

## PAPER PRESENTED AT THE ALUMNI SYMPOSIUM 2014

*The 2014 Alumni Symposium, held on 15 September 2014, involved a panel discussion on the Financial Markets Conduct Act 2013. The panel consisted of distinguished alumni Roger Wallis (Publishing Editor, 1992; now partner at Chapman Tripp), Rachel Paris (Contributor, 1999; now partner at Bell Gully) and Garth Stanish (Contributor, 1993 and 1994; now Head of Markets Oversight at the Financial Markets Authority). The panel was chaired by Nick Williams (Editor-in-Chief, 1994; now partner at Meredith Connell). We would like to thank our panellists and chairperson for their participation in our Symposium. This paper is written by panellist Rachel Paris for her presentation at the Symposium. We are extremely grateful that Rachel has given us the opportunity to publish her paper.*

### ***Curbing “Irrational Exuberance”: Conduct and Governance in the Financial Markets Conduct Act 2013***

RACHEL PARIS

#### I INTRODUCTION

The Financial Markets Conduct Act 2013 (FMCA) is founded on the core principles of conduct, governance and disclosure in order to promote confident participation in fair and efficient financial markets.<sup>1</sup> The emphasis on conduct and governance is noteworthy because it evidences a pendulum swing back to a middle ground after a long period of reliance on disclosure as the primary investor protection tool.<sup>2</sup>

Alongside new licensing requirements, the FMCA’s focus on minimum conduct and governance standards recognises that financial markets are prone to market failures and that disclosure is not a complete solution to managing that risk — a recognition that was inescapable for the lawmakers who honed the drafting of the new Act in the aftermath of the 2009 global financial crisis and New Zealand’s own finance company sector collapse. Those lawmakers were also influenced by the rise of behavioural

---

1 The main purposes of the FMCA are set out in s 3 and are supplemented by the additional purposes specified in s 4.

2 The need for this policy shift is acknowledged in *Review of Securities Law* (Ministry of Economic Development, Discussion Paper, June 2010) at [26] [*MED Review*]. Pre-FMCA, New Zealand’s securities law is mostly contained in the Securities Act 1978 and the Securities Markets Act 1988. In addition, aspects of securities law are contained in the Companies Act 1993, the Financial Reporting Act 1993, the KiwiSaver Act 2006, the Superannuation Schemes Act 1989, the Unit Trusts Act 1960 and the Reserve Bank of New Zealand Act 1989.

economics, which investigates how investors make decisions. Behavioural economics also argues that investors in the financial markets are rarely optimising and rational; rather, they often exhibit herd behaviours and can display “irrational exuberance” in their investment activities.<sup>3</sup>

The term “irrational exuberance” was famously coined by Alan Greenspan, the former chairman of the United States Federal Reserve Board. Greenspan wondered aloud during a 1996 speech at a Washington gala dinner whether “irrational exuberance” had unduly escalated asset values in the US economy, and in doing so inadvertently triggered a sharp decline in international stock markets. Since that night, “irrational exuberance” has become synonymous with the speculative fervour evidenced in asset and financial bubbles. The term subsequently became the title of an influential text by behavioural economist Professor Robert J Shiller who predicted two of the biggest bubbles of all time,<sup>4</sup> and who was awarded the 2013 Nobel Prize for Economic Sciences for his work<sup>5</sup> — coincidentally, around the same time that our FMCA was passed into law.<sup>6</sup> In New Zealand, many investors and the government are still dealing with the “irrational exuberance” that fuelled the property market bubble of 2006 and triggered the failure of 65 local finance companies in the period 2006–2009 causing a loss of approximately \$6,000,000,000 to retail investors.<sup>7</sup>

This paper briefly explores two of the principal ways in which the FMCA will help protect investors and minimise the potential for financial market failures going forward:

- (a) by setting basic conduct rules for all financial products and services that operate within the FMCA’s refreshed liability framework (the fair dealing provisions in pt 2); and
- (b) by imposing governance obligations on issuers of debt securities and managed investment products which operate within a two-tiered supervisory regime (the governance provisions in pt 4).<sup>8</sup>

---

3 *MED Review* at [13]–[14] and [18].

4 Robert J Shiller *Irrational Exuberance* (2nd ed, Princeton University Press, Princeton, 2005).

5 “Robert J Shiller – Facts” <[www.nobelprize.org](http://www.nobelprize.org)>.

6 The date of assent was 13 September 2013.

7 The government introduced its retail deposit guarantee scheme in October 2008 and has since paid out significant amounts to the depositors (“debenture stock holders”) in many finance companies, including South Canterbury Finance.

8 Further specific conduct obligations for investors and issuers trading securities on financial product markets are specified in pt 5, and for providers of some market services in pt 6. The two other principal ways that the FMCA will regulate financial markets conduct are by imposing disclosure regulation on financial products (pt 3) and some market services (pt 6), and by providing for licensing of financial product markets (pt 5) and other market services (pt 6).

## II FAIR DEALING (PART 2 OF THE FMCA)

The fair dealing provisions in pt 2 import core standards of behaviour from the Fair Trading Act 1986, customised to the financial markets and subject to the FMCA's liability regime.<sup>9</sup> They apply to a broad range of retail and wholesale financial products and financial services, and are framed in terms of three core restrictions, discussed further below:

- (a) prohibitions on misleading and deceptive conduct (ss 19–21);
- (b) prohibitions on making false, misleading and unsubstantiated representations (ss 22–23); and
- (c) anti-hawking provisions, which restrict offers of financial products from unsolicited meetings (ss 34–37).

### Application of the Fair Dealing Provisions

The fair dealing provisions apply to financial products and financial services.

#### 1 *Financial Products*

Financial products under the FMCA are debt securities, equity securities, managed investment products and derivatives.<sup>10</sup> For the purposes of the fair dealing provisions in pt 2, the definition is capable of expansion by regulation to include further classes of financial product within the wider Financial Advisers Act 2008 definition of financial products, which includes consumer credit contracts and insurance contracts.<sup>11</sup> While no such expansion has occurred to date, it is foreseeable that further classes of financial product could be included within the Financial Markets Authority's (FMA) primary jurisdiction in due course. The Ministry of Business, Innovation and Employment, which designed the FMCA policy, has itself acknowledged the inefficiencies that could result from having both the Commerce Commission and the FMA bringing separate investigations under

---

9 Refer to ss 48Q and 48R of the Fair Trading Act 1986 (as amended by the Financial Markets (Repeals and Amendments) Act 2013).

10 Section 7. If an interest or right is declared by regulations not to be a security for the purposes of the FMCA, it will equally fall outside the scope of pt 2 (see ss 7(2) and 18(a)).

11 The Financial Advisers Act 2008 defines financial products in s 5 terms of more complex category 1 products (which include futures contracts, investment-linked contracts of insurance, land investment products and other "securities") and simpler category 2 products (which include bank term deposits, cash and term PIEs and other non-investment-linked insurance contracts as well as life insurance). No additional financial products have been declared by regulations to be financial products for the purposes of pt 2 of the FMCA (under s 18(b)) at the date of this paper.

both the Fair Trading Act and the FMCA in relation to a single product and related services — particularly insurance. It has acknowledged that “[i]deally the primary regulator and liability framework would be the same for both the product and the services under that product.”<sup>12</sup>

## 2 *Financial Services*

The FMCA adopts the broad definition of financial services from s 5 of the Financial Service Providers (Registration and Dispute Resolution) Act 2008. Accordingly, it includes providing a financial adviser service (which encompasses the provision of financial advice, investment planning services and discretionary investment management service), a broking service, operating a money or value transfer service, changing foreign currency, acting as an insurer, giving financial guarantees, issuing or managing means of payment and keeping, investing, administering, or managing money, securities, or investment portfolios on behalf of other persons. In addition, the definition of “financial services” expressly includes the provision of market services. “Market services” include acting as a manager of a registered scheme, acting as a provider or a discretionary investment management service, acting as a derivatives issuer or acting as a provider of prescribed intermediary services in relation to a financial product or service.

Like financial products, the definition of financial service may similarly be modified by regulations to include or exclude specific activities.<sup>13</sup> Importantly, as at the date of this paper, it excludes the service of providing credit under a credit contract.<sup>14</sup>

## 3 *Retail and Wholesale*

Importantly, the fair dealing obligations apply to both retail and wholesale financial markets. In other words, even if an offer is not a regulated offer (that is, if it is made under an exclusion in sch 1, pt 1 of the FMCA), the fair dealing provisions will continue to apply in respect of the offer. This means that in the context of wholesale securities offerings or other business-to-business financial transactions, any promotional materials and commercial documentation will be subject to these minimum requirements. However, they do not apply to regulated disclosure documents or register entries, which are dealt with in pt 3 of the Act.<sup>15</sup>

---

12 Ministry of Business, Innovation & Employment “Chapter 3- Scope, exclusions and offer process” in *Financial Markets Conducts Regulations Discussion Paper* (Discussion Paper, December 2012) at [13].

13 Section 6, para (c) of the definition of “financial service”.

14 Financial Markets Conduct (Phase 1) Regulations 2014, reg 10.

15 Section 26 confirms that the prohibition on unsubstantiated representations in trade (in s 23) does not apply to a representation made in a disclosure document or a register entry.

## Fair Dealing: the Core Conduct Obligations

### *1 Prohibition on Misleading and Deceptive Conduct*

The misleading and deceptive conduct prohibitions closely follow existing Fair Trading Act restrictions, which came into force 1 April 2014. Unlike its predecessor — the 1978 Securities Act provision that applied only to issuers and promoters of securities — the new conduct rule prohibits any person from doing the following “in trade”:<sup>16</sup>

- (a) engaging in conduct that is misleading or deceptive or likely to mislead or deceive in relation to any dealing in financial products, or the supply or possible supply of a financial service or the promotion by any means of the supply or use of financial services;<sup>17</sup> and
- (b) engaging in conduct that is liable to mislead the public as to the nature, characteristics, suitability for a purpose, or quantity of financial products or financial services.<sup>18</sup>

In addition, the FMCA prohibits a person from engaging in conduct that is misleading or deceptive or likely to mislead or deceive in relation to any dealing in quoted financial products, regardless of whether or not the dealing is in trade (for example, shares which are listed on the NZX Markets).<sup>19</sup>

### *2 Prohibition on False, Misleading and Unsubstantiated Representations*

The fair dealing obligations set out the main standards for the advertising of financial products. They are principles-based and will have more general application than the comparatively prescriptive requirements of the Securities Act regime.<sup>20</sup>

---

16 “trade” is defined in s 18 for the purposes of pt 2 to mean “any trade, business, industry, profession, occupation, activity of commerce, or undertaking.”

17 Section 19(1). Compare s 9 of the Fair Trading Act 1986 and s 13 of the Securities Markets Act 1988.

18 Sections 20 (compare s 10 of the Fair Trading Act 1986) and 21 (compare s 11, of the Fair Trading Act 1986).

19 Section 19(2)–(3). “quoted” is defined in s 6(1) to mean financial products of a listed issuer and derivatives that are approved for trading on a licensed market.

20 There are specific rules in pt 3 for the advertising and promotion of regulated offers (ss 89–92). Refer to the new definition of “advertisement” in s 6(1) (compare to the Securities Act 1978 definition, s 2A), and ss 91–92 of the FMCA. The requirement for a “reg 30 certificate” (under reg 30 of the Securities Regulations 2009) ceases on 30 November 2014 with the repeal of the Securities Act 1978 by s 4 of the Financial Markets (Repeals and Amendments) Act 2013. Contrast that also with s 5(2CA) of the Securities Act 1978 and pts 3 and 4 of the Securities Regulations 2009. See also *Fair Dealing Provisions – Transitional Arrangements for Advertising* (Financial Markets Authority, Information Sheet, August 2014).

The FMCA prohibits a person "in trade" from making false or misleading representations in relation to certain prescribed matters in connection with any dealing in financial products or the supply or possible supply of financial services.<sup>21</sup> Also, as noted above, this reference to a person "in trade" may have broader application than the Securities Act restrictions, which applied only to issuers and promoters of the security in question.

In addition, a person must not "in trade" make an unsubstantiated representation: a representation in respect of which the person making it does not have reasonable grounds for making at the time it is made, irrespective of whether the representation is false or misleading. The Act specifies certain criteria that the courts must consider when making a determination as to whether a person had reasonable grounds. The prohibition does not apply to representations that a reasonable person would not expect to be substantiated.<sup>22</sup> Importantly, it also does not apply to representations in any regulated disclosure documents or register entries, which are governed under other sections of the Act. There are additional specific provisions and defences relating to news and advertising media (newspapers, magazines, broadcasting), publishers, licensed market operators, and where specific industry legislation applies.<sup>23</sup>

### 3 *Anti-hawking Restrictions*

There are new restrictions on offers of financial products arising from unsolicited meetings — including telephone, electronic and audio-visual meetings — with a person otherwise than in trade, designed to prevent the use of aggressive sales techniques against the general public.<sup>24</sup> There is a statutory one month cooling off period entitling investors to a full refund where a financial product has been issued in contravention of the anti-hawking rule.<sup>25</sup> Certain exceptions apply for authorised financial advisers and for other advisers in limited circumstances.<sup>26</sup>

### **The FMA as the Primary Regulator of Fair Dealing Provisions**

The effect of the fair dealing provisions is that the FMA usurps the Commerce Commission as the primary regulator to take enforcement action within the FMCA's liability framework. While the Commerce Commission will continue to have jurisdiction under the Fair Trading Act 1986 for overseeing fair trading obligations, it will require the consent of the FMA to

---

21 Section 22. Compare s 13, Fair Trading Act 1986.

22 Sections 23–24.

23 Sections 29–32.

24 Sections 34–37. These replace the door-to-door sales prohibition in s 35 of the Securities Act 1978.

25 Section 35. In relation to derivatives, the transaction is unwound and bilateral payment obligations set-off to determine which party pays the refund (see s 36(2)–(3)).

26 Section 34(2).

commence proceedings on an individual or class basis.<sup>27</sup> The two agencies entered into a Memorandum of Understanding on 31 March 2014 to clarify how they will work together to regulate fair dealing across all financial products and services.<sup>28</sup>

A contravention of the fair dealing obligations may give rise to civil liability, including pecuniary penalties of up to the greater of the consideration for the relevant transaction, three times the amount of the gain made or the loss avoided or \$1 million for an individual or \$5 million in any other case. While investors may bring direct claims for other fair dealing contraventions, only the FMA can bring proceedings in relation to an unsubstantiated representation.<sup>29</sup>

### III GOVERNANCE OF FINANCIAL PRODUCTS

The current governance requirements for financial products are scattered among a number of statutes — particularly for managed investment schemes (MIS) — and also rely heavily on contract and trust law. This can make the requirements difficult for issuers and supervisors to navigate, and challenging for regulators and investors to enforce.<sup>30</sup>

Consequently, pt 4 of the FMCA creates a coherent governance regime for financial products offered in regulated offers and for registered MIS.<sup>31</sup> The policy rationale is that more efficient contracting and a set of common, well-tested features for financial products, based on their economic substance rather than their legal form, should enable investors to focus on business risks, rather than worrying about governance risks.<sup>32</sup> Contraventions of governance provisions of pt 4 may attract both civil liability and pecuniary penalties in accordance with s 228.

---

27 Refer to ss 48P and 48R of the Fair Trading Act 1986, as inserted by the Financial Markets (Repeals and Amendments) Act 2013.

28 Memorandum of Understanding between Financial Markets Authority and Commerce Commission, 31 March 2014.

29 Section 25. See also ss 526–530, per s 38(2).

30 The pre-FMCA regulation of investment structure, governance and supervision included the Companies Act 1993, which provides a set of governance provisions for all companies; the Unit Trusts Act 1960, which sets out governance and supervision requirements for managed funds; the Securities Act 1978, which requires supervision of debt securities by a trustee in accordance with a trust deed, and participatory securities by a statutory supervisor in accordance with a deed of participation; and the KiwiSaver Act 2006 and Superannuation Schemes Act 1989, which provide for the supervision and duties of superannuation schemes. In addition, the Financial Reporting Act 2013 requires persons offering securities to the public to prepare financial accounts, which is a means for investors and their advisors to monitor how their money is being used or managed.

31 Section 41(2) defines a regulated product as a financial product that has been offered in a regulated offer, or a managed investment product in a managed investment scheme that is registered under pt 4 (a registered scheme).

32 *MED Review*, above n 2, at [18].

## Governance of Debt Securities

The FMCA prohibits a person from making a regulated offer of debt securities without a trust deed and a licensed supervisor (that is, a person licensed under the Financial Markets Supervisors Act 2011) in place.<sup>33</sup>

The trust deed must be legally enforceable as between the supervisor, the issuer and the product holders and must provide for matters prescribed in regulations which will include financial covenants, restrictions on related party transactions, and reporting requirements. The typical finance company was funded by issuing debt securities (often referred to as "debenture stock") to the public, and it was the absence of these controls in many of the trust deeds — especially those restricting related party transactions — that has proven to be a significant contributing factor to their failure.<sup>34</sup> The Act also gives the FMA the ability to specify frameworks and methodologies for how these requirements can be met.<sup>35</sup>

As such, the FMCA essentially clarifies and consolidates the existing law for debt securities, and together with recent legislation introducing prudential controls, should ensure that we do not see a repeat of a systemic failure of the non-bank deposit taker sector.<sup>36</sup>

## Governance of Managed Investment Schemes

The existing regulation of collective investment schemes contains a number of gaps and inconsistencies across legal structures. The drafters of the new legislation recognised that:<sup>37</sup>

Where regulation imposes governance standards, these need to be as consistent as possible between like products if retail investors are not to be misled and confused. Currently the regulatory regime for KiwiSaver, unit trusts and superannuation schemes, which all involve contracting out investment decisions to a professional or third party, can have different regulatory regimes, with different duties owed to investors.

Consequently, a key driver behind the new MIS provisions was to reduce the scope for regulatory arbitrage by ensuring that products of similar economic substance are regulated in the same way. To achieve this, the FMCA repeals a number of existing statutes applicable to superannuation schemes and other workplace savings schemes, unit trusts, property schemes, KiwiSaver schemes and other funds and creates a common set of governance

---

33 Section 103. Before 1 December 2014, the Financial Markets Supervisors Act was formerly called the Securities Trustees and Statutory Supervisors Act 2011. It creates a licensing regime for unit trustees, trustees of debt securities and statutory supervisors of participatory securities and retirement villages.

34 Refer to cls 6–7 of the FMC (Second Exposure Draft) Regulations 2014.

35 Section 104.

36 Non-bank Deposit Takers Act 2013.

37 *MED Review*, above n 2, at [30]. The FMCA provisions replace those currently found in the Unit Trusts Act 1960, the Securities Act 1978 and the Superannuation Schemes Act 1989, and complement the KiwiSaver Act 2006.



requirements for registered schemes which involve the pooling of investment funds, irrespective of their legal form.

The key ongoing requirement for most MIS is a governing document (likely to be a trust deed in most cases) that meets prescribed criteria. Documents are expected to include provision for immediate and periodic reporting for material limited breaks; mandatory compensation procedures for material pricing errors and non-compliance and restrictions on related party transactions;<sup>38</sup> a separate and independent licensed manager; and a licensed supervisor and appropriate custodial arrangements for scheme property.<sup>39</sup> In addition, pt 4 of the FMCA establishes a register of MIS under which a regulated offer has been made and any scheme that chooses to register. Schemes can be opted into the regime even if they are not required to be registered, but in doing so would become subject to the full provisions of the FMCA as regulated products.<sup>40</sup>

### Two-tiered Supervisory Model

The architects of the FMCA recognised that:<sup>41</sup>

... once [investors] have invested, it is often difficult for them to monitor the performance of those entrusted with managing their investment. Monitoring agents such as trustees and auditors have a role in acting on behalf of investors to monitor their investments.

For both debt securities and MIS, the trustee supervisor is charged as a front line regulator of the issuer. Part 4 of the Act expressly specifies the supervisor's core obligations: to act honestly and in the best interests of the relevant investors; to exercise reasonable diligence in carrying out its functions as a supervisor; and in certain instances, to report issuer breaches to the FMA. In addition, under the new regime, auditors, actuaries, investment and administration managers and custodians (as applicable) play a monitoring role and have obligations to report issuer breaches to the supervisor or to the FMA.

The Ministry of Business, Innovation and Employment also acknowledged that front line monitoring agents needed to be backed up by a regulator that could take meaningful action when the issuer, or monitoring agent itself, breached its obligations. For that reason, the Act gives the FMA significant and wide-ranging powers to enforce the governance and conduct requirements with remedies commensurate to the nature and consequence of the contravention.

---

38 Sections 137–141. Refer also to pt 4 (cls 6,7,14 and 15), and sch 4 of the FMC (Second Exposure Draft) Regulations 2014.

39 Section 127.

40 Section 125(2).

41 MED Review, above n 2, at [22].

#### **IV CONCLUDING REMARKS**

Only time will tell whether the FMCA's fair dealing obligations, combined with more rigorous and consistent governance standards, the new licensing regime and more fit-for-purpose disclosure will promote the development of fair, efficient and transparent financial markets.

However, as we look ahead to the Act's full implementation on 1 December 2014, it seems incontrovertible that a coherent new securities law, founded on balanced policy objectives, and with a well-resourced regulator to enforce it, will raise the bar for issuers and restore market confidence. Perhaps most importantly, the FMCA regime should go a long way in encouraging investors to be more rationally exuberant when making their investment decisions going forward.