

RUSSELL McVEAGH

BANKING LAW UPDATE

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CASES

PROSECUTION UNDER THE SECURITIES ACT

Reeves v Registrar of Companies (HC Wellington, CRI-2007-485-4, 7 November 2007, Ronald Young J)

The recent High Court case of *Michael Reeves v Registrar of Companies* (HC, Wellington, CRI-2007-485-4, 2 November 2007, Young J) related to Lombard Financial Services seeking investment funds from the public which were secured by a first mortgage over several residential sections and a first charge debenture. These were subsequently guaranteed by two persons. This transaction breached Regulation 11 of the Securities Regulations as the offer of securities did not disclose the facts that one guarantor's guarantee was limited to \$250,000 (in respect of a loan of over \$13 million) and the other guarantor could not meet the guarantee if trouble arose.

Michael Reeves, the Executive Director of Lombard, was convicted under section 59 of the Securities Act 1978.

Mr Reeves appealed. His submissions were that the Judge erred in:

- failing to differentiate between the culpability of key actors, including the appellant;

- finding that the breach of Regulation 11 was a "misrepresentation of the value of the security";
- concluding the appellant "took a risk by failing to scrutinise the documents for correction";
- devaluing the credit for the appellant's guilty plea;
- wrongly taking into account denunciation and deterrence as relevant sentencing principles in this case;
- taking irrelevant authorities on sentencing into account;
- failing to take relevant authorities into account;
- taking the increased penalty imposed by Parliament in 2002 into account when the offence occurred in 2000; and
- failing to properly assess the gravity of the offending and the effect of a conviction which consequentially resulted in an inadequate assessment of whether the direct and indirect consequences of a conviction were out of proportion to the gravity of the offence.

Cases Continued...

Justice Young dismissed the appeal stating that even if the trial Judge's exercise of his discretion was reviewable, the same conclusion would have been reached. The offence of failing to comply with Regulation 11 involved a failure to state the nature and amount of the guarantees offered and the fact that these guarantees were highlighted to investors made it all the more serious. The judge made it clear that the appellant's culpability was not reduced simply because he relied upon a lawyer who had commercial experience to advise him of any problems (who was also on the board of directors). No independent advice was sought and the appellant was himself an Executive Director and a professional director.

SPECIFIC PERFORMANCE OF CONTACTS FOR DIFFERENCE

Weatherhead v CMC Markets Ltd (HC Auckland, CIV-2007-404-8, 24 August 2007, Associate Judge Faire)

The plaintiffs (Mr Weatherhead and Ms Dunn) sought summary judgment against CMC Markets Limited ("**CMC**"). CMC deals in futures contracts and provides private investors with the opportunity to trade in financial products, including

Contracts for Difference ("**CFDs**"). The plaintiffs sought orders for specific performance against the actions of CMC whereby it had liquidated the plaintiff's position by selling their CFDs in two instances. This occurred after the plaintiffs were placed on margin call and failed to transfer the required funds before their position went below liquidation level. CMC, in defence, claimed that they were entitled to liquidate under the banking instructions provided for in the plaintiff's contract.

The main issue that Associate Judge Faire dealt with was whether the relief sought (specific performance) was appropriate to be dealt with by way of summary judgment. Contracts for the sale and purchase of shares and securities are generally specifically enforceable if the securities are not readily attainable on the market. However, as Justice Faire noted, in the case of CFDs, the underlying security is not purchased and therefore the contracts are easy to obtain. Consequently, if CMC had not been entitled to liquidate the plaintiff's position, they could have been easily compensated by immediately reopening their positions and recovering the difference between the liquidated CFDs and the market price of the new contract. The plaintiffs failed to take any

Cases Continued...

reasonable steps in mitigation and thus summary judgment was declined on this point alone.

Associate Judge Faire briefly examined the issue of whether CMC was entitled to liquidate the plaintiff's position, although it was not necessary to give judgment at the interlocutory stage. Under the banking instructions given to the plaintiffs, payments could be made between 8am and 6pm on business days. As the plaintiff's funds had been allocated outside of these times it was arguable that liquidation was valid. There was some dispute on the facts of the second liquidation as to whether the banking terms in fact applied. However, no final view was reached on the matter and the plaintiff's application was dismissed.

ARBITRATION PROCEEDINGS AGAINST A COMPANY IN LIQUIDATION

In the case of *Downer Construction (New Zealand) Ltd v One Hobson Street Ltd (in liquidation)* (HC, Auckland, CIV-2007-404-2374, 3 August 2007, Abbott AJ) Downer Construction ("**Downer**") and One Hobson Street Ltd ("**One Hobson**") were parties to a contract for the construction of a building. The contract included

provisions for the determination of disputes by reference to arbitration. On 10 August 2006 One Hobson's sole shareholder placed the company in liquidation. Downer sought leave of the court to continue arbitration proceedings commenced before One Hobson's liquidation, to commence further arbitration proceedings since One Hobson's liquidation and to extend the time for commencing those proceedings.

Under section 248(1) of the Companies Act 1993 legal proceedings can only be continued or commenced against a company in liquidation with the consent of the liquidator or with leave of the court. The court has discretion whether or not to grant leave. While no criteria are specified in the section regarding the exercise of the discretion, the case *Birchall v Project Works Construction Ltd (in liquidation)* summarised the factors recognised by the courts as relevant. Of these, the parties agreed that three factors were particularly relevant to the application:

- Assets of the company should not be dissipated in wasteful litigation particularly if there is a more convenient method for determining the claim;

Cases Continued...

- Leave will usually be declined if the proceedings sought to be commenced, even if successful, are likely to be fruitless; and
- The appropriate test is that the court be satisfied that the proposed claim is not clearly unsustainable.

Although these factors were relevant to the exercise of discretion under s 248(1), the ultimate question was whether it was fair and appropriate for leave to be granted. Downer's interest had to be balanced against the wider interests of One Hobson's creditors and contributors. Looking at the circumstances of the case the High Court deemed that it was appropriate to grant leave to Downer to continue and commence arbitration proceedings.

The court then considered, under clause 7 of the second schedule to the Arbitration Act 1996, that it would extend the time agreed for commencement of arbitration as undue hardship would otherwise be caused to the parties.

LEGISLATION

TAX BILL ENACTED

The Taxation (Annual Rates, Business Taxation, KiwiSaver, and Remedial Matters) Bill was enacted on 12 December 2007. The Bill introduced the 15% research and development tax credit, announced at the Budget in May, and also contained a number of amendments consequential to the lowering of the company tax rate to 30%.

The new legislation also contains a number of adjustments to the KiwiSaver regime, including:

- a new tax credit to match member contributions of up to \$20 per week; and
- a requirement for employers to match their employees' contributions up to 4 per cent of their gross salary or wages.

The new legislation also increases tax incentives for making donations to charitable organisations.

REGULATION OF FINANCIAL ADVISERS

Two new bills were introduced in early December as part of the ongoing Review of Financial Products and Providers ("**RFPP**"): the Financial Service Providers (Registration and Dispute Resolution) Bill on 4 December and the Financial Advisers Bill on 5 December 2007.

The Financial Service Providers (Registration and Dispute Resolution) Bill sets up a registration system under which all financial service providers will be required to be registered on the new Register of Financial Service Providers. The principal purpose of the Register is to ensure that New Zealand is able to meet its anti-money laundering obligations under the Financial Action Task Force Recommendations.

The Bill also establishes an industry-based dispute resolution to deal with consumer disputes in the financial services industry. Key features of the new system are:

- dispute resolution schemes may apply to the Minister of Commerce for approval, which will be given based on whether the scheme meets certain criteria;

Snippets continued ...

- membership of an approved scheme will be mandatory for financial service providers who transact with consumers; and
- it is anticipated that more than one dispute resolution scheme will be approved, which will give financial service providers a choice as to which scheme to belong to.

The Financial Advisers Bill introduces a co-regulatory regime for financial advisers, under which the Securities Commission and industry-based bodies will work together to regulate the financial advice industry. Key features of the Bill are:

- financial advisers will be required to be a member of an approved professional body and to be registered on the Register of Financial Service Providers;
- financial advisers will be subject to increased mandatory disclosure requirements, in particular requirements to disclose commissions;
- financial advisers will be subject to conduct standards, including obligations to act with integrity, reasonable care, diligence and skill, and a prohibition on misleading or deceptive conduct.

NEW REGULATIONS UNDER THE SECURITIES MARKETS ACT

Three sets of regulations under the Securities Markets Act 1988 were promulgated on 3 December 2007: The Securities Markets (Substantial Security Holders) Regulations 2007, the Securities Markets (Investment Advisers and Brokers) Regulations 2007, and the Securities Markets (Market Manipulation) Regulations 2007. The regulations follow the Minister of Commerce's announcement that the amendments to the Securities Markets Act, enacted in late 2006, will come into force on 29 February 2007. Consequently, the new regulations also come into force on 29 February 2007. They are available from www.med.govt.nz.

- The Securities Markets (Substantial Security Holders) Regulations 2007 set out how disclosure must be made under the substantial security holder regime in the Securities Markets Act. The regulations prescribe forms for:
 - making an initial disclosure of a substantial security holding;

Snippets continued ...

- disclosing a movement of 1% or more in a substantial holding, or a change in the nature of the relevant interest, or both;
 - disclosure of ceasing to have a substantial holding;
 - a public issuer requiring a holder to disclose a relevant interest; and
 - a public issuer that believes a person might be a holder with a relevant interest to disclose that interest.
- The Securities Markets (Investment Advisers and Brokers) Regulations 2007 contain a number of exemptions from the new investment advisers and brokers disclosure regime in the Securities Markets Act. In particular, the regulations exempt advice given over the telephone and certain advice given by lawyers or chartered accountants from the full disclosure regime. The exemptions are not blanket exemptions and depend on certain conditions being fulfilled. For example, in the case of telephone advice, disclosure must still be made orally.
 - The Securities Markets (Market Manipulation) Regulations 2007 contain exemptions for certain activities that might otherwise constitute market manipulation under the Securities Markets Act. The activities exempted are market stabilisation following the first offer of securities to the public, and short selling and crossings.

SNIPPETS

REGULATION AND MARKET ORGANISATION OF VIETNAMESE FINANCIAL MARKETS: AN INVESTOR'S GUIDE TO EMERGING MARKETS IN SOUTH EAST ASIA

M-PAYMENTS: THE NEXT PAYMENT FRONTIER - CURRENT DEVELOPMENTS AND CHALLENGES IN INTERNATIONAL IMPLEMENTATION OF M-PAYMENTS

Issue 11 of the 2007 *Journal of International Banking Law and Regulation* contains two articles of interest.

- The first is an article an article by Associate Professor Tony Ciro and Dr Quan Nguyen entitled **Regulation and market organisation of Vietnamese financial markets: An investor's guide to emerging markets in South East Asia**.

The article discusses the introduction of a Western-style securities regulation regime in Vietnam. This provided the necessary legal and regulatory framework for a functioning securities market. However, securities regulation in the form of company law-type regulation explains only half of the regulatory regime. Financial markets in Vietnam continue to be governed by a

complex and dynamic contractual system involving mandatory rules and relational contracting behaviour.

Securities regulation of Vietnamese financial markets developed along the following lines:

- 1990 Company Law Act: This Act did not provide that companies issuing shares to the public to disclose information to investors, did not impose sanctions for not disclosing, did not have any standard for fiduciary duties of directors, and did not provide a default regime for internal regulation. Furthermore, shareholders rights and duties were not well defined.
- 1999 Enterprise Law: This Act attempted to reform the regime but had no auditing requirements so shareholders could not scrutinise the financial performance of listed companies.
- 2005 Enterprise Law: This Act provided disclosure requirements and mandatory reporting requirements. It also gave shareholders a right of inspection. This improved public confidence and encouraged the public to invest.

Snippets continued ...

- 2006 Law on Securities: This Act regulated activities involving the issuing of securities to the public, listing and trading in securities and operating a securities market.
- The State Securities Commission was responsible for laying the necessary groundwork for the introduction of a securities market. The Commission can monitor market related activity and enforce provisions of the Enterprise Law and the Company Law.

During the last decade Vietnam has dramatically transformed its economy into a market economy at a pace that ranks it among the two most successful transitional economies in the world, the other being China. It is also clear that many of the Western principles influencing financial markets, as well as China's emerging leadership role, have played an important part in the development of market regulation in Vietnam.

- The second is the article **M-Payments: The next payment frontier - Current developments and challenges in international implementation of M-payments** by Angela Angelovska-Wilson and Jaimie Feltault.

It is the expectation that Mobile-Commerce ("**M-Commerce**") will quickly become the widely accepted form of payment in the near future, heralding an era in which consumers execute transactions through the use of technological adaptations to the traditional mobile phone, transforming it into a payment device for use in the everyday economy.

A mobile payment may be defined as any payment "where a mobile device is used in order to initiate, activate, and/or confirm" the transaction.

There are several advantages to use of mobile payments as an alternative to other payment systems.

- Mobile payments offer consumers an unprecedented degree of convenience and speed in executing transactions.
- A reliance on mobile devices is much more cost-effective in the long run than the expensive procedures necessary for merchants to handle cases.
- Mobile payment systems may afford a system less

suspect to security breaches, as encryption and more effective use of personal identification numbers may result in less risk of fraud or theft.

In order to implement a successful mobile payment system, all mobile and financial providers must work together to create a uniform infrastructure. Due to the significant expense of replacing existing systems, it will be easier for less developed countries to make the transition because there are no prior advanced payment mechanisms to remove. It is also necessary for the technological developments to keep pace in order to support the growth of contactless payments.

A potential hurdle is the issue of security. As mobile payments involve the transmission of highly sensitive and personal information, consumers need to be assured that they will have protections both domestically and internationally. Players in the mobile payment market have developed a number of potential safeguards, which have been argued to possibly enhance security in payment systems. Any security concerns must be balanced with other features of mobile payment systems such as convenience and usability.

Any workable system must also act within the constraints imposed by both national and international legislation. Each government has the sovereign right to regulate payment systems used in its economy. It is therefore important that individual countries work together for the good of the global community in establishing a mobile system that has acceptance and support worldwide.

SO WE'RE THE ONES IN STEP, RIGHT?

The November 2007 issue of the *Chartered Accountants Journal* contains the article **So we're the ones in step, right?** by Paul Callow.

This article postulates that New Zealand is behind the rest of the western world in terms of the quality of its infrastructure, identifying a major reason for this as that the New Zealand Government is dismissive of the advantages of funding by public private partnerships ("**PPPs**").

In the opinion of the writer, PPPs provide better quality structures due to the greater incentives to do so, such as having to live with, fund, and provide services from the facilities they build. In the United Kingdom, the effect of

these incentives are shown by 89% of PPP projects being completed on time or early, as opposed to 40% delivered on time through traditional procurement methods.

The Government appears to have identified traditional procurement as able to achieve some of the benefits of PPPs, and considers that it is a process worth pursuing as the competitive processes for procurement drive up considerable value for the public sector. The same, however, is true for PPPs. This article points out that the problem with this argument for traditional procurement is that in public sector procurement currently, competition plays little part in selecting providers.

PPP concerns are based on its apparent inflexibility. The article states that this is true for traditional models but not in more advanced markets where there is more flexibility to use PPP structures where the classification of future requirements is less certain. A benefit of PPPs is attached to this concern of inflexibility as PPPs ensure forward thinking in relation to the full life cost of the assets and their funding.

The article acknowledges that PPPs are not the only answer to infrastructure funding, only representing 10% of the total

capital spending of the United Kingdom, but identifies that it has a major role to play at such margins.

DIRECTORS' DUTIES AND CORPORATE GOVERNANCE

The November 2007 issue of *Company and Securities Law Journal* contains the article **Directors' duties and corporate governance: an analysis of the Vines appeal** by Geof Stapledon and Jon Webster.

The article analyses the regulatory enforcement of duties imposed on company directors and other officers who hold substantial power in the management of a company to exercise their powers with a reasonable degree of care and diligence. In Australia, where the Corporations Act 2001 places sanctions on directors who neglect their duties, the recent Court of Appeal decision in *Vines v Australian Securities and Investments Commission* highlighted the issue of the delicate balancing act between enforcement and the promotion of entrepreneurial behaviour.

In the Vines appeal, the majority held that Mr Vines, CFO of the GIO Group, had breached his statutory obligations to exercise due care when stating his confidence in a profit

forecast released during the AMP takeover. The majority view emphasised that a reasonable CFO would have undertaken an extensive review of the position of reinsurance subsidiary Gio RE before allowing management sign off, given the subsidiary's precarious financial situation caused by hurricane liabilities.

With the penalty a mere \$50,000 fine and millions of dollars spent on legal and administrative expenses, the authors questioned whether the enforcement action taken by ASIC in relation to Mr Vines' negligence was of public benefit. In circumstances of extreme pressure due to the occurrence of a natural disaster, Mr Vines relied upon the view of a subordinate holding intimate knowledge with the best of intentions and within an established system of accountability. In light of the fine line drawn by the case, the authors suggest there is a strong argument for a review of sanctions or the introduction of a general defence for directors' duties, outlined in a 2007 Treasury consultation paper. These would afford directors protection against breaches of duty of care and would ultimately lessen the deterrence of duties on entrepreneurial risk-taking.

UK GOVERNMENT TO IMPLEMENT COVERED BONDS REGIME IN MARCH 2008

On 8 November 2007 the United Kingdom Economic Secretary to the Treasury announced the government's intention to implement the new United Kingdom covered bonds regime on 6 March 2008. Consultation on the proposals, which were launched in July 2007, came to an end last month and legislation is expected to be enacted in January 2008.

Proposals considered by the Treasury and Financial Services Authority ("**FSA**") are developments that will bring the United Kingdom covered bonds in compliance with the Undertakings for Collective Investment in Transferable Securities ("**UCITS**") Directive. This will enable larger access to the European covered bonds market by United Kingdom issuers.

Covered bonds are structured to be high quality debt securities and have high credit ratings. A recognised covered bonds regulatory framework will provide additional safety features for investors.

The FSA and the Treasury will make the summary of responses, along with the revised Regulation, available on their websites in January 2008.



The Russell McVeagh Finance Group wishes all our readers a very Merry Christmas and a Happy New Year.

Our next issue of Banking Law Update will be in February 2008.

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