Ministry of Economic Development

Manatū Ōhanga

Review of Securities Law

Discussion Paper

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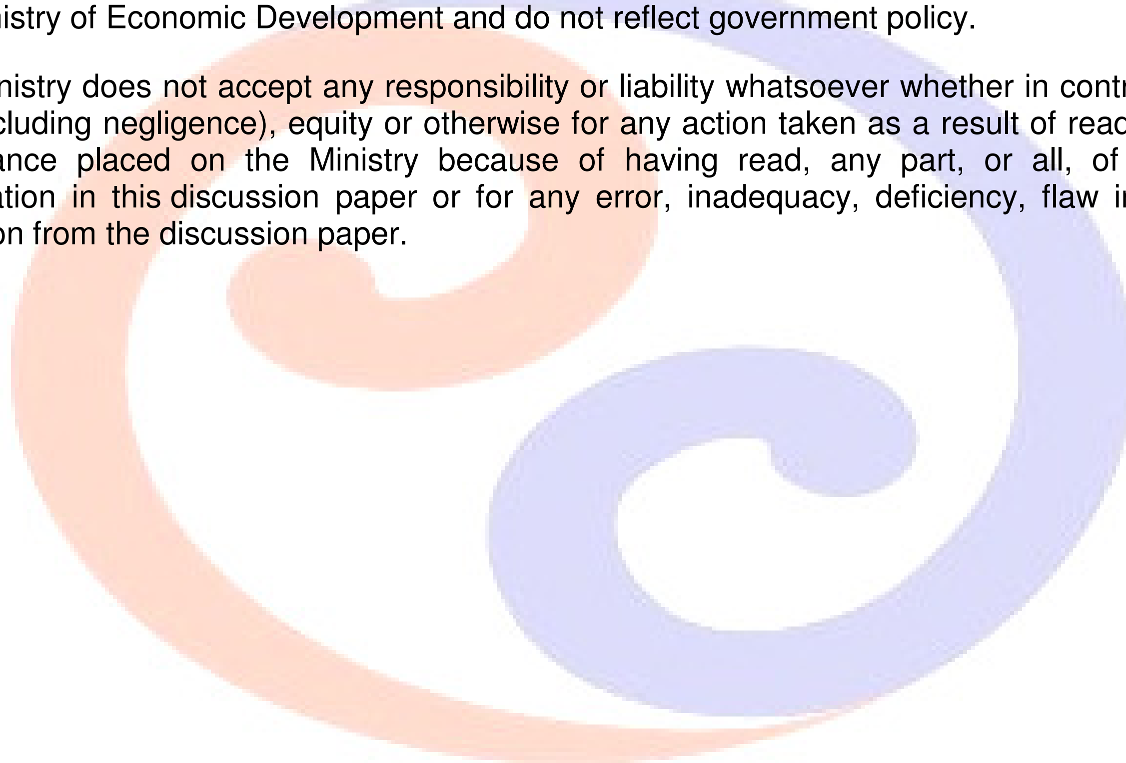

Request for comments

The Ministry seeks written submissions by email to investment@med.govt.nz or posted to Securities Law Review, Investment Law Team, Ministry of Economic Development, PO Box 1473, Wellington. If you would like to meet directly with officials then please make your request at an early date. Submissions should be provided by 20 August 2010.

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Executive summary

This discussion paper seeks submitters' views on the Ministry's proposals to substantially revise New Zealand's securities laws and update our regulatory regime. The current Securities Act is now more than 30 years old. Although it continues to be amended and improved, weaknesses remain and grow more apparent as our capital markets evolve and other countries update their regulatory regimes. The Ministry considers the Act is due for an overhaul.

The Ministry 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.

While the Ministry proposes maintaining many of the existing principles in the current regime (e.g. that it remain based on mandatory standards of disclosure and governance), changes are proposed to increase the effectiveness of the regime.

The discussion paper picks up many of the recommendations of the Capital Market Development Taskforce (the Taskforce) and will support many of the other changes that have been made or are in the process of being implemented, such as the Financial Advisers Act 2008, the Financial Service Providers (Registration and Dispute Resolution) Act, the Securities Trustees and Statutory Supervisors Bill, and recent Government decisions to consolidate the market conduct regulators into a new Financial Markets Authority, and changes to improve the regulation of retail KiwiSaver schemes.

Chapter 1: Defining regulated financial products

The Securities Act 1978 regulates "securities". The Securities Markets Act regulates "futures contracts" (among other things). The current definitions of "security" and "futures contract" in these pieces of legislation, and the different categories of securities (equity, debt, etc) are out-of-date and in many cases uncertain. This creates extra costs for issuers in determining what rules apply to them, and inappropriate or inconsistent regulation in some cases. Products are frequently regulated according to their legal form and how they are described, rather than their economic substance, which allows issuers to avoid regulations by special structuring of securities. For example, issuers of some kinds of debt and interests in collective investment schemes may instead choose to issue specially structured company shares that have fewer regulatory requirements. The Act also regulates a range of arrangements and transactions in which participants are not seeking to earn a return or hedge risk. In these situations most of the substantive requirements of the Securities Act become irrelevant and burdensome.

The Ministry proposes expressly targeting the new Act at four specified categories of financial products: equity, debt, collective investment schemes, and derivatives. We propose only to regulate financial products for which generating a financial return or hedging financial risk is a significant feature. The Financial Markets Authority and regulations will be able to "call in" products that are substantively similar to the four products that we 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 to ensure that products are regulated appropriately.

To the extent possible the Ministry proposes definitions based on the economic substance of the product, rather than its legal form, drawing in particular on accounting rules and overseas definitions. This is intended to ensure financial products are regulated in a consistent manner, and to limit opportunities for issuers to avoid regulation through careful structuring of transactions.

Chapter 2: Offers to exempt investors

The Securities Act currently provides exemptions for securities offers to specific classes of investors. These are intended to facilitate “private offers” to investors who do not require all the protections of the Act because they are sophisticated or related to the issuer, or there are no information asymmetries between the investor and the issuer (i.e. the investor can access all the information that they need about the issuer without relying on disclosure under the Act). However, the boundaries of these exemptions are uncertain, and – whether by design or because of the way they have been interpreted by the courts – the exemptions are narrow. This creates unnecessary costs and risks for issuers who wish to make private offers, and also harms investors who are excluded from participation in these offers.

The Ministry proposes 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 Review of Financial Products and Providers. We propose 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.

We 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, the Ministry proposes bright-line tests for when an investor qualifies under exemptions, rather than the current tests, which in some cases are highly subjective.

Chapter 3: Disclosure

In place of the current two document regime, we propose a shift towards a single product disclosure statement (PDS) with additional disclosures on the Register of Securities agreed to by Cabinet in April. In designing the new regime, we propose to take a product by product approach to the design of PDSs, so that they are tailored to specific financial products.

The PDS will be divided into two sections. The first will be a prescribed 2 page summary of the nature of the investment and the key risks associated with it. The second will provide additional disclosures necessary for an investor to make their decision. We consider that there may be a case for prescribing the length of PDSs for simpler financial products.

Both the long and short form PDS will include a simple risk rating set by the issuer and checked by the regulator as part of the document vetting process. Sitting behind the issuers' PDS will be additional disclosures on the relevant offer page on the Register of Securities. This additional material could include matters such as full financial statements, for example.

We make a number of proposals for ongoing disclosure by issuers. We propose that debt issuers be required to notify investors of material changes in matters that may have a bearing on the likelihood of default (i.e. material changes to trust deeds, changes to credit ratings, changes to guarantees). In respect of collective investment schemes, we think that ongoing disclosure should be based upon quarterly reports to investors covering: 1) changes to fees and charges; 2) asset holdings; 3) conflicts of interest; and 4) fund returns.

We propose that the all other material matters disclosure requirement be retained. This type of disclosure would be posted on the register of securities rather than being in the PDS. We plan to clarify the test for what is material information.

We propose to shift the regulation of advertising to a purely principles based approach (i.e. advertisements must not be misleading or deceptive and must not be inconsistent with the PDS). We also canvass possible changes to the liability regime for promoters and experts, as well as canvassing whether special provision need to be made in respect of celebrity endorsements of financial products.

Chapter 4: Collective investment schemes

We propose that a standard framework be applied to all collective investment schemes regardless of their legal form (which could include companies, trusts or partnerships amongst others).

This framework would require all collective investment schemes to have an external supervisor, who would be licensed under the licensing regime established by the Securities Trustees and Statutory Supervisors Bill.

The framework would also provide a single set of functions duties and powers that would apply to all supervisors and managers of collective investments schemes. These duties would include the manager of the scheme having a clear fiduciary duty to investors. These duties would be overlaid upon the existing rules applying to legal forms such as companies and unit trusts that may be subject to the regime.

We discuss whether it would be appropriate to licence fund managers, and seek submitters' views on whether this would be appropriate.

We also propose that all collective investment schemes be required to comply with certain requirements around returns and pricing.

Finally, we propose that the Financial Markets Authority would oversee collective investment schemes through receiving period reports from supervisors, through the licensing of supervisors (and possibly fund managers), and through the power to take proceedings against supervisors or fund managers who breach their obligations.

Chapter 5: Other matters

The paper discusses a range of other matters, including:

- A principles-based overlay that requires 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:
- Treatment of unregistered and lightly regulated securities exchanges:
- Concerns 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:
- Ensuring the Financial Markets Authority has the tools it needs to create certainty by issuing guidance, binding rulings, retrospective exemptions, and no action letters:
- Expanding the powers of the Financial Market Authority to take cases on behalf of investors, gather information from issuers, and issue infringement notices and administrative penalties:
- Public enforcement of directors' duties, management bans and culpable bankruptcy; and
- Expanding the jurisdiction of the upcoming Rulings Panel in the Financial Markets Authority to include the disciplinary committee appointed under the Financial Advisers Act and potentially a wider range of civil matters.

Introduction

1. In April 2010 the Minister of Commerce announced two significant changes to New Zealand's securities laws: the creation of a new financial regulator, the Financial Markets Authority, and a number of improvements to the regulation of KiwiSaver. These changes were fast-tracked ahead of a broader set of changes to our securities laws. These broader changes are the subject of this Ministry discussion paper.

2. This discussion paper seeks submitters' views on the Ministry's proposals to substantially revise New Zealand's securities laws and update our regulatory regime. The current Securities Act is now more than 30 years old. Although it continues to be amended and improved (including the recent fast-tracked changes), many weaknesses remain and grow more apparent as our capital markets evolve and other countries update their regulatory regimes. The Ministry considers the Act is due for an overhaul.

3. The Ministry 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 provide for specifying 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 Financial Markets Authority as regulator, and regulation of secondary securities markets.

4. This discussion paper picks up many of the recommendations of the Capital Market Development Taskforce (the Taskforce), which released its final report on 16 December 2009. The various Taskforce reports, and the Government action plan responding to the Taskforce, are available from http://www.med.govt.nz/cmdtaskforce. The Ministry's earlier Review of Financial Products and Providers (RFPP) also consulted on a range of proposals for changes to securities laws. Some of these have been implemented, while this paper seeks further comment on others. The RFPP discussion documents and a summary of submissions are available from http://www.med.govt.nz/rfpp.

5. The proposals in this paper are intended to support many of the other changes that have been made or are in the process of being implemented:

   - The prudential regime for non-bank deposit taking institution established under Part 5D of the Reserve Bank of New Zealand Act 1989 will set out detailed prudential requirements dealing with matters including governance and capitalisation requirements. The regime will also provide the Reserve Bank with significant regulatory powers over the sector;
   - The Financial Advisers Act 2008 will set minimum standards for those wishing to provide advice on financial products. It will help to ensure all financial advisers exercise appropriate care, diligence, and skill. By December 2010 financial advisers will have to have submitted their applications for authorisation and started undertaking any training necessary. They will have to have completed all necessary training and be authorised by June 2011;
   - The Financial Service Providers (Registration and Dispute Resolution) Act will require all financial service providers to register on a public register, and join a consumer dispute resolution service. All financial service providers will have to be registered by 1 December of this year;
   - The Securities Trustees and Statutory Supervisors Bill will create a licensing regime for unit trustees, trustees of debt securities and statutory supervisors of participatory securities and retirement villages. It also increases the Commission's powers to oversee and direct trustees and imposes offences and penalties if trustees fail to meet their obligations; and

- The Government recently announced the consolidation of market conduct regulators into a new Financial Markets Authority, and changes to improve retail KiwiSaver schemes. The Financial Markets Authority Establishment Board has been set up to create the new regulator, which is expected to be up and running by early 2011.

6. The Ministry is also undertaking a review of the financial reporting framework. The Ministry and the Accounting Standards Review Board simultaneously released discussion documents on 30 September 2009 and submissions closed on 29 January 2010.

7. The following section describes Ministry's view on the objectives and principles of securities law and the new Act. Each subsequent chapter of this discussion document considers an important aspect of the new Act:

   - 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 Financial Markets Authority and the possibility of public enforcement of directors' duties.

What is securities law?

8. Securities law governs how financial products are created, promoted and sold (especially to the public), and the ongoing responsibilities of those who offer, deal, and trade them.

9. In particular, securities law regulates entities that:

   a. Seek funding through equity or debt instruments;

   b. Invest in financial assets on behalf of others; or

   c. Enter into derivative contracts for risk hedging or speculation.

10. New Zealand's securities law is mostly contained in the Securities Act 1978 (which regulates *primary markets* where new securities are issued to investors) and Securities Markets Act 1988 (which regulates *secondary markets* where existing securities are traded, and also derivatives), but a number of other pieces of legislation contain aspects of securities law. For example:

    - Companies Act 1993;
    - Financial Reporting Act 1993;
    - KiwiSaver Act 2006;
    - Superannuation Schemes Act 1989;
    - Unit Trusts Act 1960; and
    - Reserve Bank of New Zealand Act 1989.

Overall objectives of securities law

11. Securities law aims to facilitate efficient capital markets:

- For investors this means that they can confidently participate in capital markets and make financial decisions that are appropriate for their financial goals; and
- For businesses, it means that they can efficiently and effectively source funds from capital markets and hedge financial risk.

12. To work well, capital markets require both investors willing to participate, and firms seeking to raise capital who provide investment opportunities to investors. If the markets do not work for both firms and investors, in the long run they will not work for either. While capital markets, like other markets, might be expected to work efficiently without government involvement, all advanced countries have found it beneficial to introduce a regulatory regime to counter market failures that financial products are inherently prone to. These regulatory regimes seek to both provide sufficient confidence to retail investors to ensure their participation, while ensuring that businesses raising capital find the regime easy to use and relatively certain.

Market failures and regulatory philosophy

13. The basic philosophy of the securities regime in New Zealand, and in most other countries, is that investors are responsible for the investments that they make. However, financial products are prone to "market failures"[1]. Financial products are often complex and non-transparent, and difficult for non-experts to evaluate. A lack of transparency makes it difficult to verify claims made by a seller, and comparatively easy to conceal costs and risks. Financial products cannot be tested before purchase, generally have no warranty, and remedies are often limited. Failures may take years to eventuate, and many financial products require long-term commitments and are critical for the well being of investors. Further, large numbers of investors contributing money may share in a single financial product, which creates free-rider and other collective action problems in monitoring providers and acting in the event of a breach of duties. Investors often lack understanding and confidence in purchasing financial products, and the purchase of a financial product frequently creates a fiduciary relationship with the company who takes on the responsibility of managing the client's investment or savings.

14. As a result of these inherent features of financial products, regulatory regimes have been designed to require disclosure (to allow investors to make informed choices) and to include governance and supervision to ensure that issuers are meeting their ongoing obligations and to reduce the risk of fraud. An alternative would be to have a form of "merit regulation" whereby a regulator vets products and determines whether each is allowed to be issued to retail investors. Most countries have not adopted a merit-based approach due to the fact that the regulator does not have a crystal ball and cannot always determine whether a product will be suitable for investors or not, because of the costs of performing these assessments, and because such a system tends to stifle innovation.

15. At the same time, some investors need fewer protections – e.g. knowledgeable or experienced investors are presumed to be able to obtain for themselves information to make an informed decision. Exemptions from some of the requirements of securities law allow firms to raise capital from investors at lower cost than would otherwise be the case.

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[1] Market failures occur when a market does not deliver the best outcome – this may be because one party has less information than another.

Regulatory mechanisms

16. Securities regulation seeks to develop a regime which allows for investor responsibility, while mitigating the difficulties outlined above. It does so by requiring disclosure; prohibiting some activities; mandating governance and supervision arrangements for some products; providing for remedies to protect investors; resourcing a regulator to monitor market activities and, where necessary, to investigate and enforce the law.

Disclosure

17. Disclosure is a key part of securities law and seeks to mitigate against the fact that firms looking to raise capital have much more information about the firm's prospects than do potential investors. To be effective, disclosure needs to be relevant to investors' decisions; provided in a format which facilitates their decision-making (e.g. by being comparable between issuers); timely; and accessible. Intermediaries (such as financial advisors) may also have a role in helping process information for investors. Making useful information available to the public also benefits the market as a whole, through more informed commentary, securities analysis, and more accurate pricing of other securities offerings.

Product regulation

18. Another role of securities law is regulating how investments are structured, governed and supervised. Some of these provisions make for more efficient contracting as there is a set of common, well-tested features to products. Investors can focus on business risks, rather than worrying about governance risks. By making minimum governance standards compulsory for offers to retail investors, they also provide a degree of investor protection.

19. Regulation of investment structure, governance and supervision includes the Companies Act, which provides a set of governance provisions for all companies; the Unit Trusts Act, which sets out governance and supervision requirements for managed funds using that structure; the Securities Act, 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 and Superannuation Schemes Act, which provide for the supervision and duties of superannuation schemes. In addition, the Financial Reporting Act 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.

Liability and enforcement

20. Finally, where there is the possibility of misrepresentation or unfair conduct by an issuer, retail investors and others can benefit from being able to impose a specific liability framework – civil and criminal – that applies and in some cases goes beyond the remedies available in the general law, and also from public regulators that help to enforce this law. Similar to the benefits of standard governance arrangements, tailored civil liability provisions reduce the costs and uncertainties of resolving disputes in courts. Securities law also provides criminal offences for some conduct.

Role of the investors, the regulator and other monitoring agents

21. As noted above, in most securities regimes, investors are responsible for the investment decisions that they take – based on their assessment of their needs and the appropriateness of a particular investment for them. For some types of investments, investors take on significant responsibilities for monitoring the issuer. For example, shareholders in a company participate in shareholder meetings, consider annual reports and financial statements, elect directors, and vote for shareholder resolutions. Investors can also take civil action through the courts to enforce breaches of duties owed to them.

22. But, just as there are limits to investors' ability to assess the merits of an investment without disclosure, once they 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 debt trustees, this includes regularly checking that the issuer is complying with its borrowing covenants, and negotiating with the issuer or taking court action on behalf of investors if there has been a covenant breach. In a managed fund, the trustee might be responsible for checking that the fund manager is complying with the management agreement and is making investments in accordance with the fund's objective. Investors need auditors to verify that financial accounts have been correctly prepared and are accurate.

23. It is important to back up the roles of investors and monitoring agents with a regulator who can take action when rules and duties have been breached – by either issuers or monitoring agents. Accordingly, an important element of most regulatory regimes is public enforcement of securities law. This can involve civil action to penalise liable parties and seek compensation on behalf of investors and investigating criminal offences and initiating prosecutions.

24. While a proactive regulator is vital, it is important to recognise that there are limits to what regulators can do. Risk is an inherent part of the financial markets, and regulators cannot – and should not try – to remove risk[2]. As we note above, regulators also do not have the information or the resources to make decisions on the merits of financial products on behalf of investors. In addition, regulators have limited resources for detecting wrongdoing. While they can review some disclosure documents and other reports from issuers, and investigate concerns and complaints, they generally cannot certify that disclosures are free from false and misleading statements, or that issuers are meeting all their legal obligations. Inevitably, some wrongdoing will only come to light after companies have collapsed and investors have lost money. The fact that investigations and enforcement occurs, and can lead to penalties, provides an important deterrent to wrongdoing by market participants.

Summary of problems with current legislation

25. While the approach of our current securities law is consistent with the objectives described above, its implementation is deficient in a number of important respects. Regulation is not always targeted at the right financial products or investors. Mandated disclosures fail to adequately inform investors, as they are poorly structured, and too long and confusing. Our regulation of collective investment schemes contains a number of gaps and is inconsistent across different legal structures.

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[2] Expect where there is the possibility of a large failure causing damage across the financial system. An important role of prudential regulation (in New Zealand, this is performed by the Reserve Bank) is reducing the likelihood of this kind of failure.

26. As noted, securities legislation in New Zealand and in most other countries is based on disclosure – with some exceptions, issuers are free to raise money from whomever they chose, provided they disclose the information considered necessary for investors to make an informed decision. In practice, the information provided tends to be of limited use to investors and is costly for issuers to produce. While formal data is not collected, anecdotal evidence is that in almost all cases, investors do not read a prospectus or the entire investment statement prior to investing.

27. Given that many retail investors have limited investment literacy, it is clear that most disclosure documents are inaccessible for their intended audience (retail investors). In addition, the information presented in them is not easily comparable across products – even in the same product class. This limits the ability of investors to compare the risk/return tradeoffs available and make informed decisions, as well as limited effective competition in the market. The ability of issuers to name products differently from the underlying economic substance of the investment also inhibits the ability of investors to make informed decisions.

28. If investors are to make informed decisions, information needs to be provided in a manner which takes account of the way in which information markets work and of the ability of investors or their agents to process the available data.

29. For those who do not require the protections of the Securities Act, and for issuers seeking to raise funds from them, the criteria under which people are exempted should be clear. Currently, some criteria are seen as unworkable due to either the extent of the liability imposed for errors, or due to the lack of clarity about what would be required to meet the test set out in legislation. Greater certainty here would reduce costs for issuers and investors.

30. 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. Such differences can cause confusion for investors and provide scope for regulatory arbitrage.

31. In addition, information on securities transactions and activities needs to be collected in a way which allows for evaluation of regulatory settings and to inform changes. Currently, there is relatively little systematic information available on which to base policy decisions in this area.

Overarching principles for reform

32. As noted above, the objective of securities legislation is to ensure that markets function efficiently. Some of the principles we have adopted in considering changes to securities laws are:

- Investor obligations – investors remain responsible for their decisions and the regulatory regime aims to create a system that allows them to do so. Regulation and regulators cannot remove risk from the financial markets;
- Regulation clearly targeted – the regime needs to ensure that the appropriate transactions are regulated (i.e. transactions that are subject to market failures). To the extent possible, it should be clear when an offer of a financial product is regulated by securities law, and what regulatory requirements apply to it. This is particularly important in the definitions adopted to classify financial products, and offers to categories of exempt investors;

- Accommodating efficiency-enhancing innovation – there are strong incentives for markets to innovate and we want to be sure that new products or practices can be introduced and are regulated appropriately. Although products may have particular governance requirements, legislation shouldn't preclude them from being offered to the public if they don't fit into defined categories. Regulators need delegated powers to provide flexibility, such as the ability to exempt new products from particular disclosure or governance requirements;
- Reducing regulatory arbitrage – products that are similar in substance should be regulated in the same way to ensure that the regulation, for example the disclosure requirements, are appropriate to the nature of the product. The regulator needs market surveillance capability to be aware of arbitrage occurring;
- Meaningful disclosure – disclosure should accessible to investors, as well as being useful to other parties (like advisers, analysts, and regulators). Disclosure to investors should be standardised as much as possible so that competing products are comparable;
- Well functioning collective investment schemes – increased competition among collective investment schemes and a market where providers and fund managers put investors' interests first. Where not inconsistent with other objectives, our regulatory regime for managed funds should be aligned with international best practice; and
- Appropriate sanctions and enforcement – sanctions must be well understood, be in proportion to offences and be imposed on appropriate parties to ensure the right incentives for both the regulator and parties involved. If penalties are excessive the regulator will be reluctant to use them, and parties, such as directors, trustees, and auditors may become risk adverse and not undertake activities that may have been desirable. If penalties are too lenient, or not sufficiently broad, they won't be an effective deterrent.

Chapter 1 – Defining regulated financial products

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CHAPTER 1: CONSOLIDATED QUESTIONS 41

1. Principles

1.1 Introduction

1. The Securities Act 1978 generally applies to all transactions that involve an offer of securities to the public. This chapter considers the current definition of "security" and the financial products that should be regulated by the new Securities Act. The next chapter considers what offers of these financial products should be covered by the new Act.

1.2 Principles

2. As discussed in the introduction, securities law should be targeted at financial products where there is potential for market failure, and should avoid regulating other products. This means consideration should be given to characteristics of products such as complexity, transparency, timeframe, their implications for investor welfare, the degree to which investors rely on the conduct of issuers or other third parties, and investor understanding.

3. Within the definition of security adopted by the Securities Act, there are a number of sub-categories of financial products that are regulated in different ways: equity securities (e.g. shares), debt securities (e.g. debentures and bonds), unit trusts (i.e. managed funds), superannuation schemes (including KiwiSaver), life insurance, and participatory securities (everything else, but mainly other types of managed funds).

4. These different types of securities require different disclosure and governance requirements. For example, an investor in a managed fund requires information about the management fees charged by the fund, which are not usually a feature of a share or bond offer. Similarly, whereas the governance of a company share is regulated by the Companies Act, investors in a corporate bond have a trustee which holds any charge over collateral and monitors the issuer on their behalf.

5. The basic principles we have adopted for defining categories of financial products are:

    - Product categories are used to apply different types of disclosure and governance requirements to different types of products. Therefore products with similar disclosure and governance requirements should be assigned to the same category. The economic substance, rather than the legal form of the product, is paramount in this respect;

    - All products should be readily classifiable into a single category, to avoid uncertainty about where a product fits;

    - Categories should reflect market concepts, and be flexible to changes in market practice; and

    - There should be as few categories and exemptions as possible. As categories are added the law becomes more complex and products are more likely to fall within more than one category. Similarly, a larger number of exemptions makes it more likely that products inadvertently fall outside the Act and there is regulatory arbitrage.

6. These principles can conflict with each other to some extent. For example, market terminology may classify differently two securities that have similar economic substance, such as redeemable preference shares (implying equity) and notes (implying debt).

2. Current regime

7. The definition of "securities" in the Securities Act is "any interest or right to participate in any capital, assets, earnings, royalties, or other property of any person".[1]

8. "Securities" specifically include equity, debt, and units in a unit trust, interests in a superannuation scheme, and life insurance policies. In addition, the Act contains a "catch all" definition: anything that does not fall into one of the other classifications is a "participatory security".

9. If a financial product is classified as a "security", the categorisation of the types of securities determines what kind of pre-investment disclosure the issuer must give, and in some cases imposes additional product regulation.

10. "Equity", "debt", and "life insurance" are defined primarily with reference to market terms and legal form for such securities:

    Equity security means any interest in or right to a share in, or in the share capital of, a company; and includes… [a] preference share, and company stock;

    Debt security means any interest in or right to be paid money that is, or is to be, deposited with, lent to, or otherwise owing by, any person (whether or not the interest or right is secured by a charge over any property); and includes… [a] debenture, debenture stock, bond, note, certificate of deposit, and convertible note;

    Life insurance policy means a policy of life or endowment insurance, or a policy securing an annuity.

11. "Units" in a unit trust and "superannuation scheme" are defined with reference to specific legal form:

    Unit means an interest or right to participate in any capital, assets, earnings, or other property of a unit trust;

    Superannuation scheme means a registered superannuation scheme within the meaning of section 2(1) of the Superannuation Schemes Act 1989.

12. The related area of derivatives is mainly left to the Securities Markets Act 1988. If a financial product is classified as a **futures contract** – the definition of which covers derivatives more generally – the approach of the Securities Markets Act is different to the Securities Act. The Securities Act primarily focuses on pre-investment disclosure with some product regulation, but issuers do not have to be licensed with the Securities Commission. The Securities Markets Act on the other hand requires "dealers" of derivatives to be authorised[2] and subjects such dealers to regulation.

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[1] Securities Act 1978, s 2D.
[2] Securities Markets Act 1988, s 38.

3. Problems with the current regime

3.1 Boundaries of "security" unclear

13. The definition of "security" is targeted at investments, though the boundaries of the definition have not been clearly established. In the general definition, the words "interest" and the phrase "right to participate" are not defined in the Act and remain unclear, notwithstanding some court decisions. It has been suggested that a narrow interpretation of these words, such as that adopted in the judgement of *R v Smith*[3] could exclude company shares, were they not explicitly included in the definition.[4] A broad interpretation, on the other hand, might encompass many contracts (e.g. for services or employment) that were not intended to be within the scope of the Securities Act.

14. The definition of debt security also appears extremely broad, encompassing "any interest or right to be paid money that is, or is to be, deposited with, lent to, other otherwise owing by, any person". Since money includes money's worth[5], a broad reading of this could include almost any instance in which a person pays money to someone else, and is then owed financial assets or services in return.

15. In practice it is usually assumed by issuers, investors and regulators that the definitions cover matters normally thought of as securities (shares, bonds, interests in managed funds, etc) and products that are similar in substance. It is assumed that, whatever these definitions mean, the broadest interpretation cannot be correct. However, these definitions do cast doubt on the status of new financial products (or products that resemble financial products) and borderline cases, such as:

- Portfolio management services. The Capital Market Development Taskforce asked for clarification of the legal framework for wrap accounts and portfolio management services that do not pool assets into a collective fund;

- Some of the products discussed in section 3.4 below, which have some features of financial instruments, but are not intended for investment. For example, gift vouchers, telephone cards, and the balance of pre-paid mobile phone accounts; and

- Various derivative contracts that are not clearly "futures contracts" (as defined in the Securities Markets Act), as discussed in section 3.5 below.

3.2 Categories allow issuers to avoid some regulation

16. The Ministry considers that current definitions mean that certain securities are not categorised appropriately, and this allows issuers to avoid important regulatory requirements. For instance, a company can choose to issue specially structured shares which can have rights equivalent in economic substance to a debt security or interests in a managed fund, but are treated as equity securities by the Securities Act. Equity securities generally have fewer regulatory requirements under securities law than other securities. In particular:

- By structuring debt as equity, the issuer is not supervised by a trustee, and does not have to comply with a trust deed. Where instruments are not clearly within either the equity or debt categories, categorisation is largely left to the way the issuer chooses to describe the securities, and under what legislation securities are issued. Investments of

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[3] *R v Smith* [1991] 3 NZLR 740; [1991] 5 NZCLC 67,120.
[4] Shelley Griffiths, "Primary Markets" in *Company and Securities Law in New Zealand,* John Farrar (ed), 2008, p.1013.
[5] Securities Act 1978, s 2.

money that are not repayable (other than at the discretion of the borrower) but do not carry voting rights as such can potentially be categorized as either debt ("perpetual notes") or equity ("preference shares" or "preferred stock") or even, in the case of convertible securities, both. Because the distinctions in the Act are different from the distinctions in accounting standards and NZX rules, it is possible for securities to be issued as equity, and then treated as debt when disclosed in financial reports and when listed on the NZDX debt market; and

- By structuring collective investment schemes as equity (e.g. redeemable preference shares), the issuer is not supervised by a trustee or statutory supervisor, does not have to comply with a trust deed or deed of participation, and disclosure specific to collective investment schemes is avoided.[6]

17. These are examples of regulatory arbitrage. In both cases securities are regulated according to their legal form and description, rather than their economic substance.

3.3 Inappropriate requirements imposed on "catch all" participatory securities

18. The Ministry considers that certain requirements that flow from the "catch all" category, participatory securities, are inappropriate for the nature of these investments.

19. The majority of the securities typically captured by participatory securities (such as bloodstock interests, property syndicates, and forestry partnerships) are in substance forms of collective investment schemes. Investors provide a pooled fund of money that is used to invest in assets. Such investment may be at the discretion of a manager, who will usually manage the assets. The participatory security regime has been designed with such forms of investment in mind. The requirements have been formulated accordingly. In particular, the role of statutory supervisor and manager. Chapter 4 discusses possible changes to the requirements for collective investment schemes.

20. However, the other large category of participatory securities are matters that have not been specifically provided for in the Securities Act, such as limited partnership interests, industrial and provident society shares, and some types of derivatives. Such securities are participatory securities because they do not fit within any of the other categories (that is, they are not equity, debt, etc). As such, they are subject to the participatory security requirements.

21. The Ministry considers the participatory security requirements (particularly the appointment of a statutory supervisor and deed of participation) to be inappropriate in some of these circumstances. In particular, the participatory security requirements are unworkable for derivatives (see the discussion below).

22. The Taskforce recommended that interests in limited partnerships be reclassified from participatory securities to equity securities. The Taskforce wrote:

> Over the course of discussions on the Limited Partnership Bill, how limited partnerships are treated for the purposes of the Securities Act became a major issue. The NZVCA took the view that they should be treated as an equity security (like a company). As it stands, interests in a Limited Partnership are a participatory security, which means that when a limited partnership raises money from the public, a statutory supervisor must also be appointed under the Securities Act. This adds cost and complexity for little gain or protection for investors. As a result of this, public limited partnerships are unlikely to be used to raise money and a company form is more likely to be used. We think that this is an

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[6] An example of this classification is found in the Securities Act (Carbon Logic Limited) Exemption Notice 2007. The notice states "the securities being offered are redeemable preference shares, but the investment will operate closer in substance to a managed fund than an ordinary offer of equity securities. In particular, transfers of shares following the initial offer will be offered at a price determined by reference to the net asset value of the fund, rather than at a fixed price".

unnecessary requirement which limits the flexibility around what is otherwise a good fund raising vehicle.

3.4 Inappropriate requirements imposed on non-investment transactions

23. The Ministry considers that the definition of securities captures some matters that are properly outside the scope of regulation under investment law. The Act regulates a range of arrangements and transactions in which participants are not seeking to earn a return or hedge risk. In these cases most of the substantive requirements of the Securities Act become irrelevant and burdensome.

24. Under the current definitions in the Securities Act, most matters that have some sort of buy-back arrangement or pre-payment for goods and services may be considered debt securities.[7] Most collective ownership may be considered participatory securities.[8] For example:

- Customers of a co-operative may be required to subscribe for member shares to transact. The subscription is typically very small compared to the other costs of the transaction;

- Clubs and charitable organisations may offer "philanthropic" type investments (either generally or for a specific purpose). Members may "invest", but such investment may be primarily to advance the club or the particular project, rather than to make an investment return. Any investment return can be considered a bonus, and any loss amounts to a pure donation;

- Some incorporated societies or companies wish to finance communal facilities, and offer paid membership or issue shares as a condition of use. These have been exempted under the Securities Act (Real Property Developments) Exemption Notice 2007, and other individual exemption notices. The notice's statement of reasons notes: "While the memberships and shares are securities in terms of the legislation, they are not offered as investments in the usual sense. Rather, the society or the company is established as a convenient vehicle through which residents in a property development can use and enjoy communal facilities and can be required to contribute to the maintenance of those communal facilities";

- Retirement villages provide a useful historic example, although this position has since been reversed by statutory exemption.[9] It has been held that the purchase of a property with compulsory buy-back amounts to a debt security (in the case of retirement villages, the retirement village was to buy-back the unit following the death of the purchaser).[10] The purchaser is exposed to the creditworthiness of the retirement village.[11] Similarly, retirement villages typically provide for the use of common property areas by residents, and for the upkeep of the property by management. Such arrangements are arguably participatory securities.[12] In certain circumstances, even the right of the purchaser to occupy his/her unit may amount to a participatory security;

- Pre-paid debits cards (such as New Zealand Post's "Prezzy Card") enable cardholders to make payments, which are deducted from the balance of the card. No interest is paid, and cardholders' funds are held in a special purpose bank account. These have

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[7] *Culverden Retirement Village v Registrar of Companies* [1997] 1 NZLR 257.
[8] See, in particular, Securities Act 1978, s 5(1)(b)(i).
[9] Retirement Villages Act 2003, ss 107 and 110 and Securities Act 1978, s 5(1)(k).
[10] *Culverden Retirement Village v Registrar of Companies*, above n 7.
[11] Although the Retirement Villages Act 2003 does provide some special protections for residents. See for example, the provision relating to memorial on title in section 21-23 of the Retirement Villages Act.
[12] See *Culverden Retirement Village v Registrar of Companies*, above n 7.

been granted exemptions on a case-by-case basis, for example by the Securities Act (New Zealand Post Limited Pre-paid Debit Cards) Exemption Notice 2007, again on the basis that they are not investments; and

- Arguably, other pre-paid goods and services are debt securities, including gift vouchers, telephone cards, and the balance of pre-paid mobile phone accounts.

25. While some of the above consumers may require some form of consumer protection, the Ministry does not consider this is best achieved through legislation designed to deal with investments.

3.5 Uncertainty of “futures contract” definition

26. There is genuine confusion about whether many derivatives fit within the definition of “futures contract” in the Securities Markets Act. This causes uncertainty about how these products are to be regulated, and is likely to hamper the introduction of new derivatives. The Capital Market Development Taskforce recommended clarifying the regulatory treatment of derivatives.

27. There are examples where specific issues have been dealt with on a case-by-case basis through a declaration by the Securities Commission that a product is a futures contract,[13] or through an exemption, but this can be a lengthy process. For example, KVB Kunlun submitted to a select committee[14] that it sought clarification of the treatment of rolling spot foreign exchange contracts, certain contracts for difference, and various types of options and forward foreign exchange dealings. The Securities Commission proposed to classify rolling spot forward contracts as “futures contracts”[15], but to date has not done so.

28. This uncertainty has a number of implications:

- Confusion to investors and additional compliance costs for business in working out which obligations apply. This uncertainty could prevent products from being offered at all in some cases;

- Inappropriate regulatory requirements: if a derivative falls outside the definition of “futures contract” in the Securities Markets Act, it may be regulated as a debt security under the Securities Act. This would require the issuer of the derivative to appoint a trustee, agree a trust deed, and register a prospectus for a debt security. These requirements come with significant compliance costs, and are unworkable for most derivatives; and

- Gaps in regulatory requirements: certain financial instruments may not fit within either of the securities or futures regime, but are in substance similar to other financial instruments that are subject to regulation.[16]

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[13] E.g. Futures Contracts (IG Markets Limited) Notice 2009 declares IG Markets’ contracts for difference to be futures contracts.
[14] KVB Kunlun’s submission on the Draft Emissions Units, Settlement Systems, and Futures Bill.
[15] See also Securities Commission “Proposal to Declare Certain Foreign Exchange Contracts to be Futures Contracts under the Securities Markets Act 1988: A Discussion Paper” (April 2006), available at: < http://www.seccom.govt.nz/publications/documents/futures-contracts/, in particular paragraph 3.14. Note that the proposals in this paper have not yet been implemented.
[16] For example, in 2006 the Securities Commission noted that many companies offering margined forward exchange rate contracts and foreign currency forward contracts have been advised by lawyers that they do not need to be authorised as futures dealers. See Securities Commission, “Proposal to Declare Certain Foreign Exchange Contracts to be Futures Contracts under the Securities Markets Act 1988: A Discussion Paper, 24 April 2006, available at http://www.sec-com.govt.nz/publications/documents/futures-contracts/01.shtml”.

3.6 Inconsistencies between securities and derivatives regimes

29. The securities and derivatives regulatory regimes take very different approaches (essentially regulation of offerings versus regulation of dealers). For exchange-traded derivatives, this approach makes sense because the dealer is akin to a securities broker. Similarly, this approach works where a dealer is brokering a derivatives transaction between two parties – essentially acting as an unregistered derivatives exchange. However, in cases where dealers are acting as parties to a derivatives contract, they are more like issuers, but are not treated as such. This leads to a number of inconsistencies:

    - Licensing: it is illegal to deal in derivatives unless the issuer is authorised as a futures dealer. The authorisation will generally state what derivatives the company can issue. There is no similar licensing regime for issuing securities;

    - Disclosure: there are standard pre-investment disclosure requirements in regulations for securities. There are no regulations stating what pre-investment disclosure is required for derivatives. The Securities Commission is able to specify this on a case-by-case basis through the authorisation process; and

    - Offers to the public: there are standard exemptions from Securities Act compliance for offers of securities to institutional investors, sophisticated investors, close business associates, relatives, and other investors who are not considered members of the public. These exemptions do not apply to derivatives under the Securities Market Act, which mean that anyone who offers a derivative to *anyone* else (or otherwise deals in derivatives) must potentially be licensed.

30. These inconsistencies are compounded by modern financial structuring, which means it is possible to structure many transactions as securities or derivatives (or neither), depending on the regulatory treatment sought. For example, an equity swap (or total return swap) can put the purchaser in exactly the same position as purchasing if it has purchased securities, but is likely a derivative for regulatory purposes;[17] similarly, the use of securitisation and special purpose vehicles can effectively turn most matters into a form of security.[18] While such structuring may have legitimate purposes, it also creates the potential for regulatory arbitrage.

3.7 Law prevents person-to-person lending services

31. Person-to-person lending services (also referred to as “peer-to-peer lending” or “social lending”) allow investors to lend money to individual borrowers, with the service acting as a “matchmaker”. Whereas traditionally such loans would be made by relatives, friends, and other associates of the borrower without any intermediation, the Internet allows for a much wider range of potential lenders to be matched to the borrower. Person-to-person lending services have become popular overseas during the past five years, through web sites such as Prosper (US), LendingClub (US), and Zopa (UK).

32. There are a number of ways that such services can operate. In one popular model, the lending service is responsible for carrying out credit checks and other vetting of the borrower, and assigns a credit rating. This rating and other information is provided to investors, who select borrowers they may wish to lend to, question borrowers, and place bids in auctions. These bids take the form of interest rates, with the loan being made by the lenders who offer the lowest rates. Generally lenders are encouraged to spread their investments across multiple borrowers, and only fund small proportions of the loans to each borrower. This diversification further reduces the risk of loss from default. As the loan is made and repaid, the lending service will typically act as an intermediary between the two parties.

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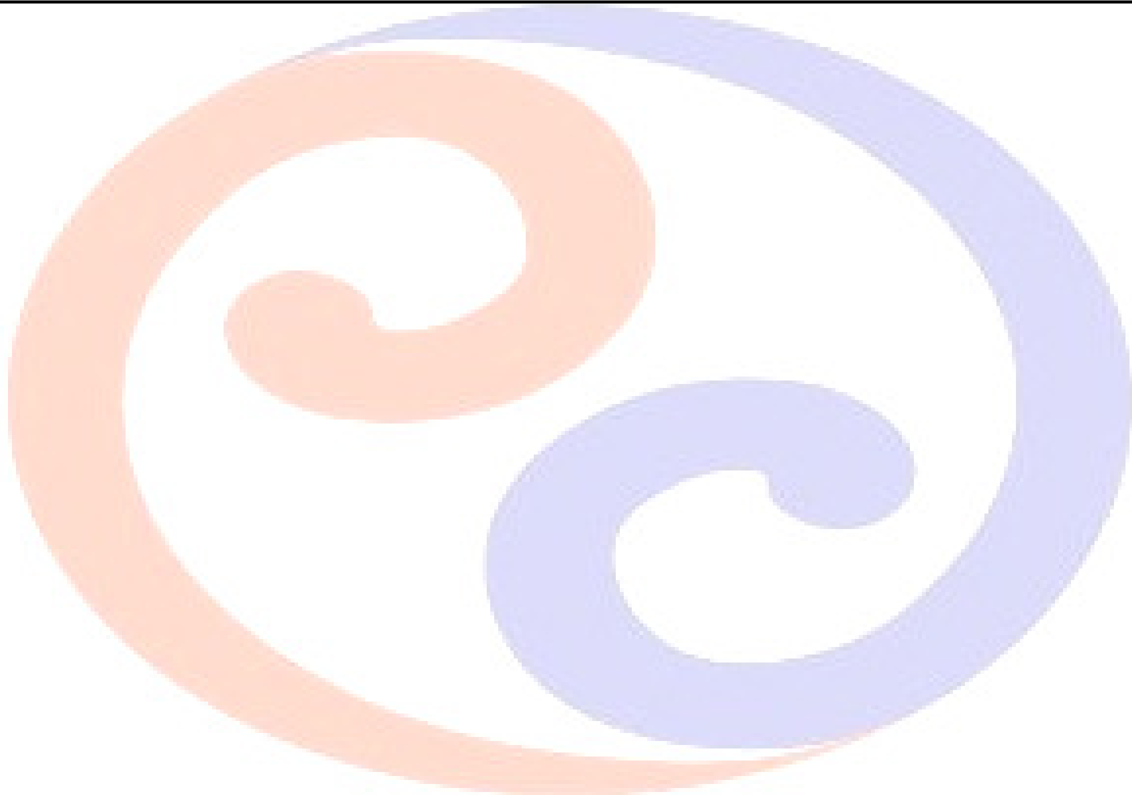
[17] See, for example, *Perry Corporation v Ithaca (Custodians) Ltd* [2004] 1 NZLR 731.
[18] For example, a credit-linked note is a type of bond with an embedded credit default swap (a derivative).

33. The Ministry is told that similar services are not practical in New Zealand because the borrower is an “issuer” for the purposes of the Securities Act and Financial Reporting Act. The Securities Act states that for a debt security the issuer is “the person on whose behalf any money paid in consideration of the allotment of the security is received”. The borrower, usually a private individual receiving a relatively small sum of money, would have to register a prospectus, produce an investment statement, and file annual audited financial reports.

34. For these services to work, it seems preferable for the service itself to be regulated, by mandating disclosure and governance for the service, rather than the borrowers. If these services are effectively regulated, New Zealand investors and borrowers have the potential to benefit from the competition they provide to deposit-taking institutions – much as the corporate bond market provides an alternative for large companies and their investors.

1.	Do you agree with problems identified with the current regime? Are there any other problems with the way that securities are defined and categorised, and if so, what impacts do they have?



4. Proposals for reform

4.1 The Act will apply to specific categories of regulated financial products

35. The Ministry proposes expressly targeting the new Act at four categories of financial products, including what are currently “securities” and “futures contracts”. The Ministry does not consider the current split regulatory regime between securities and futures is appropriate for the reasons described earlier. Similar to the existing regime, we propose to apply (different) disclosure and governance requirements specific to each category of products.

36. One option would be to obtain the existing subclasses of securities – equity, debt, unit trusts, participatory securities, etc. This would have the advantage that a body of case law has developed based on these definitions. However, this is not preferred due to the problems with these definitions noted earlier.

37. The Ministry instead proposes the following main categories:

    - Debt;
    - Equity;
    - Collective investment schemes; and
    - Derivatives.

38. We propose to define equity, debt and collective investment schemes so that these categories are restricted to *investments*. *Investments* may be defined a number of ways, but our proposal is to define them 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* (i.e. this covers derivatives used for both speculation and hedging). These concepts, and their implications, are explained in more detail later in the chapter.

39. The Authority and regulations will be able to declare products to come within one of the four specific categories (a “call in” power), and will also allow products to be shifted between these categories. These powers are discussed later in this chapter, and we seek feedback on whether restrictions should be imposed on their use.

40. The following sections define the four proposed categories of regulated financial products.

2.	Should the new Act apply different disclosure and governance requirements to each category of financial products? Is there an alternative approach that you prefer? If so, please explain the approach and the impacts of that approach compared to the proposal.
3.	We propose to use four product categories: debt, equity, collective investment schemes and derivatives. What will be the impacts of using these four product categories compared to the current regime? Would alternative categories be preferable? If so, what categories and why?

Equity securities

41. Equity securities will cover most company shares as at present, however the Ministry proposes that the definition of equity be aligned with the relevant accounting standards. We 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.

42. Consequently, equity instruments would be defined as *investments* in companies and similar entities that:

    i. Evidence a residual interest in the assets of the entity after deducting its liabilities;

    ii. Carry no obligation to deliver cash (or other financial assets); and

    iii. Are not interests in collective investment schemes (defined below).

43. The new definition of equity would have the following advantages:

    - Matters would be treated the same pre-offer (prospectus disclosure) and post-offer (financial statements);

    - The definitions could benefit from the ongoing attention and oversight given to accounting standards; and

    - The categorisation would be more robust to the legal form of securities and the way the issuer chooses to describe them.

44. Currently an equity security is limited to offers by companies registered under the Companies Act 1993. As noted above, 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. The Ministry 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 whether other entities can too.

45. It has particular implications for preference shares. In accounting standards, if an entity issues preference shares that pay a fixed rate of dividend and that have a mandatory redemption feature at a future date, the substance is that they are a contractual obligation to deliver cash and, therefore, are recognised as "financial liabilities" (debt). In contrast, preference shares that do not have a fixed maturity and where the issuer does not have a contractual obligation to make any payment are equity.

46. The Ministry is aware that there are certain issues with this definition, specifically in relation to co-operative company redeemable preference share. If necessary, the Ministry considers that certain types of shares can specifically be included in the definition of equity securities.

4.	Are there any specific impacts that we should consider in defining equity securities? Is there a better definition, and what impacts would this have compared to the current definition and the proposal?

Debt securities

47. As with equity securities, the Ministry proposes to align the definition of debt securities with an accounting-based definition of debt (a "financial liability" in accounting standards).

48. 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:

    i. 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

    ii. Are not interests in a collective investment scheme (defined below).

5.	Are there any specific impacts that we should consider in defining debt securities? Is there a better definition, and what impacts would this have compared to current definition and the proposal?

Collective investment schemes

49. The Ministry proposes a new category of collective investment schemes to cover managed funds, property syndicates, and other investments that are managed on someone else's behalf.

50. The Ministry proposes that a collective investment scheme be defined simply 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.

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

    i. is intended to provide members with benefits of investment management and risk diversification; and

    ii. 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.

52. An alternative, which is not proposed here, would be to include in the definition of collective investment schemes companies that invest a substantial proportion of their assets in securities (this is the approach adopted by the U.S. Investment Company Act of 1940). A further alternative would be to exclude companies and similar entities altogether. Some of the arguments for including open-ended investment companies within collective investment schemes are:

    - By limiting shareholder rights in constitutional documents, company shares can be structured to be almost identical to units in a trust; and

    - These products typically have fee structures, investment mandates, returns, and asset holdings similar to other collective investment schemes. Retail investors would benefit from having this information presented in a standard way, and being able to compare these companies directly to these other collective investment schemes through equivalent point-of-sale and ongoing disclosures.

53. The Ministry considers that defining this category appropriately will capture the majority of the matters currently covered by participatory securities, superannuation schemes, unit trusts, and life insurance policies with investment components.

54. A key consideration is whether collective investment schemes should extend to schemes that do not involve pooling of investors' funds with other investors or with the promoter of the scheme. This definition would cover both pooled and non-pooled schemes. For example, a typical portfolio management service takes money from an individual investor, invests in assets that are held on trust, and provides a return from those assets less fees. These schemes could be excluded by adding an additional requirement that there be some shared ownership of the assets invested in by the manager.

55. The main argument for regulating non-pooled collective investment schemes is (as with open-ended investment companies) these products can have fee structures, investment mandates, returns, and asset holdings similar to pooled collective investment schemes. Retail investors would benefit from having this information presented in a standard way, and being able to compare these services directly to pooled vehicles through equivalent point-of-sale and ongoing disclosures.

56. On the other hand, non-pooled investment schemes do not require the same level of supervision as pooled vehicles, as fewer issues arise with the entry and exit of investors, and individual investors have more direct ownership and ultimate control of assets. This suggests that if they are included in the category of collective investment schemes, they ought to have fewer regulatory requirements imposed on their governance. The Ministry seeks views on requirements that should apply to non-pooled schemes in Chapter 4, Collective Investment Schemes.

57. The subcategories of collective investment schemes that are required will depend on the diversity of investment arrangements that need tailored disclosure and product regulation, for example, open-ended investment companies. How each type of scheme will be dealt with is considered in the chapters on disclosure and collective investment schemes.

6. Are there any specific impacts that we should consider in defining collective investment schemes? Is there a better definition, and what impacts would this have compared to the proposal?

7. Should the scope of collective investment schemes include non-pooled schemes? If non-pooled schemes are excluded, how should they be regulated?

Derivatives

58. Derivatives are financial instruments whose return is linked to, or derived from, the returns of other financial instruments or commodities. As for equity and debt, the Ministry proposes leveraging from the relevant accounting definition of derivatives.[19] A derivative would therefore be based on the concept of a financial product that:

    a. 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);

    b. 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

    c. Is settled at a future date.

[19] NZ IAS 39, paragraph 9.

59. The definition would specifically exclude collective investment schemes, equity and debt.

60. The Ministry is aware that (b) in the definition above would exclude derivatives that have 100% initial margin requirements.[20] For example, some equity contracts for difference are designed to replicate the payoffs and risks of owning the underlying security without the leverage that comes from margining. While the risks associated with owning these derivatives may be largely the same as the underlying security (for which disclosure is not required, if the security were purchased on a secondary market), the buyer is also subject to counterparty risk, the tax treatment is different (e.g. no imputation credits), and the buyer may not receive additional benefits (e.g. voting rights). We therefore seek feedback on whether these derivatives should be included in the definition, and the implications of omitting (b).

61. 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. The Ministry 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.

Derivatives over own financial products

62. The Ministry 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).

8.	Are there any specific impacts that we should consider in defining derivatives? Is there a better definition, and what impacts would this have compared to the current definition of "futures contract" and the proposal?

4.2 New products and designation powers

63. Inevitably, some financial products will be created that are, in substance, similar to the regulated categories of financial products, but which are crafted in such a way that they fall outside the definitions adopted in statute, or their status is unclear. This may be because the product is genuinely innovative and takes a form that was not anticipated by the Act, or because an issuer has carefully structured a transaction to avoid the Act, or because of ambiguities in applying the definitions. Such products could harm retail investors if not appropriately regulated.

64. In response to this issue, we consider that the Authority should have the discretion to designate financial products into one of the categories, including the ability to re-classify products. More specifically, we propose that the Authority 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 Authority.

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[20] A 100% initial margin is where the buyer must post an initial margin with the issuer equal to the full price of the contract, which may therefore be the same as the price of the underlying product. For example, Stonebridge Group in Australia offers synthetic equity contracts for difference with 100% initial margins. See http://www.stonebridgegroup.com.au/Admin/Upload/Documents/products/SB_Contracts_for_Differences_PDS.pdf.

65. We seek comment on what criteria and restrictions should be applied to designations of a financial product. At present there is no test: regulations can declare any interest or right to be a security, and therefore regulated as such.

66. 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. It is important to note that the proposed definition of collective investment schemes is itself intended to be broad (e.g. the investor gives money to someone else to generate a return, and does not have day-to-day control). Therefore it may not be possible to devise a broader definition of the types of investments that can be subject to regulation, without effectively allowing almost any interest or right that provides some benefit to be called in. This could be a useful approach for calling in novel derivatives, however, which are subject to rapid innovation, and where the definition is likely to be more specific; and/or

- 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.

67. 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.

68. The Ministry 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.

69. A further possible step would be to apply some "default" regulation to a broader set of financial products, beyond the defined categories. This would apply until such time as regulations or the regulator makes a declaration on the product. For example, this might create criminal sanctions for false or misleading statements made in promoting the product.

9. What are the costs and benefits of the Authority and regulations being able to "call in" financial products that are, in substance, similar to the regulated categories of financial products, but which fall outside the definitions adopted in statute?

10. What criteria and requirements should be placed on a "call in" power, and what impacts will these criteria and requirements have?

11. Is there an alternative way to treat products that fall outside the proposed categories? What costs and benefits would this alternative have?

12. What are the costs and benefits of the Authority and regulations being able to shift regulated financial products between categories?

13. What criteria and restrictions should be placed on the power to shift regulated financial products between categories, and what impacts will these criteria and restrictions have?

14. Is there an alternative way to treat cases where there is uncertainty about which category a product belongs to, or where a product appears incorrectly categorised? What costs and benefits would this alternative have?

15. Should designations be able to be made subject to terms and conditions, and be used in conjunction with powers to make exemptions?

16. What are the costs and benefits of the Authority being able to prohibit any further allotment of a financial product, pending a decision on whether it should be called in, or shifted from one category of security to another? Is there an alternative mechanism that would be preferred, and what impacts would this alternative have?

4.3 Financial products that do not earn a return or allow for risk hedging

70. In defining the specific categories of financial products, we propose to exempt products that do not generate a return for the subscriber or hedge risk. We propose that the definitions of equity, debt and collective investment schemes 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 earning a positive financial return from the investment, or hedging financial risk (i.e. this covers derivatives used for both speculation and hedging). We propose that the exemption would be subject to the designation powers discussed above.

71. Where the design of the product means there is no possibility of there being a return or hedging financial risk, these criteria should be straightforward to apply.

72. 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. We 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.

73. If a general exemption for financial products that are not investments or for hedging financial risk is too broad, two potential further steps would be to:

- Narrow the definition to not-for-profit or mutual organisations; and/or

- Require an explicit disclosure that the product is not intended to earn a return or hedge risk, and as such is not regulated. For example, a philanthropic donation may be clearly labelled along the lines of: "This investment is not intended to earn you a financial return, and as such the protections of the Securities Act do not apply. Seek independent financial advice if you are unsure". Similar statements are currently required under the Securities Act (Charitable and Religious Purposes) Exemption Notice 2003, and are similar in purpose.[21]

74. The Ministry welcomes feedback on whether such narrowing is required.

17. What are the costs and benefits of restricting the Act to financial products that earn a return or allow for risk hedging? Is there an alternative that would be preferred, and if so, what impacts would it have compared to the proposal?

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[21] Securities Act (Charitable and Religious Purposes) Exemption Notice 2003. See in particular clause 8.

18. One way to narrow the exemption for financial products that do not earn returns or hedge risk would be to restrict it to investments in not-for-profit or mutual organisations. What impacts would this have? Is “not-for-profit or mutual” sufficiently precise, or should this be limited to (for example), incorporated societies, co-operative companies, and registered charities?

19. Another way to narrow the exemption for non-investment products would be to require an explicit disclosure that it is not intended to earn a return and the Securities Act does not apply. What are the costs and benefits of this?

20. Are there any other preferred ways to restrict this exemption, and what are their costs and benefits?

4.4 Insurance without an investment component

75. Currently, the Securities Act makes special provisions for the regulation of life insurance, but not other forms of insurance. Life insurance is regulated as a security unless it fits within the definition of “term life insurance” in the Securities Regulations. 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).

76. The Ministry 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, the Ministry has received feedback from actuaries that the phrases “specified term” and “life expectance of the life insured” are ambiguous.

77. Under the proposal outlined above, offering of insurance contracts would be defined as “collective investment schemes” if investment is a material feature of the contract. If the principle-based definition of investment above is unclear when applied to insurance contracts, 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 unexpired premium relating to a period after the date of cancellation or surrender.

21. What are the costs and benefits of regulating insurance as a collective investment scheme where investment is a component of the product?

22. Would a more tailored definition of investment be preferred for insurance products, and if so, what might this be, and what impacts would this have?

4.5 Exemptions

4.5.1 Existing statutory exemptions that may be carried forward

78. Section 5 of the Act 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.

79. 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 New Zealand Corporation (including exemptions from trustee/statutory supervisor 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); and
- Employer superannuation schemes (exemptions from prospectus requirements only).

80. We seek feedback on which of these need to be carried forward into the new Act, given the proposed categories of regulated financial products.

81. The exemption for land and chattels may no longer be necessary. Under the proposals, land and chattels will not fall within the scope of the new Act unless they are a collective investment scheme. This is the equivalent of the current concept of a "contributory scheme", although that definition also requires that the scheme has some element of pooling and at least five investors[22]. Alternatively, it may be argued that for land and chattels, the additional requirements in the definition of "contributory scheme" should still be met before the investment is regulated.

[22] Securities Act s. 2.

82. We are considering changing or removing the exemption for professional practices. This exemption is for "[a]ny interest or right to participate in the capital, assets, earnings, royalties, or other property of any company, partnership, or other person whose sole undertaking is the practice, conduct, or operation of any one or more of the professions, occupations, or businesses that may in law be practised, conducted, or operated only by persons having or possessing qualifications specified in Schedule 2 to this Act". 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. We are also of the view that an exemption for professional practices may not be necessary, as we 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 collective investment scheme.

83. 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. The Ministry 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.

84. Those exemptions carried forward would be "default" exemptions from the Act, and could be limited by designations of specific products or classes of product, as discussed above. In respect of partial exemptions, an alternative is to move these to regulations, together with existing class exemptions that have been issued by the Commission.

23. Which of the current section 5 full exemptions for land etc should be carried forward to the new Act? What are the costs and benefits of these exemptions?

24. Should some or all of the current partial exemptions in sections 5 to 5C be set out in the Act or in regulations? What are the costs and benefits of this option?

25. Is there a better way to set the scope of these exemptions, and if so what impacts would this have compared to the current scope?

4.5.2 Existing Securities Commission class exemptions put in legislation

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

Convertible securities

86. Convertible securities are securities that can be converted into other types of securities, usually at the request of the investor and at an agreed price. For instance, a convertible bond can be converted to shares.

87. The Securities Commission states:

> When a convertible security is offered and allotted to the public, and then equity securities or units in a unit trust (new securities) are allotted under the terms of a convertible security or by the exercise of

rights conferred by a convertible security, these new securities are treated as separate securities for the purposes of the Securities Act.[23]

88. This means that the issuer could have to produce another investment and prospectus for the new security. However, the Securities Act (Rights, Options, and Convertible Securities) Exemption Notice 2002 removes this requirement, provided that the issuer of the original and new securities is the same.[24] We propose that the new Act will treat convertible securities in the same manner as this class exemption.

Dividend reinvestment plans

89. Dividend reinvestment plans allow shareholders to elect to receive new shares a company rather than cash dividends. The Securities Act (Dividend Reinvestment) Exemption Notice 1998 exempts offers of dividend reinvestment plans from disclosure requirements, apart from providing investors with an offer document that contains details of the dividend reinvestment plan. We propose that the new Act will treat dividend reinvestment plans in the same manner as this class exemption.

26. Should the current convertible securities and dividend reinvestment plan exemption notices be set out in primary legislation in current or amended form? What impacts would this have?

27. Should any other class exemptions be reflected in legislation (that are not otherwise incorporated into the proposals in this discussion paper)? What impacts would this have?

4.5.3 Exempting previously allotted securities and "vendor shareholders"

90. 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.

91. 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.[25] The second avenue is where the original allotter assists the holder or offeror in connection with the offer or sale of the security.[26]

92. We intend to carry forward the current regime for previously allotted securities.

93. One specific issue has been raised by the Taskforce:

> When a firm performs an initial public offering, vendor shareholders are regarded as "issuers" under section 6(7) of the Securities Act and therefore face liability if statements in the prospectus are misleading. In a private equity fund, these vendor shareholders include management shareholders who may have advised or encouraged the IPO, but will often have little, if any, control or influence over the formation of the offer or the preparation of the offer documentation. General market practice is to avoid this liability through special structures, which can cost over $50,000 to establish, as well as being time consuming to set up. The offer also becomes more complex and difficult for investors to understand.

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[23] Securities Commission, "Summary of Securities Act (Rights, Options, and Convertible Securities) Exemption Notice 2002". Available at http://www.seccom.govt.nz/exemptions/summaries/2002/sr02-318.shtml.
[24] Or for listed companies, the issuer of the convertible security can also be a wholly-owned subsidiary of the issuer of the new securities.
[25] Section 6(2).
[26] Section 6(3).

We recommend the Securities Act be amended to remove issuer liability for vendor shareholders. Vendor shareholders should remain liable where they are directors, or have acted as promoters for the IPO. This could be achieved by adding a new subsection to section 6 to the effect that nothing in subsections (2) or (3) will apply where the original allotter has registered a prospectus and the holder of the security is not a director of the original allotter or a promoter.

94. We propose to implement this recommendation using the mechanism suggested by the Taskforce.

28. We propose to implement the Taskforce proposal that nothing in 6(2) or 6(3) of the Act should apply where the original allotter has registered a prospectus and the holder of the security is not a director of the original allotter or a promoter. What are the costs and benefits of this, compared to the current regime? Would an alternative approach to regulating vendor shareholders be preferable? If so, what impacts would this have?

29. Are there any other problems with section 6 of the Act, if so, how can these problems be addressed?

4.6 Investment brokers

95. In some cases the objectives of the Securities Act are best met by a broker or dealer in a transaction meeting disclosure and governance requirements, rather than the party that is ultimately issuing to the public or entering into a derivatives contract. For example, the current Securities Act and Securities Markets Act (and exemptions) make allowances for a broker or dealer to take on some of the responsibilities of the "issuer" of securities and derivatives. These include:

- Futures dealers are required by the Securities Markets Act to be licensed, and futures contracts they offer are exempted from most of the substantive requirements of the Securities Act. The authorisation notices for individual futures dealers set out additional regulation, including pre-investment disclosure, record keeping requirements, Financial Reporting Act requirements, capital adequacy, indemnity insurance, and reporting;

- Contributory mortgage brokers have their own regulatory regime in the Securities Act. Contributory mortgages are exempt from most of the disclosure and governance requirements associated with debt securities. Instead, brokers must be licensed and meet the requirements of the Securities Act (Contributory Mortgage Regulations) 1988; and

- Offers brokered by certain venture capital scheme administrators are partially exempted by the Securities Act (Venture Capital Schemes) Exemption Notice 2008.

96. We propose 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 Authority;

- Comply with any general regulations covering their type of brokering; and

- Comply with specific conditions imposed by the Authority.

97. 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.

98. Only specific types of brokers will initially be covered by regulations. The existing provisions in legislation, regulation and class exemptions for futures dealers, venture capital scheme administrators, and potentially contributory mortgages will be updated and re-enacted in regulations. Regulations will be also be made to regulate person-to-person lending services.

99. Companies wishing to act as regulated brokers in offerings of other financial products will be able to apply to the Authority on a case-by-case basis. This may result in the granting of a license and potentially also in the Authority seeking the drafting of regulations for that class of broker (otherwise the conditions to be met will be specified in the license). It is envisaged that this form of regulation will only be suitable for a limited range of financial products where it is appropriate for the broker to have responsibility for some aspects of compliance rather than the issuer.

100. The RFPP proposed to remove exemptions for contributory mortgage brokers on the grounds that the lower disclosure requirements (e.g. no offerings documents need to be registered) and no direct supervision were leading to a disproportionate number of breaches of the law. The RFPP suggested that alternatively, the exemption might be retained, but restricted so that it did not apply to contributory mortgages used to fund development. The RFPP also asked whether solicitors offering contributory mortgages should continue to be exempt from the Securities Act and the Contributory Mortgage Regulations.

101. Submitters were divided on the merits of the contributory mortgage exemptions and regulations: some argued they should be removed altogether, while others wanted to retain them. We seek feedback on the specific impacts of not having a regime for contributory mortgages.

30. We propose a regime for licensed investment brokers to replace the current futures dealers, contributory mortgage brokers, and venture capital scheme administrator regimes, and to accommodate peer-to-peer lending services. What impacts will this approach have compared to the current regime? Would an alternative approach to these intermediaries be preferable? If so, what, and why?

31. If the current exemptions for futures dealers, contributory mortgage brokers, and venture capital scheme administrator regimes are updated and reintroduced, what changes should be made to them? What are the costs and benefits of such changes?

32. What are the costs and benefits of removing the exemption and regulations for contributory mortgages? Is there a better alternative to the contributory mortgage regime, and what impacts would this alternative have?

4.7 Islamic finance

102. Islamic finance structures are structured differently from similar transactions that are not subject to Islamic law. Islamic law generally prohibits traditional interest (*Riba*, usury). For example, the purchase of an asset such as a house is usually financed through on-sale deferred payment plans (*Murabaha*), buy-backs (*Bai' al-inah*), or profit sharing and lease arrangements (*Musharaka al-Mutanaqisa*). Similarly, Islamic law does not allow gambling; this includes insurance. Islamic law provides instead for mutual like arrangements that provide for similar outcomes (*Takaful*).

103. Several such Islamic finance structures are likely to be securities for the purposes of the Securities Act. As discussed above, a buy-back arrangement may be a debt security, and profit sharing and mutual arrangements may be a participatory security. The non-Islamic equivalents however (mortgages[27] and insurance[28]) are not securities.

104. The Ministry considers this is an example where the Securities Act captures the form rather than the substance of a transaction. The Ministry is not aware of instances where this has been a specific issue for financial institutions looking to develop Sharia compliant financial products, but is concerned that the lack of a level playing field could inhibit the future development of these products in New Zealand.

33. Do you have any comments on the implications of Islamic finance for securities law?

[27] Securities Act 1978, s 5(1)(f).
[28] Except life insurance policies that are not "term life insurance" policies – see Securities Act 1978, s 2D(1)(e).

Chapter 1: Consolidated questions

1. Do you agree with problems identified with the current regime? Are there any other problems with the way that securities are defined and categorised, and if so, what impacts do they have?
2. Should the new Act apply different disclosure and governance requirements to each category of financial products? Is there an alternative approach that you prefer? If so, please explain the approach and the impacts of that approach compared to the proposal.
3. We propose to use four product categories: debt, equity, collective investment schemes and derivatives. What will be the impacts of using these four product categories compared to the current regime? Would alternative categories be preferable? If so, what categories and why?
4. Are there any specific impacts that we should consider in defining equity securities? Is there a better definition, and what impacts would this have compared to the current definition and the proposal?
5. Are there any specific impacts that we should consider in defining debt securities? Is there a better definition, and what impacts would this have compared to current definition and the proposal?
6. Are there any specific impacts that we should consider in defining collective investment schemes? Is there a better definition, and what impacts would this have compared to the proposal?
7. Should the scope of collective investment schemes include non-pooled schemes? If non-pooled schemes are excluded, how should they be regulated?
8. Are there any specific impacts that we should consider in defining derivatives? Is there a better definition, and what impacts would this have compared to the current definition of “futures contract” and the proposal?
9. What are the costs and benefits of the Authority and regulations being able to “call in” financial products that are, in substance, similar to the regulated categories of financial products, but which fall outside the definitions adopted in statute?
10. What criteria and requirements should be placed on a “call in” power, and what impacts will these criteria and requirements have?
11. Is there an alternative way to treat products that fall outside the proposed categories? What costs and benefits would this alternative have?
12. What are the costs and benefits of the Authority and regulations being able to shift regulated financial products between categories?
13. What criteria and restrictions should be placed on the power to shift regulated financial products between categories, and what impacts will these criteria and restrictions have?
14. Is there an alternative way to treat cases where there is uncertainty about which category a product belongs to, or where a product appears incorrectly categorised? What costs and benefits would this alternative have?
15. Should designations be able to be made subject to terms and conditions, and be used in conjunction with powers to make exemptions?
16. What are the costs and benefits of the Authority being able to prohibit any further allotment of a financial product, pending a decision on whether it should be called in, or shifted from one category of security to another? Is there an alternative mechanism that would be preferred, and what impacts would this alternative have?
17. What are the costs and benefits of restricting the Act to financial products that earn a return or allow for risk hedging? Is there an alternative that would be preferred, and if so, what impacts would it have compared to the proposal?
18. One way to narrow the exemption for financial products that do not earn returns or hedge risk would be to restrict it to investments in not-for-profit or mutual organisations. What impacts would this have? Is “not-for-profit or mutual” sufficiently precise, or should this be limited to (for example), incorporated societies, co-operative companies, and registered charities?

19. Another way to narrow the exemption for non-investment products would be to require an explicit disclosure that it is not intended to earn a return and the Securities Act does not apply. What are the costs and benefits of this?
20. Are there any other preferred ways to restrict this exemption, and what are their costs and benefits?
21. What are the costs and benefits of regulating insurance as a collective investment scheme where investment is a component of the product?
22. Would a more tailored definition of investment be preferred for insurance products, and if so, what might this be, and what impacts would this have?
23. Which of the current section 5 full exemptions for land etc should be carried forward to the new Act? What are the costs and benefits of these exemptions?
24. Should some or all of the current partial exemptions in sections 5 to 5C be set out in the Act or in regulations? What are the costs and benefits of this option?
25. Is there a better way to set the scope of these exemptions, and if so what impacts would this have compared to the current scope?
26. Should the current convertible securities and dividend reinvestment plan exemption notices be set out in primary legislation in current or amended form? What impacts would this have?
27. Should any other class exemptions be reflected in legislation (that are not otherwise incorporated into the proposals in this discussion paper)? What impacts would this have?
28. We propose to implement the Taskforce proposal that nothing in 6(2) or 6(3) of the Act should apply where the original allotter has registered a prospectus and the holder of the security is not a director of the original allotter or a promoter. What are the costs and benefits of this, compared to the current regime? Would an alternative approach to regulating vendor shareholders be preferable? If so, what impacts would this have?
29. Are there any other problems with section 6 of the Act, if so, how can these problems be addressed?
30. We propose a regime for licensed investment brokers to replace the current futures dealers, contributory mortgage brokers, and venture capital scheme administrator regimes, and to accommodate peer-to-peer lending services. What impacts will this approach have compared to the current regime? Would an alternative approach to these intermediaries be preferable? If so, what, and why?
31. If the current exemptions for futures dealers, contributory mortgage brokers, and venture capital scheme administrator regimes are updated and reintroduced, what changes should be made to them? What are the costs and benefits of such changes?
32. What are the costs and benefits of removing the exemption and regulations for contributory mortgages? Is there a better alternative to the contributory mortgage regime, and what impacts would this alternative have?
33. Do you have any comments on the implications of Islamic finance for securities law?

Chapter 2 – Offers to exempt investors

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1. Principles

1.1 Introduction

1. Securities laws generally seek to regulate initial offers of securities to retail investors (known in the Securities Act 1978 as "the public"). As discussed in the introduction, the investing public is assumed to benefit from a set of "default rules" for matters such as disclosure of information about the investment, and governance.

2. This framework is compulsory for securities offerings to the public, yet it is costly to issuers and – indirectly – to investors themselves. Securities laws therefore try to define categories of investors for whom parts of the framework are not compulsory. Issuers can make "private offers" to these investors, who are typically sophisticated investors, or those with some relationship to the issuer. These private offers are exempt from some or all of securities law. An important feature of the Securities Act is therefore defining the "the public" to include the appropriate investors. This is the goal of the proposals in this chapter.

1.2 Principles for exemptions

3. The approach of the Securities Act, like similar laws around the world, is to include all investors in "the public" by default, and then make selective exemptions from some or all of securities law for offers to certain classes of investors.

4. There is general agreement that exemptions should be provided for securities offerings to investors who are able to "fend for themselves."[29] These investors are unlikely to agree unfavourable offers without obtaining information, subjecting it to due consideration and seeking appropriate advice. Their position will be such that they are either able to negotiate the terms of the offer, or are able to reject unsuitable offers in favour of alternative offers from other issuers.

5. Some other important principles for the regime are:

- **Certainty:** A central objective of the proposals are to create certainty. Issuers and investors must be able to know what parts of the law apply and what parts of the law do not apply. To achieve this, the proposals seek to avoid providing exemptions based on subjective judgements by issuers or third parties, and to the extent possible employ bright line tests and objective criteria. This is consistent with securities legislation of foreign jurisdictions and the primacy that financial law places on certainty.
- **Simplicity:** Value should be placed on a relatively short, simple list of exemptions.
- **Low cost**: Some cost to issuers and investors is inevitable in deciding whether an exemption applies, gaining the necessary certifications, and so on. The exemptions to the law should keep this cost to a minimum by, first, providing automatic exemptions for categories of investors that should not have to give further consideration to securities law at all (for example, sophisticated institutions). Second, by ensuring that exemptions are simple and clear (as in the points above). And third, by reducing and simplifying as much as possible the steps required to obtain an exemption.

[29] *SEC v Ralston Purina Co* 346 US 119 [1953].

2. The Current Regime

6. "Private" offers do not need to comply with the majority of the requirements of the Securities Act. There are several categories of private offers:

- **Offers that are not made to the public.** This exemption is provided in section 3(2) of the Securities Act for offers to:

  a. Relatives or close business associates of the issuer or of a director of the issuer;

  b. Persons whose principal business is the investment of money or who, in the course of and for the purposes of their business, habitually invest money;

  c. Persons who have, or are each required to, pay a minimum subscription price of at least $500,000;

  d. Any other person selected otherwise than as a member of the public; and

  e. Persons invited to enter into an underwriting agreement with respect to the offer.

  Offers to these investors do not have to comply with any part of the Securities Act.

- **Exempted offers.** This exemption is provided in section 5 of the Act for offers to:

  a. Wealthy investors, being persons with net assets over $2 million, or income greater than $200,000 per year; and

  b. Persons certified on reasonable grounds by an independent financial service provider as sufficiently experienced that they can assess the offer without a prospectus and investment statement.

  Offers to these investors are exempted from the requirement to register a prospectus or supply an investment statement, as well as the governance requirements in the Act. However, the Securities Commission can still ban advertising, and directors remain criminally liable for misstatements in any advertisements.

- **Securities Commission exemptions:** this includes offers to certain types of investor (e.g. employee share schemes) and other case-by-case exemptions for classes of offer and individual issuers.[30]

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[30] Securities Act 1978, s 5(5) and Securities Commission exemption notices.

3. Problems with the current regime

3.1 Narrow scope of exemptions

7. An overarching issue with sections 3 and 5 of the Act is that – whether by design or because of the way they have been interpreted by the courts – they may be too narrow. Some issuers are advised against obtaining funding from investors who should be able to participate in private offerings, or are exposed to risks (of void offers and criminal charges) that they should not. Narrow exemptions also harm investors by preventing them from participating in private securities offers.

8. The narrowness of the exemptions comes from two sources:

   - **Uncertainty about the scope of many exemptions:** the bright-line exemptions from the Act are relatively narrow, comprising relatives, institutional investors, those investing $500,000 or more, and wealthy persons. The other exemptions that, in principle, expand the scope for making private offers are risky to use in all but the most clear-cut of circumstances, as they have uncertain boundaries, while the consequences of mistakes are severe. The issuer has the burden of proof if the issuer wishes to rely on an exemption. The courts have also taken the position that where it is finely balanced as to whether or not one of the exemptions apply, the court will rule that they do not apply and that the offer is a public one.[31]
   - **The exemptions are arguably unduly narrow in their intent:** for example, there is no exemption for small securities offerings below a certain size threshold, or for those who are relying on professional advice. Further, some have argued that investors should be able to contract out of the Act under a wider range of circumstances.

9. Many of the exemptions are based on subjective characteristics rather than objective tests. This limits their use to clear-cut situations. Such exemptions include:

   - **Close business associates**: this term is not defined by the 1978 Act, and it is unclear how "close" a business associated must be to qualify. The case of *Securities Commission v Kiwi Co-operative Dairies Ltd* provides limited guidance on this issue:

     > Although an issuer and a holder of its securities have a relationship through business, the use of the terms 'close' and 'associate' requires more than this: there must be a degree of intimacy or 'business friendship' in the relationship, though not necessarily a friendship away from business. It must be sufficient to overcome any inequality which might otherwise be present in the relationship.[32]

   - **Persons who in the course of and for the purposes of their business habitually invest money**: this is known as the "habitual investor" exemption, and was probably intended to exempt professional investors for whom investment was a secondary, but still important, activity of their business. For example, a stock broker's primary business is arranging investments, and investing is a secondary activity. Contributors to the RFPP considered this definition to be unclear. One problem identified is that some professional investors invest "in the course of" their business, but it is less clear when this is "for the purposes of" their business. Thus there remains a risk of them being counted as members of the public, contrary to the assumed intent of this section.

     Attempts to use this exemption beyond professional investors have been problematic. In a recent case it was ruled that an investor who had made seven significant

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[31] *Securities Commission v Kiwi Co-operative Dairies Ltd* [1995] 3 NZLR 26, at 33.
[32] ibid at 31-32.

investment transactions over four years was not a habitual investor.[33] The judgment suggested a number of factors needed to be considered in deciding whether an investor fell within the definition. These are: the number of investments the person has made, the period of time over which investments were made, the nature of the investments and transactions, the amount of money involved, and the success of the investments. The complexity of these considerations suggests that this exemption can only safely be used for offers to professional investors.

- **Any other person selected otherwise than as a member of the public:** this exemption is broadly worded and appears to contradict section 3(1)(a) which refers to any member of the public, "however selected". In the 1990s, the exemption was applied by the courts by reference to the mode of selection and determining whether or not the individual in question had been selected "otherwise than as a member of the public."[34] In 2004, however, the test was modified by the Court of Appeal which focussed on the previous subsections and held that this exemption only applied to individuals who are able to protect themselves "either by being able to require the issuer to provide them with relevant information or because of a general sophistication in investment matters".[35] The exemption is therefore difficult to apply with certainty, and is rarely used. The RFPP proposed that it should be removed.[36] However, many submissions were received in response to the RFPP that argued for retention of an exemption that provides flexibility to account for situations which have not been specifically contemplated but in which the Act should nonetheless not apply.
- **People certified by an independent financial service provider as sufficiently experienced**: this exemption was intended to supplement the "habitual investor" exemption, by allowing non-professional, but nevertheless sophisticated, investors to participate in private offers. A difficulty of this exemption is that the certification must be "on reasonable grounds". Thus issuers may not be able to rely on the certification at face value. The RFPP noted that financial service providers are reluctant to provide certification – probably due to both the risks to their reputation and liability if a court subsequently decided that the investor was not sufficiently sophisticated. Even if a service provider can be found, certification is likely to be costly, as the provider must form an opinion about the investors' ability to assess the offer, which also requires some analysis of the offer itself. To the best of our knowledge, this exemption is rarely used.

10. Sections 3 and 5 have been adjusted over time, which is generally considered to have resulted in a patchwork of provisions that are not consistent and coherent.[37] Where it is argued that a certain investor should be outside the scope of the Act, it can be hard to tell whether the problem is uncertainty about the boundaries of the exemptions, or that the exemptions are unduly narrow in their intent.

3.2 Severe consequences for accidentally including members of the public in a private offer

11. While the boundaries of the private offer exemption are uncertain, the consequences of getting it wrong are severe. It takes only one member of the public to receive the offer for it to be considered a public offer and therefore outside the scope of the exemptions.[38] If this

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[33] *Ministry of Economic Development v Stakeholder Finance Limited, Agnes Water Acquisitions Limited and Robert Daniel McEwan,* DC Auckland CIR 2007-004-028150, 9 December 2008 at 59-73.
[34] *Robert Jones Investments v Gardner (No 2)* [1988] 4 NZCLC 64,412.
[35] *Lawrence v Registrar of Companies* [2004] 3 NZLR 37 at 47.
[36] Ministry of Economic Development, *Review of Financial Products and Providers: Review of Securities Offerings* (September 2006), p. 21.
[37] For further discussion, see S Griffiths, *Regulating Private Offers of Securities: Time for a Major Rethink*, 15 New Zealand Business Law Quarterly, p.105.
[38] s 3(5) the Act.

occurs, or if for any other reason an offer is made in breach of the Act, the offeror and its officers may have committed a criminal offence,[39] may be subject to management banning orders[40] and may be liable for repayment of all the funds received (i.e. the offer is void).[41]

12. Some of these consequences may be justified to prevent rogue issuers from offering financial products to unsophisticated investors without adequate disclosure of risks and conflicts, or appropriate governance. However, the Ministry understands from anecdotal reports that these consequences increase risk aversion amongst honest directors, and at least some consequences appear excessive – for example, making the entire offer void.

3.3 Unclear principles for categories of exempted offers

13. The section 3 exemptions[42] exempt issuers from the entire Act. The section 5 exemptions added in 2004[43] do not exempt issuers from sections 38B and 58. As noted above, this means the Securities Commission can ban advertisements by these issuers, and they remain criminally liable for misstatements.

14. The rationale is that section 3 exemptions are for those who are not members of "the public", whereas section 5 provides relief from provisions of the Act for certain members of the public (wealthy and experienced investors). The distinctions between those placed in each group are not always clear, and there is some overlap between wealthy investors, experienced investors, and "habitual" investors.

3.4 Timing of certification of wealthy investors may be unworkable

15. There appears to be a conflict in the Securities Act's requirement that wealthy investors be certified *before* the offer is made. The Taskforce wrote:

> For a person to be considered *wealthy* (and thereby an eligible person) section 5(2CD) of the Act requires the person's assets or income be certified by a chartered accountant "no more than 6 months before the offer is made" (this was extended to 12 months in 2009.).
>
> The date of the "offer" can be unclear, as it is defined broadly in the Act to include "any proposal or invitation to make an offer". So even contacting a person to discuss whether they wish to invest could be a breach of the Act. Since it is unlikely that an investor would obtain certification *before* receiving such a proposal, most attempts to use this exemption breach the law.
>
> Accordingly, we suggest that the requirement be amended to provide that a person can be certified after receiving an offer, but prior to subscription. This could be accomplished by an amendment to section 5(2CD) to omit the word "offer" and substitute the word "subscription". An alternative would be to retain certification 12 months before the offer, but to also allow certification to occur after the offer but before subscription.[44]

16. This seems to be a technical problem with the provision, and we are not aware of a case where an offer has been declared void due to it, but it is a possibility that this could happen.

1. Do you agree with problems identified with the current regime? Are there any other problems with the way that the exemptions for offers to particular categories of investors work, and if so, what impacts do they have?

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[39] s 59 the Act.
[40] s 60A the Act.
[41] s 37(6) the Act.
[42] These exemptions deal with habitual investors, relatives, close business associates, and persons paying a subscription of at least $500,000.
[43] These exemptions cover wealthy and experienced investors.
[44] Capital Market Development Taskforce, Progress Report, July 2009, pp. 36-37.

4. Proposals for reform

17. The Ministry 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.

2. We propose that the securities regime will apply to offers to all investors apart from investors in defined exempt categories. Would there be an alternative approach that would be preferred overall (e.g. securities regime only applies to defined retail investors)? If so, please explain what the approach is and the costs and benefits of that approach compared to the proposal.

18. The Ministry 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. Based on the current exemptions, and previous proposals by the RFPP and the Capital Market Development Taskforce, we propose lesser regulatory requirements for offers to the following investors:

- 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;
- Investors who make investments of $500,000 or more;
- Relatives within four degrees of blood relationship to the issuer and directors and their spouses;
- Personal friends and close business associates, including directors, senior management, major shareholders of the company or related companies, and close relatives of these persons; and
- Employees, with offers up to 15% of assets.

19. We also seek feedback on the likely impact of the following additional exemptions, which have been put forward by the Capital Market Development Taskforce:

- Investors who have obtained a recommendation to subscribe to a securities offering from an independent financial adviser;
- Small investments of up to $2 million from up to 20 persons over 12 months; and
- Other potential exemptions, for example, retaining the wealthy investors exemption, 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.

20. Each of these is discussed in greater detail below.

3. We propose a number of categories of investors for whom securities offers are exempt from some or all of the requirements of securities law – institutions, sophisticated investors, large entities, those making large investments of $500,000 or more, relatives, close business associates, and employees. What will be the impact of using these investor categories

compared to the current regime? Would alternative categories be preferable, and if so, what categories and what impacts would they have?

21. The Ministry 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 will be recorded, potentially on a on a public register (with appropriate privacy protections), that the issuer can legally rely upon.

22. As with the Authority's power to designate novel financial products, and shift financial products between categories, we propose that the Authority 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. We also propose that a regulation making power be provided for to make these kinds of class designations without time restrictions.

4.1 Consequences of exemption

23. Offers of financial products to all investors, whether in an exempt category or not, will remain subject to civil liability for false and misleading conduct equivalent to the provisions in the Fair Trading Act and Securities Markets Act general dealing misconduct prohibition as at present. This is discussed further in Chapter 5, Other Matters.

24. 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 Financial Service Providers (Registration and Dispute Resolution) Act 2008;
- Issuer obligations under the Financial Reporting Act 1993; and
- Other issuer obligations in the Securities Act (e.g. maintaining registers of investors).

4.2 Mandated disclosure and product regulation

25. The Ministry 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).

4.3 Civil liability

26. The Ministry 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. We 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.

4.4 Criminal liability for false or misleading statements

27. The Ministry proposes that offers solely to investment businesses, sophisticated investors, large entities, and those making large investments be exempt from criminal liability under the securities law for false and misleading statements in communications to investors. These investors are assumed to be able to enforce civil claims through the courts.

28. We note that a number of countries retain high criminal sanctions for false and misleading statements in all securities offerings, including offers to institutional investors. This is the case in, for example, the United States under the Securities Act of 1933. We propose that these 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.

29. Offers to other exempt investors will be subject to criminal liability for false and misleading statements. Particularly where less sophisticated investors are making decisions, misleading statements might be used to persuade an investor that the offer is sufficiently straightforward that Securities Act protections are not required.

4.5 Financial service provider registration and offer registration

30. The Ministry is also considering whether issuers who make offers to some of these exempt classes of investors be required to:

    a. Register under the Financial Service Providers (Registration and Dispute Resolution) Act 2008 (FSPA); and/or

    b. Register the offer on the Register of Securities, to be introduced next year under the changes made to establish the Authority. 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).

31. 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 FSPA, but those who offer to wealthy and experienced investors (section 5) will have to register.[45] 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.

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

33. The Ministry 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.

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[45] The person may, of course, have to register for reasons other than being an issuer.

4.6 Financial Reporting Act obligations

34. The Ministry is 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.

4. We propose 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. We also propose that offers to other exempt investors would be exempted from everything but civil and criminal liability for false and misleading statements. What impacts will this approach have compared with applying criminal liability for false and misleading statements on offers to all categories of exempt investors? Would an alternative set of regulatory requirements for offers to exempt categories of investors be preferable? If so, what would this alternative be, and what would be the likely consequence of its adoption?

5. Should issuers to any categories of exempt investors be required to register under the Financial Service Providers (Registration and Dispute Resolution) Act 2008? What are the likely costs and benefits of this?

6. Should offers to any categories of exempt investors be required to register on the forthcoming Register of Securities? What are the likely costs and benefits of this?

7. Should issuers to any categories of exempt investors be required to register under the Financial Reporting Act 1993? What are the likely costs and benefits of this?

4.7 Exemption for investment businesses

35. The Ministry 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:

    a. keeping, investing, administering, or managing money, securities, or investment portfolios;[46]

    b. entering into derivative transactions, or trading in money market instruments, foreign exchange, interest rate and index instruments, transferable securities (including shares), and futures contracts;[47]

    c. providing advice on financial products;

    d. acting as a deposit taker as defined in the Reserve Bank of New Zealand Act 1989; or

    e. being a registered bank.

36. In addition, it would be possible to restrict this to investment businesses above a certain size. The size of an institution is an approximate proxy for its sophistication, and also its bargaining strength; larger institutions probably need less "protection". The Ministry does not consider that such size requirements are necessary, but would be open to such requirements if stakeholders thought this desirable.

[46] Based on Section 5(d) of the Financial Service Providers (Registration and Dispute Resolution) Act 2008.
[47] Based on section 5(k) of the Financial Service Providers (Registration and Dispute Resolution) Act 2008.

37. This definition would not capture highly sophisticated investors for whom one of the above activities is not a principal business. For example, the Accident Compensation Corporation is a major institutional investor in New Zealand, but its principal business is personal injury compensation, not investment. Such investors would be expected to fit within one of the other exemptions below, particularly the exemptions for large entities and sophisticated investors.

38. An alternative would be to include all persons who are registered under the FSP Act as investment businesses. However, this is not preferred for the following reasons:

- Anyone can register under the FSP Act. Registration is required by those who are in the business of providing a financial service, but they may not perform this service as a principal business, or even regularly.
- Some categories of persons required to register under the FSP Act may not have particular knowledge of investment generally. For example, insurance brokers.

8. Are there any specific impacts that we should consider in defining investment businesses? Is there a better definition, and if so, what are the impacts of this definition compared to the current definition ("persons whose principal business is the investment of money") in section 3(2)(a)(ii) of the Securities Act and the proposal?

4.8 Exemption for sophisticated investors

39. The Ministry 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, we propose to define this category with reference to objective criteria, and in particular investment activity and implied experience. The Ministry is considering a number of possible criteria to this end.

40. An alternative way to define this category would be a subjective approach. This would provide that persons that have enough knowledge and experience in investing to evaluate the risks and merits of the investment. While such an approach is relatively flexible, the Ministry is concerned that on its own this is too uncertain, as the existing exemptions in this area have demonstrated.

41. It is intended that investors in this category will be subject to few or none of the requirements of the Act, and there will be no procedural safeguards. Persons that do not satisfy the sophisticated requirements may be able to opt out using one of the other categories discussed later.

42. The Ministry 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:

   i. The person owns or manages a portfolio of financial products of at least $1 million;

   ii. The person has carried out 10 or more financial product transactions per quarter of over $2,000 in the last eight quarters; or

   iii. 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.

43. 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.

44. Bearing in mind the other exemptions that may be available, the Ministry seeks feedback on both whether the proposed criteria for sophisticated investors are sensible and whether the amounts are appropriate.

45. The RFPP also considered quantitative criteria for sophisticated investors. Submissions were generally supportive of this, although at least one submitter disagreed with using a list of criteria to define a sophisticated investor. Some additional criteria that were suggested were:

- Transactions of a significant size on securities markets. This would be a substitute for a criterion based upon the person having carried out 10 or more financial product transactions per quarter of over $2,000 in the last eight quarters, and the rationale here is that some sophisticated investors may make a smaller number of large transactions. There would be some overlap between this and a criterion based upon the person owning or managing a portfolio of financial products of at least $1 million which is discussed above.
- Three years' experience in business management, accounting, finance or commercial law. This could be a substitute for a criterion based upon the person working, or having worked, in an investment business for at least one year in a professional role that requires significant knowledge of investment in financial products. However, it would open up this criterion to a wider range of people – small business owners, for example – many of whom may not be experienced in investment.

9. Are there any specific impacts that we should consider in defining sophisticated investors? Are the proposed criteria for sophisticated investors sensible and the amounts appropriate?

10. Is there a better definition of sophisticated investor, and if so, what are the impacts of this definition compared to the current definition (i.e. persons "who, in the course of and for the purposes of their business, habitually invest money") in section 3(2)(a)(ii) of the Securities Act and the proposal?

4.9 Exemption for large entities

46. 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.

47. The Ministry 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.

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

11. Are there any specific impacts that we should consider in defining large entities? Is there a better definition, and if so, what are the impacts of this definition compared to the proposal?

4.10 Exemption for large investments of $500,000 or more

49. We propose 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. The Ministry considers these amounts are too low, being well within the range of

retail investment by individuals in, for example, failed finance companies. There may be a case for raising the exemption amount, given that the wealth of many retail investors increased substantially over the past decade from house price rises. Some investors have made investments of over $500,000 in, for example, joint ventures with Blue Chip.

50. We also do not currently propose to extend this in legislation to investors who are merely required to commit to paying $500,000 in future. We recognise that such commitments *may* indicate investor sophistication. For example, when an investor makes a large commitment to a private equity fund, this may be drawn on at any time and investors must have significant financial resources at their disposal. However, it is unclear how this can be adequately distinguished from other commitments that do not indicate sophistication, such as a scheme in which an investor pays $500,000 in instalments over a long time period.

51. In the absence of a clear way to define "true" commitments of $500,000, our preferred approach is for the Authority to grant exemptions on a case-by-case basis.

12. Are there any specific impacts that we should consider in defining large investments? Is there a better definition, and if so, what are the impacts of this definition compared to the current definition in sections 3(2)(a)(iia) 3(2)(a)(iib) of the Securities Act and the proposal?

13. Should this exemption be extended to investors who are merely required to commit to paying $500,000 in future? If so, how might this be defined, and what are the costs and benefits?

4.11 Exemptions for relatives, friends and close business associates

52. The Ministry 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.

53. The relationship between business principals and their relatives and associates is usually such that the formal requirements of the Securities Act are not considered appropriate. Business associates, friends and family are key funders of small business in New Zealand, and the existing exemption for relatives and close business associates is heavily relied upon.

54. In the RFPP, the Ministry sought views as to whether the exemptions for relatives and close business associates should be redrafted as persons who "by virtue of their relationship with the issuer [have] the knowledge or the means to obtain the knowledge of information that would normally be disclosed under the Securities Act". Submitters generally favoured retaining relatives and close business associates as a separate category, largely for the reasons outlined above. The Ministry agrees. Our preferred option is to retain a separate exemption for relatives and associates from the substantive requirements of securities regulation.

Definition of relatives

55. "Relative" in the Securities Act means a person's spouse, and anyone "within the fourth degree of blood relationship" to the person or the person's spouse.[48] In relation to any given person, this includes that person's spouse, and that person's:[49]

    a. Children, grandchildren, great-grandchildren and great-great-grandchildren;

    b. Parents, grandparents, great-grandparents and great-great-grandparents;

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[48] The Securities Act 1978 refers to the definition of relative in the Income Tax Act 2007. The Income Tax Act definition has recently been changed, but the former definition still applies for the purposes of the Securities Act.
[49] See, for e.g. http://www.sleepyhollowcemetery.org/PDF/consanguinity.pdf.

c. Siblings, nephews, nieces and grand-nephews and nieces;

d. Aunts, uncles and great-aunts and uncles;

e. First cousins; and

f. All of the above of the spouse of the person.

56. The Ministry does not propose to change the scope of the meaning of relative.

Definition of friends and close business associates

57. "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. Some argued that a fixed definition was undesirable as it will constrain the range of relationships covered. Others thought that a principle-based focus would be a more subjective test, and therefore more difficult to apply in practice. A number argued that there should be a list of accepted relationships, as well as a more general principle.

58. The Ministry's view, in line with the latter submissions, 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.

59. 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

60. The Australian Corporations Act 2001 provides a similar, but more narrow, exemption for senior managers of the company or related companies and their relatives.

61. The Ministry seeks feedback on both whether the proposed criteria for friends and close business associates are appropriate.

14. Are there any specific impacts that we should consider in defining relatives and close business associates? Are the proposed criteria for friends and close business associates appropriate?

15. Is there a better definition of relatives and close business associates to that we are proposing? If so, what are the impacts of this alternative definition compared to the current definition in section 3(2)(a)(i) of the Securities Act and the definition we are proposing?

4.12 Exemption for offers to employees (e.g. employee share schemes)

62. Employee share schemes are plans under which employees are given shares or options in the company. Employee share schemes are intended to link employee remuneration to the performance of the company, and therefore create incentives for employees to improve company performance. They are also used as a partial substitute for cash remuneration (especially in young, rapidly growing companies that are "cash poor"), and to foster a sense of ownership among employees and participation in the company's management and direction. To create incentives to boost long-term company performance, shares are often intended or required to be held for long periods before they are traded, and options may have significant delays before they can be exercised.

63. In its Progress Report of July 2009[50], the Taskforce made recommendations on employee share schemes to broaden their use while retaining safeguards to ensure they are not used as a primary form of capital raising.

64. As noted above, we are proposing that senior management be explicitly included in the exemption for "close business associates".

65. Beyond senior management, there are a number of options for employees generally:

- The current class exemptions for employee share schemes; and
- A more general exemption for all employees in all companies.

66. There are a range of ways that a general exemption could be restricted:

- By size, on a total offer basis;
- By size per employee, perhaps as a percentage of employee remuneration; and
- By the objective of fundraising.

67. In the United States, the size of offers using Rule 701 (an exemption for employee share schemes) is capped to US$1 million, or 15% of assets, or 15% of the outstanding value of securities of the same class.[51] The rule includes a preliminary note, which states:

> The purpose of this section is to provide an exemption from the registration requirements of the Act for securities issued in compensatory circumstances. This section is not available for plans or schemes to circumvent this purpose, such as to raise capital. This section also is not available to exempt any transaction that is in technical compliance with this section but is part of a plan or scheme to evade the registration provisions of the Act. In any of these cases, registration under the Act is required unless another exemption is available.

68. Securities must be issued "under a written compensatory benefit plan (or written compensation contract)". The offer must be separate from any other securities offering by the issuer, and if the offer is for US$5 million or more, a limited disclosure statement is required. "Employees" here can include employees, consultants, and their family members.

69. Australia places much more restrictive conditions on employee share schemes: offers must be less than 5% of the value of securities of the same class, and the company must be

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[50] Available at http://www.med.govt.nz/upload/69666/Interim-report.pdf.

[51] Securities and Exchange Commission, "Rule 701: Exemption for Offers and Sales of Securities Pursuant to Certain Compensatory Benefit Plans and Contracts Relating to Compensation". Available at http://www.law.uc.edu/CCL/33ActRls/rule701.html.

listed.[52] Only part-time and full-time employees are covered (i.e. no casual employees or contractors).

70. The Ministry proposes to create an exemption similar to Rule 701 in the United States. This 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 we 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.

71. Employee share schemes would be exempt from most disclosure requirements, but we 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.

16. Are there any specific impacts that we should consider in defining employee share schemes? Is there a better definition, and if so, what are the impacts of this definition compared to the current Securities Commission exemption notices, and the proposal?

17. What are the costs and benefits of the proposed disclosure regime for employee share schemes, compared to (a) no disclosure; and (b) the current exemption notices? Is there alternative regulation that should apply to employee share schemes, and what would be the impacts of applying this alternative?

4.13 Exemption for investors advised by an independent financial adviser

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

73. While the exemptions above 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.

74. 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.

75. 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 Capital Market Development Taskforce proposed that offers to investors who have received a recommendation from a conflict-free financial adviser be exempted from the Securities Act.

76. Under this exemption, the adviser would be responsible for judging whether the information and assurances provided by the issuer are adequate. This is analogous to the role played by a managed fund. When a retail investor invests in a fund, the fund manager makes

[52] ASIC, “Employee Share Schemes”, Regulatory Guide 49. Available at http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ps49.pdf/$file/ps49.pdf.

investments on their behalf. These investments will often include securities offerings that are made to institutions and sophisticated investors only, and which are therefore not subject to the disclosure obligations under securities law.

77. As well as reducing compliance costs for issuers by enabling them to make offers to these investors:

- It enables investors to participate in offers they would otherwise not have access to;
- It could improve standards of disclosure, as financial advisers are expected to demand more relevant and specific information than would normally be present in disclosure statements created to meet the requirements of legislation;
- It could encourage the development of professional independent financial advisers; and
- It could encourage the seeking of financial advice, and better investment decisions.

78. A possible set of criteria for the adviser are:

- The adviser would be an authorised financial adviser under the Financial Advisers Act 2008;
- 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.

79. It might be argued the mere fact that advice on an investment has been received from an independent financial adviser is an indication that the investor is taking a prudent approach to the offering. If this reasoning were accepted, a recommendation would not be required; evidence of consultation would be sufficient. We would not propose to take the exemption this far, as we consider the investor also needs to be given a clear understanding of the rights they are potentially foregoing, but would welcome feedback on this issue.

18.	Is an exemption for persons advised by an independent financial adviser appropriate? Are there any specific impacts that we should consider in exempting investors advised by an independent financial adviser? Is there an alternative proposal that would achieve the same objective, and if so, what are the impacts of this compared to the proposal?

Comparison with existing exemption for those certified by an independent financial service provider

80. As discussed above, there is an existing exemption for offers to people certified by an independent financial service provider as sufficiently experienced that they can assess the offer without a prospectus and investment statement. We understand that this exemption is not used, due to a reluctance on the part of financial service providers to provide certification, and for issuers to accept this certification at face value. The possible exemption may also suffer from underuse, but the Ministry considers that it has potential to make a number of improvements on the existing exemption:

- Unlike the existing exemption, consideration of the offer is being made on the investor's behalf (the appropriate role for a financial adviser), rather than the adviser having to evaluate both the offer, and the ability of the investor to make their own assessment of the offer.

- We could remove the requirement that the recommendation be made "on reasonable grounds". Thus, the issuer is entitled to place reliance on the fact that a recommendation has been made, and the adviser is generally not liable to the issuer (unless an offer is voided as a result of the adviser not being authorised or not declaring conflicts of interest). Advisers would continue to be liable to investors for negligent advice and for breaches of the Code of Professional Conduct.

4.14 Concessions for small offers

81. The Capital Market Development Taskforce's report notes that the securities laws of a number of other countries exclude offers below a certain size threshold. For example:

- Australia: a maximum of A$2 million from up to 20 investors in 12 months;
- Singapore: up to 50 people or S$5 million in 12 months;
- Hong Kong: offers of shares and debentures up to 50 people or HK$5,000,000;[53] and
- European Union: up to 100 people[54] per Member State, or €2.5m in 12 months.[55]

82. The Ministry is considering whether a small offers regime should be adopted in New Zealand. Submissions on the RFPP were generally supportive of adopting a small offers regime, but some submitters argued that the investor protection reasons for regulating offers to the public apply equally to small offers. The Taskforce suggested two reasons for New Zealand to create such an exemption:

- The high cost of complying with the Securities Act can outweigh the benefits of small offers to the issuer and the investors. In consequence, the Securities Act effectively bans offers below a certain size, except to investors who are specifically exempted under the Act.
- If the offer is made to a small number of investors, the investors more likely to have been chosen for their relationship with the issuer, knowledge of the offer, or history of making similar investments, rather than as members of the public. They are more likely to be in a position to negotiate with the issuer, or (given that these are a limited class of offers) to reject the offer in the knowledge that there are other investment opportunities available.

83. If this exemption is adopted, the Ministry would be reluctant to provide an exemption that is too broad for small offers, as we do not consider that investors in these offers are automatically going to be able to make a well-informed investment decision outside the formal requirements of securities regulation.

84. 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, we propose that the maximum offer size should be less than in some of the other countries listed above. The small offer exemption in these other countries is based on the assumption that, without it, fundraising requires the preparation of expensive disclosure documents and governance requirements. These may not be worthwhile for offers of under $2 million or more. However, if other exemptions are broad, the compliance costs in the absence of a small offers regime can be much lower than in these other 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.

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[53] Companies Ordinance, Seventeenth Schedule.
[54] Directive 2003/71/EC, Article 3, paragraph 2(b).
[55] Directive 2003/71/EC, Article 1, paragraph 2(h).

85. We propose 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. We would also propose 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.

86. We are 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.[56]

19. Is an exemption for small offers appropriate? What are the likely costs and benefits of exempting small offers? What are appropriate thresholds, in terms of total offer size, number of investors, and amounts per investor, and what are the impacts of these compared to the proposed starting point? Is there an alternative proposal that would achieve the same objective, and if so, what would be the impact of this compared to the proposal?

4.15 Other exemptions

87. The above exemption categories provide relief from the substantive requirements of securities regulation for offers to specified classes of investors. The basis for these exemptions are largely that these investors are either sufficiently experienced in investment, or have a relationship with the issuer that means they are unlikely to agree unfavourable offers without obtaining the required information and seeking appropriate advice. Their position will be such that they are either able to negotiate the terms of the offer, or are able to recognise when there are deficiencies in the terms of the offer and reject it on that basis.

88. However, some have suggested that allowance ought to be made for a broader range of investors to opt out of the Act. The Capital Market Development Taskforce recommended consideration of an exemption in which anyone could opt out of the Act, subject to conditions that investors have sought independent legal advice on the consequences of waiving their rights under the Act and signed a prescribed statement witnessed by their lawyer.

89. There are a number of reasons to consider allowing other investors to opt out of the Act. These include: the inaccuracies inherent in setting thresholds in legislation for “sophisticated” investors, the presence of valid reasons for not requiring the protections of the Act that probably cannot be captured by statutory exemption criteria, and more philosophical concerns about freedom of contract.

90. The criteria relating to sophistication are necessarily limited proxies for investors who are sufficiently sophisticated to assess the merits of a given offer without mandated disclosure and product regulation. There is a tendency to set thresholds for the exemptions that relate to sophistication to be set high to ensure that unsophisticated investors do not inadvertently fall within the scope of the exemption, but this means there will be some sophisticated investors who do not quite meet the thresholds.

91. There are likely to be other valid reasons why a person does not require the protections of the Securities Act that are not captured by the exemptions. For example:

   - an investor might be investing in a private offer alongside other much more sophisticated investors whom they know and trust; or

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[56] SCIF, The Business of Angel Investing in New Zealand: A Guide. Available at http://www.angelassociation.co.nz/template/documents/investors/angel_guide.pdf.

- the investor might have access to special knowledge about the company and its industry, as a result of running their own similar business, notwithstanding that they lack experience in investing generally; or

- the investor might have their own motivations for investing – a desire to support and become involved in the development of a promising young start-up company, for instance.

92. There are also rights-based arguments for allowing opting out of the Act. The principle of freedom of contract holds that parties to a contract should not have contractual terms imposed on them by government. If an investor genuinely does not want a statutory disclosure statement or a debt trustee, the Securities Act should not impose this.

93. Against this, consumer protection laws generally do not allow for contracting out. They exist precisely because consumers do not have the information, understanding and/or bargaining power needed to assess offers and negotiate terms. 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. If this occurs, even those investors who would be reluctant to enter into a private offer find themselves with little choice.

94. The Ministry is considering alternative procedures for opting out of the Securities Act, although we do not make any firm proposals at this stage. We consider that safeguards are necessary if provision were made for other investors to opt out, as such investors may not be sophisticated, and may not understand the offer or the consequences of opting out of the Act. 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.

95. 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

96. We discuss potential qualifying criteria in more depth below.

4.15.1 Independent legal advice

97. An investor who wants to opt out could be required to seek independent legal advice as to the requirements of the new Act and the effect and implications of opting out of the

requirements. This would be similar to the contracting out provisions of the Property (Relationships) Act.[57]

4.15.2 Prescribed statement

98. The investor could be required to sign a statement declaring that the Securities Act will not apply to the investment. A model agreement could be prescribed in regulation, and its use would be mandatory (unlike the Property (Relationships) Act, where the model agreement is optional[58]). The model declaration could set out the statutory protections provided by the Securities Act, the circumstances under which an investor could reasonably invest without those protections, and the implications of opting out. For example, it could state something like:

> By signing this agreement you are choosing to waive your rights under the Securities Act. This decision has a number of implications:
>
> **Your investment may have risks you haven't been told about**. The Securities Act requires that the person making this offer to you discloses all matters that might affect your decision whether or not to invest. By waiving your rights under the Securities Act, the person making the offer is no longer required to tell you about these matters in a disclosure statement.
>
> **[For a debt issue or collective investment scheme:] Your investment may not be adequately monitored.** The Securities Act requires that when you make an investment, the person making the offer puts in place an independent supervisor who will act in your interests to place restrictions on their activities, and will monitor their activities on an ongoing basis. For example, a trustee will try to ensure that a borrower does not become too heavily indebted and unable to pay you back. By waiving your rights, you are entirely responsible for ensuring that appropriate conditions, governance and independent monitoring are in place.
>
> **The Financial Markets Authority will have limited oversight with respect to your investment.** The Securities Act requires that offers be registered with the Authority. They are then subject to some monitoring by the Authority, and the Authority can take action on your behalf in the event that you have been misled or your rights are breached. By waiving your rights, under the Securities Act, the Authority will not see the information you have been provided by the person making the offer, and has fewer powers to act.
>
> You should **only** sign this agreement if:
>
> - you are confident you fully understand the offer and are able to assess its merits and risks;
> - you are confident you have received or will receive all the information that is relevant to your decision to invest;
> - you have your own means of verifying the accuracy and completeness of the information you receive;
> - you are able to put into place appropriate conditions and monitoring of the company making the offer on an ongoing basis;
> - you are under no pressure to accept the offer if you are not fully satisfied;
> - you have your own means of holding the company making the offer to account if something goes wrong

99. If independent legal advice were required, as above, the lawyer who witnesses the signature of the investor would need to certify that, before that investor signed the declaration, the lawyer explained to the investor the effect and implications of the declaration.

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[57] Property (Relationships) Act 1976, Section 21-21H.
[58] Property (Relationships) Act 1976, Section 21E(3).

4.15.3 An independent financial service provider or some other third party has certified that the investor is sufficiently sophisticated to protect themselves without the Act

100. Another option would be to require a person to certify an investor's sophistication.

101. This would be similar to the current exemption for experienced investors, but could be reworked. One option could be to remove the current requirement that the certification is "on reasonable grounds". This would enable issuers to take certification at face value, and protect the certifying party from liability. Another approach would be to remove the requirement that the person conducting the certification be independent of the issuer.

4.15.4 The investor meets some minimum objective standards of investment experience

102. One criterion might be that the investor has some degree of sophistication, but less than would be required to meet the criteria for sophisticated investors described in section 4.8 above. Lower thresholds and alternative criteria could be adopted where some of the other safeguards described in this section are met. For example, the criteria could be two of the following:

    a. Has a portfolio of financial products of at least $1 million;

    b. Has carried out 20 or more financial product transactions of over $2,000 in the last two years;

    c. Has carried out 5 or more financial product transactions of over $50,000 in the last two years;

    d. Works or has worked for an investment business (defined above) for at least one year in a professional role that requires knowledge of investment in financial products.

4.15.5 The investor meets some minimum investor's income, wealth, or education standards, with or without third-party confirmation

103. Another potential criterion is that the investor meets some standard of income, wealth, or education. While these are not indicators of investment experience, they may indicate that a person has greater means to protect themselves and, in the case of a wealthy person, is more able to accept loss.

4.15.6 The investor is a member of an approved investment group, e.g. an angel group

104. Another criterion could be membership of a group that specialises in particular types of investments. For instance, by joining a business angel group, a person signals that he or she wishes to make investments in small, high risk companies. The group applies a certain degree of screening of both issuers and investors and also provides support to investors.

105. The approved groups could be restricted to those prescribed in regulations. The person may only be able to invest in offers that they become aware of through the group.

4.15.7 Restrictions on offer size, marketing, and type of offer

106. The use of this exemption could be further restricted by placing limits on the maximum size of the offer, total to be raised, or number of investors who the offer will be made to.

Restrictions can also be imposed on marketing, to prevent these offers from being generally advertised. This is a common feature of overseas small offering exemptions.

107. Finally, restrictions could be placed on the use of this exemption for managed investment schemes and other investment companies, derivatives, and “blank cheque companies” without established business plans.

4.15.8 Comment

108. 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.

109. With respect to the Taskforce recommendation, the Ministry 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.

110. We are therefore seeking submitters’ views on these criteria.

20. Is an additional exemption allowing investors to “opt-out” desirable? What principles would such an exemption rest on?

21. If such an exemption were introduced, what are appropriate criteria for controlling its use, and what are the costs and benefits of these criteria?

4.16 Certification and registration of exempted investors

111. Where there are objective criteria for exempting an investor from some of the requirements of the Securities Act, the Ministry proposes that, by default, responsibility for confirming that an investor is exempt will sit with the issuer. But investors will also be able to self-certify as fitting into one of the exempt categories, and a further step would be to record this on a public register that the issuer can legally rely upon.

Self-certification vs third party verification

112. In most cases it will be clear to the issuer whether or not an investor fits in a category of exemptions, and there will be minimal benefits to extra certification. For example, it will be clear to an issuer that a fund manager is an investment business, or a large and well known company is a large entity. However, some exemptions rely on private investor information. For example, to verify that an investor is sophisticated, issuers would need to seek evidence from investors about their financial assets, transactions and work histories. Because investors have incentives to falsely claim sophistication, allowance would have to be made to protect issuers and punish investors who provided false information. This process would need to be performed for every sophisticated investor, and every transaction, and would likely be impractical for many issuers and sophisticated investors.

113. The Ministry therefore seeks feedback on whether, as in the United Kingdom, investors should be able to self-certify that they meet the criteria of an exempt investor.[59] An issuer would be entitled to rely on such certification, so that even if an investor was later determined not to be meet the criteria but had self-certified earlier that they were able to, this would not impugn the transaction or create liability for the issuer.

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[59] The form required to register as a qualified investor in the UK is available at http://www.fsa.gov.uk/pubs/ukla/qir_formb.pdf.

114. Offences might be required to avoid abuse, such as an offence for an issuer to encourage or assist a potential investor to self-certify. Some limits would be required, such as providing that it would not be an offence to simply state that the offer can only be accepted by investors certified as sophisticated and to state how certification can be obtained. To reduce the extent to which an investor might let themselves be encouraged by the issuer to falsely self-certify, it could also be an offence for an investor to certify themselves if they do not meet the criteria.

115. Another option is that a third party (perhaps the Authority, or an independent financial adviser) verifies and certifies that an investor satisfies the criteria. Third-party verification would require investors to provide evidence of their financial assets, transactions and work history to the third party. The third party would issue a certificate that could be relied upon by the issuer and subsequent issuers.

116. These alternatives were raised by the RFPP, and submissions were mixed. Some submitters favoured self-certification and argued that it is not appropriate for a public registrar to be responsible for verifying the accuracy of the certification, that it would impose high compliance costs, and investors would be reluctant to disclose private information to others. Other submitters favoured the assurance provided by third party certification.

Public register of certified investors

117. The Ministry 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 Authority. 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.

118. If there is self-certification, the advantages of a public register are:

- It creates a permanent record of certification, providing clear evidence of the certification and its timing (if it is subject to dispute).
- It allows self-certification to take place at a particular point in time, and for this to serve as evidence of sophistication over a number of subsequent investments. Otherwise investors must either (a) certify themselves as sophisticated based on their current financial assets, and most recent transaction history, such that they may find themselves falling out of the required criteria every time they attempt to make a new investment; (b) certify themselves as having, at some point in the past, met the sophistication criteria; or (c) produce their own certificate at a particular time, and provide copies of this to issuers.
- Having to register with a public authority provides an additional psychological barrier to investors misrepresenting their level of sophistication.

119. A disadvantage of a public register is the cost and delay associated with registering. A public register of sophisticated investors also has privacy implications. One option is to limit search criteria to only enable confirmation that a particular person is registered. The alternative used in the United Kingdom is that issuers can obtain a copy of the register, which would allow the register to be used to find registered investors.

120. The RFPP proposed that self-certification would be combined with a public register and did not ask whether or not a register was desirable. Submitters made reference to the register, but no submitter disagreed with a register.

121. If self-certification and a public register were used, the Ministry considers that there is a risk that requiring ongoing certifications would impose undue compliance costs. We note that

some submitters to the RFPP considered it appropriate to require certifications to be renewed periodically (for example, annually, or every two years, or every five years) as in the United Kingdom. Another submitter favoured investors having a duty to notify the register when they no longer met the criteria. The Ministry therefore seeks further information about the costs and benefits of requiring certification to be renewed. Note that in any case, investors would have to update the register when their identifying details changed.

22. What are the costs and benefits of allowing self-certification? Is there a preferred alternative, and if so, what impacts would this have?

23. If self-certification is provided for, what are the pros and cons of having an offence to encourage and assist an investor to certify, and for an investor to falsely self-certify? Is there a better way to ensure that self-certification is not abused, and what would the consequences of this alternative be?

24. What are the costs and benefits of having a public register of exempt investors?

25. If a public register of exempt investors is created, should certification be renewed, and if so how often? What are the likely costs and benefits of requiring renewal of certification?

26. If a public register of exempt investors is created, what are the pros and cons of allowing issuers to access it for the purposes of finding registered investors (in addition to checking that an investor is certified)?

4.17 Regulator and regulations to designate investors with respect to exemptions

122. We note that there may be opportunities to avoid regulation by abusing exemptions for offers to particular classes of investors. As with the Authority's power to designate financial products to be in a particular category of financial products, we consider that the Authority should have the discretion to designate an investor or class of investors as being within or not within the scope of particular exemptions.

123. Where this power is used for classes of investors, it may be made via regulations made by the Governor-General in Council on the advice of the Minister of Commerce, or temporarily by the Authority, with a maximum duration of one year.

124. Finally, we consider that this power should be able to be exercised either on the Authority's own discretion or upon application by another person.

27. What are the costs and benefits of allowing the Authority and regulations to designate an investor or class of investors as being within or not within the scope of particular exemptions?

28. What criteria and requirements should be placed on a designation power, and what impacts would these have?

29. Is there an alternative way to treat investors that technically fall within the exemptions but should not? What costs and benefits would this alternative have?

4.18 Void allotments

125. In its progress report, the Taskforce recommended that the Securities Act should be amended to "remove voiding of entire offers when they are taken up by a single member of the public".

Status quo

126. Under section 37 of the Securities Act, no allotment of a security offered to the public for subscription can be made unless, at the time of subscription for the security there was a registered prospectus relating to the security. Any allotment made in contravention of this requirement is invalid and of no effect. In addition, criminal liability under section 59 for allotment in contravention of the Act may arise.

127. Following the passage of the Business Law Reform Bill in 2004, the Securities Act now contains a specific statutory process for the granting of mandatory or discretionary relief orders in cases where the allotment is deemed to be invalid and of no effect due to the operation of section 37. Prior to the enactment of these provisions, courts had the jurisdiction to grant relief under the Illegal Contracts Act 1970. The provisions addressed perceived deficiencies in the process under the Illegal Contracts Act, such as in relation to overseas issuers.

128. Section 3(5) of the Securities Act provides that "proof of an offer of securities to one person selected as a member of the public shall be prima facie evidence of an offer of securities to the public". The effect of this section, when read in conjunction with section 3(2)(a), is that each and every person whom an offeror offers an investment opportunity must fall within one of categories referred to in section 3(2)(a) if there is to be no offer to the public.

129. If any one person to whom an offer is made and securities are allotted is a member of the public (i.e. falls outside section 3(2)(a)) and is not otherwise an eligible person under section 5(2CB), then the entire offer and allotment will have been undertaken in breach of the Securities Act if there was not a registered prospectus and an investment statement. The consequence of such a breach is that the offer is void unless the issuer is granted relief by a court.

Comment

130. Section 37 imposes a strict discipline on issuers wishing to make private offers to ensure that all of its subscribers are exempt or eligible. Relaxing the rule runs the risk that issuers will become more relaxed about applying the rules for exemptions and eligibility – leaving it to investors to decide whether they consider they are exempt.[60] On the other hand, subscribers may legitimately prefer that the investment is not made void, but be unwilling to be involved in the cost of obtaining a relief order.

131. The Taskforce recommended that the Act be amended so that it is clear that the allotment of securities to persons who are genuinely not members of the public or are eligible persons in such circumstances does not void the offer. Only the allotment of securities to a member of the public (who is not an eligible person) should be void.

132. The Taskforce considered that this would reduce the uncertainty to issuers, especially given the current uncertainties around the section 3(2)(a) exemptions. The Taskforce considered that an alternative would be to allow the regulator to validate the offer, rather than a court.

133. A third option would be to provide that such offers are voidable at the instance of the subscriber rather than void. This option would preserve the discipline on issuers of ensuring the persons fall within the scope of the exemptions. It also preserves the concept that an offer is either covered by the Act or it is not – and when it does apply, it applies in respect of all subscribers. Combined with clarification of the categories of exempt persons discussed in the section on the scope of the Act, this is the Ministry's preferred option. It would also apply to the other instances of void allotments currently specified in section 37.

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[60] Noting of course, that the issuer and its directors may be subject to the offence under section 59.

134. The period during which the offer would be voidable by the subscriber would need to be considered. Under section 37A, the subscriber has the later of 1 year from receiving the security or certificate, or 6 months after the subscriber knows, or ought reasonably to know, that the allotment was made in contravention of the section, to give notice voiding the allotment. In the case of those allotments referred to in section 37, the Ministry considers that this period should be longer, and potentially aligned with the Limitation Act (i.e. 7 years).

> 30. We propose that allotments currently specified in section 37 as void irregular allotments should instead be voidable at the instance of a subscriber. What are the costs and benefits of using this compared to the current treatment of such allotments? Would alternative treatment be preferable? If so, what treatment, and why would it be preferable?
>
> 31. If allotments currently specified in section 37 become voidable by the subscriber, what period should the subscriber have to exercise a right to void the offer?

Chapter 2: Consolidated questions

1. Do you agree with problems identified with the current regime? Are there any other problems with the way that the exemptions for offers to particular categories of investors work, and if so, what impacts do they have?
2. We propose that the securities regime will apply to offers to all investors apart from investors in defined exempt categories. Would there be an alternative approach that would be preferred overall (e.g. securities regime only applies to defined retail investors)? If so, please explain what the approach is and the costs and benefits of that approach compared to the proposal.
3. We propose a number of categories of investors for whom securities offers are exempt from some or all of the requirements of securities law – institutions, sophisticated investors, large entities, those making large investments of $500,000 or more, relatives, close business associates, and employees. What will be the impact of using these investor categories compared to the current regime? Would alternative categories be preferable, and if so, what categories and what impacts would they have?
4. We propose 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. We also propose that offers to other exempt investors would be exempted from everything but civil and criminal liability for false and misleading statements. What impacts will this approach have compared with applying criminal liability for false and misleading statements on offers to all categories of exempt investors? Would an alternative set of regulatory requirements for offers to exempt categories of investors be preferable? If so, what would this alternative be, and what would be the likely consequence of its adoption?
5. Should issuers to any categories of exempt investors be required to register under the Financial Service Providers (Registration and Dispute Resolution) Act 2008? What are the likely costs and benefits of this?
6. Should offers to any categories of exempt investors be required to register on the forthcoming Register of Securities? What are the likely costs and benefits of this?
7. Should issuers to any categories of exempt investors be required to register under the Financial Reporting Act 1993? What are the likely costs and benefits of this?
8. Are there any specific impacts that we should consider in defining investment businesses? Is there a better definition, and if so, what are the impacts of this definition compared to the current definition ("persons whose principal business is the investment of money") in section 3(2)(a)(ii) of the Securities Act and the proposal?
9. Are there any specific impacts that we should consider in defining sophisticated investors? Are the proposed criteria for sophisticated investors sensible and the amounts appropriate?
10. Is there a better definition of sophisticated investor, and if so, what are the impacts of this definition compared to the current definition (i.e. persons "who, in the course of and for the purposes of their business, habitually invest money") in section 3(2)(a)(ii) of the Securities Act and the proposal?
11. Are there any specific impacts that we should consider in defining large entities? Is there a better definition, and if so, what are the impacts of this definition compared to the proposal?
12. Are there any specific impacts that we should consider in defining large investments? Is there a better definition, and if so, what are the impacts of this definition compared to the current definition in sections 3(2)(a)(iia) 3(2)(a)(iib) of the Securities Act and the proposal?
13. Should this exemption be extended to investors who are merely required to commit to paying $500,000 in future? If so, how might this be defined, and what are the costs and benefits?
14. Are there any specific impacts that we should consider in defining relatives and close business associates? Are the proposed criteria for friends and close business associates appropriate?

15. Is there a better definition of relatives and close business associates to that we are proposing? If so, what are the impacts of this alternative definition compared to the current definition in section 3(2)(a)(i) of the Securities Act and the definition we are proposing?
16. Are there any specific impacts that we should consider in defining employee share schemes? Is there a better definition, and if so, what are the impacts of this definition compared to the current Securities Commission exemption notices, and the proposal?
17. What are the costs and benefits of the proposed disclosure regime for employee share schemes, compared to (a) no disclosure; and (b) the current exemption notices? Is there alternative regulation that should apply to employee share schemes, and what would be the impacts of applying this alternative?
18. Is an exemption for persons advised by an independent financial adviser appropriate? Are there any specific impacts that we should consider in exempting investors advised by an independent financial adviser? Is there an alternative proposal that would achieve the same objective, and if so, what are the impacts of this compared to the proposal?
19. Is an exemption for small offers appropriate? What are the likely costs and benefits of exempting small offers? What are appropriate thresholds, in terms of total offer size, number of investors, and amounts per investor, and what are the impacts of these compared to the proposed starting point? Is there an alternative proposal that would achieve the same objective, and if so, what would be the impact of this compared to the proposal?
20. Is an additional exemption allowing investors to “opt-out” desirable? What principles would such an exemption rest on?
21. If such an exemption were introduced, what are appropriate criteria for controlling its use, and what are the costs and benefits of these criteria?
22. What are the costs and benefits of allowing self-certification? Is there a preferred alternative, and if so, what impacts would this have?
23. If self-certification is provided for, what are the pros and cons of having an offence to encourage and assist an investor to certify, and for an investor to falsely self-certify? Is there a better way to ensure that self-certification is not abused, and what would the consequences of this alternative be?
24. What are the costs and benefits of having a public register of exempt investors?
25. If a public register of exempt investors is created, should certification be renewed, and if so how often? What are the likely costs and benefits of requiring renewal of certification?
26. If a public register of exempt investors is created, what are the pros and cons of allowing issuers to access it for the purposes of finding registered investors (in addition to checking that an investor is certified)?
27. What are the costs and benefits of allowing the Authority and regulations to designate an investor or class of investors as being within or not within the scope of particular exemptions?
28. What criteria and requirements should be placed on a designation power, and what impacts would these have?
29. Is there an alternative way to treat investors that technically fall within the exemptions but should not? What costs and benefits would this alternative have?
30. We propose that allotments currently specified in section 37 as void irregular allotments should instead be voidable at the instance of a subscriber. What are the costs and benefits of using this compared to the current treatment of such allotments? Would alternative treatment be preferable? If so, what treatment, and why would it be preferable?
31. If allotments currently specified in section 37 become voidable by the subscriber, what period should the subscriber have to exercise a right to void the offer?

Chapter 3 - Disclosure

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1. Introduction

1.1 The scope of this chapter

1. This chapter of the discussion document considers disclosure requirements for public issuers. It considers the purposes of disclosure and the audiences for disclosure before going on to look at the overall framework for disclosure by issuers including:

   - how point of sale disclosure should be made (i.e. in one or two documents and/or on a website);
   - what the appropriate content and format of disclosures should be;
   - what kinds of ongoing disclosures should be made by different kinds of issuers;
   - whether a requirement to disclose "all other material matters" in addition to prescribed disclosures should be retained;
   - what potential liability should attach to statements by promoters and experts, and celebrities who endorse products; and
   - what rules are appropriate for disclosures in advertisements.

2. The proposals in this chapter will be underpinned by a detailed set of regulations setting out the specific disclosures required by issuers of different kinds of securities. The Ministry proposes to conduct a separate process for designing the content of these regulations. However, where appropriate in this chapter we have indicated some of the specific types of disclosures that we anticipate different issuers making at the point of sale and on an ongoing basis. These specific disclosures are not meant to be comprehensive and will be worked through in more detail as the regulations are designed.

1.2 The purpose of disclosure

Information asymmetries for retail investors

3. The dominant purpose of regulating disclosure about financial products is to seek to balance information asymmetries, as the issuer has more information than the investor about who is offering the product, the product itself, and the terms and conditions on which it is sold. This information asymmetry disadvantages the investor, resulting in an inefficient market.

4. Where there is no information asymmetry, which might occur where the investor has or is easily able to obtain the information for themselves, then this audience does not require disclosure. This is why private offers are currently excluded from the scope of the Securities Act.

5. Product providers have incentives to misinform or not inform investors about product shortcomings. The issue is whether specific regulation is required in relation to securities markets, or whether the general law will suffice. The Ministry's view is that specific regulation is required.[61] This view accords with the views of our trading partners, who regulate financial

[61] An argument against mandated disclosure is that product providers bear the cost of insufficient information as consumers who are unable to properly value a product will pay less for it. This should incentivise product providers to voluntarily provide information in order to assist consumers to place greater value on the product. As misleading and fraudulent behaviour is already illegal under the Fair Trading Act and other laws, and if providers value their reputation, mandated disclosure should be unnecessary. Further, it will also be costly. See George J. Benston PH.D, C.P.A *Voluntary Vs Mandated Disclosure – An evaluation of the Basis for the Recommendations of the Working Group on Improved Investment Product and Adviser Disclosure*, New Zealand Business Roundtable, May 1997.

product disclosure in a manner similar to New Zealand. Internationally accepted principles for securities also require regulation of the conditions applicable to an offering of securities for public sale and the content and distribution of prospectuses or other offering documents.[62]

6. Disclosure also helps allocative efficiency. Effective disclosure should be able to assist investors (either on their own, or with the assistance of advisers and information providers) to compare investments and allocate money to the highest value investment opportunities. As a result, comparability is a disclosure objective.

7. The principal targets of disclosure are those investors who are not otherwise able to access the information they need, who we describe as retail investors. Retail investors have varying levels of knowledge, aptitude and expertise when it comes to understanding financial information. To the extent that it is possible, the Ministry considers that disclosure should be accessible and comprehensible to all types of retail investor. Where this is not possible, the Ministry considers that disclosure should be targeted at the prudent, non-expert retail investor, the current audience for investment statements.

8. The Ministry notes that if retail investors do not fully understand what they are investing in, clearly they can be hurt. New Zealand is worse off if some of its citizens are worse off. But the harm is also more widespread. When poor disclosure leads to unsuccessful investing (because, for example, an investment is riskier than investors realised), the investors and people they know are all less likely to make further investments in capital markets. This disadvantages companies raising capital and, more broadly, hinders economic growth.

Secondary audiences and purposes

9. The Ministry considers that while the primary audience for disclosure are retail investors, there are also important secondary audiences. For example, disclosure also provides the finance industry, such as financial advisers, market commentators and market analysts, with information about the issuer and the offer, so analysis can be done. This will, in turn, assist retail investors. While some of these people may be able to obtain information from other sources, a disclosure obligation appears to be an efficient means of making this information available.

10. Disclosure also assists regulators to carry out their supervisory functions by providing a formal public record of the offer. This assists enforcement of the Securities Act and other laws. For example, it forms the basis of a regulator’s power to hold issuers to account for the completeness and accuracy of the information disclosed and enables the regulator to compare advertisements about the offer with the formal disclosure of the offer.

11. Preparation of disclosure documents may also be a useful due diligence exercise for the issuer. It forces the issuer to consider all the circumstances of the offer, including the risks, and to have the offer signed off by each director.

1. Should the principal target of disclosure be retail investors?
2. Are the secondary audiences and purposes we have identified correct?

[62] See International Organisation of Securities Commissions *Objectives and Principles of Securities Regulation*, June 2010.

2. Point of sale disclosure – status quo and problem definition

2.1 Status quo

12. The Securities Act provides for disclosure to potential investors in the form of a "prospectus" and an "investment statement". In general, where an offer of securities is made to the public, a prospectus must be registered and be provided to potential subscribers on request, while an investment statement must be provided to the investor before subscribing for the security.

13. Prospectuses are intended to provide full details of the offer and the circumstances of the issuer. In general, prospectuses must not be false or misleading, including by failing to refer, or give proper emphasis, to known adverse circumstances.[63] Specific content required in prospectuses is prescribed in regulations. All prospectuses summarise the main terms of the offer and the details of the people involved in the offer. In most cases the regulations require that prospectuses disclose "all material matters in respect to the offer". In addition, the regulations specify particular detailed requirements depending on the type of offer and type of security.[64]

14. By contrast, an investment statement is intended to provide key information to assist a prudent but non-expert person to decide whether or not to subscribe for securities, and bring to their attention important information available in other documents. An investment statement must not be likely to deceive, mislead, or confuse with regard to any particular that is material to the offer of securities to which it relates and must be consistent with any registered prospectus referred to in it. The investment statement was originally introduced because it was felt that prospectuses did not fulfil all the needs of retail investors, and a separate, more accessible document was required.

15. There is currently only one set of requirements for investment statements for new offers of securities, regardless of the type of security.[65] The current investment statement uses a question and answer format, and must include details about the securities, the people involved, the monies payable, any charges, the returns, the risks, alterations, terminating or selling, contacts, complaint resolution, and where other information can be obtained.

16. There are some exceptions to the requirement to provide two documents:

   - Issuers with debt, equity or unit trust securities listed on a registered exchange such as NZX can use a "simplified disclosure prospectus". It must be registered and provided to investors before subscription (thus performing the functions of a prospectus and an investment statement). The simplified disclosure prospectus regime leverages off the continuous disclosure obligations of listed issuers. This type of prospectus can be used for offers of further issues of the listed securities and for higher ranking securities.

   - Section 5 and exemption notices made by the Securities Commission exempt certain issuers and classes of issuer from disclosure requirements under the Act. Some of these are discussed in Chapter 1 – Defining regulated products.

[63] See sections 37A(1)(b), 42, 44 and 55.
[64] See, for example, Securities Regulations 2009, schedules 1 to 12.
[65] Securities Regulations 2009, schedule 13. A particular form of investment statement is required for moratorium proposals under the Securities (Moratorium) Regulations 2009.

2.2 Problem definition

17. The Taskforce concluded that product disclosure in its present form does not work well:

> "It is not sufficiently standardised, concise, simple or understandable, and is of little use to most retail investors. This is true of many products, including managed funds, which are often the most appropriate product through which relatively unsophisticated investors can enter the market. There is also little reliable comparative information about fees and returns on these products."[66]
>
> "…[I]nvestment statements tend to be difficult to understand without some expertise. Much of the information is poorly presented, lost within marketing material and/or written in legalese. Many investors do not bother reading these documents.
>
> Even where key information is disclosed in a concise and simple manner, each firm puts this in a form that casts their data in the most favourable light, making it difficult to compare products. This is particularly true of fees disclosure for managed funds – and fees are a key element in investment decisions. Even where they are presented clearly, fees are often calculated and classified differently between providers. Overall, the current information disclosure regime is costly for issuers and yet is largely ineffective for investors."[67]

18. In addition, the Ministry notes that:

- The focus of the current enforcement regime is slanted towards false or misleading statements in a prospectus. Given that the document provided to all investors is the investment statement, this should be the most important document, and the document subject to most scrutiny;
- The current split between the investment statement and prospectus regime is not well defined. Material is duplicated between the documents, and there is limited use of cross references;
- Prospectuses appear to be excessively long. A random sample of 100 prospectuses from 2008 found they ranged from 16 to 354 pages in length, with a median of 63 pages. While there was some variation between prospectuses for different types of securities, all were long; and
- Investment statements are often also long, which makes it less likely that retail investors will read them.

19. The Ministry considers that these issues are caused by a number of factors but primarily through deficiencies in the current legal framework, concerns about the risk of liability, and issuers lacking incentives to provide adverse information to investors in a concise and clear manner.

[66] Taskforce final report, page 29.
[67] Taskforce final report, page 30.

2.2.1 Deficiencies in the legal framework

Prospectuses

20. The prescribed matters that must be included in prospectuses have, arguably, not kept pace with market developments. Prospectuses duplicate information that might be more easily accessible through other means. These other means may include contacting issuers directly, accessing aggregated and comparative information from specialist service providers, accessing the same information from other sources (particularly websites), and using “term sheets”.

21. In addition, the required contents of prospectuses are not well tailored to a clearly defined audience, whether that audience is retail investors, or other information users like market analysts.

Investment statements

22. The requirements for investment statements do not provide sufficient guidance to issuers about what matters should be included and are relevant to the various questions that must be answered in an investment statement. For example, when answering the question “What are my risks?” in the investment statement, it is unclear whether these risks should be generic or specific to the particular product, industry, or issuer. The content of investment statements also duplicates much of the content of prospectuses.

23. Finally, there is no requirement to register investment statements, even though investors are much more likely to have seen the investment statement rather than the prospectus before buying securities.

2.2.2 Concerns about the risk of liability

24. There is strong anecdotal evidence that the preparation of disclosure documents is sometimes seen as an exercise in risk management and fear of liability, rather than a genuinely useful mechanism for conveying information (although some market participants see the due diligence exercise involved in preparing such documents as a valuable discipline on would-be issuers). The risk of liability arguably encourages issuers to add in unnecessary matters, due to a concern around potential liability for missing issues out.

2.2.3 Issuers incentives to present information clearly

25. Issuers do have a natural disincentive to make adverse information easily accessible to investors. With certain relatively minor exceptions, the law does not prescribe how material must be presented in prospectuses and investment statements. While many issuers do endeavour to present information as clearly as possible to investors, the lack of control over how information is presented means that key information can be difficult to find in a prospectus or investment statement.

26. There is also a tendency for prospectuses and investment statements to contain large amounts of marketing material that can also detract from investors’ ability to easily identify adverse information about the investment in these documents.

3. Have the main problems with the current disclosure regime been identified?

4. What are your costs of compliance with the existing regime? What benefits does the current regime provide?

2.3 Recent proposals for reform in New Zealand

2.3.1 Review of Financial Products and Providers

27. In the Ministry's September 2006 discussion document on securities offerings as part of the RFPP[68], we proposed reform of the investment statement and prospectus regime into a new two-part document.

28. Part A would have been highly prescriptive, summarising the key features that an investor needs to know before deciding on whether to subscribe for the securities offered.

29. It would have provided an overview of the offer of securities and served as an introduction into Part B, the body of the offer document. It would have been limited in length, perhaps no more than 5 pages. Both the questions and the prescription underneath the questions may have differed for equity, debt, collective investment schemes and superannuation so as to cater for the differences inherent in these securities.

30. Part A would not have been intended as a substitute for reading Part B. It would have included an introductory (and cautionary) statement explaining to the investor that the offer document was in two parts; that Part A was only a summary of the key features of the offer and that to get a full picture of the offer, and before deciding to invest, the investor should read both Parts A and B.

31. Part B would have provided for fuller disclosure about the offer and the issuer.

32. For equity and debt securities, Part B would have been based on the current prospectus, updated and improved as appropriate. Part B would have been governed by a principles-based disclosure requirement which would be stated in the Securities Act. The principle would have been supported by more prescriptive disclosure content requirements, which would have been set out in the Securities Regulations. The prescription would have been tailored to reflect the nature of the security offered and the issuer offering the security.

33. For collective investment schemes and superannuation, Part B would have been based on the current investment statement but updated, improved and simplified as appropriate (recognising that it would need to be adapted to suit the various collective investment scheme products – e.g. unit trusts and superannuation schemes). Part B would have addressed the information not already set out in Part A through prescribed headings and would have provided fuller disclosure describing an investor's rights and obligations and the product's key benefits, rules, risks and fees. Part B would also have included a provision for other material matters to be included.

2.3.2 Capital Market Development Taskforce

34. The Taskforce considered that the current regime, which requires tiered disclosure, is good in principle but made three recommendations for reform.

> "It is important that both retail investors and other participants get the information they need to ensure the market works well, and it is evident that these needs cannot be met in a single document. However, we consider that the execution can be improved.
>
> We make three specific proposals in this area:
>
> 1. Replace the investment statement with a new two-part disclosure document.

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[68] *Review of Financial Products and Providers: Securities Offerings, Discussion Document*, Ministry of Economic Development, ISBN 0478284977, at http://www.med.govt.nz/upload/39199/discussion-08.pdf.

2. Introduce a 'sophistication warning' label for particularly risky or complex products.

3. Create a centralised website for all disclosure documents.

The two-part disclosure document would replace the investment statement and comprise a one or two-page cover section that provides key information at a glance (Part A), and a slightly longer section with further, more detailed information (Part B).

The whole document would be targeted at less sophisticated investors and needs to be presented in a way that induces such investors to read and understand it. A template should be designed with the help of a graphic designer and communications expert, and be standardised across providers to enable easy comparison. A short document should be less costly for issuers to prepare than the current investment statements, once they are familiar with it."

35. The Taskforce's recommendations could be achieved without changing the Securities Act. The current Act is flexible enough to allow regulation to be made to specify a two-part investment statement with mandated disclosure.

2.4 Current proposals for reform in other jurisdictions

EU - KID

36. To revive consumer confidence in the aftermath of the financial crisis, the European Union (EU) is reviewing the European regulatory landscape for packaged retail investment products (PRIPs).[69] This term broadly covers investment funds (both UCITS and non-UCITS), retail structured products, and insurance-based investment products.[70] On 30 April 2009 the European Commission (Commission) concluded "that the review has demonstrated clear inconsistencies in rules on pre-contractual disclosures and selling practices"[71] resulting from uncoordinated Member State responses to gaps in European law.[72]

37. The Commission stressed that financial losses of investors may be caused by ineffective pre-contractual disclosures, misleading advertising, product mis-selling and undisclosed or unmanaged conflicts of interests.[73] Against this background the Commission initiated the reform of a number of EU regulations to accomplish both a high level of investor protection and harmonisation.

38. As a first measure the Commission decided to replace the Simplified Prospectus of UCITS funds[74] with a new form of disclosure called Key Investor Document (KID). The consultation with stakeholders revealed that the Simplified Prospectus had failed to reach its objective, namely, to provide key information in a concise and simple manner.[75] Accordingly, the amendment of the UCITS Directive, proposed to come into force on 1 July 2011,[76] sets out new provisions for simplified disclosures.[77] As a minimum the document is to contain a description of the UCITS fund's investment aim and strategy, as well as information on the UCITS fund's historical return, costs and risk profile.

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[69] Packaged Retail Investment Products (PRIPs) are products that invest in multiple financial instruments and are typically held for a medium to long-term period. These investments are designed for, and sold predominantly to, retail investors.
[70] Commission of the European Communities "Update on Commission work on packaged retail investment products" (16 December 2009) 1, 2.
[71] Commission of the European Communities "Communication from the Commission to the European Parliament and the Council: Packaged Retail Investment Products" (30 April 2009) SEC (2009) 556 1, 39.
[72] Ibid, 41.
[73] Ibid.
[74] UCITS funds are subject to Directive 85/611/EEC of the Council of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).
[75] Commission of the European Communities "Communication from the Commission to the European Parliament and the Council: Packaged Retail Investment Products" (30 April 2009) SEC (2009) 556 1, 14.
[76] See: article 116 of the UCITS (IV) Directive.
[77] See: article 78 and the following of the UCITS (IV) Directive.

39. The new EU regulations prescribe that the KID should be a single document of limited length written in a concise and non-technical language.[78] In addition, it is to clearly indicate where and how additional information related to the KID and a UCITS fund can be obtained.

40. The Commission also plans to adapt or apply the key features of the UCITS KID to other PRIPs (such as retail structured products and insurance-based investment products). Under this approach, PRIPs pre-contractual disclosures would be governed by a single common framework which applies a consistent set of core principles. These principles would draw from the lessons learned through the process of developing the KID (subject to a number of tests with consumers).[79] The reform of the EU regulatory framework is not finished yet. It remains to be seen whether the Commission will achieve a harmonized regulatory regime for all PRIPs disclosures. Chapter 4 – Collective Investment Schemes discusses UCITS in more detail.

Australia-PDS

41. The Australian government also plans to develop shortened and simplified financial product disclosures. In general, issuers are currently obliged to provide key information relevant to a financial product such as significant benefits and risks, fees and costs. However, Product Disclosure Statements (PDSs)[80] issued in Australia have been evaluated as being too long.

42. The principles-based nature of the current disclosure regime has been identified as one of the drivers of over lengthy PDSs. A principles-based regime allows flexibility but issuers often include more, rather than less, information in PDSs to avoid liability.

43. In February 2008 Australia formed the Financial Services Working Group (FSWG) to develop a new simplified disclosure regime for a range of financial products. FSWG stressed that a simplified PDS should be a single document that is able to achieve both consumer protection and the reduction of compliance costs for the industry.[81] Against this background FSWG is in the process of drawing up short, standardised and easy to understand financial product disclosures based on consultations with industry and consumer representatives.

44. A four-page disclosure document has already been completed for First Home Saver Accounts (FHSAs).[82] The provisions prescribing the FHSA PDS are contained in the Corporation Amendment Regulations 2008 (No.4) and Corporations Amendment Regulations 2008 (No.5). Australia also plans to amend the Corporations Regulations 2001 to prescribe new standard margin loan PDSs.[83] Draft regulations (in the Financial Services Modernisation Bill 2009) for a special margin loan PDS, including an example PDS, were released for public consultation in September 2009. The public consultation has recently been completed

45. In addition, efforts were made by FSWG to develop standardised disclosure documents for superannuation and managed investment products. In terms of these kinds of investment products, FSWG has also delivered draft regulations and example PDSs. These preliminary documents have been released to the public to get feedback from the industry and consumer representatives. This feedback has been received and is currently being considered.

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[78] See: article 78(5) and paragraph 59 of the Preamble of the UCITS (IV) Directive.

[79] Commission of the European Communities "Update on Commission work on packaged retail investment products" (16 December 2009) 1, 4.

[80] Product Disclosure Documents (PDS) are defined as a pre-contractual decision-making document which contains a summary of the key information that a consumer needs to know to make an investment decision.

[81] Ibid.

[82] First Home Saver Accounts (FHSA) offer a tax-effective way of saving for first home through a combination of government contributions and concessional tax rates. These accounts are available from certain financial institutions, including banks and credit unions since 2008 (see: www.homesaver.treasury.gov.au/content/fact_sheet.asp).

[83] A margin loan is defined as a loan from a broker to a client that essentially functions as a margin account. The funds may be used for any purpose, and the loan is secured with securities owned by the client.

3. Point of sale disclosure - proposals

3.1 Introduction

46. In the discussion below, we consider the options for point of sale disclosure by issuers in three stages:

    - First, we look at the high level framework for point of sale disclosure. Specifically, whether a single document or two-document approach is appropriate, and whether disclosure document(s) should also be supplemented by additional disclosures on the new Register of Securities;

    - Second, if our preferred approach of a single disclosure document with additional disclosures on the Register of Securities is adopted, what principles should underpin the matters that are included in the disclosure document and what matters should be disclosed in the register?; and

    - Third, we look at the specific approach that we propose to take in the design of disclosure documents for different kinds of securities.

47. In section 5 of this chapter, we discuss whether there should be a principles-based disclosure requirement for "all other material matters" to be disclosed in addition to the specific prescribed disclosures we propose below.

3.2 Framework for point of sale disclosure

Option 1: Status quo, with improvements to investment statement

48. The current two document regime could be retained, but with the current investment statement replaced by a document that is standardised, concise, simple and understandable.

49. Issuers would still, however, be required to produce two documents: an investment statement aimed at retail investors and a registered prospectus of which the audience for is less certain, and the value dubious.

Option 2: One document

50. This option could implement the RFPP proposal of replacing both the investment statement and prospectus with a new a two-part document that would be provided to all investors. The disclosure document would consist of a key disclosure statement, with fuller disclosure attached as a Part B. Part B would contain information similar to a prospectus for equity and debt, and an investment statement in the case of collective investment schemes.

51. All parts would ideally be taken into account when making an investment decision. However, by dividing disclosed information up into these three parts, the issuer would be highlighting the most important information in Part A and, to a lesser extent, Part B.

52. This option has the merit of requiring only one disclosure document. That document would, however, be relatively long and, without careful design, may put investors off. Issuers would also have to keep the document up to date, which would be costly in terms of printing and design costs if any changes were required.

Option 3: One document, with additional disclosures available on a register

53. Again, issuers would be required to provide one document to investors at the point of sale. But 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 new register of securities agreed by Cabinet in April, as well as being provided to subscribers.

54. The additional disclosures referred to in this single document could be made available on the issuer's website, but the Ministry considers that these disclosures should also be made on the new register of securities irrespective of whether they are put on the issuers website or not. This would make it easier for investors to compare offers and hold issuers to account for misleading disclosures by providing an official record.

55. 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.

56. The point of sale document would include a key information summary at the start in line with the Taskforce's recommendation for a "Part A". This document could be called a "product disclosure statement" (PDS).

57. This is the Ministry's preferred option.

5. Should the investment statement and prospectus be replaced with a single disclosure document, with further disclosures available on a register? How much cost (e.g. printing, preparation) might this change save?

6. If not, what value would be gained from keeping a prospectus?

3.3 General approach to disclosure

3.3.1 Product disclosure statement

58. The Ministry considers that the PDS should contain the information that is crucial to an investor's decision.

59. In order to reflect the Taskforce's recommendations, 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.

60. The Ministry 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. The Ministry anticipates the greatest level of standardisation will be for collective investment schemes. This follows the approach taken to development of product disclosure statements in Australia, which is progressively working through the products to produce tailored documents starting with collective investment schemes. For these types of products the length of the documents could be prescribed.

61. As discussed above, the new PDS and disclosures on the register of securities are intended to replace both the investment statement and the prospectus, so the material that the Taskforce suggested would "remain in the prospectus" would instead be placed on the register.

62. The Ministry's expectation is that PDSs will have a key information section at the front. It might be argued that a two page summary may not be useful for some very short PDSs. For example, if we align with the Australian approach to disclosure for collective investment schemes, the entire document would only be 6 pages long. Notwithstanding this, we think there is value in requiring a two page summary at the beginning of, even very short, PDSs as this would make it easier for investors to compare offers side by side.

63. In order to keep printing and production compliance costs down, it is anticipated that matters that change relatively frequently and are not key information for investors, like directors' names, would not be required to be kept up to date in the PDS, but they would be kept up to date on the register. (For companies, these are maintained on the Companies Office register in any case.) However, the PDS would state the date it is printed and where on the register to look for updates. Nor would the PDS contain financial statements, which would be available on the register.

64. One issue is whether the PDS should be standalone, and whether Part B should be limited in length. Currently, there is no restriction as to what other information can be included in a prospectus or an investment statement, or on the order that the material appears, or the length of the document. One possibility is to limit material in the PDS but to allow the PDS to briefly state where other information can be obtained – such as on the issuer's website or in publications obtainable from the issuer.

65. The Ministry considers that, where possible, the length of PDSs should be prescribed. However, we acknowledge that for certain products, such as equities, this may not be practicable.

7. Do you agree that the Product Disclosure Statement concept, with prescribed documents for individual products, is sensible?

8. Is a key information statement useful?

9. Should other material be allowed to be included in disclosure documents?

10. Should the length of Product Disclosure Statements be prescribed?

3.3.2 Register of Securities

66. The Ministry considers that the Registrar of Securities should include information that provides additional details of the offer to assist an interested investor to make an informed decision. The audience would be interested investors, financial advisers, market commentators, market analysts and regulators.

67. Cabinet agreed in April 2010 to the establishment of a Register of Securities. Each security offering would be recorded on this register, which would contain searchable information about the offer. The record would cross-refer to the record of the issuer, so it could be found by clicking through from the issuer's page.

68. When PDSs are provided to the Registrar for registration, the issuer might also complete a registration form, completing fields that would be used as search fields on the register, and uploading (or attaching) the other documents required to be disclosed on the register, including financial statements.

69. The register would replace the prospectus altogether as the source of fuller information about an offer. It should, for example, be feasible to print the full record and attachments from the offer page.

70. Once initial registration of an offer has occurred, issuers should be able to enter details online and register documents themselves, subject to any registration processes that may be required. The issuer and directors of the issuer would, as they currently are, be responsible for the accuracy of the offer record.

71. In addition to being a repository for offer documents, the register could also be required to include documents disclosed in accordance with ongoing disclosure obligations, such as periodic disclosure. Ongoing disclosure is discussed further at section 5 of this Chapter.

11. Should ongoing disclosures be included on the register?

3.4 Design of product disclosure statement for different kinds of securities

3.4.1 Key information summary

3.4.1.1 Risk disclosure in the key information summary

72. In order to make an investment decision, investors need information to understand the risks involved. In New Zealand, the prospectus does not specifically require risks to be identified, but does require disclosure of information that enables the investor to identify risks for themselves. The investment statement is more direct; it includes a brief description of the principal risks of:

    a. the money paid by a subscriber not being recovered in full by the subscriber;

    b. a subscriber not receiving the returns referred to in clause 9; and

    c. a subscriber being required to pay more money in respect of a security than that disclosed in clauses 5 or 12.

73. The Ministry wishes to maintain this type of approach, but seeks to improve presentation of risk in the PDS.

74. Risks should be described that are specific to the issuer or its industry, or specific to the securities on offer. However, it is necessary to ensure that the disclosure document does not identify so many risk factors that the value of the disclosure is undermined.

75. The Ministry has identified three options for risk disclosure.

Option A: Self assessment and summary

76. 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 indentify the (for example, top three to five) risks specific to the issuer or its industry, or specific to the securities on offer.

77. If necessary, a fuller set of risks could be set out in the body of the PDS, or on the Register of Securities.

78. This option would allow the issuer to make its own assessment of the risk, which it is in the best position to do. However, it may not result in standardisation among issuers, which would reduce comparability. In saying that, the Ministry would expect that regulators would take action against issuers who understate the risk of their product.

Option B: Risk ratings

79. 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.

80. This would provide an assessment of risk at a glance. However, other than for debt ratings, the Ministry is not satisfied that there is yet an agreed basis for producing such ratings. Instead, the statement would have to include something like "[issuer's name] has rated this investment's risk as moderate", alongside a scale ranging from very low to very high risk.

Option C: Third party assessment

81. 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.

82. The Securities Act currently regulates the use of statements by experts in prospectuses,[84] but does not require an independent expert's statement to be prepared or included. The position reflects an understandable wariness about prospectuses including statements by experts who are engaged by the issuer.

83. There are partial precedents for a requirement to prepare independent experts' reports in respect of the secondary market under the Takeovers Code, and in the independent expert report that must now be prepared for moratorium proposals under the Securities (Moratorium) Regulations 2009.

3.4.1.2 Preferred approach to risk disclosure in key information summary

Collective investment schemes (option A)

84. The Ministry prefers option A in respect of collective investment schemes. A self assessment of the overall risk and the top risks should be set out in the key information summary. This approach is close to that being taken in Australia with new short form product disclosure statements. If a risk ratings system was developed, then option B could be adopted. The EU is currently working on such a system.

Equity securities (option A, but consider option C)

85. The Ministry prefers option A: self assessment of the overall risk and the top risks to be set out in the key information summary.

86. However, we seek views on the requiring of an independent expert's report to be prepared for offers of equity securities. The Ministry recognises that the costs of preparation would increase issue costs.

87. One option might be to permit the issuer to elect not to obtain a report, with reasons, and include a warning about the matter in the key information summary. In that case, the issuer would comply with option A.

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[84] See, for example, section 40 Securities Act 1978.

88. Some types of offers could be exempted, such as further issues of listed securities, in reliance on continuous disclosure.

Debt securities (option B, but option A if unrated)

89. In this case option B 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 comply with option A by providing an overall assessment and the top risks.

Derivatives (option A)

90. 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.

12. Do you have views on the three proposed options for risk disclosure and their application to different securities?

13. What are the potential benefits and costs of an independent expert's report for equity securities?

3.4.1.3 Content of key information summary (other than risk)

91. 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.

92. As discussed above, 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 (e.g. retiring existing debt, new acquisitions etc.);

- **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 (e.g. retiring existing debt, funding lending activity; new acquisitions etc.);

- **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; and

- **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.

93. 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.[85]

14.	Is the key information summary a useful part of the product disclosure statement?
15.	Do you agree with the proposed content of the key information summary for different types of securities?

3.4.2 Product disclosure statement (excluding key information summary)

3.4.2.1 Collective investment schemes

94. A number of jurisdictions are developing short form product disclosure statements for collective investment schemes. For example, the European Union is developing "key information documents".

95. Australia is currently developing short prescribed product disclosure statements. In late 2009, it released draft regulations and examples for collective investment schemes that invest more than 80 percent of their assets in financial assets.

96. Like the Australian regime, the Ministry proposes that straightforward collective investment scheme 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.

97. 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.

98. One issue might be that the PDS would need to be able to incorporate information that constantly changes (e.g. a market-linked index or, in some cases, an interest rate). To avoid the need to constantly update the PDS or register, there may be a need to allow this information to be incorporated by reference but not registered.

99. Information that must be incorporated by reference would be prescribed in regulations.

100. 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.

16.	Do you agree with the proposed approach to the content of product disclosure statements for collective investment schemes?

[85] See the Retirement Commission booklet *Investing – making your money work for you*, pages 3 to 5 available at http://www.sorted.org.nz/home/sorted-sections/investing.

3.4.2.2 Equity

101. Determining what information an investor needs before making a decision on whether to subscribe for an equity security is not an easy task. Investment in the equity of a company promises only the potential of returns through increases in share value and dividends. Returns rely on the success of the particular company which is determined by a number of factors including productivity, its management, and the economic conditions in the relevant industry and in general.

102. The Ministry 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.

103. The International Organisation of Securities Commissions' (IOSCO) 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.[86] The Ministry 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.

17.	What matters should appear in the PDS for an initial offer for equity securities – should it be based on the IOSCO standards?

3.4.2.3 Debt

104. 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.

105. IOSCO recently published *International Disclosure Principles for Cross-Border Offerings and Listings of Debt Securities by Foreign Issuers,*,[87] The Ministry 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.

18.	What matters should appear in the PDS for an initial offer for debt securities – should it be based on the IOSCO standards?

3.4.2.4 Derivatives

106. Determining disclosure obligations for derivative products is more difficult than for the above mentioned asset classes. There is wide variation in contract terms and underlying instruments, which may require the basic disclosure requirements for derivatives to be relatively high level. And while exchange-traded derivatives are standardised, over-the-counter (OTC) derivatives can be customised for the needs of the individual purchaser.

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[86] See Technical Committee of the International Organisation of Securities Commissions *International Disclosure Standards for Corss-Border Offerings and Listings by Foreign Issuers, Final Report*, September 1998.

[87] See: Technical Committee of the International Organisation of Securities Commissions *International Disclosure Principles for Cross-Border Offerings and Listings of Debt Securities by Foreign Issuers, Final Report,* March 2007.

107. Existing practice is to authorise individual OTC derivatives dealers to provide specified classes of derivative products. For example, a dealer might be authorised to provide foreign exchange forwards and options. As conditions of the authorisation, the dealer must provide disclosure of the contract terms, risks and other material matters, and meet certain reporting and capital adequacy requirements. No offer document is currently registered.

108. In bringing derivatives into the disclosure regime, we propose 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.

109. We consider that the PDS for derivatives should be required to contain matters such as:

a. The name and contact details of the issuer/counterparty;

b. 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);

c. Other fees and costs;

d. Risks; and

e. Other material matters for the class of derivatives on offer.

19.	Do you agree with our proposed approach to the content of product disclosure statements for derivatives?

3.4.3 Use of educational material in PDSs

110. 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.

111. Explanations, examples and context can enable investors with low financial literacy levels to interpret key concepts and information in the documents which in the past they may have struggled with, and so increase the quality of their financial decision making. Educational material can also make offer documents more accessible for the new investor, and thereby increase investor participation in the capital market.

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

113. The Ministry 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.

20.	Should educational material form part of the disclosure document, or be required to be provided at the same time as the disclosure document?

3.4.4 Sophistication warnings

114. As discussed above, we propose that issuers make a self assessment of the risk of their product in their PDS. As a complement to this, we consider that it would be useful to consider whether the Authority 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. It is important to note that 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).

115. The Ministry recognises that, in imposing this label, the Authority 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.

116. Provided the power came with appropriate safeguards, the existence of a labelling scheme administered by the Authority may be highly beneficial to investors' consideration of investment opportunities, and be relatively low cost to administer. The Ministry 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 Authority was taking responsibility for the product in any way.

21. Should the Authority be empowered to impose sophistication labels on complex products? If so, what safeguards do you think should apply?

3.4.5 Short form and simplified disclosure documents

117. 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:

    a. Short form prospectus for offers to existing security holders; and

    b. Simplified disclosure prospectus for listed issuers for:

        i. further offers of its listed security; and

        ii. offers of equal and higher ranking securities (for which all material matters must be disclosed).

118. The Ministry 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.

22. Should a distinction between short form and simplified disclosure prospectuses be maintained?

23. Are the current tests for determining when a short form or simplified disclosure prospectus may be used correct?

4. Ongoing disclosure

4.1 Introduction

119. 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. The Ministry 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.

4.2 Status quo and problem definition

4.2.1 Status quo

4.2.1.1 Financial reporting

120. The Financial Reporting Act 1993 requires all issuers of securities to file audited financial statements with the Registrar of Companies within 5 months of the balance date of the issuer.[88] This requirement is based upon the principle that issuers have public accountability as they raise money from the public. The requirement to file audited financial statements also ensures a certain minimum level of ongoing disclosure by issuers of different types of securities.

4.2.1.2 Periodic and request disclosure under the Securities Act

121. Sections 54A and 54B of the Securities Act provide for the kinds of information described in regulations to be provided to security holders periodically, or on request. The Securities Regulations 2009 provide for (among other things) copies of annual reports, prospectuses, investment statements, statements of actual returns against any prospective returns set out in the prospectus, to be sent to security holders on request. The only periodic disclosure currently required under securities regulations are quarterly reports that must be prepared by issuers subject to a moratorium under the Securities (Moratorium) Regulations 2009. It is notable that the power to make regulations is limited to disclosure to investors (not the public) and does not provide for event-based disclosure.[89]

4.2.1.3 Equity

122. Under section 209 of the Companies Act, all companies are required to prepare an annual report which must be made available to shareholders. The annual report must contain matters including:

- A description of any changes in the business of the company or its subsidiaries, to the extent that the board believes that this information is material for shareholders in their appreciation of the state of the company's affairs;

- The financial statements of the company;

- The remuneration of directors; and

[88] Section 18, Financial Reporting Act 1993.
[89] There is limited scope for requiring public disclosure by implying provisions into trust deeds: see for example clause 13, Schedule 3, Securities Regulations 2009.

- The number of employees who received remuneration or other benefits in excess of $100,000, and the number of employees over that level in brackets of $10,000.

4.2.1.4 Debt

123. Other than as noted above, there are no requirements to provide ongoing reporting to holders of debt securities, although an ongoing issuer is effectively required to keep its prospectus up to date in the event of any material changes.

4.2.1.5 Collective investment schemes

Unit trusts

124. Managers of unit trusts are required to send audited financial statements to unit holders each year. There are no additional ongoing disclosure requirements mandated in legislation.

Participatory securities

125. There are no formal ongoing requirements to report to investors in participatory securities other than as noted above. However, the manager of the scheme is responsible for summoning a meeting of securities holders to consider the schemes' audited financial statements for the past year. This presupposes that investors will consider the financial statements of the issuer.

4.2.1.6 Derivatives

126. There are currently no ongoing disclosure obligations for an entity that offers derivatives.

4.2.2 Problem definition

127. Listed securities are subject to the continuous disclosure regime under the rules of a registered exchange. This section considers whether there should be ongoing disclosure for unlisted securities. At one extreme, all securities, whether listed or not, could be made subject to continuous disclosure or another form of event-based disclosure.[90] The Ministry is not satisfied, however, that the benefits of implementing or policing such a regime for unlisted securities would outweigh the costs.

128. We do consider that some additional ongoing reporting for unlisted securities is necessary. Information is fundamental to ensure that markets function in an efficient and transparent manner. The holder of a non-listed security currently has limited information provided to them and, as such, they have limited sense of how the security is tracking and the issuer performing. While it might be difficult for the holder of an unlisted security to sell a security if things are going badly, that does not mean that the information is not valuable.

129. The Ministry notes that the Companies Act is designed to ensure companies are accountable to shareholders. The company must keep the companies register up to date with changes to directors, it must file annual returns and prepare an annual report for shareholders. The law regulates takeovers and restricts major transactions in relation to companies for the benefit of holders of equity securities in companies. We do not consider that there is need to add to these requirements under securities law. Likewise, the Ministry does not consider that there is any need for ongoing reporting in respect of derivatives, as the lifetime of most derivatives is sufficiently short to make ongoing disclosure unnecessary.

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[90] Chapter 5 – Other Matters looks at the issue of alternatives to continuous disclosure for registered exchanges.

130. In respect of unlisted debt securities, the Ministry considers that it is a problem that holders of debt securities are not necessarily informed about material changes in the issuer's circumstances that may impact on the likelihood of default by the issuer. This makes it harder to price debt securities on secondary markets. It also means that investors are not necessarily fully informed if the risk of the security changes over time. However, we acknowledge that material changes to the issuer's circumstances will have been reported to the trustee if they have a bearing on the likelihood of default.

131. In addition, the Ministry considers that there are issues around ongoing disclosure by collective investment schemes around basic matters such as fees, asset allocations, and returns. Specifically, not all schemes effectively report these matters to investors on an ongoing basis and, even where they do, the method of calculating matters such as fees and returns often varies from scheme to scheme. League tables currently prepared and published by private sector organisations are misleading because the information they provide is not consistent across schemes. This makes it harder for investors to judge scheme performance over time.

24. Do you agree that a comprehensive regime for information disclosure for unlisted securities equivalent to continuous disclosure is not justified? What would be the costs and benefits of such a regime?

25. Do you agree that additional ongoing disclosure requirements are not necessary for equity securities or derivatives?

26. Do you agree that additional ongoing disclosure requirements should be imposed on issuers of debt securities and collective investment schemes?

4.3 Proposals for reform

4.3.1 Debt

132. 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, the Ministry would expect that this would have been reported to the trustee.

133. However, to ensure that such information is made available to investors and the public at large, we propose 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. The Ministry proposes to develop the full list of matters to be subject to event based disclosure in the design of the regulations. The Ministry also acknowledges that continuous debt issuers are effectively required to disclose such matters through the need to keep their prospectus up to date.

27. Do you agree that issuers of debt securities should be required to update on the Register of Securities certain prescribed matters that may have a bearing on the likelihood of default, should those matters change over time?

4.3.2 Collective investment schemes

134. 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 (including, for example, percentages of the different types of assets and disclosure of top ten portfolio holdings);
- Conflicts of interest (for example, investments in related parties); and
- Fund returns (ideally both gross and net of all fees and taxes).

135. We consider 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.

28. Do you agree that collective investment schemes should be required to publish quarterly information? Should any types of schemes be exempted from the requirements?

29. Do you agree that these quarterly reports should contain information on fees and charges, asset holdings, any conflicts of interest, and fund returns? If quarterly reporting is required of collective investment schemes, are there any other matters that should be included in such reports?

5. Principles-based disclosure

5.1 Introduction

136. In this section we discuss whether a requirement to disclose "all other material matters" at the point of sale should be retained in addition to the requirement to make the specific prescribed disclosures that are discussed in Part 3 of this chapter.

5.2 Advantages and disadvantages of principles-based disclosure

137. A key issue in financial regulation relates to the degree of precision - that is, the choice of principles versus rules. New Zealand has a mixed regime at the moment. There is prescribed content for the prospectus and investment statement. This is supplemented by more general principles: requirements not to be false and misleading, and to include any other material information not specifically required. Civil and criminal liability and other effects result from breach of these requirements.

138. A principles-based approach provides a flexible framework of regulation capable of adapting to structural and institutional changes in the financial system. However, a key risk with principles-based regulation is that there is no clear assurance that policy objectives will be met in a satisfactory manner, as there will be scope for differing interpretations of the principles and - even more so - of the manner in which the principles are to be met. This may lead to a wide range of regulatory outcomes.

139. Principles-based regimes, while favoured for their simplicity and the scope they give the issuer to develop their own disclosure initiatives, rely heavily on regulatory explanation and guidance. Both the UK and Australia have principles-based regimes. While the principles tend to be relatively brief, there are lengthy guidelines clarifying how the principles will be interpreted and applied.

140. Furthermore, such a regime can lead to "risk-averse" disclosure, where issuers may feel they need to disclose large amounts of information to ensure they are meeting the requirements, due to a lack of certainty around what constitutes compliance with the principles. This can lead to complex and lengthy documents – a problem identified as one of the failures of New Zealand's current disclosure regime.

141. By contrast, a rules-based approach seeks to achieve desired outcomes through more concrete measures, either by directly specifying the specific actions or behaviours to be undertaken (or avoided) or specifying the means (direct or indirect) by which actions or behaviours are to be achieved (or avoided).

142. Rules have greater certainty in their application, and thus may be usefully applied where rule-based actions can be expected to lead directly to the achievement of policy objectives and where the tolerance for policy failure is low. However, rules may be applied inconsistently, lack comprehensiveness, become outdated in the face of rapid innovation, and encourage "box-ticking" exercises. It is also possible that prescriptive regulation may impede innovation by inducing "static" or "hard line" compliance measures.

5.3 Current regime

143. This section outlines the current regime that extends the requirement to disclose beyond the specific statements and information required by the schedules to the securities regulations, and the liability where the requirement is not met.

144. It is important to consider liability at the same time, because as discussed below, risk aversion may be a stronger driver of long, unhelpful and costly disclosure documents than the choice between a principles or rules based regime.

5.3.1 Failure to refer to known adverse circumstances

145. Section 37A(1)(c) provides that no allotment shall be made if, at the time of allotment, the investment statement or registered prospectus is known by the issuer or any director to be false or misleading in a material particular by failing to refer, or give proper emphasis to, adverse circumstances.

146. In addition, the allotment period for a prospectus may be extended by a certificate under section 37A(1A). This certificate states that, in the opinion of all directors of the issuer after due enquiry by them, the registered prospectus is not, at the date of the certificate, false or misleading in a material particular by reason of failing to refer, or give proper emphasis, to adverse circumstances.

147. The meaning of due enquiry in section 2B allows a director to rely on certain kinds of information advice from another person whom he or she believes, on reasonable grounds, is reliable and competent.

148. Allotments in contravention of these provisions are voidable at the instance of the subscriber. To make such an allotment is also an offence under section 59, which results in the possibility of a fine.

5.3.2 Directors' statement

149. All prospectuses are required to include a statement of the opinion of the directors made after "due enquiry". Except in the case of simplified disclosure prospectuses, this statement is based on whether certain matters have materially and adversely changed since the date of the latest financial statements contained or referred to in the prospectus. In the case of a full equity security prospectus, the matters are:[91]

- The trading or profitability of the issuing group;
- The value of its assets; and
- The ability of the issuing group to pay its liabilities due within the next 12 months.

150. The use of the "due enquiry" test appears to allow directors to rely on advice from the management of the issuer in coming to their opinion. Nevertheless a misleading directors' statement can result in criminal liability for the issuer and the directors, leading to potential fines, imprisonment, and civil liability.

5.3.3 Misleading statement by omission

151. Under section 55, a statement in an advertisement (which includes investment statements) or registered prospectus is deemed to be untrue if it is misleading by reason of the omission of a particular which is material to the statement in the form and context in which it is included.

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[91] The other types of prospectus are variations on this type of formulation.

152. These omissions result in issuers and directors becoming civilly (section 56) and criminally (section 58 for directors and section 59 for issuers) liable. Pecuniary penalties and compensation orders (civil), imprisonment, automatic bans from management of companies and large fines (criminal) can follow.

153. A director's defences for misstatements are quite limited. The main defence is for a director to prove that he or she had reasonable grounds to believe, and did believe, that the statement was true.[92]

5.3.4 Additional statements if otherwise misleading

154. Under regulation 12 of the 2009 regulations, if a statement required to be included in a prospectus would be misleading if additional information were not also included, the prospectus must also contain that information.

5.3.5 All material matters disclosure

155. In addition to specific disclosures designed to require statements to be made on the most important matters, most prospectuses also require the inclusion of any material matters relating to the offer of securities. For example, under the 2009 regulations., a full registered prospectus for equity securities must contain:

> Particulars of any material matters relating to the offer of securities (other than matters elsewhere set out in the prospectus or in the financial statements referred to in the prospectus under clause 23(1), and contracts entered into in the ordinary course of business of a member of the issuing group).

156. The only exceptions are short form prospectuses (used for offers to existing equity, debt, or unit trust security holders), and simplified disclosure prospectuses (but only those for offers of securities of the *same* class as listed equity or debt securities, or units in a unit trust).

157. The policy basis for excluding all material matters disclosure from these prospectuses is that the current security holders can rely on ongoing disclosure and their rights as security holders to obtain information when making decisions about subsequent offers.

158. Simplified disclosure prospectuses for higher ranking securities remain subject to an all material matters requirement. The policy basis for this difference is that, where the issuer is offering a different security from the listed security, it can leverage its continuous disclosure obligation to limit the length of its prospectus and the repetition and reformulation of information already disclosed under continuous disclosure. But the issuer is still required to consider whether there are other material matters in relation to the security on offer that should be disclosed.

5.4 Problems with the current regime

159. The current regime has been criticised on a number of grounds.

160. As discussed above prospectuses, in particular, are considered to be overly long and unhelpful as a disclosure document for most investors, and are costly to produce.

[92] See sections 56(3)(ba) and 58(2).

161. The Ministry considers that the relatively complex interrelationship between the legislative tests for liability, and the significant penalties for directors (including imprisonment), may have contributed to a risk management culture in preparing prospectuses. The Ministry is told that some directors insist on (overly) thorough due diligence before signing prospectuses, with consequent high issue costs. This increases the cost of compliance with the Securities Act, and pushes companies to the private market. This, in turn, puts pressure on the government and the regulator to exempt offers from the Securities Act requirements.

162. The regime may not benefit investors either. First, many are put off reading prospectuses because of their length. Second, even those who read the documents may not find them very useful. Instead of focusing on information that prudent investors need in order to make appropriate investment choices, prospectuses include every known risk in order to prevent directors from becoming liable. This results in poorer outcomes for investors because, while the documents list all the possible risks, it is not easy to determine which are real risks and which are added for risk management purposes.

163. The Ministry has been told that the current rules may have led to poorer corporate governance, dissuading some capable people from acting as professional or independent directors of issuers, as the risk to their reputations, and potentially their freedom, is disproportionately high.

164. The length and lack of focus may also assist less scrupulous issuers who may be able to effectively bury disclosures about the high risk of the investment within a document that few people read.

30. Do you agree with the problems identified with the “all material matters” disclosure requirement?

31. What impacts and costs does the regime have on incentives of directors and corporate governance of issuers?

5.5 International: principles- vs rules-based disclosure

165. It is common practice for issuers to be required to disclose all material matters relating to the offer of securities in a prospectus or equivalent disclosure document.

Australia

Prospectuses

166. In Australia, the basic prospectus rule is contained in section 713 of the Corporations Act 2001. A prospectus must contain all the information that investors and their professional advisers would reasonably require to make an informed assessment of certain matters. In the case of an offer to issue (or transfer) shares, debentures or interests in a managed investment scheme the matters are:

- the rights and liabilities attaching to the securities offered; or
- the assets and liabilities, financial position and performance, profits and losses and prospects of the body that is to issue (or issued) the shares, debentures or interests.

167. The prospectus must contain this information:

a. only to the extent to which it is reasonable for investors and their professional advisers to expect to find the information in the prospectus; and

b. only if a person whose knowledge is relevant:

i. actually knows the information; or

ii. in the circumstances ought reasonably to have obtained the information by making enquiries.

168. The Corporations Act also requires specific disclosures, and has a modified test for continuously quoted securities, or an "offer information statement" where less than $10 million is sought.

169. Liability for defective disclosures is set out in section 728. It prohibits offers if:

a. there is a misleading or deceptive statement in the disclosure document;

b. there is an omission of material required to be included by the general disclosure test and specific requirements; or

c. a new circumstance has arisen that would need to be disclosed, and the deficiency has not been remedied.

170. A person who contravenes this requirement commits an offence if the defect is materially adverse from the point of view of the investor. The directors are not liable for this offence, but can be liable as an accessory under the general rules in the Australian Criminal Code. There are defences for the person to prove that they undertook due diligence or lacked knowledge.[93]

171. The person making the offer and directors are liable for loss or damage resulting from the contravention, even if the person did not commit and was not involved in the contravention.

172. The directors must also inform the person making the offer on becoming aware of a contravention – failure to do so is a strict liability offence under section 730.

Product disclosure statements

173. The general requirements for product disclosure statements are different from prospectus requirements. In addition to requirements specified under section 1013D of the Corporations Act, section 1013E requires the statement to "also contain any other information that might reasonably be expected to have a material influence on the decision of a reasonable person, as a retail client, whether to acquire the product".[94]

174. The Corporations Act provides for offences for giving defective PDS documents. Consistent with the prospectus, directors are not directly liable for these offences. Some of the offences are strict liability, while some include a mental element, such as knowledge or recklessness. Civil liability for loss is also provided for.[95]

5.6 Proposals for reform

175. The Ministry considers that the current approach of requiring specific disclosures, together with some sort of material matters disclosure, should continue as a general rule.

176. In our view, the "all matters disclosure" should be required to be set out on the Register of Securities rather than in the PDS, although we acknowledge that this is reliant on the PDS appropriately summarising and/or referring to this disclosure.

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[93] Section 731, 732, Corporations Act.
[94] All these requirements will be replaced by regulations in the case of proposed tailored PDSs.
[95] See Chapter 7, Division 7.

177. As in Australia, the all matters requirement should, however, be able to be overridden on a case by case basis – as is done currently for short form and one type of simplified disclosure prospectus.

32. Should an "all other material matters" disclosure obligation still be retained? If so, do you agree that this disclosure should be made on the Register of Securities rather than in the PDS?

33. What products should be exempted from the requirement to disclose "all other material matters"?

Test for materiality – Align with Securities Markets Act test?

178. Materiality in terms of the Securities Act is not defined, but has been considered in a number of cases. A matter is "material" if it would be likely to influence a reasonable person in making a decision whether or not to subscribe for the securities without necessarily being determinative of the decision.[96]

179. The retention of the "all material matters" test in the Simplified Disclosure Prospectus for different debt and equity was due, in some part, to concerns that information that is "material information" under the Securities Markets Act may be different from information that is "material" in the context of the Securities Act.

180. In the Securities Markets Act material information, in relation to a public issuer, is information that—

    a. 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; and

    b. relates to particular securities, a particular public issuer, or particular public issuers, rather than to securities generally or public issuers generally.[97]

181. In the case of a futures contract listed for trading on an authorised futures exchange, material information is information that—

    a. a reasonable person would expect, if it were generally available to the market, to have a material effect on the value of the futures contract; and

    b. relates to the particular futures contract, rather than to futures contracts generally.[98]

182. One option is to adopt a test using the same structure for requirements for principles-based disclosure under the Securities Markets Act - although the Ministry is not satisfied that it is helpful to refer to the "price" or "value" of a security at initial offer, particularly as there is no market established for the security. This might end up something like:

    Material information in relation to an offer of securities to the public is information that—

    - a reasonable person would expect, if it were disclosed, to have a material effect on their decision to subscribe for the security; and
    - relates to the particular security or the particular issuer, rather than to securities or issuers generally.

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[96] See Company and Securities Law in New Zealand, John Farrer general editor 2008, page 1033.
[97] Section 3, Securities Markets Act.
[98] Section 3A, Securities Markets Act.

183. An alternative option would be to adopt a test like the Australian prospectus test, which is also similar to that used in other jurisdictions such as Singapore and the United Kingdom.

184. This test would require disclosure of all information that investors and their professional advisers would reasonably require to make an informed assessment of the rights and liabilities attaching to the securities offered; and the assets and liabilities, financial position and performance, profits and losses and prospects of the issuer.

185. The Ministry prefers a test modelled on the Securities Markets Act.

Certification and currency of offer documents

186. As noted above:

- the Securities Act requires that all directors or their agents must sign the prospectus; and
- An allotment is voidable under section 37A if the issuer or any director knows that offer documents are false or misleading by failing to refer or give proper emphasis to adverse circumstances.

187. Section 37A also restricts the life of a prospectus to nine months from the date of the statement or interim statement of financial position contained in, or referred to in, the prospectus. This can be extended by nine months in the case of a prospectus that contains, or refers to, a statement of financial position (but not one that contains, or refers to, an interim statement). In all other cases, the lifetime of a prospectus is six months from the date of the prospectus.

188. The Taskforce, in its 31 July 2009 progress report, recommended amendment to these requirements. It stated that:

> [I]f there has been a material and adverse change to the financial position of the company, the Companies Office does not allow issuers to extend the life of the prospectus by inserting new interim financial statements and by disclosing these changes. Instead, issuers need to register a new prospectus.
>
> To allow a memorandum of amendments would be consistent with the reduced disclosure required of listed issuers in the Securities Disclosure and Financial Advisers Amendment Bill, which is based on an original prospectus plus announcements made under continuous disclosure. The investor would still have access to all information material to the offer, while the costs to some issuers of having to reissue a prospectus would be avoided.
>
> The Taskforce suggests that section 37A be amended to allow issuers to extend the life of a prospectus by issuing interim financial statements, in conjunction with a statement of material and adverse changes to the issuer’s financial position.

189. Under the Ministry’s 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.

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

191. It would also be possible to impose a periodic certification obligation on issuers for the period that offers are open. Issuers would have to disclose material information not generally available to the market on the Register of Securities.

> 34. Should directors be required to certify disclosures on issue periodically?
>
> 35. What should directors' certificates contain?

5.7 Disclosure and liability

192. In rewriting the Securities Act, the Ministry will seek to simplify and clarify the interrelationship between the provisions that provide for voidable allotments and liability for misstatements. In doing so, the Ministry will seek to clarify the interaction between voidability, civil penalties and compensation, and make criminal offences more coherent. The changes would have consequent effects on the liability regime that applies to advertisements. Offence and penalty provisions are also discussed in Chapter 5 – Other Matters.

> 36. What disclosure failures should result in voidability?
>
> 37. Who, and in what circumstances, should persons be civilly and criminally liable for disclosure failures?

6. Promoters, experts, and celebrity endorsements

6.1 Promoters

193. The Securities Act defines a “promoter”, in relation to an offer of securities to the public, as a person who is instrumental in the formulation of a plan or programme pursuant to which the securities are offered to the public, and includes directors of a promoter that is a body corporate.

194. 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.

195. A promoter must be named in prospectuses and has civil and criminal liability. Criminal liability for promoters is specified in section 59, under which a promoter and its directors may commit an offence if there is an allotment in contravention of the Act. The offence under section 59 has a maximum fine of $300,000, so is a lesser penalty than for misstatements under section 58, which can lead to imprisonment and an automatic management ban. Civil liability for promoters can also arise under section 56.

196. 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. The requirements can, for example, attach responsibility to the provider of a superannuation scheme (for which, at present, the trustee is the issuer). It should also result in a financial service provider that establishes a unit trust having some responsibility for the statements made by the unit trust.

197. 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), the Ministry considers that that person should also be included within the definition of promoter.

38.	What changes, if any, should be made to the current definitions and liability that attaches to promoters?

6.2 Experts

198. An “expert” means, in the Securities Act, a person who holds himself or herself out to be of a profession or calling that gives authority to a statement made by him or her. Experts have potential civil liability in respect of advertisements or prospectuses that contain untrue statements purporting to be made by those experts.

199. As for promoters, many participants consider that the definition of expert is uncertain, difficult to apply, and catches individuals such as distributors who should not be caught. Furthermore, under the Securities Act statements in advertising material that were purportedly made by experts have to:

- be made with the permission of the expert;
- state the expert’s qualifications; and
- disclose any relationship with the issuer including, for example, if they are a director of the issuer.

200. The Ministry 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 we consider that there should be some regulation around the use of experts in advertising material. We 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.

39. What changes, if any, should be made to the current definitions and liability that attach to experts?

40. What changes, if any, should be made to the current regulations around the use of experts in advertising material? Would it be simpler to rely instead on the deceptive, misleading or confusing test for advertisements?

6.3 Celebrity endorsement

201. There has been significant criticism of the practice of finance companies engaging well-known persons to appear in advertisements. In at least one case the celebrity specifically endorsed the strength of the finance company, while in another the person may have been used because their other employment implied integrity. 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.

202. The Ministry is not very concerned about the practice of appointing celebrity directors. A celebrity director is as liable for untrue statements as a non-celebrity. Recent charges laid against well-known persons involved as directors of finance companies and public comment about celebrity directors of other companies suggest that well-known persons are likely to think about the implications for their reputations before becoming directors of issuers in the future.

203. The Ministry 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.[99] 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.

41. Should a celebrity who appears in an authorised advertisement relating to a securities offer be liable for the statements they make?

[99] Authorised advertisements under the Securities Act are excluded from the Financial Advisers Act 2008.

7. Advertising

7.1 Pre-prospectus publicity

204. In its progress report, the Taskforce recommended that the Securities Act should be amended to:

> Remove restrictions on pre-prospectus publicity.

205. The Taskforce said:

> Restrictions imposed on pre-prospectus publicity prevent issuers from fully testing the demand for their securities, and tailoring their offer to suit this demand. This increases the risk that offers will be undersubscribed. It also prevents issuers from communicating with their shareholders about the development of new offers. Restrictions on pre-prospectus publicity in section 5(2CA) should be removed.

Status quo

206. Section 5(2CA) of the Securities Act provides a limited exemption for pre-prospectus advertising. The advertisement must state that the issuer is considering making an offer and that no money is being sought, or applications will be accepted until an investment statement is received by the investor. The advertisement may seek preliminary indications of interest but must state that no indication will involve an obligation of any kind. The advertisement must be no more than six months old.

207. Sections 38B (prohibition of advertisements) and 58 (criminal liability for misstatement in advertisement or registered prospectus) still apply to an advertisement. This means that the Commission can ban the advertisement, and the directors of the issuer are criminally liable for untrue statements made in it.

208. Under section 5(2CA)(c), the advertisement may contain no other information except any or all of the following:

    i. the name of the issuer;

    ii. a description of the securities intended to be offered, including a brief description of any rights or privileges to be attached;

    iii. the rate or rates of interest (if any) that may be earned by holding the securities intended to be offered;

    iv. the total number of securities intended to be offered;

    v. a statement of the intended use of the subscriptions;

    vi. the terms of the intended offer;

    vii. a description of the class of persons to whom it is intended the offer will be made; and

    viii. the date at which the issuer expects that the offer will be made.

209. The current form of the exemption was inserted by the Securities Amendment Act 2004, which arose from a Business Law Reform Bill. In its report on the bill,[100] the Select Committee recommended the exemption be inserted, and commented that:

> We recommend a revised exemption for pre-prospectus advertising. Currently potential issuers who advertise an offer of securities to the public must comply with certain disclosure requirements under Part II of the Securities Act. This does not allow issuers to assess the likely level of support for the offering before an offer is made, and may inhibit some issuers from making public offers of securities.
>
> The bill allows issuers to place advertisements seeking expressions of interest in the offer and a number of protections are included to ensure that members of the public understand that the advertisement does not amount to an offer. The advertisement must state that no money is currently being sought and that no applications will be accepted or money received unless the subscriber has received an investment statement.

210. Prior to the Business Law Reform Bill, the exemption was in section 3, and was for an activity that was not an offer to the public. The Business Law Reform Bill carried over the same list of matters that the advertisement could include, but extended it by allowing it to seek expressions of interest and inserted the time restriction. The key change in moving the exemption to section 5 was to bring these advertisements within the scope of the banning and untrue statement provisions of the Securities Act.

Comment

211. The Taskforce's recommendation seeks to broaden the content that may be included in pre-prospectus advertising.

212. 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.[101]

213. While this is a serious policy issue, the Ministry 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. Further, the current content restrictions assume that the design of the security is relatively settled, and there appears to be potential benefit in allowing scope for other material to be included.

214. Options for changing the content restrictions specified in section 5(2CA)(c) include:

    a. specifying other content that may be included, such as a business description and issuer financial information;

    b. not specifying content in the Act, but providing for regulations to specify or prohibit content;

    c. removing content restrictions and relying on the power to ban and liability for untrue statements.

215. The Ministry's preliminary preference is option c.

42.	Do you agree that restrictions on the content of pre-prospectus advertising should be removed? If not, why not?

[100] http://www.parliament.nz/en-NZ/PB/SC/Documents/Reports/c/a/1/ca154adec51e4f63b658ef699433124a.htm.
[101] See Securities Commission *The Bulletin No. 2,* 1 May 1984, available at http://www.seccom.govt.nz/downloads/bulletin-issue-1984-02.pdf.

7.2 Advertisements generally

216. An important function of the Securities Act is regulating advertisements for securities. Advertising is currently regulated under the Securities Act and the Securities Regulations.

7.2.1 Status quo

217. The Securities Act as it is currently drafted does not give much guidance regarding advertisements. It generally:

- creates a class of authorised advertisements;
- creates a power for the Commission to prohibit advertisements; and
- governs statements by experts.

218. The majority of regulations regarding advertising are found in Part 3 of the Securities Regulations. The regulations generally address:

- misleading, deceptive and confusing statements;
- inconsistency with offer documents;
- guarantees;
- asset holdings; and
- guidance around certificates for advertising.

219. There is civil and criminal liability for false or misleading statements in advertisements. The Commission can ban advertisements that are likely to deceive, mislead or confuse, are inconsistent with the prospectus, or do not comply with the Act and Regulations. There is also a range of content restrictions in the Act and Regulations. For example, expert statements must state the qualifications of experts and their relationship to the issuer.

220. Under regulation 30, an advertisement must not be distributed unless directors sign a certificate stating that they have reviewed the advertisement and it is not misleading or inconsistent with offering documents. An exception is made by regulation 31 for advertisements that state, and only state, particular information.

7.2.2 General redrafting

221. The Ministry considers that controls around advertising are generally sufficient (notwithstanding the specific issues addressed below). We consider, however, that the way that the duties are currently split between the Securities Act and the Securities Regulations may need to be adjusted.

222. We consider 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 Authority 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.

223. We consider that advertisements should be guided by the two overarching principles:

- advertisements should not deceive, mislead or confuse (currently regulation 23 and section 38B(1)); and
- advertisements should not be inconsistent with any offer documents (currently regulation 24 and section 38B(1)).

224. The Ministry considers that these two principles should be included in the Act as a requirement that all advertisements must adhere to.

43. Do you agree that a principles-based approach to the regulation of advertising is appropriate?

44. Are there any other matters regarding advertising (other than what is mentioned in the following detailed proposals) that you consider should be expressly addressed in the Act?

7.2.3 Definition of advertisement

225. 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.

Status quo

226. Section 2A of the Act defines an advertisement for securities more broadly than the standard English definition, to include any form of communication—

(a) That—

(i) Contains or refers to an offer of securities to the public for subscription; or

(ii) Is reasonably likely to induce persons to subscribe for securities of an issuer, being securities to which the communication relates and that have been, or are to be, offered to the public for subscription; and

(b) That is authorised or instigated by, or on behalf of, the issuer of the securities or prepared with the co-operation of, or by arrangement with, the issuer of the securities; and

(c) That is to be, or has been, distributed to a person.

227. Advertisements therefore include both public and private communications.

Comment

228. The Ministry 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.

229. The alternative is to remove the specific requirements for advertising, and to simply apply the general principles as discussed above. We would welcome feedback on this.

45. Do you agree that specific advertising requirements should only be applied to public communications, with a more general prohibition on false or misleading communications? If not, why not?

46. Should certification of advertisements be required? How should this certification be achieved for websites?

Chapter 3: Consolidated questions

1. Should the principal target of disclosure be retail investors?
2. Are the secondary audiences and purposes we have identified correct?
3. Have the main problems with the current disclosure regime been identified?
4. What are your costs of compliance with the existing regime? What benefits does the current regime provide?
5. Should the investment statement and prospectus be replaced with a single disclosure document, with further disclosures available on a register? How much cost (e.g. printing, preparation) might this change save?
6. If not, what value would be gained from keeping a prospectus?
7. Do you agree that the Product Disclosure Statement concept, with prescribed documents for individual products, is sensible?
8. Is a key information statement useful?
9. Should other material be allowed to be included in disclosure documents?
10. Should the length of Product Disclosure Statements be prescribed?
11. Should ongoing disclosures be included on the register?
12. Do you have views on the three proposed options for risk disclosure and their application to different securities?
13. What are the potential benefits and costs of an independent expert's report for equity securities?
14. Is the key information summary a useful part of the product disclosure statement?
15. Do you agree with the proposed content of the key information summary for different types of securities?
16. Do you agree with the proposed approach to the content of product disclosure statements for collective investment schemes?
17. What matters should appear in the PDS for an initial offer for equity securities – should it be based on the IOSCO standards?
18. What matters should appear in the PDS for an initial offer for debt securities – should it be based on the IOSCO standards?
19. Do you agree with our proposed approach to the content of product disclosure statements for derivatives?
20. Should educational material form part of the disclosure document, or be required to be provided at the same time as the disclosure document?
21. Should the Authority be empowered to impose sophistication labels on complex products? If so, what safeguards do you think should apply?
22. Should a distinction between short form and simplified disclosure prospectuses be maintained?
23. Are the current tests for determining when a short form or simplified disclosure prospectus may be used correct?
24. Do you agree that a comprehensive regime for information disclosure for unlisted securities equivalent to continuous disclosure is not justified? What would be the costs and benefits of such a regime?
25. Do you agree that additional ongoing disclosure requirements are not necessary for equity securities or derivatives?
26. Do you agree that additional ongoing disclosure requirements should be imposed on issuers of debt securities and collective investment schemes?
27. Do you agree that issuers of debt securities should be required to update on the Register of Securities certain prescribed matters that may have a bearing on the likelihood of default, should those matters change over time?

28. Do you agree that collective investment schemes should be required to publish quarterly information? Should any types of schemes be exempted from the requirements?
29. Do you agree that these quarterly reports should contain information on fees and charges, asset holdings, any conflicts of interest, and fund returns? If quarterly reporting is required of collective investment schemes, are there any other matters that should be included in such reports?
30. Do you agree with the problems identified with the “all material matters” disclosure requirement?
31. What impacts and costs does the regime have on incentives of directors and corporate governance of issuers?
32. Should an “all other material matters” disclosure obligation still be retained? If so, do you agree that this disclosure should be made on the Register of Securities rather than in the PDS?
33. What products should be exempted from the requirement to disclose “all other material matters”?
34. Should directors be required to certify disclosures on issue periodically?
35. What should directors’ certificates contain?
36. What disclosure failures should result in voidability?
37. Who, and in what circumstances, should persons be civilly and criminally liable for disclosure failures?
38. What changes, if any, should be made to the current definitions and liability that attaches to promoters?
39. What changes, if any, should be made to the current definitions and liability that attach to experts?
40. What changes, if any, should be made to the current regulations around the use of experts in advertising material? Would it be simpler to rely instead on the deceptive, misleading or confusing test for advertisements?
41. Should a celebrity who appears in an authorised advertisement relating to a securities offer be liable for the statements they make?
42. Do you agree that restrictions on the content of pre-prospectus advertising should be removed? If not, why not?
43. Do you agree that a principles-based approach to the regulation of advertising is appropriate?
44. Are there any other matters regarding advertising (other than what is mentioned in the following detailed proposals) that you consider should be expressly addressed in the Act?
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1. Introduction and principles

1.1 Introduction

1. Collective investment schemes act as intermediaries between investors seeking a return and businesses seeking additional capital for investment and expansion. They therefore perform an important function in directing capital to areas of the economy that will generate economic growth.

2. Collective investment schemes are defined in Chapter 1: Defining Regulated Financial Products to cover vehicles in which investors give money to someone else to invest, with the earning of a financial return being a significant objective, and investors do not maintain day-to-day control over the management of their money. This definition will include, but may not be limited to, pooled vehicles often referred to as “managed funds”. If the scheme is a collective investment scheme, then it will be required to comply with the regime described in this chapter.

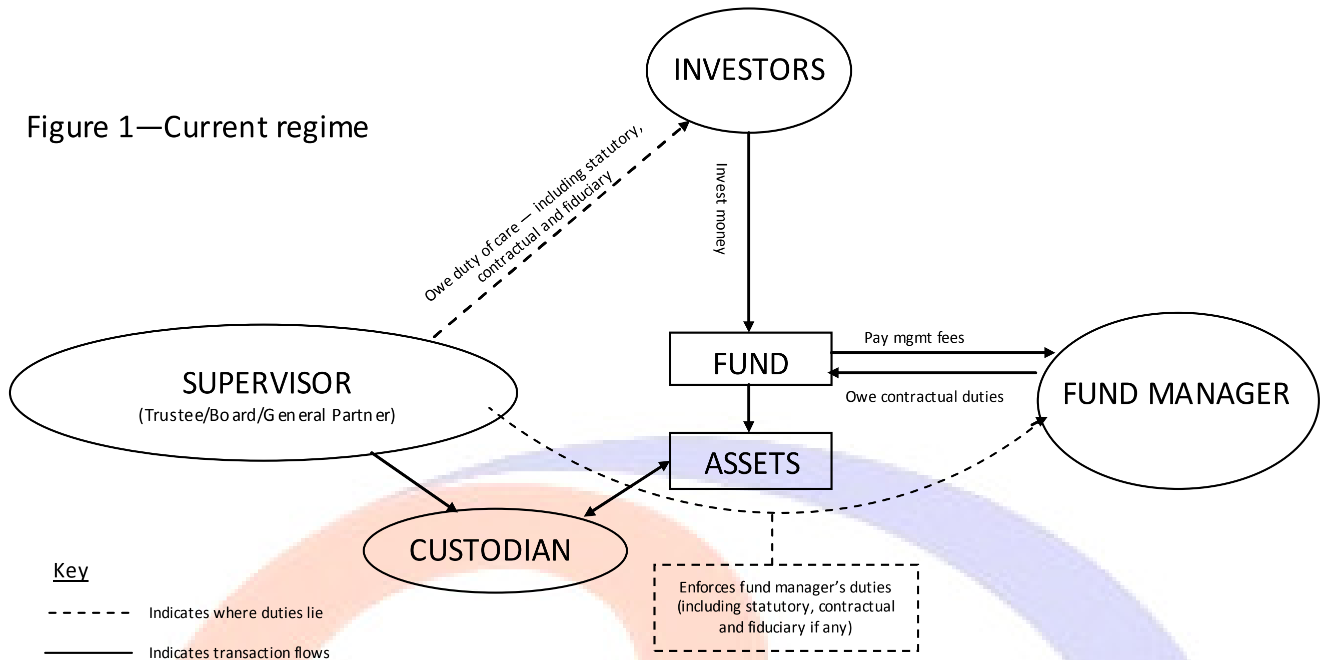
3. Chapter 1 also asks whether the definition should include schemes where there is no pooling of multiple investors’ funds, and whether certain investment companies should be treated as collective investment schemes (rather than as ordinary companies issuing equity securities). The proposals in this chapter consider what regulation should apply to collective investment schemes in the broadest sense. However consultation on the questions posed by Chapter 1 may result in a narrowing of this definition.

4. Collective investment schemes provide individual retail investors with a means of accessing a diversified portfolio of investments, suited to their investment risk profile. Some retail investors do not have the resources, knowledge or skills to undertake this role themselves, and cannot access investment products that are reserved for sophisticated investors and institutions or which require a large investment amount. Globally, collective investment schemes are becoming the predominant method of investing for retail investors.

5. Generally speaking, in a collective investment scheme a fund manager[102] manages and promotes the scheme. The various tasks associated with operating the scheme (e.g., making investment decisions, holding assets, scheme administration) may be either performed by the fund manager or contracted to others. Most regulatory regimes provide for a supervisor who monitors the fund manager and associated persons, checks that the scheme is operated in accordance with contracts, trust deeds, constitutions etc., and acts on behalf of investors. Certain tasks (such as the holding of scheme assets) are often also separated from the fund manager.

[102] In this paper, the fund manager is assumed to have an equivalent meaning to the “manager” as currently defined in the Unit Trusts Act 1960.

6. Figure 1 depicts the structure of a typical collective investment scheme.



1.2 Why we regulate collective investment schemes

7. Governments regulate collective investment schemes because of issues inherent in the governance and operation of schemes. In a collective investment scheme, a relationship is created whereby an investor delegates decisions about their investment portfolio to fund managers. Information and power asymmetries arise in this situation for two primary reasons:

- The characteristics of typical investors; and
- The nature of collective investment schemes.

8. For many investors, investment via a collective investment scheme will be their only interaction with financial products, outside of bank accounts, loans and insurance. Because of this, it is important that the regulatory regime enhances competition and provides investors with confidence that supervisors and regulators will discover illegal or inappropriate behaviour when it occurs and take action.

9. In New Zealand, collective investment scheme investors may be unsophisticated retail investors with a relatively low level of investment literacy. These investors may lack the time, ability, or inclination to conduct detailed research for informed investment decisions or to effectively monitor fund managers. Instead, they rely on fund managers to have the specialist skills needed to invest successfully (or to delegate to those that do have such skills) and to act with integrity and competence. This can leave investors vulnerable to self-interested behaviour.

10. Within collective investment schemes large amounts of assets are owned by a dispersed group of investors with incomplete information, while those assets are controlled by a fund manager with considerable ability to control flows of information. In investing in a financial product, investors often have very limited means of assessing the capacity of the issuer to meet their promises and claims.

11. Collective investment schemes also act as financial intermediaries, directing capital into potentially rewarding economic opportunities. There is a role for public policy in establishing robust regulatory frameworks which facilitate the development of transparent markets and sound governance, and facilitate investor confidence and protection. However, all capital market activity inherently involves risk taking and our goal is not to try to legislate against the possibility of loss. Rather, it is to build a legislative framework "in which risk is voluntarily assumed under fair and transparent conditions".[103]

1.3 Principles and objectives for regulation

12. The Ministry's objective in reviewing existing regulation of collective investment schemes is to deliver improved outcomes for investors by ensuring robust regulatory frameworks around the governance of schemes and better enabling investors to make informed investment decisions. This chapter focuses on governance and supervision, and the disclosure chapter discusses options to improve the information provided to investors. To achieve this objective we propose a regulatory framework for the collective investment schemes market based on the following principles:
    - The market should be competitive;
    - Providers and fund managers should put investors' interests first; and
    - Where consistent with other objectives, regulation should align with international best practice.

The market should be competitive

13. Competitiveness of a market is driven by low barriers to entry, transparency and comparability of information. Investors need ready access to information about their current or prospective investments in a clear and concise format. This includes information being provided on an ongoing basis so that investors can monitor the performance of their investment scheme and the fund manager.

14. In addition, similar products should be subject to similar regulation so as to avoid opportunities for regulatory arbitrage by providers. Likewise there is the need to ensure effective monitoring and enforcement of the rules. Otherwise, there is little incentive for schemes and their fund managers to observe the rules and regulations.

Providers should put investors' interests first

15. Fund managers, supervisors, and other market participants offering collective investment scheme products to investors should be required to act in the best interests of their investors. Where any function is delegated it should be the fund manager's obligation and responsibility to ensure the person performing the function is acting in the best interests of investors. If and when these expectations are breached, investors should have practicable and direct access to redress against the fund manager.

[103] OECD White paper on Governance of Collective Investment Schemes (CIS) 2005, page 138.

If consistent with other objectives, regulation should align with international best practice

16. Regulation that aligns with international best practice has the potential to increase New Zealand's attractiveness to both domestic and international investors. New Zealand also has potential export opportunities as an international funds domicile. For the latter to occur, our regulatory regime would need to be world class. In particular, it is likely that our regime would have to match or better the requirements under the European Union's Undertakings for Collective Investment in Transferable Securities regime (UCITS), which is generally considered to be the benchmark for international best practice. Section 6.1 includes a more detailed discussion of the UCITS requirements.

17. On the other hand, imposing "international best practice" could arguably impose significant costs on New Zealand businesses which may not be justified in terms of the additional benefit to investors. A particular concern is that overregulation could limit the development of a competitive market by precluding small innovative fund managers.

2. Status quo and problem definition

2.1 Current regulation of collective investment schemes

18. In New Zealand collective investment schemes can employ a variety of legal forms. Some forms are of general application and can be used by anyone for any class of investments (for example, unit trusts and participatory securities). Others are only offered by certain persons (for example, group investment funds offered by trustee companies), or may only be used for specific classes of investments. All collective investment schemes offered to the public are subject to the provisions of the Securities Act 1978. In addition, some types of collective investment schemes are subject to other pieces of legislation, for example, unit trusts are also subject to the requirements of the Unit Trusts Act 1960. The legislation for each type of scheme prescribes a different regulatory framework, with varying duties and obligations for trustees, statutory supervisors and fund managers.[104] Some types of participatory securities, such as proportionate property schemes, are exempt from some provisions of the Securities Act, subject to certain conditions.

19. Table 1 below provides an overview of the different types of collective investment schemes and the legislation applicable (in addition to the general disclosure requirements required under the Securities Act).

[104] Note that, as the law currently stands, collective investment schemes in company form that issue shares will be offering equity securities and fall outside this regime.

Table 1: Overview of current forms of collective investment schemes

Type	Relevant legislation	Description
Unit trusts	Unit Trusts Act 1960 Trustee Act 1956 Securities Act 1978	A unit trust offered to the public is established by trust deed under the Unit Trusts Act 1960. The trust deed is the founding document and contains all the powers and duties necessary to establish and maintain the trust, some of which are implied by the Unit Trusts Act 1960. The unit trust must have a trustee and a fund manager that is independent from the trustee. Independent means the manager and the trustee must not be associated with each other as defined in sub-part YB of the Income Tax Act 2007. The fund manager is the issuer of the unit trust for the purposes of the Securities Act, and has vested in it all powers of management of the fund. They will often, however, delegate investment management to a third party. The trustee holds the assets (and may appoint a nominated person or nominee to hold the assets) and also has the role of supervising the fund manager. It does not have day-to-day involvement in the management of the unit trust but ensures that the fund manager acts in accordance with the trust deed and to protect the interests of the unit holders as a whole. It has a right to veto decisions of the fund manager that it considers manifestly are not in the best interests of unit holders. Investors buy units in the fund which are priced at the time of purchase based on the value of the fund's assets. Unit holders who wish to cash in their units have them redeemed or repurchased by the fund manager. Unit trusts are one of the most common types of collective investment schemes. The Unit Trusts Act contains certain implied provisions for trust deeds and imposes specific duties on fund managers and trustees. A fund manager has the same liability in the exercise of its powers and functions as if it were exercising those powers and functions as trustee.
Company	Companies Act 1993 Securities Act 1978	A company comes into existence after incorporation under the Companies Act 1993. Once incorporated it is recognised as an independent legal entity which means it is treated as being a separate 'person' from its directors and shareholders. Investors purchase shares in a company that invests on behalf of shareholders. Shares are redeemable in accordance with the company's constitution, generally at the option of the company, subject to the rights relating to the shares. Prior to the company exercising an option to redeem a share the company must satisfy the solvency test in accordance with the Companies Act. Companies need to comply with the Securities Act if they offer securities to members of the public. In such instances the company is deemed to be the issuer under the Securities Act.
Super-annuation schemes	Super-annuation Schemes Act 1989 Trustees Act 1956 Securities Act 1978	A superannuation scheme is a trust established by trust deed and registered under the Superannuation Schemes Act 1989 with the principal purpose of providing retirement benefits to members who are natural persons. Superannuation scheme investors' funds are usually locked in for a defined period – based on intended retirement dates or ages, or other restrictions. The trustees of a superannuation scheme are responsible for all aspects of the scheme. A trustee can either be a company or a number of individuals with at least one trustee required to be resident in New Zealand. There is no requirement for the trustee to be independent from fund management. The trust deed sets out the powers and duties of the trustee as well as rules applying to the operation of the scheme. The trustee is responsible for all aspects of the management and administration of the scheme and is the issuer for the purposes of the Securities Act. Trustees generally delegate functions to administration managers and investment managers for the efficient operation of the scheme.

		The Trustee Act 1956, Superannuation Schemes Act common law and the trust deed contribute to the regulation of the operation of a superannuation scheme. The Superannuation Schemes Act implies certain provisions into the trust deed and imposes duties on trustees and investment managers. Superannuation schemes may be set up by employers offering benefits to employees, industry associations or by financial service providers offering membership to the public.
KiwiSaver	KiwiSaver Act 2006 Super-annuation Schemes Act 1989 Trustees Act 1956 Securities Act 1978	KiwiSaver schemes are trusts established by trust deed and registered under the KiwiSaver Act 2006. Their purpose is to encourage a long-term savings habit and asset accumulation by individuals to help them enjoy standards of living in retirement similar to those in pre-retirement. The Act facilitates individual savings, principally through the workplace. Although the KiwiSaver Act has the concept of "provider" the trustee of a KiwiSaver scheme is responsible for all aspects of the scheme. At least one trustee must be resident in New Zealand and in most situations the scheme must have at least one independent trustee. KiwiSaver is a voluntary (opt-out) scheme. There are a number of Government incentives to encourage New Zealanders to join. The principal method of contributing is via deductions from an investor's salary. For most purposes a KiwiSaver scheme is treated as a registered superannuation scheme, including under the Superannuation Schemes Act (in respect of prescribed matters) and any other enactment, unless the enactment indicates otherwise. The matters required to be specified in a trust deed of a registered superannuation scheme apply to a KiwiSaver scheme trust deed with the implied terms under the Superannuation Schemes Act also applicable. The KiwiSaver Act also sets out certain powers and duties of the trustee and rules applying to the operation of the Scheme.
Participat-ory securities	Securities Act 1978	Participatory securities is the "catch-all" classification in the Securities Act for securities that are not equity, debt, a unit trust, KiwiSaver, a superannuation scheme or a life insurance policy. It includes a range of collective investment schemes such as group investment funds, limited partnerships, contributory mortgages, bloodstock interests, partnerships (e.g. some forestry ventures) and proportional title schemes. These are all subject to different pieces of legislation as well as the requirements for participatory securities under the Securities Act (unless exempted). Many involve investors contributing towards some kind of property and then sharing in the profits earned via the management of that property, for example, a film syndicate may invest in a film. These are not regulated as such other than as participatory securities under the Securities Act. Unless exempted, the issuer (manager) of a participatory security is required to appoint a person as statutory supervisor and enter into a deed of participation relating to the security. The statutory supervisor must be a trustee company or person approved for that purpose by the Securities Commission. The manager of a participatory security is the issuer under the Securities Act. Regulations under the Securities Act set out matters to be specified in the deed of participation. Clauses are implied into the deed. These include a duty of the statutory supervisor to exercise reasonable diligence to ascertain whether or not any breach of the terms of the deed or of the offer of the participatory securities has occurred and, except where it is satisfied that the breach will not materially prejudice the interests of the holders of the participatory securities, to do all such things as it is empowered to do to cause any breach of those terms to be remedied.

2.2 Significant upcoming changes to regulation

Financial Service Providers (Registration and Dispute Resolution) Act 2008

20. The Financial Service Providers (Registration and Dispute Resolution) Act 2008 (FSPA) is expected to be implemented by the end of 2010 and will require all issuers, including fund managers, to be registered to continue in the business of providing a financial service. In order to be registered, a financial service provider must:

    a. Not be disqualified. This is a "negative assurance test" – for example, a financial service provider is disqualified if it, or a controlling owner, director or senior manager is an undischarged bankrupt or is subject to a management banning order;

    b. Belong to an approved, or the reserve, consumer dispute resolution scheme; and

    c. In the case of a person who provides or offers to provide a "licensed service", the person is a licensed provider. This mechanism could potentially be used to require fund managers to be licensed.

Securities Trustees and Statutory Supervisors Bill

21. The Securities Trustees and Statutory Supervisors Bill establishes a licensing and monitoring regime for certain securities trustees and statutory supervisors, which will become licensed services for the purposes of the FSPA. The Bill removes the automatic statutory approval for the current six trustee corporations, and requires all trustees of debt securities, statutory supervisors and unit trustees to be licensed by the Securities Commission. It is anticipated that the Authority will take over this role.

22. Under the Bill all licensed trustees and statutory supervisors must be bodies corporate. Their directors and senior managers must be of good character, and the trustee (or where appropriate their directors or staff) must have the necessary skills, qualifications, financial resources, infrastructure, governance structures, independence and professional indemnity insurance.

23. The Authority, in determining the scope of the licence, will ensure that the licence is tailored so that it is "fit for purpose", imposing obligations that reflect the characteristics of the issuers being supervised. The Bill contains a number of provisions designed to ensure that trustees comply with their obligations, including enhanced requirements for reporting to the Commission. The Bill also provides the Commission with the power to directly intervene in certain prescribed circumstances where the issuer being supervised is likely to breach the terms of the trust deed or offer or become insolvent.

Changes to regulation of KiwiSaver schemes

24. Government has agreed to make changes to the regulation of retail KiwiSaver schemes, which will result in fund managers becoming the "issuer" (in place of the trustee). In addition, fund managers will owe direct duties to investors, and KiwiSaver trustees will be licensed under the regime established by the Securities Trustees and Statutory Supervisors Bill. Schemes will also be required to periodically report scheme performance in a standardised manner. A bill to provide for these changes is expected to be introduced into Parliament soon, as part of a Bill to establish the Authority.

2.3 Problems with the current regime

25. New Zealand's regulatory regime for collective investment schemes has been reviewed by the IMF[105] and Morningstar[106], a provider of independent investment research. Both organisations judged New Zealand's regulation of collective investment schemes as poor, as did the Taskforce. There has also been discussion by industry participants and investors on the need for a more robust regulatory regime.

26. 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;
- Unclear duties and supervision of fund managers;
- Inadequate regulation of pricing and valuation methodologies;
- Inadequate regulation of treatment of pricing errors;
- Inadequate regulation of 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; and
- No licensing of fund managers, which is inconsistent with many other jurisdictions.

27. Inconsistent regulation leads to inequities across investors in different categories and to regulatory arbitrage by issuers. It also impedes transparency and comparability of information. These issues ultimately serve to reduce the competitiveness of the market and reinforce information asymmetries and principal-agent issues.

28. A duty to put investors' interests first is essential for the effective regulation of collective investment schemes. This is appropriate as it is the investor who is entrusting the fund manager (and by association the supervisor) with the safe stewardship of their monies. Clear designation of monitoring and enforcement roles to the regulator and the supervisor, the assigning of statutory duties to the fund manager and supervisor, and the ability for investors to easily access effective redress mechanisms all work to achieve this outcome.

2.3.1 Inconsistent governance and obligations across legal forms

29. As recognised in the RFPP[107] inconsistency of governance and legal obligations across the various legal forms that collective investment schemes can adopt has led to inconsistency in both the rights of investors and duties of fund managers. As a result there is no minimum standard of protection for investors.

[105] New Zealand: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy Transparency, Banking Supervision, and Securities Regulation, International Monetary Fund, 5 May 2004.

[106] Global Fund Investor Experience, Morningstar Fund Research, May 2009.

[107] Review of Financial Products and Providers: Collective Investment Schemes, MED, September 2006 available at http://www.med.govt.nz/templates/ContentTopicSummary____22191.aspx.

30. Multiple collective investment scheme structures with different oversight and obligations for fund managers can also be difficult for investors to understand and differentiate. This complexity can reduce effectiveness of monitoring of schemes and fund managers. A lack of proper monitoring and enforcement can lead to a lack of competition in the industry, as investors cannot easily determine which schemes are better managed and provide good value for money.

2.3.2 Inadequate measures to safeguard investors' interests

31. The current regulatory regime permits gaps to exist that allow conduct damaging to investors to occur. The gaps are discussed below.

Duties owed by fund managers

32. For some of the current collective investment scheme structures used in New Zealand, it is only the trustee or statutory supervisor who owes a direct duty of care to investors. The fund manager only has a contractual relationship with the trustee (and no direct duty to investors in the scheme). Under a unit trust there are some specific duties owed by the fund manager to investors, but the duties remain unclear to industry participants and investors, are difficult and expensive for individuals to enforce, and have rarely been tested in law.

33. The obligations on the manager of a collective investment scheme are determined by the fund management agreement, which is a contract between the trustee or statutory supervisor and the manager. Investors are not party to the fund management agreement (or any delegation documentation, such as the investment management contract). Fund managers therefore discharge their obligations to the scheme by carrying out their duties to the standards stipulated in the contract. Problems can arise due to the fact that the fund manager is also typically the fund founder. As a result, the fund manager is in the driving seat when negotiating the terms of the contract with the trustee or statutory supervisor. Consequently, the standards in the contract will not necessarily be in the best interests of the investors and the standards are often insufficient to mitigate the conflicts of interest inherent within schemes.

Supervision of fund managers

34. Most collective investment schemes are required to have a supervisor (for example, the trustee) that is responsible for monitoring the performance of the fund manager. Because the body which selects, contracts with, and appoints a supervisor is usually the fund manager there is an inherent conflict of interest. However, not all schemes are required to have an independent supervisor nor do all types of securities technically require a supervisor (for example, contributory mortgages, proportionate ownership schemes and superannuation schemes).

35. While, in respect of unit trusts under the Unit Trusts Act, the trustee has, in certain circumstances, the power to remove the fund manager, and is not obliged to act on the fund manager's direction if this is not manifestly in the interests of unit holders, this is not a consistent requirement across the various scheme structures. As a result, the fund manager may have the ability to negotiate trust deeds which can be subsequently altered with ease and may not give the supervisor any effective power to censure or remove the fund manager. The Ministry anticipates that this issue will be dealt with through the licensing of supervisors under the Securities Trustees and Statutory Supervisors Bill.

Pricing and valuation

36. Fund managers or a related party often perform collective investment scheme administration, including calculation of unit prices and asset valuation. There are no standard industry-wide practices for asset valuation within schemes and there are conflicts of interest between fund management and pricing. In particular, for assets that are difficult to value (i.e., illiquid and lightly traded assets) there may be large variances in pricing practices and procedures. Fund managers have few incentives to invest in accurate pricing, and to adequately review pricing procedures.

37. There is very limited monitoring of pricing practices and usually no mechanism for pricing to be independently reviewed. While there is a fiduciary duty on trustees to act in the best interests of investors in dealing with pricing and valuation issues, there is not a general duty across the variety of scheme structures. In addition, any fiduciary duty is to investors as a group (i.e. the scheme) and not to each investor individually.

38. There are a number of issues regarding the treatment of pricing errors. There is no agreed industry wide policy as to how to deal with pricing errors. There is no regulatory oversight as to how these errors are treated by schemes or trustees and pricing error policies are not usually disclosed by schemes. Pricing errors can potentially have a significant impact on investor returns, especially those buying in or cashing out of the scheme, so there is a strong argument for ensuring that these policies are better regulated and disclosed to investors.

Redemption/exiting rules

39. The liquidity policies of collective investment schemes are not always fair to investors, particularly where the scheme is underperforming. For example, where a scheme is having difficulty liquidating assets, it might allow investors to redeem their units on a first-come, first-served basis. This means that until the scheme is "rebalanced" with more liquid assets, those remaining in the scheme are exposed to a higher level of risk, and those exiting the scheme benefit to the detriment of remaining investors.

Constitutional documents

40. There are inconsistencies in constitutional document requirements across different types of collective investment scheme structures. A primary concern is that this results in inconsistent obligations and duties across the variety of forms. Some forms, such as unit trusts, require a trust deed to meet their constitutional document obligations, while for investment companies, the rights attaching to shares may be set out in the company's constitution. Where the scheme is being offered as a participatory security, issuers are required to have a deed of participation. Additional consequences of this are:

    a. The ability to monitor and compare different products is constrained by the lack of consistency in available information and the way that information is presented; and

    b. It is difficult to monitor the industry as a whole because of the variances in duties and obligations across different legal forms.

Access to redress

41. Where duties owed to investors are breached, it is difficult for investors to obtain redress for losses. It is costly for investors to take civil action, and a class action is difficult to coordinate across a large and dispersed investor base. Moreover, the duties owed are not always clear, which makes pursuing legal action more difficult, time consuming and expensive, with no guarantee of a favourable outcome.

42. However, the Ministry considers that this aspect will at least be partly addressed under the FSPA as all fund managers and trustees (or statutory supervisors) will be required to belong to a dispute resolution scheme.

1. Have all the issues with the current regulation of collective investment schemes been accurately identified? If not, what other areas should we consider?

2. Do you consider that all the issues identified need to be addressed by legislation? If not, why not?

3. Do you have evidence of problems with the current regulatory regime for collective investment schemes? Do you have examples of types of behaviour by fund managers and/or trustees that require a regulatory response? If so, please clarify and identify if there have been any wider associated costs to the economy.

4. Is there a legal form of collective investment scheme (e.g., unit trusts) that you consider better aligns the fund manager with investor interests than other legal forms? If so, why?

5. Do you have evidence where regulation in other jurisdictions has either advanced or impeded the development of an effective collective investment schemes market?

3. Previous proposals

3.1 IMF Financial Sector Assessment Programme (2004)

43. The International Monetary Fund's Financial Sector Assessment Programme (FSAP)[108] assessed the extent to which financial regulation in New Zealand complies with the IOSCO Objectives and Principles of Securities Regulation. These principles include several relating to collective investment schemes. FSAP highlighted issues in several areas and made a number of recommendations including:

- More consistent regulation, because the current collective investment schemes regime is relatively complex, and somewhat less transparent than some other aspects of the securities regulatory regime;
- Requiring all collective investment schemes to have a supervisor, or be subject to direct regulatory oversight;
- High level minimum entry and ongoing standards with respect to collective investment scheme operators' honesty and integrity, competence, and financial capacity;
- General conflict of interest standards for collective investment schemes operators and their trustees or supervisors;
- Requiring supervisors to conduct periodic inspections of issuers, and for issuers to provide periodic reports to the supervisor (or regulator); and
- The regulator should have the power to direct the supervisor, or to remove them where the investors' interests are at risk.

3.2 Review of Financial Products and Providers (2006)

44. The Ministry's RFPP[109] proposed a framework for regulation of most collective investment schemes including unit trusts, superannuation schemes (with a few minor exceptions), KiwiSaver schemes, most participatory securities and life insurance policies with an investment component. The proposals included:

- Requiring all collective investment schemes offered to the public to have an issuer that is approved by the regulator;
- The issuer should have a number of duties including, amongst other things:
  - A duty to use its best endeavours and skill to ensure that the scheme is carried on in a proper and efficient manner, and
  - A duty to use the same care and diligence in the exercise and performance of its functions, powers and duties as it would if it exercised those functions, duties and powers as a trustee;
- Requiring all collective investment schemes offered to the public to have an independent trustee who is approved by the regulator. The trustee was intended to act as first-level supervisor of the scheme by undertaking the initial "fit and proper" assessment of the issuer and ensuring that the issuer carries out its duties properly;

[108] New Zealand: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy Transparency, Banking Supervision, and Securities Regulation, International Monetary Fund, May 5 2004.

[109] Review of Financial Products and Providers: Collective Investment Schemes, Ministry of Economic Development, September 2006 available at http://www.med.govt.nz/templates/MultipageDocumentTOC____22186.aspx.

- Regulator oversight of the trustee, primarily to ensure that the trustee is effectively undertaking its role as supervisor. The regulator was proposed to have the power to enforce the trustee to comply with the trust deed, as well as to approve and continually monitor the fit and proper requirements of trustees; and

- Common requirements for certain matters to be addressed in all trust deeds. It was considered that this will establish a minimum set of rights for investors in collective investment schemes and obligations by trustees in relation to the operation of schemes.

45. Some of these proposals have been addressed by the Securities Trustees and Statutory Supervisors Bill currently before select committee.

3.3 Capital Market Development Taskforce (2009)

46. The Taskforce identified many of the issues described above. In particular, the Taskforce was concerned with the lack of "clear and enforceable duties to act in the best interests of individual investors."[110] The Taskforce made a number of recommendations to improve the transparency and governance of collective investment schemes. These included:

- Clarifying and standardising the minimum duties owed to individual investors to "ensure that there is an appropriate level of protection for investors of all collective investment schemes, regardless of a collective investment scheme's legal structure";
- Imposing a clear, direct, fiduciary duty on fund managers (and supervisors) to act in the best interests of individual investors (subject to the investment mandate of the scheme);
- Requiring fund managers and supervisors to specifically disclose to investors the duties owed to them (and any restrictions on these), and to annually confirm that they have not breached these duties. The Taskforce believed that this would help focus professionals on the duties they owe to investors, and ensure investors are aware of their rights; and
- Require all schemes to establish fair entry, exit and unit pricing rules that are disclosed to investors.

[110] Capital Market Development Taskforce, "Capital Markets Matter," December 2009, page 42.

4. Proposals for reform

47. This section describes the requirements that the Ministry is considering should apply to collective investment schemes which offer to the public. Section 5 discusses how the regime will apply to different legal forms and products, and indicates exemptions that might be allowed or seeks comments on other exemptions that might be appropriate.

4.1 Summary of proposals

48. All collective investment schemes will have a fund manager, which will be the issuer and an independent supervisor (e.g. for a trust, the trustee; or for a company, an independent supervisor). Each scheme will be registered individually.

49. 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. Supervisors will be licensed in accordance with the regime set out in the Securities Trustees and Statutory Supervisors Bill.

50. We are considering whether fund managers and custodians should be licensed, in accordance with international best practice. The alternative may be to rely on the disqualification provisions in the FSPA and oversight by a licensed supervisor.

51. The fund manager will be legally responsible for investment decisions, even if they have delegated this function to an investment manager.

52. 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 Authority. 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.

53. The constitutional documents of collective investment schemes will need to comply with, contain, or have implied into them, a set of required provisions, and must have provisions relating to the matters described in the section below on constitutional documents.

54. There will also be a common set of initial and ongoing disclosure requirements, although where necessary, these will be tailored to the type of product. These requirements are described further in the following section. In addition, we discuss further proposals regarding pricing, valuation, entry, and exit policies.

4.2 Registration

55. We propose that all collective investment schemes 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.

56. The registration requirement would replace the current registration requirements for unit trusts and superannuation schemes, and apply to all collective investment schemes regardless of their legal form. Note that 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.

57. As currently envisaged, the collective investment schemes register would operate as a separate register to the FSPA register and the register of securities provided for under chapter 3, as each register serves slightly different purposes. However, the same registrar and computer platform would operate all the registers, and the Ministry would explore opportunities to integrate the registers to promote efficiency and minimise compliance costs.

6. Do you agree that all collective investment schemes should be registered by the Registrar before offering securities to the public? If not, why not? What are the costs and benefits of this proposal?

4.3 Authority oversight

Supervisors

58. Under the Securities Trustees and Statutory Supervisors Bill, supervisors will be obliged to supply six-monthly reports to the Authority on their ongoing compliance with the terms of their licence and must also report to the Authority when they believe they have breached their obligations, or their circumstances have changed in a way that materially affects their ability to comply with their obligations.

59. The Bill also provides the Authority with an attestation power, whereby they can request that supervisors either attest that there are no concerns, or if they are unwilling to make such an attestation, explain why they are unwilling to make the attestation. In addition, the Bill provides that the regulator can apply for civil pecuniary penalties of up to $200,000 against supervisors if they have breached their duties, and also take proceedings against supervisors on behalf of investors in these circumstances.

60. We propose that the regime established under the Bill would apply to all supervisors under the proposals in this chapter. In addition to this, we propose that supervisors be required to report key changes and events, such as significant pricing errors and limit breaks, to the Authority (see below).

Single responsible entity model

61. A possible alternative to the existing regime of trustee supervision is centralising the role of trustees within the Authority, similar to the single responsible entity model in Australia. Under this model, the Authority would provide direct supervision of entities issuing interests in collective investment schemes to the public.

62. In Australia, each scheme has a single entity that is legally responsible for the roles of trustee and manager of the scheme. The responsible entity must be an Australian public company holding a licence to act as a responsible entity. It must have minimum net tangible assets of AU$50,000 or, where the scheme's assets are in excess of AU$10 million, 0.5% of the value of the scheme's assets, up to a maximum of AU$5 million.

63. Australian law imposes extensive duties on the responsible entity and its officers. These include the duty to act honestly, exercise a reasonable degree of care and diligence, act in the best interest of investors and to treat scheme investors equally. Breaches relating to the scheme that have or are likely to have a material adverse effect on the interests of investors, must be reported by the responsible entity to the Australian Securities and Investment Commission (ASIC). Breach of a duty by a responsible entity can attract civil penalties (up to AU$1 million for the responsible entity and up to AU$200,000 for its relevant officers) and in some cases criminal sanctions.

64. The benefits of this option may be in applying a more even standard of supervision across different issuers, and the economies of scale that may arise out of having a single entity conducting supervision of all relevant issuers.

65. However, this option has the potential to result in a significant increase in costs and it may be difficult for the Authority to establish a sufficiently large pool of suitably qualified people to perform the supervisory function. This approach is also not consistent with that taken by many other countries which may create issues for recognition of our collective investment schemes in other jurisdictions.

66. The Ministry considers that changes to the existing regime currently in progress (for example, the Securities Trustees and Statutory Supervisors Bill) when combined with many of the proposals contained within this document, will ensure a regulatory regime that delivers similar or superior outcomes.

Fund managers

67. The supervisor will continue to serve as the frontline regulator of fund managers. However, it is proposed that the Authority will have the ability to take enforcement action for breach of the fund manager's statutory duties. This would include a power to seek pecuniary penalties and compensation on behalf of investors and apply to a court to have the fund manager removed.

7. Do you consider that the powers proposed for the Authority over supervisors and fund managers are sufficient, overreaching or inadequate? What are the likely costs and benefits?

8. Do you agree with the Ministry's view that the single responsible entity model is not an appropriate approach? If not, why not? What are the likely costs and benefits?

4.4 Licensing of fund managers

Should fund managers be licensed?

68. There has been much discussion regarding the need for a mechanism to provide for more active supervision of fund managers. In this section we consider:

- Fit and proper requirements;
- Monitoring by the Authority; and
- The potential role of the supervisor.

69. Under the FSPA, all issuers of a security, which will include fund managers of a collective investment scheme, will be required to register as a financial service provider. This requires issuers to belong to an approved dispute resolution scheme, not be disqualified ("a negative assurance" type test), and where the service provided is a licensed service, be licensed.

70. We are considering whether acting as a fund manager of a collective investment scheme should be a licensed service. 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 FSPA currently does and would be intended to ensure issuers:

    a. are subject to consistent minimum standards of entry, to promote the protection of investors' interests;

    b. are competent and have the capacity to carry out their functions; and

    c. are of good and sound character and the Authority is satisfied that they will act honestly and with integrity in carrying out their functions.

71. A licensing-type requirement was proposed in the RFPP and is consistent with international best practice. In Australia for example, new collective investment schemes that are offered to retail investors must be registered before they can operate. To register, the responsible entity that runs the scheme must be a registered Australian public company and hold an Australian Financial Services Licence which authorises the entity to operate the scheme. In order to obtain a license, the entity must satisfy a number of requirements which pertain to honesty, managing conflicts of interests, capacity and competence.[111]

72. 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. This issue is discussed further in section 6 below.

73. The benefits of licensing would need to be weighed against the costs. Licensing might impose significant costs on fund managers (which would be passed on to investors) which may not be justified in terms of the benefits to investors. A particular concern is that overregulation could limit the development of a competitive market by precluding small innovative fund managers. The alternative may be to rely on the disqualification provisions in the FSPA and oversight by a licensed supervisor.

74. Conversely, licensing could also be viewed as an integral part of effective supervision of schemes, and important in helping to ensure that issues are identified at an early stage and dealt with before significant harm occurs.

Model if licensing of fund managers was required

75. This section outlines a possible model for licensing of fund managers for comment.

76. Fund managers would be required to provide information to satisfy the Authority that they meet fit and proper entry requirements. They would also have to continue to meet these requirements on an ongoing basis.

77. When deciding whether to approve the application, the Authority would look at both the capacity of the fund manager as an entity, and senior managers, owners and directors. Some of the criteria the Ministry is considering that fund managers might have to meet in order to satisfy the Authority are:

    a. Appropriate skills, qualifications and experience required for the particular product offered;

    b. Capacity of the fund manager to perform the services required e.g. adequate administration, operating systems and risk management processes are in place;

[111] Similarly, the Financial Advisers Act 2008, scheduled to come into force in June 2011, will require authorised financial advisers to comply with ethical, competence and client care standards similar to the standards imposed in Australia.

c. Meeting a minimum capital requirement of $250,000 and maintaining the capacity to meet the minimum capital requirement at all times;[112] and

d. Satisfying the Authority that there is nothing to indicate that the fund manager is not of good and sound character or that the fund manager would not carry out its functions honestly and with integrity.

78. Upon approving an issuer to be licensed, the Authority would liaise with the Registrar of Financial Service Providers, who would then register the issuer as a financial service provider, subject to meeting the other criteria under the FSPA.

79. Should licensing be introduced, the Ministry is considering the best method for ensuring ongoing compliance with licensing requirements. Fund managers could be required to send to the Authority annual reports which contain information pertaining to the fit and proper requirements above. Where the Authority became aware, or suspected, the fund manager (including any member of its senior management team, owners or directors) no longer met the fit and proper requirements, it would have certain powers, including the power to investigate further and, ultimately, to revoke or vary licenses.

80. The supervisor would have an ongoing role to monitor the fund manager and alert the Authority where it become aware, or suspected, that the fund manager no longer met the requirements outlined above.

9. Should fund managers be required to be licensed? What are the costs and benefits associated with licensing?

10. What, if any, might be an alternative approach to ensuring accountability and the protection of investors' interests? What are the pros and cons?

11. If licensing is required, are the proposed fit and proper requirements and licensing criteria appropriate?

12. Should all persons of influence (e.g. senior management, owners and directors) within a collective investment scheme be required to meet licensing requirements? What are the costs and benefits of doing so?

13. Are the proposals for oversight of fund managers by the Authority appropriate? Are there preferable options, such as placing more reliance on the supervisor? What are the costs and benefits of the options?

4.5 Proposed roles of participants

81. This section considers the proposed roles of the supervisor, the fund manager, the administrator and custodian (where applicable) as defined in legislation. We suggest possible functions, duties and liability, and powers and rights for comment.

4.5.1 The supervisor

82. Under the proposed regime, all collective investment schemes will be required to have a supervisor licensed under the regime in the Securities Trustees and Statutory Supervisors Bill. Regardless of the type or legal form of collective investment scheme, we propose that all supervisors will have the same functions, duties, powers and rights.

[112] This is consistent with the capital adequacy requirement imposed for compliance with UCITS standards.

Functions of supervisors

83. The purpose of the supervisor is to ensure that someone without an interest in the scheme is looking after the best interests of investors. A possible set of functions of supervisors could be:

    - To act in the best interests of investors, to act on their behalf, and to fulfil all of the other duties of a trustee of a unit trust;
    - To negotiate the terms of the constitutional document and the offer of the securities with the fund manager (refer to the section on constitutional documents);
    - To take responsibility for custody of scheme property; and
    - To supervise the fund manager to ensure compliance with its obligations and seek appropriate remedies on behalf of investors for any breaches.

Duties and liability of supervisors

84. The Ministry proposes that the provisions relating to liability be similar to the liability of the fund manager of a unit trust under section 24(1) of the Unit Trusts Act 1960. That is, the supervisor shall have the same duty in performing its functions as if it were a trustee.

85. In addition to current duties at law (for example, trustees of trusts), a possible set of duties for supervisors could be:

    a. To act in the best interests of investors and not to act on the fund manager's direction if the direction is manifestly not in the interests of investors.

    b. Not to act on the fund manager’s direction if the direction is in breach of the constitutional document or investment policy of the scheme.

    c. To monitor a fund manager’s adherence to the terms and duties in the constitutional document and the scheme’s management agreement, the terms of the constitutional document and the terms of the offer. This includes ensuring that the scheme’s assets are invested in accordance with the scheme’s objective.

    d. To take any relevant enforcement action within its powers against the fund manager and to seek remedies on behalf of investors where a fund manager breaches any of its duties to investors.

    e. To comply with its reporting requirements to investors and the Authority, including regular reporting requirements and any other requirements such as advising investors regarding moratoria proposals.

    f. To comply with any reasonable requests for information about the scheme and/or the supervisor for the purposes of the proposed legislation from the Authority and to allow the Authority, or a person appointed by the Authority, to make inspections for the purposes of the proposed legislation.

    g. To respond to an attestation request by the Authority.

    h. To maintain appropriate custodial arrangements, whereby the assets are segregated and are held in the name of the supervisor or external custodian. It is proposed that the supervisor would retain liability for the performance of the duties and obligations relating to the custody of the scheme’s assets, even if an external custodian is appointed. Like the supervisor, any nominated custodian would have to be independent from the fund manager. This requirement for the supervisor to ensure sufficient custodial arrangements will help ensure consistency across different legal forms. This

duty will also ensure that scheme property is ring-fenced and adequately protected, reducing the risk of fraudulent conduct. (See paragraph 103 for a discussion of further regulatory controls regarding custodians.)

i. To act on the directions of investors so far as the law and the constitutional document dictates.

j. To convene and chair meetings of investors.

k. To explicitly disclose the duties that they owe to individual investors and any restrictions on these, and annually declare (e.g. in their statements to individual investors) that they have not breached their duties.

Powers and rights of supervisor

86. A possible set of powers and rights of supervisors in their capacity as supervisors of collective investment schemes could be:

a. To require periodic reporting from the fund manager, in addition to the requirements to publish quarterly information as proposed in Chapter 3: Disclosure.

b. To request information relating to the scheme, or to the business, property or the affairs of the fund manager and to inspect or review, or appoint a person to inspect or review, the fund manager's books and papers and all books and papers relating to the scheme.

c. To summon a meeting of investors and appoint a person to chair those meetings of investors. For example, the supervisor may wish to use this power to obtain directions from the investors, or for investors to vote on a resolution to remove the fund manager.

d. To require the fund manager to summon a meeting of investors. This is consistent with current requirements under the Unit Trusts Act. We do not consider the fund manager should be allowed to decline a supervisor's request to summon a meeting of investors because matters to be discussed at a meeting might concern, for example, breach by the fund manager or a resolution to remove the fund manager.

e. To attend and be heard at a meeting of investors of the scheme. This is a fundamental right which allows the supervisor to communicate with the investors of the scheme – for example, by keeping the investors informed about relevant matters.

f. To nominate a person to chair a meeting of investors, where that meeting was requested by the supervisor or investors. This power is necessary to ensure a meeting, which was not initiated by the fund manager and therefore may be contentious by nature, is run fairly.

g. To apply to the court for a direction that the fund manager comply with its duties or with the terms of the constitutional document or of the offer or the funds management agreement, within a specified time frame. For example, a direction to act, a direction prohibiting the fund manager from acting, an order imposing terms or conditions on the fund manager or on the operation of the scheme, or an order that no more investors be accepted into the scheme.

h. If fund managers are not licensed, the power to apply to a court for removal of a fund manager.

i. To take an action to the court on behalf of investors to seek a remedy (including compensation) for breach by the fund manager of any of its duties or the terms of the constitutional document or of the offer.

j. To apply to the court for the types of orders currently available to trustees and statutory supervisors under 49 of the Securities Act. This might include court orders that the constitutional document be amended; that restrictions be imposed on the fund manager; directing the fund manager or supervisor to convene a meeting of security holders; or giving such other directions as the court considers necessary to protect the interests of security holders, other holders of securities of the issuer, any guarantor of the securities, or the public.[113]

k. To apply to the High Court to assess damages against a delinquent director or other officer of the fund manager if, in the course of winding up the scheme, it appears that the fund manager has misapplied or retained or become liable or accountable for any money or property of the scheme, or committed any misfeasance or breach of trust in relation to the scheme. This power would be similar to that contained in section 27 of the Unit Trusts Act.

l. To amend the constitutional document after consulting the fund manager, but without consultation of investors, in cases where the amendments are not prejudicial, administrative or are clearly in the interests of investors.

m. To amend the constitutional document in all other cases after consulting the fund manager and obtaining approval of 75% of investors.

87. These powers would be standard across all collective investment schemes, regardless of the legal form they adopt and could not be contracted or negotiated out of. Additional powers may arise out of the legal form adopted, or specific clauses in the constitutional document of a specific scheme.

88. Any delegate (for example, a provider of administration or custodian services) will be subject to the same duties as required of the supervisor.

14. Should supervisors have a standard set of functions, duties and liability, and powers and rights across all collective investment schemes? What are the likely costs and benefits?

15. What are the pros and cons of the possible set of functions, duties and liability, and powers and rights of supervisors set out in this paper? Should some be omitted or others included? If so, why?

4.5.2 Fund managers

89. The fund manager will have responsibility for the offer and issue of securities, administration and investment management. Under our proposal, the fund manager will always be considered the issuer in any collective investment scheme and will also be subject to registration requirements under the FSPA.

90. We also propose 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 Authority to more easily monitor the conduct of the fund manager.

[113] Section 49(3) Securities Act 1978.

Functions of the fund manager

91. The proposed functions set the scope for the fund manager's duties and powers. They provide a general overview of the role of the fund manager, and what we expect the fund manager will do and will be responsible for. They will apply to all collective investment schemes, regardless of legal form.

92. A possible set of functions for the fund manager are:

    a. To offer and issue securities in the scheme (this is the same function as currently prescribed in section 3(2)(b) of the Unit Trusts Act).

    b. Responsibility for ensuring that investment occurs in accordance with the constitutional document, and monitoring any individual investment manager, whether internal or external. Although the fund manager will be able to contract out the investment management function, the fund manager will ultimately remain responsible for investment management.

    c. To maintain robust systems and controls and to appropriately manage risk.

    d. To report to the supervisor, and to investors of the scheme, and publish quarterly information.

    e. To be responsible for all administration and management functions.

Duties of the fund manager

93. A possible set of duties of the fund manager that we are considering are:

    a. To act in the best interests of investors.

    b. To adhere to the terms of the constitutional document.

    c. To adhere to the obligations and duties of a fiduciary.

    d. To ensure that the scheme, including sale and purchase of investments and management of assets, is carried on in a proper and efficient manner. This includes the duty to use its best endeavours and skill in carrying out its functions. Because investors do not have day-to-day control over the operation of the scheme or of the fund manager, it is important that fund managers observe a high standard when operating the scheme. Where a fund manager has delegated any of its duties, including investment, it will be responsible for the actions of its delegate.

    e. Where an investor has given reasonable notice requesting information relating to the affairs of the scheme, to provide such information. This duty allows investors to be provided with relevant information about the collective investment scheme and the fund manager, and enables investors to make informed decisions about the collective investment scheme (for example, to direct the fund manager to act) or for themselves individually (for example, to exit the scheme).

    f. To ensure reporting requirements specified in the legislation and the constitutional document are met (for example, keeping proper books of account and having them audited periodically).

    g. To register any documents required to be registered with the Authority (for example, offer documents and ongoing disclosure).

h. To pay or pass to the supervisor any money and other scheme property received by the fund manager in respect of purchases of, or subscriptions for, interests in the securities within a prescribed period. This duty ensures the fund manager is accountable for any monies and other scheme property it receives from investors.

i. To provide the supervisor with such information as it requests relating to the scheme, to the business or the affairs of the fund manager, or to breaches, and to allow the supervisor, or a person appointed by the supervisor, to inspect or review the fund manager's books and papers and all books and papers relating to the scheme. This power ensures the supervisor is kept informed about the activities of the fund manager and the scheme, and will assist the supervisor in its monitoring and supervisory role.

j. To summon a meeting of investors when so requested by the supervisor or the investors.

k. To provide the Authority with such additional information as it requests relating to the scheme, to the business, property or the affairs of the fund manager, or to breaches where it has been unable to obtain the necessary information directly from the supervisor.

l. To report to investors and to keep them informed about their investments. So that investors (and their agents) can monitor the management of their investments it is proposed that fund managers publish information periodically. This is described further in Chapter 3: Disclosure.

m. To explicitly disclose the duties that they owe to individual investors and any restrictions on these, and annually declare (for example, in their statements to individual investors) that they have not breached their duties.

94. It is proposed that these powers would be standard across all schemes, regardless of the legal form they adopt and could not be contracted or negotiated out of. Additional powers may arise out of the legal form adopted, or specific clauses in the constitutional document of a specific scheme.

95. If the fund manager delegates any of its functions, they must first inform the supervisor and the Authority and meet a number of other conditions such as, for example, delegation should not prevent the scheme from being managed in the best interests of its investors. The delegate will not owe a direct duty to investors.

Breach of fund manager's duties

96. In the event the fund manager, or any delegate, breaches any of its duties owed to investors, or the terms of the constitutional document or the terms of the offer, the fund manager will be liable to investors. A possible set of consequences of breach are:

a. Investors will be able to call a meeting of investors to consider what actions to take against the fund manager for breach of its duties, the terms of the constitutional document or the terms of the offer. For details of how meetings are called, quorum requirements and voting requirements see the section below on meetings.

b. Investors will be able to remove the fund manager or give directions to the fund manager (for example, a direction that the scheme be wound up) if the investors obtain the appropriate threshold at a meeting of investors.

c. Investors will be able to direct the supervisor to take an action in a court to seek compensation for loss caused by a breach by the fund manager of any of its duties, the terms of the constitutional document or the terms of the offer.

d. The Authority may take court action on behalf of investors to seek compensation for loss caused by a breach by the fund manager of any of its duties, the terms of the constitutional document or the terms of the offer.

e. Investors will be able to take court action seeking compensation for loss caused by breach by the fund manager of any of its duties, the terms of the constitutional document or the terms of the offer. However, court action is costly for individual investors to pursue and it is difficult for investors to coordinate collective action.

f. The supervisor will have a number of powers to deal with the fund manager's breach of its duties or breach of a term of the constitutional documents or of the offer as discussed above.

g. The fund manager may be liable for criminal penalties in situations where there is a high level of culpability.

16. Should fund managers have a standard set of functions and duties across all collective investment schemes? Should the same consequences apply to across all collective investment schemes when a fund manager breaches its duties?

17. What are the pros and cons of the possible set of functions and duties for fund managers set out in this paper? Should some be omitted or others included? If so, why?

18. Do you consider it necessary to place a direct duty on fund managers to act in the best interests of investors? If not, why not? What would be the costs and benefits?

19. Should fund managers be required to disclose the duties that they owe to individual investors and any restrictions on these, and annually declare that they have not breached them?

20. Should fund managers be liable for criminal penalties in certain situations? If so, why and in what situations?

4.5.3 Administration

97. There are a number of duties generally related to valuing assets and setting unit prices that could be undertaken either by the fund manager or an external administrator. The rationale for using an external administrator for asset pricing is that it reduces the risk of a manager manipulating the unit price to serve their own purposes. In addition it serves as a check on the valuation processes of the fund manager.

98. External administration may incur high additional costs, especially as the fund manager would still have to value the assets themselves for their own purposes. This additional cost may provide little benefit to investors, particularly if there is already regulatory oversight in place regarding asset valuation practices.

99. Furthermore, the New Zealand market may not currently have the requisite expertise and capability in this area to meet the likely demand for external administrators, if external administration were to be mandated.

100. The Ministry is seeking submissions as to whether external administration should be mandated.

Functions and duties of the person undertaking administration functions

101. A possible set of functions are:

a. Administration and management of the scheme, and monitoring any administration or any other agents appointed by the fund manager (again, the fund manager will be able

to contract out the administration management function, but will ultimately remain responsible for this function); and

b. Asset pricing.

102. A possible set of duties are:

a. To carry out their functions in accordance with the terms of the constitutional document and with due diligence, honesty and skill; and

b. To carry out functions in a transparent manner.

21. What do you consider to be the pros and cons of mandating external administration in New Zealand? Do you have a view as to what an alternative might be?

22. Should administrators have a standard set of functions, duties and liability across all collective investment schemes?

23. What are the pros and cons of the possible set of functions and duties of administrators set out in this paper? Should some be omitted or others included? If so, why?

4.5.4 Custodian

103. Given the importance of ensuring assets are held in an appropriate manner, we are 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 FSPA. We are seeking feedback as to whether custodians should be subject to a more specific licensing regime.

104. Many other jurisdictions (for example, Europe, UK and Ireland) require collective investment schemes' assets to be lodged with a depositary which is subject to prudential supervision. These are generally banks, subsidiaries of banks, or investment firms. The EU Commission is in the process of looking at strengthening this supervision to better protect investors' interests subsequent to the global financial crisis, particularly in respect to UCITS funds (see section 6 below).

105. The role of custodian in New Zealand is currently performed by off-shore banks, the domestic subsidiaries of banks (including off-shore), and trustee corporations. The assets held in custody are substantial and the providers are largely unregulated. A specific regulatory framework is likely to be a pre-requisite for an Asia-Pacific managed funds domicile industry to establish here (as discussed in section 6).

24. What do you consider to be the pros and cons of regulating custodians in New Zealand? Should a specific licensing regime be imposed, or are the requirements for FSPA registration sufficient?

4.6 Further regulatory controls

106. In addition to the legislatively defined roles and duties listed above, we propose further regulatory controls regarding returns and pricing, constitutional documents, meetings and whistle-blowing protections.

4.6.1 Returns and pricing

Asset valuation and pricing

107. It is important that returns and pricing of units are calculated equitably and accurately for two key reasons. First, investors need accurate information to gauge performance. Second, it is important to ensure accurate unit prices are applied at the point where investors are entering or exiting a collective investment scheme.

108. The terms and conditions associated with the benefits or returns that a collective investment scheme investor obtains, the pricing of those benefits, and the way in which they can be realised can all influence the value of an investor's financial interest. It is important that they are clear and evident to the investor and that the investor has some protection against unnecessary changes to these provisions. However, the Ministry recognises that there may, at times, be a need to make amendments to these terms and conditions, and proposes to maintain a power to do so on the condition that investors consent to any adverse changes.

109. Given the ability for broad variance between provisions in the constitutional documents of different collective investment schemes around asset valuation, pricing and redemption of units, there could be significant variation in investor protection across different collective investment schemes. Therefore, the FSAP specifically recommended that consideration be given to consistent minimum regulatory standards regarding asset valuation, pricing and redemption.

110. By way of comparison, the Australian Corporations Act 2001 requires the responsible entity of a managed investment scheme to comply with several obligations which are relevant to asset valuation and pricing, including:

    a. Treating investors who hold interests in the same class equally and investors who hold interests in different classes fairly;

    b. Ensuring that scheme property is valued at regular intervals;

    c. Ensuring that all payments out of the scheme property are made in accordance with the scheme's constitution and with the Corporations Act; and

    d. Ensuring that the constitution of a registered scheme makes adequate provision for matters including consideration to be paid to acquire interests in a scheme, withdrawal from a scheme and dealing with complaints.

Timing of valuations

111. The Ministry understands that different asset classes, and even different schemes, would require different frequencies of valuation. In addition the costs involved with valuing assets may vary greatly between different classes. For example, listed equities which are openly and frequently traded can be valued easily and without any real cost. However, property or unlisted equities are illiquid assets so take longer to value and dispose and incur a real cost. The Ministry recognises the need to balance these costs against the value of accurate asset valuation.

112. The Ministry does not consider that mandating a time that valuations are made[114] is a desirable option. While a standard time could potentially provide greater comparability of pricing between different products, which may be of benefit to investors, it would unnecessarily constrain issuers. This could be particularly so for a scheme that has an overseas parent, as the domestic entity's process for pricing assets might be done on a consistent basis with the off-shore parent.

113. A further concern relates to the effectiveness of any regulatory controls around timing. Because a majority of collective investment schemes in New Zealand have high overseas exposure, overseas markets timing points are likely to be more influential in practice than domestic timing. Therefore, a specific valuation timing point for a New Zealand scheme may not in fact achieve the comparability in pricing that the provision is intended to achieve. What is important is that a consistent methodology is applied by the fund manager, i.e., that the frequency and time established for valuation purposes is uniformly applied and adhered to.

114. The Ministry proposes that, in principle, collective investment schemes be given the flexibility to determine the timing of valuations through negotiation between the fund manager and the supervisor. However, the Ministry proposes imposing a minimum frequency for the valuation of assets in addition to a requirement that all constitutional documents expressly include the details of the timing for valuation where it differs from the legislative guidelines, and a mechanism for changing this should the need arise.

Process for valuing assets

115. The Ministry considers that it is essential that the process for valuing assets be described in the constitutional document. The Ministry recognises, however, that some practical issues arise when considering how the process for valuing assets may be specified in a constitutional document.

116. We propose that fund managers have the freedom to set their own process for valuing assets, but that they must include this in their constitutional document. They would also be required to include a mechanism for changing this process should the need arise.

117. However, given the importance of this issue, we consider it important that some guidance be put in place. We recommend that the Authority be required to set enforceable guidelines for valuing assets, and monitor the processes put in place by schemes. This could be a condition for the registration of schemes or fund managers (or of fund manager licences if they are licensed).

118. Fund managers will also have a duty to ensure that any changes to their valuation policies still comply with the guidelines. Collective investment schemes would be required to report to the Authority any changes that they have made and where these are not satisfactory, the Authority would intervene to veto the change. The valuation policies will also be reported to the Authority in the fund manager's periodic reports to the Authority.

119. In addition, the supervisor will have ongoing responsibility for ensuring that valuation policies are consistent with the guidance notes issued.

[114] For example, for funds that choose to value on a daily basis, the time could be set at 5pm each day, and for funds that choose to value on a weekly basis, the time could be set at 5pm on each Wednesday.

120. One issue is to ensure that the process specified will address whether expenses are covered within asset valuation. There is currently the potential for schemes to "hide" fees charged to investors by including expenses in the valuation of units, rather than separating expenses out as an administrative cost of the scheme. Where this occurs, we would anticipate that the constitutional document should specify that expenses are included within the asset valuation, and what those expenses are (for example, supervisor fees, custodian fees, and brokerage).

121. A further issue that has been raised is the pricing process around allotment of units to investors. Again, it is important for investors to have clarity about this process, because the timing and process of pricing can have an impact on the value of their interest in the scheme. It is therefore proposed that the process specified for valuation of assets include the process of allotment of units to investors.

Pricing errors and limit breaks

122. Pricing errors are potentially of great concern to investors, especially when they are entering or exiting a collective investment scheme. As previously stated, accurate pricing is essential to enable investors to monitor the performance of a scheme. At the moment there is no industry standard for addressing pricing errors. In addition, there is also no standard approach for whom to notify when an error occurs. It is essentially up to each fund manager to decide how to address these problems.

123. Due to the substantial consequences of pricing errors, the Ministry considers that it is essential that some guidelines be established to both limit the occurrence of pricing errors, and ensure that they are dealt with properly should they occur. The Ministry proposes that, in addition to the requirement to have a pricing methodology in constitutional documents, fund managers will be required to put policies in place on how they deal with pricing errors.

124. Similarly limit breaks, where a collective investment scheme breaches investment limits set in its constitutional document (and subsequently its offer document), can affect the nature and the performance of schemes. As with pricing errors, the Ministry proposes that fund managers will be required to put policies in place regarding how they deal with limit breaks.

125. The fund manager will have to report to their supervisor if a pricing error or limit break occurs. These reports will explain what has occurred, why it has occurred and what actions will be taken in the future to prevent it happening again. The supervisor and the fund manager would then be obliged to ensure the actions to stop future breaches are sufficient and that they are actually implemented.

126. Supervisors will be required to report to the Authority on breaches above a threshold set by legislation. The Authority would then be obliged to analyse these reports and take any further action it deems necessary, such as a further investigation or disciplinary procedures. In addition, they would have an attestation power to check that supervisors have ensured that the collective investment scheme implements the actions necessary to stop future breaches.

25. Do you consider the requirements set out above for collective investment scheme returns and pricing adequate, insufficient or excessive? Are there items that should be included or omitted? If so, why?

26. What, in your view, are the pros and cons of the proposal regarding returns and pricing? What are the likely costs and/or benefits?

4.6.2 Constitutional documents

127. The constitutional documents of a collective investment scheme comprise any document that establishes or provides for the operation of the legal form (e.g. trust deed, partnership agreement, company constitution) and any document that provides for the supervision of the scheme. It may be possible for there to be a single constitutional document for some forms, such as trusts.

128. Functions, duties and processes will be prescribed in legislation or implied into constitutional documents. Implied provisions would override any provisions in the documents to the contrary. Implied provisions might include, for example, processes to change constitutional documents, remove fund managers and supervisors, and call meetings.

129. In addition to implied provisions, we are 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.

Investment policy and objectives

130. We are considering whether all collective investment schemes should be required to have stated investment policies, which would be included in the constitutional documents for that scheme. The Ministry recognises that an overly specific investment policy could hamper the fund manager's ability to effectively manage the scheme. However the Ministry considers that there is value in a clear statement in the constitutional document of the core investment policies of the collective investment scheme. This would include statements about the risk/return profile, major classes of assets that are permitted or prohibited and any asset class preferences to enable investors to make informed investment decisions.

131. The Ministry also proposes that where a scheme has a performance objective, this should be specified in the constitutional document. The Ministry seeks views on whether schemes or certain types of scheme should be *required* to set out performance objectives, which would be used to benchmark actual performance of the scheme.

132. The Ministry does not have a view on what would be the most appropriate mechanism to allow an issuer to change the investment policy or objectives of a collective investment scheme. This may be by investor vote or by meeting. However, it may be that where change will alter the risk/reward profile, then the threshold may need to be set higher than a change in the asset allocation of the scheme per se. The Ministry seeks feedback on this issue.

Conditions of scheme entry and exit

133. The Ministry is considering whether conditions of entry and exit should be specified in the constitutional document, including any penalties incurred for early withdrawal. This is important to give investors, and potential investors, certainty about their rights to join, remain in and exit the collective investment scheme, as these factors can significantly impact the value of an investor's interest in the scheme (for example, if investors cannot readily access their funds).

134. In addition, many other jurisdictions have rules around exit and entry policies and cooling off periods. The Ministry seeks feedback as to whether it would be appropriate to implement similar rules in New Zealand.

Contribution levels and rates

135. While the majority of collective investment schemes do not require continuous payments, some schemes may brand themselves as savings schemes, and thus require continual investment at a specified level. It is therefore proposed, that where a collective investment scheme requires minimum contribution levels, this should be specified in the constitutional documents. In order to retain some flexibility around how those levels are set, it should be sufficient for this provision to describe a process around how those minimum contribution levels will be established and revised. This will also be required to be disclosed in the offering document. This will help ensure that investors know what their obligations are, and can have confidence that these obligations cannot be changed without investors and the supervisor being first notified and an approved process being followed.

Authorised investments

136. A collective investment scheme may specify limits on the nature or type of its investments. The nature of a scheme's investments will likely be a significant factor in an investor's decision to subscribe to a collective investment scheme. Therefore, the Ministry considers it important that investors have certainty that the scheme will adhere to these limits. However, it is also important that a scheme is not unnecessarily restricted when making investment decisions. There may be good reasons why a scheme should alter its investment strategy, such as a shift in economic conditions. If authorised investments are specified too prescriptively in the constitutional documents, it may inhibit the ability of the fund manager and supervisor to amend the investment strategy in line with their duties to invest prudently.

137. The Ministry proposes that where these limits are in place, they should be included in the constitutional documents.

138. As a way of balancing the objectives identified, the Ministry is considering whether the constitutional document should also be required to contain a methodology for how the investment strategy can be developed, amended and measured. At its broadest, this could potentially state that the investment strategy would be reviewed from time to time by the fund manager and changes will be approved by the supervisor. Any changes in authorised investments would be required to be communicated to existing investors, who would be given the opportunity to exit the scheme at no penalty if they not satisfied with the changes.

Returns and pricing

139. The Ministry considers that there is clearly a case for requiring constitutional documents to specify the conditions of the collective investment scheme in relation to allocations, withdrawals, redemptions (including when they can be withheld) and distributions. The benefits of a regime based on disclosure are rendered largely redundant when there are inconsistent standards set for such conditions, making comparability and analysis of fees and scheme performance unfeasible.

140. Furthermore it is proposed that constitutional documents will be required to specify a methodology for valuing assets, and a mechanism for changing this methodology should the need arise due, for example, to changes in industry practice regarding pricing. Issues arising around the detail of such a requirement are discussed above at 4.6.1.

Fees

141. As with other factors that influence an investor's decision to subscribe to a particular collective investment scheme, the Ministry considers it is important that investors have certainty about how fees are charged. However, the level of fees charged is likely to change over time, and it is also important that scheme providers have the ability to revise fees, particularly if cost structures change.

142. As a way of balancing these objectives, constitutional documents might be required to specify the types of fees that are, or could be, deducted and how they would be calculated but that they might not be required to specify particular fee levels. It may be equitable to allow investors the opportunity to exit a scheme without penalty upon notice of a fee increase. These sorts of provisions are relatively common in superannuation scheme trust deeds.

143. Detailed fee information will need to be disclosed in offer documents (see the Chapter 3: Disclosure).

Winding up

144. Both the trigger and procedure for winding up schemes are significant for investors. Whether a wind-up occurs and the timing of the wind-up impacts on the level of the investor's investment in the scheme. For example, a scheme that is closed to new investors may become expensive to administer over time if it does not have sufficient investors. In this situation, there may be real benefit in the scheme winding up. In addition, the procedure for distribution of assets on wind-up will be important for particular investors, particularly if they are considering whether to continue with a scheme or redeem their investment.

145. We propose that constitutional documents be required to detail the specific circumstances that trigger a wind-up, the procedure for wind-up and the subsequent distribution of assets of the collective investment scheme. The Ministry recognises that for some of the proposed legal forms (for example, company based schemes) the inclusion of these provisions may already be required. However other forms, such as unit trusts, do not currently require the inclusion of these provisions. The Ministry considers it is important that these provisions are included in constitutional documents, and propose that all schemes be required to include provisions for winding up, regardless of the legal form they adopt. The Ministry considers that a supervisor should also have a residual power to wind up a scheme in circumstances where these triggers have not been breached and is seeking feedback on this.

146. There is a further issue of whether the legislation should include standard trigger-points which could initiate a wind-up. Specifying trigger-points for wind-up would give investors greater clarity about when wind-up would occur for all schemes. However, there is a question as to whether these sorts of triggers would add anything to the fund managers' and supervisors' existing duties in terms of investing in the interests of the investors. The Ministry does not currently propose to set standard trigger points for winding up schemes.

27. What is your view of the proposals outlined above for mandatory inclusion in constitutional documents? Are there any that should be excluded? If so, why? Are there others that should be included? If so, why?

28. What do you consider to be the pros and cons of mandatory requirements? Are there likely to be any costs and/or benefits?

29. Is there an alternative approach that you consider would work better? If so, why?

30. What do you consider to be the most appropriate mechanism for changing matters that must be included in constitutional documents and why? What are the likely costs and benefits?

4.6.3 Meetings

Initiation of a meeting

147. The ability to call meetings is an important mechanism for investors of a collective investment scheme to exercise control over the fund manager and supervisor. It is also important to have some restrictions on the ability of investors to call meetings, as meetings are generally held at some cost to the scheme. However, the Ministry considers that it can be difficult for investors to effectively co-ordinate a large number of investors in order to call a meeting. We are 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. This could address some of the concerns about the difficulties of very large schemes to meet high thresholds, while ensuring that there is a significant threshold to deter vexatious meeting requests.

148. The Ministry recognises that for an investor to be able to initiate a meeting, they need access to the contact details of other investors so as to get sufficient support to reach the threshold to call a meeting. Investors are currently able to access this information about other securityholders under the Securities Act. Access to this information is discussed in Chapter 5: Other Matters.

Quorum and voting requirements

149. The Unit Trusts Act in effect requires, for directions to the trustee, a quorum of unit holders who between them hold not less than 25 percent of the value of the interests in the unit trust. At the meeting, resolutions may be passed by unit holders holding not less than 75 percent of the value of interests in the unit trust who are present (in person or by proxy) at the meeting.

150. The Companies Act requires a quorum of shareholders who are between them able to exercise a majority of the votes to be cast on the business to be transacted by the meeting. Depending on the nature of the resolution, it can then be passed by either an ordinary resolution (a simple majority) or a special resolution (75 percent majority).

151. If a low quorum is required, there is the potential for very few investors to dominate the voting on a particular issue. Conversely, if the size of the quorum required is too large, there is a risk that it will be very difficult to convene the numbers necessary for a resolution to be passed. It should also be noted that there may be different considerations around requirements for collective investment scheme quorums than for normal company quorums. Collective investment schemes are characterised by the lack of direct control by investors over the scheme. For example, investors in a scheme are not able to change the requirements of a trust deed through a vote at a meeting. This contrasts with shareholders in a company, who are able to exercise considerable control over the direction of the company by resolutions at meetings. In addition, because investors in a scheme are only given authority to vote on relatively significant issues, the high threshold better aligns with the Companies Act special resolution threshold (75 percent).

152. The Ministry seeks feedback on whether the Companies Act voting thresholds or the Unit Trusts Act threshold is the most appropriate standard for all collective investment schemes. An alternative may be to specify that for non-material matters, the threshold be set at greater than 50 percent (for example, the ordinary resolution concept under the Companies Act) and for all material matters the threshold be set at 75 percent. Provision could also be made for written resolutions.

31. What is your preference for provisions regarding meetings and written resolutions and why? What are the pros and cons of your choice? What are the likely costs and benefits?

4.6.4 Whistle-blowing

153. The Superannuation Schemes Act currently contains a whistle-blowing provision (section 18A) 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. This section also provides an associated protection against any liability for such disclosure where it was made in good faith.

154. The Ministry 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.

32. Do you agree with the Ministry's assessment as to the importance of whistle-blowing provisions? If not, why not? Who should they apply to?

33. Is there an alternative approach that you consider would work better? If so, why?

4.6.5 Reporting requirements

155. 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. KiwiSaver scheme providers 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. Chapter 3: Disclosure contains a fuller discussion of proposed reporting requirements.

5. Application of the regime

5.1 Statutory overlay

156. There are a number of possible approaches to regulation of collective investment schemes governance. One is to maintain the status quo with a multiplicity of legal forms for different classes of investments and types of issuers. However this may not address all issues of market confusion and regulatory arbitrage. An alternate option is to prescribe a single legal form and set of substantive legal requirements that all schemes must use (for example, all schemes must be unit trusts). However this may lead to inflexibility and impede the development of new innovative products: what seems the most appropriate form of investment vehicle now may not be the most appropriate in the next decade.

157. The Ministry considers that the best solution is to strike a middle ground between the two preceding options. The Ministry proposes to create a single regime that will apply to all structures that are, in substance, collective investment schemes. Schemes would be free to adopt any legal form, but would have to comply with a common set of substantive requirements to ensure consistency of minimum standards for investor protection. This is consistent with proposals from the Taskforce and RFPP.

158. Under this proposed approach, a person wishing to set up a collective investment scheme would be able to continue to choose between any available legal forms. Whatever the legal form, it would be subject to any registration and other regulatory requirements imposed by the regime proposed in this paper. This represents a departure from the current regime, where, essentially, only unit trusts, superannuation schemes and KiwiSaver schemes are required to register under their respective legislation.

159. This approach is one of substance over form. If a scheme falls within the definition of collective investment scheme, then it will be captured by the regime and it will be required to meet the substantive regulatory requirements for collective investment schemes. This will reduce the potential for regulatory arbitrage and ensure a consistent, coherent set of protections for investors.

160. For all the legal forms of collective investment scheme, consistent governance and registration requirements will act as a statutory overlay, in a similar manner to the Unit Trusts Act 1960, which imposes particular requirements for a trust that wishes to operate as a unit trust.

161. In the case of a company that is a collective investment scheme, a specific legislative overlay to the Companies Act 1993 may be required to enable the regime to work properly, similar to the approach taken in the Co-operative Companies Act 1996. We discuss this more fully below.

34. Should the legal forms that can be collective investment schemes be limited? If so, why? If not, why not?

35. Do you consider the proposal to provide for a statutory overly for collective investment schemes to be appropriate? What are the costs and benefits of this proposal?

5.2 Companies

162. In many other jurisdictions (such as the UK, Ireland and the US) the company form is the preferred legal form for collective investment schemes. The Ministry considers that those companies that are, in substance and purpose, a collective investment scheme, should be subject to the regulatory overlay of the proposed regime. Such companies will be required to appoint a statutory supervisor and custodian. The board of the company will be deemed the fund manager and issuer.

163. There are several means available to give effect to this proposal. One, as discussed above, may be to introduce legislation which acts as an overlay to the Companies Act 1993. An alternative may be to introduce a new part to the Companies Act, specifically adding or excluding existing requirements where appropriate and in order to meet the requirements of the regime. For example, the Act may need to be modified to make it easier to issue and redeem shares, and to allow for corporate directors.[115]

164. Chapter 1: Defining Regulated Financial Products proposes that for a company or other body corporate to be a collective investment scheme it would be one that was:

- intended to provide investors with benefits of investment management and risk diversification; and

- allow investors to withdraw their investment on demand (in a reasonable time), at a price based on the value of the assets owned by the company.

36. What, in your view, are the pros and cons of having a statutory overlay to the Companies Act as compared to a new schedule to the Companies Act defining investment companies? Do you have a view as to whether the company form should be permitted for collective investment schemes and how did you come to that view?

5.3 Superannuation and KiwiSaver

165. Cabinet has recently agreed to changes with respect to retail KiwiSaver schemes, the most significant of which is that the fund manager, rather than the trustee, will become the issuer and so will owe duties directly to investors.

166. There are issues in extending the regime to existing superannuation schemes (including workplace superannuation schemes and defined benefit schemes) particularly the likely impost of additional compliance costs on smaller-scale schemes. On the other hand, most workplace superannuation schemes are master trusts[116] and the policy reasons for regulating collective investment schemes apply equally here.

167. The Ministry's initial view is that an expedient approach may be to grandfather all existing schemes (thus precluding any new investors joining these schemes while maintaining the status quo for existing investors) and include new schemes within the proposed regime.

168. Defined benefit schemes may require a different approach. The RFPP identified a number of issues with the current regulatory regime for defined benefit schemes, but it also recognised that the regulatory framework proposed would not be appropriate for these.

[115] In the UK, legislation allows for Authorised Corporate Directors – these can be a corporate body and an authorised person given powers and duties under FSA regulations to operate an open-ended investment company.
[116] http://www.sorted.org.nz/life-stages/at-work/info-for-employers/company-saving-schemes

37. What are the costs and benefits of applying the proposed collective investment schemes regime to all defined contribution superannuation schemes, including employer-sponsored schemes?

38. How do you consider master trusts be dealt with under the proposed regulatory framework?

39. How do you consider that defined benefit and employer sponsored schemes should be dealt with under the proposed regulatory framework?

5.4 Insurance

169. In accordance with the proposals in Chapter 1: Defining Regulated Financial Products, insurance products will come within the collective investment schemes regime if they include an investment component. As noted in the RFPP, insurance policies with an investment component can be classified into two separate categories:

- Where the insurance policy and the investment component are offered by an insurance company within one policy; or

- Where the insurance policy is a separate contract from the investment contract (whether this is offered by one company, a group of related companies, or unrelated companies).

170. Regardless of which of these forms the contract takes, we propose that any new insurance policies that have an investment component will be regulated as if they were two separate contracts – one for insurance and one for investment. These policies will still be able to be bundled and sold together as a single product offering; however, as the interests of policyholders in insurance and the interests of investors in schemes are different, they require different regulatory protections.

171. Separating the two discrete products will not only ensure accounting separation of product, but will also ensure that the separate interests of policyholders and investors are looked after through the appropriate supervisory framework, that is, prudential supervision for the insurance component, and supervision by a licensed collective investment scheme supervisor and the Authority for the investment component.

172. In light of the proposed new definition of collective investment schemes, we consider it will almost always be clear what category most products or policies will fall within. However, the Authority, in conjunction with the prudential regulator, will have the power to declare which regulatory regime a scheme or a policy must comply with.

173. In relation to existing policies with an investment component, we propose that where the products are:

- governed by one policy, that the regulatory requirements for insurance apply, but that disclosure of the investment component of the insurance policy must comply with the disclosure requirements prescribed for collective investment schemes – see Chapter 3: Disclosure for further discussion; and

- governed by two separate contracts (one insurance and one investment), the requirements will be that the issuer of the life insurance component will be subject to the regulatory requirements for life insurance and the issuer of the investment component will be subject to the regulatory requirements for collective investment schemes. This would apply regardless of whether separate entities offer the separate contracts (whether related or not) or where one company offers both contracts.

40. Do you see any practical problems with regulating insurance policies that have an investment component as if they were two separate contracts – one for insurance and one for investment?

41. What are the likely costs and benefits of this proposal and any alternative that you consider preferable?

5.5 Exemptions

Existing exemptions

174. A number of collective investment schemes are currently exempted from some provisions of the Securities Act (subject to certain requirements) such as group investment funds (GIFs), contributory mortgages, property syndicates and bloodstock interests. Many of these exemptions are justified, and equivalent exemptions from specific requirements are likely to be replicated under the new regime. For example, in some of these cases the scheme is exempt from the need to have a statutory supervisor, and has tailored disclosure requirements.

175. However, we propose that the Securities Act (Externally Managed Group Investment Funds) Exemption Notice 2003 not be replicated. The original purpose of GIFs was to allow trustee companies to invest assets held by them on trust, or on another fiduciary basis, in their ordinary course of business. GIFs have since evolved and are offered to the public by commercial fund managers or trustee companies. In practice, this means they are very similar to retail unit trusts.

176. The Ministry proposes that the exemption be restricted so that GIFs that are offered to the public are no longer exempt. For existing externally managed GIFs, the exemption notice will not be rolled over upon its scheduled expiry in April 2013. GIFs that are used for their original intended purposes are unlikely to come within the proposed definition of collective investment schemes as they are not offers to the public. This is consistent with the RFPP proposal.

177. The Ministry seeks feedback as to the merits of this proposal and other current exemption notices that should be retained or removed.

Closed-end schemes

178. In many schemes, investors pool their money to purchase assets and their money is "locked in" for a number of years until the assets are sold and the scheme is wound up. Investors may be able to sell their stake in the assets to another investor on a secondary market, but there are no new issues of units or shares. Some of the requirements of the proposed regime may not be appropriate for these "closed-end" collective investment schemes, as they do not allow investors to continuously join or exit the scheme or make or withdraw contributions.

179. The Ministry seeks feedback on whether closed-end collective investment schemes should be exempt from some requirements of the proposed regime.

180. Note that under the proposed definition of collective investment scheme, closed-end investment companies issuing shares will be excluded from the collective investment scheme regime, and the new Act will continue to regulate them as equity securities.

Portfolio management services

181. Chapter 1: Defining Regulated Financial Products discusses whether portfolio management services, in which investments are managed by an investment adviser selecting from a pre-vetted suite of financial products, but where assets are not pooled with other investors, should be included within the collective investment schemes regime. These services can operate through wrap platforms.

182. If portfolio services are included, this raises the issue of which of the collective investment schemes regime requirements should apply.

42. Should any classes of collective investment scheme products be exempt from some or the entire proposed collective investment scheme regime? If so, which requirements should they be exempt from and why?

43. In particular, should the Securities Act (Externally Managed Group Investment Funds) Exemption Notice 2003 be replicated? What are the costs and benefits of doing so?

44. If platform management services are included as collective investment schemes, which of the collective investment schemes regime requirements should apply? What are the costs and benefits associated with regulating them in this way?

5.6 Mutual recognition of securities offerings between New Zealand and Australia

183. Regulation providing for mutual recognition of securities offerings between New Zealand and Australia came into force in 2008. This initiative allows issuers lawfully offering a product in one country (home jurisdiction) to offer it into the other country (host jurisdiction) without complying with most of the substantive requirements of the securities and fundraising laws of the host jurisdiction.

184. Under the regime, a single disclosure document prepared in accordance with regulation in the home jurisdiction can be used in the host jurisdiction with inclusion of a prescribed warning statement. Only minimal requirements of the securities and fundraising laws of the host jurisdiction apply.

185. The Ministry notes that under the regime, Australian regulated collective investment schemes would not be subject to the collective investment schemes regime proposed in this paper when they make an offer in both Australia and New Zealand. However, if an Australian collective investment scheme chose to make an offer solely in New Zealand then they would be subject to the proposed collective investment scheme regime.

6. Requirements for a funds domicile in New Zealand

186. The Government is investigating the possibility of New Zealand becoming an Asia Pacific centre for fund domicile and servicing.

187. In evaluating this opportunity, other fund domiciles have been considered, particularly Ireland. It is evident that 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 we require a world class regulatory regime and it is clear that this means we must either meet or better the UCITS regime.

188. This section provides a brief overview of the UCITS regime, the approach New Zealand could take to create a regulatory regime that satisfies the requirements to become a funds domicile, and additional controls that would be needed over and above the proposals outlined in this paper.

6.1 Overview of UCITS

189. UCITS schemes are retail investment products. They are open-ended funds that can be established as unit trusts, common contractual funds or investment companies. They were established by a series of EU-wide UCITS directives, the first of which was in 1985. Each successive UCITS drective has added to or amended this original 1985 EU Directive. The initial aim of UCITS was to remove the barriers that existed for fund management firms seeking to do business in multiple markets across the EU. It has been agreed by the EU countries that once a collective investment scheme is authorised as complying with the UCITS directives in one member state, it can gain the benefit of being under the UCITS brand and be distributed to investors across the EU.

190. The UCITS directives lay down common requirements for the organisation, management and oversight of UCITS schemes. The directives define a list of eligible assets in which a UCITS scheme can invest. It also imposes rules relating to the diversification and liquidity of the scheme's portfolio. Largely because of these strict requirements, UCITS schemes enjoy world-wide the reputation of a well supervised financial product. It has also been suggested that this has protected UCITS schemes against the severe effects of the recent financial turmoil.

191. The most recent UCITS directive to be released is the UCITS III Directive, released in 2008. UCITS III allows investment in a much wider range of underlying asset classes than the earlier UCITS requirements. UCITS IV is the next directive, set to be introduced in 2011. This will introduce new regulations designed to enhance and strengthen the existing UCITS framework.

192. UCITS schemes have proven to be successful and are widely used by European households. The latest figures from the European Fund and Asset Management Association show that UCITS net assets under management amount to almost $6 trillion. UCITS has arguably been the key to the successful development of the European market for collective investment schemes.

193. More recently, UCITS schemes have spread beyond Europe, and become a global investment brand. UCITS schemes are distributed in over 140 countries around the world, including in Asia, the Middle East and South America. Nearly 40 percent of UCITS sales are now conducted outside the EU.

6.2 Key requirements

6.2.1 Authorisation

194. Before a UCITS scheme can be offered, it must be authorised. To be authorised, the UCITS scheme must have a depository that meets certain conditions (usually a bank and subject to prudential supervision) and holds the scheme's assets. The depository is responsible for, amongst other things, ensuring that the sale, issue, repurchase, redemption and cancelling of units is carried out in accordance with the law and the scheme's rules.

195. In addition, the management company operating the scheme must be authorised (once authorised in one state, the management company can operate in all EU states). In deciding whether to grant authorisation, the local member state authority ("the competent authority") will consider a number of matters including whether the directors of both the depository and the management company are of sufficiently good repute and are sufficiently experienced. Generally though, the requirements for authorisation of the UCITS are light, with most of the focus on authorisation requirements for management companies.

6.2.2 Risk management

196. Article 12 requires that "competent authorities" ensure each UCITS scheme has sound risk management systems. Committee of European Securities Regulators guidelines indicate that the adequacy and effectiveness of the risk management process should be considered by the "competent authorities" as part of the process for licensing the management company and subsequently supervised on an ongoing basis. Risk management policies should be proportionate to the nature, scale and complexity of the company's activities and of the UCITS scheme.

6.2.3 Conduct/duties of management companies

197. Article 14 states that each member state must draw up rules of conduct that management companies shall observe at all times. These must require management companies to:

    - Act honestly and fairly in conducting its business activities in the best interests of the UCITS scheme it manages and the integrity of the market;

    - Act with the due skill, care and diligence, in the best interests of UCITS scheme it manages and the integrity of the market;

    - Have and employ effectively the resources and procedures that are necessary for the proper performance of its business activities; and

    - Try to avoid conflicts of interest and, when they cannot be avoided, ensure that the UCITS scheme it manages are fairly treated.

198. In addition, and amongst other things, the directive outlines rules for investment policies and products, liquidity, and information provided to investors. Prudential regulations and some other operating rules (e.g. reporting to the Authority) are drawn up by each member state.

6.2.4 Developments

199. The European Parliament has recently voted in favour of UCITS IV which proposes a number of changes to the UCITS regime. These changes, which are to be implemented by mid-2011, deal with a number of issues:

    - The procedure for marketing UCITS between Member States is too long and bureaucratic;

- Disclosure documents are not helping investors to make informed assessment on proposed investments; and

- Compared to the US, the average size of a European scheme is small. Without a consolidation mechanism, or the possibility of co-managing funds, the costs of managing UCITS schemes remain high – and this cost is passed on to investors.

200. The changes will:

- Remove administrative barriers to cross-border marketing;

- Replace the simplified disclosure prospectus with the key information document (see Chapter 3: Disclosure);

- Make mergers between UCITS easier;

- Provide for "master-feeder" structures; and

- Improve cooperation mechanisms between national supervisors.

6.3 Application to New Zealand – a dual regime?

201. Rather than impose the required regulatory regime on all collective investment schemes 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 this paper, 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. It should be noted that, while the domestic regime might be less onerous, we expect that it will adequately meet the needs of New Zealand consumers and providers.

202. This is the approach used in Ireland, which apply different regulations to UCITS and non-UCITS schemes. Note that non-UCITS schemes in these jurisdictions are still subject to robust regulation, with many of the UCITS requirements being imposed on non-UCITS schemes where appropriate. Furthermore, New Zealand investors could still elect to invest in a UCITS-compliant scheme if they preferred.

6.4 Additional requirements

6.4.1 Fund vehicles

203. In order to become a successful funds domicile, the New Zealand regulatory regime would need to provide for at least the same types of scheme vehicles as UCITS. These are unit trusts, common contractual funds and investment companies.

204. In New Zealand, we currently have unit trusts, but would need to make changes to the regulatory environment to provide for common contractual funds and investment companies.

205. It has been suggested that investment companies are a favoured form of investment vehicle. In the UK and Ireland, open-ended investment companies (OEICs) have become the predominant form for investing and have largely superseded unit trusts. See section 5.2 above for further discussion of what changes would be made to allow investment companies in New Zealand.

206. A Common Contractual Fund (CCF) is an investment platform. It is a contractual arrangement; an unincorporated body that is established under a deed of constitution. Its key attribute is that it provides a look-through vehicle for tax purposes. The investors in the CCF are co-owners of the CCF's assets; the ownership interests are represented by notional units that are issued and redeemed in a manner similar to a unit trust. The assets of a CCF must be entrusted to a custodian and the CCF must have a fund manager.

207. Legislation would be needed to establish certain rules surrounding the CCF structures.

6.4.2 Regulatory controls

208. Generally our proposals above regulate many of the same areas as the UCITS regime. However, there are a number of additional regulatory controls in the UCITS regime, including:

- More onerous authorisation requirements of management companies (akin to our licensing regime for fund managers). Including:
  - Capital requirements: In order to be authorised, management companies must have a minimum initial capital of at least €125,000, plus 0.02% of the value of their portfolios that exceed €250m up to €$10m. We canvass imposing a similar capital requirement as part of a possible licensing regime for fund managers.
  - Shareholders: The UCITS directives require management companies to inform the relevant authority of the identity of its shareholders (holding a proportion of assets above a qualifying amount), and they can be refused authorisation on the basis that these shareholders are not suitable.
  - Delegation of functions: If the management company delegates any of its functions, they must first inform the regulator and meet a number of other conditions e.g., delegation should not prevent the UCITS from being managed in the best interests of its investors.
- Investment policies: The UCITS impose a number of obligations regarding the investment policies of UCITS such as risk-spreading rules and confining investment to specified eligible assets. We do not propose imposing any such obligations on collective investment schemes in New Zealand, other than requiring these to be disclosed.
- Borrowing and lending: Neither an investment company, management company or depositary acting on behalf of a unit trust is allowed to borrow or grant loans, or act as a guarantor on behalf of third parties, except in very limited circumstances.

45. Do you have any comments on the implications of the UCITS regime for regulation of collective investment schemes in New Zealand? Should New Zealand's domestic regime comply with UCITS? What are the pros and cons?

Chapter 4: Consolidated questions

1. Have all the issues with the current regulation of collective investment schemes been accurately identified? If not, what other areas should we consider?
2. Do you consider that all the issues identified need to be addressed by legislation? If not, why not?
3. Do you have evidence of problems with the current regulatory regime for collective investment schemes? Do you have examples of types of behaviour by fund managers and/or trustees that require a regulatory response? If so, please clarify and identify if there have been any wider associated costs to the economy.
4. Is there a legal form of collective investment scheme (e.g., unit trusts) that you consider better aligns the fund manager with investor interests than other legal forms? If so, why?
5. Do you have evidence where regulation in other jurisdictions has either advanced or impeded the development of an effective collective investment schemes market?
6. Do you agree that all collective investment schemes should be registered by the Registrar before offering securities to the public? If not, why not? What are the costs and benefits of this proposal?
7. Do you consider that the powers proposed for the Authority over supervisors and fund managers are sufficient, overreaching or inadequate? What are the likely costs and benefits?
8. Do you agree with the Ministry's view that the single responsible entity model is not an appropriate approach? If not, why not? What are the likely costs and benefits?
9. Should fund managers be required to be licensed? What are the costs and benefits associated with licensing?
10. What, if any, might be an alternative approach to ensuring accountability and the protection of investors' interests? What are the pros and cons?
11. If licensing is required, are the proposed fit and proper requirements and licensing criteria appropriate?
12. Should all persons of influence (e.g. senior management, owners and directors) within a collective investment scheme be required to meet licensing requirements? What are the costs and benefits of doing so?
13. Are the proposals for oversight of fund managers by the Authority appropriate? Are there preferable options, such as placing more reliance on the supervisor? What are the costs and benefits of the options?
14. Should supervisors have a standard set of functions, duties and liability, and powers and rights across all collective investment schemes? What are the likely costs and benefits?
15. What are the pros and cons of the possible set of functions, duties and liability, and powers and rights of supervisors set out in this paper? Should some be omitted or others included? If so, why?
16. Should fund managers have a standard set of functions and duties across all collective investment schemes? Should the same consequences apply to across all collective investment schemes when a fund manager breaches its duties?
17. What are the pros and cons of the possible set of functions and duties for fund managers set out in this paper? Should some be omitted or others included? If so, why?
18. Do you consider it necessary to place a direct duty on fund managers to act in the best interests of investors? If not, why not? What would be the costs and benefits?
19. Should fund managers be required to disclose the duties that they owe to individual investors and any restrictions on these, and annually declare that they have not breached them?
20. Should fund managers be liable for criminal penalties in certain situations? If so, why and in what situations?
21. What do you consider to be the pros and cons of mandating external administration in New Zealand? Do you have a view as to what an alternative might be?

22. Should administrators have a standard set of functions, duties and liability across all collective investment schemes?
23. What are the pros and cons of the possible set of functions and duties of administrators set out in this paper? Should some be omitted or others included? If so, why?
24. What do you consider to be the pros and cons of regulating custodians in New Zealand? Should a specific licensing regime be imposed, or are the requirements for FSPA registration sufficient?
25. Do you consider the requirements set out above for collective investment scheme returns and pricing adequate, insufficient or excessive? Are there items that should be included or omitted? If so, why?
26. What, in your view, are the pros and cons of the proposal regarding returns and pricing? What are the likely costs and/or benefits?
27. What is your view of the proposals outlined above for mandatory inclusion in constitutional documents? Are there any that should be excluded? If so, why? Are there others that should be included? If so, why?
28. What do you consider to be the pros and cons of mandatory requirements? Are there likely to be any costs and/or benefits?
29. Is there an alternative approach that you consider would work better? If so, why?
30. What do you consider to be the most appropriate mechanism for changing matters that must be included in constitutional documents and why? What are the likely costs and benefits?
31. What is your preference for provisions regarding meetings and written resolutions and why? What are the pros and cons of your choice? What are the likely costs and benefits?
32. Do you agree with the Ministry's assessment as to the importance of whistle-blowing provisions? If not, why not? Who should they apply to?
33. Is there an alternative approach that you consider would work better? If so, why?
34. Should the legal forms that can be collective investment schemes be limited? If so, why? If not, why not?
35. Do you consider the proposal to provide for a statutory overly for collective investment schemes to be appropriate? What are the costs and benefits of this proposal?
36. What, in your view, are the pros and cons of having a statutory overlay to the Companies Act as compared to a new schedule to the Companies Act defining investment companies? Do you have a view as to whether the company form should be permitted for collective investment schemes and how did you come to that view?
37. What are the costs and benefits of applying the proposed collective investment schemes regime to all defined contribution superannuation schemes, including employer-sponsored schemes?
38. How do you consider master trusts be dealt with under the proposed regulatory framework?
39. How do you consider that defined benefit and employer sponsored schemes should be dealt with under the proposed regulatory framework?
40. Do you see any practical problems with regulating insurance policies that have an investment component as if they were two separate contracts – one for insurance and one for investment?
41. What are the likely costs and benefits of this proposal and any alternative that you consider preferable?
42. Should any classes of collective investment scheme products be exempt from some or the entire proposed collective investment scheme regime? If so, which requirements should they be exempt from and why?
43. In particular, should the Securities Act (Externally Managed Group Investment Funds) Exemption Notice 2003 be replicated? What are the costs and benefits of doing so?

44. If platform management services are included as collective investment schemes, which of the collective investment schemes regime requirements should apply? What are the costs and benefits associated with regulating them in this way?

45. Do you have any comments on the implications of the UCITS regime for regulation of collective investment schemes in New Zealand? Should New Zealand's domestic regime comply with UCITS? What are the pros and cons?

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1. Securities law rewrite

1. The Ministry proposes that a new Act will replace the Securities Act 1978 and the Securities Markets Act 1988. The Securities Act 1978 is more than 30 years old and has been substantially amended on a number of occasions. As a result, the Act contains a range of outdated terminology and is not well organised. The Securities Markets Act began life as the Securities Amendment Act 1988 and is itself more than 20 years old. Like the Securities Act it has been substantially amended on a number of occasions.

2. There is a relatively clear boundary line between the Securities Act, which establishes the regulator and regulates primary offers, and the Securities Markets Act, which regulates the secondary market and (for the moment) investment advisers and brokers. However, the subject matter – securities regulation – is the same, and it is likely that a single new Act drafted in a number of Parts will replace the current Acts.

3. This chapter does not seek to cover all the issues that will arise in drafting the new Act, but seeks feedback on specific issues that were the subject of Taskforce recommendations and other issues that have been raised with the Ministry.

4. A number of other issues will arise in drafting the new Act, such as the correct boundary between the Act and regulations, rights of appeal and review, appropriate use of strict liability offences, and privacy concerns. Drafting will be guided by the Legislation Advisory Committee Guidelines, and best practice in accordance with laws such as the New Zealand Bill of Rights Act 1988 and the Privacy Act 1993.

5. The changes to regulation of collective investment schemes will also likely result in the replacement of the Unit Trusts Act 1960, and potentially significant changes to the Superannuation Schemes Act 1989 and the KiwiSaver Act 2006. Amendments to other Acts will also be required including, for example, if 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) are progressed following this consultation.

6. If changes proposed in Chapter 2 – Offers to Exempt Investors are made, there are likely to be consequential changes to the wholesale regime under the Financial Advisers Act 2008, in order to ensure the regimes are appropriately aligned.

7. The Ministry is interested in any other comments that submitters may have about the operation of the current securities legislation.

1.	Are there any other issues that the Ministry should consider when rewriting securities legislation?

2. Treating customers fairly

8. In addition to the specific regulatory framework created by securities legislation, the Ministry is considering whether a principles-based overlay along the lines of that in the United Kingdom, and proposed in Singapore, should apply. This 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.

9. The aim would be to acknowledge that, particularly in financial markets, innovation occurs rapidly and some seek out opportunities for regulatory arbitrage. 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.

10. An option to implement the principle of fairness could be for the Authority to develop a code of practice for financial market participants. The process for developing a code of practice could potentially be similar to the process for developing the code of professional conduct for authorised financial advisers under the Financial Advisers Act 2008.

11. Options for enforcement of a code of practice could be to establish a disciplinary committee (such as in the Financial Advisers Act) or to include breaches of the code within the jurisdiction of a financial markets Rulings Panel referred to below.

12. An alternative option could be to provide for the incorporation of a code of practice into dispute resolution schemes that financial service providers must join in accordance with the Financial Service Providers (Registration and Dispute Resolution) Act 2008 (FSP Act). Approved dispute resolution schemes must allow complaints to be made by persons with 19 or fewer employees, which would limit the fairness obligation to consumers and small business. Under this option, the Authority would not enforce the code itself.

13. The FSP Act provides for the rules of an approved dispute resolution scheme to provide that consumers may complain about breaches of industry codes by a member. Complaints may also be made about breach of contract, breach of statutory obligations and other matters provided in the rules. It would be a relatively simple matter to extend ‘industry codes’ to a code of practice approved by the Authority that incorporated principles of acting fairly.

2. Do you consider that financial market participants should be required to treat customers fairly, in accordance with certain principles developed by the Authority as part of a code of practice?

3. If so, do you agree with one of the options we have set out above, or, is there a better option to achieve the objective of providing some enduring principles? What are the pros and cons of the various options?

3. Securities markets

3.1 Registered and unregistered exchanges

14. The Taskforce recommended that the Government should:

    Allow NZX (as a registered exchange) to own and operate unregistered and exempt exchanges – so that NZX capability and expertise is available to help develop the pipeline of companies coming through to fully public markets.

    Create an environment in which unregistered and exempt exchanges can develop their own rules with a lower regulatory burden than on NZX (e.g. without continuous disclosure), so that companies can attract the capable directors and quality intermediary resources able to help companies develop business plans and raise capital for growth.

Status quo

15. Part 2B of the Securities Markets Act requires an entity be registered as an exchange if:

    a. It calls itself a "stock exchange" or "securities exchange";

    b. It states or implies that it is regulated; or

    c. The Minister declares that it must be registered.

16. The Minister of Commerce can require a facility to be registered as an exchange if he or she is satisfied that not being registered is likely to be detrimental to the integrity and effectiveness of securities markets in New Zealand, or the confidence of investors in securities markets in New Zealand.

17. The companies listed on a registered exchange become "public issuers". The provisions of the Securities Markets Act that apply to registered exchanges and public issuers include a requirement for a set of approved rules, a prohibition on insider trading and market manipulation and various disclosure requirements for the public issuers, directors and key office holders, and substantial securities holders. NZX is currently the only registered exchange.

18. These requirements contrast with the regulation of unregistered trading facilities such as Unlisted and Sharemart. These facilities allow issuers to list their shares, and display the last trade price, offers (bid and ask prices), and an order matching service. However, the facility, its issuers and its investors are not subject to the Securities Markets Act sections that apply to registered exchanges. Insider trading and market manipulation are not specifically prohibited, and activity is subject to the more limited restrictions of the Companies Act, and common law. Similarly, the Securities Market Act provisions for disclosure by issuers, directors, officers, and substantial security holders do not apply.

19. In the past, consideration has been given by the Minister of Commerce as to whether or not to require some of these unregistered exchanges to register. In particular, in 2005 a decision was made, for the time being, not to require Unlisted to register, largely on the basis that there was little evidence of investor confusion about its unregulated status, and trading volumes were low.

Comment

20. The Ministry accepts that the current requirements of the Securities Markets Act and the conduct rules of the NZSX and NZAX are demanding for listed companies and may dissuade some companies (especially small companies) from listing on a registered exchange. We also recognise the regulatory uncertainty surrounding the current unregistered exchanges and any future lightly regulated exchanges.

21. It appears to be possible for a registered exchange to seek an exemption under section 36E of the Securities Markets Act to operate with more limited issuer disclosure rules (or no issuer disclosure rules) and governance rules, and to obtain exemptions from the other conduct obligations, as well as insider trading and market manipulation laws. To date, the Government has not granted a partial or full exemption for a registered exchange.

22. The Ministry's view is that the main board of NZX (or any future "national exchange") should always be subject to the full range of Securities Markets Act provisions (including continuous disclosure) and a robust set of governance standards. We propose that other markets, whether operated by NZX or some other party, should be able to register and be exempted from some or all of the provisions of the Securities Markets Act, and to develop their own rule sets that may be quite dissimilar to those of the main board of the NZX. Conditions of exemptions could be:

    - Clear disclosures to investors stating which parts of the Securities Markets Act apply and do not apply to the facility, significant features of the facility's rules, and the implications of this; and

    - Restrictions on how trading facilities and their issuers are marketed. For example, any advertising would have to be clear about the regulatory status of the facility (particularly if NZX were to own an exempt or unregistered exchange).

23. We also note that the Securities Markets Act assumes that all registered exchanges will use continuous disclosure, even though alternatives to continuous disclosure might be more suitable for alternative markets (for example, periodic disclosure, disclosure of certain events, or no disclosure). A redrafted Securities Markets Act could refer to "disclosure rules" more generally, with continuous disclosure being one option for disclosure.

24. We are also of the view that the current model of regulating registered exchanges has a number of conceptual drawbacks:

    - Registration is required if the facility uses the words "stock exchange" or "securities exchange" in its name but there is little indication in the Securities Markets Act as to what kinds of facilities are otherwise intended to be regulated. There are a range of facilities that can be used to publicly trade securities: from notice boards advertising securities for sale, internet forums, and general auction and trading sites, through to securities dealers and electronic order matching services.

    - The Securities Markets Act regulates securities which host issuers' primary listings. The Act does not appear to envisage registering trading facilities that do not have a direct relationship with issuers. In other countries alternative trading systems (such as electronic communication networks or ECNs) allow trading of other exchange's securities (e.g. Chi-X, BATS, and Liquidnet). There are also trading facilities that allow traders themselves to list securities that they intend to deal in.

    - Although the Securities Markets Act establishes a process for approving new rules, and certain types of rules are required (e.g. governance of listed issuers) the Securities Markets Act is unclear about what the rules must achieve, and what range of exchange rules are permissible.

25. We therefore seek feedback on alternative approaches to any of these matters.

4. Are the current mechanisms in the Securities Markets Act for registering, requiring registration of, and exempting securities markets working? How could they be improved?

5. What are the pros and cons of allowing partial and full exemptions for registered exchanges (apart from the main board of NZX) from the Securities Markets Act? If so, what allowances should be made, and what conditions should apply? Is there preferred alternative to achieve the Taskforce's objective?

6. Should alternatives to continuous disclosure be able to be used for particular registered markets? What are the pros and cons of this option? What alternatives to continuous disclosure might be suitable?

7. How might securities law in New Zealand regulate alternative trading systems (such as electronic communication networks)? What are the pros and cons of this approach, compared to not specifically recognising them?

3.2 Access to securities registers

26. 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.

Status quo

27. Issuers are obligated to keep a register of securities and investors under section 51 of the Securities Act. Section 52 of the Act allows access to a register of by any holder of securities without a fee, or any other person on payment of a fee (except for superannuation schemes and life insurance policies). Any person can request a copy of a register for a fee.

Australian proposal

28. In Australia, similar concerns have resulted in a proposal to prevent registers being accessed for "improper purposes". Specifically, it has been proposed in Australia that a company may refuse shareholders and third parties access to the register unless they satisfy the company that they wish to access the register for a proper purpose. As part of this process, the person seeking access to the register would have to explain to the company the purpose for which the information is being sought and whether or not the information would be passed on to a third party.

29. A non-exhaustive list of improper purposes would be specified in the Corporations Regulations (for example, the solicitation of off-market trades), and the Australian Securities and Investment Commission (ASIC) would publish guidance on what constitutes a proper purpose.

30. If the company decides that an applicant's intended purpose is improper, the application could apply to the court for a review of the company's decision.

United Kingdom approach

31. A similar process to that being proposed in Australia already applies in the United Kingdom, but with one important difference. If the company believes that the request for access to the register is for an improper purpose, it is the company that must refer the matter to the court, which will determine whether the request is for a proper purpose or not.

Comment

32. The Ministry is not convinced that New Zealand should adopt an approach similar to that currently applying in the United Kingdom or that proposed in Australia. We have yet to see evidence to suggest that there is a significant problem in New Zealand, but we would be interested in evidence where access to registers has resulted in significant disadvantage.

33. 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. This should effectively deal with use of registers for direct marketing of unrelated products and other similar issues.

34. Where access to registers has been raised as a problem, this has generally been in the context of registers being accessed to make ‘predatory’ offers to investors for the securities that they hold. We are not convinced, however, that there is anything improper about an offer to existing holders *per se* – the issue seems to be whether the offer is seen as being predatory or not. We see risks in the issuer having effective control over what offers are made to its security-holders, and we are not convinced that a court or a company is necessarily in a good position to determine whether or not an offer is “predatory”. Further, any process will result in increased compliance costs.

35. There may also be other options to respond to the predatory offer issue. One possibility is to allow the issuer or a trustee to require a statement to be included in any unsolicited offer made as a result of accessing the securities register. There may also be a need to reconsider the timeframe that the issuer has to deal with the request and recovery of costs.

8. What are the pros and cons of issuers being entitled to refuse access to securities registers? If so, on what grounds, and what process should be followed?

9. Are there other options, such as allowing the issuer or a trustee to require a statement to be included in any unsolicited offer made as a result of accessing the securities register, and what are the pros and cons?

3.3 Hague convention on indirectly held securities

The Convention

36. The Hague Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary (“Convention”)[117] 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. This problem resulted from a shift in market practice from a direct holding to a mixed and indirect holding system. Particular problems that led to the development of the Convention include:

    a. Lack of certainty of the international approach to conflict of laws issues;

    b. The traditional approach (*lex situs*) is not appropriate for interests held with an intermediary; and

    c. PRIMA is not appropriate as securities are an intangible having no real location.

[117] http://www.hcch.net/index_en.php?act=conventions.text&cid=72

37. These problems give rise to real costs such as: legal fees for advice relating to uncertainty of transactions; higher regulatory capital provisions[118] for certain participants; in dealings with collateral takers, charges related to credit risk; and certain business lines may be shut-down or not pursued, because uncertainty over exposures makes the business unviable.

38. The intention of the Convention is to provide a workable solution to this conflict of laws issue. The Convention:

- is a pure conflict of laws convention. It does not impose any changes on existing or future substantive law. In particular, it does not disrupt the nature of an investor's interest in securities held by an intermediary or the requirements concerning how an interest may be provided as collateral or otherwise transferred; and

- does not apply to securities held directly, i.e. where no intermediary is involved and the investor's interest is recorded on the books of the issuer or is embodied in bearer certificates in the investor's possession.[119]

39. The Convention allows the account holder and intermediary to expressly agree on an applicable law subject to a "qualifying office" criteria.

40. Where there is no express agreement, the Convention provides three fall-back rules (and determinative elements), operating sequentially, to determine the applicable law. These fallback determinative elements consider:

- the law of the place of the office that a written account agreement expressly and unambiguously identifies as the office through which the relevant intermediary entered into the account agreement;

- the law of the place of incorporation or organisation of the relevant intermediary; and

- the law of the (principal) place of business of the relevant intermediary.[120]

41. Signatories to the Convention include the USA, Switzerland, and Mauritius. Australia, the UK, and some Asian and EU countries are currently considering whether to adopt it.[121]

The status quo

42. The general rule in New Zealand is that New Zealand law will apply to securities if the securities are located in New Zealand. If the securities are located outside of New Zealand the law of the jurisdiction where the securities are located will apply. This rule reflects the common law *lex situs* rule. The conflict of laws sections in the Personal Property Securities Act 1999 (PPSA) are also relevant.[122]

43. If New Zealand were to align its law with the Convention, the PPSA may require review. The PPSA only relates to security interests in securities, not the transfer of securities generally. The PPSA specially provides that an investment security that is not in the form of a security certificate (referred to as dematerialised securities under the Convention) is situated where the records of the clearing house or where the securities depository is kept.[123] This is a

[118] As required by the Basel II capital adequacy regime applying to banks.
[119] Roy Goode, Hideka Kanda, & Karl Kreuzer, Hague Securities Convention, Explanatory Report, 2005.
[120] Above n2
[121] Including support from ISDA, see letter to the European Commission regarding Directive 2002/47/EC on financial collateral arrangements, 15 September 2006; Also see Harry C. Sigman and Christophe Bernasconi, Myths about the Hague Convention debunked, IFLR, November 2005. www.iflr.com.
[122] Richard Potok (general editor), Cross Border Collateral: Legal Risk and the Conflict of Laws, Chapter 20 New Zealand, 2002; and Widdup & Mayne, Personal Property Securities Act: a conceptual approach (revised edition), 2002
[123] Section 26(2)

variation on the place of the relevant intermediary approach or 'PRIMA' rule, and does not completely satisfy either the primary rule under the Convention or any of the fall-back rules.

44. While the PPSA does not provide a similar rule for intangible negotiable instruments or investment securities that are not traded or settled through a clearing house or securities depository, it is likely that New Zealand law would apply to possessory security interests in this property if the records in which the secured party's interest is recorded are located in New Zealand.[124]

The Ministry's preliminary proposal

45. The Ministry's preliminary proposal is to align New Zealand law with the Convention and possibly review relevant aspects of the PPSA. Notably, in drafting its PPS legislation, Australia harmonised the concepts in its PPS Act with those in the Convention, such as the concept of 'intermediated securities'. Taking this approach would:

- be in line with jurisdictions that have adopted the Convention;
- likely be in line with jurisdictions that are considering adopting the Convention;
- provide a workable solution for New Zealand to provide certainty to business; and
- provide an opportunity to achieve a common solution to the issue of the law governing proprietary issues affecting international securities in all major financial jurisdictions.

46. The Ministry understands that legal advisers in New Zealand regularly provide advice on the issue the Convention addresses and that advice on this issue will increase as secured transactions become more common, given concerns about credit in the current economic environment. The Ministry understands that on a per transaction basis (where there is a cross-border element), the cost savings from alignment with the Convention would be principally a reduction in legal costs and a reduction in internal time having to consider potential foreign law perfection issues.

47. Alignment with the Convention would help to achieve harmonisation of the New Zealand and Australian personal property regimes under the Single Economic Market Outcomes framework. Harmonisation with Australia and other jurisdictions would also provide greater certainty and confidence to parties which may result in an increased flow of money into, or through, New Zealand and help to develop New Zealand's capital markets.

10. Do you support or oppose the proposal to align New Zealand law with the Hague Convention on indirectly held securities? Would the proposal have additional costs or benefits (e.g. will it help to enhance and develop New Zealand's capital markets)?

11. Should New Zealand adopt the Convention (rather than just align New Zealand law with it)?

12. What effect will the proposal have on your business operations? In dollar terms, what average costs (e.g. legal fees) would alignment with the Convention mitigate?

13. On an annual basis how often do you encounter a conflict of laws in respect to securities as addressed by the Convention? Do you anticipate this number will increase or decrease over the coming years and why?

[124] Widdup & Mayne, Personal Property Securities Act; a conceptual approach (revised edition) 2002, page 290.

4. Financial Markets Authority

48. The Government has decided to establish a new market conduct regulator, to be called the Financial Markets Authority. The Authority will be a new Crown entity that consolidates the functions of the Securities Commission with certain functions currently undertaken by the Ministry and the NZX. This section considers some additional functions and powers that could be given the Authority as part of the review of securities law.

4.1 Guidance and certainty

49. In its interim report the Taskforce recommended that the Securities Act should be amended to include:

- a new power for the Securities Commission to issue 'no action' letters, which would prevent it from taking action in relation to a matter (particularly where the question of breach is arguable or on matters which are not material); and

- a retrospective exemption power for the Securities Commission.

50. In its progress report, the Taskforce recommended changes to the Securities Act:

Amend requirements for Securities Commission exemptions to be gazetted to be consistent with the Takeovers Panel.

Status quo

51. The Securities Commission currently has the power to provide exemptions from the provisions of the Securities Act under section 5(5). Broadly speaking, these exemptions can be categorised as either exemptions which exempt a firm from certain requirements under the Act, or exemptions that have the effect of clarifying the application of the Securities Act to certain issuers. Exemptions come into force after they have been gazetted and the Commission has no power to grant retrospective exemptions.

52. We understand that the Commission also provides guidance to firms about the Commission's views on compliance with the Act. This guidance does not provide absolute certainty around the Commission's view on the issue in question.

53. The Government has agreed that the Authority will have the power to grant individual exemptions but, unlike the Commission, it will only have the power to grant class exemptions for up to one year. Permanent class exemptions will need to be made by regulations.

Comment

54. One of the key objectives of a financial market regulator should be to assist firms by providing certainty around the requirements needed to comply with the law. In particular, in a securities law context this often means providing clarity on whether a particular financial instrument is a security and whether a proposed offer is to the public or not.

55. The Authority will already have the power to provide certainty around:

- Whether the Act applies to an issuer and, if so, how it applies to that issuer (through the exemption making power);

- Whether a financial instrument is a regulated security and, if so, what type of regulated security (through the designation power referred to in Chapter 1); and

- Issue ‘no action’ letters (though without specific statutory backing).

56. However, there is a question around whether the Authority should be able to:

- make binding rulings;
- issue retrospective exemptions; and
- issue no action letters under a formal statutory process.

57. Finally, there is also a question around whether exemptions should come into force immediately after being made rather than after being gazetted.

Binding rulings

58. Some market participants and others have suggested that the regulator should make, on request, binding rulings on the meaning of the law or its application to particular facts.

59. The making of binding rulings is a quasi-judicial function, and as such the Ministry does not consider that the Authority is best placed to carry it out. It is likely that the Authority would develop a judicial-type process which would itself result in significant costs, and rulings may not give significant increased certainty for issuers as they would not be binding on the courts.

60. The Ministry considers there is merit in seeking efficient methods of determining general issues of interpretation in a way that is legally binding on the regulator and third parties. An independent Rulings Panel is being established to deal with the enforcement of NZX rules (i.e. the existing jurisdiction of the New Zealand Markets Disciplinary Tribunal) and could (as discussed later in this chapter) have wider jurisdiction to deal with civil matters under securities law.

61. It might be relatively simple to add a power for the Rulings Panel to rule on cases stated to it, and would be a better fit with its functions than the Authority. Rulings could be made legally binding on both the Authority and third parties and could deal with matters of fact or law or either, and be subject to rights of appeal to a court. If this option were adopted, any person would be able to seek a ruling from the Panel, but would be liable for costs. We would propose that the Authority would also have the power to seek a ruling from the Panel.

62. Rulings might however, be expensive to obtain, and issuers might prefer to seek a designation or an exemption from the Authority.

14. What are the costs and benefits of a specialist Rulings Panel being able to make rulings on matters relating to securities law, or is there a better option?

15. Should any rulings power of the Rulings Panel be binding on the Authority and third parties and on matters of fact or law or both, and be subject to rights of appeal?

Retrospective exemption-making power

63. Concerns have been raised about the consequences of minor breaches of exemptions being disproportionate to the magnitude of the breach involved (e.g. in some cases a breach of an exemption could result in the offer being void or voidable). Relief orders can be sought in these cases from the court. However, the Taskforce noted that having to apply to the court in these circumstances may be onerous if the breach is immaterial.

64. We have concerns about the retrospective validation of a breach of the law implied in a retrospective exemption-making power. If remedies are disproportionate for certain breaches, we think that it is preferable for the law to be adjusted so that it is not disproportionate, or for the court to grant relief. We note that Chapter 2 proposes changes intended to at least partially mitigate the consequences of the current rules making allotments void.

65. While the Takeovers Panel has a retrospective exemption-making power, we consider that this is more likely to be justified in a takeovers context because of the speed at which events can occur in a takeover and the difficulties of unwinding a takeover once it has occurred.

16.	What are the costs and benefits of a retrospective exemption-making power for a breach of securities law, or is there a better option to deal with this issue?

'No action' letters

66. We agree with the Taskforce's recommendation that the Authority should be able to issue 'no action' letters. While such letters do not bind third parties and will only apply in relation to a specific set of facts, we consider that they are a relatively inexpensive and efficient way of providing certainty on the Authority's view of a transaction before it takes place.

67. We are not certain, however, that there is a need for this power to be set out in legislation, as it seems to be within the powers of the existing Securities Commission (or any other regulatory body) to issue 'no action' letters at present.

17.	What are the costs and benefits of providing for 'no action' letters in legislation?

Gazetting of exemption notices

68. Given that the Authority will only have the power to issue individual exemptions and class exemptions for up to one year, we think that the case for requiring individual exemptions to be gazetted before coming into force is weaker than currently the case.

69. In principle, notice in the *Gazette* provides the public with the ability to know the law when it comes into force, which is an important legal principle related to the principle that the law does not have retrospective effect. There appears to remain a case for class exemptions coming into force on or after notice in the *Gazette* because they can affect a broad range of parties, some of whom may not be aware of the exemption application.

70. Where an exemption relates solely to the applicant, however, the benefits to the applicant and subscribers from an exemption coming into force as soon as it is communicated may outweigh the public interest reflected in the *Gazette* requirement. Accordingly, we agree with the Taskforce recommendation to the extent that individual exemptions should come into force when they are made rather than after notice in the *Gazette*.

18.	What are the costs and benefits of individual exemptions coming into force when they are made, rather than on or after notice in the *Gazette*?

4.2 Authority's powers to bring proceedings

71. The Taskforce recommended that the Government should:

- Give the regulator the power to seek civil remedies on behalf of investors and to initiate and coordinate class actions.

Status quo

72. The Securities Act and Securities Markets Act currently contain provisions that enable the Commission to lead proceedings seeking compensation orders for investors where there has been a contravention of either of those Acts. If the Commission does not take action individual investors are still able to bring their own proceedings.

73. Under both Acts the Commission may seek a declaration of contravention in respect of civil liability events at the same time as it applies for a pecuniary penalty. If the court makes a declaration then any investor who brings his or her own civil proceedings may rely on the declaration and is not required to prove the civil liability event. Under the Securities Act, the Commission can also seek a compensation order in respect of any person who subscribed for the securities on the faith of an advertisement, or registered prospectus, that contained an untrue statement. Under the Securities Markets Act, the test is whether the person has suffered or is likely to suffer loss or damage because of the contravention.

74. The Commission has recently commenced civil action for breach of the Securities Act (in relation to certain finance companies) and the Securities Markets Act (in relation to an alleged breach of continuous disclosure). In proceedings under both Acts, the Commission has sought declarations, pecuniary penalties and compensation for investors. The civil proceedings under the Securities Act have been stayed until criminal proceedings are complete.

Are class action laws needed?

75. The Securities Commission is using its powers to seek civil remedies on behalf of investors. There may, however, be a case for detailed rules around class actions and how the Commission could lead proceedings that seek compensation.

76. New Zealand does not currently have specific laws to facilitate class actions. The High Court Rules Committee and the Ministry of Justice have been considering the issues and a draft bill has been prepared for discussion purposes.[125]

77. The Ministry's current view is that there is no clear problem with the current provisions and that, if improvements are needed to facilitate class actions, these should be considered at the same time as general class action laws are considered.

Validity of settlements – Member's Bill

78. The Illegal Contracts (Unlawful Limitation on Regulators' Powers) Amendment Bill, a Members' Bill proposed by Hon Lianne Dalziel provides that where any provision in any contract purports to oust, or limit, the power of a regulator to award any remedy or distribute any proceeds of a settlement or order of the court to any individual, the provision shall be void and of no effect.

[125] See http://www.courtsofnz.govt.nz/about/system/rules_committee/meetings/MinutesPDF94kb.pdf

79. The Bill arose from a situation faced by a group of investors who felt that they were forced to accept or reject a full and final settlement before knowing whether the person who sold them the product had broken the law. The explanatory note for the draft Bill states:

> There is no problem making a settlement conditional on not proceeding with a civil cause of action, but where a regulator has identified a breach of the very rules designed to protect investors, no such agreement should be allowed to stand. It simply exacerbates the wrong should it transpire that these rules were broken.

80. It is preferable that investors have full information when considering a settlement offer. Arguably, however, there is not a difference in kind between investors making decisions before or after a regulator has completed its investigation into whether it thinks there is wrongdoing. Both relate to potential civil liability and a corresponding contingent benefit to investors. In both circumstances, the individual weighs up the value of the settlement against the potential value he or she may derive from eventual court proceedings. A regulator's investigation is a factor to be considered, rather than a guarantee of a specific outcome.

81. There is always a possibility of an independent regulator deciding to investigate a matter, and it is possible that the policy in the Bill would discourage settlements, or result in lower settlement offers. This is because the person offering the settlement would need to consider that the settlement may not be full and final if the regulator decides to investigate.

General dealing misconduct and the Fair Trading Act

82. Section 13 of the Securities Markets Act mirrors section 9 of the Fair Trading Act 1986. It provides that a person must not engage in conduct, in relation to any dealing in securities, that is misleading or deceptive or is likely to mislead or deceive. Dealing in securities is defined broadly to include acquiring or disposing of securities, or offering securities for subscription (although section 16 specifically excludes offers to the public to extent they are regulated by the Securities Act).

83. The Fair Trading Act is currently enforced by the Commerce Commission. Amongst other things, that Act prohibits:

    a. general misleading and deceptive conduct (section 9);

    b. misleading conduct in relation to goods (section 10);

    c. misleading conduct in relation to services (section 11); and

    d. false or misleading representations (section 13).

84. There is some overlap between breaches of the Fair Trading Act and securities law in respect of misleading conduct and disclosures. However, the Fair Trading Act provides that a person cannot be liable under that Act if they are not also liable under the Securities Act or Securities Markets Act. In practical terms, this means that where a matter may raise issues under the Fair Trading Act and either the Securities Act or the Securities Markets Act, it will usually be enforced by the Securities Commission under one of those Acts instead.

85. Breach of the general misleading and deceptive conduct provision in section 13 of the Securities Markets Act results in civil liability only. This matches section 9 of the Fair Trading Act, but the Fair Trading Act also provides for criminal liability for breach of other provisions such as false or misleading representations under section 13.

86. The Securities Markets Act provision is relatively new, and it is possible that it will become a very important provision. The Authority could rely on the provision to, for example, bring proceedings for civil penalties and compensation in relation to a range of securities offers and markets, including offers that are exempt from disclosure obligations as a result of the proposals in Chapter 2.

87. The Ministry is interested in views on whether the Authority should be given the ability, in relation to dealings in securities, to use its investigation powers in relation to suspected breaches of the Fair Trading Act, and to be given enforcement powers that sit alongside the Commerce Commission's powers.

88. An alternative might be to mirror additional provisions from the Fair Trading Act (such as section 13) in a similar manner to the general dealing misconduct prohibition, and whether criminal liability should also be provided for where conduct would be criminal under the Fair Trading Act. The latter option might create needless complexity, as the mirrored securities law provisions would likely need to be kept consistent over time.

Ability to bring action for breach of other laws

89. The Securities Commission's powers to facilitate civil actions are limited to contraventions of the Securities Act and Securities Markets Act. They do not, for example, allow the Commission to take action on behalf of investors for breach of other legislation, or for other civil wrongs (such as negligence) that it discovers in the course of an investigation.

90. In Australia, ASIC has a specific power to cause civil proceedings to be begun on behalf of other persons:[126]

> "Where, as a result of an investigation or from a record of an examination (being an investigation or examination conducted under this Part), it appears to ASIC to be in the public interest for a person to begin and carry on a proceeding for:
>
> a. the recovery of damages for fraud, negligence, default, breach of duty, or other misconduct, committed in connection with a matter to which the investigation or examination related; or
>
> b. recovery of property of the person;
>
> ASIC:
>
> c. if the person is a company--may cause; or
>
> d. otherwise--may, with the person's written consent, cause;
>
> such a proceeding to be begun and carried on in the person's name.

91. The Ministry is interested in comments on the potential for the Authority to be given an equivalent power in New Zealand.

19. Are there options to improve the provisions that enable the Authority to lead compensation claims for investors (for example, laws to facilitate class actions)? What are their costs and benefits? 20. Do you agree with the policy intent reflected in the Illegal Contracts (Unlawful Limitation on Regulators' Powers) Amendment Bill? What are its costs and benefits?

[126] Australian Securities and Investments Commission Act 2001 - Section 50.

21. What are the pros and cons of the Authority using the Securities Markets Act's general dealing misconduct prohibition to regulate behaviour in exempt securities markets?

22. What are the pros and cons of the Authority having an enforcement role under the Fair Trading Act, or of other rules in the Fair Trading Act being replicated in securities law?

23. What are the pros and cons of the Authority being able to cause civil proceedings to be begun in a similar manner to ASIC's power in section 50 of the Australian Securities and Investments Commission Act 2001?

4.3 Credit Contracts and Consumer Finance Act

Status quo

92. The Credit Contracts and Consumer Finance Act 2003 (CCCFA) is currently enforced by the Commerce Commission. The CCCFA imposes information disclosure requirements for consumer credit transactions and regulates methods of interest charging, fees and payments. It also regulates consumer leases and allows for changes to the terms of contracts on the basis of hardship to a consumer. The CCCFA provides for the reopening of oppressive credit contracts, and penalties if the Act is breached. A policy review of the CCCFA is currently being undertaken by the Ministry of Consumer Affairs.

93. ASIC has an enforcement role in respect of equivalent legislation in Australia, although in other jurisdictions credit contracts enforcement is not consistently the responsibility of financial market conduct regulators.

Comment

94. Given the Authority's responsibility for enforcing the laws applying to financial products, and its likely expertise in this area, we seek views on whether responsibility for enforcing the CCCFA should be transferred from the Commerce Commission to the Authority.

24. Should the Authority, rather than the Commerce Commission have responsibility for enforcing the CCCFA? What are the pros and cons?

4.4 Financial literacy

95. There are currently a number of public and private organisations with an interest in financial literacy. These include the Securities Commission, Retirement Commission, Reserve Bank, Ministry of Consumer Affairs, and Ministry of Education. In particular, the Retirement Commission is an autonomous crown entity that has a statutory role in helping New Zealanders prepare for retirement and is the established main provider of financial education.

96. In other jurisdictions financial market regulators have a significant role in respect of financial literacy. For example, in 2008 ASIC gained a leadership role in promotion of financial literacy when it took over responsibility for the Financial Literacy Foundation. In the United Kingdom, the Financial Services Authority has recently been tasked with establishing a new consumer financial education body, the function of which will be to enhance the understanding and knowledge of members of the public on financial matters, and the ability of members of the public to manage their own financial affairs.

97. However, as noted in a report to the Taskforce last year,[127] existing initiatives tend to focus more on personal financial management topics such as budgeting and debt. The report suggested that education about investing is one area for improvement in New Zealand. Moreover, the ANZ/Retirement Commission Financial Knowledge Survey carried out last year indicates a lack of investment knowledge, particularly with respect to compounding interest, shares as higher-growth long-term investments, and what to look for in investments.

98. Given the ongoing importance of financial literacy, or more specifically investment literacy, to the operation of financial markets and the benefit individuals can obtain from them, we propose that the Authority have a specific statutory function of promoting investment literacy.

25.	What are the pros and cons of the Authority having a function of promoting investment literacy, or do you prefer other options for improving investment literacy?

4.5 Monitoring and evaluation

99. The Authority will have an express function of monitoring the operation of securities law. The government also needs to evaluate the effectiveness of the law. In order to do this effectively, both need information including about dealings in financial products and offerings that are exempt from the substantive requirements of the law.

100. We note that the Authority will have investigation powers similar to those of the Securities Commission under Part 3 of the Securities Act. This includes powers to inspect documents, receive evidence and summon witnesses. It will be an offence to fail to produce a document, to fail to appear or refuse to answer a question when summoned, or to mislead the Authority in providing evidence.[128]

101. The Authority may also be aware of a wider range of issuers and offerings under the proposals in Chapter 2 that require issuers making use of some exemptions to register as issuers under the Financial Service Providers (Registration and Dispute Resolution) Act 2008 and/or register their offers on the Securities Register.

102. However, these information-gathering powers are likely to be unsuited to statistical data collection, general market monitoring or evaluation purposes. The document inspection power only relates to pre-existing documents held by a person. The power to summon witnesses is intended for investigation of complaints and other situations where misconduct by a specific party is suspected and cannot be used to collect information from a sample of any size.

103. We seek views on whether there needs to be regulation-making or specific powers for the Authority to require information on financial markets and for this information to be made available to the government, and potentially publicly. Any person raising capital could, for example, be required to:

    a. submit returns, on a periodic or event basis, about capital raisings (potentially as part of the annual return provided by companies or other bodies);

    b. provide information on request by the Authority; and

    c. keep written records

[127] O'Connell, A., "Financial Literacy in New Zealand", Capital Markets Matter Research Reports, 345. This can be found at: http://www.med.govt.nz/templates/MultipageDocumentTOC____41831.aspx.
[128] Securities Act, s 59A.

104. Information might include the types of products being offered, exemptions that were used, the amount of capital raised, and the number of investors subscribing to offers. Information gathering is common in regulation of the energy sector, which provides for information gathering and statistical returns.[129] Such regulation could provide a model for information about capital markets. The KiwiSaver Act also provides for annual statistical returns to be provided to the Government Actuary.

105. The Ministry acknowledges that supplying information is potentially costly and may have confidentiality implications and, therefore, seeks feedback on whether the Authority should have such powers, the form these powers should take, and what restrictions should be placed on their exercise.

26. What are the pros and cons of the Authority having powers allowing it to collect written information from persons raising capital? Are there alternative sources for this information?

27. If the Authority has such powers, what are the costs and benefits of different ways of collecting such information such as requests of issuers or requiring information to be provided in an annual return?

28. If the Authority has such powers, what restrictions should be placed on its exercise of them, and what impacts would this have?

[129] See for example the Electricity (Statistics) Regulations 1996, section 7 of the International Energy Agreement Act 1976, and section 35B and 36 of the Energy (Fuels, Levies, and References) Act 1989.

5. Director duties, management bans and bankruptcy

5.1 Enforcement of director duties

106. There are concerns that there is under-enforcement of directors' duties under the current system of private enforcement.

Status quo

107. The law, as it relates to directors' duties, should balance two objectives. One is to avoid having a combination of prohibitions, enforcement and penalties which discourage individuals from accepting director appointments and discourage boards from taking reasonable business risks. The other is to have prohibitions, enforcement and penalties which:

- Encourage directors to act in socially appropriate ways; and
- Provide effective remedies for people who are adversely affected by contraventions of the duties.

108. Directors do not always have incentives to act in ways that are consistent with the interests of the company, its shareholders and creditors. Examples of undesirable conduct by directors include:

   a. Selling assets they own to the company for more than their economic value;

   b. Obtaining assets from the company at less than their economic value;

   c. Buying or selling shares in the company using information they obtain as directors;

   d. Not putting sufficient effort, or applying sufficient skill, when making decisions on behalf of the company; and

   e. Taking excessive risks with the remaining assets of an insolvent company.[130]

109. Directors' duties aim to discourage such conduct. The duties that appear in the Companies Act 1993 summarised accumulated jurisprudence that was obtained from a large volume of complex case law. Those duties are:

   a. To act in good faith and in the best interests of the company (s 131);

   b. To exercise a power for a proper purpose (s 133);

   c. To comply with the Act and the company's constitution (s 134);

   d. To exercise the care, diligence and skill that a reasonable director would exercise in the same circumstances (s 137)[131];

   e. To avoid carrying on the business of the company in a manner likely to create a substantial risk of serious loss to the company's creditors (i.e. reckless trading (s 135)); and

[130] The incentives to take excessive risks arise because the capital available for use has been provided by creditors, not shareholders.
[131] A duty of care can also arise from a contract between an executive director and the company.

f. To not incur an obligation unless the director believes that the company will be able to perform the obligation when it is required to do so (s 136).

Private enforcement

110. Directors are personally liable for acts and omissions that amount to failures to comply with directors' duties. The directors' duties are owed to the company (including the two duties that are largely aimed at protecting the interests of creditors (i.e. sections 135 and 136)) and the company is responsible for enforcing the duties. In practice, many directors' duties cases take place after a company has become insolvent. Therefore enforcement action, when it does occur, is often taken by a receiver or liquidator. Depending on the circumstances, the company can seek the following orders against the director from the court:

- A prohibitory or mandatory injunction;
- Compensation or damages;
- Payment of a profit made by the director; and
- To have a contract rescinded and property returned.

111. Section 165 allows the court to grant leave to shareholders to take derivative actions on behalf of the company, or participate in other proceedings to which the company is a party. Although derivative actions are brought in a personal capacity, any remedies ordered by a court (e.g. compensation) are obtainable by the company.

112. Section 169 also permits shareholders to bring actions against directors for breaches of duties owed to them as shareholders. These remedy provisions, which are not discussed here, are available to protect minority shareholders against oppressive or illegal conduct.

113. The Companies Act and the Securities Act include provisions for banning persons from being a director or promoter, or taking part in the management of a company or issuer. The relevant provisions do not include contraventions of directors' duties as a reason for imposing bans. Nevertheless, it seems likely that the conduct that has led to a ban will often have been accompanied by a breach of one or more directors' duties. The Companies Act also contains criminal penalty provisions in relation to conduct that would sometimes be an indicator that there has been a contravention of directors' duties (e.g. failure to keep proper accounting records). Overall, however, these prohibitions are incidental to directors' duties. The directors' duties enforcement system is clearly a private enforcement regime.

Officers' duties in Australia

114. The duties are substantively similar in Australia and New Zealand. However, there are differences between New Zealand and Australia in relation to the following matters:

- The range of persons to whom the duties apply; and
- The enforcement system.

The range of persons to whom the duties apply

115. Part 2D.1 of the Australian Corporations Act 2001 refers to "general duties" rather than "directors' duties". Most of the duties apply to directors, secretaries and other officers. In some cases they apply to employees. The definition of "officer" includes other people who manage the corporation or its property, such as receivers and liquidators.

The enforcement system

116. In Australia, the statutory directors' duties are enforced by ASIC. Companies enforce the common law duties. The statutory duties include civil obligations and there is a criminal offence provision for more serious conduct. The civil obligations under the Corporations Act 2001 are as follows:

- To exercise powers and discharge duties with care and diligence (s 180);
- To act in good faith and the best interests of the corporation and for a proper purpose (s 181); and
- To avoid using their position, or the information they obtain from holding the position, to gain an advantage for themselves or someone else, or cause detriment to the corporation (ss 182 & 183).

117. Under section 184 it is a criminal offence:

- If the person is reckless or intentionally dishonest and fails to exercise their powers or discharge their duties in good faith in the best interests of the corporation or for a proper purpose; and
- To use a position dishonestly, or the information obtained from holding the position dishonestly, to gain advantage for themselves or another person or cause detriment to the company.

Orders obtainable in Australia

118. ASIC can seek the following civil orders:

- For each offence, pecuniary penalties of up to $200,000 against an individual and $1 million against a body corporate (s 1317G);
- Compensation orders on behalf of the corporation, registered scheme or any other person, including the amount of the profit made by the person from the contravention (sections 1317H and 1317HA); and
- Prohibitory and mandatory injunctions (s 1324).

119. The maximum penalties for a criminal conviction are:

- $220,000, imprisonment for five years, or both against an individual; and
- $1.1 million against a body corporate.

Comment

120. We consider that there is no need to consider the following two matters because we are not aware of any problems with the status quo, being:

- The definitions of the statutory duties appearing in sections 131-138; and
- The classes of persons to whom the statutory duties apply.

121. The issues that we are seeking submissions on relate to:

- Whether public enforcement should be introduced; and

- If so, whether criminal offence provisions should be included.

Public enforcement

122. The main reason for considering the possible introduction of public enforcement is whether there is under-enforcement under the current private enforcement system. The following matters tend to indicate that there is under-enforcement:

    a. Private costs and benefits – A regulator would have an interest in legal action against all cases of serious offending. However, the company (including a liquidator or receiver) does not have the incentive to take cases every time there is serious offending. The company only has incentives to pursue the directors if the expected compensation awarded to the company multiplied by the probability of the case being successful exceeds the expected cost of the legal action. The cost-benefit analysis is worse from the perspective of shareholders taking a derivative action, given that any compensation award will be payable to the company; and[132]

    b. Large closely-held companies – The incentives for the company to take legal action against the directors are very weak if a company is closely held. It would, in effect, amount to the directors taking legal action against each other.[133]

123. Another reason for introducing public enforcement relates to concerns that regulators may be using inapt offence provisions as an indirect way of obtaining an enforcement result against what the regulators may regard as breaches of directors' duties. For example, cases have been taken against directors alleging misleading statements in prospectuses, failing to keep proper accounting records and approving financial statements that do not give a true and fair view. If a regulator's main concern relates to possible breaches of directors' duties, it would be better for cases to be taken under targeted provisions with appropriately scaled penalty and remedy provisions.

124. The main reason for retaining the status quo is the potential concern that public enforcement would discourage individuals from becoming directors or taking reasonable business risks. This risk relates to any increased likelihood of unwarranted enforcement action or judicial error, not the nature of the substantive prohibitions. The courts have made it clear in their decisions that they distinguish between appropriate and inappropriate behaviour. For example, the courts distinguish between reasonable commercial risks and "illegitimate risks" in reckless trading cases.

Pecuniary penalties

125. If public enforcement is to be introduced, an issue that arises is whether the courts should be able to award pecuniary penalties, as is the case in relation to the Securities Act and the Securities Markets Act. The main benefit of pecuniary penalties is to reduce concerns about under-enforcement by providing the courts with the ability to impose a higher total cost on the director.

126. An argument against is that the amount of any pecuniary penalties may be small in comparison with compensation orders, meaning that the ex ante cost-benefit analysis, from the offender's perspective, would not be materially different. To illustrate, in the litigation involving the failure of HIH Insurance in Australia, two directors were ordered to pay compensation of almost $8 million plus interest. They were also ordered to pay pecuniary penalties between them of $700,000.

[132] There have been failed attempts recently by lawyers to coordinate shareholders or investors in legal actions against directors.
[133] These circumstances apply to at least one failed finance company in which there were related-party transactions and substantial dividend payments shortly before the company failed.

Criminal offences

127. As noted above, Australia has criminal offence provisions for serious contraventions of general duties. One set of prohibitions uses dishonest intent or recklessness as a test for the criminal offence provisions, while the other set uses dishonesty only. The main issue is whether New Zealand should introduce criminal offence provisions and, if so, the appropriate scope of the offence provisions and the maximum penalties.

128. Chapter 12 of the Legislation Advisory Committee Guidelines on Process and Content of Legislation provides a framework for analysing whether it is necessary to create a new offence. The Guidelines state that "the criminal law is concerned with the punishment of offenders and the deterrence of others from wrongdoing." They also state that the criminal law "is intended to punish only that conduct which is in some way blameworthy" but also notes that "ultimately it must be acknowledged that the proper scope of the criminal law is a matter involving political and ethical judgments."

129. The Guidelines state that some of the questions that need to be addressed when considering whether to create a criminal offence include the following:

- Will the conduct in question, if permitted or allowed to continue unchecked, cause substantial harm to individual or public interests?
- Would public opinion support the use of the criminal law, or is the conduct in question likely to be regarded as trivial by the general public?
- Is the conduct in question best regulated by the civil law because the appropriate remedies are those characteristic of the civil law (e.g., compensation, restitution)?
- Is the use of the criminal law being considered solely or primarily for reasons of convenience rather than as a consequence of a decision that the conduct itself warrants criminal sanctions?
- If the conduct in question is made a criminal offence, how will enforcement be undertaken, who will be responsible for the investigation and prosecution of the offence, and what powers will be required for enforcement to be undertaken?

Discussion - deterrence

130. The Guidelines refer to deterrence as an objective of criminal law. In this case, it can be argued that criminal offence provisions in relation to directors' duties could deter would-be offenders by substantially changing the ex ante cost-benefit analysis. The minimum additional cost is the stigma of obtaining a criminal record. The availability of fines can add to the cost. However, as noted in relation to pecuniary penalties, the fine element might not contribute significantly to the total cost.

131. The costs can be substantially higher again if prison sentences are also available, for two reasons. First, imprisonment imposes a much higher societal stigma. The second substantial cost is the loss of liberty. Unlike compensation awards, pecuniary penalties and fines, the stigma and loss-of-liberty costs cannot be met by another party (e.g. the company or an insurance provider).

Discussion – moral blameworthiness

132. The main ethical question posed by the LAC is whether the conduct in question, if permitted or allowed to continue unchecked, will cause substantial harm to individual or public interests. There is an arguable case both at the individual and public levels.

133. A large number of entities have failed in New Zealand in recent years in which such entities have held substantial assets in a fiduciary capacity for broad groups of outsiders. Most of the entities were finance companies. It has not been established by the courts whether the directors breached their duties or whether they were reckless or dishonest. The extent of the contravention of directors' duties may never become fully known due to the disincentives noted above for companies and shareholders to take private actions.

134. However, we do know what the consequences have been for individuals and society:

- Investors have lost, or are likely to lose, several billions of dollars. Many investors were on fixed incomes and have lost a substantial proportion and, in some cases, all of their savings. Some will have endured a significant fall in their standard of living and quality of life; and

- There has been a contagion effect, with a general loss in confidence in the finance company sector, including loss of confidence in finance companies that have been governed and managed well.

135. The main issue is whether New Zealand society regards these outcomes, if they have been caused in whole or part by dishonest and/or reckless conduct, as sufficiently immoral to justify creating a new offence. We are seeking feedback on this matter.

Conclusions on public enforcement of directors' duties

136. The Ministry has not drawn any conclusions to date on whether there should be public enforcement of directors' duties. However, we consider 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.

137. The main concerns with civil penalty provisions relate to the risks that directors may have their actions investigated by the regulator with a view to taking court cases that would be judged on the balance of probabilities. This could raise concerns that:

- Fewer people would make themselves available for directorships;

- Boards would become unduly risk-averse; and

- The regulator would second-guess whether directors have made sound business decisions.

138. By contrast, criminal offence provisions that were only targeted at egregious conduct are less likely to have such effects, except in relation to individuals who should be discouraged from becoming company directors and in relation to conduct that should be deterred. Criminal offence provisions would apply only in relation to serious offending judged against the criminal standard of proof. The directors will know, or ought to know, that any conduct that might be at risk of criminal prosecution would be beyond the margins of civil lawfulness.

139. Even if civil penalty provisions are not included, there may be a case for providing a power for the regulator to bring proceedings for breach of directors' duties in its own name for the purposes of seeking compensation for investors.

29. What are the costs and benefits of public enforcement of civil statutory directors' duties?

30. If there is to be public enforcement of civil statutory directors' duties, what are the pros and cons of introducing pecuniary penalties?

31.	What are the costs and benefits of introducing a new criminal offence provision in relation to directors' duties? What should any mental element for the offence be?
32.	If criminal offence provisions are to be introduced, what are the pros and cons of following the model in section 184 of the Australian Corporations Act 2001 – or do you prefer a different approach?
33.	If criminal offence provisions are to be introduced, what are the costs and benefits of imprisonment as an option?

5.2 Management bans

140. There are concerns about whether the current management ban regime adequately protects the public interest in New Zealand.

Status quo

141. The objective of banning a person from being a director or taking part in the management of a company or other body is, in the first instance, to protect the public in cases where a person has been convicted of a relevant offence or has had a pecuniary penalty order made against him or her (where these are available). Banning orders are designed to protect the public from the harmful use of the corporate structure or from use that is contrary to proper commercial standards.

142. In addition to protecting the public in cases where directors or managers have committed offences, it may also be seen as appropriate to protect the public from those with a proven record of commercial failure. In thinking about the length of time for which a ban should apply, it is necessary to balance the personal hardship of the person who is the subject of the ban against the public interest and the need for protection of the public from any repeat of the conduct.

143. Management banning provisions are found in a range of company and securities law related statutes.

144. The Companies Act provides for automatic disqualification for a five year period (section 382) where a person has been convicted of certain offences (including offences involving dishonesty), court imposed disqualification for up to 10 years (section 383), and the Registrar has the power to impose bans where there has been mismanagement (section 385):

- In terms of section 382, a person can apply to the court to be allowed to undertake a director or manager role in spite of their disqualification. The court can impose terms and conditions if it decides to grant the application;

- The court has the power under section 383 to impose bans. Applications to the court can be made by the Registrar, the Official Assignee, the liquidator of the company, or a shareholder or creditor of the company. Court imposed bans may be made for a broader range of conduct than the automatic bans, namely conviction for certain offences, persistent failure to comply with certain legislation, a breach of duty to the company or a shareholder, acting in a reckless or incompetent manner in performing as a director, or being prohibited in an overseas jurisdiction from being a director. An application to the court would likely be made in circumstances where a ban for a period longer than five years is considered desirable; and

- Under section 385, the Registrar may prohibit a person from managing a company for up to five years where the Registrar is satisfied the person was, during the previous five years, part of the management of the company that was wholly or partly

responsible for a company's financial difficulties. The person must have been involved as a director and/or manager in at least one company that has failed within the last five years.

145. Where a person has been identified as a candidate for prohibition on the basis of multiple failed companies, the onus is on that person to satisfy the Registrar that their management of the affairs of those companies was not at least partly responsible for their demise, or that prohibition would not be just or equitable.

146. The Securities Act provides that people convicted of making an untrue statement in an advertisement or prospectus, or of making an offer of securities in contravention of that Act, are automatically banned from being a director or promoter of, or in any way being concerned in the management of, an entity that carries on business in New Zealand for a five year period.

147. In addition, the court has the power to impose a management banning order for a period of up to ten years. Banning orders can be made against directors who have persistently contravened the Securities Act, the Companies Act, the Securities Markets Act and the Takeovers Act. Orders may also be made banning persons who have been banned in an overseas jurisdiction for a securities law contravention.

148. The Securities Markets Act has equivalent automatic and court-imposed banning provisions for people convicted of dealing misconduct offences or who have had a pecuniary penalty order made against them for a dealing misconduct contravention. The Takeovers Act has equivalent provisions for people who have been convicted of an offence under the Takeovers Act or have had a pecuniary penalty order made against them for a contravention of the Takeovers Code.

149. Where a person's conduct is grounds for a management banning order to be made under more than one Act, only one order may be made for the same conduct.

Australia

150. The Corporations Act provides for a five year automatic disqualification period from managing corporations for people who have been convicted of a relevant offence, undischarged bankrupts, and people banned by a court order in a prescribed jurisdiction. Relevant offences include fraud or offences under company law, such as a breach of directors' duties or insolvent trading. ASIC may apply to the court to extend the period of disqualification by up to 15 years for those people convicted of an offence.

151. The court has the power to disqualify people:

- For an indefinite period where they have contravened a civil penalty provision of the Corporations Act;
- For an indefinite period where they have repeatedly contravened the Corporations Act (on application by ASIC);
- For an indefinite period where they have been disqualified under the law of a foreign jurisdiction from being a director or being concerned in the management of a foreign company; or
- For up to 20 years where they have been involved in two or more corporations that have failed within the last seven years.

152. ASIC has the administrative power to disqualify people for up to five years from managing corporations where they have been an officer of two or more corporations that have been wound up within the last seven years, and where the liquidator has reported to ASIC that they may have been guilty of any negligence, default, breach of duty or breach of trust in relation to the company, or may have misapplied company property.

United Kingdom

153. Director disqualification orders are made by the court under the Directors Disqualification Act 1986. For orders made against an unfit director of an insolvent company, there is a minimum period of two years and a maximum of 15 years. The Court can make disqualification orders for:

- Certain criminal offences connected with the Companies Act legislation;
- Wrongful trading (such as trading while insolvent);
- Failure to comply with filing requirements under the Companies Act; and
- Unfit conduct in insolvent companies.

154. Disqualification undertakings are an administrative equivalent of a disqualification order. They have the same effect but do not involve court proceedings.

Comment

155. Providing for directors or managers to be prohibited or banned under certain circumstances is a common feature of many jurisdictions' corporate law framework, although provisions vary. The maximum length of ban in New Zealand is 10 years, compared with 15 years in the UK and an indefinite period left to the court's discretion in Australia.

156. The section above on enforcement of directors' duties looks at punishment for breaches and the deterrent effect of penalties. This section focuses on the appropriate level of protection for the public from those who have breached directors' duties or committed certain offences.

157. Not all company failures warrant banning action against the directors. The need for action will depend on the severity of the conduct. The type of mismanagement conduct that may result in a regulator-imposed ban will vary. However, common types of conduct that have resulted in bans include the failure to keep company records, particularly accounting records; the failure to pay taxes; insolvent and reckless trading; the misappropriation of assets; and the intermingling of the affairs of the companies. The threshold for this type of ban is lower than the serious and persistent failures or dishonesty tests that are grounds for a court imposed ban.

158. We seek submissions on whether the status quo adequately protects the public interest in New Zealand. For example, a number of the recent finance company collapses have involved directors who have previously been involved in failed companies, and have previously been automatically disqualified through bankruptcy or conviction of an offence. The consequences of the finance company failures in terms of losses incurred by investors and loss of confidence in the sector are discussed in the section on directors' duties. If the prohibition of a person from undertaking a director or manager role is seen as a method of protecting the public from future misconduct, are the current provisions effective?

The Ministry's preliminary proposal

159. Our preliminary proposal is to increase the maximum period for regulator-imposed bans to ten years and to empower the High Court to impose indefinite banning orders.

160. This proposal takes account of the fact that court-imposed bans apply in relation to the most serious types of conduct and that there may be instances where a ten year ban is not sufficient to protect the public interest. While the threshold for the ban currently able to be imposed by the Registrar is lower than that for court-imposed bans, where a person has been identified by the regulator as a candidate for prohibition on the basis of multiple failed companies and there has been serious and fundamental mismanagement, five years may not be sufficient to meet the purpose of the ban.

34. Do you consider that the five year automatic disqualification provision provides adequate protection of the public interest? If not, what alternative would you propose and what are the pros and cons of your proposal?

35. What are the pros and cons of the preliminary proposal to change the ten year maximum period for court-imposed bans to an indefinite period?

36. What are the pros and cons of the preliminary proposal to change the five year maximum period for regulator-imposed bans to ten years?

5.3 Culpable bankrupts

161. There are concerns that the law may not be adequately protecting the public and commercial community from people who abuse personal bankruptcy ("culpable bankrupts"). Some people cannot be trusted to be honest in the way that they obtain and spend money or carry on business. The law should deter recklessness and dishonesty and provide members of society with the information they need to make informed decisions about insolvent individuals. These objectives are more likely to be achieved if:

a. Information provided to the community clearly distinguishes between culpable and non-culpable bankrupts;

b. The penalty provisions make it difficult for culpable bankrupts to behave recklessly and dishonestly and discourage others from doing so;

c. The regulator has the resources to take enforcement action where needed to protect the public; and

d. Would-be offenders have a broad understanding of the likely adverse consequences for themselves if they are reckless or dishonest.

Status quo

162. Individuals can become insolvent for a variety of reasons. Among other things, personal bankruptcy can be associated with:

a. Changes in personal circumstances such as loss of employment, ill-health and relationship breakdowns;

b. Business failure;

c. Excessive use of credit by individuals who do not understand that they will be unable to meet their obligations as they fall due and/or place excessive value on the benefits of immediate consumption; and

d. Dishonesty and/or recklessness including fraud, borrowing to finance gambling or a lavish life style, borrowing when they know they have no prospect of repaying the loan, and misusing limited liability to defeat the interests of creditors.

163. The general duty of a bankrupt is to assist in the realisation of his or her property and the distribution of the proceeds among the creditors. During bankruptcy, the person may not:

a. Be a director of a company;

b. Incur credit of $1,000 or more without disclosing that he or she is bankrupt;

c. Conceal assets; or

d. Stop, or attempt to stop, or hamper the Official Assignee (OA) dealing with any property or assets.

164. The OA can also require bankrupts to make payments towards their debts and vacate land and/or buildings. Bankrupts are also required to obtain the OA's consent before:

- Leaving New Zealand;
- Entering into, carrying on, or taking part in the management or control of any business; or
- Being employed by a relative or an entity that is owned, managed or controlled by a relative.

165. Bankrupts are usually automatically discharged after three years and they may apply for an earlier discharge. The OA may apply to the High Court objecting to automatic discharge or seek an order restricting the person from engaging in business after discharge for a specified period or without a time limit. The bankruptcy may be extended by the court if it considers that it is appropriate to do so having regard to all the circumstances of the case. The court may specify the earliest date when the bankrupt may apply for a discharge.

5.3.1 The problems

166. There are two potential problems. First, requiring the OA to seek orders from the High Court in relation to culpable bankrupts is onerous. The need for the OA to file an affidavit in support of the application and collate all relevant documentation and evidence in support of the application takes approximately 40 hours of staff time, before referral to Crown Law for action. The OA could expect to pay at least $10,000 in legal fees when seeking to pursue a business prohibition or make an objection to automatic discharge. The current system also consumes excessive amounts of court time.

167. The burden on the OA can be much greater than outlined above where the bankrupt seeks to vigorously oppose the OA's application. One example of legal proceedings against a culpable bankrupt that were drawn out over several years involved a person who was bankrupted twice in Australia, prosecuted by the New Zealand Police on fraud charges, prosecuted by the Ministry for managing a company while being disqualified, convicted under the Fair Trading Act and investigated by Immigration New Zealand.

168. The other problem is that the law does not recognise that there is a far greater likelihood that a person will be reckless or dishonest if bankrupted twice or more. Examples provided by the OA include:

- Complaints received about a two-time bankrupt from several creditors, asserting misappropriation of funds advanced totalling millions of dollars;
- A two-time bankrupt who was convicted on tax-related fraud charges involving millions of dollars, breached a company management banning order and acted with purported authorities he did not have; and

- A three-time bankrupt who has a track record of misleading creditors and the public and was convicted on deceit-related charges.

5.3.2 The Ministry's preliminary proposals

169. Our preliminary proposals are:

    a. To introduce a power for the OA to extend the term of bankruptcy for up to seven years beyond the original three years. The person to whom the order applies would have a right of appeal to the High Court; and

    b. 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.

170. Proposal (a) could halve the time involved (to 20 hours) to prepare the necessary documentation and greatly reduce legal costs. Proposal (a) would also be consistent with the proposal in relation to director banning provisions (see the previous section).

171. Proposal (b) would effectively create a rebuttable presumption that a person who has been bankrupted on at least two occasions is likely to be unable to be trusted to be honest in the way that they obtain and spend money or carry on business. We consider that this is a reasonable presumption.

37. What are your views on the costs and benefits of the preliminary proposals (or alternative options) to empower the OA to extend the term of bankruptcy for up to seven years beyond the original three years in relation to culpable bankrupts?

38. What are your views on the costs and benefits of the preliminary proposals (or alternative options) 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?

6. Enforcement

6.1 Infringement notices/administrative penalties

172. Infringement notices or administrative penalties may allow for more flexible and cost effective enforcement of less serious securities law offences.

Status quo

173. The Securities Act and Securities Markets Act do not allow the use of infringement notices to penalise less serious offences. Only civil pecuniary penalties and criminal convictions are used in these Acts.

174. In New Zealand the maximum level of infringement fees are usually small, generally around $2,000.[134] There are a few precedents for higher fees: the infringement fee for late filing under the Financial Reporting Act 1993 is $7,000, under the Civil Aviation Act 1990 is up $12,000 for a body corporate, and under the Gambling Act is up to $50,000.

175. A 2009 Ministry of Justice paper discusses some issues with, or possible new approaches to, the present system of infringement fees. No policy changes were put forward, but a number of scenarios were discussed to indicate the potential range of changes that could be implemented, which have advantages and disadvantages.[135]

The Ministry's preliminary view

176. The Ministry's preliminary view is that the ability to issue infringement notices of amounts in the $2,000 range are unlikely to be useful as a deterrent in respect of breaches of securities laws in relation to offers to the public. There may, however, be scope (and a need) for infringement notices in respect of enforcement of market conduct rules of a registered exchange.

177. As noted by the Ministry of Justice, a possible alternative model to infringement notices is the Fisheries Act 1996 as amended in 1999. This Act draws a distinction between administrative penalties (fines not exceeding $250,000) and infringement fees (which may not exceed $3,000).

178. An administrative penalty may be proceeded by way of a notice served on the offender by a Fishery Officer. The offender may admit the offence and also make submissions as to what should be taken into account when the penalty is determined. The regulator then decides on a penalty (which cannot exceed one-third of the maximum monetary penalty) and notice of the penalty is served on the offender. If it is paid there is no conviction. Alternatively, upon receiving notice of the offence the alleged offender may require that the matter be subject to court proceedings. The offence can still result in a conviction if it goes to court.

179. We seek views on whether an administrative penalty regime is a useful addition to the enforcement regime under securities law.

[134] See Radiocommunications Act 1989 ($2,000), Telecommunications Act 2001 ($2,000), Unsolicited Electronic Messages Act 2007 ($2,000), Electricity Act 1992, Plumbers, Gasfitters and Drainlayers Act 2006 and Gas Act 1992 ($1,000 for individual, $3,000 for body corporate), Biosecurity Act 1993 ($1,000), Dog Control Act 1996 (up to $750), Fisheries Act 1996 ($3,000), Animal Welfare Act 1999 ($250).

[135] http://www.justice.govt.nz/publications/global-publications/r/review-of-monetary-penalties-in-new-zealand/issues-for-fines-and-infringement-fees-1.

39. What are the pros and cons of infringement notices being available in respect of contravention of securities laws and, if so, what laws and what should be the maximum infringement fee?

40. What are the pros and cons of the regulator being able to seek administrative penalties?

6.2 Offences and penalties

180. The offence and penalty levels and interaction between civil and criminal causes of action will need to be considered in rewriting securities legislation.

Status quo

181. There are currently a number of reverse onus offences in the Securities Act, a notable example being section 58. Directors are liable to up to 5 years' imprisonment and an automatic 5 year management ban for any untrue statements in a prospectus they sign, unless the director proves either that the statement was immaterial or that he or she had reasonable grounds to believe, and did up to the time of the distribution of the prospectus believe, that the statement was true.

182. Section 58 is similar in scope to section 242 of the Crimes Act 1961, but the Crimes Act offence does not contain a reverse onus. Under Section 242 every one is liable to imprisonment for a term not exceeding 10 years who, in respect of any body, makes or concurs in making or publishes any false statement in a prospectus, with intent to induce any person to subscribe to any security within the meaning of the Securities Act 1978. A false statement is any statement in respect of which the person making or publishing the statement:

- knows the statement is false in a material particular; or
- is reckless as to the whether the statement is false in a material particular

Comment

183. The Ministry does not have current policy proposals for changes to penalty levels or the relationship between offences in securities law and the Crimes Act. There will, however, be a need to reconsider reverse onus offences in light of the New Zealand Bill of Rights Act 1990. There may continue to be a case for retention of reverse onus in the circumstances of securities offerings, but it is perhaps notable that (more recent) offences under the Securities Markets Act for dealing misconduct generally require subjective or objective knowledge. There may also be a case for giving more consideration to charging serious misconduct under the Crimes Act, perhaps through close coordination between the Authority and the Serious Fraud Office.

184. Another issue is that there is significant overlap between civil and criminal liability, so that conduct that results in criminal offence (which could result in a fine) is likely also to amount to a civil contravention (which could result in a pecuniary penalty). In practice, the Commission has commenced both civil and criminal proceedings, but stayed the civil proceedings pending the outcome of criminal proceedings. We are interested in comments on whether this overlap is causing significant problems, or whether we should try to more clearly separate matters into those for which a civil action is possible, and those for which a criminal proceedings are possible.

41. Do you have any comments on the levels of offences and penalties under the Securities Act and the Securities Markets Act, and their relationship with Crimes Act offences?

42.	What are the pros and cons of retaining reverse onus for offences under the Securities Act?
43.	Do you have any comments on the interrelationship between civil and criminal causes of action under the Securities Act and the Securities Markets Act?
44.	What impact do civil penalties have on behaviour? Should they be retained and, if so, for what conduct?

6.3 Specialist civil judicial-type body

185. Recent finance company prosecutions have highlighted the fact that it can take a long time for proceedings against directors and issuers to be completed. As has been noted in the past, proactive and public enforcement of market rules is essential to market confidence. As a result, we consider that consideration needs to be given to ways to speed up the enforcement process, while not detracting from natural justice.

Status quo

186. Cases under the Securities Act and Securities Markets Act are currently taken by the District Court or High Court. The Authority will be responsible for servicing a Rulings Panel that replaces the New Zealand Markets Disciplinary Tribunal. The Financial Advisers Act provides that the disciplinary committee will be chaired by the Commissioner of Financial Advisers, a member of the Securities Commission, together with other members appointed by the Minister.

Comment

187. It would be potentially a small step to expand the jurisdiction of the Rulings Panel to deal with civil matters in respect of legislation administered by the Authority.[136] In addition, the interpretation of securities law (and corporate law more generally) can require a high degree of specialist expertise and market knowledge. The degree of specialist expertise that can be required in this area also supports the idea of having a specialist judicial-type body dealing with these matters.

188. The Ministry is also considering providing the Rulings Panel with the jurisdiction of the disciplinary committee appointed under the Financial Advisers Act. It appears to be a better conceptual fit for this quasi-judicial function to be included in the jurisdiction of a specialist civil judicial body for financial markets.

189. We seek submitters' views on whether the Rulings Panel should be able to deal with a wider range of civil matters. As an indication, we are contemplating limiting its jurisdiction to deal with all civil matters arising out of specified legislation and up to the amount of $500,000, and be subject to appeals to the High Court. Criminal proceedings would continue to be dealt with by the courts.

190. An alternative might be to establish a specialist Financial Court rather than a tribunal, which could have civil and criminal jurisdiction in relation to financial matters. This move to a specialist court would, of course, be a significant departure from the current courts regime.

45.	What are the pros and cons of a specialist judicial-type body to deal with civil breaches of securities law and other laws enforced by the Authority?
46.	Do you have any comments on the design of such a body and its jurisdiction?

[136] As well as civil matters under securities law, this could also include civil actions under the Companies Act, Financial Reporting Act, Superannuation Schemes Act, KiwiSaver Act and others.

47.	Do you prefer any alternative options, such as establishing a specialist Financial Court which would have jurisdiction over financial matters? If so, why?

7. Special partnerships

191. In its progress report, the Taskforce recommended that the law should be amended to:

> Clarify that a special partnership that re-registers as a limited partnership succeeds to the rights and liabilities of the special partnership.

Status quo

192. Before 2008, Part 2 of the Partnerships Act 1908 provided for the establishment of special partnerships, which are a form of partnership with two classes of partners. These two classes were general partners who were jointly and severally liable for the activities of the special partnership, and special partners, who were liable only to the extent of their capital contribution to the special partnership. Special partnerships could last for a maximum of 7 years.

193. Part 2 of the Partnerships Act was repealed by the Limited Partnerships Act 2008, which established the new form of limited partnership. Like special partnerships, limited partnerships also have the two classes of partners, with general partners being jointly and severally liable for the activities of the partnership, and limited partners being liable only to the extent of their capital contribution. Limited partnerships also have several other advantages over special partnerships, including "flow-through" tax treatment, separate legal personality and no restrictions on their potential lifespan.

194. The Limited Partnerships Act provided that special partnerships in existence at the time the Act came into effect would continue to be regulated under Part 2 of the Partnerships Act as though it had not been repealed, but that special partnerships could no longer be registered. As a result, all special partnerships will have expired before 1 May 2015.

Comment

195. If a special partnership wanted to transition to a limited partnership it would have to wind itself up and register as a limited partnership. Transferring the rights and liabilities of the special partnership to the limited partnership in these circumstances is likely to involve some cost and uncertainty for special partnerships. For example, it may involve the need to satisfy all of the liabilities of the special partnership before transitioning across to the limited partnership form, and there may be some other difficulties involved in transferring the rights of the special partnership to the limited partnership.

196. We propose that it should be clarified in legislation that a special partnership that re-registers as a limited partnership succeeds to the rights and liabilities of the special partnership.

197. We note that a special partnership would, in these cases, still have to comply with the requirements of the Limited Partnerships Act before registering as a limited partnership.

48. Do you agree legislation is required to clarify that a special partnership that re-registers as a limited partnership succeeds to the rights and liabilities of the special partnership?

49. What are the pros and cons of this intervention?

Chapter 5: Consolidated questions

1. Are there any other issues that the Ministry should consider when rewriting securities legislation?
2. Do you consider that financial market participants should be required to treat customers fairly, in accordance with certain principles developed by the Authority as part of a code of practice?
3. If so, do you agree with one of the options we have set out above, or, is there a better option to achieve the objective of providing some enduring principles? What are the pros and cons of the various options?
4. Are the current mechanisms in the Securities Markets Act for registering, requiring registration of, and exempting securities markets working? How could they be improved?
5. What are the pros and cons of allowing partial and full exemptions for registered exchanges (apart from the main board of NZX) from the Securities Markets Act? If so, what allowances should be made, and what conditions should apply? Is there preferred alternative to achieve the Taskforce's objective?
6. Should alternatives to continuous disclosure be able to be used for particular registered markets? What are the pros and cons of this option? What alternatives to continuous disclosure might be suitable?
7. How might securities law in New Zealand regulate alternative trading systems (such as electronic communication networks)? What are the pros and cons of this approach, compared to not specifically recognising them?
8. What are the pros and cons of issuers being entitled to refuse access to securities registers? If so, on what grounds, and what process should be followed?
9. Are there other options, such as allowing the issuer or a trustee to require a statement to be included in any unsolicited offer made as a result of accessing the securities register, and what are the pros and cons?
10. Do you support or oppose the proposal to align New Zealand law with the Hague Convention on indirectly held securities? Would the proposal have additional costs or benefits (e.g. will it help to enhance and develop New Zealand's capital markets)?
11. Should New Zealand adopt the Convention (rather than just align New Zealand law with it)?
12. What effect will the proposal have on your business operations? In dollar terms, what average costs (e.g. legal fees) would alignment with the Convention mitigate?
13. On an annual basis how often do you encounter a conflict of laws in respect to securities as addressed by the Convention? Do you anticipate this number will increase or decrease over the coming years and why?
14. What are the costs and benefits of a specialist Rulings Panel being able to make rulings on matters relating to securities law, or is there a better option?
15. Should any rulings power of the Rulings Panel be binding on the Authority and third parties and on matters of fact or law or both, and be subject to rights of appeal?
16. What are the costs and benefits of a retrospective exemption-making power for a breach of securities law, or is there a better option to deal with this issue?
17. What are the costs and benefits of providing for 'no action' letters in legislation?
18. What are the costs and benefits of individual exemptions coming into force when they are made, rather than on or after notice in the *Gazette*?
19. Are there options to improve the provisions that enable the Authority to lead compensation claims for investors (for example, laws to facilitate class actions)? What are their costs and benefits?
20. Do you agree with the policy intent reflected in the Illegal Contracts (Unlawful Limitation on Regulators' Powers) Amendment Bill? What are its costs and benefits?

21. What are the pros and cons of the Authority using the Securities Markets Act's general dealing misconduct prohibition to regulate behaviour in exempt securities markets?
22. What are the pros and cons of the Authority having an enforcement role under the Fair Trading Act, or of other rules in the Fair Trading Act being replicated in securities law?
23. What are the pros and cons of the Authority being able to cause civil proceedings to be begun in a similar manner to ASIC's power in section 50 of the Australian Securities and Investments Commission Act 2001?
24. Should the Authority, rather than the Commerce Commission have responsibility for enforcing the CCCFA? What are the pros and cons?
25. What are the pros and cons of the Authority having a function of promoting investment literacy, or do you prefer other options for improving investment literacy?
26. What are the pros and cons of the Authority having powers allowing it to collect written information from persons raising capital? Are there alternative sources for this information?
27. If the Authority has such powers, what are the costs and benefits of different ways of collecting such information such as requests of issuers or requiring information to be provided in an annual return?
28. If the Authority has such powers, what restrictions should be placed on its exercise of them, and what impacts would this have?
29. What are the costs and benefits of public enforcement of civil statutory directors' duties?
30. If there is to be public enforcement of civil statutory directors' duties, what are the pros and cons of introducing pecuniary penalties?
31. What are the costs and benefits of introducing a new criminal offence provision in relation to directors' duties? What should any mental element for the offence be?
32. If criminal offence provisions are to be introduced, what are the pros and cons of following the model in section 184 of the Australian Corporations Act 2001 – or do you prefer a different approach?
33. If criminal offence provisions are to be introduced, what are the costs and benefits of imprisonment as an option?
34. Do you consider that the five year automatic disqualification provision provides adequate protection of the public interest? If not, what alternative would you propose and what are the pros and cons of your proposal?
35. What are the pros and cons of the preliminary proposal to change the ten year maximum period for court-imposed bans to an indefinite period?
36. What are the pros and cons of the preliminary proposal to change the five year maximum period for regulator-imposed bans to ten years?
37. What are your views on the costs and benefits of the preliminary proposals (or alternative options) to empower the OA to extend the term of bankruptcy for up to seven years beyond the original three years in relation to culpable bankrupts?
38. What are your views on the costs and benefits of the preliminary proposals (or alternative options) 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?
39. What are the pros and cons of infringement notices being available in respect of contravention of securities laws and, if so, what laws and what should be the maximum infringement fee?
40. What are the pros and cons of the regulator being able to seek administrative penalties?
41. Do you have any comments on the levels of offences and penalties under the Securities Act and the Securities Markets Act, and their relationship with Crimes Act offences?
42. What are the pros and cons of retaining reverse onus for offences under the Securities Act?
43. Do you have any comments on the interrelationship between civil and criminal causes of action under the Securities Act and the Securities Markets Act?

44. What impact do civil penalties have on behaviour? Should they be retained and, if so, for what conduct?
45. What are the pros and cons of a specialist judicial-type body to deal with civil breaches of securities law and other laws enforced by the Authority?
46. Do you have any comments on the design of such a body and its jurisdiction?
47. Do you prefer any alternative options, such as establishing a specialist Financial Court which would have jurisdiction over financial matters? If so, why?
48. Do you agree legislation is required to clarify that a special partnership that re-registers as a limited partnership succeeds to the rights and liabilities of the special partnership?
49. What are the pros and cons of this intervention?