legal update
BUDDLEFINDLAY

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LEGAL UPDATE ON COMMERCIAL AND BANKING LAW

In the last week, the government has released a number of significant items relating to banking and finance. This special edition of Buddle Findlay's legal update series summarises:

- The findings of the Capital Markets Development Taskforce
- Proposed amendments to the Financial Advisers Act
- The new Securities (Moratorium) Regulations
- The new Securities Trustees and Statutory Supervisors Bill

Capital Markets Development Taskforce releases final report

The government's Capital Markets Development Taskforce (CMDT) released its final report on 16 December 2009. In a wide-ranging report, the CMDT considers such diverse matters as product design and disclosure, corporate governance, market design, the roles of regulatory agencies, tax, employment, protecting property rights, and New Zealand's potential as a back and middle office hub for funds.

Fundamentally, the CMDT concluded that New Zealand's capital markets are not working as they should. Retail investors have lost money and confidence in the markets. Many of New Zealand's best companies are unable or choose not to raise public money, and those that do go public face a higher cost of capital than they should. The CMDT puts this in no uncertain terms:

That is not good enough. We can – and must – improve. It is critical for individuals' wellbeing, and for the country as a whole, that our markets provide investors with better outcomes. We need to equip New Zealanders with the information and advice they need to make wise investment decisions, improve the quality of existing products and provide new opportunities to invest in high-quality products.

With these aspirational goals in mind, the CMDT goes on to make 52 recommendations ranging from extremely high level to extremely detailed and from the principled to the pragmatic. Among the more notable recommendations:

- Excluding "private" transactions from the scope of the Financial Advisers Act 2009 (FAA). New Zealand's financial markets regulation traditionally focused only on financial transactions involving the (retail) public, and largely left alone those able to "look after themselves" (wholesale and institutional investors). The FAA rejected this approach and brought all financial advisers (whether retail, wholesale or institutional) within its ambit. The FAA is not yet in force, and the government is currently looking to make amendments. It will be interesting to see whether the government picks up this CMDT recommendation in the short term
- Partially floating government entities, both central and local government owned. The CMDT pointed out that only one-third of New Zealand's biggest businesses are public, compared to two-thirds in Australia. The task force has in mind State Owned Enterprises (SOEs) and other commercial Crown-owned companies
- Related to the previous point, the CMDT wants more agriculture investment opportunities in the market. The report points out that the majority of New Zealand's flagship industry is predominately co-operatively or privately owned. The CMDT has identified this as an NZX issue to progress. We wait with interest to see whether anyone can tempt co-operative supplier-shareholders to join the market, particularly following recent high profile attempts

- The CMDT makes a detailed set of recommendations for the managed funds sector, including “fiduciary” duties for managers, entry, exit and unit pricing rules and fostering alternative structures such as wraps and portfolio management services. We believe these recommendations will be considered by the government’s already-announced review of the Securities Act. Potentially of more immediate impact, the CMDT recommends that KiwiSaver schemes should not default to a conservative option. Instead investors in default schemes would be allocated an investment profile according to their status, primarily their age. A younger investor (with a long term investment horizon) would be defaulted to a growth default option under the CMDT recommendations
- Unsurprisingly, the report looks at investor confidence and the standard of information disclosure. The CMDT recommends simplifying and standardising product disclosure – disclosure documents should be short, prescribed and in plain English. Complex high risk products should have explicit warnings. We believe that these recommendations will be considered as part of the review of the Securities Act. The results of this will also be extremely interesting; we understand that there is a general international trend away from “principles” based (and lengthy) disclosure to shorter “prescribed” documents. Actually getting all material information, in a short plain English form without jargon, and understandable to retail investors, in anything less than 20 pages will be a significant challenge
- The CMDT report does not just look at “public” markets. It also wants to improve the regulatory regime for private companies so they can effectively access “capability and risk capital”, and to improve the links between public and private markets. This may include the development of more lightly regulated exchanges, and raises the possibility of lightly regulated exchanges being owned by fully regulated exchanges – potentially a return to the old “Grey Market”
- The CMDT recommends merging parts of the Securities Commission, the regulatory functions of NZX and the Registrar of Companies into a single “market conduct” regulator, which would look something like the Australian Securities and Investments Commission (ASIC)
- Overlapping with the work of other government task forces and committees, the CMDT takes aim at New Zealand’s tax regime, in particular reducing the tax biases between different forms of investment. The CMDT identified a range of options, including a risk-free return method tax (in the case of housing or buildings), denial of depreciation deductions for buildings, a specific capital gains taxes (on any under-taxed asset), and a general capital gains tax, but indicated it would be guided by the government’s tax working group
- Finally, the CMDT recommends pursuing opportunities to develop New Zealand into an “exporter of high-value middle and back office financial market services for funds management firms.” It is not fully clear what is envisaged here, but potentially turning New Zealand into something of an “offshore financial centre” or funds management service hub such as Singapore. There is a reason offshore financial centres are often also known as “tax havens” and a massive shift in the tax position will be necessary to realise this objective.

The report makes a number of interesting recommendations in varying degrees of detail and with varying ease of implementation. Some features we could see appearing within 12 months but others are realistically years away, if not altogether impossible or very unlikely. We will be awaiting the government response with interest.

The final report and executive summary is **available here**.

Financial advisers amendments

On 8 December the government introduced the Financial Service Providers (Pre-Implementation Adjustments) Bill (the Bill). The Bill amends the Financial Advisers Act 2008 (FAA) and Financial Service Providers (Registration and Dispute Resolution) Act 2008 (FSPA).

QFE changes

The most significant of the amendments relate to Qualifying Financial Entities (QFEs). Under the FAA’s current provisions, the employees of a QFE may give financial advice or perform investment transaction services in relation to:

- Category 2 products
- Category 1 products of which the employer is the issuer.

"Agents" of a QFE may only give financial advice or perform investment transaction services in relation to category 2 products. A person who is not directly "employed" by the issuer of a category 1 financial product may not give advice in relation to it, unless he or she goes through the process of becoming an authorised financial adviser

This approach causes issues for various approaches to selling products. For example, some financial adviser firms operate a franchise-style model, where each outlet is a separate business with its own employees. The employee financial advisers would not be able to give advice in relation to any category 1 products, even if those products are issued by the "head office" of the franchise group. Similarly, many financial institutions operate on a "group" basis. Specific entities within the group are responsible for certain functions. Most significantly, the Securities Act deems the "issuer" of certain managed funds (in particular, unit trusts) to be the manager of that unit trust. Group financial institutions will usually have a fund manager subsidiary. Only employees of the fund manager, and not other employees of the group, would be able to give advice on such products.

The Bill proposes 2 changes. First, it proposes replacing the concept of "agents" with a new class of people called "nominated representatives". Unlike an agent, a nominated representative would be able to give advice in relation to category 1 products of which the "nominator" is the issuer. The quid pro quo however is that the issuer would have to nominate its list of representatives in advance (although the Bill does provide some relief from this on a transitional basis). This will correct the "franchise" issue, where the persons giving advice ultimately work for the issuer but are not formally employed by them.

The second change is to allow promoters (as defined in the Securities Act) of a financial product to register as a QFE. This will allow the "parent" of a financial services group to register as a QFE, rather than individual subsidiaries that are the technical issuer of a financial product. This will correct the "group" issue described above, allowing all employees or nominated representatives of a group to give advice in relation to the group's financial products.

The combination of the 2 amendments mean that the QFE provisions will be substantially streamlined and wider groups will be able to become QFEs, rather than multiple individual subsidiaries. The major category not included in the new model is "white labelled" products. If a QFE "offers" a white labelled product but does not become a promoter of that product, its employees and representatives will not be able to give advice unless they become authorised financial advisers.

Category 2 products

In a welcome change, the Bill will expand the list of category 2 "simple" products. Anyone that is registered or a QFE employee or nominated representative is able to give advice on category 2 products. It is not necessary to satisfy the higher-level authorised financial adviser (AFA) requirements.

The Bill adds to the existing list bonus bonds, building society call shares, and expands the definition of call debt securities and insurance. The full list of category 2 products will be:

- Bank term deposits
- Bonus bonds
- Call building society shares
- Call debt securities (including cash PIE funds)
- Consumer credit contracts
- Insurance products (including term life, but excluding endowments or annuities)
- Life insurance (including endowments and annuities) issued before 1 January 2009.

We consider this will improve the efficacy of the regime, by ensuring advisers of relatively simple products will not face unnecessary requirements.

Clarifying financial advice

The Bill will also make a number of smaller changes designed to clarify what is and what is not financial advice. These include:

- Clarifying that in certain circumstances where employees act on behalf of employers in relation to excluded activities, those employees are excluded too
- Excluding rating agencies
- Excluding annual reports, company records, notices of meetings, and public disclosures to securities exchanges from “financial advice”.

Other changes

The Bill changes the territorial application of the FSPA. Under the old approach, the FSPA only applied to financial services provided by a person who is in New Zealand (regardless of where that person was incorporated or registered). Under the proposed approach, the following would need to register under the FSPA (regardless of where they reside, are incorporated or carry on business):

- Persons that provide financial services in New Zealand
- Persons that are or should be authorised under the FAA.

This essentially imports the FAA territorial application provisions into the FSPA. That is, all financial services “performed” in New Zealand will need to be registered and potentially licensed.

The Bill also makes some more minor and technical changes, including transitional arrangements and certain minor changes to the investigation and offence provisions.

Investment transactions

The major omission from the Bill is investment transactions. The Bill does not contain anything in this regard at all. The Minister of Commerce, Simon Power, has announced that he is “still working through potential changes to the way investment transactions are regulated… following recent targeted consultation with industry.” The investment transaction regime as it currently stands is widely considered to be unworkable, not taking into account matters such as automated transactions.

Simon Power's media release can be **viewed here**.

Securities (Moratorium) Regulations 2009

The Securities (Moratorium) Regulations 2009 (the Regulations) were Gazetted on 18 December 2009. The Regulations come into force on 31 January 2010. However, they expressly provide that certain provisions apply to issuers that are "in moratoria", even if the moratorium proposal was accepted prior to 31 January 2010.

The Regulations apply to all “moratorium proposals”. This is in similar terms to the Securities Act (Renewals and Variations) Exemption Notice 2002 – any variation of debt securities that (in substance) extends the time for repayment, or reduces the amount of repayment, of principal or interest.

The Regulations are the government’s response to the perceived issues associated with moratorium proposals, specifically that retail investors voting on moratorium proposals did not understand the full implications of the proposals. A key feature of the proposals is requiring a tailored investment statement to be provided to investors. The new investment statement for moratorium proposals will be required to include the following information (in a question-and-answer format):

- What is the moratorium proposal?
- Who is involved in this moratorium proposal?
- How would the moratorium proposal affect my rights?
- Why are the directors putting this moratorium proposal to security holders?
- What are the other options, and how do they compare with a moratorium proposal?
- What are the directors’ plans for the issuer?

- What will ultimately happen to the issuer?
- What does the independent expert say about the moratorium proposal?
- Who else has an interest in approval of this moratorium proposal?
- What does the trustee say?
- Who would monitor the issuer while it is in moratorium?

The Regulations also:

- Modify the prospectus requirements for moratorium proposals (most notably requiring an expert opinion and prospective financial information (PFI))
- Insert additional deemed clauses in trust deeds, including:
  - restricting amendments to the trust deed as a result of a moratorium proposal unless the proposal complies with the prospectus and investment statement requirements above
  - additional rules about moratorium meetings (in particular, a 21 day notice requirement of such meetings)
  - even if a moratorium proposal is accepted, give the investors the right to "recall" the moratorium proposal and place the issuer in receivership
- Require periodic disclosure of information to security holders and the Registrar of Companies, including half-yearly reports with the following information:
  - the state of affairs of the issuer
  - the conduct of the moratorium (including all amounts received and paid)
  - a statement identifying the most recent audited financial statements and interim financial statements, and that these are available on the Companies Register
  - property disposed of since the last report and proposals for the future disposal of property
  - amounts owing to preferential creditors
  - other amounts that are likely to be available as of that date for payment to creditors
  - disclosure of all related party transactions
  - a comparison of actual receipts against the prospective receipts disclosed in the moratorium proposal's PFI
  - a statement as to the trading prospects of the issuer
  - any updates in forecasts of PFI
  - a statement about whether the forecasts in the moratorium proposals have been achieved
  - any other material matters
- Require a quarterly report with the following information:
  - any material changes since the last half-yearly report
  - a statement identifying the most recent audited financial statements and interim financial statements, and that these are available on the Companies Register
  - comparative financial information.

The full text of the Regulations is **available here**.

Securities Trustees and Statutory Supervisors Bill

The government has introduced the Securities Trustees and Statutory Supervisors Bill (the Bill). The Bill’s self-stated raison d’être is to “to protect the interests of security holders, and enhance investor confidence in financial markets”. It aims to do this by:

- Requiring trustees to be capable of effectively performing trustee functions

- Requiring trustees to actually perform trustee functions effectively
- Holding trustees accountable if they fail to perform their functions effectively.

The Bill extends to trustees of debt securities, statutory supervisors of participatory securities, trustees of unit trusts and (in part) to statutory supervisors of retirement villages.

The major initiative of the Bill is setting up a licensing regime for trustees, to be administered by the Securities Commission (the Commission). Trustees will only be able to act if licensed. In order to be licensed, trustees will have to convince the Commission that they have the experience, skill, financial and other resources, procedures, independence, governance structure and professional indemnity insurance (and anything else the Commission considers relevant) in order to be an effective trustee.

The Bill also provides for ongoing monitoring and enforcement of licensed trustees. Trustees must report regularly to the Commission, as well as event based reporting where the trustee has breached an obligation or has had a material change in circumstances. The Bill provides that the Securities Commission has relatively wide-ranging powers to direct trustees, including removing trustees and cancellation of licences. There are also provisions allowing the Commission to seek pecuniary penalty and compensation orders.

Finally, the Bill does not forget the actual issuers of the securities. Trustees will again have to report to the Commission if an issuer has or is likely to breach its obligations, and lets the Commission give directions to trustees that will in turn be passed on to issuers.

The Bill is very much process driven. It contains very little information about what actually must be done to who and when, preferring instead to cast its requirements in terms of “notices”, “directions”, “hearings”, “action plans” and “appeals”. The government is placing a lot of reliance on “good processes lead to good outcomes”, and on the ability of the Commission to get the terms and conditions of licences right. This approach is likely to be very flexible to take into account specific circumstances, but does lack much in terms of specifics.

Fundamentally, the majority of Bill’s direct requirements will fall on trustees. Indirectly however issuers of debt and participatory securities and unit trusts are likely to see a downstream impact. Trustees will presumably want more robust trust deeds, and we believe there will be a significant increase in the amount of information trustees will be requesting or requiring from issuers. The ultimate sanction of removing a non-performing trustee is available to the Commission, although the Bill is very careful to hedge this about with more procedure, and provides for certain arrangements (including a Commission appointed trustee) to ensure that an issuer will not have to cancel offers because its trustee gets in trouble.

The Bill leans rather towards the pragmatic rather than principled end of the spectrum. It does not justify its focus on treating debt, participatory securities and unit trusts differently from other securities, other than that these securities have “trustees” at the moment. It continues the trend of shifting more and more responsibility on to the trustee, without directly addressing the role of directors or managers of an issuer. And as already discussed, it focuses far more on processes than actual requirements. While it may form the basis of long term regulation, we hope that the government’s current wider-ranging review of the Securities Act will more fundamentally consider the respective roles and responsibilities of investors, issuers, managers, directors, trustees and regulators.

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