

Review of Securities Laws Discussion Document (abridged)

June 2010

Purpose of this document

This document extracts from the Review of Securities Laws Discussion Document the conclusions and recommendations and briefly summarises the analysis and problem definition where necessary to understand those recommendations. The shaded boxes and italicised sections are summaries, the remainder is substantially as presented by MED.

Defined Terms:

CIS	Collective investment scheme
FMA	Financial Markets Authority, the new securities super regulator
FSP Act	Financial Services Providers (Registration and Dispute Resolution) Act 2008
MED	Ministry of Economic Development, author of the document
RFPP	Review of Financial Products and Providers (reported August 2006)
Taskforce	Capital Markets Development Taskforce

COVERAGE

The Review is broken down into the following sections:

- » Chapter 1 covers the definitions of the financial products that will be subject to regulation under the new Act;
- » Chapter 2 covers the statutory exemptions for offers to particular classes of investors who do not require all the protections of the Act, such as sophisticated investors and relatives;
- » Chapter 3 covers disclosure obligations of issuers before sale, ongoing obligations over the life of the financial product, and regulation of advertising;
- » Chapter 4 covers regulation of collective investment schemes, such as managed funds, including the governance of funds and the duties owed to investors; and
- » Chapter 5 considers other matters that may require reform under the new Act, including additional powers for the FMA and the possibility of public enforcement of directors' duties.

NEW LEGISLATION

MED proposes that a new Act will replace the Securities Act 1978 and the Securities Markets Act 1988, and amend a range of other legislation. The new Act will set out what offers of financial products are to be regulated, how they will be regulated, and how this regulation will be enforced.

The new Act will specify a range of financial products that are to be regulated, providing exemptions for offers to particular classes of investors, disclosure regulation, product regulation, the structure and powers of the FMA as regulator, and regulation of secondary securities markets.

The Securities Regulations will also be re-written and are expected to contain a lot of the detail, particularly about the content of disclosure documents. It has been signalled, however, that there will be less specific regulation of the content of advertisements (and prospectuses), which currently takes up the bulk of the Securities Regulations (excluding the Schedules).

The changes to regulation of collective investment schemes will also likely result in the replacement of the Unit Trusts Act 1960, Superannuation Schemes Act 1989 and the KiwiSaver Act 2006. Amendments to other Acts will also be required including, for example, if there are changes to enforcement of director duties (Companies Act 1993), to treatment of bankrupts (Insolvency Act 2006), or to align with the Hague Convention on indirectly held securities (Personal Property Securities Act 1999).

Chapter 1: Defining regulated financial products

Problem definition

MED raises the following concerns about the current definitions and scope of the Securities Act:

- » Current definitions mean that certain securities are not categorised appropriately, and this allows issuers to engage in regulatory arbitrage.
- » Definitions are too subjective. Objective tests and substance versus form approach is appropriate.
- » Concern about the breadth of some definitions – particularly the debt security category following the landmark Culverden case.
- » There are too many categories, and in particular the ‘catch-all’ participatory are better analysed as collective investment schemes.

Rationalising the categories of financial products

MED proposes targeting the new Act at four categories of financial products, including what are currently “securities” and “futures contracts”. MED does not consider the current split regulatory regime between securities and futures is appropriate. They propose to apply (different) disclosure and governance requirements specific to each category of products.

MED instead proposes the following main categories of financial products:

- » Debt
- » Equity
- » Collective investment schemes
- » Derivatives

MED proposes only to regulate financial products for which generating a financial return or hedging financial risk is a significant feature. Specifically, equity, debt and CISs will be defined to be restricted to “investments”, which is proposed to be defined as arrangements in which money (or other financial assets) are paid to someone else and a material feature is the possibility of earning a positive financial return. The definition of derivatives will require that they are either investments or used for hedging financial risk.

The Financial Markets Authority and regulations will be able to “call in” products that are substantively similar to the four products that they propose the regime focus on, but fall outside a strict reading of the definitions, so that they become regulated. They will also be able to shift products from one category to another category.

MED proposes definitions based on the economic substance of the product, rather than its legal form, drawing in particular on accounting rules and overseas definitions.

Equity securities

Equity securities will cover most company shares as at present, however MED proposes that the definition of equity be aligned with the relevant accounting standards. They do not necessarily propose that the new Act directly reference accounting standards, as these may be inappropriate in some circumstances, but they provide a useful starting point for definitions.

Equity instruments would be defined as investments in companies and similar entities that:

- » Evidence a residual interest in the assets of the entity after deducting its liabilities;
- » Carry no obligation to deliver cash (or other financial assets); and
- » Are not interests in collective investment schemes.

Currently an equity security is limited to offers by companies registered under the Companies Act 1993. There have been suggestions that the interests offered by a limited partnership should also be included. Other entities also offer securities that “look” like shares in a company, particularly industrial and provident societies registered under the Industrial and Provident Societies Act 1908. MED is inclined to include limited partnerships and industrial and provident societies within the scope of entities that can issue equity securities, and seeks feedback on other entities can.

Debt securities

As with equity securities, MED proposes to align the definition of debt securities with an accounting-based definition of debt (a “financial liability” in accounting standards). Debt securities would be defined as investments in a company or similar entity (where “similar entity” would be defined the same as in the definition of equity) that:

- » Create an obligation to deliver cash (or other financial assets) either at a fixed point in time, on demand, or if a certain event occurs; and
- » Are not interests in a collective investment scheme.

Collective investment schemes

MED proposes a new category of collective investment schemes (CISs) to cover managed funds, property syndicates, and other investments that are managed on someone else’s behalf. MED proposes that a CIS be defined as an investment in which a subscriber pays money to another person to invest, but the subscriber does not have day-to-day control over investment decisions or the assets purchased using his or her contributions.

This definition would cover all equity and debt securities; therefore for investments in companies and similar entities, MED proposes additional criteria would need to be met, to distinguish CISs from equity and debt securities. Based on UK legislation, these would be that the investment:

- » Is intended to provide members with benefits of investment management and risk diversification; and
- » Allows investors to withdraw their investment on demand (in a reasonable time), at a price based mainly on the value of the assets owned by the company.

MED considers this category should capture the majority of matters currently covered by participatory securities, superannuation schemes, unit trusts and investment life insurance.

MED is also considering whether CISs should extend to schemes not involving pooling – notably platform or wrap services. The argument for this is that they have fee structures, investment mandates, returns and asset holdings similar to pooled CISs. The contrary argument is that they do not require the same level of supervision because there are fewer issues with the entry and exit of investors and individual investors have more direct ownership and ultimate control of assets.

Derivatives

MED proposes leveraging from the relevant accounting definition of derivatives. A derivative would therefore be based on the concept of a financial product that:

- » Changes value in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (i.e. the underlying);
- » Requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and

- » Is settled at a future date.

The definition would specifically exclude CISs, equity and debt.

Under some circumstances (e.g. defining different types of disclosure or governance requirements) it may be necessary to further categorise derivatives, specifically into over-the-counter ("OTC") and exchange traded derivatives. MED proposes that an exchange traded derivative would be a derivative made on or affected through a derivatives exchange (in New Zealand or overseas). OTC derivatives would then be all other derivatives.

MED considers that where an issuer issues derivatives over its own regulated financial products (e.g. equity warrants, options), then the derivative should generally be treated the same as the underlying, i.e. an equity warrant should have the same disclosure as the underlying equity security, with an additional explanation of the conversion process (strike price, strike date etc).

MED is also calling for comment on treatment of CFDs requiring 100% up-front 'margin'.

Call-in power

MED proposes that the FMA should have the discretion to designate financial products into one of the categories, including the ability to re-classify products. More specifically, they propose that the FMA have the power to make designations in respect of products of an individual issuer, and to make class designations for kinds of products or issuers for a limited period. There would also be a regulation-making power for class designations, without a time restriction. This process for making designations mirrors the process for making exemptions that is expected to be set out in the legislation to establish the FMA.

MED is seeking comment on what criteria and restrictions should be applied to designations (there being no test applicable to the current regulatory power to declare instruments to be securities). Possible additional criteria and restrictions for this use of designations are:

- » The decision-maker could be required to be satisfied that the designation is necessary to achieve some regulatory objective (e.g. protecting investors).
- » The decision-maker could be required to first consult with affected persons.
- » Except for re-classification, the product could be required to fall within a broader principles-based definition of products that can be made subject to regulation.
- » The product must be designated into one of the regulated categories. This would restrict the power to resolve uncertainty about whether or not a product fits within a defined category.

Designations would not have retrospective effect, but the regulator could potentially also have the power to prohibit any further allotment of a financial product pending a decision on whether it should be designated. Designations would be regulations, or deemed to be regulations for the purposes of the Regulations (Disallowance) Act 1989.

MED proposes that the proposed designation powers could be made subject to terms and conditions and would sit alongside the exemption powers. This will mean that once a product is designated into a category, the regulation that applies under that category can be adjusted in the same manner through terms and conditions and exemptions.

Exclusion of products not involving financial returns or hedging

MED considers that the definition of securities captures some matters that are properly outside the scope of regulation under investment law and in respect of which most of the substantive requirements of the Securities Act are irrelevant and burdensome. They propose that the definitions of equity, debt and CISs include a requirement that a material feature of the offer is the possibility of earning a positive financial return from the investment. The definition of derivatives will require that a material feature of the offer is the possibility of a financial return or hedging financial risk. The exemption would be subject to the FMA's designation powers.

Under the current definitions in the Securities Act, most matters that have some sort of buyback arrangement or pre-payment for goods and services may be considered debt securities. Most collective ownership may be considered participatory securities.

Among the issues here – particularly in terms of characterisation as debt securities – are philanthropic investments, communal facilities, pre-paid debit cards, and pre-paid goods and services, including gift vouchers, telephone cards, and the balance of pre-paid mobile phone accounts.

The criteria become more difficult to apply where there is some financial return or risk hedging, but this is immaterial to the investor's decision, e.g. there might be the possibility of a negligible return from the investment, but the predominant purpose of the investment is to achieve some other aim. They propose that the test for what is "immaterial" would be based around the concept that the absence of this feature would not be expected to influence the subscriber's decision to purchase it. The way that an offer is marketed will also influence whether investment or risk hedging are material features.

Non-investment insurance

Currently the Securities Act makes provision for life insurance (other than term life insurance) but not other types of insurance. MED considers that the boundaries of what is and is not "life insurance" are not well defined. Term life insurance is defined as a policy that meets two conditions:

- » An amount (other than an amount not exceeding the sum of the premiums paid to the issuer) is payable only if during the term of the policy the life insured dies or becomes ill or disabled; and
- » Is for a specified term that is less than the life expectancy of the life insured (measured in accordance with generally accepted actuarial practice).

MED understands these definitions are unclear and outdated, because:

- » The boundaries of what is "life insurance" and what is not, are no longer well defined. "General insurance" products (e.g. vehicle insurance) can include payments in the event of death or injury, and "life insurance" products include payments in the case of other events, e.g. redundancy;
- » The bundling of investment with life insurance is now rare; and
- » The definition of term life insurance is unclear. In particular, MED has received feedback from actuaries that the phrases "specified term" and "life expectancy of the life insured" are ambiguous.

MED proposes to include life insurance products within the category of CISs if investment is a material feature of the contract. If the principles-based definition is unclear, guidance could be issued, or a special definition could be included to avoid doubt. For example, an insurance contract might be considered an investment if under some circumstances it could have a value on its cancellation or surrender that is greater than the value of any underlying premium relating to the period after its cancellation or surrender.

Existing statutory exemptions that may be carried forward

MED is seeking input on the continuation of the various statutory exemptions under section 5 of the Securities Act, which currently provides complete exemptions from the substantive requirements of the Act for:

- » Land and chattels, unless they are a contributory scheme;
- » Flat or office owning companies (under section 121A(1) of the Land Transfer Act 1952);
- » Professional practices;
- » Mortgages of land, unless they are a contributory scheme;
- » Employee share purchase schemes (under section YA1 of the Income Tax Act 2007);
- » The Government Superannuation Fund; and
- » Retirement villages.

Section 5 to 5C of the Act also provides partial exemptions for:

- » Debt securities issued by registered banks (including exemptions from trustee and prospectus requirements, but not investment statement or advertising rules);
- » Call debt securities, call building society shares and bonus bonds (exempt from investment statement requirements);

- » Any security issued by the Crown, National Provident Fund Board, Reserve Bank, Housing Corporation (including exemptions from trustee and prospectus requirements, but not investment statement or advertising rules);
- » Debt securities issued by local authorities (conditional exemption from prospectus requirements, but not trustees, investment statement or advertising requirements);
- » Employer superannuation schemes (exemptions from prospectus requirements only).

Some of these are discussed further below.

Inclusion of class exemptions in the Act

Where appropriate, MED proposes to incorporate existing class exemption notices into primary legislation. Two examples are given below, but they would welcome input on other class exemptions that submitters would like to see in the new legislation. Class exemptions will also be able to be set out in regulations.

- » **Convertible securities:** MED proposes that the new Act will treat convertible securities in the same manner as the existing class exemption, in the Securities Act (Rights, Options, and Convertible Securities) Exemption Notice 2002.
- » **Dividend reinvestment plans:** MED proposes that the new Act will treat dividend reinvestment plans in the same way as the existing class exemption, in the Securities Act (Dividend Reinvestment) Exemption Notice 1998.

Professional partnerships

MED is considering changing or removing the exemption for professional practices. As drafted, it does not seem to achieve its aim of exempting partners in professional practices. This is because it requires that the practice's sole undertaking be activity that may only be practiced by qualified persons. Most professional practices undertake additional activity that can be performed by other persons. They are also of the view that an exemption for professional practices may not be necessary, as they are proposing that earning a return or hedging risk will need to be a significant feature of the practice, and investors will have to not have day-to-day control over the practice. To the extent both of these conditions do not hold, an arrangement should be regulated as a CIS.

Call debt securities and bank-issued term deposits

The partial exemptions for registered banks and call debt securities together have the effect of requiring banks to provide an investment statement for a term deposit, but no disclosure document for standard deposit accounts. In economic terms, the differences between these products are minor, the main difference being that the term deposit will incur a break fee and potential forgone interest for early redemption. MED is not convinced that the costs of preparing an investment statement are justified in this case, if customers are fully informed about the potential break costs. This reasoning might also extend to other bank products.

Secondary market exemption - 'previously allotted securities'

Section 6 of the Securities Act provides for certain exemptions from the Act in respect of offers of securities that have previously been allotted. The intention of this section is to allow securities that have already been issued to be on-sold to other investors (for example, on a securities exchange) without the need for disclosure or the other requirements of the Act.

While the current Act has only limited application to the secondary market, section 6 provides two anti-avoidance measures by which Part 2 of the Act may apply to secondary market activities. The first is where securities were originally allotted to non-public investors with a view to being offered for sale to the public. The second avenue is where the original allotter assists the holder or offeror in connection with the offer or sale of the security.

MED intends to carry forward the current regime for previously allotted securities, but to create be an additional exemption for vendor / management shareholders in an IPO, in line with a recommendation from the Taskforce.

Investment Brokers

There are existing provisions in the securities laws for brokers, rather than the issuer, to meet relevant requirements, effectively in substitution for a detailed disclosure regime. Examples include authorised futures dealers, contributory mortgage brokers and venture capital scheme administrators.

MED proposes to generalise this concept to allow new investment brokering arrangements to be recognised under the Act – for instance, person-to-person lending providers. Investment brokers will have to:

- » Be licensed by the FMA;
- » Comply with any general regulations covering their type of brokering; and
- » Comply with specific conditions imposed by the FMA.

Issuers using those brokers in compliance with the brokers' conditions will be exempted from parts of the new Act, as well as – under some circumstances – obligations under the Financial Reporting Act 1993.

Islamic finance

MED is seeking feedback on whether the current Act would inhibit implementation of Sharia-compliant products and structures in New Zealand.

Chapter 2: Offers to exempt investors

Principles and issues

MED raises the following issues about the current exemptions in the Securities Act:

- » Exemptions are narrow in scope and uncertain in application.
- » There is a lack of “brightline” exceptions – too many are subjective.
- » Risk aversion, uncertainty and the severe consequences of non-compliance mean that there is a reluctance to use some existing exemptions. For example, few people have been designated as “sophisticated investors” by independent financial advisers, utilising the eligible persons exemption.

Consequences of exemptions

One of the first issues is what should be the consequences of an exemption. For each exemption the following parts of the Act may be reduced or removed:

- » Mandated offering documents (these can be replaced by less costly offering documents, or removed altogether);
- » Product regulation, e.g. the requirement that managed investments have a licensed trustee and required terms in the trust deed;
- » Civil liability for false and misleading statements;
- » Criminal liability for false or misleading statements;
- » Registration of offers;
- » Issuer registration under the FSP Act;
- » Issuer obligations under the Financial Reporting Act 1993; and
- » Other issuer obligations in the Securities Act (e.g. maintaining registers of investors).

MED proposes that offers to all of the exempt classes of investors will not require full offering documents or product regulation. Some more limited disclosures might be required for certain exemptions (e.g. employee share schemes).

Civil and criminal liability in relation to exempted offers

MED proposes that offers made solely to investment businesses, sophisticated investors, large entities, and those making large investments be exempt from all substantive parts of the Securities Act apart from the civil liability. These investors are assumed to be able to enforce civil claims through the courts. They propose that institutional investors will, with the agreement of the issuer, be able to opt in to the sections of the Securities Act that make issuers criminally liable for false and misleading statements. MED also proposes that offers to other exempt investors would be exempted from everything but civil and criminal liability for false and misleading statements.

MED proposes that, as at present, offers to all of the exempt classes of investors will be subject to civil liability for misleading and deceptive conduct under the Securities Markets Act and Fair Trading Act. They are also considering whether to extend the civil liability regime under the Securities Act to all offers of financial products. This would allow pecuniary penalties to be imposed for false and misleading statements in advertisements for these offers.

Financial Service Providers Act registration and Financial Reporting Act

MED is also considering whether issuers who make offers to some of these exempt classes of investors be required to:

- » Register under the FSP Act; and/or
- » Register the offer on the Register of Securities, to be introduced next year under the changes made to establish the FMA.

This may include providing and maintaining basic information about the name of the issuer and offer, type of financial product, directors, promoters, date of first allotment, closing date, and the status of the offer (pre-allotment, open to allotment, closed).

Currently, those who offer only to persons exempt under section 3 of the Securities Act (relatives, close business associates, institutional, and habitual investors) are exempt from the requirement to register as an “issuer” under the FSP Act, but those who offer to wealthy and experienced investors (section 5) will have to register. All issuers who do not have to produce a registered prospectus are exempt from offer registration requirements, including both section 3 and section 5 exemptions.

Where there are large numbers of non-professional investors, issuer registration under the FSP Act would enable such investors to take advantage of dispute resolution schemes. Issuer registration or offer registration would also allow the FMA to obtain information from those issuers, to monitor market activity, and check that exemptions are being used correctly.

MED acknowledges that registration has some compliance costs, and therefore seeks feedback on the likely costs and benefits of requiring registration under some circumstances. For example, it may be appropriate to require such registration only where the offer is made to more than a certain number of investors or a certain minimum amount of capital is raised.

MED is also considering which issuers should be exempt from requirements to file audited financial statements under the Financial Reporting Act 1993. Currently, all issuers who do not have to produce a registered prospectus or investment statement are exempt.

Definition of ‘offers to the public’ and exempted categories

MED proposes that offers to certain classes of persons will not be required to meet any requirements of securities law, unless issuers and investors agree to opt in. There will be a new set of exemptions for offers to investors where the full regulatory requirements of the Securities Act would be inappropriate. These are based partly on the current exemptions, and partly on proposals sourced from overseas jurisdictions, the Taskforce, and the RFPP. MED proposes exemptions for offers to:

- » **Investment businesses**, being those whose primary business is investment or related activities;
- » **Sophisticated investors**, as determined by minimum quantified levels of investment activity and experience;

- » **Large entities**, as determined by minimum assets, income and employees;
- » Individuals making investments of **\$500,000** or more;
- » **Relatives**; and
- » **Personal friends and close business associates**, including directors, senior management, major shareholders of the company or related companies, and close relatives of these persons.

They also seek feedback on the following additional exemptions:

- » Offers to investors who have obtained a recommendation to buy a financial product from an independent financial adviser;
- » Small investments up to \$2 million and 20 persons over 12 months (based on the equivalent Australian exemption); and
- » Other potential exemptions, for example, retaining wealthy investors, or allowing an opt-out for those who have sought independent legal advice and signed a prescribed statement declaring that the Securities Act will not apply to the investment.

To create certainty for issuers, MED proposes bright-line tests for when an investor qualifies under exemptions, rather than the current tests, which in some cases are highly subjective.

MED considers that all parts of securities regime should apply to offers of financial products to all investors apart from those in defined categories. This should have the same effect as the current regime, but remove the need to define “an offer to the public” and the consequent uncertainty as to whether or not an offer falls within that definition. This also removes any possibility that the boundaries of a “public offer” and “private offer” do not coincide and resolves an issue that the courts have grappled with on occasion between the scope of sections 3(1) and 3(2)(a)(iii) of the Securities Act.

Investment businesses

MED proposes to base the definition of investment businesses on the first part of section 3(a)(ii) of the Securities Act (“persons whose principal business is the investment of money”) expanded using definitions from the FSP Act. Thus, investment businesses would be based on the concept of persons whose principal business is:

- » Keeping, investing, administering or managing money, securities or investment portfolios;
- » Entering into derivative transactions, or trading in money market instruments, foreign exchange, interest rate and index instruments, transferable securities (including shares), and futures contracts;
- » providing advice on financial products;
- » Acting as a deposit taker as defined in the Reserve Bank of New Zealand Act 1989; or
- » Being a registered bank.

Sophisticated investors

MED proposes that this category will replace the current exemption for persons “who, in the course of and for the purposes of their business, habitually invest money”. In line with the Taskforce recommendations, they propose to define this category with reference to objective criteria, and in particular investment activity and implied experience.

MED considers that a “sophisticated investor” should be able to satisfy at least two of the following, based on the standard for a “qualifying investor” in the European Union:

- » The person owns or manages a portfolio of financial products of at least \$1 million;
- » The person has carried out 10 or more financial product transactions per quarter of over \$2,000 in the last eight quarters; or
- » The person (or a director or employee with a key role in the investment decision) works or has worked for an investment business (defined above) for at least one year in a professional role that requires significant knowledge of investment in financial products.

Financial products in (i) and (ii) may need to exclude common retail products such as deposits, KiwiSaver, and superannuation schemes, as well as shares in businesses that the person controls.

Large businesses

Large businesses and other entities are not retail investors, and are expected to have access to resources and apply investment disciplines that mean they do not require all the protections of securities regulation in assessing securities offerings. MED proposes to define large entities as those which, over the last two accounting periods, have two of the following:

- » Gross assets of \$10,000,000;
- » Annual turnover of \$20,000,000; or
- » 50 or more full-time equivalent employees.

Entities that meet this threshold are required to comply with full generally accepted accounting practice under the Financial Reporting Act and Financial Reporting Standards.

Minimum subscription

MED proposes retaining the current exemption for persons who have, or are each required to, pay a minimum subscription price of at least \$500,000, and for subsequent offers to those investors. Some submitters to the RFPP proposed lower thresholds of \$200,000 or \$250,000. MED considers these amounts are too low, being well within the range of retail investment by individuals in, for example, failed finance companies. They do not propose to extend this in legislation to investors who are merely required to commit to paying \$500,000 in future.

Relatives and close business associates

MED proposes to retain the existing exemption for "relatives", to add an exemption for personal friends, and to create a number of safe harbours for who is a "close business associate", while retaining a principle-based definition.

MED does not propose to change the scope of the existing Securities Act definition of relative.

"Close business associate" is not defined by the Securities Act. Submitters to the RFPP had mixed views about whether to redefine close business associate to refer to specific relationships.

MED's view is that friends and close business associates could be defined in relation to the offeror as including:

- » Personal friends of the issuer or directors of the issuer;
- » Senior management of the issuer;
- » Investors with an equity stake above 10% in the issuer (i.e. major shareholders);
- » Directors, senior management, and major shareholders of related companies;
- » Persons who are partners to whom the Partnership Act 1908 applies;
- » Companies controlled by any of the above;
- » Relatives of the above, being children, grandchildren, parents, grandparents, and siblings of the person or the person's spouse; and
- » Any other person who, by virtue of their relationship with the issuer, has the knowledge or the means to obtain the knowledge of information that would normally be disclosed under the disclosure obligations in securities law.

The boundaries of the last subcategory "any other person..." are uncertain, but should be read as retaining the flexibility of the current definition, while the other specific inclusions provide safe harbours.

Employee share plans and other offers to employees

MED proposes to create an exemption that would apply to offerings of equity and equity options to employees of all companies (listed and unlisted), up to 15% of assets or 15% of the outstanding value of securities of the same class.

An additional restriction that they are considering is to require that employee share schemes are offered as part of an employment contract, and would form a single, discrete offering not integrated with any other offers. This would focus the scheme on the employment relationship and its role in remuneration rather than allowing offers to all employees for fundraising purposes.

Employee share schemes would be exempt from most disclosure requirements, but they propose that employees see the full terms of the offer, the purpose of the scheme and prescribed statements on the generic risks of such schemes. If the employer has an annual report or financial statements, these should also be provided. Employee share schemes would be subject to other requirements of the securities law.

Recommendations from independent financial advisers

MED seeks comments on the merits of an exemption for investors who have received a recommendation to invest from an independent financial adviser.

While the exemptions earlier in the discussion document are largely premised on investors being able to make their own judgements about whether or not to make an investment, an alternative approach is for them to rely on the advice of others with greater expertise. Traditionally this has not been a safe approach due to failings in the financial adviser industry. Advisers have often had conflicts of interest, lacked competency, or been negligent in their advice.

When the Financial Advisers Act 2008 is fully implemented, it will establish a new licensing regime for financial advisers that will include standards for disclosure, competency and conduct, as well as a dispute resolution scheme. It will still not be appropriate for investors to rely on the advice of many financial advisers, as they work for or receive commissions from issuers. However, some advisers will be truly independent and able to assist investors with their decision-making without regard to their own interests. The Taskforce proposed that offers to investors who have received a recommendation from a conflict-free financial adviser be exempted from the Securities Act.

A possible set of criteria for such an adviser are:

- » The adviser would be an authorised financial adviser under the Financial Advisers Act;
- » The adviser would need to be free of conflicts of interest. The general requirements for “independent financial advisers” are being developed for the Code of Professional Conduct. This requires that the adviser is independent of the issuer, and does not receive any remuneration from the issuer. An additional requirement could be that the adviser cannot have been recommended by the issuer; and
- » The investor would need to be supplied with a written statement recommending their subscription to the securities offering and confirming the lack of conflict.

Small offer exemption

MED proposes a small offer exemption with, as a basis for discussion, a maximum offer size of \$2 million from a maximum of 20 investors over a 12 month period, as in Australia. MED considers that the appropriate maximum offer size for offers making use of this exemption would depend on the other exemptions that are available. For example, if investors can opt out of the Act under a broad set of circumstances, they propose that the maximum offer size should be less than in some of the other countries with these provisions. However, if other exemptions are broad, the compliance costs in the absence of a small offers regime can be much lower than in the other identified jurisdictions – for example, it may only be the cost of investors’ receiving legal advice. In this case, this exemption would be primarily targeted at offers where even the low compliance costs of opting out are too onerous.

MED also proposes that small offers cannot be made through any general advertising or general solicitation, including newspapers, magazines, radio and television broadcasts, web pages accessible by the general public, or seminars advertised through one of the above media.

MED is also considering whether there should be a maximum amount per investor, such as \$100,000. Note that since a typical investment by a business angel in a start-up is \$20,000 to \$250,000, many angel investments would not be possible under such a limit.

Opt-out procedures

MED noted that some have suggested that allowance ought to be made for a broader range of investors to opt out of the Act.

MED set out various arguments for allowing opting out of the Act, but noted that consumer protection laws generally do not allow for contracting out. A further concern is that broad opt outs may undermine the regime in its entirety. An important cost of making a private offer is the limited pool of investors who are exempt from the Securities Act and willing to enter into private offers. As exemptions from a consumer protection regime become broader, the pool of exempt investors widens, and the cost of not complying with the regime reduces. At some point it is no longer cost effective to make a public offer and most or all offers of financial products become private.

MED is considering alternative procedures for opting out of the Securities Act, although they do not make any firm proposals at this stage. An opt-out could be available based on an agreement by the investor that some or all of the terms of the Securities Act will not apply to the offer, subject to some combination of qualifying criteria and procedural safeguards. Potential qualifying criteria are:

- » The investor has sought independent legal advice on the consequences of waiving their rights under the Act;
- » The investor has signed a prescribed statement waiving their rights under the Act, witnessed by their lawyer or some other third party;
- » An independent financial service provider or some other third party has certified that the investor is sufficiently sophisticated to protect themselves without the Act;
- » The investor meets some minimum objective standards of investment experience, with or without third-party confirmation;
- » The investor meets some minimum investor's income, wealth, or education standards, with or without third-party confirmation;
- » The investor is a member of an approved investment group, e.g. an angel network;
- » There are restrictions on offer size and marketing.

MED's comment: If an additional exemption is required, it could be developed through combinations of the above qualifying criteria. How restrictive the criteria ought to be is a judgement based on the trade-off between reducing compliance costs and protecting investors.

With respect to the Taskforce recommendation, MED is concerned that, notwithstanding the safeguard of independent legal advice, there remains a considerable risk that unsophisticated investors would be encouraged to make investments in rogue issuers on the basis of insufficient information and understanding. On the other hand, as additional criteria are introduced the number of investors that can make use of the exemptions is significantly reduced, as is the amount of capital available to private markets. MED is therefore seeking submitters' views on these criteria.

Self-certification vs third party verification of exempt status

MED proposes that, by default, responsibility for confirming that an investor is exempt from some of the requirements of the Securities Act will sit with the issuer. But investors will also be able to self-certify as fitting into one of the exempt categories, and this could be recorded, potentially on a public register (with appropriate privacy protections), that the issuer can legally rely upon.

MED proposes that the FMA should have the discretion to designate an investor or class of investors as being within or not within the scope of particular exemptions. These types of class designations would only last for a limited period. They also propose that a regulation making power be provided for to make these kinds of class designations without time restrictions.

Public register of exempt investors

MED also seeks feedback on whether the government should establish a public register of exempt investors. If there is self-certification, an exempt investor could be required to register, and to state which criteria they meet, but would not have to provide evidence or any other information about their financial activities to the FMA. If there is third party verification, the third party could provide a notice to the register. The issuer could use the register to confirm that the investor is exempt.

Void or voidable allotments for contravention

MED considered Taskforce recommendations about the harshness of an entire offer becoming void because a single ineligible investor (the current position under the Securities Act). MED proposes that offers made to ineligible investors should be voidable rather than void.

Chapter 3: Disclosure

Problem definition

- » MED cites the Taskforces criticisms that the current product disclosure is not sufficiently standardised, concise, simple or understandable, and it of little use to most retail investors. The regime is costly for issuers and largely ineffective for investors.
- » MED added that the current enforcement regime is slanted toward the prospectus when the most important document is the investment statement; the split between the those documents is ill-defined and there is much duplication; prospectuses, and many investment statements, are too long, making it less likely retail investors will read them.
- » Matters prescribed in prospectuses have not kept pace with market developments.
- » There is insufficient guidance as to what should be set out in investment statements, eg whether risks should be generic or confined to the product, issuer or industry.
- » The risk of liability encourages issuers to add in unnecessary matters.
- » Issuers have a disincentive to make adverse information easily accessible to investors. Investments also have a tendency to contain large amounts of marketing material that can detract from investors' ability to easily identify adverse information.

Form of offer document

After reviewing the RFPP and Taskforce recommendations (both to replace the investment statement and prospectus regime with a single, two-part document) and examples from the European Union and Australia, MED outlined three options: (1) status quo with improvements to the investment statement; (2) one document, containing a more detailed "part B"; and (3) one document, with additional disclosures (such as might have been included in a prospectus) available on a public register. It opted for the third, which is the only option described here.

The investment statement and prospectus will be replaced with a Product Disclosure Statement (PDS). This document would contain only the information considered crucial to an investor's decision. Information that an investor might want would not, however, be included in a later part of the document. Instead, the disclosure document would identify disclosures made elsewhere, and tell readers how to find them. No prospectus would be required. The disclosure document would be registered on the Securities Register, as well as being provided to subscribers.

The additional disclosures referred to in this single document could be made available on the issuer's website, but should also be made on the Securities Register irrespective of whether they are put on the issuers website or not. It is expected that the Register will comprise searchable fields for, among other things, issuer details, type of security, offer period, directors and other people involved in the offer. Other fields could comprise the terms and conditions of the offer, summaries of trust deeds and material contracts. Searchers would be able to obtain comparable information, side by side, on a range of investment products.

The PDS would include a two-page key information summary at the start.

The PDS would be heavily prescribed for mainstream products in order to promote comparability. Separate requirements would be prescribed for different types of financial product and different types of offer. This would enable comparability between similar products and offers, while ensuring the most relevant information is provided to investors.

MED further proposes that the level of standardisation would vary from financial product to financial product. The content would be prescribed in regulations made under the new securities legislation, as it is currently under the Securities Act. MED anticipates the greatest level of standardisation will be for CISs. For these types of products the length of the documents could be prescribed. For certain products, such as equities, prescribing the length of PDSs may not be practicable.

Contents of PDS (1): Key Information Summary

The PDS is in two parts: first, a 2-page key information summary and then the more detailed disclosures.

Risk disclosure in the key information summary

MED identified three options for risk disclosure in the key information summary:

- » **Self assessment:** An issuer could be required to state in the key information summary its opinion of the overall risk level in the form of a summary. The issuer could also be required to identify the (for example, top three to five) risks specific to the issuer or its industry, or specific to the securities on offer.
- » **Risk ratings:** Issuers could be required to apply a risk-meter or some other graphical representation such as a scale of, for example, one to five, or use a predetermined descriptor, with specific risks identified in the body of the document.
- » **Third party assessment:** There could be a requirement to obtain an independent expert's report on the merits and risk of the offer. This report would be summarised in the PDS with the full report to be lodged on the Register of Securities.

MED's preferred approach for the different categories of securities is:

- » **Collective investment schemes:** MED prefers self assessment in respect of CISs. A self assessment of the overall risk and the top risks should be set out in the key information summary. If a risk ratings system was developed, then the second option could be adopted. The EU is currently working on such a system.
- » **Equity securities:** MED prefers self assessment of the overall risk and the top risks to be set out in the key information summary, but seeks views on requiring an independent expert's report to be prepared for offers of equity securities.
- » **Debt securities:** In this case the risk ratings option is feasible, as credit ratings from recognised agencies are highly relevant to the risk and are relatively standardised. The issuer would be required to disclose the credit rating of the debt, and an explanation of what this means in the key information summary. If the debt is unrated, the summary would include a warning about that, and provide an overall self-assessment and the top risks.
- » **Derivatives:** A self assessment of the overall risk and the top risks should be set out in the key information summary. Derivatives might also be required to include a sophistication warning.

Content of key information summary (other than risk)

The key information summary is intended to be a short (around two pages) presentation of key information about the investment in an accessible format that is understandable and comparable for retail investors. The information to be disclosed would be prescribed by law; there would be no need to decide what information is key, nor any discretion to include, or exclude, particular information.

Different requirements would be prescribed for different financial products. In addition to risk, the key information summary may therefore include brief information on matters such as:

- » **Equities:** Details of the issuer including a brief description of its business, the type and class of security, the price, whether the securities will be listed, the issuer's dividend policy (including whether dividends can be reinvested), how investors can get their money out, and a summary of the purpose of the issue.
- » **Debt:** Details of the issuer including a brief description of its business, the type and structure of the security, the credit rating (if any), the interest rate (or how it is calculated), the term of the investment, whether and how an investor can withdraw before maturity, and a summary of the purpose of the issue.

- » **Collective investment schemes:** Details of the people involved in the fund's management; the investment options (conservative, balanced, aggressive etc.); the return objective, what the returns will consist of (interest, dividends, rent etc), and whether returns will be paid to investors, reinvested, or whether that will be optional; the asset classes invested in and the percentage range for each class; the fees (worked dollar examples), any minimum contribution levels or rates and how investors may withdraw their money.
- » **Derivatives:** The details of the counterparty to the derivative, the underlying commodity, index, asset or security, and how the derivative makes/loses value, potentially a statement that this is a complicated financial product that should not be entered into without financial advice, and how investors can get their money out.

The key information section would also include a prescribed text (probably a paragraph) briefly describing the type of investment product. This might be similar to material provided by the Retirement Commission.

Contents of PDS (2): Longer form disclosure

MED specified the information content required for the non-key information summary part of the PDS for the four categories of financial products.

Collective investment schemes

MED proposes that straightforward CIS PDSs will be required to contain a summary of all of the key information a client needs to know before deciding to purchase the product. The intent is that this document will be very prescriptive, specifying the number of headings, topics and, in exceptional circumstances, providing prescribed text. There would not be a requirement to disclose all material information in the PDS, but this information could be required to be registered and incorporated by reference.

More specific PDSs might be prescribed for other products such as bloodstock partnerships or property syndicates, due to the specific nature of these product classes.

Equity

MED understands that it is common practice to provide a prospectus to prospective investors for equity securities. As such, investors require fuller disclosure than would normally be contained in an investment statement. This suggests that the PDS for equity securities needs to meet these information needs, provided that detailed information could be summarised and incorporated by reference into the document and registered.

The International Organisation of Securities Commissions (IOSCO) has published International Disclosure Standards for Cross-Border Offerings and Initial Listings for Foreign Issuers, which it considers to be broadly accepted as a disclosure benchmark for equity securities. MED is likely to use these international standards as a starting point for the PDS, but with departures where appropriate and use of references to information on the Register of Securities. The exact detail will be covered as part of a later consultation on the design of the regulations.

Debt

The crucial information for an investor considering an offer of a debt security is the amount of the returns, and the risk that the issuer will default on payment of returns or repayment of the principal on maturity. IOSCO recently published International Disclosure Principles for Cross-Border Offerings and Listings of Debt Securities by Foreign Issuers, MED is likely to use these international standards as a starting point for the full PDS, but with departures where appropriate and use of references to information on the Register of Securities. The exact detail will be covered as part of a later consultation on the design of the regulations.

Derivatives

In bringing derivatives into the disclosure regime, MED proposes that issuers should register PDSs containing information on the classes of derivatives they offer, while allowing individual contracts to be customised, consistent with the PDS. The PDS for derivatives should be required to contain matters such as:

- » The name and contact details of the issuer/counterparty;
- » A description of how the derivatives work, and their key terms and features (including, for example, a description of the contract and the underlying, margins, liability, and delivery/settlement);

- » Other fees and costs;
- » Risks; and
- » Other material matters for the class of derivatives on offer.

Educational materials

The RFPP proposed to provide educational information either within, or as a supplement to, the offer document. The purpose of the educational material would be to facilitate investor understanding of the information disclosed. The Taskforce recommended signposts in Part B pointing to financial education resources such as www.sorted.govt.nz or the Securities Commission website.

A decision of whether to include this material in the document requires a trade-off between length and accessibility.

MED prefers the Taskforce's proposal. The PDS for all securities should include a link or description of where more information about investing can be obtained from the Retirement Commission and the regulator's websites.

Sophistication warnings

MED proposes that issuers make a self assessment of the risk of their product in their PDS. As a complement to this, they consider that it would be useful to consider whether the FMA should have the power to place a sophistication warning on a product to indicate that it is highly complex and/or likely to be more suitable for experienced investors. Such a label would be based upon a judgement as to the complexity of the product, rather than the risk of the product (which would be left to the issuer's self assessed risk rating).

MED recognises that, in imposing this label, the FMA would be stepping beyond checking whether disclosures comply with the law, into making more of a substantive judgement on the security, and that this could affect (while not actually preventing) the issuer's fundraising.

Provided the power came with appropriate safeguards, the existence of a labelling scheme administered by the FMA may be highly beneficial to investors' consideration of investment opportunities, and be relatively low cost to administer. MED notes, however, that safeguards would be essential so as to ensure that this did not overlap with the issuer's self assessed risk rating, or imply that the FMA was taking responsibility for the product in any way.

Short form prospectuses and simplified disclosure documents

The Securities Regulations currently provide for two situations where a short form disclosure document can be used, both of which apply in the case of subsequent offers:

- » Short form prospectus for offers to existing security holders; and
- » Simplified disclosure prospectus for listed issuers for further offers of its listed security and offers of equal and higher ranking securities (for which all material matters must be disclosed).

MED proposes maintaining short form or simplified disclosure documents in these circumstances, although the detailed disclosures in these documents will need to be determined when the regulations are developed.

Ongoing disclosure

Much of the current disclosure requirements under the Securities Act relate to disclosure at the point of sale, rather than ongoing disclosure to a holder of securities. MED considers that it is appropriate to look at whether additional ongoing disclosure to existing security holders should be required under securities law, at least in respect of certain kinds of security. Depending upon the circumstances, such disclosure could be either periodic or event based.

Continuous disclosure for debt

The key information for an investor in debt securities is information indicating the likelihood of default by the issuer. The matters indicating the likelihood of default by the issuer will need to have been disclosed in the PDS and on the offer page. In addition, where there is any material change in these matters during the year, MED would expect that this would have been reported to the trustee.

However, to ensure that such information is made available to investors and the public at large, MED proposes that debt issuers be required to update any material change to certain prescribed matters on the Register of Securities. These matters could include changes to credit ratings, changes to guarantors of the issuer, and significant changes to the terms of the trust deed. MED proposes to develop the full list of matters to be subject to event based disclosure in the design of the regulations.

Continuous disclosure for collective investment schemes

In April 2010 Cabinet agreed to the provision of a regulation that would require periodic reporting by KiwiSaver schemes to their members. Work is currently underway on designing these regulations, which are likely to require quarterly reporting of at least the following matters:

- » All fees and charges (for example, in the form of a total expense ratio);
- » Asset holdings;
- » Conflicts of interest (for example, investments in related parties); and
- » Fund returns (ideally both gross and net of all fees and taxes).

MED considers that quarterly reporting by schemes is appropriate, and that the above matters provide a good starting point for the matters that should be disclosed on this basis. The detail of the required contents of the quarterly reports will be filled out in regulations.

Principles-based disclosure

MED outlined the pros and cons of principles-based versus prescriptive disclosure and issues with the current (prescriptive) regime.

MED considers that the current approach of requiring specific disclosures, together with some sort of material matters disclosure, should continue as a general rule. The "all matters disclosure" should be required to be set out on the Register of Securities rather than in the PDS, but the PDS must appropriately summarise and/or refer to this disclosure.

Test for materiality

Materiality in terms of the Securities Act is not defined, but has been considered in a number of cases. In the Securities Markets Act material information, in relation to a public issuer, is information that:

- » A reasonable person would expect, if it were generally available to the market, to have a material effect on the price of listed securities of the public issuer (or, for exchange-traded futures, the value of the futures contract);
- » Relates to particular securities, a particular public issuer, or particular public issuers, rather than to securities generally or public issuers generally.

Certification and currency of offer documents

In relation to the issue of extension of prospectuses under section 37A of the Securities Act, and the corresponding director's certification, MED noted that, under its proposal, there will no longer be a registered prospectus to sign or extend so it should be unnecessary to replicate the relevant provision. If designed correctly, offer documents should not need to be periodically reissued or recertified unless material information has changed.

MED considers that there is value in initial certification by directors as it requires that the directors periodically turn their minds to the offer documents, but is not satisfied that every director should have to sign. Directors are liable for prospectuses whether they sign or not.

Promoters

Some market participants consider that the promoter definition is uncertain and difficult to apply, and catches mere distributors, facilitators, and third party contractors who do not intend to make representations or assurances to investors.

The policy intent behind attaching responsibility to a promoter is to ensure that a person who is behind an offer of a security to the public has liability even if they are not technically the issuer. This concept of promoter is different from

that of a distributor or third party seller of a product, whose liability is perhaps more appropriately dealt with through financial adviser regulation. However, where a person appears to the public to be the issuer or to be lending its brand to the issue (for example “white labelled” products), MED considers that that person should also be included within the definition of promoter.

Experts

MED recognises that in cases where an expert is used in advertising material, especially in cases where they are portrayed as an impartial third party, this may influence investors. As such there should be some regulation around the use of experts in advertising material. They question, however, whether the current requirements effectively protect against the misuse of experts. One option would be to remove the expert-specific requirements and simply apply the misleading standard that applies to advertisements generally.

Celebrity endorsements

There has been significant criticism of the practice of finance companies engaging well-known persons to appear in advertisements. Another criticised practice is the appointment of well-known persons to act as directors of finance companies and other issuers. In both cases, the issuer is effectively leveraging the reputation of the celebrity to imply that it has strength and integrity itself.

MED is not very concerned about the practice of appointing celebrity directors. A celebrity director is as liable for untrue statements as a non-celebrity, but is interested in views on whether a person who endorses a security offer in an advertisement should have similar liability to an expert for statements made by that person. The rule would have to make a distinction between a person appearing in the advertisement in an endorsing role and a person appearing simply as a performer and might be quite difficult to apply in practice.

Pre-prospectus publicity

The Taskforce recommended removal of the restrictions on pre-prospectus publicity. The policy behind the restriction is to limit the risk that issuers might “condition” the public towards acceptance of an offer on a basis that is not borne out by the facts subsequently disclosed in the registered prospectus or investment statement. While this is a serious policy issue, MED considers that the Taskforce’s recommendation has merit. Given the power to ban the advertisement, and that the directors are liable for any untrue statements in it, there seems to be limited risk in allowing other material in pre-prospectus advertising.

MED’s preliminary preference is to remove content restrictions and rely on the power to ban advertisements and liability for untrue statements.

Restrictions on advertising

MED considers that advertising should be regulated in a more principles-based fashion. Given the nature of advertising, and the ever-changing array of communication methods, a principles-based approach would give the FMA the ability to ensure that the guidelines around advertising are up to date and able to deal with the realities of the retail investment product market.

MED considers that advertisements should be guided by the two overarching principles: first, advertisements should not deceive, mislead or confuse (currently regulation 23 and section 38B(1)) and, second, advertisements should not be inconsistent with any offer documents (currently regulation 24 and section 38B(1)). These two principles should be included in the Act as a requirement that all advertisements must adhere to.

Some submitters to the RFPP stated that the definition of “advertisement” is too broad and, given the requirement for director certification of advertisements, this impedes communication with customers. In particular, advertising could be taken to include informal conversations and e-mails to a single customer. These cannot practically be certified, nor substituted for the prescribed content of an advertisement.

MED proposes to make a distinction between “communications” and “advertising”. “Communications” will be a broad concept, and there will be liability for false and misleading statements made in a communication. Advertising will be a subset of communications, and will include only public communications. Director certification and possibly other specific requirements will be applied only to advertising.

Chapter 4: Collective investment schemes

Problem definition

IMF and Morningstar have both judged New Zealand's regulation of collective investment schemes as poor, as did the Taskforce. The following have been identified as problems with the existing regulatory framework:

- » Inconsistent regulation across collective investment schemes' legal forms, inadequate measures for investor protection, and unclear duties and supervision of fund managers
- » No licensing of fund managers, which is inconsistent with many other jurisdictions.
- » Inadequate regulation of pricing and valuation methods, pricing errors, redemption and exit rules
- » Inconsistent content of constitutional documents, both between legal forms and between different collective investment schemes in the same legal form;
- » Lack of effective access to redress.

Requirements for public schemes

They propose that all collective investment schemes (CISs) will have to be registered before offering securities to the public. Before approving an application for registration, the scheme will be checked to ensure that it has:

- » A registered and (if required) licensed fund manager;
- » A registered and licensed supervisor; and
- » Constitutional documents that comply with the statutory requirements.

In addition to those legislatively defined roles and duties, MED proposes further controls on returns and pricing, constitutional documents, meetings and whistle-blowing protections.

Institutional requirements

All CISs will have a fund manager, which will be the issuer and an independent supervisor (eg for a trust, the trustee; or for a company, an independent supervisor).

Supervision

Supervisors will be licensed in accordance with the regime set out in the Securities Trustees and Statutory Supervisors Bill. The supervisor will be responsible for supervising the conduct of the fund manager (compliance with the law, trust deed, partnership deed, constitution, investment management agreement, etc.) and representing the interests of investors. In particular, the supervisor will be responsible for ensuring the custody of the assets of the scheme and supervising specific requirements such as pricing and valuation.

The supervisor will be required to report certain matters to the FMA. There will be no ability for the fund manager to remove the supervisor (unless agreed to by a court on application by the fund manager) and the supervisor will have the power to refuse to act on a direction of the fund manager if it is contrary to the terms of the constitutional document, investment policy, regulations or the best interests of investors.

Fund Manager's responsibilities

The fund manager will have responsibility for the offer and issue of securities, administration and investment management. The fund manager will always be considered the issuer in any CIS and will also be subject to registration requirements under the FSP Act.

MED proposes to strengthen the duties fund managers owe to investors by imposing a clear direct duty to act in their best interests. These proposals help set a clear expectation of fund manager conduct and enable both investors and the FMA to more easily monitor the conduct of the fund manager. The fund manager will also be legally responsible for investment decisions, even if they have delegated this function to an investment manager.

If the fund manager, or any delegate, breaches any of its duties owed to investors, the constitutional document or the terms of the offer, the fund manager will be liable to investors.

Custodian

Given the importance of ensuring assets are held in an appropriate manner, MED is considering a regulatory regime for persons that carry out these functions if they are not directly carried out by the supervisor. Currently, custodians will have to register under the FSP Act. MED is seeking feedback as to whether custodians should be subject to a more specific licensing regime.

Registration

Each scheme will be registered individually. The registration requirement would replace the current registration requirements for unit trusts and superannuation schemes, and apply to all CISs regardless of their legal form. Some schemes may have additional registration requirements depending on their legal form: companies will have to be registered as a company under the Companies Act; limited partnerships under the Limited Partnerships Act 2008; and KiwiSaver Schemes under the KiwiSaver Act 2006.

Both supervisors and fund managers will be registered as financial service providers under the FSPA, and belong to a consumer dispute resolution scheme that enables investors' practical access to redress.

Licensing

They are considering whether fund managers and custodians should be licensed, in accordance with international best practice. Licensing should provide greater protection for investors by ensuring the fund managers are fit and proper persons, and providing for direct oversight by the regulator. Licensing would impose higher obligations than the FSP Act currently does and would be intended to ensure issuers:

- » Are subject to consistent minimum standards of entry;
- » Are competent and have the capacity to carry out their functions; and
- » Are of good and sound character and the FMA is satisfied that they will act honestly and with integrity in carrying out their functions.

Licensing of fund managers is also likely to be necessary in order to comply with the UCITS model in connection with the possibility of New Zealand becoming an Asia-Pacific funds domicile centre. The alternative may be to rely on the disqualification provisions in the FSPA and oversight by a licensed supervisor.

Regulatory controls

In addition to the legislatively defined roles and duties for funds managers, statutory supervisors and custodians, They propose the following further regulatory controls:

- » **Asset valuation and pricing:** MED proposes consistent minimum regulatory standards regarding asset valuation, pricing and redemption. There should be legislative guidelines for valuations. Schemes should have the flexibility to determine the timing of valuations through negotiation between the fund manager and the supervisor, subject to a required minimum frequency for the valuation of assets and a requirement that all constitutional documents expressly include the details of the timing for valuation where it differs from the legislative guidelines.
- » **Constitutional documents:** Functions, duties and processes will be prescribed in legislation or implied into constitutional documents. Implied provisions might include, for example, processes to change constitutional documents, remove fund managers and supervisors and call meetings. In addition to implied provisions, MED is considering whether a number of matters must be included in constitutional documents, namely: Investment policy and objectives; Conditions of scheme entry and exit; Contribution levels and rates; Authorised investments; Returns and pricing; Fees; and Winding-up.
- » **Meetings:** MED is considering imposing a threshold of 1/20th of the number of unit holders or alternatively unit holders with over five percent of the value of units in the scheme.

- » **Whistle-blowing protections:** The Superannuation Schemes Act currently contains a whistle-blowing provision requiring any administration manager, investment manager, actuary or auditor of a scheme to disclose information to the regulator where they form the opinion there is a serious problem with the scheme, plus associated protection against any liability for such disclosure where it was made in good faith. MED considers such a duty and corresponding exemption from liability to be, on balance, an important mechanism in minimising the risk of unfair and fraudulent conduct as it provides another check and balance on the issuer and supervisor and enhances investor protections.

Initial and ongoing disclosure

There will be a common set of initial and ongoing disclosure requirements, although where necessary, these will be tailored to the type of product. As part of the decisions made by Government in April 2010, a discussion document is being prepared with respect to periodic reporting requirements for retail KiwiSaver schemes, which will be required to periodically publish and provide to the regulator, specified information on fees, returns, asset allocation and conflicts of interest in a prescribed manner. (Discussed further in Chapter 3.)

Asia-Pacific funds hub, "dual regime"

The Government is investigating the possibility of New Zealand becoming an Asia Pacific centre for fund domicile and servicing. In evaluating this opportunity, other fund domiciles have been considered, particularly Ireland. The European Union's Undertakings for Collective Investment in Transferable Securities (UCITS) is the predominant global investment vehicle used. For New Zealand to become a successful funds domicile it requires a world class regulatory regime and this means it must either meet or better the UCITS regime.

Rather than impose the required regulatory regime on all CISs within New Zealand, an option is to introduce a "dual" regime. This would mean that schemes which trade domestically would only be required to meet the standards proposed in the discussion document, and schemes trading internationally would have to meet a more onerous regime similar to UCITS. This would avoid unnecessarily imposing stricter standards and higher costs on domestic schemes while creating the reputation and regime needed for a managed funds domicile. While the domestic regime might be less onerous, MED expects that it will adequately meet the needs of New Zealand consumers and providers. This is the approach used in Ireland, which apply different regulations to UCITS and non- UCITS schemes.

Chapter 5: Other matters

Treating customers fairly

MED is considering regulations that would require those providing financial services to retail customers, at any point in the value chain, to do so in a manner which treats those investors fairly. The objective would be to establish principles that would allow market participants to be held to account for behaviour that did not treat customers fairly, even if it would otherwise not be contrary to the requirements of the law. A principles-based approach ensures that the regulatory regime is more likely to keep pace with market developments. However, a potential disadvantage of a principles-based approach is uncertainty for market participants as to how particular products or practices will be viewed by the regulator. This disadvantage could, at least partially, be dealt with by the regulator issuing guidance on how it interprets the principles.

An option to implement the principle of fairness could be for the FMA to develop a code of practice for financial market participants, which could be similar to the process for developing the code of professional conduct for authorised financial advisers under the Financial Advisers Act. Another alternative could be to provide for the incorporation of a code of practice into dispute resolution schemes that financial service providers must join under the FSP Act.

Securities markets

MED is considering the requirements for registration of exchanges, currently contained in Part 2B of the Securities Markets Act and, in particular, the extent to which there should be varying levels of requirements for different types of exchanges, with corresponding duties (as to ongoing disclosure, insider trading and market manipulation rules etc) applying to participants. There are other issues with the current regime, which have little indication as to what types of facilities are intended to be regulated.

Access to securities registers

Concerns have been raised about the ability of third parties to access share registers or registers of security holders for improper purposes, such as the solicitation of donations or making predatory offers to buy securities from investors.

After reviewing the approaches taken in Australia and the UK, MED is not convinced that New Zealand should adopt a similar approach as they have not seen evidence to suggest that there is a significant problem in New Zealand. In redrafting the Securities Act, the provisions relating to access to securities will be informed by the Privacy Act 1993. This is likely to result in changes to the provisions to explicitly include privacy principles into the provisions around access to securities registers, which should deal with use of registers for direct marketing of unrelated products and other similar issues.

In relation to registers being accessed to make 'predatory' offers to investors, MED is not convinced that there is anything improper about an offer to existing holders per se. The issue is whether the offer is predatory, but there are risks in the issuer having effective control over what offers are made to its security-holders, and MED is not convinced that a court or a company is necessarily in a good position to determine whether or not an offer is predatory.

Hague convention on indirectly held securities

The Hague Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary was developed because there was no common legal approach internationally to determine the applicable law governing proprietary issues affecting securities holdings in securities accounts maintained by an intermediary. It is a conflict of laws convention which applies only where securities are held by an intermediary and provides for rules to determine the applicable jurisdiction. MED proposes alignment with this regime.

Financial Markets Authority

In this section MED looks at the powers and responsibilities that ought to be held by the new FMA, including the ability of FMA to make binding rulings, issue retrospective regimes and issue no-action letters, and the parameters around any such powers. There was also the suggestion that a Rulings Panel, to be established to deal with enforcement of NZX Listing Rules, could have some of these functions (particularly binding rulings). MED is concerned about retrospective validation of a breach of law, considering there would be better ways to achieve the objectives raised by the Taskforce. In relation to no-action letters, there is currently nothing preventing them so the issue is whether the power should be set out explicitly in legislation.

FMA's powers to bring proceedings

In this section, MED considered whether existing powers in the Securities Act and Securities Markets Act for the Securities Commission should be expanded under the FMA regime. This could include specific powers to cause civil proceedings to be brought on behalf of other persons, for example to recover damages for fraud or negligence, and whether should take over from the Commerce Commission responsibility for enforcing the Credit Contracts and Consumer Finance Act 2003. Also considered was whether there should be provision for class actions, but this is subject to a separate Ministry of Justice review.

Probably the most significant proposal is that FMA should have the power to enforce directors' duties and, in addition, whether these duties should be subject to criminal enforcement. MED has not drawn any conclusions to date on whether there should be public enforcement of directors' duties, but considers that the case for establishing criminal offence provisions appears to be stronger than the case for civil penalty provisions, providing that the criminal offence provisions include a "guilty mind" element.

Management bans

MED looked at whether the current provisions for management bans are sufficient and recommended increasing the maximum period for regulator-imposed bans to 10 years and empowering the High Court to impose indefinite banning orders.

Culpable bankrupts

MED proposes to introduce a power for the Official Assignee to extend the term of bankruptcy for up to seven years beyond the original three years (subject to a right of appeal to the High Court) and to impose the onus of proof on a

person who has been bankrupted on two or more occasions to demonstrate why they should be discharged after three years.

Infringement notices

MED considers a proposal for infringement notices for minor breaches of securities laws, but thought that these were unlikely to be a useful deterrent.

Special partnerships

MED proposed that it be clarified that a special partnership which re-registers as a limited partnership under the Limited Partnerships Act 2008 succeeds to the rights and liabilities of the special partnership.

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