

## Consultation Paper: Fund update template and guidance for calculating risk indicators

1 December 2014

This paper is for market participants that manage funds and for their supervisors and investors. It explains how we propose to use two of the tools available to the FMA under the Financial Markets Conduct Act 2013 (FMC Act) and the Financial Markets Conduct Regulations 2014 (Regulations) to support the new offers regime for managed funds. We are consulting on a proposed 'frameworks or methodologies' (FM) template for fund updates and new guidance for calculating risk indicators.

We invite you to review our proposals and share your feedback with us. We welcome general comments and have also included a number of questions seeking specific feedback. Your response will inform the final (and binding) fund update template as well as the final risk indicator guidance note. It may also provide the FMA with further areas where FMs or guidance may be useful or necessary.

**Submissions close on 16 January 2015.** The form at the back provides more details.

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## Terms used

CESR	Committee of European Securities Regulators  CESR provided technical advice on securities markets to the European Commission until it was replaced by ESMA
ESMA	European Securities and Markets Authority  ESMA is the regulator for the European Union that has a role similar to the FMA's role in New Zealand
FM	Frameworks or methodologies are notices issued by FMA under sub -part 4 of Part 9 of the Act
FMA	Financial Markets Authority
FMC Act	Financial Markets Conduct Act 2013
Key investor information document (KID)	A KID is the European equivalent of our PDS
Managed funds MIS	A managed fund MIS as defined in regulation 5 FMC Regulations 2014
Manager	As defined in Section 6(1) of the Act
MIS	A managed investment scheme that is registered on the MIS register and defined in section 9 of the FMC Act
PDS	Product Disclosure Statement in relation to a regulated offer as defined in Section 41 of the Act
Regulations	Financial Markets Conduct Regulations 2014
Registered scheme	A managed investment scheme registered on the register of managed investment schemes under the FMC Act
Restricted scheme	A KiwiSaver, superannuation, or workplace savings scheme that has restricted membership or is closed to new members, <u>and</u> which is registered as a restricted scheme  A restricted scheme does not need a licensed manager or a licensed supervisor, but must instead have a licensed independent trustee  All restricted schemes are managed investment schemes
Risk Indicator	The value calculated under clauses 5-8 of Schedule 4 of the Regulations
Synthetic risk and reward indicator (SRRI)	The term used in the CESR Guidelines that is equivalent to the term risk indicator in New Zealand legislation
Supervisor	As defined in section 6(1) of the Act and if financial markets legislation does not requires a person to be designated or appointed as a supervisor of a scheme, the supervisor is the FMA

## Section 1: Two new regulatory tools to support offers of managed funds

1. The FMA has previously used regulatory tools such as exemptions, guidance notes, information sheets and market engagement to support participants operating under the Securities Act offers regime. The FMC Act has introduced additional tools called 'frameworks or methodologies' and 'designations' for the FMA to use in appropriate situations.
2. At this stage the FMA is proposing to introduce one framework or methodology (FM) and one new guidance note to support managers in meeting their legislative obligations for managed funds. Other FMs may be possible in the future. The FM being proposed now will take the form of a fund update template. This proposed guidance note is on the calculation of the risk indicator. The drafts of both the template and the guidance note are in the Schedules of this paper.

### Other FMs are possible in the future

3. Although we are currently proposing only one FM, it is possible we will identify the need for one or more additional FMs at a later time. The need for additional FMs may arise in several ways. There may be inappropriate responses from market participants to the legislative requirements under the FMC regime. Participants may also raise issues that will be best addressed by an FM rather than guidance or one of the other regulatory tools available.
4. The FMC Act identifies 14 areas for potential FMs and the Regulations provide for 17 others. Some of these areas relate to requirements for regulated product offers, others are to help determine whether statutory exclusions may apply. Schedule 3 provides a table of the potential FMs that may be used to clarify the legislative requirements for market participants.
5. When you provide your feedback, we are open to receiving comments on any other issue you think would benefit from the provision of an FM or guidance and your reasons.

## Section 2: An FM template for fund updates

6. FMs are a new tool under the FMC Act. They set out the detailed or technical aspects for how particular matters in the FMC Act and Regulations are required or permitted to be determined, calculated, valued, presented, or prepared. Although the legislation provides for FMs to be used in a variety of situations, we have not identified an immediate need for many such tools.
7. In relation to managed funds, however, it is our view that there is value in issuing an FM relating to the requirement to update information about managed funds. The purpose of the fund update template is to provide investors with a consistent, transparent and easy comparison for the various managed funds available for investment.
8. The legislation requires fund managers of registered schemes to provide fund updates periodically<sup>1</sup> if the scheme is available to the public. The Regulations allow the format of the fund update to be specified in an FM<sup>2</sup>. The proposed FM is a template that will determine in detail how the required information, graphs and tables for periodic updates are set out.
9. The proposed template is similar to the existing annual and quarterly disclosure requirements in the KiwiSaver (Periodic Disclosure) Regulations 2013<sup>3</sup>. The FMA worked closely with KiwiSaver participants to ensure disclosure for the schemes was consistent and comparable for investors. That experience demonstrated the value of a detailed template to follow. The documents produced from these templates have been useful to KiwiSaver members and potential members when making decisions about which funds are appropriate for their needs.
10. Although the fund update information must be in the same format as in the FM fund update template, the Regulations allow slight deviations that will still comply with the requirement to follow the template. Additional information is allowed if it is necessary for clarification or to provide context to ensure it is not false or misleading<sup>4</sup>. In certain circumstances, minor variations in font, borders, shading or colours are allowed (unless specifically prohibited) and managers can include logos, brands or contact information if it is not distracting<sup>5</sup>.
11. A draft of the proposed template for fund updates is in Schedule 1 of this paper. It is important that market participants take a careful look at the template and provide any comments on the workability of the draft and any areas that you think need further clarification. The FMA will consider whether the feedback should be reflected in the final template and make any necessary adjustments before the final FM notice is issued.

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<sup>1</sup> FMC Act section 97 and FMC Regulation 58

<sup>2</sup> Regulation 59(1) of the FMC Regulations

<sup>3</sup> Schedules 3 (Annual disclosure statement template) and 4 (Quarterly disclosure statement template) of the KiwiSaver (Periodic Disclosure) Regulations 2013

<sup>4</sup> Regulation 59(3) of the FMC Regulations

<sup>5</sup> Regulation 59(4) of the FMC Regulations

### **Questions**

Q1: The final FM template will be similar to the proposed template in Schedule 1 and it will be a legislative requirement. This means you will need to follow it when providing your fund update. You will also still need to consult the regulations when you are filling out the template to ensure you include the required information in different cases. Would additional information or guidance be appropriate, and if so what?

### Section 3: Guidance on calculating risk indicators

12. We propose to publish new guidance to assist market participants to understand their obligations and the FMA's expectations in relation to calculating and presenting the risk indicator for managed funds. A draft of the guidance is set out in Schedule 2.
13. Your overriding obligation under the legislation is to determine a risk indicator that reflects the potential future volatility of the fund. The FMC Regulations require a risk indicator to be included in the PDS<sup>6</sup>, register entries<sup>7</sup>, the updates for the fund<sup>8</sup> and the register<sup>9</sup>. The risk indicator is an important part of the disclosure about the risks associated with managed funds<sup>10</sup>. It is intended to provide investors with a way to compare the risks of the relevant funds when making investment decisions.
14. Clause 6 of Schedule 4 of the FMC Regulations prescribes the general methodology for calculating the risk indicator (Clause 6 Methodology). The Clause 6 Methodology is based on European standards from the Committee of European Securities Regulators (CESR)<sup>11</sup>, which was the predecessor of the European Securities and Markets Authority (ESMA). The CESR produced guidelines for the calculation of a 'synthetic risk and reward indicator' for key disclosure documents (CESR Guidelines)<sup>12</sup>.
15. The Clause 6 Methodology is expected to apply to most markets funds. However, the Clause 6 Methodology does not apply if it results in an indicator that is likely to mislead or deceive market participants in a material way. In that case, the Regulations require that you use an alternative method for calculating the risk indicator<sup>13</sup>. The alternative methodology is not prescribed in the Regulations. Instead, the manager is responsible for using a calculation method that results in a risk indicator that accurately represents the volatility of the fund.
16. The proposed guidance note discusses how managers may use the CESR Guidelines as a guide when calculating the risk indicator under Clause 6 and when assessing alternative methodologies for funds that are not suited to using the Clause 6 Methodology. The FMA considers that a CESR methodology identified for a particular type of fund will be an appropriate method for you to use in calculating your risk indicator, if your fund is that type. The FMA expects these methodologies to be adopted widely so that the resulting risk indicators will provide investors with a consistent comparison of the risk associated with funds.

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<sup>6</sup> FMC Regulations Schedule 4, clauses 25-29

<sup>7</sup> FMC Regulations Schedule 4, clause 53(c)(ii)

<sup>8</sup> FMC Regulations Schedule 4, clause 58(1)

<sup>9</sup> FMC Regulations Schedule 4, clause 54(1)(a)(i)

<sup>10</sup> FMC Regulations Schedule 4 (Managed investment products in managed fund), clauses 4-8

<sup>11</sup> The CESR has now been replaced by the European Securities and Markets Authority (ESMA) and the intention is that the CESR Guidelines become enforceable technical standards.

<sup>12</sup> *CESR's guidelines on the methodology for the calculation of the synthetic risk and reward indicator in the Key Investor Information Document*, Committee of European Securities Regulators, 1 July 2010, CESR/10-673: [http://www.esma.europa.eu/system/files/10\\_673.pdf](http://www.esma.europa.eu/system/files/10_673.pdf).

<sup>13</sup> FMC Regulations Schedule 4, clause 8

17. You should consider the draft guidance in Schedule 2 and whether you would like to comment on our intended approach or on other options. It is important that market participants take a look at both the proposed FMA guidance and the CESR Guidelines to determine whether there are other questions that need to be addressed in the guidance.

**Questions**

Q1: The CESR Guidelines provide an alternative methodology for calculating risk indicators for absolute return funds, total return funds, life cycle funds and structured funds. If your fund is one of these types, do you agree that the proposed methodology will work as an appropriate risk indicator for your fund?

Q2: If your answer to Q1 is no, please explain why and describe the alternative methodology that you consider to be more appropriate in the case of your fund.

## Section 4: Proposed timelines and engagement

December 2014 to January 2015	FMA consultation on fund update FM and guidance on risk indicators.
January – February	Finalise and issue fund update FM and publish Guidance Note on calculation of the risk indicator.
31 March 2015	First expected fund updates under new regime.

### We would appreciate your submission by 16 January 2015 date

18. To make a submission on this paper, please use the feedback form below – this gives the details of what you need to do. Forms must be submitted electronically in both PDF and word formats and emailed to [consultation@fma.govt.nz](mailto:consultation@fma.govt.nz) - please put 'Feedback on fund update and risk indicator' in the subject line.
19. **Submissions close on 16 January 2015**

### To find out more information

20. You will find more information about the new financial products offers regime requirements:
  - on our website [www.fma.govt.nz/keep-updated/the-future-of-financial-markets/](http://www.fma.govt.nz/keep-updated/the-future-of-financial-markets/)
  - on the Ministry of Business, Innovation, and Employment website [www.med.govt.nz](http://www.med.govt.nz). Locate relevant information under 'Business' then 'Current business law work'
  - on the New Zealand legislation website [www.legislation.govt.nz](http://www.legislation.govt.nz) are the newly made Financial Markets Conduct Regulations 2014.
21. If you have feedback about the consultation paper or process, please get in touch.

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## Feedback: Fund update and risk indicator guidance

Please submit this feedback form electronically in both PDF and MS Word formats and email it to us at [consultation@fma.govt.nz](mailto:consultation@fma.govt.nz) with 'Feedback on fund update and risk indicator guidance' in the subject line. Thank you. **Submissions close on 16 January 2015.**

Date: \_\_\_\_\_ Number of pages: \_\_\_\_\_

Name of submitter: \_\_\_\_\_

Company or entity: \_\_\_\_\_

Organisation type: \_\_\_\_\_

Contact name (if different): \_\_\_\_\_

Contact email and phone: \_\_\_\_\_

Section # or Schedule #	Para # or Question #	Comment
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*You don't need to quote from the consultation document if you use section and paragraph numbers. You may attach extra pages - please label each page with your name and organisation.*


**Feedback summary** – if you wish to highlight anything in particular

**Please note:** Feedback received is subject to the Official Information Act 1982. We may make submissions available on our website, compile a summary of submissions, or draw attention to individual submissions in internal or external reports. If you want us to withhold any commercially sensitive or proprietary information in your submission, please clearly state this and note the specific section. We will consider your request in line with our obligations under the Official Information Act.

## Schedule 1 Template for fund update

### FUND UPDATE

**Fund Update for the [quarter]/[year] ended:** *[specify: period to which fund update relates]*

*[Specify: name of scheme]*

*[Specify: name of fund]*

This fund update was first made publicly available on: *[specify]*

*[if relevant: Replacement Fund Update]*

*[if relevant: This fund update is a replacement fund update and replaces the previous [select one: fund update/fund updates].*

Below is a summary of changes that have been made:]

Date the fund update was made publicly available	Section of fund update	Description and reason for the change	Original disclosure	Updated disclosure
<i>[specify]</i>	<i>[specify]</i>	<i>[specify]</i>	<i>[specify]</i>	<i>[specify]</i>

#### What is the purpose of this update?

This document tells you how *[name of specified fund]* has performed and what fees were charged. The document will help you to compare the fund with other funds. *[Name of manager]* prepared this update in accordance with the Financial Markets Conduct Act 2013. This information is not audited and may be updated.

#### Description of this fund

*[Specify: brief description of the specified fund and its investment objectives]*

Total value of the fund	<i>[specify]</i>
Number of investors in the fund*	<i>[specify]*</i>
The date the fund started	<i>[specify]</i>

*[\* applies only to a specified fund of a KiwiSaver scheme, superannuation scheme, or workplace savings scheme]*

#### What are the risks of investing?

Risk indicator for *[specify: name of specified fund]**[if relevant specify note†]:*

⇐ Potentially lower returns				Potentially higher returns ⇐		
1	2	3	4	5	6	7
⇐ Lower risk				Higher risk ⇐		

The risk indicator is rated from 1 (low) to 7 (high). The rating reflects how much the value of the fund's assets goes up and down. A higher risk generally means higher potential returns over time, but more ups and downs along the way.

To help you clarify your own attitude to risk, you can seek financial advice or work out your risk profile at *[specify a URL for an appropriate page on an Internet site maintained by, or on behalf of, the manager or the Retirement Commissioner]*.

Note that even the lowest category does not mean a risk-free investment, and there are other risks that are not captured by this rating.

This risk indicator is not a guarantee of a fund's future performance. The risk indicator is based on the returns data for *[insert time period]*. While risk indicators are usually relatively stable, they do shift from time to time. The risk indicator will continue to be updated in future fund updates.

*[Select one: See the Product Disclosure Statement (PDS) for more information about the risks associated with investing in this fund/[specify: describe the specific risks for investing in the specified fund.]]*

[if relevant: \*briefly state or explain (as the case may be) the nature of the use of market index returns in accordance with clause 7(b) of Schedule 4 of the Regulations ]

**How has the fund performed?**

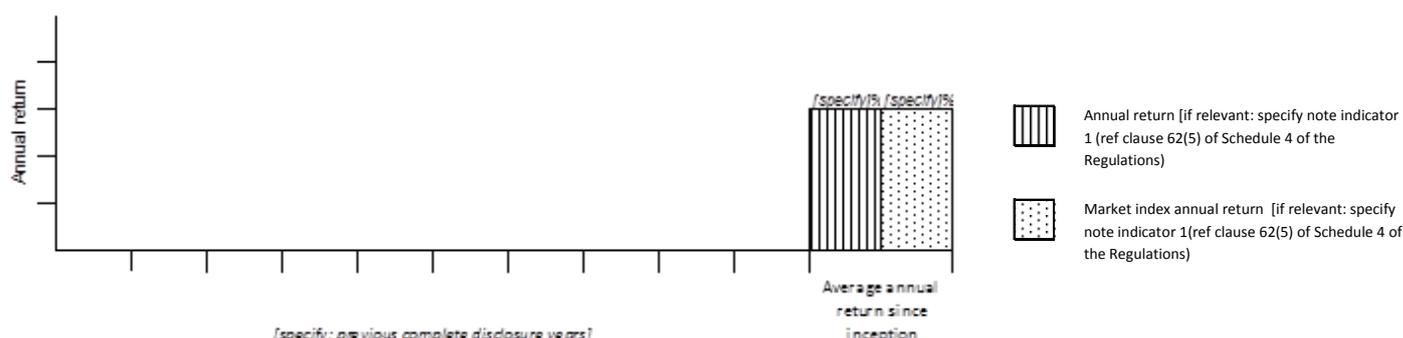
	<i>[if relevant Average over past 5 years]</i>	<b>Past Year</b>
<b>Annual return</b> (after deductions for charges and tax)	<i>[specify]</i>	<i>[specify]</i>
<b>Annual return</b> (after deductions for charges but before tax)	<i>[specify]</i>	<i>[specify]</i>
<b>Market index annual return</b> (reflects no deduction for charges and tax)	<i>[specify]</i>	<i>[specify]</i>

*[Specify: a brief description of the market index on which the market index annual return is based]*

*[If relevant, specify: a statement to the effect that the market index has changed since the last fund update and the reasons for the change]*

Additional information about the market index is available on the offer register.

**Annual return graph**



This shows the return after fund charges and tax *[select one: for each year ending 31 March since the fund started/for each of the last 10 years ending 31 March]*. The last bar shows the average annual return since the fund started, up to *[specify date]*.

**Important:** This does not tell you how the fund will perform in the future.

*[If relevant: Returns in this update are after tax at the highest prescribed investor rate (PIR) of tax for an individual New Zealand resident. Your tax may be lower.]*

*[If relevant: Prior to [specify: date], returns in this update are after tax at [specify: tax rate]]*

## What fees are investors charged?

Investors in *[name of the specified fund]* are charged fund charges. *[Select one: In the year to [specify date] these were:/Based on the PDS dated [specify: date], these are expected to be:]*

	% of net asset value
<b>Total fund charges [A = B + C]</b>	<i>[specify]% [if relevant: (estimate)<sup>2</sup>] [if relevant: specify note <sup>¥</sup>]</i>
Which are made up of-	
<b>Total management and administration charges [B = D + E]</b>	<i>[specify]% [if relevant: (estimate)<sup>2</sup>]</i>
Including-	
Manager's basic fee [D]	<i>[specify]% [if relevant: (estimate)<sup>2</sup>]</i>
Other management and administration charges [E]	<i>[specify]% [if relevant: (estimate)<sup>2</sup>]</i>
<b>Total performance-based fees [C]</b>	<i>[specify]% [if relevant: (estimate)<sup>2</sup>]</i>
<b>Other charges</b>	<i>[if relevant: NZ Dollar amount per investor or description of how charge is calculated]</i>
<i>[Specify: for example, administration and member fees]</i>	<i>[\$specify]</i>
	<i>[if relevant: Basis or method of calculating the charge]</i>
<i>[Specify]</i>	<i>[specify]</i>

*[If relevant: The total fund charges shown above do not include all fund charges incurred by the fund as the manager was unable to determine the total amount of fund charges incurred by the fund as a result of investing in the following [select one: investment/investments].]*

Name of investment	% of net asset value (if available)	<i>[Specify: type of fund charge(s) (if known) that has/have been omitted in the calculation of fund charges]</i>
<i>[specify]</i>	<i>[specify]%</i>	<i>[specify]</i>

*[If relevant: \*The manager expects that [select one: some/all] of the fund charges will be materially different in the next year. Below are the fund charges expected to be different in the next scheme year.]*

Type of fund charge	Expected for the next year	<i>[Select one: Year ended [specify]/PDS dated [specify]]</i>
	% of net assets	% of net assets
<i>[specify]</i>	<i>[specify]%</i>	<i>[specify]%</i>

[If relevant: Investors may also be charged individual action fees for specific actions or decisions (for example, for withdrawing from or switching funds). See [specify a link to or URL that contains full particulars of these fees] for more information about those fees.]

**Example of how this applies to an investor**

Small differences in fees and charges can have a big impact on your investment over the long term.

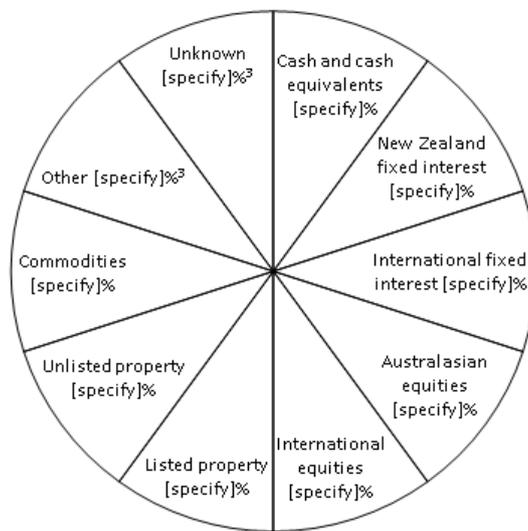
“[Name] had \$[specify] in the fund at the start of the [select one: year/period] and did not make any further contributions. At the end of the [select one: year/period], [name] received a [select one: return/incurred a loss] after fund charges were deducted of \$[specify] (that is [specify]% of [select one: his/her] initial \$[specify]). [name] also paid \$[specify] in other charges. This gives [name] a total [select one: return/loss] after tax of \$[specify] for the [select one: year/period].”

**What does the fund invest in?**

This shows the types of assets that the fund invests in.

**Actual investment mix**

[Omit any categories not required]

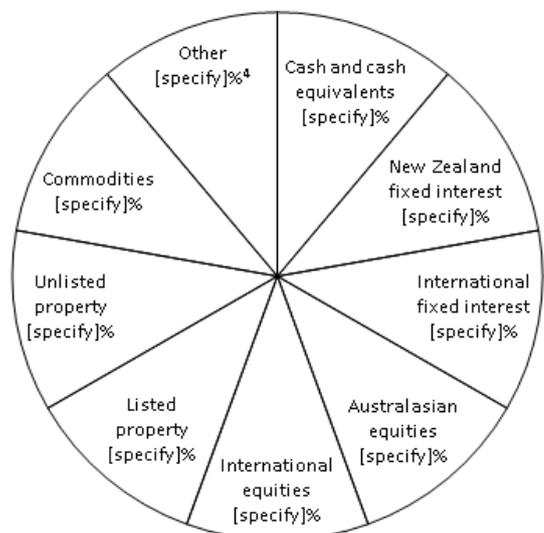


**Target investment mix**

[Select one: either the table or pie graph]

[Omit any categories not required]

Cash and cash equivalents	[specify]%
New Zealand fixed interest	[specify]%
International fixed interest	[specify]%
Australasian equities	[specify]%
International equities	[specify]%
Listed property	[specify]%
Unlisted property	[specify]%
Commodities	[specify]%
Other <sup>4</sup>	[specify]%



## Top 10 investments

	Name	Percentage of fund net assets	Type	Country	Credit rating (if applicable)
1	[specify]	[specify]%	[specify] [if relevant specify note <sup>5j</sup> ]	[specify]	[specify]
2	[specify]	[specify]%	[specify] [if relevant specify note <sup>5j</sup> ]	[specify]	[specify]
3	[specify]	[specify]%	[specify] [if relevant specify note <sup>5j</sup> ]	[specify]	[specify]
4	[specify]	[specify]%	[specify] [if relevant specify note <sup>5j</sup> ]	[specify]	[specify]
5	[specify]	[specify]%	[specify] [if relevant specify note <sup>5j</sup> ]	[specify]	[specify]
6	[specify]	[specify]%	[specify] [if relevant specify note <sup>5j</sup> ]	[specify]	[specify]
7	[specify]	[specify]%	[specify] [if relevant specify note <sup>5j</sup> ]	[specify]	[specify]
8	[specify]	[specify]%	[specify] [if relevant specify note <sup>5j</sup> ]	[specify]	[specify]
9	[specify]	[specify]%	[specify] [if relevant specify note <sup>5j</sup> ]	[specify]	[specify]
10	[specify]	[specify]%	[specify] [if relevant specify note <sup>5j</sup> ]	[specify]	[specify]

The top 10 investment make up [specify]% of the fund.

## Key personnel

	Name	Current position	Time in current position	Previous or other current position	Time in previous or other current position
1	[specify]	[specify]	[specify]	[specify][select one: (previous)/(other current position)]	[specify]
2	[specify]	[specify]	[specify]	[specify][select one: (previous)/(other current position)]	[specify]
3	[specify]	[specify]	[specify]	[specify][select one: (previous)/(other current position)]	[specify]
4	[specify]	[specify]	[specify]	[specify][select one: (previous)/(other current position)]	[specify]
5	[specify]	[specify]	[specify]	[specify][select one: (previous)/(other current position)]	[specify]

[If relevant: The following key personnel above were not named in a previous fund update for the fund:

- [specify]]

## Further information

You can also obtain this information, the PDS for [the name of the registered scheme], and some additional information from the offer register at [specify Internet site address].

## Notes

1. [If relevant: briefly describe those matters (including how) that significantly affect the comparability of returns in the bar graph]
2. [If relevant: state that estimates have been used in calculating some/all of the fees and costs and describe the information and assumptions used to make the estimate]
3. [If relevant: explanation of the nature of the assets in the “other” or “unknown” category]
4. [If relevant: explanation of the nature of the assets in the “other” or category]
5. [If relevant: <sup>A</sup>explanation of the nature of the assets in the “other” category]

## Schedule 1 (a) - Legislative references for Fund Update template

Section of fund update	Legislative reference in FMC Regulations	FMA comment on aspects of the template that are not already prescribed in the Act or Regulations
Information at the start of the fund update	Regulation 57	
Replacement fund update information [if relevant]	Regulation 61	If the replacement fund update replaces multiple previous versions, the column “Date the fund update was made publicly available” must state the date that each fund update was made publicly available. The aim is to clearly state to readers the chronological changes to the original disclosure from when it was first disclosed.
“What is the purpose of this update”	Schedule 4 Clause 56	Content prescribed by regulations.
“Description of this fund”	Schedule 4 Clause 57	Content and need for a table prescribed in regulations. Format of table specified by template.
“What are the risks of investing?”	Schedule 4 Clauses 5 & 58	Content prescribed. The visual depiction of how the risk indicator should be disclosed is specified by template in accordance with clause 5.
“How has the fund performed”	Schedule 4 Clauses 59–62	Most of content, format of table and requirement for bar graph prescribed in regulations. Format of bar graph specified in template.  Additional wording has been specified in template for funds which are PIEs and have been accepting contributions before the PIE regime. Managers will have to specify the tax rate for disclosure years prior to being a PIE.
“What fees are investors charged?”	Schedule 4 Clauses 63-65 and Regulation 33(2)(b)	Most content, format of total charges table prescribed in regulations. Template annotates each fund charge category in total charges table to aid readers in understanding the break-down of the charges.  A sub-heading “Basis or method of calculating the charge” was added to the table prescribed by clause 65(1) to take into account the requirement to disclose other charges that are not a fixed dollar amount as required under clause 64(3). The required disclosures under clause

		63(6)(c) refers to “underlying fund”. The template refers to these funds as “investments” as we consider this plain English more useful for investors.
“Example of how this applies to an investor”	Schedule 4 Clause 66	Content prescribed in regulations.
“What does the fund invest in?” - Actual investment mix - Target investment mix - Top 10 investments -	Schedule 4 Clause 67 Clauses 68 & 71 Clauses 69 & 71 Clauses 70 & 71	Content and requirement for pie graph and table prescribed in regulations. Template specifies format of graphs and table.
“Key personnel”	Schedule 4 Clause 72	Content prescribed in regulations. Template specifies a table and its format.
“Further information”	Schedule 4 Clause 73	Content prescribed in regulations.
“Notes”	Schedule 4 Clause 74	Notes prescribed in regulations. Template specifies location.

## Schedule 2 DRAFT Guidance for calculation of risk indicators

1. This guidance note is for managers of managed investment schemes that provide financial products in managed funds and their supervisors.
2. It gives guidance on your obligations under the legislation in relation to providing a risk indicator for your fund and on the expectation the FMA has for your approach to the calculation and presentation of the risk indicator.

### Background

3. Risk indicators and risk indicator diagrams are an important element of the disclosure requirements for managed funds under the Financial Markets Conduct Act 2013 (FMC Act) and the Financial Markets Conduct Regulations 2014 (the Regulations). The Regulations require that managers include the risk indicator for a managed fund in the PDS<sup>14</sup>, as an entry in the register when the PDS is lodged<sup>15</sup>, in each fund update<sup>16</sup> and in the corresponding register update<sup>17</sup>.
4. The purpose of the risk indicator is to provide investors with a simple tool that shows the volatility of returns and the related overall risk for the fund. It is intended to provide investors with a way to compare the risk profiles between various products when they are making investment decisions.
5. The Regulations provide that the FMA may issue frameworks or methodologies (FM) for risk indicators. The FMA, however, considers that a guidance note is more appropriate. Our risk indicator requirements are based on European standards. This guidance focuses on how these European standards may be used to assist your preparation of the risk indicator for your fund.

### Section 1: Your obligations related to risk indicators

6. Schedule 4 of the Regulations (Schedule 4) provides the legislative requirements for how the risk indicator diagram should look<sup>18</sup>, how the indicator should be calculated<sup>19</sup> and when alternative methods must be used to arrive at risk indicators<sup>20</sup>. The Regulations require you to calculate a risk indicator that is relevant for your fund using different approaches for different situations. The methodologies include:
  - a. A general methodology for calculating the risk for a managed fund using the standard deviation for past changes in weekly or monthly returns (Clause 6 Methodology):

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<sup>14</sup> FMC Regulations Schedule 4, clauses 25-29.

<sup>15</sup> FMC Regulations Schedule 4, clause 53(c)(ii).

<sup>16</sup> FMC Regulations Schedule 4, clause 58(1)

<sup>17</sup> FMC Regulations Schedule 4, clause 54(1)(a)(i)

<sup>18</sup> FMC Regulations Schedule 4, clause 5

<sup>19</sup> FMC Regulations Schedule 4, clauses 6-7

<sup>20</sup> FMC Regulations Schedule 4, clause 8

- i. For funds that have a performance history of at least five years, the calculation is based on the latest five years of the fund returns (Full History Funds)<sup>21</sup>; and
    - ii. For funds that do not have a sufficient return history (Short History Funds), either because their investment policy is now significantly different or because the fund has not existed for five years, the calculation is based partly on fund returns and partly on the returns of a relevant market index (Index Funds)<sup>22</sup>.
  - b. An alternative methodology for calculating risk when the nature of the fund means that risk indicators calculated using the Clause 6 Methodology would be likely to mislead or deceive investors. The risk indicator calculated by an alternative method must accurately reflect the future volatility of the fund<sup>23</sup>.
7. The New Zealand legislative requirements related to risk indicators are based on guidelines produced by the Committee of European Securities Regulators (CESR) for the calculation of a 'synthetic risk and reward indicator' for key disclosure documents (CESR Guidelines).<sup>24</sup> The CESR has now been replaced by the European Securities and Markets Authority and the intention is that the CESR Guidelines will become enforceable technical standards for the European Union. The CESR Guidelines are available here: [http://www.esma.europa.eu/system/files/10\\_673.pdf](http://www.esma.europa.eu/system/files/10_673.pdf).

## Section 2: Clause 6 methodology will apply to most managed funds

8. The Regulations require the risk indicator to be based on annualised standard deviations calculated using the change in returns from week to week or (if not available) from month to month over five years. This is essentially a measure of how volatile the returns have been over the relevant period. The more the weekly/monthly return differs from the average weekly or monthly return, the higher the standard deviation and the higher the risk (volatility).
9. The CESR Guidelines are a useful resource when meeting your requirements under the FMC Regulations. They provide additional detail for managers by setting out a standard deviation formula and defining the variables that will produce a risk indicator as required by clause 6<sup>25</sup>. In addition, the CESR Guidelines show a diagram<sup>26</sup> that meets the requirements and description of the risk indicator diagram required under clause 5 of Schedule 4. The risk categories (from 1-7) that show the fund volatility or risk in the Regulations are the same as the risk classes in the CESR Guidelines<sup>27</sup>.

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<sup>21</sup> FMC Regulations Schedule 4, clause 6(1)

<sup>22</sup> FMC Regulations Schedule 4, clause 6(2)

<sup>23</sup> FMC Regulations Schedule 4, clause 8

<sup>24</sup> CESR's guidelines on the methodology for the calculation of the synthetic risk and reward indicator in the Key Investor Information Document, Committee of European Securities Regulators, 1 July 2010, CESR/10-673.

<sup>25</sup> FMC Regulations Schedule 4, clause 6(1)(a) and the CESR Guidelines (Box 1), page 5.

<sup>26</sup> CESR Guidelines (Box 1), page 5

<sup>27</sup> FMC Regulations Schedule 4, clause 6(1)(b) and the CESR Guidelines (Box 2) page 7.

10. The Regulations require adjustments to the risk calculations when the fund is not a Full History Fund and there is insufficient relevant performance history for calculating five years of returns. The adjustment involves identifying an appropriate Index Fund that is a widely recognised and used market index<sup>28</sup>, administered by a person who is not connected with the scheme, and appropriate for assessing the type of assets relevant to the fund.<sup>29</sup> The Index Fund returns are then used as a substitute for the Short History Fund returns over the period of time that the new fund did not exist or over the period of the significantly different investment policy<sup>30</sup>.
11. Although the CESR Guidelines have different requirements for the choice of index, the Guidelines may again assist your thinking because they contain a fuller description of the reasons and method behind the Short History adjustments<sup>31</sup>.

### **Section 3: Alternative methodologies must be used if Clause 6 Methodology is likely to mislead or deceive**

12. If the nature of your managed fund is such that the Clause 6 Methodology leads to a misleading or deceptive risk indicator, you are directed instead to use a method that you reasonably consider will produce a risk indicator that accurately reflects the potential future volatility of the fund<sup>32</sup>. In other words, you have an obligation to assess whether the Clause 6 methodology will work for your fund and if not, to make a reasonable choice of alternative methodology when calculating your risk indicator.
13. The Regulations do not prescribe alternative methodologies if the Clause 6 Methodology is not appropriate for your fund. In contrast, the CESR Guidelines do provide specific alternative methodologies for certain categories of fund. We recommend the Guidelines as a useful resource when you are looking for a reasonable method to calculate the risk indicator if your fund is one of the identified categories.
14. The CESR Guidelines set out four alternative methodologies for funds that may require adjustments to the risk calculation because of the nature of the fund.
  - a. Absolute return funds<sup>33</sup>: funds managed according to investment policies or strategies based on a variable allocation of the portfolio of the fund across asset classes, under the constraint of a predetermined risk limit.
  - b. Total return funds<sup>34</sup>: funds managed according to investment policies or strategies focused on certain reward objectives by participating, through flexible investment in different financial asset classes.

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<sup>28</sup> FMC Regulations Schedule 4, clause 61

<sup>29</sup> FMC Regulations Schedule 4, clause 61(3)

<sup>30</sup> FMC Regulations Schedule 4, clause 5(2) and the CESR Guidelines (Box 4), page 9

<sup>31</sup> CESR Guidelines (Box 4), page 9

<sup>32</sup> FMC Regulations Schedule 4, clause 8

<sup>33</sup> CESR Guidelines (Box 5), page 10

- c. Life cycle funds<sup>35</sup>: funds managed according to investment policies or strategies which imply a shifting over time of their portfolio allocation from equity to fixed-income assets, according to some pre-determined rules as a target maturity date approaches.
  - d. Structured funds<sup>36</sup>: managed funds that provide investors, at certain predetermined dates, with algorithm-based payoffs that are linked to the performance, or to the realisation of price changes or other conditions, of financial assets, indices or reference portfolios.
15. The FMA considers that, in most cases, the CESR methodologies are appropriate alternatives for calculating risk indicators for funds in the identified categories. We expect managers of these types of funds to use the CESR Guidelines when assessing alternative methods to calculate a risk indicator representative of the fund. The widespread use of risk indicators that have been determined under the same methodology will provide investors with a consistent comparison between funds.

**Calculating risk indicators for funds not covered under by a CESR methodology or when the resulting indicator is misleading**

16. It is possible that all of the methodologies set out in the Regulations and the CESR Guidelines will result in an unacceptable risk indicator for your particular fund. This may be the case even if your fund is one of the specific types covered under the legislation or the CESR Guidelines. This may also be the case if your fund is not a typical market fund or a fund that is one of the types identified for a CESR methodology.
17. In every case, your overriding obligation under the legislation is to determine a risk indicator that reflects the potential future volatility of the fund. If the Clause 6 Methodology and the CESR alternative methodologies do not work for your fund, you must use a different method to calculate your risk. If you have concerns about the methodology to use or the resulting calculations, it is important to talk to the FMA to present and explain your proposals. We will be happy to discuss the options and issues with you.

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<sup>34</sup> CESR Guidelines (Box 6), page 11

<sup>35</sup> CESR Guidelines (Box 7), page 12

<sup>36</sup> CESR Guidelines (Box 8), page 13

## Terms used

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CESR	Committee of European Securities Regulators CESR provided technical advice on securities markets to the European Commission until it was replaced as the European regulatory authority by ESMA
ESMA	European Securities and Markets Authority ESMA is the regulator for the European Union that has a role similar to the FMA's role in New Zealand
FM	Frameworks or methodologies are notices issued by FMA under subpart 4 of Part 9 of the FMC Act
FMA	Financial Markets Authority
FMC Act	Financial Markets Conduct Act 2013
Key investor information document (KID)	The key investor information document (KID) is the European equivalent of our PDS
Managed funds MIS	A managed fund MIS as defined in regulation 5 FMC Regulations 2014
Manager	Manager of a registered managed investment scheme, including in the case of a restricted scheme, the trustees of that scheme
MIS	A managed investment scheme that is registered on the MIS register and defined in section 9 of the FMC Act
PDS	Product Disclosure Statement in relation to a regulated offer as defined in section 41 of the FMC Act
Registered scheme	A managed investment scheme registered on the register of managed investment schemes under the FMC Act
Regulations	Financial Markets Conduct Regulations 2014
Restricted scheme	A KiwiSaver, superannuation, or workplace savings scheme that has restricted membership or is closed to new members, <u>and</u> which is registered as a restricted scheme  A restricted scheme does not need a licensed manager or a licensed supervisor, but must instead have a licensed independent trustee  All restricted schemes are managed investment schemes

Risk Indicator	The value calculated under clauses 5-8 of Schedule 4 of the Regulations
Synthetic risk and reward indicator (SRRI)	The term used in the CESR Guidelines that is equivalent to the term risk indicator in New Zealand legislation
Supervisor	Supervisor of debt securities and/or of managed investment schemes as defined in section 6(1) of the FMC Act

## Schedule 3 The scope and list of potential FMs

1. The FMC Act provides the FMA with a new regulatory tool to support the financial markets regime. Subpart 4 of Part 9 of the Act empowers the FMA to issue frameworks or methodologies (FMs) relating to detailed or technical matters (rather than matters of general principle). The ‘technical’ aspect of FMs relate to how matters are required or permitted to be determined, calculated, valued, presented or prepared.
2. The Act also provides for the FMA to enforce FMs. Section 554 of the Act empowers the FMA to require any person, class of persons, information or class of information to comply, in whole or in part, with any FM notice. Non-compliance with an FM is a breach of legislative obligations. The FMA will use this new type of regulatory tool as necessary to clarify and set out the technical detail of the legislative requirements for market participants.
3. Section 568(1) sets out three general areas where FMs can be issued, as well as suggesting there will be some specific FMs contemplated under the regime. The general areas are:
  - a. Information required in relation to ongoing disclosure and updating of registers (subpart 4 of Part 3: sections 95-100);
  - b. Governing document for debt securities and registered schemes, SIPO, materiality of limit breaks or pricing errors (Part 4: sections 102-228)
  - c. Eligibility criteria and conditions for market services licences (Part 6: sections 386-449)
4. As well as the general areas where FMs may be used, section 568(1)(e) of the Act authorises an FM notice to be issued for any matter that is required or permitted to be done in accordance with the Act or Regulations (or any other legislation). The FMs that are specifically identified in the Act and Regulations are listed in the table below.

## Specific FMs contemplated in the FMC Act

	Framework or methodology that may be specified in FMA notice	Section or clause
1.	How contents of trust deeds are determined, calculated, valued, presented or prepared	Section 104(5)
2,	How contents of governing documents for registered schemes are determined, calculated, valued, presented or prepared	Section 135(3)
3.	How content of statement of investment policy and objectives of registered scheme are determined, calculated, valued, presented or prepared	Section 164(3)
4.	How to determine whether or not a pricing error or non-compliance with a registered scheme's pricing methodology is material	Section 167 (3) See also Regulation 96(2)(e)
5.	How to determine price (pricing methodology) for managed investment products (non-compliance carries an obligation to correct, report and remedy the breach)	Section 168(1)(b)(ii) See also Regulations 97- 99
6.	How to determine whether a pricing error or non-compliance with a pricing methodology is material	Section 168(3)
7.	How to calculate the in-house assets ratio of a restricted scheme	Section 176(4)
8.	How to assess whether a financial product market meets criteria related to transaction number and aggregate value that exempts the market from the licensing requirement	Section 312(1)(a)
9.	How to determine, calculate, or present matters to be set out in DIMs investment authority related to nature and type (and limits) of investments, limits on proportion of each asset type, methodology for developing investment strategy and measuring performance (note material breach of limits carries an obligation to report see section 438(2))	Section 437(4)
10.	How to determine whether a DIMs limit break (related to section 437 matters) is material (note, if material, reasons why it is material must go into the report on the break)	Section 438(3) See also Regulation 232(2)(e)

	<b>Framework or methodology that may be specified in FMA notice</b>	<b>Section or clause</b>
11.	How to calculate annual gross income to determine whether the income threshold of \$200,000 is met for the small offers exclusion (Schedule 1, clause 12, definition of personal offer para (b))	Schedule 1 clause 14(4)(b)
12.	How to determine whether the investment activity threshold is met for the wholesale investor exclusion in relation to: portfolio or transaction value of at least \$1M; or material participation in an investment business (Schedule 1, clauses 3(2)(b) and 36(b)(ii))	Schedule 1 clause 38(3)
13.	How to determine whether person meets criteria for being large is met for the wholesale investor exclusion in relation to net assets or consolidated turnover greater than \$5M (Schedule 1, clause 39(1))	Schedule 1 clause 39(2)
14.	How to determine notional value of a derivative to determine whether the threshold of \$5M is met for the wholesale investor exclusion (Schedule 1, clauses 3(3)(c) and 49(1))	Schedule 1 clause 49(2)

### Specific FMs noted in the FMC regulations

	<b>Framework/methodology that may be specified in FMA notice</b>	<b>Regulation or clause</b>
1.	A template setting out the format for information required under the regulations for the fund update	Regulation 59(1)
2.	How to calculate the number of underlying quoted voting products in which a person has a relevant interest for the purposes of substantial holding disclosure. This arises when a person has a relevant interest in a derivative, and the underlying of the derivative is a quoted voting product of a listed issuer	Regulation 132(1)(c)
3.	How to prepare the diagram showing the total liabilities and equity of the issuer of debt securities which is required in the PDS key features for the debt securities when describing the ranking of the debt securities on the issuer's liquidation (see Schedule 2, clause 30(2)(b))	Schedule 2, Part 1, clause 31(2)
4.	How to prepare financial information and ratios table required in the PDS (see clauses 37 & 38)	Schedule 2, Part 1, clause 39(1)(a)
5.	The form of tables showing how to calculate information for NBDTs in relation to capital ratios, aggregate exposures to related parties, and liquidity measures contained in the PDS or register entry	Schedule 2, Part 1, clause 66(b)

	<b>Framework/methodology that may be specified in FMA notice</b>	<b>Regulation or clause</b>
6.	How to prepare issuer's financial information (EBITA, capitalisation, key investment metrics) in PDS for equity securities (Schedule 3, Part 1, clauses 35, 36 & 38)	Schedule 3, Part 1, clause 39(a)
7.	How to determine value of assets, calculation of returns and other amounts for MIS documents and information (Schedule 4)	Schedule 4, clause 3(b)
8.	How to calculate, prepare and present the risk indicator for managed investment products in managed fund	Schedule 4, clause 6(1)(c)
9.	How to calculate the returns in relation to a managed fund or a market index for a period	Schedule 4, clause 6(3)(b)
10.	An alternate methodology for calculating, preparing and presenting a risk indicator if clause 6 method misleading	Schedule 4, clause 8(2)(a)
11.	How to determine the minimum suggested time frame for holding the investment for table showing investment options in the PDS for managed investment products in managed fund	Schedule 4, Part 1, clause 23(1)(d)
12.	'Other' fees that must be included in the synthetic total expense ratio (see clause 53(1)(c)(v)) in respect of the fund or underlying funds	Schedule 4, Part 2, clause 53(3)
13.	Format for the fund information required related to the assets of the fund and value in clause 53(1)(j)	Schedule 4, Part 2 clause 53(8)(c)(ii)
14.	Format for fund information on weekly/monthly returns in clause 53(1)(k)	Schedule 4, Part 2, clause 53(9)(b)
15.	How to prepare financial information for 'other' schemes (managed investment products <i>not</i> in managed funds) relating to prospective income, expenses, returns and financial measures for scheme borrowings	Schedule 5, Part 1, clause 30(1)(a)
16.	How to prepare a diagram showing total liabilities and equity of the issuer (registered bank or the Crown) when describing the ranking of the debt securities on a liquidation of the issuer (see Schedule 9, clause 24(2)(b))	Schedule 9, clause 25(2)
17.	How to calculate the return in relation to a composite or model portfolio for a period for DIMS (see Schedule 21, Part 2, clauses 30-33)	Schedule 21, Part 2, clause 34(c)