LEGISLATION NOTE

Financial Markets Conduct Act 2013

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I INTRODUCTION

The Financial Markets Conduct Act 2013 (FMCA) has taken almost 10 years to come to fruition. The Act aims to promote healthy financial markets in New Zealand by focusing on the confidence and informed participation of businesses, investors and consumers in financial markets.[1] The Act is part of a broader set of reforms that stem from the Review of Financial Products and Providers in 2005. It responds partly to the Global Financial Crisis, failings of New Zealand finance companies and the subsequent recommendations of the Capital Markets Development Force.[2]

This article first considers the development of the FMCA in the context of responding to, and being driven by, the financial crises of 2007 and 2008. Secondly, this article will evaluate the Act as a forward-looking framework for finance in New Zealand. The authors will particularly focus on peer-to-peer lending schemes, which embrace new ways of financing driven by online access. Lastly, some consideration is given to whether the Act has gone too far down the path of merit-based regulation, for example, in the introduction of intermediary licensing requirements in response to the financial crises.

This article concludes that the FMCA has struck an appropriate balance between promoting investor confidence, and being ambitious and forward-thinking in seeking to develop New Zealand's capital markets.

II THE DEVELOPMENT OF THE FMCA: A CONTEXT OF FINANCIAL CRISIS

The story of New Zealand securities regulation is essentially the story of post-crisis clean up.[3] The Securities Act 1978 can be seen as a response to the collapse of Securitibank, which utilised a fundraising structure that circumvented the fundraising provisions of the previous Companies Act 1955. Equally, the FMCA of 2013 can be seen as responding to the

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1 Financial Markets Conduct Act 2013, s 3(a) and (b).

2 *A Guide to the Financial Markets Conduct Act 2013 Reforms* (Financial Markets Authority, November 2013) [*FMCA Guide*].

3 Gordon Walker "Reinterpreting New Zealand Securities Regulation" in Gordon Walker (ed) *Securities Regulation in Australia and New Zealand* (2nd ed, LBC Information Services, Sydney, 1998) 88.

2007/2008 global recession, the subsequent round of finance company collapses and the Blue Chip saga.[4] From 2008, there was public demand for tougher regulations. In particular, people were looking for a wider range of powers for the regulator to be able to intervene in advance to protect investors, rather than waiting for harm to occur and subsequently widening the range of civil and criminal penalties for defective, negligent or misleading disclosure.

The Act can also be seen as being driven by the global recession in its progress through Parliament. Initially, the Labour Government mooted a review of the Securities Act in 2007/2008. Later, Simon Power of the 2008 National Government vigorously pursued the FMCA. He saw the potential to reform the capital markets and took the lead by getting the Ministry of Economic Development to review current securities laws and set up a process for reform. The Securities Act — now 30 years old — was seen as outdated, costly, inefficient and out of pace with international regulations. There was some pressure from Australia and other jurisdictions for New Zealand to modernise its securities law, especially around disclosure documents and governance requirements.[5]

The Capital Markets Development Taskforce was set up to review New Zealand's financial system and its efficiency, productivity and global competitiveness. It was launched in early 2008 by Lianne Dalziel as Minister of Economic Development for Labour, and tasked with developing a blueprint and action plan. The Taskforce was a collection of industry experts with business, finance, economics and legal backgrounds, as well as public sector participants drawn from the Ministry of Economic Development, the Treasury, the Reserve Bank and the Inland Revenue Department. Simon Power in a press release in early 2010 said:[6]

> We need to rebuild mum and dad investor trust in capital markets which has been severely dented by the global recession and finance company collapses. We want everyday investors to feel more confident about putting their savings into capital markets, through understanding the basics of investment, getting advice they can trust, and making informed choices.
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> ...
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> The taskforce identified flaws in our markets and where there are opportunities for improvement, and we need to act quickly to fix them.

The Taskforce made more than 60 detailed recommendations to the government. Not all of them were adopted in the drafting of the FMCA, although a significant amount were, and the broad objective of devolving the

4 See *Hickman v Turn and Wave Ltd* [2011] NZCA 100, [2011] 3 NZLR 318.

5 Michel Prada and Neil Walter *Report on the Effectiveness of New Zealand's Securities Commission* (September 2009) at 7.

6 Simon Power "Govt responds to capital markets recommendations" (press release, 18 February 2010).

capital markets to ensure growth while providing for adequate investor protection is certainly an important theme in the FMCA.

An example of the link between the Taskforce's findings and the subsequent FMCA scheme are the revamped disclosure requirements. The Taskforce recommended that the government introduce plain English into investment statements and prospectuses, with clear warnings on risky or complex products. The Taskforce criticised disclosure as not being sufficiently standardised, concise or comprehensible.[7] The FMCA then enacted a requirement for issuers to prepare a single product disclosure statement (PDS) that is aimed at prudent, non-expert investors and is required to be worded clearly and efficiently.[8] If the PDS is defective, investors could be entitled to a refund, while issuers could face civil or criminal liability.

III RESPONDING TO THE FINANCIAL CRISIS: REFORMS TO RESTORE INVESTOR CONFIDENCE

A key theme underlying the legislation is the perceived need to promote (or restore) investor confidence, in part as a response to the events of 2007/2008. This theme is apparent in the reform of the criminal liability regime, the powers of the Financial Markets Authority (FMA) and the reformulation of the securities definition.

Criminal Conduct Provisions

The reforms to the liability regime under pt 8 of the FMCA have attracted considerable public attention. This is unsurprising given the widespread losses suffered by investors as a result of the failure of the finance company sector during the Global Financial Crisis and the high-profile criminal prosecutions of directors resulting from those failures.[9]

The reform attempts to strike a balance between the competing objectives of promoting compliance with the law and deterring conduct that undermines market integrity. Equally, the aim is to not be unreasonably strict so as to deter conduct that is beneficial for society.[10] The increased emphasis on civil sanctions brings New Zealand into line with international trends and it is hoped the streamlined and accessible liability provisions will promote investor confidence.[11]

There are three main changes to criminal liability under the FMCA. First, the Act narrows the scope for criminal liability with an emphasis on civil over criminal sanctions for violations of the Act. Secondly, fault

7 *FMCA Guide*, above n 2, at 22.
8 At 21. See also pt 3 of the FMCA, above n 1.
9 Thomas Gibbons and others *Morison's Company and Securities Law* (looseleaf ed, LexisNexis) at [6,002,007].
10 Ministry of Economic Development *Financial Markets Conduct Bill: Initial Briefing to Commerce Select Committee* (1 May 2012) at [83].
11 Gibbons, above n 9, at [6,003,601].

elements of knowledge or recklessness are introduced for the key criminal offences. Thirdly, the Act increases the maximum available penalties for those who are convicted.

The FMCA introduces an escalating hierarchy of liability. This hierarchy aims to ensure that the enforcement response is proportionate to the conduct in question. Criminal liability is reserved only for the most egregious violations of the Act, while civil pecuniary penalties, infringement notices and other regulatory tools serve as the primary enforcement measures.

Under the Securities Act, the key offence for material misstatements in an offer document was a strict liability offence, meaning criminal liability could be imposed even where directors acted honestly and diligently. The FMCA has departed from this approach. The three primary offences found in ss 510–512 now require fault elements of knowledge or recklessness. The provisions hold offerors criminally liable for knowingly or recklessly contravening the prohibition on offers where there is defective disclosure in the PDS or register entry. Directors of the offeror will be criminally liable if the offer took place with their authority, permission or consent, if they knew or were reckless as to whether there was defective disclosure.[12] There is also a similar offence for knowingly making (or authorising the making of) a statement in a document required by the Act that is false or misleading in a material particular.[13]

These changes address the uncertainty of the Securities Act regime.[14] The clarity of the provisions under the FMCA result in them being easier to comply with. This facilitates market activity by reducing the risk of bona fide offerors being deterred from beneficial conduct by uncertain and highly punitive criminal sanctions in the event of failure.[15]

While the scope of criminal liability has been narrowed, the FMCA provides for a higher maximum penalty when convicted. An individual may be liable to imprisonment for a term of up to 10 years or a fine of $1,000,000 (or both). A company is liable for a fine of up to $5,000,000.[16]

It is also relevant to note that subpt 5 gives the FMA the power to issue infringement notices for less serious contraventions of the Act, as an alternative to prosecution. This procedure is designed to allow for proportionate liability for contraventions that otherwise may not be prosecuted due to cost and enforcement priorities.[17] Again, this is consistent with the objective of promoting confidence in the regime.

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12 FMCA, above n 1, ss 510–511.

13 Section 512.

14 One example of uncertainty under the Securities Act regime is the highly protracted enforcement proceedings of Lombard Finance directors. See for example *Graham v R* [2013] NZSC 104; *R v Graham* [2012] NZHC 575; *R v Graham* [2012] NZHC 265; *Jeffries v R* [2013] NZCA 274; and *Jeffries v R* [2013] NZCA 188.

15 This risk is also reduced through the introduction of a due diligence defence against civil liability: see s 499.

16 Section 510(3).

17 Gibbons, above n 9, at [6,002,110].

FMA Powers

The criminal and civil liability regime is supplemented by the enforcement tools of the FMA at the lower end of the hierarchy of liability. The FMA has indicated that it is committed to proportionate enforcement action and will use the full toolkit available to promote investor confidence.[18]

The main tools are the stop order and direction order. Stop orders may be made under ss 462–467 to prohibit further action in respect of offers of financial products with disclosure that is likely to deceive, mislead, or confuse, and other contraventions of the Act.[19] Direction orders are available under ss 468–469 to require a market participant to take stipulated reasonable steps to remedy a breach, avoid contravention, or mitigate the effects of contravention, of an obligation under the Act. In addition, the FMA may make orders to prohibit simplified product disclosure statements under s 471 and orders to prohibit offers under ss 471–473.

The FMA may make an order on the terms and conditions that it thinks fit. It may vary, revoke or suspend any order.[20] Non-compliance with an FMA order under subpt 1 is a criminal offence.

These powers are fine-grained tools that guide issuers to comply with their FMCA obligations. They can be enlisted as a proportionate response to minor contraventions, and thereby avoiding the potentially disruptive effects of stronger regulator action.

IV CREATING NEW OPPORTUNITIES FOR CAPITAL MARKETS IN NEW ZEALAND

The FMCA is not solely focused on investor protection. Section 4(d) explicitly provides that a purpose of the Act is to promote innovation and flexibility in the financial markets. This indicates a modern, forward-thinking approach to securities law in New Zealand.[21]

This aim is reflected in the introduction of peer-to-peer lending and crowd funding to the New Zealand marketplace and the expansion of regulation powers to keep pace with innovation in the sector.

Peer-to-Peer Lending

Peer-to-peer lending is a platform for raising capital through online forums. The platform links borrowers with private lenders, essentially bypassing banks. The online forum gives lenders the opportunity to bid for prospective loans. Equity crowd funding works through many people investing small

18 "FMA Enforcement Policy" (3 October 2014) Financial Markets Authority <www.fma.govt.nz>.
19 *Initial Briefing to Commerce Select Committee*, above n 10, at [86].
20 Section 478.
21 Gibbons, above n 9, at [6,002,802].

amounts to raise money for a company or project. By putting money into crowd funding, investors are purchasing shares in that business or project.[22]

Peer-to-peer lending platforms such as Harmoney cite more competitive interest rates and therefore increase transparency for both parties.[23] RateSetter suggests the platform can also benefit society as a whole, through reducing systemic risk and increasing competition in the banking sector.[24] However, peer-to-peer lending is not risk-free. It is characterised by its use by untested, speculative and small businesses.[25] The FMA warns investors that they may not get their money back.

The FMCA provides for a new category of "licensed intermediaries"; persons licensed to provide peer-to-peer lending and crowd funding services. Offers through licensed intermediaries are excluded from disclosure requirements under pt 3.[26] The exemption provides for the licensing process under pt 6 to provide an appropriate safeguard for investors instead of the disclosure process.[27]

The intention of including these activities in the licensing regime is to enable them to operate as licensed services under the supervision of the FMA, rather than through the disclosure regime. In effect, the protection for the general public is to come from the licensing regime of the FMCA — through requirements for disclosure to clients about the services provided and FMA supervision of the licensed service providers — rather than the use of offering documents under the disclosure regime.[28]

The Financial Markets Conduct (Phase 1) Regulations 2014 provide for a $2,000,000 "aggregate limit" on peer-to-peer lending and crowd funding services in any 12-month period. This cap applies to issuers, not investors. It should be noted that the FMCA regime does not impact on the use of crowd funding for artistic or philanthropic purposes. Such activity is well established in New Zealand and does not raise legal issues from a securities law or financial markets perspective. Generally under such offers, any "reward" for participating is either the satisfaction of supporting a good cause or a non-financial reward such as concert tickets.[29]

In July 2014, the FMA announced it had licensed the first peer-to-peer lending platform and expects to soon license a crowd funding platform.[30] This area of reform is a prime example of New Zealand embracing technology and innovative developments in the finance sector.

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22 The FMA released an online brochure: "Crowd funding: investing with the crowd" (June 2014) Financial Markets Authority <www.fma.govt.nz>.

23 Harmoney <www.harmoney.co.nz>.

24 Letter from Daniel Foggo (Chief Executive Officer of RateSetter Australia Pty Ltd) to the Financial System Inquiry regarding peer-to-peer lending (31 March 2014).

25 Sue Brown "Opinion: Crowd funding and peer to peer lending: Will it end in tears?" *NZ Lawyer* (online ed, Auckland, 23 July 2014).

26 Part 3 requires issuers to prepare a single PDS aimed at prudent, non-expert investors and worded in a clear, concise and effective manner.

27 Gibbons, at [6,002,008].

28 At [6,002,106]–[6,002,107].

29 At [6,003,404].

30 Brown, above n 25.

The progressive regime brings New Zealand in line with developments in the United Kingdom and the United States.

Excluded Offers

The FMCA introduces "bright line" exemptions for key excluded offers. This streamlined approach will provide greater clarity for entities seeking to raise capital and their advisers.

The new approach is that offers of financial products for issue require disclosure under pt 3 unless an exclusion under pt 1 of sch 1 applies.[31] Equally, all offers of financial products are regulated offers under the Act unless they are being offered to investors to whom disclosure under pt 3 is not required.[32] The key excluded offers are offers to wholesale investors, offers to close business associates and relatives, and offers under employee share purchase schemes, small offers and offers to certain classes of persons (including registered banks, the Crown, a range of public bodies and the Reserve Bank).[33]

The exclusion for small offers is one of the key changes under the Act.[34] This exclusion, based on Australian law, allows issuers of equity or debt securities to raise up to $2,000,000 during any 12-month period from up to 20 investors.[35] This exemption will make early stage capital raising easier and reduce unnecessary risk.

Regulation Powers

Part 9 of the FMCA provides for the creation of regulations to give effect to the other provisions in the Act. The regulations will fill in the details of the Act, including prescribing the form and content of product disclosure statements and eligibility criteria for the issue of market service licences.[36] The Ministry of Economic Development's Initial Briefing to the Commerce Select Committee, which considered the Financial Markets Conduct Bill, stated that flexibility in regulations was essential in order for the regime to be adaptable to new situations.[37] The broad pt 9 powers will allow the regime to keep pace with innovation in the financial sector without time-consuming legislative amendments.

The Minister is required to consult the FMA before making a recommendation for regulations.[38] This explicit step gives a formal influence to the FMA over regulation.[39]

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31 Section 39.
32 Section 41.
33 Gibbons, above n 9, at [6,002,009]; and sch 1, cls 3–23.
34 Schedule 1, cls 12–14; and Gibbons, at [6,002,009].
35 *Initial Briefing to Commerce Select Committee*, above n 10, at [42].
36 Sections 543–546.
37 *Initial Briefing to Commerce Select Committee*, at [98].
38 Section 549.
39 Gibbons, above n 9, at [6,002,111].

Part 9 extends the FMA's existing exemption-granting power to the provisions of pt 2–7 and any schedules and regulations made under the Act. It is expected that the power will be used less under the new regime. But where necessary, it will be employed to deal with particular issues as they arise as well as for unusual circumstances.[40]

Subpart 3 introduces the FMA's new designation power. This is intended to ensure the regime is sufficiently flexible to deal with complex financial instruments and to ensure that the purposes of the Bill (including prompting innovation in financial markets) are not frustrated.[41] This power is subject to procedural safeguards, including that the FMA must first consult the persons affected and that a declaration does not operate retrospectively.[42]

Finally, pt 9 provides for the FMA to issue frameworks or methodologies relating to detailed or technical matters of the Act. [43]

There is a concern that flexibility comes at the cost of certainty and transparency. Leaving the substantive details of the regime up to regulations has the potential to produce a maze of delegated legislation, arguably detracting from the attempt to create a clear and accessible regulatory framework in the sector. Moreover, there is a degree of discomfort with granting the executive broad powers to develop the detail without the regular checks and balances of a legislative process.

The Reformulated Definition of Securities

The definition of "securities" and nebulous subcategories, such as participatory securities and debt securities, were subject to considerable litigation under the old Act.[44] In general, the definitions in the Securities Act were largely based on the legal form of the security, rather than their economic substance or purpose. This created loopholes for issuers and the ability to create novel products that avoided regulation, most notably the Blue Chip Schemes.

The FMCA attempts to remedy this by defining products more broadly, focusing on their economic substance. It defines four types of financial products: debt, equity, managed investment products and derivatives.[45] The "managed investment product" is an idea inherited from Australian law and provides much needed clarity. Furthermore, the courts can now rely on a broad range of Australian case law to define difficult concepts like security. That will help deal with future changes through market movements and new innovations, for example, new forms of equity, shared participation in early stage companies, or new forms of property investment or ownership. The FMCA also redefines "debt-security" as a

40 *Initial Briefing to Commerce Select Committee*, above n 10, at [100].

41 At [102].

42 Sections 563–564.

43 Section 567.

44 See for example *Hickman*, above n 4, dealing with participatory securities; and *Culverden Retirement Village Ltd v The Registrar of Companies* (1996) 1 BCSLR 162 (CA) dealing with debt securities.

45 *FMCA Guide*, above n 2, at 9. The definitions in the FMCA are at ss 6–10.

right to be "repaid money" in contrast to the definition in the Securities Act of a right merely to be "paid" money.[46] A broader change is reflected in the change from the phrase "securities" in s 2 of the Securities Act to "investment products" in ss 7–8 in the FMCA. This indicates a departure from the traditional understanding of a security as form-based to a regime that is concerned with the economic substance over the legal form.[47]

Furthermore, where there is doubt, the FMA has the power to categorise products approriately, giving the authority the ability to respond to novel products or schemes.

This subtopic ties in with the theme of responding to the financial crisis by giving the regulators more powers to respond to novel schemes. This promotes investment confidence by attempting to prevent Blue Chip type-scenarios from recurring.

V THE RETURN TO MERIT-BASED REGULATION?

Arguably, in being driven by a response to the financial crises, the reforms have erred on the side of caution. This is particularly reflected in the return to investor-focused regulations as part of a broader shift to merit-based regulation.

The philosophical aim of regulation in New Zealand has been traditionally aimed at disclosure-based regulation outside the banking sphere.[48] This is designed to ensure full information transparency for investors in the market. Contrast this with merit-based regulation, which gives the regulator powers to exclude subjectively illegitimate parties or securities from the market.[49] The justification of disclosure-based regulation is to promote freedom in the market, uninhibited by assessments of legitimate "risk" from the regulator.

A Treasury working paper on financial systems and economic growth states:[50]

> The preference for a disclosure based regime for the non-bank parts of the system in New Zealand over merit regulation reflects a view that with a disclosure based regime well-informed markets can develop their own solutions to many of the problems caused by asymmetric information and that more direct merit regulation can undermine those market solutions.

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46 FMCA, above n 1, s 8(1)(a).

47 Evan Mackenzie Jones "Has the Supreme Court *Turned and Waved* Goodbye to the Essence of the New Zealand Securities Regime? An Analysis of the Purposes Underpinning Securities Market Regulation in New Zealand" (LLB (Hons) Dissertation, University of Otago, 2013).

48 Iris Claus, Veronica Jacobsen and Brock Jera *Financial systems and economic growth: An evaluation framework for policy* (New Zealand Treasury, Working Paper 04/17, September 2004) at [8.3].

49 Matthew Harrison "Disclosure-Based Regulation" (June 2000) HKEx <www.hkex.com.hk> at 3.

50 *Financial systems and economic growth*, above n 48, at [8.3].

One of the biggest changes is that the new regime will regulate the offeror and the issue of securities somewhat separately. Under the Securities Act, the conduct of the issuer or offeror was regulated after they had commenced an issue onto the market. This is visible in the form of the various "licensing" requirements that apply to the operators themselves.[51] This creates barriers to entry in terms of things that issuers have to do to be able to offer or deal in securities but arguably it improves standards. This makes it easier for the regulator to exclude dubious operators before any financial loss is incurred by investors.

These changes bring New Zealand in line with Australia and, to an extent, the United Kingdom, as the regulatory approaches are split into this same structure: regulate the person; and regulate the offer.[52] This type of regulation is also consistent with the recommendations of groups like the Capital Markets Development Taskforce, in particular with its aim of developing New Zealand into a financial services hub.

However, the changes arguably restrict entry into the market unnecessarily. The principle of disclosure-based regulation is one of free market ideals; fully consenting, informed individuals ought to be capable and responsible in their investments.[53] The regulator, excluding some investors or offers, for example in the peer-to-peer context, can plausibly be seen as discouraging positive risk-taking and biasing the market against smaller start-up offers.

Regulators can often act conservatively and limit innovations. Innovations, while risky, can also drive efficiency and result in better returns for investors.[54] Merit- based regulation may produce a perverse outcome — investors may think that the investment must be 'good' if a regulator has reviewed an operator. This may mislead investors as to the risk of the investment. In fact, failures in the market can eventually help to ensure that securities are priced properly for the risk. This is the underlying rationale of the Treasury's statement above, whereby full information eventually allows market solutions.[55] However, in the wake of the public demand for increased regulation following 2007/2008, the Government is eager to be seen to be protecting peoples' investments. It is too early to say whether the FMCA is too investor-protective in this respect.

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51 FMCA, pts 5 and 6.

52 "The Financial Conduct Authority: *An overview*" (1 April 2013) Allen Overy <www.allenovery.com>.

53 Harrison, above n 49, at 2.

54 Foggo, above n 24, at 4.

55 *Financial systems and economic growth*, above n 48, at [8.3].

VI CONCLUSION

Many of the provisions of the Act have yet to come into force, and businesses have a two-year period to ensure compliance with the new regime. It is perhaps therefore too early to make conclusions about the long-term impact of the reform. Starrenburg and Tubman in a 2013 New Zealand Law Society Intensive Conference stated:[56]

> [A]t this stage the general consensus is that the Bill represents a more rational regime and is a great deal more targeted than the current regime, reflecting the significant amount of industry input that has gone into the Bill.

Nevertheless, the authors consider the reform has struck a positive balance between promoting investor confidence and facilitating market activity. While the reform has been heavily influenced by fears flowing from the financial crisis, it also represents a progressive modernisation of the law in this area, providing an integrated and enduring framework for the regulation of New Zealand's financial markets.

56 Nathanael Starrenburg and Tim Tubman "The Finacial Markets Conduct Bill – a new approach to raising capital" (paper presented to the New Zealand Law Society Commercial Law Intensive Conference, June 2013) 31 at 31.