Regulatory Impact Statement

EXECUTIVE SUMMARY

The role of retirement village statutory supervisors is broadly analogous to that of securities trustees and statutory supervisors, as both act on behalf of residents or investors to supervise the village operator or issuer. Similar problems have been identified in both industries. Some firms have clients which fall in both categories. However, the trustee licensing regime as currently drafted will not cover retirement village statutory supervisors. Subjecting the two to differing levels of regulation is anomalous and means retirement village residents receive a lower level of protection. Accordingly, the preferred option is to include retirement village statutory supervisors within the trustee licensing regime agreed to by Cabinet in August 2009, and described below in the "Status quo and Problem" section of this RIS.

ADEQUACY STATEMENT

The Regulatory Impact Statement (RIS) for this proposal was prepared and assessed under the RIA requirements that applied prior to 2 November 2009. The RIS has been independently reviewed by the Regulatory Impact Analysis Team (RIAT). RIAT considers that it accurately reflects the analysis undertaken in relation to the proposal and contains the required information.

STATUS QUO AND PROBLEM

Background

Problems with trustees' supervision of debt issuers and certain collective investment schemes have been identified in recent years, principally in respect of trustees' accountability, competence and capability, the lack of clarity around trustees' role, the potential for conflicts of interest and the weakness of some trust deeds. As a result, Cabinet agreed in August 2009 to the establishment of a licensing regime for trustees, statutory supervisors, and unit trustees. At the same time Cabinet also agreed to a range of other measures designed to improve the supervision of issuers by trustees and statutory supervisors (CAB Min (09) 30/6B refers). The key features of this regime are outlined below in the preferred option section.

Status Quo

The principal legislation governing retirement village statutory supervisors is the Retirement Villages Act 2003 (RVA). The RVA requires that (unless an exemption is granted, which will occur only in exceptional cases) village operators appoint a statutory supervisor for each village. The key duties of retirement village statutory supervisors are to:

- Monitor the financial position of the village;
- Report annually to the Registrar and residents on the performance of its duties; and

- Provide a facility to hold on trust deposits or progress payments made by residents.

The role of a statutory supervisor of a retirement village is broadly analogous to that of many trustees or statutory supervisors of debt issues and collective investment schemes. Both act on behalf of the residents or investors as a whole to supervise the financial position and actions of the retirement village operator or issuer, to ensure the latter is complying with its duties under statute and the deed of participation or supervision. This similarity is reflected in the fact that, before the enactment of the RVA, some retirement villages were classified as participatory securities under the Securities Act and as a result were required to have a statutory supervisor.

A separate regime for retirement villages was established in 2003 because some Securities Act requirements (such as those relating to disclosure) were not appropriately crafted for retirement villages. The RVA was intended to give specific consumer protection to retirement village residents, beyond protecting their purely financial investment. When the RVA was passed, the requirement for retirement villages to have a statutory supervisor under the Securities Act was carried over into the RVA, and extended to all retirement villages.

The Law Commission report[1] which led to the RVA, proposed a model whereby the prudential risk to residents would be mitigated by the dual mechanisms of financial disclosure and supervision. The intention was to continue the Securities Act model whereby "a supervisor or trustee in breach of its duties would plainly be liable for causative loss"[2]. The Law Commission made it clear that the role of the supervisor was to monitor the financial position of the operator and to take action in the event of a breach or likely breach of the operator's financial obligations.[3]

The RVA imposes a very light regulatory regime, whereby the statutory supervisor must be approved by the Registrar of Companies before accepting an appointment, and must report annually to residents and the Registrar of Companies on the exercise of its functions and duties. Ttransitional provisions enabled some statutory supervisors who were previously approved under the Securities Act 1978 to have automatic approval to supervise retirement villages.

Problem Definition

Principal problems with the status quo

There are two main types of problem with the existing regime regulating retirement village statutory supervisors. The first is that the regime is deficient and does not contain aspects necessary for robust regulation. [Withheld – to avoid prejudice

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[1] Law Commission report (No 57) dated September 1999
[2] Law Commission Report (supra) para 22
[3] Law Commission Report (supra) para 29

Deficiencies in the existing regulatory framework: The existing framework contains deficiencies which severely limit the powers of regulators to oversee retirement village statutory supervisors and incentivise compliance. The approval power of the Registrar is constrained, as the RVA does not set out any criteria or minimum requirements for a person to be approved as a statutory supervisor. In practice, the Registrar requires information as to the character, independence and the financial and professional capacity of any person or entity that applies to be approved as a statutory supervisor. There is no ability for the Registrar to impose any reporting requirements, conditions or time limits on an approval.

Sanctions would be an important incentive for compliance but they are absent from the current regime. [Withheld – to avoid prejudice

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Deficiencies in the quality of supervision currently provided by some statutory supervisors: [Withheld – to avoid prejudice

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Many of the same problems have been identified with statutory supervisors in the retirement villages as have been identified with trustees and statutory supervisors in other areas. Specifically, the Retirement Commissioner has identified problems with statutory supervisors in the retirement village sector, including:

- A lack of proven analysis of operators' financial reports;
- Some statutory supervisors not working through problems of financial inadequacy on the part of the village in an appropriate way with the operator;
- Statutory supervisors allowing inaccurate summary financial information to be given to village residents;
- A risk that a statutory supervisor's independence may be compromised by relying on one operator for a large part of its income [Withheld – commercial confidentiality

  ];
- Undue reliance being placed on the financial health of a parent of a group of villages; and

- Examples of failures to follow good procedure for holding funds on trust, particularly the practice of one supervisor permitting residents' deposits to be lodged in the trust accounts of solicitors acting for the operator. This is a clear breach of the requirements of the Act, and gives rise to serious conflict of interest issues.

These failures to comply with good practice by some retirement village statutory supervisors suggest that they may also fail to identify when a retirement village is getting into financial difficulties, or potentially not take effective action in these types of situations.

In the worst case scenario, where a statutory supervisor fails to provide supervision of the necessary quality, this could mean that they may fail to identify financial problems in a retirement village and consequently will not be able to retrieve the situation. If a retirement village fails, the residents risk losing their investment, their assets and their home. While the magnitude of this risk varies from case to case, the consequences of the risk occurring are potentially severe.

[Withheld – to avoid prejudice

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Other problems with the status quo

<u>Lack of clarity around the role of statutory supervisors</u>: Anecdotal evidence also suggests that some residents question the value of statutory supervisors in overseeing the management of the village, and also the level of protection that statutory supervision provides in practice. There is confusion on the part of residents as to the extent and nature of the role of the statutory supervisor. [Withheld – to avoid prejudice

] Approval by the Registrar, who is also responsible for the registration of villages and their disclosure documents, only adds to this confusion.

[Withheld – to avoid prejudice

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Risk of regulatory arbitrage arising out of a different regime for retirement village statutory supervisors: Regulating statutory supervisors of retirement villages to a different standard than trustees and other statutory supervisors would also be anomalous. This is a problem because it could potentially expose residents of retirement villages to a lesser level of protection in certain important respects than investors in debt securities and managed funds. Residents are potentially a vulnerable class of investor as they risk losing their homes as well as their investment and thus they deserve an adequate level of protection.

There are currently nine retirement village statutory supervisors. Five of these entities also act as trustees or statutory supervisors of securities, and will be required to be licensed under the trustee licensing regime. However, the retirement village statutory supervisor parts of those businesses will not have to be assessed for competence under the regime as currently drafted. The other four retirement village statutory supervisors will not be required to be licensed.

[Withheld – to avoid prejudice

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In addition, there is a risk that having different parts of the market regulated to different standards could create issues of competitive neutrality, and encourage some villages to engage cheaper but less effective statutory supervisors.

OBJECTIVES

The primary objective of the proposals is to ensure that retirement village statutory supervisors effectively protect residents' interests.

Secondary objectives are to ensure that:

- Statutory supervisors have the capacity, industry knowledge and experience to undertake effective and risk based frontline monitoring of issuers;
- There is appropriate oversight to ensure that statutory supervisors carry out their role to the required standard, and effective remedies are available to use against statutory supervisors that fail to do so; and
- Retirement village residents have equivalent protection to that of investors in debt securities and managed funds in certain important respects.

ALTERNATIVE OPTIONS

Best practice guide

The Retirement Commissioner is working with the Trustees Corporations Association to produce a voluntary best practice guide for statutory supervisors. An option is to wait and see whether this private sector-initiated guide improves the quality of supervision.

However, this option was discounted for the following reasons:

- Most retirement village statutory supervisors are not members of the Association, so the voluntary code may not apply to them. [Withheld – to avoid prejudice];
- A best practice guide is unlikely to contain sufficient or effective sanctions for statutory supervisors who fail to carry out their role to the required standard;
- There is cause for concern about the likelihood of enforcement of a best practice guide, due to the small size of the Trustee Corporations Association and its resources;
- A more formal regulatory regime is likely to provide greater confidence to residents than an industry best practice guide; and
- It is anomalous to the approach taken towards trustees of debt securities, certain participatory securities and unit trusts.

Give the industry time to improve, with the threat of regulation if it does not

An option is to communicate the noted concerns to the retirement village statutory supervisors industry and give the industry a period, for example, 18 months to improve its performance. If it fails to do so, the regime would then be extended to retirement village statutory supervisors. The fact that the regime is already being implemented for other trustees and statutory supervisors means the retirement village statutory supervisor industry would consider this a plausible risk.

However, this option was discounted for the following reasons:

- It is anomalous to the approach taken towards trustees of debt securities, certain participatory securities and unit trusts;
- It is unlikely to improve residents’ confidence in statutory supervision;
- It would be difficult to measure whether improvements had been made, as there are no official reporting processes under the status quo;

- There would be no way to be sure that the industry would maintain any improvement made; and

- It is a more efficient use of government resources to regulate retirement village statutory supervisors at the same time as trustees and other statutory supervisors.

Increase regulation of statutory supervisors under the RVA

An option is to improve the regulation of retirement village statutory supervisors under the RVA to mirror the powers granted to regulators under the Securities Act, rather than including them in the corporate trustee licensing regime. However, this option was discounted as likely to create regulatory duplication.

No alternative options were suggested by stakeholders in consultation.

PREFERRED OPTION

The preferred option is to include retirement village statutory supervisors in the licensing regime for trustees administered by the Securities Commission agreed to by Cabinet in August 2009 (CAB Min (09) 30/6B refers). The key features of this proposal are described below.

Key features of the preferred option

The existing approvals of retirement village statutory supervisors granted by the Registrar of Retirement Village or carried over from the Securities Act will be revoked and they will be required to apply for a licence.

The Securities Commission will consider applications and grant licences on the same conditions as are applied to trustees and other statutory supervisors. Retirement village statutory supervisors will be required to regularly report to the Securities Commission to demonstrate ongoing satisfaction of approval criteria and ongoing fulfilment of responsibilities. They will also be required to report to the Commission on any breaches of their licence conditions, or material change in their circumstances.

The Securities Commission will be provided with a graduated set of powers to deal with a retirement village statutory supervisor that appears to be in breach. These powers will consist of:

- The power to request further information from a retirement village statutory supervisor;

- The power to order the retirement village statutory supervisor to comply with the terms of the trust deed or the trustee's duties;

- The power to direct a retirement village statutory supervisor to fix a breach within a particular time frame, and to require the retirement village statutory supervisor to provide the Commission with details of how it proposes to address the breach;

- Where the Commission is not satisfied with the retirement village statutory supervisor's proposed course of action to rectify the identified breach, the Commission will have the power to direct what course of action the retirement village statutory supervisor will take, with a right to be indemnified from liability when acting under such direction;

- The power to apply for a civil pecuniary order against the retirement village statutory supervisor where it has breached the trust deed or their duties, and the breach materially prejudices the investors' interests;

- The power to apply to the Court for an order requiring the retirement village statutory supervisor to pay compensation to all investors who have suffered loss or damage as a result of the breach of the trust deed or their duties;

- The power to suspension from taking on new appointments to act as a retirement village statutory supervisor; and

- In a severe situation, the ability to apply to the High Court for an order removing a retirement village statutory supervisor from a specific appointment, or revoking its licence. A court order is necessary as such a move may have severe consequences for the livelihoods of those involved.

The Commission will also have the power to seek a court order for one of a range of measures when it is of the opinion that the issuer is unlikely to be able to pay the money owing in respect of securities when it falls due, or the trust deed provisions no longer adequately protect investors (this would mirror the retirement village statutory supervisor's current powers under section 49 of the Securities Act).

Under section 11 of the Corporations (Investigation and Management) Act 1989 a retirement village statutory supervisor must give notice to the Registrar of Companies when it believes a corporation it supervises is likely to become insolvent or to breach the terms of its agreement with residents. The preferred option would require a retirement village statutory supervisor to report to the Securities Commission as well, and to standardise these reporting requirements to government agencies, so that one report would be made concurrently to both agencies.

An aspect of the trustee licensing regime which would be omitted in relation to retirement village statutory supervisors is the requirement for statutory supervisors to report a breach by an obligation by an operator and to attest, on request of the Commission, that an operator is compliant with its obligations. This aspect is omitted because the Commission has no power to act on such information as it does not have jurisdiction over retirement village operators as it does over securities issuers.

Legislative changes required

The proposals will require changes to the Securities Trustees and Statutory Supervisors Bill, the Retirement Villages Act 2003, and the Retirement Villages (General) Regulations 2006.

Benefits of the proposal

The preferred option will result in a significantly improved regime for the supervision of retirement villages.

- Capability: The proposal will help ensure a minimum level of capability by including criteria requiring retirement village statutory supervisors to have appropriate experience, infrastructure, governance standards, capital adequacy and monitoring systems. The ongoing monitoring by the Commission will help ensure the retirement village statutory supervisors maintain these standards. The Commission's power to impose conditions on a licence (such as limiting the size or number of villages it can supervise) will help ensure that retirement village statutory supervisors do not take on clients for which they do not have the expertise or capacity.

- Role clarity: The licensing regime will give greater role clarity to retirement village statutory supervisors through the approval criteria. This should help ensure more consistency in the standard of supervision provided.

- Independence: The proposal will help ensure that retirement village statutory supervisors maintain a minimum level of independence from the operators they supervise by requiring the Commission to assess the independence of the statutory supervisor as part of the licensing process (and by giving the Commission the ability to impose conditions on the licence).

- Accountability: The proposal will improve retirement village statutory supervisors' accountability by requiring them to report to the Securities Commission, both regularly and on occasion of a breach by the supervisor or operator. It also gives the Commission significant powers to punish supervisors who are not fulfilling their duties including compelling them to act, revoking their licence and applying for a compensatory order. This will help to protect residents' interests.

- Consistency: The proposal will help ensure that residents of retirement villages receive the same level of protection as investors in debt securities and certain collective investment schemes in certain important respects. This is because the result of the proposal would be that debt issuers, collective investment schemes, and retirement villages would all be supervised by trustees or statutory supervisors that are regulated in the same way.

More broadly, these measures as a whole will mean that retirement village statutory supervisors are more likely to identify any problems faced by retirement villages at an earlier stage and take appropriate action as a result, thereby protecting residents.

Costs of the Proposals

Requiring statutory supervisors of retirement villages to be licensed will create costs for the Securities Commission in carrying out the initial licensing and ongoing monitoring of retirement village statutory supervisors, and any interventions or enforcement that is required. We do not expect the cost of licensing and monitoring statutory supervisors of retirement villages to be significantly different from the cost of licensing other trustees and statutory supervisors.

The licensing regime for trustees and statutory supervisors agreed by Cabinet in August this year will cost $600,000 in the first year, $640,000 in the second year, and $660,000 in the third year and outyears.

We estimate that four extra statutory supervisor firms will be required to be licensed under this extension, as the remainder would already be required to be licensed through their other roles as trustees and statutory supervisors. We expect that adding statutory supervisors of retirement villages to the regime will add approximately $200,000 per year to the cost of the regime. This amount has been extrapolated from the figure of $50,000 per applicant estimated in the August 2009 Cabinet paper (CAB Min (09) 30/6B refers), and includes overheads, staff hours required for licensing, monitoring and an estimated number of investigations per year. The Commission believes that the costs involved with licensing and monitoring retirement village statutory supervisors will not differ from that of other statutory supervisors and trustees. It is likely that the four extra statutory supervisor firms will successfully achieve licences, but this is not certain. If some of these statutory supervisors failed to obtain a licence then the extra cost of the regime would reduce in the short term due to the smaller number of supervisors for the Commission to monitor.

As with the rest of the regime, this cost will be entirely recovered from the licensed statutory supervisors by way of fees and levies. The amount recovered will be calculated for each firm, to be proportionate to the number and size of entities each monitors. For example, we expect the cost recovered from a statutory supervisor of a small retirement village to be significantly lower than that of a trustee of a large corporate debt issue.

We expect the direct cost per resident will be small: based on the last census figures there are 26,000 residents living in retirement villages. Our preliminary estimate of $200,000 for this licensing regime averages out to be $7.80 per resident, per year. On balance we believe this additional cost is justified as residents should receive benefits of more effective supervision by statutory supervisors, and increased transparency around the activities of their statutory supervisor.

In some circumstances there will be indirect costs to retirement village statutory supervisors arising out of the need to carry out more intensive supervision of certain village operators (for example, through increased costs charged to the operator if more time is taken to scrutinise documentation received from the operator). However, this cost will in most cases be passed on to the village operator in the form of higher fees from retirement village statutory supervisors.

The magnitude of these indirect costs is impossible to quantify, as they rely on the specific circumstances of each village and supervisor. In many cases there will be no additional costs to operators short of the need to pay slightly higher fees to retirement village statutory supervisors. In the smaller number of cases where the supervision of issuers by retirement village statutory supervisors is currently inadequate the costs may be much more significant.

Any increase in retirement village statutory supervisors' fees charged to operators is likely to be passed to residents in increased weekly fees. Across the retirement villages sector, 50% of residents are reliant on superannuation as their main source of income and an increase in compliance costs could impact negatively on residents. However, we do consider that these costs would be justified the improved supervision provided by statutory supervisors under the preferred option.

There will also be a cost to any retirement village statutory supervisors which are unsuccessful in their application for a licence, or have their licence revoked following a breach. In such situations the statutory supervisor firm may go out of business and this is likely to impact the ability of the firms' principals to earn a living. There is a small likelihood that licences will be declined or revoked. However, if some existing players exit the market this will create opportunities for other, more competent, firms to enter.

IMPLEMENTATION AND REVIEW

The proposed legislation would come into force on a date which is the earlier of 9 months after the date on which the Bill receives the Royal Assent or an earlier date to be specified by Order in Council. This means that, assuming that the Bill is passed by the end of June 2010, it will come into force sometime between December 2010 and March 2011.

The transitional arrangements for retirement village statutory supervisors will be the same as for other trustees and statutory supervisors. All entities approved to act as trustees and statutory supervisors at the time the Bill comes into force will receive a temporary licence, valid for 6 months from the date the regime becomes operative. The regime will commence nine months after the date of the Royal Assent or on a date to be specified by order in council if earlier than nine months after the Royal Assent. This will enable statutory supervisors to continue uninterrupted in their role and gives them potentially as long as 15 months to apply and be assessed for a licence.

This will give retirement village statutory supervisors currently operating in the market adequate time to adjust to the new requirements, and the Securities Commission time to prepare for licensing applications. It will also give trustees, statutory supervisors and issuers or retirement village operators time to make other arrangements if an application is unsuccessful.

The legislation will be reviewed no later than 5 years after it comes into force (CAB Min (09) 30/6B refers).

CONSULTATION

Targeted consultation on the proposal to include statutory supervisors of retirement villages in the licensing regime for trustees and other statutory supervisors was carried out. The Trustee Corporations Association, the Retirement Villages Association, Grey Power, Age Concern New Zealand, key retirement village statutory supervisors, and several law firms that advise on retirement village issues were contacted directly, provided an outline of the proposal and were asked for comment.

The Trustee Corporations Association and Grey Power supported the inclusion of retirement village statutory supervisors in the regime, on the basis that this would provide greater protections to residents of retirement villages.

The Retirement Villages Association and the retirement village statutory supervisors who were consulted raised serious concerns about the cost of the regime (especially if this cost were to be passed on to residents), and also questioned whether there were any major problems with the status quo. They did not suggest alternative options, instead seeking to maintain the status quo.

As noted earlier, I consider that there is evidence of problems with the quality of supervision provided by some retirement village statutory supervisors. In addition, while I am very conscious of not imposing unnecessary cost on this section, I do consider that the costs here are justified.

The following departments and agencies have been consulted on the proposal to include statutory supervisors of retirement villages in the licensing regime for trustees and other statutory supervisors: The Treasury, Securities Commission, Department for Building and Housing, Reserve Bank, Ministry of Justice, the Office of the Retirement Commissioner, and Registrar of Companies. The Department of Prime Minister and Cabinet has been informed.