Property law investment issues under the Financial Markets Conduct Act

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New Zealand financial markets will be affected during 2014 by the phased implementation of the Financial Markets Conduct Act 2013 (FMC Act). This article looks at the potential treatment of different forms of property investment schemes under the FMC Act in contrast to the Securities Act 1978 (SA), and speculates on some potential implications.

Changing tests for disclosure requirements

The FMC Act will replace or amend a number of pieces of legislation. Most importantly it will replace the SA, which at present governs the raising of investment funds from the public.

One of the criticisms of the SA is that it focuses on the legal forms of investment products, rather than their economic substance. By contrast the FMC Act seeks to place a greater emphasis on economic substance, and reserves regulation for those products that are intended to make an investment or manage a financial risk.

This can be seen with the tests for when disclosure is required. Under the SA, the trigger is an offer of securities to the public for subscription. "Security" in turn is broadly defined to mean "any interest or right to participate in any capital, assets, earnings, royalties, or other property of any person". Critically this can include interests in not-for-profit schemes. This wide reaching definition is carved back in two ways - by statutory exemptions contained in the SA itself, and by exemptions granted by the market regulator (currently the Financial Markets Authority (FMA)) - reducing the disclosure burden.

By contrast the FMC Act applies its disclosure regime to a narrower scope of investment products, termed "financial products". These narrow definitions are supplemented by a power under the FMC Act for the FMA as market regulator to "call in" investment products and rule that they will be subject to regulation. This is the "designation" power.

Application to real estate related investments - current regime

At present the SA contains a statutory exemption for offers of securities giving an interest in real estate, and the market regulator has granted a number of exemptions from disclosure requirements.

The statutory exemption is at section 5(1)(b), and it provides that the SA's disclosure regime will not apply in respect of any estate or interest in land for which a separate certificate of title can be issued, with a limited exception for "contributory schemes" (essentially schemes where individual subscribers do not hold an identifiable interest with a separate certificate of title).

In addition to this broad statutory exemption the market regulator has granted various exemptions over time that can apply to real estate associated products which do not meet the requirements of section 5(1)(b), for example the Securities Act (Real Property Developments) Exemption Notice 2007 (RPD Notice). The RPD Notice can be used where an offer of real estate carries with it an entitlement to use communal facilities. Although the interest in real estate the purchaser acquires is exempt by reason of section 5(1)(b), the interest in the communal facilities is still a security for the purposes of the SA, and hence an exemption is required. The exemption provides relief from SA requirements, but still requires certain information to be provided.

Application to real estate investments - the new regime

By contrast under the FMC Act the narrower scope of the categories of financial product may mean that many property related investments will not be subject to disclosure requirements.

The four categories of financial product defined under the FMC Act are: debt securities; equity securities; derivatives; and managed investment products (MIPs). MIPs are defined in turn as interests in managed investment schemes (MISs), a blanket term for products pooling investor funds.

The definition for an MIS has three key elements: pooling of investor funds; investors having a right to financial benefits under the scheme; and investors not having day-to-day control over the scheme. In addition, there is a carve-out for MISs where investors acquire either a legal or beneficial interest in distinct underlying property.

Potential implications

As a result it would appear that any not-for-profit arrangement that may be associated with a real estate development or other transaction, such as the types of arrangements presently covered by the RPD Notice, would be excluded from the MIS definition. Similarly any arrangement whereby investors are involved in day-to-day decision-making would also be excluded. Together with the exclusion for MISs where investors receive a distinct legal or beneficial interest in underlying property, there are a wide range of arrangements that would be excluded from being an MIS, and hence the disclosure and governance regimes under the FMC Act.

It should be noted that once the FMC Act is fully operational (expected in December 2014) transitional provisions will come into force that allow schemes that constituted offers of securities under the SA to "opt-out" of the FMC Act regime, which may also be of assistance.

Looking forward

These changes are not absolute - offers of debt and equity securities will continue to be caught, so a property-based investment offering these products would still require FMC Act disclosure. Nevertheless, it may be the case that a considerable number of investment proposals may fall outside the scope of the new FMC Act, and industry participants and their advisers should consider the application of the new regime.

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