

# Securities Trustees and Statutory Supervisors - Feedback from monitoring visits

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## Introduction

### Context of this report

In September 2012, FMA licensed securities trustees and statutory supervisors (*licensees*) pursuant to the Securities Trustees and Statutory Supervisors Act 2011 (*the Act*). Prior to the Act, licensees in New Zealand were not subject to independent regulation.

FMA recognises that it can take time for any newly regulated population to adapt to their new compliance obligations. In the context of licensee's, adapting processes and building a culture of regulatory oversight of supervised interests can take time. This monitoring report and the guidance issued by us in June 2013 on Monitoring by Securities Trustees and Statutory Supervisors have been designed to help licensees move towards best standards of compliance.

In 2013, FMA conducted on-site reviews of all licensees and made a number of recommendations in our resulting feedback to assist them to fully comply with our expectations of licensee standards. The level of engagement and response from licensees has been very positive.

The findings in this report reflect common issues recorded during our on-site visits and summarises the overall assessment of monitoring quality (section 1). It also provides key messages for licensees (section 2) and outlines the future focus of monitoring reviews (section 3).

*However, the observations made in this report do not necessarily relate to every licensee and the ones we have noted may not be directly applicable, or applicable only in part, to a particular licensee.*

### FMA's approach to regulation

FMA's principal objective is to promote and facilitate the development of fair, efficient, and transparent financial markets. We work with financial market participants in an open and educative way, to achieve the best standards of compliance. We aspire to be clear about FMA's expectations, while providing the market with scope to develop the way it meets our expectations.

FMA monitors market participants' compliance with the obligations imposed upon them. On-site review of licensees' file practises is just one of our monitoring activities, which are designed to facilitate voluntary compliance by market participants and are one of the ways through which we communicate our expectations and work to raise standards. Our expectations of regulated participants will increase over time, as regulatory regimes are embedded.



## **Key findings**

From the on-site reviews, we identified four key areas requiring improvement by some licensees:

- timeliness and context of monitoring activities
- the exercise of professional scepticism
- evidence of internal monitoring triggers
- monitoring documentation and evidence.

Our comments on these key areas are detailed in Section 2.

# 1. Assessment of licensee monitoring quality

## 1.1 Review approach

The law does not specify the form or content of a licensee's procedures for ensuring that an entity it supervises complies with its relevant obligations. FMA recognises that each licensee will have developed its own monitoring procedures.

When we conduct on-site licensee file reviews we are not looking for evidence of a particular prescribed form of monitoring. Rather we are looking for evidence that the licensee has applied the principles FMA has set out in previous guidance<sup>1</sup> or feedback.

## 1.2 Assessment of individual files

FMA's focus is on determining whether monitoring is appropriate for a particular supervised entity, given:

- the risks specific to that entity
- the risks of the industry in which it operates
- the particular relationship with the supervised interest (e.g. is the entity proactive, providing more information than it is strictly required to, engaging on issues it is facing in its business with the licensee, or are they reactive and minimalist or recidivist late providers of information)

For the most part, we did not select the files to be reviewed. We requested that each licensee produce a representative sample including, in each category in which the licensee was licensed, at least one high risk and one low risk appointment.

In future reviews, FMA may change this approach and request licensees to produce files we consider should be reviewed. Factors taken into account by us in selecting files may include:

- entities that are likely to be of significant public interest, such as KiwiSaver schemes and listed companies
- those entities and industries that are more vulnerable to risks arising from existing and emerging market conditions and other higher risk entities
- entities where FMA has had prior instances of engagement e.g. through prospectus review.

Our review focusses on how particular monitoring was performed - it is not designed to assess whether the information received by a licensee has been correctly reported to it by the supervised entity. However, if our review identifies instances where information is received from a supervised entity which appears to:

- contradict other information received from that entity
- contradict other information received from another source e.g. the manager
- contradict market trends or practice

we will raise queries with a licensee to understand how the licensee assesses the accuracy (or otherwise) of the conflicting information.

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<sup>1</sup> Guidance Note: Monitoring by Securities Trustees and Statutory Supervisors – June 2013

## 2. Key findings

Key findings arising from our 2013 on site reviews are set out in this section. Licensees should pay particular attention to these findings in order to assess whether they can improve the quality of their monitoring.

The key findings relate to:

- the timeliness and context of monitoring activities
- the exercise of professional scepticism
- evidence of internal monitoring triggers
- monitoring documentation and evidence.

Each key finding section contains a summary of FMA's expectations and where appropriate, examples of non-compliance identified during our visits.

We believe it is important for licensees to embed systems and processes that promote monitoring quality. We noted opportunities for some licensees to demonstrate a greater commitment to monitoring quality. This could be achieved through senior management engagement, reviewing monitoring plans, creating a culture of continuous improvement, and providing adequate resources to support best monitoring practice.

### 2.1 The timeliness and context of monitoring activities

- **Licensees should ensure they have sufficient trained staff to perform detailed and timely analysis of information received from a supervised interest.**
- **Analysis of information should include analysis of what trends are evidenced and how any changes in performance over time may impact on investors.**

FMA found on various on-site visits that licensee processes for analysing information and data from supervised interests could be improved.

We expect that reporting and information received from supervised interests is reviewed in a timely and informed manner. We saw examples of information that had been reviewed weeks, or in extreme cases, months after its receipt. Reviewing information from a supervised entity after such a delay will reduce the opportunity to take action, or eliminate options for alternative courses of action, should an issue of concern be noted.

Equally important is that the review is carried out in a thorough manner and is more than a 'tick-box' exercise. Information must be reviewed in context. For example, a decline in the cash position over the last two quarters may not necessarily be significant, but a decline in the cash position over the last two quarters with a pending large repayment due to investors is likely to be more significant. Licensees should review information considering "if this trend continues/does not reverse what is the effect for investors?"



Similarly, information received from a supervised entity should not be reviewed only against whether it complies with a specific trust deed ratio or covenant, but whether any trends are emerging. A licensee should analyse what that trend means to the state of the supervised entity's financial health and whether it increases or diminishes risk to investors. Steadily decreasing headroom under a relevant covenant would, for example, be a warning sign regardless of whether the supervised entity was in technical compliance with the covenant.

Industry knowledge and 'lessons learnt' from issues occurring in one supervised interest should be translated to the supervision of other supervised entities. For example: should a failure in one entity's systems produce a unit pricing error, FMA expects that not only should the issue with that particular supervised entity be addressed and remedied, but the issue creating the error be considered in terms of a possibility of it occurring at other supervised entities in the same industry.

FMA expects monitoring to be carried out in accordance with a risk rated monitoring plan. We saw some licensees who applied the same standard of monitoring to both high and low risk entities.

Management must reflect on the appropriate personnel to conduct supervision at any given point in time. Having a single identified staff member may not be appropriate as circumstances change. The skills required to assess a legal opinion will be different to those skills required to assess a set of audited accounts. In times of financial stress, it may be more appropriate to transfer the supervision to more experienced staff, or staff with particular qualifications.

Continuity of staff with a supervised interest is important, as this adds to the licensee knowledge base of that entity. However there should be a method on the file of recording all material information so that it is easily accessible, ideally in one place, should the need arise to transfer the file to, or have a review of part of the file performed by, another staff member.

The multi review system, where the second review actively reviews the initial assessment by the first staff member, is a useful tool to ensure effective review of any information received. On one level, it provides real time training as the second reviewer can actively improve the quality of a review of a new or junior staff member. More importantly, it adds value to the supervised interest as a more experienced staff member is more likely to identify potential or actual issues.

Most licensees have a multi review model. This model appears most robust where the second reviewer actively questions assumptions made, or conclusions drawn by the initial reviewer. This active second review was demonstrated by several licensees using one or more of the following methods:

- exchange of emails between licensee staff
- the second reviewer actively engaging with the supervised entity to raise queries
- a referral of the initial review back to the initial reviewer for further details or analysis.

Management can assist the development of this robust system by encouraging staff to:

- compare views and experiences of supervising various entities
- explore whether regular peer review of files is appropriate to gain fresh perspectives on monitoring approaches

- inform themselves of updates or changes in industry practice, both within the trustee industry and the various industries in which the licensee's supervised interests operate.

More generally, management should support staff in their review by ensuring:

- sufficient resources to adequately assess each document in a timely fashion
- review by more than one staff member
- a culture that supports staff training, or assigns work appropriately to adequately trained specialist staff.

## 2.2 Professional scepticism

- **Licensees must reinforce the importance of exercising professional scepticism and should provide appropriate training to all staff.**

Professional scepticism is a critical component of contextual monitoring. In particular, where information is presented to a licensee by a supervised entity, FMA expects a licensee to:

- form its own view on the validity of that information
- be alert for evidence that contradicts or brings into question the reliability of documents or representations.

Professional scepticism can be negatively impacted by many factors, including:

- pressure on staff to 'process' reviews of reports received from supervised entities to meet internal timescales, at the expense of conducting an appropriately in-depth review
- long standing relationships between licensees and supervised interests
- over-reliance on industry experts without an independent review by the licensee of the information presented.

Our reviews noted a number of areas where we considered some licensees lacked appropriate professional scepticism. These included:

- accepting directors' representations regarding compliance with trust deed covenants without any other form of evidence, or where there was conflicting evidence provided in accompanying financial information
- no evidence of monitoring procedures prior to the approval of a supervised entity entering into a new banking facility, nor evidence of monitoring of the use of those funds against the stated intention
- accepting valuations performed by a property valuer who had been performing valuations for the supervised interest for 10 years, when there was a lack of comparable evidence to substantiate the value of the property
- when relying on work of experts, not evaluating the competence and independence of the expert or assessing all the assumptions made in the valuation report
- raising queries with a supervised entity, but then when a vague response or no response was received to the queries, not following up with the entity

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- where it is noted that one individual at a supervised entity was ‘difficult’ or ‘aggressive’, being reluctant to raise queries with that individual
  - where, having raised a query upon noting an event in one month’s financial information, and accepting an explanation, not challenging whether the explanation was still correct where a re-occurrence of the event occurred in the subsequent month
  - not questioning an entity when actual financial information provided does not correspond with a forecast
  - where an entity in some financial stress provides a business plan, not questioning:
    - the details of that business plan
    - any pre-conditions to the success of that plan
    - the timescale for that plan
    - the costs associated with that plan
    - whether the consents/agreements of third parties have/will be obtained.

FMA believes that licensees should emphasise the importance of professional scepticism in their monitoring and review work performed, and provide sufficient ongoing training for all staff to improve professional scepticism. A clear cultural acceptance within the licensee that queries should be raised with supervised interests will assist the application of professional scepticism.

Furthermore, we expect to see documentation and evidence on the file of the exercise by the licensee of professional scepticism.

Professional scepticism of a stressed entity should also include early assessment by the licensee of ‘worst case scenario’. If a licensee issues a section 46 notice advising FMA that a supervised entity is in breach of its obligations, the licensee should work through its options for enforcement, should the breach be unable to be resolved quickly.

Accordingly, FMA expects a licensee to know:

- what its various enforcement options are
- which option it is most likely to adopt for the situation
- which options it will discount and the basis for doing so
- the likely consequences of the various proposed courses of action.

## 2.3 Evidence of internal monitoring triggers

- Each licensee should have developed its own methodologies for monitoring financial information received from the supervised entity.
- These methodologies should provide for an escalation of monitoring oversight by a licensee.

During our on-site visits, we found instances where events indicating an unusual stress or sudden change in the financial performance of a supervised interest had not triggered any additional query or monitoring. This raises questions as the robustness of these monitoring processes.

Licensee monitoring should not be solely focussed on whether there is a breach of a formal deed or statutory ratio.

Best practise would include the identification of internal key trigger points, which if breached, result in increased monitoring and supervision by the licensee, prior to events progressing further to a breach of the deed or statutory obligation. We expect that, if internal ratios are breached, a licensee should work more closely with its supervised entity to develop an approved course of action. Trigger points for increased levels of supervision could include:

- a large one off drop in the cash position
- a significant change in performance or return of the supervised entity
- a breach of SIPO, or fund investment guidelines, or a unit pricing error, which although corrected at no loss to investors, may indicate the supervised entity is under stress or that there is a systemic issue within the supervised entity which requires correction
- a series of small drops in the cash position which, when reviewed over the previous six months, cumulatively indicate a large change in position
- a series of small errors or incidents of concern with a supervised entity, which if viewed individually are not material, but the accumulative effect indicate the supervised entity is under stress.

The trigger points must also be subject to regular review. For instance: a 10 unit retirement village under development with no residents will have different pressure points compared to that same village:

- following completion of the development when fully occupied, or
- 10 years later, when it requests approval for a significant banking facility to fund a staged development including an upgrade of existing common facilities.

Similarly, FMA expects that monitoring plans are regularly reviewed. As part of this process, all material received from a supervised entity is regularly assessed to ensure it provides sufficient information for the licensee to effectively carry out its role.

## 2.4 Monitoring documentation and evidence

- **Licensees should maintain adequate files recording not only the information received from supervised interests, but the assessment of this information.**
- **Discretionary decisions made by each licensee should be noted clearly, including instances where there is a decision not to act, along with the rationale.**
- **The risk assessment of each appointment should also be clearly noted on the file. The licensee should be able to clearly explain how monitoring undertaken reflects this assessment.**

Following the on-site visits, many licensees, in responding to FMA's feedback noting poor documentation, advised that:

- the full set of information held by the licensee in relation to a particular matter was not provided to FMA
- FMA was only given part of the file
- FMA reviewed only the physical file and not electronic records related to the file
- on files where FMA could see no evidence of identification or analysis of material issues being demonstrated on the reviewed file, various licensees have commented that consideration was given to this issue, but not documented.

This response was made despite our request for full and complete files prior to the monitoring visit. On future visits, licensees should present their complete files to FMA, whether these are stored physically, electronically or in multiple locations within the licensee. If the file structure is difficult to follow or it is not clear from a file index that there are multiple locations for various parts of the file, a licensee should ensure that FMA staff are made aware of the relevant different locations of the information at the commencement of the visit.

FMA expects licensees to obtain sufficient and appropriate evidence from their supervised interests to be able to draw reasonable conclusions as to the ongoing financial health and compliance with the relevant statutory obligations of that supervised entity, and for that evidence to be held on file supporting the conclusions.

Further, if any waiver or approval is sought by a supervised interest, or an event triggers the need to escalate monitoring, FMA expects the file to evidence the consideration by the licensee of the waiver or approval request, or that a considered change in monitoring commensurate with the new level of risk has been implemented. Conversely, should a supervised interest improve its financial health to a level the licensee feels changes the risk rating of that entity, FMA would expect the monitoring standard to be appropriately reduced and the reasons for that reduction documented.

In many cases, the concerns raised with licensees arose out of a failure to fully record the review of information received, or all the information the licensee relied on in forming conclusions.

In the absence of adequate documentation held on file, it is difficult for FMA to assess whether an appropriate review of information was conducted and if all relevant considerations were made when



determining a waiver or approval request. If there is no documentation on file, the presumption will be that the licensee did not perform a review or did not consider the relevant information when making a decision.



### 3. Future focus

FMA will continue to monitor licensees, including conducting on-site visits. Our monitoring and review programme will continue to focus on the risks that non-complying supervised entities pose to investors, and how licensees as front line supervisors, identify these risks and monitor their supervised entities. Our monitoring and review programme will also build on the findings of the reviews performed over the previous period and seek to assess compliance with any previous FMA recommendations.

Similarly to the process followed after our last on-site visits, FMA will provide formal written feedback to each licensee. Further industry-wide feedback may also be produced on common themes or issues identified during our on-site visits. We are happy to discuss individual feedback and general industry feedback with each licensee.

Should FMA identify during future visits, evidence of an issue previously noted as a concern, or a material recommendation from us not being adopted, FMA may issue directions for the licensee to implement the required changes. We will conduct follow-up or spot reviews for licensees where we have seen significant issues in our previous review. These ongoing reviews help to ensure that licensees are taking appropriate actions to address our recommendations.



