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Legal update - Financial Markets Conduct Bill update

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Financial Markets Conduct Bill update

On 22 April 2013 the Minister of Commerce, the Hon Craig Foss, publicly released what are likely to be the final changes to the Financial Markets Conduct Bill (FMC Bill). These are in the form of a Supplementary Order Paper (SOP), which will be tabled in the House to amend the provisions of the FMC Bill.

The SOP can be accessed online here and the Minister's press release announcing the SOP can be accessed here. The Ministry of Business, Innovation, and Employment (MBIE) has also released the Cabinet paper behind the recommendations.

The Minister has focused on certain high profile issues, but the SOP contains an extensive range of amendments to the FMC Bill. In this update we provide a breakdown of not only the headline issues, but the key points of the full suite of changes, looking at the Bill as a whole and what the proposed amendments mean for market participants.

High profile changes

In announcing the SOP, Mr Foss singled out four areas of change for particular attention in his press release - "headline" changes - which relate to issues that have been the subject of public comment as a result of the Ross Asset Management collapse and the interrelationship of the relevant pieces of legislation. These four areas are:

- An increase in the investment value threshold for deeming an investor to be a wholesale investor from $500,000 to $750,000
- Extending the partial disclosure requirements that apply to offers made under exclusions (to wholesale investors (so issuers making an offer to wholesale investors will need to comply with the particular compliance regime that will be prescribed by the regulations)
- Further controls over the provision of discretionary managed investment services (DIMS), in particular where these may be provided by authorised financial advisers (AFA) operating under the Financial Advisers Act (FAA)

Aligning the purpose provisions of the different pieces of financial markets legislation so that the relevant provisions of the FAA and the Securities Trustees and Statutory Supervisors Act (which will become the Financial Market Supervisors Act) are brought into line with the FMC Bill.

Hidden surprises - what else is in the SOP? How to make sense of it all?

In addition to these headline changes, the SOP contains a large number of other changes, plus minor edits and amendments. The SOP is presented in the form of a 31-page Explanatory Note and a marked-up copy of the Bill showing the proposed changes. While this makes for a more user friendly document, it is very large – a healthy 695-page document in total.

We suggest that instead of wading through the entire document, you should:

- Read this update for a quick summary
- Review those parts of the Explanatory Note to the SOP that are of most relevance to you to gain an overview of the changes and the Cabinet paper for the reasoning behind the changes
- Go to those parts of the marked-up FMC Bill that are of interest and see how they will look once amended.

Below we work through the FMC Bill's provisions part-by-part, identifying and commenting on the changes that have been recommended by the SOP. Where there are schedules or amendments to other relevant legislation we have included comments on these as well.

Part One - Definitions and purpose

Part One of the FMC Bill contains definitions and various preliminary provisions, most importantly the stated purposes of the new legislation (clauses 3 and 4). The SOP makes some minor changes to this Part of the Bill, but these broadly remain the same.

As mentioned above, the SOP does contain amendments to bring the purpose provisions for financial advisers and statutory supervisors/trustees in line with the FMC Bill. Given that the Financial Markets Authority (FMA) will exercise its powers under different pieces of legislation in accordance with these purpose provisions, this change appears appropriate.

Part Two - Fair dealing

The fair dealing provisions in Part Two of the FMC Bill have the potential to make a major impact on market participants. In summary, they import obligations akin to those in the Fair Trading Act (FTA) into the financial markets legislation, and make the FMA the regulator for these obligations.

To avoid potential doubling up of liability the FMC Bill previously contained an amendment to the FTA carving out financial products and services from the FTA's scope. The intention here was to avoid the current areas of overlap between securities law and general consumer protection legislation, and give the FMA the lead role in applying fair-dealing obligations to market participants.

The SOP has removed this carve-out. The Cabinet paper describing the changes sets out the options that were considered, but in brief the view was reached that a clean break between the two pieces of legislation would not be workable in practice, given the uncertainty that often arises at the early stage of investigations as to what legislation might apply. On this basis the SOP now provides for a co-regulatory type model, in place of the former carve-out. The FTA will be amended to provide that the Commerce Commission may take proceedings under the FTA in respect of financial products and services, but must obtain the FMA's consent before doing so. A new double jeopardy provision that will be added to the FTA will prevent market participants being fined under the FTA and paying a pecuniary penalty under the FMC regime in respect of the same conduct.

The effect of this change would appear to be that the current practice of the FMA and Commerce Commission liaising on investigations and deciding between themselves who should be lead agency in a particular case will continue, but on a more formalised basis. This seems likely to retain the uncertainty associated with dealing with two regulators, but this uncertainty may be reduced if the FMA, as the regulator exercising a right of veto, communicates its policies and intentions to the marketplace.

In addition to this change the SOP also amends Part Two of the FMC Bill to add unsubstantiated representation provisions, to match those being added to the FTA and ensure that the two pieces of legislation are as similar as practicable in this regard.

Part Three (and Schedule One) - Offering financial products

Part Three and Schedule One of the FMC Bill are concerned with the disclosure requirements for regulated offers of financial products, and the boundary between regulated offers and those that are exempt from the FMC Bill's disclosure requirements.

Part Three has seen only minor stylistic amendments, and otherwise remains in the same shape as returned from the Select Committee. Schedule One, on the other hand, has seen some material changes. Key changes include the extension of partial exclusion to wholesale investors, and the removal of the exclusions for contributory mortgages and financial products offered by local authorities.

The distinction between wholesale and retail investors has been debated at length since the Ross Asset Management failure. In particular, because a large number of the investors who trusted Mr Ross with their funds were classed as wholesale investors (for FAA purposes), arguments had been made that classification as a wholesale investor on the basis of a substantial private placement investment was not appropriate, for an example see here.

The SOP has responded to this in two ways – first, by lifting the threshold for private placements from $500,000 to $750,000, and second, by applying the partial disclosure provisions in clause 26 of Schedule 1 to wholesale offers. This clause provides that in situations where standard securities disclosure is not required, regulations can be made providing for some form of alternative reduced disclosure (which may range from, for example, a simple warning statement or term sheet to a more substantial disclosure document). Until regulations are drafted we cannot anticipate what form any such disclosure might take, but we expect some form of differentiation will be likely between financial institutions and private individuals using the private placement or high net worth exclusions.

Contributory mortgages offered by lawyers may be on the way out – or not. Formerly a popular capital-raising method, traditionally in smaller centres but with a flurry of metropolitan activity in the early 2000s, the FMC Bill initially provided an exclusion for contributory mortgages offered by lawyers. Following discussion with the FMA and the Law Society, this exclusion has been removed. As part of its 2012 exemption review process, the FMA had concluded that there were no principled reasons for distinguishing contributory mortgages offered by lawyers from other providers – the effect of this removal would be to leave any tailored disclosure regime for lawyers to the FMA's exemption power.

Local authorities are also to be removed from the list of excluded offerors. Historically local authorities had an exemption from securities legislation on the basis that councillors were sometimes reluctant to sign prospectuses (in a manner analogous to directors). However since it will be possible under the new legislation for entities to register offer documents without all directors being required to sign, the basis for the exclusion was no longer considered necessary.

Part Four - Governance of existing securities

Part Four of the FMC Bill is concerned with the governance arrangements for debt securities and managed investment products, and consequently the powers and duties of supervisors and managers. It also discusses register and record-keeping obligations for all categories of issuer.

While the general shape of the Part remains the same, there are a number of additions and amendments that will be relevant to market participants involved with funds and debt products. There is a helpful list of these in the Explanatory Note to the SOP, but some of the more important changes are:

- Clarification that trust deeds and governing documents may be amended in accordance with powers under enactments other than the FMC Bill
- Clarification that the FMA may set preconditions that must be satisfied before it uses its powers to amend trust deeds and governing documents (to avoid a perceived risk that market participants would rush to the FMA instead of using other means to make amendments)
- Confirmation that supervisors may delegate performance of functions, subject to any conditions set by the FMA
- Removing the protection against self-incrimination that issuers had with their self-reporting requirements (at clauses 103 and 137) – instead, any such report would be inadmissible as evidence in a criminal proceeding (other than one regarding the falsity of the report)
- Adding workplace savings schemes as a separate category of registered scheme, rather than as a subset of superannuation schemes, and hence allowing a wider range of benefits
- Allowing managed investment schemes to register sections of the scheme separately as superannuation schemes and workplace savings schemes.

Part Five - Listed issuers and market dealings

This Part of the FMC Bill mostly carries over Securities Markets Act provisions that were the subject of extensive review and consideration in 2010 and 2011. As such this Part of the Bill has attracted relatively less attention through the legislative process, and this is reflected in the SOP.

Other than minor drafting changes, relevant points include:

- Clarifying that the market conduct rules in Part Five will apply to conduct both inside and outside New Zealand, in respect of New Zealand listed products
- Extending the scope of the Chinese Wall defence to insider trading liability, by providing that a person disclosing inside information to another has a defence if the person believed on reasonable grounds that the recipient had appropriate Chinese Wall arrangements in place
- Adding derivatives to the substantial holdings regime, so that derivatives with a quoted underlying product will count towards the 5% threshold – so, for example, an entity with relevant interests in 4% of a listed issuer's voting products and derivatives with underlying equivalent to 2% of the issuer's voting products would be a substantial product holder and required to make disclosure accordingly.

Part Six (and amendments to the FAA) - Licensing, DIMSs, and financial advisers

Most of the licensing provisions of the FMC Bill remain generally unchanged by the SOP, other than minor changes of a "tidying-up" nature – for example, amending the protection against self-incrimination. Those provisions that deal with DIMS, however, have been subject to considerable revision.

The coming into force of the FMC Bill will mean that there are two paths to offering DIMSs – either by a corporate entity holding an FMC licence as a DIMS provider, or by an AFA providing the DIMS as a financial adviser service under the FAA. As a result any changes to the DIMS provisions in the FMC Bill have required corresponding amendments to the FAA to ensure consistency and minimise the potential for arbitrage (for example, aligning the definition of wholesale investor under the FMC Bill with the FAA definition in the case of DIMSs provided under the FAA).

A particular area of concern in relation to the provision of DIMSs has been custody arrangements. MBIE publicly consulted on this issue in its December discussion paper, with submitters strongly supporting more stringent custody requirements for DIMS providers. The FMC Bill currently requires licensed DIMS providers to appoint an independent custodian. The SOP stops short of adding a licensing requirement for DIMS custodians, but instead takes the following measures:

- Clarifying that a DIMS custodian is a "broker" for the purposes of the FAA, and hence subject to the broker obligations under that legislation

- Expanding the regulation making powers in the FMC Bill to potentially provide for FAA custody requirements for retail clients to be extended to wholesale clients.

In addition to these changes, other key additions to the DIMS provisions in the FMC Bill and FAA include:

- Adding statutory duties for AFAs providing DIMSs under the FAA, that correspond with the duties imposed on FMC licensed DIMS providers
- Enabling the FAA to individually authorise AFAs to provide DIMSs as part of the authorisation process
- Removing the ability of QFEs to provide DIMSs, so that an FMC licence will be the only means for a corporate entity to provide DIMSs.

Part 6A - Financial reporting

Part 6A (it was added to the FMC Bill later in its development, hence the non-sequential numbering) sets out issuers' requirements to maintain proper accounting records and have financial statements audited. It is virtually unchanged by the SOP, other than adding the FMA to the list of persons issuers must make their accounting records available for inspection by.

Readers should be aware, however, that the Financial Reporting Bill, once enacted, will replace the existing Part 6A and add a new financial reporting regime. Essentially the existing obligations that issuers have under the Financial Reporting Act 1993 will be moved to the FMC Bill. This will have the effect of bringing them more directly within the FMA's scope for investigation and enforcement purposes, together with some oversight of standard setting and the FMA's exemption power. The "new look" Part 6A can be viewed here. For Parliamentary procedural reasons, the amendments are in a (separate) SOP to the Financial Reporting Bill.

Part Seven - Enforcement

Given the extensive discussion of the FMC Bill's liability regime at early stages of the legislative process, it is perhaps unsurprising that there have been few changes at this late stage – the relevant provisions have all been extensively reviewed and amended prior to the SOP being drafted.

The enforcement and liability provisions of the Bill have had the following key changes:

- The stop order, direction order, and unsolicited offer order powers have been expanded to enable the FMA to issue "pre-emptive" orders where the FMA considers that a market participant is likely to contravene a relevant provision
- Consequential changes in line with the removal of the FTA carve-out as described above in Part 2
- An ability for regulations to prescribe situations where directors will not be held liable for disclosure contraventions – the Cabinet paper for the SOP notes that in some situations the associated costs of doing so may outweigh the benefits of holding directors liable, and emphasises that this would not affect the criminal liability provisions in the FMC Bill.

Next steps

When Parliament next sits (on 7 May 2013) the SOP will be tabled by the Minister. Given the bipartisan support for the FMC Bill, we expect that it will complete the Parliamentary process and become law without further changes.

MBIE officials are currently working on the regulations, which are necessary to give effect to the FMC Bill. Their indicative timetable for finalising these regulations and the FMC Bill coming into force is May 2014, but this may be subject to slippage.

Buddle Findlay will continue to provide updates and seminars on the new regime as the FMC Bill and the regulations develop.

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