BNA International

World Securities Law Report

International Information for International Businesses

Monthly News & Comment on Securities Regulation from Around the World

Volume 16, Number 9 September 2010

New Zealand's Proposed Reform Of The Collective Investment Scheme Regime

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Significant change to the regulation of collective investment schemes (CISs) may flow from the recently launched Securities Law Review. They get their own chapter in the Ministry of Economic Development's (MED's) 200 page discussion document and are the subject of 45 questions for consultation.

This article summarises the areas marked for reform and identifies some potential issues. Submissions are due by August 20, 2010.

[Editor's Note: The Securities Law Review is examined by Roger Wallis, of Chapman Tripp, Auckland, at WSLR, August 2010, page 28.]

Key Reform Proposals for Collective Investment Schemes

The key proposals arising out of the discussion document in relation to CISs are:

- a broader definition of "collective investment schemes";
- application of a standard framework to all schemes falling under this definition regardless of their legal form;
- independent supervisors to oversee all schemes, registration of CISs, managers and trustees, with licensing of trustees and (possibly) custodians and managers;
- enlarged managers' duties and responsibilities;
- prescribed requirements for constitutional documents (more implied provisions);
- further regulatory controls surrounding asset valuation and pricing, (including requiring disclosure of how pricing errors will be dealt with and how limit breaks will be rectified); and
- powers, additional to those held by the Securities Commission, for the new Financial Markets Authority (FMA) to take proceedings against trustees and managers.

The proposals build on, and to some extent revisit, issues in the Review of Financial Products and Providers.

Proposed Definition of CIS

The discussion paper proposes a consistent framework be applied to all CISs, regardless of their legal form. This is to address the potential for regulatory arbitrage arising from the current inconsistent treatment under the Securities Act between unit trusts, superannuation and/or KiwiSaver schemes, group investment funds, investment-linked insurance policies and (potentially) wrap accounts.

The proposed definition of a CIS is: an investment in which a subscriber pays money to another person to invest, but the subscriber does not have day-to-day control over investment decisions or the assets purchased using his or her contributions, provided that the investment:

- is intended to provide members with benefits of investment management and risk diversification, and
- allows investors to withdraw their investment on demand (in a reasonable time), at a price based mainly on the value of the assets owned by the company.

The bullet-pointed provisions are based on U.K. legislation and are intended to exclude debt and equity securities. Clearly, the definition will need some work, as it does not cover superannuation and KiwiSaver schemes, which do not allow withdrawal on demand, nor does it clearly cover investment-linked insurance.

Investment companies could also be CISs, if they meet the criteria. Where a company is a CIS, the board of the company would be deemed to be the manager and the issuer. However, a statutory supervisor would need to be appointed.

The CIS definition is intended to be broad to catch some participatory securities under the existing regime, such as bloodstock interests, property syndicates and forestry partnerships.

The MED is seeking comment on whether non-pooled schemes should be included within the scope of CISs — *i.e.,* schemes where investors' funds are not pooled with other investors or with the promoters of the scheme, but where (for example) an investment management service takes money from an individual investor and invests those assets on behalf of that investor.

Basic CIS Framework

All CISs will have to have both a manager and a supervisor (usually the trustee). The manager will be the issuer (except for some superannuation schemes, which will be grandfathered, and non-retail KiwiSaver schemes). A single responsible entity model (like that adopted in Australia) has been discounted by the MED.

There would be no ability for the manager to remove the supervisor, unless agreed to by a court.

Registration

All managers, trustees and custodians will need to register under the new Financial Service Providers (Registration and Dispute Resolution) Act 2008 (FSPA) in order to continue in the business of providing financial services.

All CISs will have to be registered with the proposed Registrar of Securities before offering securities to the public.

To be registered, schemes will need to have:

- a registered and (if required) licensed manager;
- a registered and licensed supervisor; and
- constitutive documents that comply with the new statutory requirements for CISs (see below).

This will replace the existing registration regime for unit trusts and superannuation schemes. Where CISs are subject to additional requirements — such as companies under the Companies Act 1993, limited partnerships under the Limited Partnerships Act 2008 and KiwiSaver schemes under the KiwiSaver Act 2006 — these will continue to apply.

Managers' and Supervisors' Functions and Duties

It is proposed that all supervisors of CISs will have the same functions, duties, powers and rights, regardless of the scheme's legal form. Both managers and supervisors will have clear and direct duties to investors to act in their best interests.

These functions and duties will be prescribed in legislation. Many of the proposed functions would commonly appear in trust deeds now.

We support this move, as it will ensure greater accountability and transparency of roles and duties to investors without imposing large additional costs. Most scheme managers doubtless already act in the best interests of investors, so the proposal should simply formalise existing practice, provided the obligation is limited to taking only all reasonable actions.

Managers' Functions and Duties

Managers are to be legally responsible for all administration and management functions of the scheme, even where these functions are delegated, and are to have duties and liabilities similar to those of a manager under the Unit Trusts Act 1960. This would include adherence to the terms of the constitutive document, reporting to the supervisor and investors and publication of quarterly information. It is also proposed that they adhere to the duties of a fiduciary.

Consequences of a breach of the proposed duties include:

- removal by investors;
- a direction from investors that the scheme supervisor take action in court to seek compensation for loss caused by the breach;
- prosecution on behalf of investors by the FMA; and
- liability for criminal penalties where there is a high level of culpability.

Supervisors' Functions and Duties

The role of the supervisor will extend beyond mere supervision.

Proposals are that supervisors also:

- have functions, duties and liabilities similar to those of a trustee under the Unit Trusts Act 1960 (including negotiating the terms of the constitutive document and securities offers with the manager);
- monitor the scheme's adherence to the constitutive document, any management agreement and offer terms and take relevant enforcement action against the manager where duties to investors are breached;

   ISSN 1357-0889

- disclose to investors the duties the supervisor owes the investor as well as any restrictions on those duties, and submit an annual declaration to the FMA that these duties have not been breached; and

- comply with reporting requirements to the regulator and investors, and maintain appropriate custodial arrangements and take responsibility for scheme property. (Even where an external custodian is appointed, supervisors would retain liability for the performance of the duties and obligations relating to the custody of the scheme's assets.)

Licensing

The supervisor of a CIS will have to be licensed under the proposed new Securities Trustees and Statutory Supervisors Bill. Input is sought on whether managers and custodians should also be licensed.

The rationale behind licensing custodians is that it is important for assets to be held in an appropriate manner, and that custodians in overseas jurisdictions are subject to a more rigorous regime than currently proposed under the FSPA.

Regulation of Asset Valuation and Unit Pricing Errors

The MED wants the asset valuation and pricing methodologies to be prescribed in the constitutive document for the scheme, including a mechanism for changing the methodology should the need arise.

Managers will have the freedom to set their own process, including timing of valuation, but this will have to comply with enforceable guidance notes issued by the FMA. Responsibility for ensuring that the valuation policies are consistent with the FMA guidelines will lie with the scheme supervisor.

To prevent schemes "hiding" fees, the constitutive document will specify that, where expenses are included in the unit valuation, they must be identified and their purpose given (*e.g.*, supervisor fees or brokerage).

Because the treatment of unit pricing errors can have a significant impact on investor returns, the MED proposes that scheme managers be required to develop policies to deal with pricing errors and breaches of investment limits and to set these out in the constitutive document.

Managers will be required to report to the supervisor if a pricing error or limit break occurs, explaining why it occurred and what actions will be taken to avoid a recurrence. Supervisors will be required to report to the FMA on breaches above a set threshold.

Additional Provisions Required in Constitutive Documents

Additional provisions identified for mandatory inclusion in constitutive documents include:

- the CIS's investment policies, how any minimum contribution levels and rates will be established and revised, entry and exit rules, returns, pricing, fees, the circumstances which will trigger a wind-up, how it will be conducted, and the distribution of assets;

- any limits on the investments of the scheme, and (possibly) a methodology for how the investment strategy can be developed, amended and measured (existing investors would need to be advised of any changes in authorised investments and given the opportunity to exit the scheme at no penalty if not satisfied with the changes); and

- the types of fees that are, or could be, deducted and how they would be calculated (with investors able to exit without penalty upon notice of a fee increase).

Much of what is proposed is already standard practice in the industry, and for that reason we welcome these changes in principle, provided that they are not made too prescriptive. There might be arguments for prescribing investment objectives, asset class preferences and categories of excluded assets within a scheme's constitutive document. But it would seem more flexible (without loss of transparency) to require disclosure of the permitted ranges of asset allocation through a statement of investment policy and objectives which are described in the offering documents, as these can be more easily changed if required.

Meetings

To better enable scheme members to call meetings to exercise control over the fund manager and supervisor, the MED proposes that investors have access to the contact details of other investors so they can seek support to reach the relevant thresholds to call a meeting. Members of some CISs can get this information now via the Securities Act in some cases, although there are some exemptions from this general disclosure requirement.

This right is not available to KiwiSaver or superannuation scheme members, and, on balance, we do not think it appropriate in other CIS contexts, given that public disclosure of individuals' personal information has significant privacy implications. Also, to date these powers have been more often used by competitors, seeking to identify target clients to promote their own products or, more rarely, by low price offerors seeking names of the unwary to make unauthorised offers.

The MED is looking for submissions on whether voting threshold requirements should be changed, for example, to a simple majority rather than extraordinary resolution (75 percent majority) to more closely align CISs with companies. Such a change, together with proposals to relax requirements to requisition meetings and for reduced quorums, would make it easier for investors to remove the manager of a CIS.

External Administration

The MED is seeking feedback on whether CISs should be required to have an external administrator to carry out duties relating to valuing assets and setting unit prices.

The rationale for the move is that it would serve as a check on the valuation processes of the fund manager. We consider, however, that the benefits would not justify the costs, especially as those benefits can be delivered in large part by the oversight of the supervisor.

Whistle-Blowing

The discussion paper asks whether a whistle-blowing regime similar to that contained in Section 18A of the Superannuation Schemes Act 1989 should apply to all CISs. This would require the administration manager, investment manager, actuary or auditors to disclose information to the FMA if they consider that there is a serious problem with a scheme, and would provide protection against any liability for such disclosure where it was made in good faith.

We are unconvinced that this is necessary, given the oversight of the FMA and the statutory obligations proposed for scheme managers and supervisors. Also the anecdotal evidence to date regarding the effectiveness of the provisions in relation to the regulation of superannuation schemes is not compelling, particularly given that the last formal notice received by the Government Actuary under Section 18A was in 1997.

Other Issues

Wrap Accounts

Wrap accounts (where a provider holds securities on behalf of an individual investor) are separately regulated in Australia, and the MED is considering whether the same should apply here.

Group Investment Funds

It is proposed that group investment funds (GIFs) no longer be exempt from the relevant requirements in the Securities Act when the current exemption for externally managed GIFs expires. As the main reason for the exemptions was to ensure that these products were treated in the same manner as unit trusts, it may be that they will be made redundant by the proposed reforms. As the original applicants for the exemptions, we will monitor their continued need.

Mutual Recognition Offerings

Australian securities offered into New Zealand by way of the Mutual Recognition Regulations should continue to be subject to only minimal requirements under the New Zealand securities framework.

Investment-Linked Insurance Policies

It is proposed that any new insurance policies that have an investment component would be regulated as if they were two separate contracts — one of insurance and one for investment. The policies would still be able to be bundled and sold together as a single product offering. The insurance part of the contract would be covered by the insurance prudential supervision framework and the investment part of the contract would be regulated as a CIS. Existing investment-linked policies are regulated entirely under the Securities Act and the relevant provisions in the Life Insurance Act 1908.

New Zealand as a Financial Hub — a Possible Dual Regime?

To support the Government's aim of establishing New Zealand as a financial hub, a dual regime is proposed under which schemes that are offered domestically would be subject to lesser regulation than those being offered internationally. Requirements which would at least match and (possibly) better the European Union's Undertakings for Collective Investment in Transferable Securities (UCITS) regime would be necessary for international offerings if New Zealand is to be competitive.

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   ISSN 1357-0889