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Te Kāhui Ture o Aotearoa

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Financial Markets Authority
Wellington

By email: consultation@fma.govt.nz

Tēnā koe,

Feedback on the Financial Markets Authority's related party transactions insights consultation paper

1 Introduction

1.1 The New Zealand Law Society Te Kāhui Ture o Aotearoa (**Law Society**) welcomes the opportunity to provide the Financial Markets Authority (**the FMA**) with feedback on the consultation paper outlining the FMA's position on certain related party transactions involving registered managed investment schemes.

1.2 This submission has been prepared with input from the Law Society's Commercial and Business Law Committee.[1]

2 What is a 'benefit'?

Do you agree the ordinary meaning of the word 'benefit' is appropriate and that what may amount to a 'benefit' is not limited in any way?

2.1 Generally, the Law Society agrees that the ordinary meaning of the word 'benefit' is appropriate and fits the purpose of sections 172 to 176 of the Financial Markets Conduct Act 2013 (**the FMC Act**). The purpose of the related party transactions regime is to protect investors. Consequently, it makes practical sense to cast the net widely when beginning the process of deciding which transactions are captured, thereby side-stepping the types of avoidance issues that may arise from a granular argument as to whether a particular benefit falls within the four walls of a narrower qualification such as a benefit that is 'financial', 'material', or sufficiently 'direct'.

2.2 In our view, the FMA's guidance could be strengthened by clearly setting out that proportionality is achieved at the next stage of the test, which asks whether a benefit was, in reality, 'given to or received by' a related party from scheme property.

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1 See more about the Law Society's Commercial and Business Law Committee here: www.lawsociety.org.nz/professional-practice/law-reform-and-advocacy/law-reform-committees/commercial-li/.

Do you agree with the examples of non-financial benefits? Are there other useful examples of non-financial benefits?

2.3 The Law Society agrees with the given examples. Other useful examples of non-financial benefits include those noted on page 6 of the consultation paper under (b). Industry participants are likely to be better positioned to identify any further useful examples.

2.4 In the course of preparing this response, it was suggested that there should be scope to recognise the 'negative' benefits (such as the benefit to a related party of cost savings by sharing overheads, etc) where scheme property effectively picks up costs the related party would otherwise have to bear.

3 What is a 'related party benefit'?

Do you agree with the position taken in the examples above?

3.1 The Law Society generally agrees. Examples 2 to 5 helpfully focus on practical implications rather than a narrow prescription that hinges on (technical/legal) definitions, and illustrates that the 'manager's fee' carve-out in section 172(1)(c) is narrow.

3.2 However, we consider the analysis in Example 5, Scenario 1 (that there is no increase in the aggregate level of funds under management (**FUM**)) may be too absolute and query whether it matches comments about observed market practices. We do not have sufficient market data to assess whether the comment in this example regarding the benefits of achieving scale raises concerns about potential double-counting in the FUM reported by individual managers. This could have implications where such figures are used externally to attract investors, justify fees, and demonstrate scale.

3.3 As a result, the Law Society supports the comment acknowledging the potential financial and non-financial benefits that may be a related party benefit obtained from this scenario.

In Example 5, do you agree that there is no increase in FUM in Scenario 1?

3.4 We agree there is no increase in net FUM at a group level. The same quantum of funds are under the management of a cluster of related parties that includes an extra vehicle. However, we note that 'FUM' is not a defined term and consider industry participants may be able to more accurately gauge whether a more consistent measurement approach might be achieved to address suggestions that there are disparities in measurement or reporting (i.e. on a 'gross' rather than 'net' basis).

In Example 5, Scenario 2:

(a) Do you agree that an increase in FUM is a benefit on the basis that the manager of the scheme receiving the increase of FUM will use it for purposes such as marketing, operating leverage or to attract additional funding?

3.5 The Law Society agrees. An uplift in FUM is clearly an advantage to the receiving manager and is consistent with how the term 'benefit' is understood commercially.

(b) For the purposes of s172(1)(a) of the FMC Act do you consider that an increase in FUM is a related party benefit because it is a transfer of scheme property from Scheme A to Scheme B that:

(i) is given out of scheme property,

(ii) creates an exposure to loss, or

(iii) both of the above.

3.6 The Law Society considers option (iii) to be the best option here. The investment of scheme property is the very mechanism by which the FUM uplift is created. Without putting the scheme's funds into Scheme B, the benefit could not arise; therefore, the benefit is given 'out of scheme property.' The same investment also exposes scheme property to losses Scheme B may suffer, thereby satisfying the second limb. Treating both limbs as available is principled and avoids the artificial exercise of having to choose between them.

(c) Alternatively, do you consider that an increase in FUM is not of itself a benefit, but may give rise to a benefit through the advantages that may flow from that increase?

3.7 In practice, we understand that FUM growth is the single most important metric managers use to demonstrate scale, attract investors and justify fees. It is accurate to treat the FUM increase itself as a benefit, while recognising that the significance of that benefit is reliant on the downstream advantages that flow from it (marketing gains, operating efficiencies, or easier access to capital).

Are there other helpful examples we can consider?

3.8 Whilst the Law Society considers feedback from industry participants to be more useful here, we suggest periodic or occasional rebalancing of scheme property across related schemes that may impact returns in one fund while altering the risk exposures of each, may be one such helpful example.

4 When is another investment manager a 'related party'?

Do you agree with the distinction between investing in other financial products and contracting the investment of scheme property?

4.1 The Law Society agrees. The distinction is consistent with the FMC Act definition of 'investment manager' in section 6. We consider that it also gives effect to what Parliament intended: the regime applies where the manager has actually outsourced its core investment role, and does not apply every time the scheme's funds are invested into a third-party fund.

4.2 If every fund-into-fund investment had to be treated as the appointment of an investment manager, the result would not be supported by the words of the FMC Act, and would impose a disproportionate compliance burden on multi-manager and platform structures (such as a scheme that holds its assets through several underlying specialist funds, each managed by a different external manager) – potentially also obscuring the nature and true extent of related party transactions entered into by the manager/s.

What are the key factors that distinguish between investing in other financial products, and contracting the investment of scheme property?

4.3 We suggest that the key factors may include:

(a) Whether the third party owes investment management duties to the scheme itself (as it would under a management agreement), rather than simply offering the scheme the same investment products in a fund that any other investor could buy – for example, the difference between hiring a portfolio manager under contract and buying units in a widely offered fund;

(b) Whether the manager has negotiated bespoke mandate, fee or governance terms that apply only to that scheme (as opposed to taking the same terms set out in the third party's offering made to every other investor);

(c) Whether the manager has retained the practical ability to direct the third party, or to redeem the investment on terms that are materially different to other investors;

(d) Whether the third-party fund is 'white-labelled' (re-badged for the scheme), purpose-built for the scheme, or otherwise tailored to it;

(e) Whether the third party is selected, paid and removed from office in the same way as an outsourced service provider would be; and

(f) Whether the manager has effectively imported the third party's investment process into its own product through contractual constraints. Indicators that the relationship is confined to an investment in a financial product include common form investor documents, standardised disclosure (the same statements given to every investor), common terms across all investors, and the absence of any contractually retained discretion by the manager over how the third party invests the funds.

Are there other examples we can consider?

4.4 It would assist to include examples covering:

(a) Investment in a wholesale fund that has many unrelated investors and is issued by an otherwise unrelated third party, but where the manager has separately negotiated rebates, side letters (bespoke side agreements giving that investor materially different terms from the rest of the investors) or mandate constraints that are materially different to those applicable to other investors. These can blur the line between investing in other financial products and effectively contracting out some of the investment role;

(b) The appointment of an investment adviser (rather than an investment manager), where the registered managed investment scheme (**MIS**) manager retains the final decision-making function over what to do (i.e. the adviser advises but does not make the investment decision itself);

(c) 'Segregated mandate' or 'managed account' arrangements — where, rather than putting funds into a pooled fund alongside other investors, the scheme keeps its own discrete portfolio in its own name and an external manager makes the investment decisions for that discrete portfolio that may or may not follow those for the balance of the pooled fund (for example, a scheme handing over management of an identified parcel to a specialist global equities manager to run in the scheme's own name); these sit between fund investment and outsourcing and need clear treatment; and

(d) 'Sub-advisory' arrangements, where one manager hires another manager to undertake a discrete part of the investment management role on their behalf (for example, a scheme manager hiring an offshore global equity specialist as a sub-adviser to pick international shares for it).

5 Indirect transactions

Do you agree that related party benefits can arise through indirect transactions? If not, why not?

5.1 The Law Society agrees. A purposive or 'substance over form' approach (i.e. looking at the purpose or effect of the arrangement, rather than the legal labels used) is necessary to give effect to the purpose of the related party transactions regime and to stop the checks and balances in the regime being side-stepped by routing funds through additional entities. The wording of section 172(1)(b) (a benefit 'given to, or received by, a related party') is wide; and section 173(1) does not say it applies only to a particular form of contract, which supports reading it as applying both directly and indirectly.

Do you agree that if a manager knows, or ought reasonably to know, that an investment will result in scheme property being applied for the benefit of a related party, that will be a part of the relevant transaction or series of transactions?

5.2 The Law Society agrees this is an appropriate threshold for this test. The test included in this part of the FMA's proposed guidance is consistent with that for other enforcement provisions in the FMC Act where knowledge is a necessary element (such as those relating to insider trading or market manipulation).

5.3 We query whether the FMA guidance should explicitly connect the 'ought reasonably to know' standard to the manager's duties under Part 4 of the FMC Act. This includes the prudent professional standard outlined in section 144. This approach would ensure the test is integrated with the responsibilities managers already have, rather than introducing it as a new, separate standard. It is also noted that the paper indicates that the FMA's guidance takes the stance that the relevant time for assessment is when the decision to transact (i.e. the investment decision) is made. Information that comes to light afterwards should not, of itself, retrospectively turn a specific transaction into a breach of section 173 (albeit that it may trigger a different approach being taken to the question of the presence of a relevant party element for future transactions).

Do you agree with the facts and circumstances detailed above being relevant considerations? Are there other facts or circumstances that may be relevant?

5.4 The Law Society agrees the listed considerations are relevant. We would add:

(a) Whether the intermediary has independent governance – which would support the view that the manager could not reasonably have identified that scheme property would be applied for the benefit of a related party, and the investment decision in question would not, of itself, have been improperly influenced;

(b) Whether the registered MIS manager has any ability (through contractual rights, side letters, etc.) to direct or influence how the intermediary invests the funds; and

(c) Whether there are other hallmarks of improper influence on decision-making. A relevant consideration is the closeness in timing between a scheme's investment

and the intermediary's downstream investment in a related party, and whether this may suggest that the transactions constitute a single integrated arrangement.

Do you agree with the position taken in the examples above? If not, please provide rationale.

5.5 We agree with the conclusions drawn in Example 7, which provides a clear case for the look-through approach: the manager's decision is, in substance, directed to Company C, and the investment in Scheme B is just a necessary step to get there.

5.6 We suggest, however, that the FMA guidance clarify the level of pre-decision awareness that is required. A stated investment strategy that 'may' include investments in a related party is materially different from a known commitment to do so, and the language used by the FMA's guidance on this point will be influential in practice.

5.7 For consistency, the FMC guidance should also explain how the look-through process interacts with section 174(b) (which permits investment in other registered schemes) since, on its face, that exception applies only to the immediate counterparty. By logical extension, this exception should also apply to investments made via an intermediary.

Do you agree with the relative risk ratings in Example 8?

5.8 In general terms, the Law Society agrees. The ratings sensibly reflect both how much the manager knows about what happens with the funds downstream and how far removed the related party is from the initial transaction.

5.9 However, we consider that a fourth illustration at the lower end of the risk scale would be useful. For example, a registered scheme investing in a broad market index fund (such as a fund tracking the NZX 50) where one of the index companies happens to be a related party, the manager has no influence over which companies are in the index, and there is no foreseeable benefit being directed to the related party. Making the low-risk end visible may reduce the risk that the look-through approach is applied too widely and in a manner that ignores the purpose approach heralded as underpinning the FMA's guidance.

Are there other helpful examples we could consider?

5.10 The Law Society considers additional helpful examples could include:

(a) Investment in a diversified externally managed fund where one of many holdings happens to be a related party, but the manager has no influence over (and no commercial expectation) the funds that will reach the related party;

(b) Co-investment alongside unrelated parties (i.e. investing in the same deal at the same time as other independent investors) in a vehicle where the registered scheme has no contractual ability to influence where the funds are ultimately invested;

(c) 'Structured products' that reference a related party. That is, packaged investments (often a note issued by a bank) whose return is determined by reference to some external measure such as a share price, an index or a basket of assets. An example would be a capital-protected product whose return is linked to the share price of a related party company; and

(d) 'Feeder fund' / 'master fund' structures where investors put scheme assets into a 'feeder' fund, which simply pools the funds and then invests them all in a single 'master' fund where the actual (in an active manager sense) investment decisions are made. We understand that this is a common arrangement in the KiwiSaver environment. Each KiwiSaver fund is in effect a feeder, which invests in one or more underlying wholesale master funds.

6 What are 'arm's length terms'?

Do you agree with the list of relevant considerations?

6.1 The Law Society agrees. The list is appropriately broad and reflects standard commercial principles. The framing rightly recognises that whether something is on 'arm's length terms' (the kind of terms two unrelated parties dealing at arm's length would have agreed) is a matter of judgment, not a checklist exercise, and that scrutiny should be proportionate to risk. Keeping the list non-exhaustive is appropriate.

What other considerations may be relevant?

6.2 Again, the feedback of industry participants will be instructive. However, we suggest that other considerations which may be relevant include:

(a) The relative bargaining strength and realistic alternatives available to each party at the time of the transaction (a related party with no realistic alternative cannot meaningfully be said to be bargaining at arm's length);

(b) Departures from market/industry norms in areas that impact the risk profile – for example those governing how easily the manager can get their money out, including 'liquidity' (how readily the underlying assets can be turned into cash), 'redemption rights' (the right to ask for their money back), and 'gating' provisions (rules that let the manager limit or suspend withdrawals in times of stress. For example, many property funds use gates to prevent a run on redemptions when too many investors try to exit at once). These often drive commercial value but are easily overlooked when benchmarking focuses on fees alone;

(c) The presence of side letters, 'hold harmless' letters (separate undertakings by one party not to hold another responsible for losses) or other undocumented arrangements that materially affect the economics of the deal;

(d) Evidence about the process of decision-making, including the involvement, and recusal (i.e. stepping aside), of conflicted directors or executives; and

(e) Treatment of risk, such as those for tax, foreign exchange and counterparty risks (whilst these are not standardised across the market) or arrangements which are unusual/not readily explicable, warrant further enquiry.

7 Notification and certification of related party transactions

Do you agree with the above?

7.1 We agree and endorse the FMA's encouragement of early engagement between manager and supervisor before the formal related party certificate (**RPC**) is issued, and the practice of using a draft RPC as a vehicle for that engagement.

7.2 Two clarifications would assist. First, the practical effect of the rule that the RPC must be in place before the manager 'enters into' the transaction needs further guidance, particularly in the context of multi-step transactions (such as commitment documents, conditional agreements or capital commitment arrangements where funds are paid in tranches over time – with elements of the staged transaction themselves being conditional). The FMA's guidance should clarify the FMA's view on when, in a staged transaction, the relevant transaction is treated as 'entered into' for section 173 purposes.

7.3 Secondly, the FMA's guidance should confirm that making the execution of a transaction conditional on the issuance of an RPC is acceptable, provided the manager is not subject to a binding commitment which would require the manager to perform any part of the transaction that would result in a benefit being transferred or exposure to loss before certification.

Are there other market practices we should consider?

7.4 We found the section on risk management considerations and strategies to be useful and practically focused. While feedback from industry participants will likely assist in further developing the FMA's guidance, one practice that may warrant inclusion is the periodic (no less than annual) review and re-certification of long-standing 'series' RPCs (i.e. RPCs covering a class of recurring transactions). This approach can help mitigate the risk of certifications becoming stale, as well as address the possibility that incremental changes may give rise to additional benefits not previously identified.

8 What is meant by 'key terms'?

Do you agree with the list of key terms above?

8.1 The Law Society agrees. The list captures the matters that ordinarily go to the substance of a transaction and how risk is allocated under it. It is appropriately principles-based and avoids prescribing a rigid template.

Are there other key terms you think should be included?

8.2 Feedback from industry participants will likely be informative here. The Law Society considers additional key terms that should be included are (possibly under the subheading of terms that are otherwise unusual for similar transactions between unrelated parties):

(a) Provisions about how and when constraints on a liquidity event, such as unusual redemption rights, lengthy 'lock-up' periods (which may be relevant to a transaction with a private equity fund) and gating provisions that limit the ability for withdrawals in certain cases – such as to manage the risk of a "run" on the underlying fund or where the underlying assets are relatively illiquid;

(b) Provisions that result in priority of payments, or ranking and subordination structures, that are not aligned with the associated risk or expected return;

(c) Restrictions on information rights which affect the manager's ability to monitor the transaction and assess changes over time;

(d) Change of control and key person provisions (so that, for example, the transaction can be revisited if the related party is taken over or its key investment professional/s leave); and

(e) Any side letters or undertakings that modify the key commercial terms.

9 How much detail should be included in the notification and RPC?

Do you agree with this approach to determining the appropriate level of detail?

9.1 The Law Society agrees. A risk- and complexity-proportionate approach is consistent with regulatory practice in adjacent areas (anti-money laundering, climate disclosures, conflict management). We have considered whether the FMA's guidance would benefit from including a worked example (as a benchmark) of a notification and RPC for a relatively routine example transaction. There is some strength in the argument that this would be an aid to achieving standards of industry consistency and reduce the burden on managers and supervisors alike – for example by reducing the risk that they are each in the position of repeatedly dealing with requests for further information. Ultimately however, because the issues are fact and circumstance-dependent, we acknowledge that the supervisors, as gatekeepers, are sufficiently experienced to set their own requirements and respond in a more practical and timely manner than might be the case for some form of (regulator-driven) industry benchmark based on generic examples. The latter may be ill-suited and would likely not age well.

10 What is 'reasonable evidence'?

What do you consider to be good practice on this issue?

10.1 We note that the paper includes a useful section on risk management considerations and strategies as a benchmark for good practice. Some of the discussion about other good practice indicators includes a dissection of valuation-related issues and appropriate benchmarking. Ultimately, we consider industry participants are best placed to provide the FMA with practical, experienced, feedback on some of these technically focussed issues.

11 RPCs to be kept under review

Do you agree with the position that the RPCs for a series of transactions must be kept under review? Are there other examples that we should include in the changes that may be material?

11.1 We agree. The paper clearly identifies appropriate triggers for review based on changes to transaction terms, and changes to the benefit or basis for a permission. As well as testing changes over time that may alter the compliance pathway for broadly similar transactions, the FMA's draft guidance highlights the need to consider the appropriateness of relying on an existing certificate for subsequent transactions.

12 Risk management considerations and strategies

Do you have any comments on this section?

12.1 The Law Society welcomes the provision of practically focused guidance on 'early warning indicators' of higher-risk related party transactions and risk management strategies in this section.

12.2 We suggest managers (in conjunction with the FMA) could consider developing and appropriately scaling their internal systems and processes, such as creating an 'escalation pathway' to outline how concerns are to be raised, verified, and directed through the relevant compliance channels. This could include incorporating checks and balances, such as the involvement of an audit and risk committee (or equivalent), and, where appropriate, some form of independent oversight. However, we suggest that the FMA's guidance also briefly addresses:

(a) How the related party process is integrated with the manager's broader conflicts management framework under section 431K, so it sits alongside (rather than duplicates) existing conflict management arrangements; and

(b) Its expectations of supervisors where issues are escalated, particularly where the manager and supervisor reach different views on the related party status and/or compliance pathway for a transaction under the regime.

13 Final consultation questions

Do you have any suggestions about how this paper could be improved?

13.1 Overall, we consider the draft guidance to be a positive step towards achieving the FMA's objectives of providing the sector and its advisers with greater clarity as to how the regime is intended to be applied in practice. The explanation of broad concepts, the use of examples, and the guidance on risk management practices are useful and largely practical. Perhaps the FMA's guidance would benefit from:

(a) A short executive summary or 'key takeaways' section at the front;

(b) A flow chart that maps the decision-making process from identifying a transaction through to certification and ongoing review; and

(c) A glossary of recurring concepts (including FUM, series of transactions, intermediary, look-through, and other key terms).

What other issues with related party transactions would be useful to include in this paper?

13.2 Issues that may benefit from inclusion are:

(a) How the related party regime interacts with the broader Part 4 duties. In particular, the duty to act in the best interests of scheme participants in section 143, the prudent professional standard in section 144, and the conflict management obligations under section 431K;

(b) The remedial steps the FMA expects a manager to take where there are compliance oversights, particularly where there is no or minimal 'benefit'. The operation of section 173(6) makes it clear that non-compliance does not affect the validity of an impugned transaction – nonetheless it is prohibited with the potential for severe consequences for the manager as well as issues of accessory liability. Compliance infringements are inevitable, and there should be some guidance available about the impact of such an oversight – for example in cases of a self-reported breach. We would expect an innocent oversight (in terms of there has been an inadvertent failure to certify an otherwise certifiable transaction and/or no material exposure of the scheme to loss and/or absence of a material

benefit to generate a different remedial pathway to infringements where (even if the failure to identify the related party element itself was inadvertent) – there was a likelihood of material mischief; and

(c) The position of restricted schemes (in particular the 'in-house assets' rule under section 176, which is not addressed in the paper).

13.3 We also consider it may be useful to include related party transaction rules that apply to discretionary investment management services (**DIMS**) licensees. We note there is acknowledgement that there are parallels with the related party requirements for DIMS licensees, and there will likely be aspects of the proposed guidance that are relevant to DIMS providers. There may be good reasons (both for and against) for dealing with the two related party regimes in tandem. However, when we factor in the second limb of related party compliance obligations, in terms of the disclosures that apply to MIS managers in their capacity as an FMC reporting entity, in our view, a comprehensive approach to the regulatory framework impacting related party provisions might better reflect the challenges faced by those required to navigate the regime.

14 Next steps

14.1 We hope this feedback is useful. Please feel free to get in touch with Shelly Musgrave, Law Reform and Advocacy Advisor (shelly.musgrave@lawsociety.org.nz) if you have any questions or wish to discuss this feedback further.

Nāku noa, nā

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