Monitoring of KiwiSaver Offer Documents

FMA

FINANCIAL MARKETS AUTHORITY

TE MANA TATAI HOKOHOKO - NEW ZEALAND

Financial Markets Authority
Website: www.fma.govt.nz

Auckland Office
Level 5, Ernst & Young Building
2 Takutai Square, Britomart
PO Box 106 672
AUCKLAND 1143

Wellington Office
Level 2
1 Grey Street
PO Box 1179
WELLINGTON 6140

June 2013

Contents

Introduction **4**

Background **5**

Summary of Findings **7**

Introduction

KiwiSaver is one of the key priorities for FMA in 2013. For many individuals, KiwiSaver will be the first investment they make and will represent a large part of their retirement savings. Therefore, inadequate or misleading disclosures in offer documents could have a significant impact on their retirement.

As part of FMA's ongoing monitoring of KiwiSaver, we announced to market participants in November 2012 that we would carry out theme-based monitoring of all KiwiSaver offer documents.

The key objective in our monitoring is to continue to promote high standards and increase public confidence in offer documents.

During the course of this review, FMA wrote to a number of issuers to clarify certain disclosure matters. As a result, some issuers re-assessed the disclosures in their offer documents and volunteered to make improvements. In addition, FMA is currently in the process of taking action against two issuers due to non-compliance with securities legislation relating to potentially misleading statements in their offer documents.

This report outlines to issuers, their directors and advisers, our views and observations on current market practices.

In FMA's view the principles outlined in this report are relevant to managed funds in general and not just KiwiSaver schemes.

Background

As at November 2012 there were 50 KiwiSaver schemes in the market, including both restricted and non-restricted schemes. FMA's review looked at 15 KiwiSaver schemes that comprised a cross section of the market, taking into account the scheme's restricted or non-restricted status, investment managers, trustees and auditors, as well as some other factors.

The 15 KiwiSaver schemes had total funds under management of $5 billion, which represented 40 percent of the total KiwiSaver market[1].

We reviewed each KiwiSaver scheme's investment statement, prospectus, financial statements, statement of investment policy and objectives (**SIPO**), where applicable, as well as other publicly available advertising material such as websites (together the **offer documents**).

The review of offer documents was based on all applicable securities and financial reporting laws in force as at November 2012.

FMA also considered our Effective Disclosure Guidance Note (**guidance note**) issued in June 2012[2] and the KiwiSaver (Periodic Disclosure) Regulations 2013 (**Periodic Disclosure Regulations**).

The guidance note stated that FMA would not use this guidance as part of our risk-based assessment of offer documents for continuous issues until 1 January 2013. We acknowledge that a significant number of continuous issuers have not issued an investment statement or registered a prospectus since 1 January 2013. Nevertheless, we consider it useful to communicate with market participants our views and observations on the current level of compliance with our guidance note.

FMA is also taking this opportunity to highlight areas that require particular attention due to the additional disclosure obligations under the Periodic Disclosure Regulations, which will apply to all non-restricted KiwiSaver schemes.

References made in this report to issuers have the same meaning as defined in the Securities Act 1978[3].

---

[1] Based on the KiwiSaver annual returns for the year ended 31 March 2012 provided to FMA as required by Section 125 of the KiwiSaver Act 2006

[2] FMA Effective Disclosure Guidance Note 2012. See: http://www.fma.govt.nz/media/1105126/guidance_note_-_effective_disclosure_june_2012.pdf

[3] Refer to Section 2(1) of the Securities Act 1978. With respect to a restricted KiwiSaver scheme, the issuer is the superannuation trustee of the scheme. With respect to a non-restricted KiwiSaver scheme, the issuer is the Manager of the scheme.

KiwiSaver (Periodic Disclosure) Regulations 2013

The Periodic Disclosure Regulations come into force 1 July 2013, and require issuers of non-restricted KiwiSaver schemes to prepare quarterly and annual disclosure statements[4] (**QDS** and **ADS** and together **periodic disclosure statements**) for every KiwiSaver fund[5].

The first QDS and ADS are due to be completed and published by 21 October 2013 and 27 June 2014, respectively[6].

The Periodic Disclosure Regulations will standardise the reporting of investment returns and fees[7], making it easier for investors to compare funds offered by non-restricted KiwiSaver schemes.

The periodic disclosure statements are advertisements for the purposes of the Securities Act 1978[8] and must be consistent with the investment statement or prospectus[9].

However, where there are inconsistencies, the highly prescriptive nature of the periodic disclosure statements will mean that it is unlikely that a manager will be able to change the content or form of periodic disclosure statement to remove any inconsistencies. Therefore an important consideration for managers of non-restricted KiwiSaver schemes is to ensure their investment statements and prospectuses are consistent with any periodic disclosure statement[10].

In this report, we highlight instances where we consider the additional disclosures required in the periodic disclosure statements may be inconsistent with current disclosures in offer documents. When read as a whole, the offer documents and periodic disclosure statements must convey information in a consistent manner. Where disclosures are materially inconsistent, the offer documents could be confusing or misleading to investors.

FMA has provided examples in this report to help explain our approach. These examples are not exhaustive and are not intended to be a checklist.

---

[4] Regulation 7(1) of the Periodic Disclosure Regulations
[5] As defined in Regulation 4 of the Periodic Disclosure Regulations
[6] The first QDS will be for the quarter ended 30 September 2013 and the first ADS will be for the year ended 31 March 2014
[7] In addition, the Periodic Disclosure Regulations also standardise the reporting of asset allocations and portfolio holdings, liquidity and liabilities, and key personnel. Refer to Regulations 9 and 12 with respect to the ADS and QDS.
[8] Section 2A(2)(c) of the Securities Act 1978
[9] Regulation 24 of the Securities Regulations 2009
[10] Paragraph 139 of the Effective Disclosure Guidance Note June 2012

Summary of Findings

We outline below our findings and suggested areas for improvement:

Investment Returns

The Securities Regulations 2009 requires disclosure of historical five year investment returns in prospectuses[11], but do not prescribe the basis of calculation.

FMA found that issuers adopted a range of methods to report their investment returns, including the inclusion and exclusion of fees and/or tax. In some instances issuers didn't have internal consistency within their offer documents. For example, the basis of calculation of investment returns in their prospectus was different to that on their website.

These inconsistencies can be confusing for investors, even if there are sufficient disclosures to explain the different basis for calculation.

We believe the periodic disclosure statements are likely to cause further inconsistencies in the disclosure of investment returns, where the prescribed basis of calculation by the Periodic Disclosure Regulations differs from the basis of calculation used in offer documents.

It is likely that as more periodic disclosure statements are prepared issuers of non-restricted KiwiSaver schemes will end up disclosing historical investment returns that cover periods before and after the Periodic Disclosure Regulations apply.

This could lead to confusion for investors as they will not be able to compare investment returns between periods, as not all the periods will be calculated on the same basis. Below we have listed two approaches that issuers might consider when disclosing investment returns, in order to reduce the likelihood of confusing or misleading investors.

- issuers could recalculate past investment performance figures in accordance with the Periodic Disclosure Regulations. This would ensure a consistent approach to disclosing the historical investment returns.

- issuers could present historical investment returns that are prepared under more than one basis. Cautionary statements should be used to make sure investors are aware that they cannot necessarily compare returns between periods, as returns are not all calculated on the same basis, and could therefore be materially different if they had been calculated on the same basis.

[11] Clause 6(8) of Schedule 5A and Clause 4(7) of Schedule 6 of the Securities Regulations 2009

Risk Disclosures

FMA considered the risk disclosures in many of the investment statements and prospectuses to be too generic in nature and did not reflect any specific risks that the scheme or funds were likely to be exposed to, which could result in losses to investors.

Generally, risk disclosures that FMA considered to be the most useful to investors involved presenting the risks in categories. For example, those risks that affect the scheme generally, specific risks that the scheme or fund is exposed to, and where applicable specific risks associated with particular asset classes. In addition, attention was paid to presenting the most significant risks prominently, rather than giving equal prominence to all risks regardless of their significance.

We remind issuers to consider FMA's guidance note when assessing the disclosure of all material risks a scheme or fund may be exposed to[12].

Below we summarise our views on other areas where risk disclosures should be improved.

Risk management

In many instances FMA considers the offer documents did not provide sufficient information to investors to assess whether the issuer is managing and/or mitigating a particular risk, and therefore whether that risk is heightened or alleviated.

We consider that the tools and means with which issuers and/or investment managers manage and/or mitigate risks, can have a material impact on investment returns and therefore this is likely to be material to investors.

Managers should consider, where possible, disclosure of how risks are managed and/or mitigated, as it will aid investors to better understand how their investments will be managed.

The disclosures could be made within the specific risk disclosure section of an investment statement or prospectus, or they could be made as part of the description of the fund or scheme's investment objectives and policies[13].

Using currency risk as an example, we illustrate below how an issuer's risk management policy could be disclosed.

[12] Paragraphs 92 to 100 and table VII of the Effective Disclosure Guidance Note June 2012
[13] Clause 6(7) of Schedule 5A and Clause 4(6) of Schedule 6 of the Securities Regulations 2009

Currency Risk

Currency risk means there is a risk that the fund's investments that are denominated in a foreign currency are adversely impacted by the New Zealand dollar appreciating relative to the foreign currency. If this occurs, it is likely the value of the investments will fall, resulting in losses to members. The fund's exposure to foreign currency risk is primarily with respect to the Australian dollar and the US dollar.

This risk is reduced by the investment manager directly entering into foreign currency forward contracts as a hedge against foreign currency volatility. The investment manager will review and adjust, if necessary, the fund's foreign currency exposure on a monthly basis. The fund's benchmark hedging policy is shown in the table below:

Investment	Benchmark hedging position	Impact of the NZ dollar appreciating relative to the foreign currency on the value of the investments
Australian equities fund (Australian dollar)	unhedged	High
US equities fund (US dollar)	45-55% hedged	Medium
US fixed interest fund (US dollar)	95-105% hedged	Low

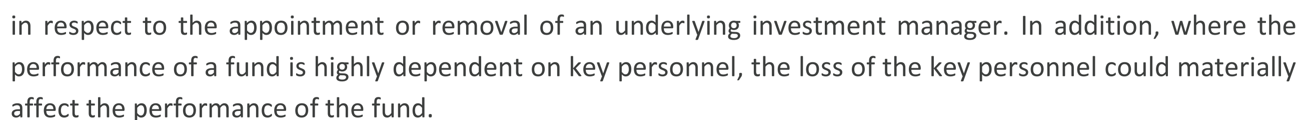
Members should note that there is a cost to hedging and this cost will impact members' returns.

Risk topics to consider

FMA identified the following risks that were generally not disclosed. Our view is that issuers should consider these topics when assessing the material risks that a KiwiSaver scheme or fund is exposed to:

- Benchmark risk – where a fund's investment objectives contain references to benchmarks as a measure of performance, the risks associated with not meeting the benchmark should be disclosed. For example, where a fund's benchmark is to outperform the rate of inflation, there is a risk that even if nominal returns are positive, the effects of inflation could lead to real returns being negative.

- Manager risk – the risk that the manager or investment manager makes poor investment decisions (or other decisions which have an adverse impact on investors). Where managers employ the 'manager of managers' model, the risk is that the manager and/or the investment manager could make a poor decision



in respect to the appointment or removal of an underlying investment manager. In addition, where the performance of a fund is highly dependent on key personnel, the loss of the key personnel could materially affect the performance of the fund.

- Derivatives and gearing risk – where derivatives or gearing are used as an investment tool, gains and losses on investments can be exacerbated. Investors should be made acutely aware that these types of instruments are being used and the risks associated with them should be prominently disclosed.
- Lifestages products - where an investment option is offered that automatically switches an investor into different products based on their age, there is the risk that the predefined asset/fund allocation is not suitable for the investor as it does not take into account an investor's personal circumstances such as their financial risk appetite and financial circumstances.

Directors and Senior Management

FMA's effective disclosure guidance note[14] outlines what we consider to be material information with respect to directors and senior management. Reference to 'directors and senior management' should not be strictly construed to exclude, and should be taken to include, individual trustees or directors of trustee companies.

We observed in our review a lack of disclosure, beyond that required by legislation[15], of information about the directors and senior management of the issuer, investment managers, and trustees.

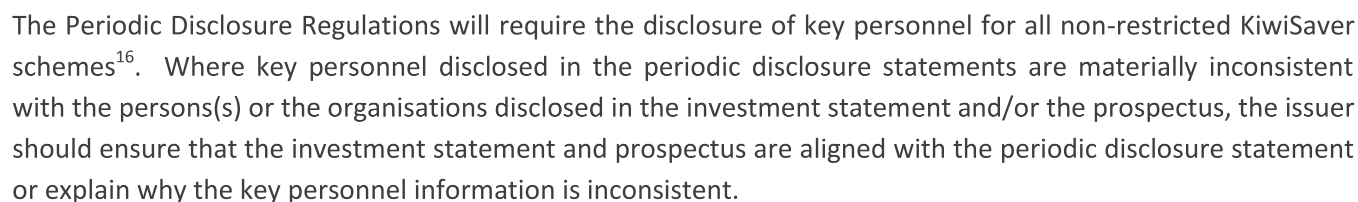
FMA considers that an investor's decision about whether or not to invest in a particular KiwiSaver scheme is in part down to the expertise and experience of the issuer and investment managers. Promotional material on websites and investment statements corroborates this.

Where issuers and investment managers are described with words like 'experts' or 'proven investment managers', the disclosures should be presented in a balanced manner. FMA observed the use of phrases implying a high level of expertise or proficiency but there was no information provided to substantiate these claims. Issuers must be mindful that this type of information should be disclosed in a balanced manner and relevant information should be disclosed to support these claims.

Where the issuer or investment manager employs one or more underlying investment managers, FMA considers it material to disclose who the underlying investment managers are, and include information on their expertise and experience.

We acknowledge this may not always be possible where it can be reasonably expected that the underlying investment managers will change frequently. In such circumstances, issuers should consider disclosing the selection criteria for appointing and removing underlying investment managers.

[14] Paragraphs 81 to 85 and table VI of the Effective Disclosure Guidance Note June 2012
[15] Clause 2 of Schedule 5A, Clause 3 of Schedule 6, and Clause 3 of Schedule 13 of the Securities Regulations 2009



The Periodic Disclosure Regulations will require the disclosure of key personnel for all non-restricted KiwiSaver schemes[16]. Where key personnel disclosed in the periodic disclosure statements are materially inconsistent with the persons(s) or the organisations disclosed in the investment statement and/or the prospectus, the issuer should ensure that the investment statement and prospectus are aligned with the periodic disclosure statement or explain why the key personnel information is inconsistent.

Fund Fees & Performance fees

The Periodic Disclosure Regulations require fund fees to be categorised as annual management fees charged by the manager, performance fees charged by the manager, and all other fees and costs[17].

FMA considers all other fees and costs to include all underlying performance fees charged by any underlying funds[18] (except where a manager cannot make an estimate of the underlying fee after the manager has made reasonable endeavours to obtain all relevant information[19]).

It was not common for issuers of the 15 schemes to directly charge performance fees.

Some schemes were however exposed to performance fees indirectly via investments in underlying investment funds. Where performance fees were charged by underlying investment funds, most schemes disclosed in a clear manner which funds could be subject to performance fees, including the percentage of any excess returns above the nominated benchmark.

However there is scope in our view to improve the transparency of underlying performance fees in offer documents. Where possible, issuers should consider disclosing the following in offer documents:

- the specific funds that are exposed to underlying performance fees rather than disclosing at the scheme level.
- details of how underlying performance fees are to be charged - this should be aligned with FMA's guidance note on performance fees[20].

The issuer should also consider providing explanations where any fund fees disclosed in the periodic disclosure statements differ materially from the disclosures in the investment statement or prospectus.

For example, where performance fees (or any other specific type of fee or cost) charged by underlying funds are not quantified, either as a percentage or dollar value, in the investment statement or prospectus. In these cases the issuer should consider disclosing the amount and type of fees or costs charged in previous periods, where the issuer considers it to be materially relative to the fees and costs that are disclosed in the investment statement and/or prospectus as a percentage or dollar value.

[16] Regulation 9(e) of the Periodic Disclosure Regulations
[17] Regulations 21(2)(a)-(c) of the Periodic Disclosure Regulations
[18] Regulation 21(2)(c) of the Periodic Disclosure Regulations
[19] Regulation 21(6) of the Periodic Disclosure Regulations
[20] Refer to page 5 of the FMA guidance note on performance fees under the heading “Disclosure elements of performance fees: http://www.fma.govt.nz/media/784989/kiwisaver_performance_fee_guidance_note_final_-_new_image.pdf

Investment objectives and policy

Where a scheme had a SIPO, FMA reviewed it to ensure that it was consistent with the disclosures in the offer documents. Generally we found this to be the case.

There were however instances, where we considered the description of a fund's investment objectives in the offer document did not provide an investor with enough information to determine where the fund's investments would be invested. In particular, whether a fund could invest directly or indirectly at the manager's discretion.

Where there is a clear intention to invest a fund's investment into specific underlying funds, these should be named. For example:

> The Balanced Fund intends to exclusively invest into the XYZ suite of wholesale unit trusts in order to gain exposure to the various asset classes
>
> or
>
> The Balanced Fund intends to exclusively invest into the XYZ Wholesale Balanced Fund

FMA noted that for some funds that invest into multiple asset classes, the asset allocation ranges for each asset class was so wide that the fund's risk profile could theoretically be invested anywhere in a conservative to aggressive risk profile spectrum.

Risk Profile Questionnaires (RPQ)

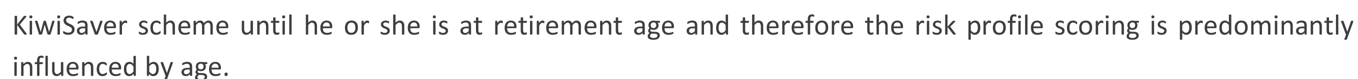
10 of the 15 schemes provided investors with risk profile questionnaires to complete in order to aid investors in making an informed investment decision.

All the RPQs contained questions regarding an investor's age, investment timeframe and their tolerance to investment risk. Six of the 10 RPQs asked about an investor's expectation of investment returns and five of the 10 RPQs asked about an investor's investment knowledge and experience.

FMA tested the 10 RPQs using three hypothetical investors, to test whether each RPQ gave the same answer in terms of the investment fund an investor should consider investing in.

Generally we found that most RPQs provided the fund choice which could reasonably be deemed appropriate for each of the three hypothetical investors. Two of the RPQs did however guide investors to funds that were considerably more aggressive or conservative compared with the other eight RPQs.

We acknowledge that the RPQs are a guide only and do not take into account an investor's personal circumstances. Most of the RPQs appear to be based on similar principles, for example an investor will stay in a



KiwiSaver scheme until he or she is at retirement age and therefore the risk profile scoring is predominantly influenced by age.

FMA's review has highlighted the following matters which issuers should consider when disclosing RPQs in offer documents:

- if a scheme offers different versions of RPQs. For example a RPQ in an investment statement that is different to the RPQ on the scheme's website. Issuers must consider if this is appropriate and whether the questions in both RPQs will guide potential investors to the exact same investment fund.
- the ability for some KiwiSaver scheme members to withdraw some of their member funds as a first home buyer may result in those members being guided to an inappropriate investment fund when using the RPQ. For example, where a 25 year old investor has the intention to withdraw their member funds to facilitate the purchase of their first home, the RPQs would generally guide this investor toward investment funds that exhibited higher levels of risk due to their age. It is arguable whether it is appropriate for this potential investor to use the RPQ at all. Issuers should therefore, carefully consider whether additional disclaimers should be made where it is clear that the RPQ is not suitable for a particular investor.

Trustee Statements in Prospectuses

Trustees of non-restricted KiwiSaver schemes are required to make a statement (**trustee statement**) in the scheme's prospectus confirming whether or not in the trustee's opinion the manager of the scheme has complied with the trust deed and the offer of interests in the scheme[21].

The trustee statement in the majority of the non-restricted KiwiSaver prospectuses FMA reviewed included the required wording but also stated that the trustee had assumed that the factual information contained in the prospectus and all information given to the trustee by the manager is correct and that the trustee has not carried out an independent check of that information.

In FMA's view these disclaimers are not aligned with how a trustee should conduct itself as a front-line regulator of a KiwiSaver scheme or a debt security and FMA has engaged with trustees concerning its expectations in this respect. In our view trustees should be doing sufficient work to satisfy themselves of the accuracy of the information provided by the manager to make the trustee statement without a disclaimer.

[21] Clause 18 of Schedule 5A of the Securities Regulations 2009

Financial Reporting

FMA's review of all 15 schemes' 2012 financial statements found no material non-compliance with New Zealand's generally accepted accounting practice.

However FMA did observe discrepancies on how investments in unlisted managed funds were classified using the fair value hierarchy[22], with approximately equal number of schemes disclosing them as levels 1 or 2.

FMA has liaised with the Big 4 audit firms[23] to clarify why there were inconsistencies in this disclosure, as there is no evidence to suggest that there should be inconsistencies.

All of the Big 4 audit firms confirmed that they are comfortable with classifying such investments as level 2 in the fair value hierarchy.

---

[22] Paragraph 27A of NZ IFRS 7 Financial Instruments: Disclosures
[23] Deloitte, PwC, KPMG, and Ernst & Young

FMA

FINANCIAL MARKETS AUTHORITY

TE MANA TATAI HOKOHOKO - NEW ZEALAND