .....	<b>Error! Bookmark not defined.</b>
Hedge funds .....	<b>Error! Bookmark not defined.</b>
Proposed Solution.....	7
Alternative Options Considered.....	9
Technical and Cost Considerations .....	10

## Who we are – Financial Services Council

The Financial Services Council of New Zealand Incorporated (**FSC**) has 16 member companies and 15 associate members at 31 August 2017. Companies represented in the FSC include the major insurers in life, disability, income and trauma insurance, and some fund managers and KiwiSaver providers. Law firms, audit firms and other providers to the financial services sector are represented among the associate members.

The FSC's vision is to be the voice of New Zealand's financial services industry, with three areas of strategic intent:

- 1 Strong and sustainable consumer outcomes
- 2 A sustainable the financial services sector
- 3 Increased professionalism and trust in the industry through the FSC Code of Conduct.

Our purpose is to:

- be recognised as an organisation that represents the interests of the New Zealand financial services industry, including to regulators and Government
- promote best practice and integrity in the financial services industry, including through the institution of codes of conduct and standards and the publication of guidance for industry participants
- promote the financial services industry for the economic benefit of New Zealand and to enhance the sustainability of the industry, whilst recognising the primacy of the interests of consumers
- develop and promote evidence-based policies and practices designed to assist New Zealanders to build and protect their wealth
- promote the financial services industry as a medium for investment and protection for consumers
- promote, assist and generally advance the interests of members.

To deliver on our vision and purpose FSC activity centres on five strategic pillars:



### **POLICY AND ADVOCACY**

**Aim:** To be the trusted voice of the financial services sector in New Zealand



### **INDUSTRY LEADERSHIP & INSIGHT**

**Aim:** Bringing the industry together with knowledge and insight for the benefit of all New Zealanders



### **INDUSTRY BEST PRACTICE**

**Aim:** Showcasing industry excellence in understanding, growing and protecting New Zealanders' wealth



### **COMMUNITY OF PROFESSIONALS**

**Aim:** A community developing itself to better understand and serve the needs of New Zealanders



### **DEVELOP THE FSC**

**Aim:** A sustainable business model delivering an effective and efficient industry body

## Who we are – Workplace Savings NZ

Workplace Savings New Zealand Incorporated (**Workplace Savings NZ**) is a not-for-profit apolitical membership organisation representing the interests of employers who offer workplace retirement savings schemes, their trustees and their members, other retirement scheme managers and supervisors, retirement savings industry service providers and professional advisers. WSNZ's membership embraces all types of retirement schemes (KiwiSaver, workplace savings and superannuation schemes) and participants who are public and corporate, union-sponsored and industry-based.

The objective of Workplace Savings NZ (which works closely with the Financial Services Council) is to be the *Voice of Workplace Savings* - advancing the sustainable, effective and efficient delivery of workplace savings outcomes for all involved, including the workplace savings scheme members who remain key to the organisation. WSNZ aims to do this through:

- 1 **Advocacy** – proposing and commenting on legislative and public policy initiatives beneficial to workplace savings and participation in the workplace savings industry, making submissions, engaging with policy-makers and officials and issuing media commentary to advance those causes.
- 2 **Education** – promoting trustee, employer and member financial and regulatory education through dedicated training programmes, newsletters and special interest seminars.
- 3 **Networking** – providing trustees, employers and service providers involved in workplace savings and other retirement schemes with a regular forum for sharing ideas and information on industry matters.
- 4 **Promotion** – publicising the benefits of workplace savings and helping to improve public confidence and participation in workplace savings.

## Our submissions

### MARKET INDEX REQUIREMENT

#### Question 1 – Do you agree with our view on the policy rationale for the market index? Do you consider current settings for the market index requirement are effectively achieving that policy aim?

**Yes** – We agree that the purpose of a market index return is to provide a ‘benchmark’ for a fund as described on page 4 of the Consultation Paper. This is the reason why many fund managers use a composite market index return comprising the individual benchmark indices which they use to monitor the performance of the specific asset classes in which the relevant fund invests.

The Financial Markets Conduct Regulations 2014 (**Regulations**) require each market index to be “*appropriate in terms of assessing movements in the market in relation to the returns from the assets in which the specified fund directly or indirectly invests*”. The Regulations do not refer to appropriateness in terms of allowing comparisons between fund managers - a market index is not a tool for measuring the performance of a fund relative to the performance of other funds.

The goal of the Regulations is to produce clear and concise disclosure, but the current ‘market index’ requirement frustrates this goal by requiring non-intuitive comparative performance measures in some cases.

### DIFFICULTIES ENCOUNTERED WITH THE MARKET INDEX REQUIREMENT

#### Question 2 – Do you agree with our view that alternative funds may not be able to comply with the market index requirement?

**Yes** – We agree with the FMA’s view that any funds with allocations to assets which are not readily benchmarked may not be able to comply with the market index requirement.

The basic concern is the potential incompatibility of the requirements in the Regulations that a market index be both:

- a “*broad based securities index*”; and
- “*appropriate in terms of assessing movements in the market in relation to the returns from the assets in which the specified fund directly or indirectly invests*”.

These criteria may be mutually exclusive to the extent that any fund is invested:

- in assets other than securities - for example direct holdings of real property, infrastructure investments or direct lending; and/or
- otherwise in such a way that a securities index does not provide an appropriate comparator.

This issue will become an increasingly systemic concern as funds under management (notably in KiwiSaver schemes) grow over time and fund managers pursue greater assets-side innovation and more exposure to alternative and other non-traditional assets. Overseas, the trend towards direct investing by Australian and Canadian superannuation schemes is particularly instructive<sup>1</sup>.

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<sup>1</sup> <http://www.oecd.org/pensions/pensionfundinfrastructureaustraliacanada2013.pdf>

In our view it would be a failure of regulation if strict legal requirements imposed in connection with reporting to investors (which are intended merely to impose descriptive requirements) operated as a practical constraint on innovation and/or diversification in terms of actual investment decision-making.

**Question 3 – Are there any other types of funds that are also likely to have difficulty with the market index requirement? If yes, please describe the issues faced by these funds.**

**Yes** – The requirement has proved significantly problematic for a number of restricted workplace savings schemes with exposures to a limited range of unlisted assets - perhaps some direct New Zealand property, private equity assets or other direct investments such as forestry – for which securities index benchmarks of the type required are simply not available.

Some hedge funds may also have found it difficult to comply. While hedge fund indices do exist, they will not always provide an appropriate performance measure.

More generally, a number of diversified funds that invest in emerging asset classes or into third party hedge funds (for example) are likely to have had difficulty with the market index requirement where there are no established or high quality indices against which the performance of the relevant assets may be benchmarked.

It is also anticipated – see below – that some of these funds may find it difficult to comply with the FMA’s proposed alternative ‘peer group’ benchmark. This would be true, for example, where a fund has an exposure to more novel emerging asset classes such as crypto-currencies. To date, there are no authoritative benchmark indices for such investments, and there are also few if any ‘peer group’ funds in New Zealand to benchmark against.<sup>2</sup>

Some restricted workplace savings schemes, in particular, also report that for certain of the assets to which they have exposures there are not only no ‘market index’ comparators but also no meaningful peer group comparisons, so an alternative compliance solution is required.

The lack of both an appropriate index and, in some cases, a comparator peer group (meaning even the exemption would be unavailable to certain affected funds) may create an unwarranted regulatory barrier to innovation in practice.

In short, there are a range of funds (and not just alternative investment funds) facing difficulties with the current ‘market index’ requirements and indeed the FMA’s proposed exemption, though welcomed, may not completely solve the issue in some cases. As we outline below, an absolute return benchmark may offer a better disclosure outcome for investors in the absence of any appropriate benchmark or reference peer group.

**Question 4 – Do you agree with our assessment that the market index is a mandatory requirement? If not, what implications does this have for managers that cannot produce a compliant market index?**

**Yes** – We agree with the FMA’s assessment that the use of a market index is a mandatory requirement as matters stand.

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<sup>2</sup> While not an index as such, the website <https://www.worldcoinindex.com/> indicates that new and emerging digital asset classes will, at some point, require indexation.

## PROPOSED SOLUTION

### **Question 5 – Do you think the best option to solve the issue faced by alternative funds is to allow for the use of other types of benchmarks? If not, what response do you consider to be preferable?**

**Yes** – We agree with the FMA that fund managers should be permitted to use other types of benchmarks where appropriate.

We think though that the best option to solve the issue where the use of a market index is not practicable will be to allow a manager (subject to clear pre-conditions – see Question 6 below) simply to select or compile a composite benchmark comprising a compliant broad-based securities index to the extent practicable but also a peer group measure or (to the extent that this too is impracticable) the absolute returns from a comparable asset class.

This will mean that where (for example) a fund holds securities and direct real property, it can have a composite benchmark comprising a compliant broad-based securities index (or indices) with respect to its securities investments, and the real estate market with respect to direct property.

Managers seeking to rely on the exemption could also be required to notify the FMA. We elaborate below.

### **Question 6 – We have proposed to allow for the use of peer groups. Do you think our approach will resolve the difficulty faced by managers of alternative funds?**

**No** – We do not consider that the proposal (though welcome) will provide a complete solution.

This is because we consider that there will likely be circumstances where there is no appropriate ‘peer group’ - and in those cases the most appropriate ‘benchmark’ against which to assess returns from the assets (or certain of the assets) in which the relevant fund directly or indirectly invests may be a comparison of the change in value of (or the returns from) similar assets.

As there will be circumstances where no appropriate benchmark *or* peer group exists, we consider that the most appropriate solution is for fund managers to be exempted from the requirement to use a “*broad-based securities index*” as a market index where they consider that:

- an alternative measure (e.g. reference either to a peer group or to the absolute returns from a comparable asset class) is considered appropriate in terms of assessing against movements in the market the returns from the assets in which the specified fund directly or indirectly invests; and
- there is no broad-based securities index which is appropriate in terms of assessing against movements in the market the returns from the assets in which the specified fund directly or indirectly invests.

Managers (who of course include the trustees of all restricted schemes – also a significant area of focus) would then be free to provide performance measurements based on one or more alternative measures that they considered appropriate, such as peer group analysis *or* absolute return measures.

The exemption could include a further condition requiring managers to notify the FMA of their reliance on the exemption. This would empower the FMA to monitor reliance without being required to review every fund update to determine whether the exemption facility was being invoked.

Our suggested exemption could be combined with the conditions already suggested by the FMA to the effect that where managers rely on the proposed exemption then they must briefly:

- state where a measure (or measures) other than a broad-based securities index has (or have) been used in preparing the market index; and
- explain the reason why each such measure has been used, including why it the manager considers that it appropriately reflects market movements in relation to the returns from the assets in which the fund directly or indirectly invests.

Permitting the use of appropriate alternative measures in this way would squarely align with one of the purposes of the Financial Markets Conduct Act 2013, which is to promote innovation and flexibility in financial markets.

**Question 7 – Do you think that we have made an appropriate distinction in allowing for the use of peer groups but not absolute returns or other forms of benchmark?**

**No** – As indicated above, in some cases a better disclosure outcome for investors will be achieved by benchmarking the performance of the relevant fund against a stated absolute return objective. For example:

- a capital protection fund designed to beat inflation (but no more) would logically benchmark its performance against CPI, and not the 90 Day Bank Bill Rate as a proxy for CPI; and
- an absolute return fund with asset allocations that are never ‘fixed’ should be able to benchmark its performance against its own return target or, where there is no return target, against (say) the return that must be achieved in order for a performance fee to be payable with respect to any given accounting period.

The exemption we propose could allow an alternative to meeting the requirement in clause 61(3)(b) of Schedule 4 to the Regulations to use a broad-based securities index (or indices) that:

*“are appropriate in terms of assessing movements in the market in relation to the returns from the assets in which the specified fund directly or indirectly invests.”*

by expressly allowing an alternative benchmark that (after due enquiry) is considered appropriate in terms of assessing the returns of the specified fund against its stated performance objectives.

We acknowledge the FMA’s view that the use of an absolute return for benchmarking purposes does not provide contextual information to investors about the performance of the assets or markets in which a fund invests, or the performance of similar strategies. Absolute return measures do, however, give investors concrete information about a fund’s performance against its investment objective, which may well have been the basis on which they chose to invest in that fund.

The risk that an absolute return measure does not provide appropriate contextual information on performance could be addressed by requiring that such a measure can only be used if (and to the extent that) the use of either a compliant market index or a peer group measure is impracticable, and imposing disclosure conditions. The disclosure conditions might be, for example, requiring a disclaimer that any absolute return benchmark:

- is not appropriate for the purpose of comparing the fund’s investment returns against investment returns from similar assets or markets; but

- is provided for the purposes of enabling investors to compare the returns of the fund relative to its investment objective.

**Question 8 – Are there any risks for investors from allowing the use of peer groups? How do you think these risks should best be managed?**

**Yes** – there are risks, as noted by the FMA, but we consider that (to the extent that using peer group comparisons is in fact practicable) these risks will be suitably mitigated through the proposed conditions of the exemption. We reiterate though that we consider the FMA should reconsider its stance in relation to not allowing flexibility for managers to use another type of alternative benchmark measurement in their fund updates, to the extent that they consider this objectively necessary.

**Question 9 – We have proposed a condition that requires the manager to disclose that they have elected to use a peer group for a particular fund, and the reasons they consider the peer group they have selected to be appropriate. Do you think this condition ensures investors have access to sufficient relevant information about the benchmark?**

**Yes** – We consider that a condition along the proposed lines will ensure that investors have sufficient information about any alternative benchmark used by the manager.

**ALTERNATIVE OPTIONS CONSIDERED**

**Question 10 – In the paper we consider whether it would be appropriate to provide managers with the ability to opt out of the market index or to disclose more than one benchmark. Do you agree with the risks we have identified with these approaches? Do you think it would be appropriate to provide either of these options to managers, either in addition or as an alternative to our proposed exemption?**

**Yes** – While we support the proposal that fund managers be able to use appropriate alternative performance measures, we consider that some of the risks identified in the consultation paper may be overstated and could be addressed through conditions to the exemption.

**Question 11 – Where a manager uses a peer group, either on its own or as part of a composite, the treatment of fees may diverge from the existing market index requirement. Do you think that our proposed disclosures and the ability of managers to modify prescribed statements mean investors will be provided with understandable information about how the market index factors in fees? If not, what approach do you think would be preferable?**

**Yes** – We support the proposed disclosure conditions and consider that the manager’s ability to modify prescribed statements under regulation 9 of the Regulations will be sufficient to ensure investors are given understandable information about how the market index factors in fees. The FMA should consider providing one or more examples in guidance on permissible market index fee disclosure.

## TECHNICAL AND COST CONSIDERATIONS

**Question 12 – What would be the cost implications for your managed fund of providing a peer group or absolute returns? To what extent are these costs different or incrementally higher than for funds that disclose a market index?**

We do not have costings to compare the difference between peer group and absolute return measures. We expect, however, that the incremental difference in cost associated with a peer group comparison would depend on the level of rigour of any given peer-group analysis carried out by a manager.

**Question 13 – Do you think the proposed class exemption raises any issues with how a fund would calculate its risk indicator or performance fee estimate? Do the current FMC Regulations offer enough flexibility for fund managers to work around these issues?**

**No** – The FMA’s proposed class exemption (allowing peer group comparators) is unlikely to cause any issues with the way a fund would calculate its risk indicator or performance fee estimate.

Where an absolute return measure used in a fund update would not be appropriate to use in a risk indicator (to the extent that this was presumptively required under clause 6(2) of Schedule 4 to the Regulations) clause 8 of Schedule 4 would apply, thus affording both enough flexibility for managers and sufficient protection (given the standard imposed) for investors.

**Question 14 – Where fund updates are included in a PDS, what is the best way to allow managers to transition between market indices, if the proposed exemption is granted?**

Where a PDS is supplemented by fund updates under clause 8A of Schedule 4 of the Regulations and the manager intends to rely on the exemption for future fund updates, we consider that the best way to allow for managers to transition between market indices without re-issuing their PDS is to include a specific clause in the exemption to the effect that it will apply to any fund update incorporated into a PDS by reference under clause 8A(1)(b) of Schedule 4 of the Regulations.