



SUBMISSION

to

The Ministry

of

Economic Development

on the

**Financial Markets Conduct Bill
Exposure Draft**

September 2011

Introduction

1. This Submission is from Trustee Corporations Association of New Zealand Inc (“TCA”) in response to the Financial Markets Conduct Bill Exposure Draft. We are available to meet with MED to discuss our Submission. We can be contacted at:

Trustee Corporations Association of New Zealand Inc
Level 12
City Chambers
Cnr Johnston & Featherston Streets
PO Box 2382
WELLINGTON 6140

Ph: 04 499 6791
Attention: David Brown Douglas
Email: davidbd@tca.org.nz

2. TCA is a long established association to which all Trustee Corporations belong. The members of the TCA are Public Trust and each of the Trustee Corporations authorised under the Trustee Companies Act 1967 to act as Corporate Trustee for financial products – being Trustees Executors Limited, The New Zealand Guardian Trust Company Limited, New Zealand Permanent Trustees Limited (wholly owned by Public Trust) and Perpetual Trust Limited. The Māori Trustee joined TCA on 1 June 2011. Covenant Trustee Company Limited, although not authorised under the Trustee Companies Act 1967, is an associate member of TCA.
3. TCA maintains relationships with government ministries, regulatory bodies and financial sector groups. TCA sets minimum standards as practice guidelines for the performance of Corporate Trustees – standards for integrity, competence, financial capacity, internal controls, powers and duties, standards for conflict of interest management and for reports from scheme operators.
4. Trustee Corporations are most often associated with drawing up wills and trusts, putting in place enduring powers of attorney and handling estates, a service known as Personal Trusts. TCA contends that its members are uniquely qualified to fill this important role which requires independence, experience, professionalism and above all a focus on investor and beneficiary protection.
5. TCA members also provide prudential supervision of a wide range of investment products and financial arrangements in a number of ways and at various levels. In certain instances, fund managers must appoint a Corporate Trustee to meet regulatory requirements before they can offer a financial product to the market.
6. As at 30 June 2011, total Personal Trusts (excluding agencies and administrations) under supervision exceeded 26,000 with a value in excess of \$6.3b. Corporate Trust funds under supervision exceeded \$173b.
7. TCA appreciates this opportunity to comment on the Financial Markets Conduct Bill Exposure Draft.

TCA Issues Identified:

Introduction

TCA is fully supportive of the intent of the review although there are a number of important areas of uncertainty highlighted below. We are concerned at the short time frame available for submissions and as a result TCA members haven't been able to fully consider all aspects of the Bill and given the fundamental change in the securities legislation proposed. There are concerns that matters will be overlooked. Accordingly, we reserve our position so we can submit further at a later date on important matters if necessary.

Our comments in respect of the Exposure Draft focus on areas of particular interest and concern to TCA members as a whole. Individual members will be making their own submissions on matters specific to them where appropriate.

Our submission does not respond to the format suggested, (although most of the issues we have identified occur in Part 4). We have preferred to discuss the key topics of interest to Trustee Corporations by reference to the section numbers in the draft bill.

A. Audit - audit opinions (general comment)

- 1 We have serious concerns about the direction that audit opinions are taking as we have highlighted to you. There are two issues. The first is the disclaimers that are being attached to audit opinions, limiting the persons to whom they are addressed. The second is that auditors are moving to giving negative rather than positive assurances. TCA has been in discussions with NZICA for some time but to date there has been no acceptance of the auditors' statutory responsibilities
- 2 TCA's experience is that auditors are not allowing Trustees to rely on their audit opinions, on the basis that the audit opinions are expressed as being for the benefit of the issuer and not any other person (including investors). The fact that the audit opinion is expressed as a negative rather than a positive assurance only compounds this problem.
- 3 These two issues undermine the utility of audit reports to point where they have very little value. Trustees have the (soon to be statutory) function of acting for investors in relation to the issuer and supervising the financial position of the issuer/scheme. The Trustee is put in an extremely difficult position when it is told that neither it, nor the investors, can rely on the audit report.
- 4 In this regard, we note that for continuous debt issuers, clause 9(2)(c) of the Securities Regulations 2009 currently implies a provision into debt security trust deeds requiring the issuer to ensure that the terms of audit engagement are such that the auditor confirms that the audit opinion is for the benefit of the Trustee. We consider that a similar provision should be brought across into the draft Bill and apply not only to continuous debt, but also to non-continuous debt and registered managed investment schemes (MIS).
- 5 We also consider that it would be useful if this provision was not expressed as an implied provision in trust deeds but rather that as an affirmative statutory statement to the effect that, regardless of the terms of engagement of the auditor, every audit opinion by

the auditor of a debt security issuer or a registered MIS is for the benefit of the Supervisor and the investors on whose behalf that Supervisor acts.

B. Audit - Securities Regulations 2009 (clause 205)

- 6 The draft Bill brings across the audit provisions of the Securities Act 1978. However, for continuous debt issuers, there are a number of additional reporting and audit provisions in the Securities Regulations 2009. These include important rights and powers for Trustees, such as the requirement for a half-yearly audit, the right to be consulted on the selection of the auditor and the right to replace the auditor in certain circumstances. These rights and powers are important for the protection of investors' interests. The omission of these rights and powers from the draft Bill is a concern and TCA submits that they should be hard-coded into the body of the legislation.
- 7 TCA notes these rights and powers could be introduced using the clause 501(1)(e) regulation making power, which provides for regulations to imply provisions into trust deeds. However, TCA also notes that most of the reporting, audit and duty provisions implied into trust deeds by the Securities Regulations 2009 have already been hard-coded into the body of the draft Bill. These include, by way of example, the rights of debt security Trustees to obtain information (clause 2 of Schedule 15 of the Securities Regulations 2009 and clauses 105 and 101 of the draft Bill) and the duty of unit trustees to ascertain breaches of the trust deed or offer terms and to have those breaches remedied (new clause 43A of the Securities Regulations 2009 and clauses 128 and 129 of the draft Bill). TCA therefore considers that it would be appropriate for the continuous debt issuer audit provisions to be inserted into the body of the Bill itself, with the ability to modify these through regulation. Consideration should be afforded to expanding these rights and powers so that they do not just exist in respect of continuous debt issuers but also in respect of non-continuous debt and MIS issues.

C. Non-investment participatory securities (general comment)

- 8 Currently, *sui generis* property and investment arrangements fall within the catch all category of participatory securities. Examples include forestry partnerships, racehorse owning syndicates and marina schemes. Where these have an investment component, they will almost certainly be regulated under the draft Bill as MIS. However, there are a number which do not include an investment. On the repeal of the participatory security regime in the Securities Act 1978 they will become completely unregulated by securities legislation.
- 9 Such schemes often have no unifying structure such as a body corporate in a unit title scheme. It is the participatory security regime that provides the structure in the form of a requirement for a deed of participation and a statutory supervisor. With the repeal of the participatory security regime, investors will cease to have any effective statutory framework for governance arrangements or a collective voice. Important collective rights will be taken away from these investors, including the right to sue, to meet and be heard, to review levies and to receive reports. Often, these investors have invested large capital sums and while they do not get a financial return they do receive rights, including the right to on-sell their interests in the scheme.
- 10 TCA therefore submits that these types of schemes should either be:

- 10.1 Brought back within the scope of the MIS regime in the draft Bill. This can be achieved by removing or expanding the financial benefit limb of the MIS definition in clause 9; or
- 10.2 Grandfathered by putting place provision to the effect that the current participatory securities regime continues to apply to these types of schemes.

D. KiwiSaver - Official Assignee claims on bankrupt member's interests - (general comment)

- 11 The Official Assignee has been making claims for the vesting and immediate payment of the accounts of bankrupt KiwiSaver members. TCA's understanding is that, under current superannuation law, the interest in a bankrupt member's account can vest in the Official Assignee but that the Official Assignee has no right to immediate payment (unless the members would have been entitled to such payment).¹
- 12 What needs to be clarified is the position of the account after the member has been discharged from bankruptcy. There are differing views as to whether ownership of the account reverts to the member or whether it remains vested in the Official Assignee. This is an important issue that needs to be addressed. We understand that the Government Actuary (as the office was then called) sought clarification on the matter but that no firm view has been reached.
- 13 TCA submits that the draft Bill provides an opportunity to deal with this technical but important issue. In TCA's submission, the ownership of a member account should be returned to the member on his or her discharge from bankruptcy. The statutory purpose of superannuation and KiwiSaver is to provide for retirement benefits. Superannuation and KiwiSaver do this by locking in member contributions for certain periods or until the occurrence of certain events. It would defeat the retirement benefit purpose if a member account was to be retained by the Official Assignee. Furthermore, given that the Official Assignee has no right to immediate payment of the member account, vesting and retention of a KiwiSaver member account on bankruptcy would not, in the vast majority of cases, further the interests of the bankrupt's creditors.

E. Definition of 'issued' (clause 10)

- 14 Under the current Securities Act 1978 a managed funds product, such as a unit in a unit trust, is considered to be issued to a person when that person receives that product. This means that where an existing investor in a managed fund subscribes for further securities in that fund, there must be a registered prospectus and current investment statement for that product.
- 15 Under the draft Bill's definition of "issued", it is unclear whether subsequent issues of certain managed funds products to existing investors require fresh disclosure. Clause 10(1)(a) of the draft Bill provides:
 - (a) a financial product is issued to a person when it is first issued, granted, or otherwise made available to a person (subject to subsection (2)):

¹ *Official Assignee v NZI Life Superannuation Nominees Limited* [1995] 1 NZLR 684

- 16 Clause 10(2)(a) of the draft Bill makes it clear that subsequent issues of interests in KiwiSaver Schemes and superannuation schemes do not need fresh disclosure to members of those schemes:
- (a) a managed investment product that is an interest in a superannuation scheme or KiwiSaver scheme is issued to a person when the person becomes a member of the scheme:
- 17 However, it remains unclear whether subsequent issues of financial products in other kinds of financial products (eg, regular MIS) require fresh disclosure. The existence of clause 10(2)(a) seems to indicate that fresh disclosure is required. However, we consider that it would be preferable if a new provision were inserted into clause 10 making this clear.

F. Debt security Trust Deed (clause 90)

- 18 Clause 90 requires that the Trust Deed must provide for the right to enforce the issuer's duty to repay. This clause needs to be expanded to take into account the unique features of a Capital Note type issue which is hybrid debt/equity instrument. Capital Notes are subordinated instruments with special terms applying to them which restrict the rights and powers of the Trustee and/or the Noteholders to require redemption of the Capital Notes. Prior to any liquidation the Trustee has limited rights of recourse against the Issuer. Non-payment of interest on the Capital Notes or breach by the issuer will generally not by themselves constitute a default by the issuer under the Trust Deed or the conditions, or entitle the Trustee to exercise any rights of recourse against the issuer. The only right of the Trustee or the Noteholder to require redemption of the Capital Notes is on commencement of the liquidation of the company, being where a liquidator or statutory manager is appointed.

G. Supervisor's obligations (clauses 97(1)(a)(iv) and 128(1)(a)(iv))

- 19 Clause 97(1)(a)(iv) imposes responsibilities on the Trustee of debt securities for 'any contravention or alleged contravention of this Act by any person in connection with the debt security, the Trust Deed or the terms of the regulated offer'. Clause 128(1)(a)(iv) imposes similar obligations on the Supervisor of MIS. These are exceptionally wide monitoring obligations and would mean that Trustees are not restricted to monitoring the issuer and may be required to monitor directors of the issuer, auditors, Registrars, NZX (for listed products), investment bankers, and independent experts. Trustees and Supervisors generally have no contractual relationship with these other parties and therefore no effective mechanism through which to discharge this obligation. Furthermore, such a broad monitoring obligation falls outside the scope of what, in TCA's view, is properly considered the role of the Supervisor. Accordingly, TCA submits that this provision should be deleted.

H. Wholesale Managed Investment Products (clause 109)

- 20 The draft Bill requires MIS that offer to retail clients to be registered and become subject to the new MIS governance regime. MIS that are exclusively offered to wholesale clients have the option, but not the obligation, of registering and becoming subject to these requirements. TCA endorses this position on the basis that requiring registration of wholesale MIS may force wholesale funds offshore, counter to the current government policy of encouraging New Zealand's growth as a funds domicile.

I. MIS governing document (clause 117)

- 21 The definition of governing document needs to be extended to include the Product Disclosure Statement as some terms and rules are disclosed separately in this document and are not specified in the Trust Deed. The current disclosure document may specify these matters eg, an agency arrangement for the Manager to act on behalf of a Unit holder and fees applying to such arrangement. Accordingly clause 119 will need to reflect that not all governing documents would be legally enforceable by the Supervisor. This clause will not cause any conceptual or policy difficulties because the scheme participant may be able to enforce the agency arrangement.

J. Custodian's holding of property (clause 136)

- 22 It is common industry practice for custodians to hold client property in the custodian's name but to keep internal accounts appropriately recording what cash and securities are held for each client. Clause 136 needs to make it clear that robust internal procedures for recording client interests fulfil the requirements of that provision.

K. MIS Supervisor's duties - manifestly not in the interests (clause 138)

- 23 The MIS regime is modelled in part on the regime for unit trusts. Section 12(1)(c) of the Unit Trusts Act 1960 provides:

- (c) that the trustee of the unit trust shall not act on any direction of the manager to acquire any property for the unit trust or dispose of any property of the unit trust if, in the trustee's opinion conveyed in writing to the manager, the proposed acquisition or disposal is manifestly not in the interests of the unit holders; and the trustee shall not be liable to the unit holders or to the manager for so refusing to act on any direction of the manager:

- 24 This provision has been adopted and expanded in the draft Bill. Clause 138 of the draft Bill provides:

138 Duty of supervisor to refuse to act on wrongful directions

- (1) The supervisor of a registered scheme must refuse, and must direct any other custodian to refuse, to act on a direction of the manager that relates to the acquisition or disposal of scheme property if the supervisor considers that the proposed acquisition or disposal would be—
- (a) in breach of the scheme's governing document, statement of investment policy and objectives, or any enactment; or
- (b) manifestly not in the best interests of the scheme participants.
- (2) If the supervisor refuses, or directs any other custodian to refuse, to act on a direction of the manager, the supervisor must notify the manager and the FMA in writing of that fact and the supervisor's reasons for refusing to do so.
- (3) A supervisor of a registered scheme, and any other custodian of the scheme, is not liable to the scheme participants or the manager for refusing, or directing any other custodian

to refuse, to act on a direction of the manager in accordance with this section.

- 25 The key differences are:
- 25.1 The Supervisor's duty has been expanded to cover refusing to act on the direction of the manager where doing so would breach the scheme's governing document, the SIPO or any other law; and
 - 25.2 The Supervisor's duty to refuse a direction where it is "manifestly not in the interests of investors" has moved to refuse a direction where it is "manifestly not in the **best** interest of investors".
- 26 These are significant expansions of the current duty.
- 27 Where the manager has delegated the investment management function to professional external investment managers, the Supervisor should not be under an obligation to monitor compliance with the SIPO. The Supervisor's function should be limited to ensuring that the manager has appropriate systems in place to ensure that the investment decisions by the underlying investment managers comply with the SIPO and the investment guidelines. By contrast, where the manager carries out the investment management function internally, it may be appropriate for the Supervisor to be put under the obligation of monitoring compliance with the SIPO and the investment guidelines. The draft Bill should recognise this distinction.
- 28 The Supervisor should not be under an obligation to consider what is in the **best** interests of investors when considering the manager's direction to acquire or dispose of investments. The investment selection and management is the manager's role under clause 124 of the Bill. Supervisors should not be put in the position of having to second guess the manager's investment decisions.

L. Automatic Transfers (clause 155)

- 29 The method of transfer of scheme participants to another section of a scheme needs to also extend to an automatic transfer based on the age of the member, if the member had elected into this option. An example of this is the AMP KiwiSaver "Lifesteps" where the member's savings are invested in one of six investment options depending on their age and when they reach a birthday that corresponds with the minimum age for the next Lifesteps fund, the savings are automatically reinvested in the next Lifesteps fund. The members elect into this regime at inception.

M. Custodian's duty to notify serious problem (clause 173)

- 30 Investment managers and administration managers carry out functions which are delegations of the fund manager. It is therefore appropriate that they be subject to obligations to monitor the MIS and notify the FMA and the Supervisor of any "serious problem".
- 31 By contrast, the custodian's function is a delegation of the Supervisor. Its functions are generally restricted to the holding of assets and the execution of trades. As such, custodians are not in a position to undertake the monitoring obligations that this clause implies on them: they simply will not have the required information. TCA therefore submits that the reference to custodians should be removed from this clause.

N. Financial product register (clause 189)

- 32 This needs to provide that the issuer must keep or “cause to be kept” a register. In many instances it won’t be the issuer but it will be parties like Computershare or an administration manager that will perform the Registry functions.

O. Fund manager, custodian and administrator licensing (Part 6)

- 33 The licensing regime should extend to the licensing of custodians, administration managers and registrars. These entities play important roles in the protection of the rights of investors. Leaving them outside the scope of central regulatory oversight increases investor risk.
- 34 The Ministry's commentary on the licensing regime notes that Cabinet has decided that licensing of fund managers will be limited. It is not clear why licensing for fund managers should be limited when they play the central role in the operation of the managed investment scheme.

P. Transitional provisions (clause 585)

- 35 We understand that a transitional period of 24 months is currently being considered. We strongly support a transitional period of at least 24 months. Any shorter period may cause difficulties in ensuring the smooth transition to the new regime.

Q. Re-registration of existing schemes / Group Investment Funds (clauses 570 and 585)

- 36 This overhaul of an entire suite of financial legislation will cause significant and far-reaching change to financial markets and risks destabilising a large amount of investments, incurring significant costs. Comprehensive transitional provisions will need to be included in the legislation to ensure that the repeal and amendments of all the affected Acts will not compromise the integrity of existing securities, funds, and ultimately, investors’ interests. Adequate discretion will need to be afforded to Supervisors and managers to ensure that the transition is effected as smoothly as possible.
- 37 A specific example is the need to call meetings of scheme participants to approve changes to trust deeds to reflect the new regime. TCA submits that provisions must be included that are designed to mitigate in part the impact by allowing the supervisor to approve required amendments without calling a meeting. The Supervisor has both the capability (once it has been licensed) and the responsibility under the draft Bill to carry out this role in the best interests of participants.
- 38 Tax also needs to be considered. The re-registration of schemes under the draft Bill may crystallise tax obligations as a result of the disposition or deemed disposition of assets. There is no economic reason why this tax liability should accrue as a result of a statutorily mandated re-registration. Accordingly, any transitional provisions should deem there to be no tax arising as a result of re-registration.
- 39 Existing managed funds will need to be transitioned to the Bill's MIS regime. This will require re-registration on the MIS register as contemplated by clause 570 as well as coming into compliance with the substantive requirements for MIS over the transitional period.

- 40 The draft Bill also proposes amendments to the Trustee Companies Act 1967 and the Public Trust Act 2001 that will end the ability to offer Group Investment Funds (GIFs) as a managed funds product. It is intended that GIFs will be restricted solely for "internal" use.
- 41 TCA is concerned about the phraseology used. It is unclear what restricting the use of GIFs to the "internal" management of estate and assets would mean in practice. Trustee Companies act in a wide variety of different roles which include, for example, as co-trustee, as co-executor or under an enduring power of attorney. The draft Bill needs to make it clear that GIFs can be used for investment in these situations, despite the fact that the Trustee Company may be acting as attorney, agent or fiduciary for, or alongside, a person to whom disclosure might otherwise need to be made. Without this, Trustee Companies' ability to use GIFs for the purposes of internal management and estate administration would be severely compromised.
- 42 The transition for other kinds of GIFs also throws up unique issues.
- 43 "Externally offered GIFs" (ie, those where the Trustee company is both Trustee and manager, and a separate statutory supervisor is appointed) are participatory securities under the current regime. They may only be offered to persons with whom the Trustee Company has a relationship that is relevant to its functions eg, as Trustee, administrator etc (see section 8 of the Public Trust Act 2001 and section 29(5) of the Trustee Companies Act 1967). Subject to this relationship requirement being met, TCA submits that Trustee Companies should continue to be able to offer schemes in the nature of externally offered GIFs under the regime proposed by the draft Bill. To achieve this, existing externally offered GIFs would become subject to MIS regime and future schemes of this nature would be structured as MIS from the outset. This would maintain the status quo in terms of Trustee Companies' investment management functions but bring the structures used within the draft Bill's regulatory framework. Consequential amendments would be needed to the Public Trust Act 2001 and the Trustee Companies Act 1967 (relevant provisions referred to above) to ensure that Trustee Companies had the requisite authority to act as manager of the MIS, as the current empowering provisions refer to the management of GIFs (and not MIS).
- 44 "Externally managed GIFs" (ie, where the Trustee acts as trustee but management is carried out by an external party such as a bank) have the benefit of the Securities Act (Externally Managed Group Investment Funds) Exemption Notice 2003 under which they are treated like unit trusts for regulatory purposes. They are widely offered to the public. Although externally managed GIFs may appear superficially similar to unit trusts they, in fact, have significantly more complex rights, duties and responsibilities. For example, the Trustee Company will act as agent and trustee for the investor and have limited powers in its capacity as Trustee but broad powers in its capacity as agent. This is very different to unit trusts. Transitioning this unique and complex matrix to the unit trust-like regime for MIS would be hideously complicated. TCA therefore submits that existing externally managed GIFs should be grandfathered, with the Trustee Companies Act 1967 or Public Trust Act 2001 (as appropriate) provisions relating to GIFs continuing to apply to them. In future, no new externally managed GIFs would be established. The new MIS structure would replace these instead.

R. Exemption for small schemes (Schedule 1, clause 16)

- 45 For the purposes of counting the number of scheme participants in a MIS this clause should provide for Portfolio Investment Proxies (PIP) and other funds are deemed to be looked through to the underlying beneficiaries for counting purposes.

S. Cash and terms PIEs (Schedule 1, clause 18(a))

- 46 A cash or term portfolio investment entity that is offered by a registered bank is intended to be excluded from the disclosure regime as it is an exemption under Schedule 1 clause 18(a). This exemption is captured as it is a category 2 product issued by the banks.
- 47 Cash and term PIEs should be included in the disclosure regime and should also have a Supervisor monitoring the manager's compliance. Cash and term PIEs are managed funds with unique features and should be subject to the new regime. The fund has suspension provisions, unit pricing, registry, fee arrangements and PIE tax rules that must be complied with and disclosed to investors and is not a straight bank deposit.

T. Financial Reporting Act 1993

- 48 The financial statements for all MIS should be subject to the Financial Reporting Act on a limited basis. In the United Kingdom there is an exemption for collective investment schemes needing to comply with IFRS. We should have a similar exemption as it would lead to a more concise disclosure which could be made in a more timely basis. Most MIS investors do not have the financial skills to understand and read detailed full IFRS accounts.

U. Independence

- 49 TCA notes the change to the test for independence required between the Supervisor and manager of a managed investment scheme, and the Trustee and issuer of a debt security. TCA supports this change. The current Income Tax Act test has a broad focus which includes matters which are not relevant (or appropriate) for testing independence within managed investment schemes and debt security structures. The proposed "associated person test" in the draft Bill is better suited to the corporate environment and the fiduciary responsibilities in which managed investment products and debt securities exist.

We are happy to discuss any of these comments in further detail.

**Trustee Corporations Association of New Zealand Inc
6 September 2011**