Guidance note

May 2016 (as amended July 2017)

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

Fee disclosure by managed funds

Disclosing information about fees and charges is important for managed funds under the *Financial Markets Conduct Act 2013* and the *Financial Markets Conduct Regulations 2014*.

This guidance helps managers and supervisors understand how fees should be disclosed in Product Disclosure Statements, fund updates and, in respect of KiwiSaver schemes, confirmation information. It includes guidance on the classification and disclosure of performance-based fees, management and administration charges, underlying fund charges, and how to use third-party information.

About this guidance note:

This guidance note is for: managers and supervisors of managed funds.	It gives guidance on: how fees of managed funds should be disclosed in PDSs fund updates and, in respect of KiwiSaver schemes, confirmation information.

About FMA guidance

Our guidance:

1. explains when and how we will exercise specific powers under legislation
2. explains how we interpret the law
3. describes the principles underlying our approach
4. gives practical examples about how to meet obligations.

Guidance notes: provide guidance on a topic or topic theme. Typically we will seek industry feedback via a public consultation paper, or more targeted consultation before we release a guidance note.

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

You might also like to check the reports and papers on our website. For example, our monitoring reports describe actual practice we are seeing and our comments on this.

Document history

This version was issued in May 2016 (as amended in [#] July 2017) and is based on legislation and regulations as at the date of issue.

FMA document reference code 3411943

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About this guidance

1. Disclosing information about fees and charges is important for managed funds under the *Financial Markets Conduct Act 2013* (FMC Act) and the *Financial Markets Conduct Regulations 2014 (FMC Regulations)*. In order for investors to make fully informed decisions, it is important for managers to correctly classify and disclose a fund's fees.
2. Fee information must be disclosed in the fund's Product Disclosure Statement (PDS), in the ongoing quarterly fund update and, in respect of KiwiSaver schemes, confirmation information provided to investors annually.[1] This guidance is intended to help managers and supervisors understand the various categories of fees and charges they are required to disclose. The table below provides a brief summary of the fees and charges covered by this guidance.

Management and administrative charges	
The cost of all fees and charges which affect investors in proportion to their interest in the fund.	(see paragraph 4)
It includes fees and costs charged by an underlying fund which the fund is invested in.	(see paragraph 17 for information on how to determine whether an investment is an underlying fund)
Manager's basic fee	
This is a component of management and administration charges. It refers to the total fees payable for management services provided to the fund.	(see paragraph 8)
Other management and administrative charges	
This refers to the costs of services provided and charged to the fund which are not part of the manager's basic fee.	(see paragraph 10)
Performance-based fees	
This is any fee charged by the manager based on the performance of the fund.	(see paragraph 12)
It also includes fees charged by managers of related underlying funds.	(see paragraph 17 for information on how to determine whether an investment is an underlying fund)

[1] Clause 32(1) and clause 63(1) of schedule 4 of the FMC Regulations and regulation 70 of the FMC Regulations.

3. In addition to the above, the final section of this guidance outlines our expectations of what managers and supervisors should do when they are relying on third-party information or are required to estimate fees and charges.

Management and administration charges

4. The fund update must disclose the fund's total management and administration charges[2]. This is the cost of all fees and charges which affect investors in proportion to their interest in the fund.[3] This definition is quite broad. It will include any fees or charges which affect the amount of income or capital distributions made to investors.

5. Management and administration charges do not include performance-based fees or trading expenses[4]. They also do not include any fees charged to a member for their membership of, or participation in, the fund.[5]

Example 1

An exchange-traded fund incurs expenses related to the management of the fund. These fees are charged by the manager to members as an annual percentage of the total value of the fund. Investors' interests are affected when the fees reduce the fund's total net asset value (NAV). The NAV represents the intrinsic value of the fund's shares, and the value of the investors' interest. The fee would need to be disclosed as a management and administrative charge.

6. Management and administration charges also include fees charged by an underlying fund which the fund is invested in.[6] Managers should take into account whether the underlying fund's fees and costs affect what's being distributed to the investors. In our view, when fees and costs of underlying investments affect the amount distributed to members, they need to be disclosed as part of the fund's management and administrative charges.

7. Managers should consider whether an underlying fund's fees and costs affect the price of the underlying fund's interests or shares. In some instances (particularly for listed investment vehicles) the price of interests or shares is not closely correlated with the assets of the underlying fund. As such, fees and costs charged to the underlying fund may not affect the market value of the interests or shares. If fees do not affect the market value of the underlying fund they are unlikely to affect the interest of investors in the primary fund. If the fees of the

[3] Clause 2 of schedule 4 of the FMC Regulations
[4] Clause 2 of schedule 4 of the FMC Regulations
[5] These types of fees are defined as 'other charges' under clause 2 of schedule 4 of the FMC Regulations
[6] We provide guidance on what investments may constitute an underlying fund in paragraphs 17 -34 of this guidance note.

underlying fund do not affect the interests of investors they are not required to be disclosed as part of the fund's management and administration charges.

Manager's basic fee

8. A fund update must include information about the manager's basic fee. This fee is required to be disclosed as a subset of the fund's total management and administration charges.[7] An example of the required disclosure is set out below:

Total management and administration charges including:	% of net asset value
Manager's basic fee	% of net asset value
Other management and administration charges	% of net asset value

9. The manager's basic fee represents the total fees payable by investors in respect of the management services. provided for the fund. This may include third party fees, but only where the fee:
    a. is paid by the manager (ie not charged to the fund directly); and
    b. is charged in respect of management services provided to the fund; and
    c. is paid to a third party to whom management services have been outsourced by the manager.
10. The manager's basic fee should be distinct from the costs of services provided and charged to the fund which are not for directly managing the assets. The types of fees which fall within the 'other management and administration charges' include:
    - fees paid to the supervisor
    - legal and auditor expenses
    - fees and expenses charged by underlying funds in which the fund invests
    - scheme expenses passed onto the fund.
11. For management fees that are charged to a scheme rather than directly to a particular fund, we would expect the manager to allocate the fees appropriately across the scheme's funds. These fees would then be reported as part of the relevant fund's 'other management and administrative charges'. Note this allocation is only required if the fees are passed on by the scheme to the funds.

[7] Clause 63(2) of schedule 4 of the FMC Regulations

Performance-based fees

12. Managers must disclose any performance-based fees.[8] These are fees charged by the manager based on the performance of the fund.
13. Managers must include any performance-based fees charged by the manager of a related underlying fund as part of their total performance-based fees disclosure.[9]
14. A related underlying fund is defined as any fund managed by the same fund manager or an associated person of that manager. Where a fund's assets are managed as a whole by someone other than the manager, a related underlying fund will include any fund managed by that person or persons associated with him.[10]

Example 2

A KiwiSaver scheme is managed by ABC Investment Limited. The scheme provides an option for members to select XYZ Balanced Fund, whose assets are managed by XYZ Investment Ltd. All underlying funds managed by ABC Investment Limited, XYZ Investment Ltd, an associated person of ABC Investment Limited; or an associated person of XYZ Investment Ltd, are related underlying funds.

15. All underlying funds that are not related underlying funds are considered 'non-related underlying funds'. The performance-based fees of non-related underlying funds do not have to be disclosed as part of the fund's performance-based fees. However, these fees will generally have an effect on investors' interests in the fund, so they must be incorporated as part of the disclosure on management and administration fees.
16. Managers must comply with additional disclosure obligations for performance-based fees. These have been set out in previous guidance which is available at:

    https://fma.govt.nz/assets/Guidance/160225-Infosheet-Performance-Fee-Disclosure.pdf

    https://fma.govt.nz/assets/Guidance/120501-kiwisaver-performance-fee-guidance-note.pdf

[8] Clause 33 and 63(2) of schedule 4 of the FMC Regulations
[9] Clause 2 of schedule 4 of the FMC Regulations
[10] Regulation 5(1) of the FMC Regulations

What is an underlying fund

17. In addition to fees incurred or charged by the fund itself, the FMC Regulations also require managers to disclose to investors the fees and charges of underlying funds. These fees are not required to be disclosed separately. Instead they must be included within the fund's overall fee disclosure, either as a 'performance-based fee' or 'management and administrative charge' (as appropriate). This ensures the full cost of investment is disclosed to investors.
18. Fund arrangements often involve a range of investment vehicles. It is important for managers to consider whether any of these are, in substance, underlying funds. An underlying fund is essentially any other fund in which the fund invests, whether directly or indirectly.[11]
19. The FMC Regulations defines a fund as a pool of assets held for the benefit of a group of investors and managed under a single investment mandate.[12] Some common examples of a fund include:
    - a unit trust or group investment fund
    - a superannuation scheme
    - a managed investment scheme registered (or required to be registered) under the FMC Act
    - an exchange-traded fund (ETF).

Determining whether an investment vehicle is an underlying fund

20. The definition of an underlying fund is very broad. It is broader than just funds that are investment options in licensed managed investment schemes. To help managers, we have developed some additional tests that can be used to clarify whether an investment vehicle is an underlying fund. These tests have been developed with the intention of the fee disclosure provisions in mind. That is, to ensure investors are informed of the additional fees or costs they incur when they invest in a fund, as opposed to directly investing in the underlying asset.
21. The flowchart in the Appendix summarises the process managers should use to determine whether an investment vehicle is an underlying fund. This helps managers decide whether the vehicle's fees should be included as part of their own fund's fee disclosure.

Characteristics test

22. There are several characteristics which are common to most funds. Managers should consider whether an investment vehicle has any of these common features. These include:
    - the investment vehicle is widely held by many investors

[11] Regulation 5 (1) of the FMC Regulations
[12] Regulation 5(1) of the FMC Regulations

- the investment vehicle gets most of its income from passive sources such as interest, dividends, and capital gains
- the investment vehicle has the word ‘fund’ or other similar designation in its name
- the assets of the investment vehicle are managed externally
- the investment does not confer any voting rights or similar controls on the management of the vehicle
- investment and redemption in the vehicle must be made via a manager or administrator.

23. Managers should consider whether an investment vehicle has sufficient characteristics that it should reasonably be classified as a fund. An investment vehicle is not required to satisfy all of the above criteria to be considered an underlying fund. However, the more criteria it satisfies, the more likely it is that it should be considered an underlying fund.
24. If there is still uncertainty, managers should consider the further tests set out below.

Business test

25. One of the distinctive features of a fund is that it gets most of its income from sources such as interest, dividends, and capital gains. We believe an investment vehicle should be considered an underlying fund if it is principally engaged in the business of investment. That is, if most of the investment vehicle’s assets are invested in financial products.[13]
26. As part of the proper performance of their duties, managers should have access to information that will enable them to decide whether an investment vehicle has most of its assets invested in financial products. This will come from knowledge about the investment vehicle or about the investment strategy it applies. Managers do not need to know precisely the nature of an investment to make this decision. Their decision should be based on what they have reasonable grounds to believe.
27. Some examples of investment vehicles that are likely to be principally involved in the business of investing in financial products include investment trusts, listed investment companies, exchange-traded funds, and hedge funds.

Example 3

A fund offers investors exposure to New Zealand shares. The fund invests in a wholesale investment company that invests in shares to track the S&P/NZX50 index. The wholesale managed fund is an underlying fund because it is principally involved in the business of investing in financial products (equity securities).

[13] For the purposes of this guidance ‘financial products’ has the meaning set out in section 7 of the Financial Markets Conduct Act 2013.

Purpose of investment

28. Investments in underlying funds are generally made to get exposure to some underlying asset. We consider an investment vehicle to be an underlying fund if investment is made to get exposure to (and therefore the benefit of) the underlying assets of the vehicle.

Example 4

A KiwiSaver scheme offers a balanced investment fund. This fund invests in unlisted property funds. The PDS for the KiwiSaver scheme indicates that these investments provide exposure to real property that the manager considers appropriate as part of offering a balanced investment option. The property funds will therefore be regarded as underlying funds, as it is the property that is the purpose of the investment, not the fund itself.

29. An investment vehicle will not be an underlying fund if the purpose of the investment is to invest in the vehicle itself. In other words, there is information from which it could reasonably be regarded that shares or interests in the vehicle are held as the end investment, and not just as a means of gaining exposure to a particular class of assets.
30. A fund's PDS, its general investment objective, its strategy and asset allocation will help determine whether an investment is made in the vehicle, or for its underlying assets.

Example 5

A fund invests in the shares of a listed company specialising in operating airports. The investment is made as part of the fund's investment strategy of holding shares in infrastructure companies. The listed company is not an underlying fund because it is the company's shares that are most reasonably regarded as the investment, not the airports.

31. It will often be easier to establish that an investment vehicle is not an underlying fund if it is listed. This is because returns on investment are mainly received from increases in the market price of shares (or interests). The market price will reflect the overall nature of the business and market sentiment, not just the value of its assets. In such instances, it could more readily be regarded that the holding of those shares or interests is the purpose of investment. In other words, the investment vehicle (as opposed to its underlying assets) is the end investment.
32. This can be contrasted with having shares or interests in unlisted businesses, where the valuation of interests or shares may depend exclusively on the value of its underlying assets. In such instances, the investment is unlikely to be viewed as anything other than as a means of getting exposure to those underlying assets.
33. An investment vehicle will be considered to be listed if it is included in the list of either:

- a licensed financial product market in New Zealand (such as the NZX, NXT, etc)[14], or
- a financial market operating outside of New Zealand that is regulated by a foreign government or an agency of a foreign government.

34. We cannot give a definitive list of whether an investment vehicle is considered to be an underlying fund. However, we would be happy to hear from managers if they have any concerns about their classifications and we encourage industry bodies and groups to work together to help achieve consistency. We will continue to monitor market trends in this area and issue further guidance about underlying funds if necessary.

Calculating fees and charges

35. To the extent that is possible, managers are required to disclose actual fees and costs for the fund.[15] This includes the actual fees and costs of any underlying fund. Where a fund has invested in an underlying fund, it is generally necessary for managers to get information from third parties to determine the underlying fund's charges.

Reliance on third-party information

36. We expect managers to be able to get the actual fees and charges for related underlying funds. If not, they must be able to explain why not.
37. For non-related underlying funds, managers will rely on information provided or published by a third party. Managers need to have policies and processes to determine whether third-party information is accurate. We do not expect managers to conduct a detailed audit of all financial information published by third parties. However, there should be some scrutiny, particularly where managers doubt the accuracy or appropriateness of the published information.
38. Where information is provided directly to the manager, managers may choose to rely on certification or some other form of confirmation of its accuracy. If a manager has reasonable grounds to suspect the information provided is incorrect, the manager should get clarification.
39. If a manager doubts the accuracy of third-party information, they are likely to estimate the underlying fund charges. Accordingly, they need to disclose that the fees are estimated.[16]

[14] A list of all New Zealand licensed financial product markets can be found at: https://fma.govt.nz/compliance/lists-and-registers/licensed-market-operators/
[15] Clause 32(2) and 63(3) of schedule 4 of the FMC Regulations and regulation 70A(1) of the FMC Regulations
[16] Clause 32(3) and 63(5) of schedule 4 of the FMC Regulations and regulation 70(2)(e) of the FMC Regulations

Estimating fees

40. If actual figures are not available (for example, figures for underlying funds are not available or appear unreliable), managers are required to make a best estimate of fees and charges.[17]

41. Managers are expected to make 'reasonable endeavours' to get all relevant information to make a best estimate.[18] This means they should act as a reasonable person would to get the required information. It does not require managers to exhaust all possible actions. It will therefore depend on individual circumstances.

42. To determine whether steps are reasonable, managers may consider (among other things):
    - the cost or effort involved
    - the likelihood of the action materially changing what would otherwise have been estimated and disclosed.

43. We expect managers to take into account the size of the investment. For instance, where a fund has a significant amount invested with an underlying fund, we would expect more comprehensive attempts to be made to get information than we would for a negligible investment.

44. For particularly minor investments, 'reasonable endeavours' may require the manager to do no more than ascertain whether appropriate fees information for the underlying fund have been published. If not, the manager may then estimate the fees based on any information they do have, or omit the fees for that investment vehicle and rely on the disclosures set out in paragraph 47 below.

Disclosures relating to estimates

45. Where estimates rather than actual figures are used, managers must comply with additional disclosure obligations.

    In a PDS, they must:
    - identify which amounts are estimated.[19]

    In a fund update, they must:
    - state, next to the fees table, which fees or costs are estimated[20]
    - include an explanatory note stating that an estimate has been used. A reference note should be provided next to the information containing the estimate, referring to the explanatory note at the end of the fund update[21]
    - describe the information and assumptions used to make the estimate.

    For confirmation information provided by KiwiSaver schemes, they must:

[17] Clause32(2) and 63(3) of schedule 4 of the FMC Regulations and regulation 70(A)(1) of the FMC Regulations
[18] Clause 63(5)(b) of schedule 4 of the FMC Regulations and regulation 70(A)(2) of the FMC Regulations
[19] Clause32(3) of schedule 4 of the FMC Regulations
[20] Clause 63(5)(a) of schedule 4 of the FMC Regulations
[21] Clause 63(5)(c) of schedule 4 of the FMC Regulations

- include a statement of the fees or costs that are estimated in the confirmation information, and an explanatory note stating that an estimate has been used[22]
- describe the information and assumptions used to make the estimate on a website maintained by or on behalf of the manager [23].

If estimates cannot be made for underlying funds

46. If, after making reasonable endeavours, the manager still does not have enough reliable information to make a reasonable estimate of an underlying fund's fees and charges, the manager may omit that fund's charges from its fee disclosure.[24]
47. Where any underlying fund charges are omitted:
    a. the PDS or fund update must include a prominent statement (below the incomplete totals):
        - stating that the manager is unable to determine what has been charged by some underlying funds
        - specifying which underlying funds have information omitted and the proportion of the fund's net asset value that those underlying funds represent (if available)
        - specifying which type of fund charges have been omitted (if known); and[25]

    b. for a KiwiSaver scheme, the confirmation information must include a statement recording that the manager is unable to determine those fund charges[26]. And the manager must include a statement, on a website maintained by or on behalf of the manager, specifying:
        - which underlying funds have information omitted and the proportion of the fund's net asset value that those underlying funds represent (if available), and
        - which type of fund charges have been omitted (if known)[27].

KiwiSaver confirmation information

48. We have issued a methodology notice for KiwiSaver confirmation information. This notice prescribes the method to use to calculate the total fees paid by each investor for disclosure in the confirmation information.

    Key points to note:

    a. The methodology notice will help KiwiSaver scheme providers attribute fees charged at the fund level (including underlying fund charges) to each investor.

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[22] Regulation 70(2)(e) of the FMC Regulations
[23] Regulation 64A of the FMC Regulations
[24] Clause 32(5)(b) and 63(6)(b) of schedule 4 of the FMC Regulations and regulation 70(A)(3)(b) of the FMC Regulations
[25] Clause 63(6)(c) of schedule 4 of the FMC Regulations
[26] Regulation 70(2)(f) of the FMC Regulations
[27] Regulation 64A of the FMC Regulations

b. KiwiSaver scheme providers are not required to use the methodology if they can calculate the actual fees charged to each investor for the relevant period. We expect that this would only be the case if the management fee charged covered any additional underlying fund charges or if there were no underlying fund charges.

c. KiwiSaver scheme providers can choose whether to allocate fees charged at the fund level for the accounting period to investors using either the investor's average balance (total annual fund charges calculation) or using the investor's balance as at the date the units of the fund are valued (cents per unit calculation). Please note: KiwiSaver scheme providers must publish the method of calculation used on a website maintained by or on behalf of the manager of the scheme [28].

d. Our current preference is for KiwiSaver scheme providers to use the cents per unit calculation, given that method provides a more accurate and therefore more meaningful fees figure for investors. We will review the methodology notice within the next five years with a view to deciding whether or not all KiwiSaver scheme providers should only use the cents per unit calculation in the future.

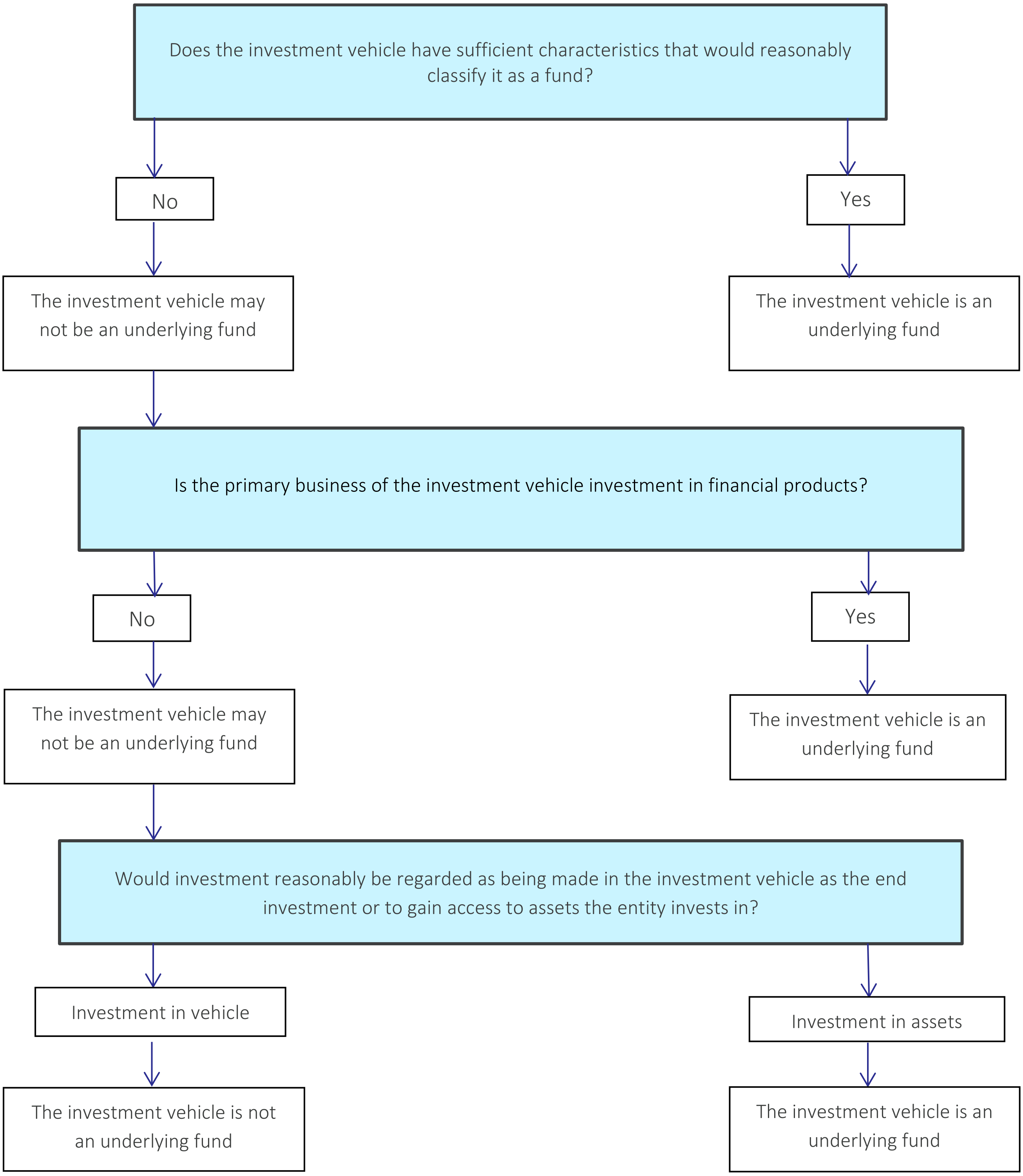
e. The methodology notice only applies to the accounting periods of a KiwiSaver scheme commencing on and after the commencement date of the notice. This means KiwiSaver providers will not need to comply with the methodology notice when producing their 2018 annual statements. In practice, we expect providers will still comply with the methodology notice in order to avoid the cost of changing systems when producing their 2019 annual statements.

49. We would largely expect KiwiSaver scheme providers to adopt the same processes to calculate the fees and charges used for the confirmation notice as they use in the PDS and quarterly fund update, including the use of best estimates if actual figures are not available. KiwiSaver scheme providers using the cents per unit calculation are not required to exchange information about fees in the Investment Savings and Insurance Association files (ISI files) with other providers, but we would encourage this as it leads to more accurate fees.

50. The FMC Regulations require disclosure of total fees in a dollar amount. But KiwiSaver scheme providers can include additional information. We strongly encourage providers to also disclose total fees in a percentage amount, personalised, if possible. Disclosing the fee both ways will help investors to make the most use from the disclosure. They can use the dollar amount to understand the direct financial impact on them of paying the fee, particularly as their balance increases. They can then use the percentage amount to broadly compare their provider with others and be able to work out, because they also have a dollar amount, what it would cost to invest somewhere else.

[28] Regulation 64A of the FMC Regulations

Appendix: Process for determining an underlying fund



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