

Corporate Advisory Alert

29 June 2010

Securities Law Review

Introduction

The Ministry of Economic Development recently released its long anticipated discussion paper outlining the Government's proposals to overhaul New Zealand's securities laws. This review, commenced in 2004, is intended to result in a new Act to replace the Securities Act 1978 (along with the Securities Regulations 2009) and the Securities Markets Act 1988. It is likely that a wide range of other legislation will also be amended as a result of this process.

The discussion paper covers a broad range of issues in great depth. We have set out below what we have identified as some of the key issues in the paper. We have also attached a condensed summary of the proposals to assist in overcoming the barriers to entry of this 200 page document and a condensed extract of the questions for submission. The discussion paper itself can be viewed at <http://www.med.govt.nz/upload/73375/discussion-document.pdf>.

Background to the review and regulatory philosophy

The proposals contained in the discussion paper arise in the context of the wide-ranging legislative developments that have been, and are being, undertaken in relation to capital markets and the financial sector to provide a coordinated and coherent financial markets regulatory regime. The Ministry notes that the proposals contained in the discussion paper build on recent developments, including the non-bank deposit taker regime, the wide-ranging reforms of the financial intermediary sector and the monitoring regime for statutory supervisors and trustees.

The discussion paper also contains proposals relating to the proposed consolidation of market conduct regulators into a new Financial Markets Authority ("FMA"), which is expected to be operational in early 2011. The Establishment Board for the FMA was formed in late May this year. These proposals largely relate to monitoring and enforcement powers to be provided to the FMA over and above the powers of

current regulatory bodies. These proposals, together with the establishment of the FMA itself, demonstrate the Government's commitment to enacting a more coordinated and effective regulatory regime. However, based on current Government indications it is likely that the FMA will be established in parallel to this review and will be operating some time before any of the proposals contained in the discussion paper come into force.

The discussion paper has adopted or built on many of the recommendations contained in the final report of the Capital Market Development Taskforce, released late last year. Some earlier recommendations of the Taskforce were urgently implemented during 2009 in response to the global financial crisis. These included the introduction of the simplified disclosure prospectus regime, amendments to the categories of persons who are exempt from the full disclosure requirements of the Securities Act and relaxation of various NZX listing rules to allow listed issuers to raise capital more easily. It is likely that those palliative measures will be continued.

A key theme of the discussion paper is ensuring that the mandated disclosures and liability provisions of the securities laws are not wider than necessary to ensure the primary objective of protecting those who "cannot fend for themselves". With this in mind, much expanded categories of exempted persons and offers are proposed. These include some potentially radical departures, for example an exception for products recommended by a qualified and non-conflicted independent adviser and a relatively straightforward opt-out regime. The Ministry cautions that its positions in these areas are exploratory in the sense that they may detract from the ethos of consumer protection and an informed market, but they are an indication that the regulators are at least prepared to consider moving away from the tried and true.

Defining regulated financial products

The Ministry is proposing to reform the manner in which securities are classified (ie as debt, equity, participatory

securities etc), and therefore regulated, under the Act. It intends to rationalise the existing range of securities into four categories, subject to clear, substance-over-form definitions. Most notably, the existing range of pooled securities (including unit trusts, superannuation schemes, life insurance and participatory securities) will be grouped into a single category of collective investment schemes. Derivatives are also to be brought into the fold, with equity and debt securities being the other categories. Key definitions will be modernised by reference to relevant accounting standards.

In addition, the Ministry proposes that only financial products that generate a financial return or, in the case of derivatives, hedge financial risks would be subject to the Act.

The Ministry also recommends that the FMA be given discretion to designate financial products into one of the categories, or re-classify a product. This is aimed at avoiding the possibility of a security falling outside of the defined categories, whether by design or otherwise.

Exemptions from the regime

The Ministry considers that the current categories of persons to whom an offer of securities can be made without complying with the prospectus and investment statement requirements are too narrow. It proposes that the categories of persons to whom such an exempt offer can be made should be widened and the tests for those categories simplified, set out in full in the legislation and made more objective.

The most notable of the additional exemptions on which the Ministry is seeking comment are:

- » a prescribed "sophisticated investor" exception;
- » an exemption for small offers, likely to be based on the Australian exemption for offers of up to \$2 million from up to 20 persons over a 12 month period;
- » an exemption for an offer to an investor who has obtained a recommendation to buy the security from an independent financial advisor; and
- » an exemption for an offer to an investor who has 'opted out' of the Act by signing a prescribed statement declaring that the Act will not apply to the investment and who has received independent legal advice.

Although it will remain primarily the responsibility of the issuer to determine whether an exemption applies to an investor, the Ministry suggests that investors may be able to 'self-certify' that they fit within a certain exemption. This certification would then be noted on a public register for issuers to consult.

The Ministry also proposes an exemption for employee share schemes. The exemption would apply to an offer of shares or share options to employees of a company up to a value equal to 15% of the assets of the company or 15% of the value of the outstanding securities of the same class.

Disclosure

The Ministry proposes to scrap the investment statement and prospectus disclosure regime. Instead, investors would be provided with a single product disclosure statement ("PDS"). The PDS would begin with a two-page summary of the nature of the investment and key risks associated with it. The remainder of the document would provide the additional disclosures necessary for an investor to make their investment decision.

The new regime would be aimed at reducing the length of the disclosure provided to investors, which the Ministry considers currently makes it less likely the disclosure will be read at all. To that end, any additional disclosures that may be of interest to investors, such as full financial statements, would not be contained in the PDS but instead would be available by way of a searchable online Register of Securities, which Cabinet agreed in April this year to establish.

The Ministry proposes requiring an issuer to include a risk rating of the investment within the PDS. This risk rating would take the form of either:

- » a self-assessed summary of the risks of the issue (the Ministry's preferred option for all but a rated debt issue);
- » a standardised risk assessment of the issue set out as a risk-meter or a graphical representation such as a scale; or
- » a third party independent report on the merits and risks of the issue (ie along the lines of what is required under the Takeovers Code).

The Ministry proposes that issuers of debt securities and issuers in respect of collective investment schemes be required to make additional ongoing disclosures. Debt issuers would be required to notify investors of material changes in matters that may have a bearing on the likelihood of the issuer defaulting on the security. Collective investment scheme issuers would be required to provide quarterly reports disclosing changes to fees and charges, asset holdings, conflicts of interest and fund returns.

The discussion paper also considers the current restrictions on pre-prospectus publicity, which create problems for many issuers who announce an offer of securities prior to registering a prospectus for the offer. The Ministry proposes removing the restrictions on the content of pre-prospectus publicity, relying instead on the general prohibition on untrue statements. More generally, the Ministry wishes to reduce the "red tape" regulation of advertisements.

As with the earlier Review of Financial Products and Providers (RFPP) discussion documents, the review is light on the specific content of the disclosures that will be required for the various categories of securities. However, the following observations can be made:

- » Unlike the current 'one-size-fits-all' regime, the specific disclosure requirements will be adapted to suit the particular securities, with more standardised (and brief) disclosure for vanilla securities (eg most collective investment schemes) moving through to less standardised and potentially more lengthy disclosures for debt and, in particular, equity.
- » The Ministry favours content requirements that are consistent with international norms (and perhaps thus 'hub friendly'). Accordingly, it suggests as a starting point for both equity and debt IOSCO's International Disclosure Standards for Cross-Border Offerings for those products. For collective investment schemes it draws on the regulation of managed funds (UCITs) in the European Union and recent Australian regulatory initiatives.
- » The PDS is to be specifically targeted to retail investors whereas the matters required to be disclosed on the new Register of Securities are expected to be of more interest to analysts, advisers and regulators.
- » The details will be left to the implementing regulations, which logically will follow on from the basic statutory and institutional design contemplated in this review.

Collective investment schemes

At present, collective investment schemes (such as managed funds and property syndicates) exist in a wide variety of legal forms, and are therefore subject to differing regulatory frameworks. The Ministry considers that this inconsistent regulation leads to regulatory arbitrage by issuers, inequities across investors in different categories and a lack of comparability. It therefore proposes overlaying the existing regulations applying to collective investment schemes with a standard regulatory framework which would apply regardless of legal form.

This new framework would require all collective investment schemes to have a fund manager (which will be the issuer), an external supervisor who would be subject to the new trustee licensing arrangements and possibly an independent custodian.

There will also be more substantive requirements for the terms of collective investment schemes, including

specifying matters such as investment policy and objectives, fees and returns and pricing. This will then lead on to standardised point-of-sale disclosure and ongoing reporting obligations.

The discussion paper also addresses the Government's stated desire to establish New Zealand as an Asia-Pacific financial services hub, which was a recommendation of the Capital Market Development Taskforce. The Ministry notes that, in order to achieve this, New Zealand's regulatory regime regarding collective investment schemes would have to be markedly strengthened. In order to avoid imposing an overly onerous regulatory burden on domestic schemes, the discussion paper proposes a "dual" regime, whereby schemes trading internationally would be subject to a more stringent regulatory regime than those which only trade domestically.

Transparency

Along with efficiency and consumer protection, a key theme of the review is transparency. This is intended to be achieved primarily with the new Register of Securities, which will contain a lot more detailed or technical matters (financial statements, terms of securities, material contracts etc). It is contemplated that this Register will be searchable by reference to key terms in order to assist comparability across products.

Other matters

The discussion paper goes on to discuss a range of other matters, the most notable of which are:

- » a duty to treat retail investors fairly;
- » the degree of regulation of securities exchanges, including partially regulated exchanges;
- » whether the FMA should be given a similar power to that of ASIC in Australia to bring civil actions on behalf of investors; and
- » whether directors' duties should become enforceable by a public authority and subject to civil or criminal sanctions.

Urgent attention required for submitters

With submissions on the discussion paper due by 20 August 2010, there is a very tight timeframe on this significant regulatory review. The securities review process will be of interest to a wide range of parties, not only those who issue securities on an ongoing basis. We therefore encourage you to contact us if you would like to find out more about how these proposals may affect your business or if you would like us to assist you with a submission.

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