

Response to the request for submissions by

Ministry of Economic Development  
on the  
Financial Markets Conduct Bill

6 September 2011

STRICTLY CONFIDENTIAL



## TABLE OF CONTENTS

INTRODUCTION .....	3
EXECUTIVE SUMMARY .....	3
SUBMISSIONS.....	4
CONCLUSION	
.....	3
3	

## 1.0 INTRODUCTION

1.1 This submission has been prepared by the Bank of New Zealand ('BNZ') in response to the request by the Ministry of Economic Development ('MED') on the Financial Markets Conduct Bill ('Bill').

## 2.0 EXECUTIVE SUMMARY

2.1 BNZ welcomes this opportunity to provide this submission on the Bill. We also take this opportunity to commend the work of officials in the lead up to the Exposure Draft and, in particular, the consultative approach taken by Bryan Chapple and his team.

2.2 We endorse both the concept of setting out clear purposes for this framework legislation and the purposes themselves, in particular the first purpose "promote the confident and informed participation of businesses, investors, and consumers in the financial markets". We consider that the Bill constitutes a great leap forward in setting the regulatory groundwork for a strong domestic capital markets.

2.3 Together with technical and drafting matters, we have focused our submissions in the Bill on areas which we think have the potential to create unintended adverse consequences that are either unnecessary to achieve the regulatory goals or outweigh the benefits from the particular approach taken.

2.4 One of the key challenges facing the domestic retail capital markets is that attention is disproportionately taken up by the recent failures that have occurred there. Despite a global financial crisis and subsequent deleveraging and recessionary conditions, the problems in the New Zealand retail market in the past few years have been overwhelmingly confined to a single part of the market: unlisted debenture debt instruments continuously offered by finance companies lending, often on a subordinated basis, to speculative property and similar projects. This particular issue was addressed early in the reform process by the dual-pronged approach of requiring higher standards of the financial adviser industry (the Financial Advisers Act 2008) and imposing prudential requirements and supervision on second-tier lenders (Part 5D of the Reserve Bank of New Zealand Act 1989).

2.5 Our primary concern in the Bill in terms of its overall impacts and tenor is that its provisions and instruments are framed not just with a view to curtailing and controlling the activities of a sector that now, for all intents and purposes, no longer exists but with the positive vision of a retail market populated with strong and responsible issuers. A key

consideration in framing legislation for a specific market (the New Zealand retail securities market) is that no market exists in a competitive vacuum. Strong issuers – who are the key to the market in terms of liquidity and reducing the risks from participation – are characterised by the choice they have in offering formats (particularly offshore wholesale formats such as EMTN and USPP), in their conservative and cautious approach to liability, and in their deep concern for their reputation and the value of their public brand. The involvement of these sorts of issuers in the domestic retail market is crucial not just to the strength and vibrancy of that market but to retail investor outcomes. It is therefore vital that the Bill is designed as much with these issuers in mind as with higher risk issuers who have tarnished the reputation of the market and whose options outside the domestic retail market are normally very limited.

- 2.6 In relation to the question of the attractiveness of the domestic retail market to high quality issuers (and the corresponding issue of “adverse selection” where this does not occur, we strongly urge that the “waiting period” provisions are amended so that the FMA’s consideration occurs prior to launch. Not only does the post-launch consideration create “execution” risk that represents a significant drawback for this offering format for high quality issuers, the exercise of a stop power (other than one initiated by the issuer itself due to a change in circumstances) would be damaging to the standing and appeal of the domestic retail market to a degree that is difficult to exaggerate.

### 3.0 SUBMISSIONS

Clause number	Clause heading	Submission
Part 1	Preliminary provisions	
Clause 6	Interpretation	
	“acquire”	In respect of the reference to “entering into the relevant legal relationship”, this ought to be expressed as relating only to derivatives, consistent with the definition of “dispose of” and the current treatment in the Securities Markets Act.
	“business”	It is not clear why “business” carries the proviso: “whether or not carried on with the intention of making a pecuniary profit”. It is normally inherent in the concept of a business that it has such intent and the actual usage of the term in the Bill does not tend to suggest any different usage is appropriate.

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	“confirmation”	<p>It may be useful to have a definition of “confirmation” in connection with the requirement in section<sup>1</sup> 197 to provide confirmations (see also “statement of holding” below):</p> <p>“<b>confirmation</b>, in relation to any derivative transaction, means any confirmation or other document entered into or exchanged between the parties to that derivative transaction which creates or evidences present or future rights or obligations to provide or receive consideration, but does not include any master or similar agreement or schedule to any such agreement”</p>
	“give”	<p>The definition of “give” is the same as the current definition of “receive” in the Securities Act.</p> <p>We submit that the definition should be modernised to take into account electronic modes of delivery which are now commonplace. These modes include:</p> <ul style="list-style-type: none"> <li>• delivery of a PDF to a known email address</li> <li>• delivery of a hyperlink to a known email address</li> </ul> <p>This refinement could be achieved by a simple addition to the definition, which clarifies that, for the purposes of the definition, attachment of a PDF or hyperlink (URL) to a known email address for a person is (in the absence of a “bounce back” email) sufficient to constitute the “giving “ of that document.</p>
	“recognised rating agency”	<p>We have submitted that the provisions with respect to consent for “statements” (section 41) and with respect to liability for those statements (section 462(b)(v)) should exclude ratings (and related disclosure) given by credit rating agencies (such as Standard &amp; Poor’s, Moody’s and Fitch) and fund rating agencies (such as Morningstar). The importance of credit ratings is recognised by the Reserve Bank’s regime for non-bank deposit takers, such that they are a regulatory requirement for those entities – refer generally <a href="http://www.rbnz.govt.nz/finstab/nbdt/creditratings/3914649.pdf">http://www.rbnz.govt.nz/finstab/nbdt/creditratings/3914649.pdf</a>.</p> <p>The quality and integrity of those ratings is normally managed by the concept of a “recognised” or “approved” rating agency – for policies relevant to such approval, refer to <a href="http://www.rbnz.govt.nz/finstab/nbdt/regulation/3421403.pdf">http://www.rbnz.govt.nz/finstab/nbdt/regulation/3421403.pdf</a>.</p> <p>The new Non-Bank Deposit Takers Bill contains a definition of “approved rating agency”, being an agency that is approved by the Reserve Bank under the procedures in clause 85 of that Bill.</p> <p>We submit that a similar approach should be adopted in the Bill. Because the Bill also regulates Managed Investment Schemes, the ambit of such agencies should be expanded to include approved or recognised fund rating agencies, which</p>

<sup>1</sup> In our submissions we have used the word “section” for clauses in the body of the Bill in order to distinguish from the “clauses” in the Schedules to the Bill.

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		provide an understandable quick reference guide to the relative performance of fund managers.
	<b>“underwriter”</b>	<p>One change that has not been previously signalled and which represents a material change from current law is the</p> <p>Section 59:</p> <p style="padding-left: 40px;">For the purpose of working out whether a condition referred to in this section or section 61(2)(a) has been satisfied, a person who has agreed to take financial products as an underwriter is taken to have applied for those products.</p> <p>Section 462:</p> <p style="padding-left: 40px;">(iv) an underwriter (but not a sub-underwriter) to the issue or sale who is named in the PDS or register entry with the underwriter’s consent:</p> <p>Under section 62, underwriters must also inform authorities with respect to disclosure deficiencies.</p> <p>Given the significance of these provisions and the significant ambiguity in ordinary and market usage about what an “underwriter” is, we submit that this term needs to be defined.</p> <p>In relation to the market ambiguity for the term “underwriter”, we note that genuine underwrites are relatively rare in the New Zealand securities market (and practically non-existent in the debt market). Rather, the practice is to appoint one or more investment banking / broking institutions as “arrangers”, to assist in formulating, documenting and marketing the offer, a group of such institutions as “joint lead managers” to assist in marketing and distributing the securities, and sometimes “co-managers”, who have a lesser role in advising the issuer or marketing the offer, but generally receive this title in recognition of having agreed to take a large firm allocation of securities during the bookbuild process. There are many variations on this basic theme – eg sometimes there is no arranger and sometimes there may only be a single “lead manager”.</p> <p>The key with all these titles, other than co-manager, is that they do not normally agree to underwrite the issue <i>per se</i>, but merely to facilitate the offer. A part of the ambiguity of the phrase “underwriter” is that such role is often referred to as a “best endeavours underwriting”. Another ambiguity is that the term “underwriter” under the United States securities laws would refer generally to all those institutions. Finally, and most significantly in a New Zealand context, the selling process usually does involve an agreement to take securities whether there is an end-buyer or not, because the bookbuild process involves the issuer and lead managers soliciting bids which become legally binding firm allocations. These are drawn from the core manager panel but also from a much wider range of retail brokers, banks (in particular their private banking or portfolio arms) and buy-side institutions. These firm allocations are probably “underwrites” in the proper sense, but the brokers involved in them will often have had no</p>

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		<p>part at all in advising the issuer, structuring the issue or due diligence.</p> <p>In terms of the contextual indications about the meaning of “underwriter”, the “but not a sub-underwriter” reference suggests an actual underwriting, and therefore would exclude the normal arranger / joint lead manager roles, and would result in a situation where underwriter responsibility is sporadic and more or less random. Section 59 (which relates to minimum fulfilment conditions) tends to support the interpretation that institutions acquiring under firm allocation are underwriters – this would be a poor outcome because the end brokers / advisers in the distribution chain have little part in the offering process beyond getting in touch with their retail clients and providing them with the offering documents delivered by the issuer or advising on the basis of those documents. To involve such a wide group in the due diligence process would be totally unwieldy and impractical without serving any useful regulatory end.</p> <p>We have submitted in relation to section 462 that care needs to be taken in determining whether the overall consequences of introducing underwriter liability into the New Zealand market. If that step is undertaken, we submit that a definition will be required to properly frame the extent of who is to be covered by this.</p>
<b>Clause 7</b>	<b>Relationship between derivatives and the Gambling Act 2003</b>	<p>In our view, the Gambling Act 2003 did not change the previous law, which is that a derivative entered into for a legitimate commercial purpose is not “gambling”. For example, in <i>Morgan Grenfell &amp; Co Ltd v Welwyn Hatfield District Council</i> [1995] 1 All ER 1, it was held that interest rate swaps and other derivative transactions are not void wagering contracts where entered into for a commercial purpose. Moreover, Hobhouse J effectively created a presumption that transactions in the capital or loan markets are not for wagering purposes:</p> <p style="padding-left: 40px;">“In the context of interest rate swap contracts entered into by parties or institutions involved in the capital market and the making or receiving of loans, the normal inference will be that the contracts are not gaming or wagering but are commercial or financial transactions to which the law will, in the absence of some other consideration, give full recognition and effect.”</p> <p>This line of authority is old (going back at least as far as <i>Carlill v Carbolic Smoke Ball Co</i> [1892] 2 QB 484) and is consistent, but unfortunately it is not particularly amenable to reproduction in the language of statute, because the question of appropriate commercial purpose will largely be a discretionary matter for judges based on facts and circumstances. If any exception is cast too broadly it would defeat the objects of the</p>

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		<p>Gambling Act as it would not be difficult for a syndicate to, for example, structure sports betting as a contract for differences. Equally, the test of 'commercial purpose' is not particularly helpful (beyond the intuitive level) because the syndicate would have a commercial purpose, just not one that is viewed as legitimate in the eyes of the law unless properly licensed.</p> <p>As a result, we do not favour an exemption that is either so broad as to stretch to all derivatives (Option A) nor one that does not correlate with the common law distinction between gambling and legitimate commercial transactions (which is true of both Option B and Option C).</p> <p>If this matter is to have any regulatory treatment, the best formulation is a statement that the common law is unaffected. However, the best approach may be simply to note the common law in the Explanatory Note to the legislation, particularly since such materials are now acceptable in interpreting statutes at common law, including in New Zealand.</p>
<b>Clause 9(2)(c)</b>	<b>Definitions of managed investment scheme and financial benefit</b>	
	<b>Insurance contracts</b>	The exclusion from the definition of a managed investment scheme of a "pure risk" contract of insurance in clause 9(2)(c) should be the same as that used in the Financial Advisers (Definitions, Voluntary Authorisation, Prescribed Entities, and Exemptions) Regulations 2011.
<b>Clause 10</b>	<b>Definitions of "issuer" and "issued"</b>	
<b>10(1)(b)(i)</b>	<b>"Issuer" – debt security</b>	Because "debt security" is defined to include redeemable shares, the definition here should refer to "interest <u>or other returns</u> ".
<b>10.1(b)(iv)</b>	<b>"Issuer" – derivative</b>	<p>In our view the complications surrounding who would be the "issuer" of an exchange-traded derivatives is a red herring because there is no good case for regulating transactions in such a market, or participants in such transactions (beyond regulation of the market itself, if it is in New Zealand). The definition of "issuer" does not fit exchange-traded derivatives because they do not have characteristics of securities and do not fit well within a framework designed for securities.</p> <p>In particular, there is no merit in having a concept such as the "issuer" of standardised futures and options issued in a market such as the Sydney Futures Exchange because:</p> <ul style="list-style-type: none"> <li>• the real issuer is the exchange or clearing house and there can be a variety of unknown holders during the life of the instrument, any of whom has as valid a claim to being the 'issuer' as the first holder;</li> <li>• information from or about the "issuer" is irrelevant to</li> </ul>

Clause number	Clause heading	Submission
		<p>the value of the instrument, which derives from the underlying; and</p> <ul style="list-style-type: none"> <li>there is no counterparty risk because all positions are novated to the central counterparty.</li> </ul> <p>For these reasons, we do not see any difficulty with the definition of “issuer” in the Bill in relation to derivatives, but there ought to be an exclusion of exchange-traded derivatives from the ambit of the Bill (ie only the exchanges themselves should be regulated).</p> <p>Because there are very few licensed exchanges in New Zealand but increasingly counterparties will, or will be required to, conduct what have traditionally been OTC transactions through central clearing counterparties (CCPs), it will be important to have a recognition regime for overseas exchanges and CCPs. Ideally, this should not be a situation of case-by-case licensing but of recognising specified exchanges as defined in regulations and others that meet defined characteristics.</p>
10(2)(b)	“Issued” – derivatives	<p>In relation to derivatives, there is a distinction between the framework documents that may be entered into (most commonly an ISDA Master Agreement and accompanying Schedule, and sometimes a Credit Support Annex) and which do not give rise to any transaction, rights or liabilities, and the Confirmation that defines a particular transaction that will have the terms set out in the Confirmation, Schedule and Master Agreement (in that order). Because it would sensibly be the creation or incurring of rights/obligations that would normally be associated with something being “issued”, then it would make sense to relate actual issuance to that last step in the process. It is also not uncommon to have Confirmations entered into before the Master Agreement and Schedule have been agreed (and the ISDA documentation provides for these circumstances). We have previously suggested that a definition of “confirmation” be added in relation to the obligations in section 197. If that is done, this subsection could be amended to say:</p> <p>“a derivative is issued to a person when the person <u>enters into a particular transaction</u> <del>enters into the legal relationship</del> that constitutes the derivative <u>and under which present or future rights or obligations to provide or receive consideration are created or evidenced</u>”</p>
10(2)(c)(i)	“Issued” – KiwiSaver	<p>We support the clarification (and effective confirmation of existing practice) in clause 10(2)(c) that making a further contribution to a superannuation or KiwiSaver scheme does not constitute a fresh issue of a financial product.</p> <p>We submit that this concept should also apply to other types of managed investment schemes. This would remedy the</p>

Clause number	Clause heading	Submission
		<p>current uncertainty that exists in the market as to whether a new investment statement (or PDS under the Bill) needs to be provided when it is changed. This requirement is onerous and unnecessary, particularly for investors who make regular contributions to the scheme.</p> <p>If there are materially adverse circumstances affecting the scheme, or there is a materially (adverse) misleading statement in a PDS, there is adequate protection for investors under clause 63 (i.e. the offer could not continue), and in those circumstances it would be reasonable to require an issuer to give a new PDS to “repeat” investors before their next investment, so that they have the opportunity to decide whether to continue with that investment (or indeed whether to withdraw).</p>
<b>Clause 12</b>	<b>Miscellaneous interpretation provisions</b>	
	<b>12(2)(c)</b>	<p>This provision, which is a replication of section 55(b)(iii) of the Securities Act, is unnecessarily problematic with respect to the words “incorporated by reference or referred to in” because these have (understandably on the face of it) been interpreted as meaning that when a web reference / url is included in an offer document, all the material in that website is potentially covered by the relevant regulations, prohibitions and liabilities relating to offer documents and or “advertisements”, and would usually be impossible to properly diligence as part of an ordinary offering process. Because it is useful to refer investors to the general website, and reasonably investors would not expect all material on an issuer’s general website to be subject to the level of scrutiny that a ‘prospectus’ type document should receive, we recommend that there be a proviso to this clause along the following lines:</p> <p style="text-align: center;"><u>“provided that a reference to a website shall not be deemed to incorporate by reference the whole website”</u></p>
<b>Part 3</b>	<b>Disclosure offers of financial products</b>	
<b>Clauses 28-30</b>	<b>Options and convertibles</b>	
		<p>We agree that, with options and convertibles, the offer should be of both the option/convertible and the underlying and that both should be subject to disclosure when the option / convertible is issued and not upon exercise or conversion. We also submit that there should be no disclosure on exercise or conversion beyond the relevant ongoing requirements of the general law (which will include publication of current financial statements and, if listed, various periodic and continuous disclosure requirements).</p> <p>The drafting of sections 28 to 30 (which is based on the Australian Corporations Act) seems to us very opaque. We wonder if these clauses could not be drafted in a manner to</p>

Clause number	Clause heading	Submission
		make their meaning more clear / plain English.
<b>Clause 33</b>	<b>Purpose of PDS</b>	<p>For the most part, the disclosure regime is left to be developed under regulations. However, clause 33 provides that the PDS, like the existing investment statements, is aimed at the “prudent but non-expert person”.</p> <p>We question whether this is the optimal regulatory approach to mandatory disclosure as it continues to emphasise a “do it yourself” approach to investing that arguably has not yielded beneficial results in New Zealand and it omits any reference to the information needs of financial intermediaries and securities analysts, an issue that is highlighted under the recently effective requirements of the Financial Advisers Act 2008 and related Code rules. Connected to this is that there is little direction on what the purpose, scope and content of the Register of Securities will be, particular in relation to the now-abandoned concept of a prospectus for securities issues.</p>
<b>Clauses 39</b>	<b>Disclosure of material information</b>	<p>We support the move toward a more principles-based approach to disclosure, away from the prescriptive ‘check the box’ regime that currently applies.</p> <p>For managed investment schemes, we believe disclosure should be <b>targeted</b>. Rather than requiring a PDS and the register entries to disclose all “material information”, the level of disclosure required should be targeted to the scheme in question.</p> <p>The “material information” disclosure touchstone for schemes could be aligned (or similar to) the Australian standard in section 1013E of the Corporations Act – being “information that might reasonably be expected to have a material influence on the decision of a reasonable person, as a retail investor, whether to acquire the product” – to the extent it is actually known by the manager (see section 1013C(2) of the Corporations Act).</p> <p>This recognises that an investment in a scheme is fundamentally different proposition from an investment in a company issuing debt or equity. The former involves an investment in a product managed by a company with the investment risk reflecting the investment parameters and policies of the product itself; the latter involves an investment in the company itself, with the investment risk being on <b>the company</b>. In our view this difference is critical - the extent of risk attaching to a managed fund is naturally constrained by its investment parameters, and is therefore less than an investment in a company where by definition an investor takes a risk on the company’s business, its directors and its management. There is no need for the same standard of</p>

Clause number	Clause heading	Submission
		<p>“material information” disclosure to apply to schemes (where it should be possible to largely prescribe the necessary content). These refinements should be complemented with:</p> <ul style="list-style-type: none"> <li>• an amendment to the liability regime to the effect that, for schemes, the issuer is primarily liable for any breaches, with the directors only being liable if the issuer does not pay (reflecting the reality that the business is more likely to have the product knowledge than the directors);</li> <li>• criminal liability on directors only arising in egregious situations (where they have engaged in “knowing and reckless” behaviour (e.g. where a director has knowingly permitted a PDS to be issued with a materially misleading statement)).</li> </ul> <p>These changes would take us closer to the Australian position, and also relieve the need for extensive due diligence for offer material relating to managed investment schemes.</p> <p>In our view, this would make New Zealand a more attractive destination for managed investment schemes, consistent with the purposes of the Act set out in clauses 3 and 4.</p>
<b>Clause 40</b>	<b>Material information</b>	
		<p>From our experience the overwhelmingly predominant formulation of “material information” in the New Zealand market is Option B, and therefore we submit that should be the favoured option. Predicting demand is a fraught business and lacks the objectivity conferred by the notion of “persons who commonly invest in financial products”. Option B is also most consistent with New Zealand case law (eg <i>Coleman v Myers</i> [1977] 2 NZLR 225) and with the NZX Listing Rules.</p>
<b>Clause 41</b>	<b>Consent of person to whom statement is attributed</b>	
		<p>This is an important provision because of the liability attaching to persons consenting under section 462(4)(b)(v) and, in the light of that liability, the difficulty the issuer will have in obtaining consents to statements. As a result of this, care must be taken in framing the extent of the ‘statements’ that trigger this requirement, in order to avoid the offering process becoming more burdensome and expensive than it needs to be (particularly since there are no materiality or other qualifications). We submit that there are a number of matters that should be excluded from the ambit of the section 41 requirement (and the section 462(4)(b)(v) consequences) for policy reasons or because they are too routine, minor or immaterial to justify these requirements, as follows:</p> <ul style="list-style-type: none"> <li>• <b>Credit and other independent ratings:</b> Credit ratings, in relation to debt securities in particular, are a valuable source of independent information for investors. This is evidenced, for example, by the legislative policy of</li> </ul>

Clause number	Clause heading	Submission
		<p>requiring non-bank deposit takers to have and disclose such ratings, under Part 5D of the Reserve Bank of New Zealand Act 1989. The current position adopted in relation to the provisions of section 40 of the Securities Act in relation to statements by experts of not treating an alphanumerical credit rating (or basic definitions relating to such rating or standard warnings or disclaimers) as a “statement”. The doubt on this point is unsatisfactory and ultimately rating agencies are likely to prevent their ratings being disclosed in retail offers if they have to sign a consent that will attract liability. Since the disclosure of credit ratings is something that should be encouraged as a policy matter, they should be explicitly excluded from this requirement. Similarly, there are rating agencies for funds, such as Morningstar, to which we submit the same principles should apply.</p> <ul style="list-style-type: none"> <li>• <b>“No guarantee” or similar statements by or about affiliates:</b> In many cases, for regulatory reasons or to avoid misleading investors, there is disclosure about other members of a corporate group, typically including the statement that they do not guarantee the relevant securities. For example, in bank groups it is an explicit APRA requirement to state that securities issued by a subsidiary (including for example a New Zealand registered bank) are not deposit liabilities of the Australian bank parent, and in any event issuers will often choose to state that parent companies or affiliates do not guarantee the securities in order to avoid misleading investors or simply for clarity about the credit. Such statements should be excluded from the ambit of section 41 because ultimately such statements are at least anodyne and sometimes useful, but to get a written consent in circumstances where liability (and in particular, for foreign companies, unfamiliar liability) is attached can be a very arduous and costly procedure.</li> <li>• <b>Chairpersons’ letters:</b> It is very common to include in an offer document a communication from the board of the issuer, or its chair, concerning the offer. In our submission such statements should not be discouraged because they tend to be briefer and more direct than other parts of the offer document and to focus on key matters of relevance about the issuer or the securities. By their nature, chairman’s letters also tend to be closely scrutinised for balance and not being misleading. Given the extensive and unavoidable liability already borne by the directors in relation to an offer of securities, in our view there is no benefit in imposing a further layer of potential liability by virtue of this being a “statement by a person”.</li> <li>• <b>Names and brief details about participants and agents:</b> An offer of a regulated product will normally involve a number of non-issuer parties, including a trustee, registrar and paying agent, auditor, legal advisers and joint lead managers. In our view there is nothing to be gained</li> </ul>

Clause number	Clause heading	Submission
		<p>by requiring their written consent to inclusion of anodyne information such as their name, address and a brief description of their role.</p> <p>We therefore submit that section 41 should be amended by adding a new subsection (2) or (3) as follows:</p> <p><b><u>The following shall not be a statement for the purposes of this section and section 462(4)(b)(v) (but without limiting any other provision of this Act):</u></b></p> <p>(a) <b><u>A credit or fund rating [from an internationally recognised credit or fund rating agency], any definitions given in connection with that rating, or any customary warnings, disclaimers or similar information with respect to such ratings;</u></b></p> <p>(b) <b><u>Any statement by or on behalf of the directors of the issuer;</u></b></p> <p>(c) <b><u>Any statement concerning the credit relationship between the issuer and any of its related bodies corporate, including the extent to which they do or do not guarantee the relevant securities; or</u></b></p> <p>(d) <b><u>The name, address and role of agents to the issuer or other participants in the offer.</u></b></p> <p>In our submissions on section 6 we suggested that there be a new definition of “recognised rating agency” or “approved rating agency” for this purpose.</p>
<b>Clauses 45-46</b>	<b>Notification of FMA; Waiting period</b>	<p>The notion of a waiting period has been included in recent amendments to the Securities Act and is continued in sections 45 <i>et seq</i> of the Bill. In our view this approach is a materially retrograde step from the previous practice of regulatory pre-vetting of prospectuses, and one which is unnecessary to achieve the regulatory objectives (including of remedying the defects in the pre-vetting system).</p> <p>This is particularly important in New Zealand because of the constrained size of the domestic capital market and the consequent critical factor of timing and execution in relation to retail offers of securities. For example, if two significant offerings of debt or equity securities took place at the same time (as can happen because of the restrictions on ‘pre-prospectus publicity), this can significantly impact on the success of one or both offers because of the capacity of the market.</p> <p>In practical terms, it is also a less than optimal way to proceed because, for listed securities, all offering documents and advertisements will be scrutinised by NZX. Typically these</p>

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		<p>processes have been run simultaneously and in concert to ensure that each overseer's comments are incorporated in a consistent manner.</p> <p>The consequences of exercising influence or explicit powers to require amendment of disclosures before or after launch is very significant for both issuers and the market in general. The costs of printing offering documents are a key differentiator between the domestic retail market and the wholesale markets here and offshore (which are always an option for better credits but not generally for lesser ones), so the requirement to re-issue a PDS post-launch can be a very costly exercise, after additional legal, audit and other costs are also factored in. At least as significantly, a requirement to suspend an offer and re-do a PDS after launch would be a very public humiliation for the issuer, and for the senior managers in relation to their board. We submit also, on the basis of the experience our advisers have had with highly rated corporate issuers, that the exercise of stop orders and requirements to re-do prospectuses would be damaging to the attractiveness of the market to strong and credible issuers in a way that materially outweighs the 'deterrent' benefit (it is different where this is prompted by an issuer itself in relation to a change of circumstance – something which should be rare in the light of the extensive due diligence undertaken by responsible issuers).</p> <p>In our opinion, it is no answer that these provisions have abided in the Australian market. First, while that is true, it is also true that they cause problems in that market (including by being a factor in dissuading strong credits from issuing in that format). Second, the Australian market is substantially larger than the New Zealand market and is not engaged in the same battle for survival (in terms of attracting highly rated issuers) against competing offshore and wholesale formats, such as USPP.</p> <p>The main purpose of the Bill is "to promote the confident and informed participation of businesses, investors, and consumers in the financial markets". This purpose is best achieved by enabling issuers to engage the FMA's consideration of their offering documents prior to launch. The purposes of the Bill would not be advanced by making public examples of one or two issuers in a way that will repel quality issuers from engaging in retail issuance.</p> <p>Ultimately these factors impact on the appeal of the domestic retail capital markets, their vibrancy and liquidity. The absence of these in the New Zealand retail space, and the consequential impact on the quality of choice available to New Zealand retail investors, on was one of the key matters underlying the securities reform process.</p>
<b>Clause 55</b>	<b>Consents needed for lodgement</b>	
		Consistent with our comments on clause 39 above, we submit

Clause number	Clause heading	Submission
		that director consents should not be required to accompany a PDS when lodged.
<b>Clause 63</b>	<b>Misleading or deceptive statements etc</b>	
63(1)(a)		<p>We submit that the requirement to cease to offer financial products under a regulated offer where there is a misleading statement in a PDS or register entry should only apply if that statement is misleading “in a material adverse particular”.</p> <p>Items which may be misleading but are beneficial to investors should not prevent the issuer from continuing to offer the product, and it should be open for the issuer in those circumstances simply to correct the statement when the PDS is next updated for other reasons (this reflects existing market practice for materially beneficial changes, a recent example being the changes to the PIE tax rates, where many issuers chose to wait until the next “rollover” to update the prospectus and investment statement to reflect those rate changes).</p>
<b>Clause 67</b>	<b>Money for financial products to be held on trust</b>	
		<p>Section 67 requires money paid to an issuer of regulated products (which would include derivatives offered to a non-exempted person) to be held on trust. This could create operational difficulties, for example where margin accounts are maintained or collateral is posted.</p> <p>If (as we have submitted) the “issue” of derivatives is defined as being when a particular is entered into, there should not be a problem with this in terms of acquisition of derivatives. To address the question of collateral provided for OTC derivatives or margin provided for quoted derivatives, we suggest that the example in section 67(2)(b) be extended to say:</p> <p style="padding-left: 40px;">“(for example ... to pay a fee, <u>premium, any collateral or margin</u>)”</p> <p>We also submit that section 67(2)(d) should be expanded to say:</p> <p style="padding-left: 40px;">“... A’s instructions <u>or prior agreement</u>.”</p>
<b>Clause 69</b>	<b>Prohibition of offers in course of unsolicited meetings</b>	
		<p>We submit that this clause, which goes well beyond current law, is too restrictive. It could hamstring advisers from instigating legitimate conversations with existing or new customers about financial products which may be appropriate for them, as well as constrain employer / employee discussions regarding membership of an employer-based superannuation scheme. The Financial Advisers Act requirements provide adequate consumer protection for these types of conversations.</p>

Clause number	Clause heading	Submission
		We believe this should be amended to be more consistent with the current position – a prohibition on door-to-door sales only.
<b>Subpart 3</b>	<b>Advertising and publicity</b>	
		<p>We support the principles-based approach to the regulation of advertising and publicity in connection with offers of regulated products. However, there is one prescriptive provision among the Securities Regulations 2009 that we submit merits inclusion in the Bill, namely regulation 36:</p> <p style="padding-left: 40px;">A registered prospectus or an advertisement must not state or imply that investment in the securities to which it relates is safe or free from risk.</p> <p>Our reasons for this view are that it will almost never be appropriate to describe an investment as “safe or free from risk”, but this is something that – from our experience and that of our advisers – marketers seem to have an almost irresistible urge to do. As a result, this provision tends to reduce issuer’s compliance cost by delivering a ready answer to why statements like “this investment is safe as houses” should not be included in offering documents or advertisements.</p>
<b>Schedule 1</b>	<b>Disclosure offers of financial products (when disclosure is required)</b>	
<b>Clause 11</b>	<b>Offers of financial products for no consideration</b>	While we agree with the concept of this clause, it may require some clarification because it provides that <b>options</b> are not covered (in the normal course they would not be in this category because a premium is usually payable to the writer of the option upon issue) but make no reference to other derivatives for which no upfront consideration will necessarily be payable, notably <b>swaps</b> .
<b>Clause 18</b>	<b>Offers of category 2 products by registered banks</b>	We strongly support the exclusion for category 2 products and debt securities issued by registered banks and their subsidiaries (clause 18 of Schedule 1). Such products are simple and well understood and this treatment appropriately recognises the prudential supervision, capital adequacy, liquidity and other requirements to which registered banks are subject under the Reserve Bank of New Zealand Act 1989.
	<b>Forward exchange contracts</b>	A large percentage of derivatives issued both retail and wholesale are vanilla and well-understood currency forwards. Where issued by a registered bank (which is a regulated entity) and for a period of, say, less than one year, there does not seem to be any adequate justification for imposing additional requirements, which add costs without corresponding benefits.

Clause number	Clause heading	Submission
Parts 3 & 4	Exclusion from governance requirements	We support the approach that has been taken of identifying areas where more focused, targeted or limited disclosures may be appropriate. In general, we think the current one-size-fits-all disclosure regime creates more problems than it solves. A further alternative is to take an approach more akin to that in Australia and have a broadly principles based approach to disclosure without prescribing particular requirements in relevant areas. However, such a regime to a degree rests on an evolved market approach and the history of the New Zealand market has been based around an additional level of regulatory guidance.
Part 4 and schedule 3	Governance of financial products	
Clause 112	Additional and ongoing registration requirements for KiwiSaver schemes	
		<p>We submit that the word “<i>principal</i>” should be inserted before the word “<i>purpose</i>”.</p> <p>Section 116(1)(b) of the KiwiSaver Act 2006 and section 2A(1)(a)(i) of the Superannuation Schemes Act 1989 both use the expression “<i>principal purpose</i>”. This removes any doubt about the permissibility of such features as:</p> <ul style="list-style-type: none"> <li>• the home purchase, significant financial hardship and emigration-based withdrawal facilities that are compulsory for KiwiSaver schemes;</li> <li>• the leaving service benefits and early partial withdrawal facilities provided by registered superannuation schemes (including our own Bank of New Zealand Officers’ Provident Association); and</li> <li>• the provision of death and disability insurance.</li> </ul> <p>We expect that the early withdrawal provisions in the KiwiSaver Scheme Rules could reliably be said to override the “<i>retirement benefits</i>” purpose constraint for KiwiSaver schemes. Clause 113(1)(d) of the draft Bill also clarifies that a superannuation scheme trust deed can allow non-retirement-based withdrawals in “<i>defined circumstances</i>” such as financial hardship or ceasing employment.</p> <p>However, it is unclear whether the purpose constraint will allow:</p> <ul style="list-style-type: none"> <li>• for superannuation schemes, the maintenance of other early withdrawal facilities such as those allowing partial withdrawals (as of right) after certain membership periods and/or at certain intervals; or</li> <li>• for superannuation and KiwiSaver schemes, the provision of insured benefits payable on (for example) death or disability.</li> </ul> <p>Superannuation schemes commonly provide life insurance</p>

Clause number	Clause heading	Submission
		<p>benefits, for example. Additionally, section 68 of the KiwiSaver Act expressly contemplates a KiwiSaver scheme provider receiving money in respect of both:</p> <ul style="list-style-type: none"> <li>• the provision of retirement benefits for members of the scheme; and</li> <li>• other things (for example life insurance premiums).</li> </ul> <p>Unless the word “<i>principal</i>” is left intact, the legislation risks adversely affecting existing superannuation schemes and unduly restricting innovation and the provision of value-adds for participants.</p>
<b>Clause 117</b>	<b>Contents of governing document for registered scheme</b>	
117(1)(f)		<p>The reference to “fees” in this clause is too narrow. The clause should be amended so that:</p> <ul style="list-style-type: none"> <li>• it is possible to specify a numerical range of (or cap on) fees, and</li> <li>• fees payable to service providers (such as the investment manager) can be reimbursed as an expense of the scheme, rather than being limited to being expressed as a fee.</li> </ul> <p>Fees are required to be disclosed to investors in any event, and for that reason are ultimately constrained by the market forces (and can be a key competitive differentiator).</p>
117(1)(j)		<p>The reference to the governing document containing any other matter that “materially affects...the management and operation of the scheme” does not recognise that there may be other documents which affect the management and operation of the scheme (for example, an investment management agreement or a registry agreement), which cannot by definition appear in the governing document.</p> <p>This issue could be easily remedied by adding the following words (or similar) to the end of clause (117(1)(j)(i):</p> <p style="text-align: center;"><i>“by the manager (but not by any third parties who provide services to, or in respect of, the scheme)”</i></p>
<b>Clause 125</b>	<b>General duties applying in exercise of Manager’s functions</b>	
125(1)(c)(ii)		<p>The requirement for the manager, when exercising powers or performing duties, to treat scheme participants equitably, imposes too high a standard on the manager, and should be removed.</p> <p>A manager already has common law duties to act in the interest of investors generally (reflected in clause 125(c)(i)). Overlaying those common law duties with a further statutory requirement to treat investors “equitably” creates confusion and is an unnecessary obfuscation of existing common law.</p> <p>When a manager makes decisions concerning a scheme</p>

Clause number	Clause heading	Submission
		inevitably some of those decisions may not be favoured by all investors (for example, a decision to invest in one asset class over another). Providing an actionable claim for those investors (through an argument that they have not been treated “equitably”) will make day to day decision making much more difficult for managers. It could also increase compliance costs, as managers will need to factor the extra statutory liability into their risk / reward assessment when setting management fees.
125(1)(d)		This clause should clarify that a manager is able to use information for other purposes (e.g. marketing other products) where the investor has consented to that use.
<b>Clause 127</b>	<b>Contracting out of management functions</b>	
		<p>It is not uncommon for managers to contract out certain functions (such as custody, registry and investment management), and for the governing document to provide that, as long as that contracting out is reasonable and has been appropriately monitored, the manager is not liable for that performance. Instead, the scheme would have a contractual claim against the provider.</p> <p>This concept should be reflected in the Bill, in place of clause 127(2)(b), to recognise that a manager who has acted entirely prudently should not be liable for the fault of others. Naturally, it would be reasonable for a manager which has been negligent in the selection and/or monitoring of a third party provider not to have the benefit of this type of exoneration.</p>
<b>Clause 132</b>	<b>Duty of manager to provide requested information to supervisor</b>	
132(3)(b)		The requirement for all reports requested by the supervisor to be signed by two directors (or one director, if there is only one) is too onerous and administratively impractical. This requirement should be deleted.
<b>Clause 134</b>	<b>Power of supervisor to engage expert</b>	
134(2)(b)		Expert fees should be able to be reimbursed to the manager out of the assets of the scheme, if the manager is not at fault. This will also act as a natural constraint on the supervisor not to engage an expert lightly, and reserve the appointment of experts for appropriately serious matters, given they are ultimately putting investor funds at risk if the manager is found to be blameless.

Clause number	Clause heading	Submission
<b>Clause 136</b>	<b>Custodian holds scheme property on trust</b>	
136(2)		<p>The requirement for a custodian to ensure that scheme property is “held separate” from other property of the custodian (including other registered schemes) is unclear.</p> <p>Custodians often hold multiple parcels of the same securities on behalf of multiple schemes, and keep separate records of those holdings. Whether that is sufficient to constitute “separate holding” under clause 136(2) is doubtful.</p> <p>This clause should be amended to require separate record-keeping only.</p>
<b>Clause 138</b>	<b>Duty of supervisor to refuse to act on wrongful directions</b>	
138(1)(b)		<p>This clause requires a supervisor to refuse to act on any direction from the manager which is in breach of the scheme’s governing document or statement of investment policies and objectives (SIPO) or any enactment. It significantly extends the previous requirement under section 12(1)(c) of the Unit Trusts Act, which only requires the supervisor to refuse to act if the direction is “manifestly not in the best interests of unit holders”.</p> <p>We believe only the section 12(1)(c) requirement should be carried over into the Bill. Any extension along the lines proposed would:</p> <ul style="list-style-type: none"> <li>• increase compliance costs (which would ultimately be borne by investors), because supervisors will need to build compliance systems to monitor whether a breach will occur, so that they are in a position to act under this clause,</li> <li>• potentially create a hair trigger, requiring the trustee to step into the manager’s sphere of operation more regularly than is appropriate or necessary, and</li> <li>• create uncertainty for managers, and potentially unwelcome (and repetitive) debates over whether each decision it makes is within the terms of the governing document and SIPO.</li> </ul>
<b>Clause 142</b>	<b>Requirement for statement of investment policy and objectives</b>	
		<p>We are not opposed to the requirement to have a SIPO, but believe that it should not be required to be publicly filed but instead should be available to investors on request, for the following reasons:</p> <ul style="list-style-type: none"> <li>• in our experience SIPOs are (or at least should be) “living documents”, which can be updated as often as monthly. Requiring ongoing filing is therefore likely to be administratively burdensome, and</li> <li>• if SIPOs are generally available providers are more</li> </ul>

Clause number	Clause heading	Submission
		<p>likely to include wide investment limits, so as not to give away proprietary investment strategy information to competitors but also to minimise the prospect of limit breaks.</p> <p>It is also worth noting that SIPOs vary greatly in their approach, but common market practice (if there is one) is that the SIPO is a “high level” statement of investment objectives and investment type, with detailed asset allocations being set out in a subsidiary “investment guidelines” document. The requirement for a SIPO in this clause should, therefore, be sufficiently broad to recognise this market approach, and not require these “high level” SIPOs to be amended to come into line with a rigid set of criteria (otherwise there is a real risk that providers will simply have SIPOs with wide investment limits, as described above).</p>
<b>Clause 145</b>	<b>Action that must be taken on limit breaks</b>	<p>We submit that only <i>material</i> limit breaks need to be reported to the supervisor (similar to other provisions where only material items need be reported – see in this context our comment on clause 393(2)(a) below). Minor, inadvertent limit breaks can occur for a variety of reasons (e.g. tax adjustments and market movements), and there should be no need for these to be reported to the supervisor.</p> <p>In addition, there should be an opportunity for limit breaks to be remedied within a reasonable period, and if they are remedied within that period there should be no obligation for that break to be reported to the FMA.</p> <p>We also submit that the “prescribed circumstances” for a supervisor to report limit breaks to the FMA should be set at a high threshold (for example, where the break has caused, or is likely to cause, a material adverse impact on investors). This standard strikes an appropriate balance between allowing supervisors to do their job (monitor manager performance and manage non-performance) and alerting the regulator of serious matters.</p>
<b>Clause 152</b>	<b>Certain related party benefits permitted without supervisor consent</b>	<p>We believe that the related party rules in this clause (and clauses 150-151) are sensible but too restrictive. They should be amended to allow the following items, without the need to go through the procedure in that clause:</p> <ul style="list-style-type: none"> <li>• the payment of fees to the manager and the supervisor, and</li> <li>• reimbursement of expenses of the manager and the supervisor.</li> </ul> <p>In addition, clause 152 should be drafted on the basis that “The following transactions are not transactions giving rise to a</p>

Clause number	Clause heading	Submission
		related party benefit.”. Otherwise, it is arguable that, while supervisor consent is not required, the manager must nevertheless notify the supervisor (under clause 151(2)(a)).
<b>Clause 173</b>	<b>Duty of investment manager etc to report serious problems</b>	
173(2)(a) & (d)		<p>These two provisions require (respectively) the relevant persons to report on any breaches (or potential breaches) by an issuer of an issuer obligation or if a supervisor has breached (or is likely to breach) a licence obligation.</p> <p>As with our earlier comment on clause 145, only <i>material</i> breaches (or potential breaches) should need to be reported.</p>
<b>Clause 189</b>	<b>Issuers must keep registers of regulated products</b>	
		<p>Section 189 requires there to be maintained a register of all regulated products and products of the same class. This makes sense for securities, the vast majority of which in New Zealand are in registered form, but does not apply as well to derivatives, which are entered into constantly, on a client-by-client bilateral basis (ie not in classes or pursuant to grouped offerings) and, most significantly, are not “registered” instruments (being evidenced normally by a confirmation, which is likely to incorporate terms from a Master Agreement). A further issue is that the application of this provision to quoted derivatives is not straightforward and is rapidly evolving because of the development of swap execution facilities and CCP requirements under international agreements with respect to the clearing of OTC derivatives. Equally, the content of registers in section 190 is designed largely with securities in mind.</p> <p>We suggest that subsection (1) applies to regulated products which are securities and a new subsection is created for derivatives issuers, requiring them to keep records of all confirmations of derivatives which are regulated products entered into by them (we proposed a definition of that term in our submissions on section 6). Reference to such records could be added to section 189(3) [form of register] and section 191 [audit]. We submit that the other provisions about registers (section 190, 192 and 193) should not apply to such records, because their nature makes it impracticable.</p>
<b>Clause 197</b>	<b>Issuer to send confirmations of financial products</b>	
	<b>Generally</b>	<p>Section 197 requires the issuer of a regulated product to send to the product holder a confirmation document, evidencing the nature, terms and conditions of the product and the name of the product holder, within 1 month of issue. For different reasons, this section is potentially problematic for both registered and certificated securities and for derivatives:</p>

Clause number	Clause heading	Submission
		<ul style="list-style-type: none"> <li>• <b>Registered securities:</b> The requirement that the confirmation document properly evidences the nature, terms and conditions of the financial product. This is not consistent with market practice for registered holdings and, we submit, would be very inefficient. Specifically, for registered securities basic entitlements (holder, amount etc) are determined by reference to the register and detailed terms are contained in the constitution (for equity) or the trust or other governing document (for debt or managed funds). Other than obvious details, the register itself is confined to practical information concerning IRD numbers etc, as well as recording transfers or transmissions. What is usually sent to holder is a 'statement of holding' (normally generated by the registrar and paying agent), which for legal reasons is not evidence of entitlement and for practical reasons does not purport to summarise the terms of the security.</li> <li>• <b>Certificated securities:</b> For certificated securities (which are rare in New Zealand and almost invariably confined to specialised forms of wholesale offers), the security is the physical document itself, which may be held under security arrangements, on escrow or otherwise on trust. The straightforward solution is to provide that it is a copy of such document that is required to be sent.</li> <li>• <b>Derivatives:</b> Although "confirmations" are often issued for derivatives (and indeed this term has a specialist meaning for derivatives), this is problematic as the terms of derivatives derive from the actual confirmation, which is likely to also incorporate other terms from an ISDA Master Agreement plus Schedule or similar framework documentation (in contrast, the terms of <b>registered securities</b> – by far the predominant kind in New Zealand – do not derive from any security certificate but from the register and the trust or other governing document). As a result, the certificate would need to strictly conform with those matters in order to avoid legal basis risk.</li> </ul> <p>To address these issues, we suggest recasting section 197 as follows:</p> <p style="text-align: center;"><b>197 Issuer to send confirmation of financial products</b></p> <p>(1) Every issuer of a regulated product must send to the product holder <del>either the product or a confirmation document</del> within 1 month of the issue, or receipt by or on behalf of the issuer of a <del>registrable</del> <b>duly effected</b> transfer, of the product:</p> <p style="margin-left: 40px;"><b>(a) <u>in the case of a security in registered form, a statement of holding setting out the name of the product holder and other prescribed details;</u></b></p> <p style="margin-left: 40px;"><b>(b) <u>in the case of a security in bearer form, a copy of the relevant security</u></b></p>

Clause number	Clause heading	Submission
		<p><u>certificate; and</u></p> <p><u>(c) in the case of a derivative, a copy of the confirmation.</u></p> <p>(2) <del>In this section, confirmation document means a document that properly evidences the nature, terms, and conditions of the financial product and the name of the product holder.</del></p> <p><del>(3)</del>—A person who contravenes this section commits a tier 1 infringement offence.</p>
	<b>Managed funds</b>	Consistent with current legal requirements for managed funds (in particular, the relief provided under the Securities Act (Unit Trust Certificates) Exemption Notice 2002, confirmations for managed fund holdings should only be required to be sent every six months.
<b>Part 5</b>	<b>Dealing in financial products on markets</b>	
<b>Clause 211</b>	<b>Price v. value in materiality test</b>	
		<p>The concept of material information in relation to derivatives is not problematic so much because of the distinction between price and value, but because insider trading and continuous disclosure concepts do not translate from the securities area into the field of derivatives.</p> <p>Whether they are futures or options, such instruments are invariably priced according to the movement of the underlying asset (stock, commodity, index etc), as opposed to securities which are priced effectively from the net present value of future cashflows / distributions, something that the issuer and its insiders are in a unique position to know about.</p> <p>Adapting notions from the securities markets of inside information is problematic. The value of the underlying reflects the views of the market on the direction of interest rates, currencies, share indices etc – each in turn reflecting myriad factors that everyone in the market has some information on but no one has definitive knowledge about. Although this is true to a degree of securities, those trade and price according to information about a particular issuer's likely future cash flows and financial position, something that the issuer itself, and its insiders, are in the best position to know about. By contrast, the nature of information as to the value of most derivatives is that it is not particular to an issuer (other than for credit default swaps, and even there the disclosure obligations are not on the person who writes the CDS but on the reference entity with respect to material information about itself).</p> <p>There are two primary types of participant in most derivatives markets: financial institutions (who transact primarily in order to manage their own risks or to provide hedging services to</p>

Clause number	Clause heading	Submission
		<p>clients) and corporates (who usually have some interest in the relevant underlying, for example as a supplier or buyer). For both, but for different reasons, continuous disclosure obligations and insider trading prohibitions would not be workable:</p> <ul style="list-style-type: none"> <li>• For financial institutions, they have access to information about corporate credit that cannot be disclosed or used by the bank in a trading capacity. They also conduct research and otherwise have access to a wide variety of information relevant to ideas about future interest rates, exchange rates, commodity prices and so on. In neither case is it useful or practical to require disclosure of any of this information or to prevent trading by a person who possesses it or is deemed to possess it.</li> <li>• For corporates, the issues can be even more significant, because by nature they will tend to possess material information about commodities in which they have an interest as supplier or buyer. Participants cannot practicably be required to disclose this information because, first, it is commercially sensitive and, second, to do so may make them guilty of price fixing under New Zealand or other laws.</li> </ul> <p>The second issue has been addressed in the legislation through an exception in section 228 relating to knowledge of one's own transactions etc. In our view, this is only a partial answer because the prohibition and the exception read together are too confusing in their respective scope and application to form the basis for a criminal offence which (being Tier 3 in the Bill's framework) provides for imprisonment for 5 years and a fine of \$500,000.</p>
<b>Clauses 218 - 235</b>	<b>Inside information – derivatives</b>	<p>In relation to section 101(a), you have asked for comment on extending the prohibition on insider trading to non-quoted derivatives in which the underlying is a quoted financial product of a listed issuer. We do not see any great advantage in this, because in practice it would be of very limited application (probably applying only to warrants for listed shares).</p> <p>With respect to extending a regime of this sort to non-quoted financial products, we submit that the benefits of such a move are smaller in this part of the market and the costs are relatively greater and more difficult to bear. The reason for the second is that in the non-listed market, the issuers tend to be small-to medium sized enterprises (SMEs) whose stocks are tightly held, who are not geared up to cope with disclosure obligations, and who do not readily have access to resources to assist in meeting compliance obligations of this type.</p> <p>In relation to the benefits side of the equation, the intervention</p>

Clause number	Clause heading	Submission
		<p>of insider liability is primarily a signalling device with respect to the parts of the market that impose the highest standards (ie the listed market) and to be a factor in increasing confidence in the market and thus lowering the cost of capital. In this part of the market it is also easier for people to derive information from close business or personal contacts or to be able to contract for their desired level of control and disclosure.</p> <p>In summary, we do not think that the case for extending insider trading laws beyond the listed securities market stacks up.</p>
<b>Subpart 289</b>	<b>Licensed markets</b>	<p>Subpart 7 of Part 5 of the Bill focuses on the licensing of financial products markets (including derivatives markets) operating in New Zealand. We are supportive of this concept and submit that, where financial products are traded on such markets, compliance with the rules of such market, together with any regulations applicable to acting as an intermediary, should largely comprise the extent of regulation in that context.</p> <p>In our view, there are increasingly going to be a number of markets – particularly for derivatives – that are significant but will not operate in New Zealand as such. For example, under the G20 Pittsburgh agreement (September 2009) and the U.S. Dodd-Frank Act, centralised clearing will be required for an increasingly wide range of what were previously “over the counter” (OTC) derivatives, through “swap execution facilities” and “organised trading facilities”, such as CME, ICE and Clearnet. These are important initiatives in terms of reducing systemic risk, increasing transparency and reducing risks for participants (including as a result of the requirement for central counterparty (CCP) clearing).</p> <p>Because New Zealand banks and businesses will have no choice but to participate in such exchanges, and to act in accordance with their rules and procedures, we submit that the MED should investigate an appropriate recognition regime for such facilities and exchanges, in relation to the local licensing, conduct and reporting requirements of derivatives issuers and other providers of market services.</p>
<b>Part 6</b>	<b>Licensing and other regulation of market services</b>	
<b>Clause 370</b>	<b>When provider of market services must be licensed</b>	
		<p>Derivatives issuers are required to be licensed as market service providers. Most if not all registered banks in New Zealand will be “derivatives issuers”, as their business inherently includes offering derivatives. Similarly, registered banks will need to operate on the basis that these are offers of “regulated products” because it is inevitable that at least some of their derivatives products will be offered outside the</p>

Clause number	Clause heading	Submission
		<p>wholesale sphere and they will generally therefore need to have common procedures and requirements for all their derivatives product offerings.</p> <p>We submit that registered banks should be licensed as market service providers in respect of their activities as “derivatives issuers” automatically unless their Conditions of Registration restrict them in undertaking such activities. The licensing requirements as a registered banks are at least as demanding and rigorous as those that will apply to derivatives issuers who are not registered banks and – as already noted – already will inherently include licensing and oversight of their derivatives business by the Reserve Bank.</p>
<b>Clause 381</b>	<b>License may cover subsidiaries</b>	<p>We support the recognition that a licence may cover subsidiaries, and submit that this should be extended to allow the licence to cover related bodies corporate.</p> <p>We would also strongly encourage the inclusion of express machinery requiring the FMA to facilitate “centralised compliance” for corporate groups holding multiple licences (for example, a bank with the parent company holding a derivatives issuer and DIMS licence, but with a subsidiary holding a manager of a registered scheme licence).</p> <p>These provisions would require the FMA to recognise the characteristics of the group, to ensure efficiencies can be obtained, for example:</p> <ul style="list-style-type: none"> <li>• common baseline conditions,</li> <li>• simultaneous reporting, and</li> <li>• identical record keeping as far as possible.</li> </ul> <p>An express requirement of this nature on the FMA would result in conditions which improve efficiency for multiple licence holders, consistent with the purpose of the Bill.</p>
<b>Clause 393</b>	<b>Licensee must report material matters</b>	<p>A licensee should only be required to report <i>material</i> breaches of a market services licensee obligation (similar to other provisions in the draft Bill which only require reporting for material matters (for example clause 102)).</p>
<b>Clause 411</b>	<b>Licensees to provide services under client agreements</b>	<p>Sections 411-413 require derivatives issuers to have client agreements, which may contain a number of deemed provisions under regulations and will not be able to altered or replaced without the prior written consent of the client.</p> <p>We submit that, in a retail context, the rules that client</p>

Clause number	Clause heading	Submission
		<p>agreements cannot be replaced without the prior written consent of the client is impractical and is potentially harmful, to the extent that (for example) changes to the client agreement were prompted by regulatory amendments or issues or by an improvement to the service or terms provided to clients.</p> <p>While client agreements are common in service arrangements, their extension to derivatives is questionable as best practice for documenting derivatives transactions differs widely depending on the nature of the product, the client and other circumstances and, in any event, would rarely be something which could properly be described as a “client agreement”. For example, in relation to quoted derivatives transactions, the rights and obligations will be defined by the rules and procedures of the exchange – in a retail context the actual “derivatives issuer” (being the exchange or clearing house) will not have a client agreement with end-buyers but will have privity only with the institutional participants in the exchange. In relation to over-the-counter transactions, for larger issuers and/or more complex transactions, these are documented under standard form ISDA Master Agreements, Schedules, Protocols and Confirmations. Simpler products may be under simpler master agreements or short or long form confirmations.</p> <p>In relation to assessing the costs and benefits of this requirement to derivatives, we are not aware of any issues that have arisen in the market through the absence of this requirement. On the other hand, we submit that the costs of adapting such requirements properly to derivatives would be substantial and are also contrary to the general thrust of derivatives regulation internationally, which is to provide protection and transparency through the requirement for swap execution facilities and CCP clearing.</p>
<b>Clause 413</b>	<b>Changes to client agreement</b>	
		<p>Both for DIMS and – in many cases – for derivatives issuers, the requirement for client agreement changes to be consented to by each retail investor is impractical for a service that may be provided to large numbers of clients. We believe that it should be possible to change client agreements unilaterally, in the following circumstances:</p> <ul style="list-style-type: none"> <li>• if the change is not material</li> <li>• if the change is required to comply with legislation</li> <li>• by giving notice to the retail client, with an ability for the retail client to opt-out of the service during that period.</li> </ul>
<b>Subpart 6</b>	<b>Provision of discretionary investment management services (DIMS)</b>	

Clause number	Clause heading	Submission
		<p>We generally support the approach to DIMS in the draft Bill, which allows (or in the case of class DIMS on category 1 products to retail clients, requires) a licence under the Bill.</p> <p>However, if a provider chooses to obtain a DIMS licence for both class and personalised DIMS, those services should be governed solely by the Bill (and the terms of the licence), and not by the “backdoor” importing of Financial Advisers Act (FAA) requirements through the conditions of the licence. In particular, there should be no suggestion that DIMS provided under a licence must, for personalised services, be provided by an authorised financial adviser (AFA) under the FAA.</p> <p>If this was to occur, it would effectively result in “double regulation”, requiring compliance by a DIMS provider with both the Bill and the FAA.</p> <p>We therefore submit that it should be made clear in the Bill (possibly through refinements to clause 384) that DIMS licences cannot have a condition attached to them requiring any aspect of the service to be provided by an AFA, nor any other conditions which are designed to “mirror” FAA compliance (for example, compliance with the Code of Professional Conduct for AFAs).</p> <p>There are three main reasons for this:</p> <ul style="list-style-type: none"> <li>• The requirements in the Bill (e.g. disclosure, client agreements and the duties on a DIMS licensee) provide adequate consumer protection, and requiring compliance with the FAA would be excessive and create duplicative compliance costs.</li> <li>• It is consistent with the intention of the Bill that a DIMS licensee which is an entity should be able to provide both class and personalised DIMS itself, rather than being required to provide them “through” an individual.</li> <li>• It is also consistent with the Bill’s recognition that DIMS is conceptually different from other financial advice, and is often (in the case of class DIMS) more akin to a managed investment product, so is more appropriately regulated under the Bill, rather than the FAA.</li> </ul>
<b>Clause 421</b>	<b>Action that must be taken on limit breaks</b>	
		<p>As with clause 145 above in relation to SIPOS, we submit that only <i>material</i> limit breaks need to be reported to the FMA.</p>
<b>Clause 423</b>	<b>General prohibition on transactions giving related party benefits</b>	
		<p>Similar to clause 152, we believe that the related party rules in this clause are sensible but too restrictive. They should be amended to allow:</p> <ul style="list-style-type: none"> <li>• the payment of fees to the DIMS licensee or an</li> </ul>

Clause number	Clause heading	Submission
		<p>associated person, and</p> <ul style="list-style-type: none"> <li>reimbursement of expenses of the DIMS licensee.</li> </ul>
<b>Clause 426</b>	<b>Requirement for custodian</b>	
426(2)(b)		<p>The requirement in clause 426(2)(b) – that a custodian must not be the same person as, or associated with, a DIMS licensee (unless the licence permits otherwise) – is problematic.</p> <p>It is common in the New Zealand market for financial service providers to have their “own” custodians (i.e. nominee company subsidiaries who hold client assets). Leaving it for the “licence to permit otherwise” means that these types of arrangement will be subject to uncertainty as to whether they can continue.</p> <p>This clause pre-supposes that an independent custodian will always be more robust (in terms of client protection) than an associated custodian. In our view this assumption is dangerous, and in assessing the efficacy of a particular custodian the proper emphasis is on the governance, compliance and management surrounding the custodian arrangement, rather than on ownership relationships.</p> <p>We therefore submit that requiring an independent custodian is unnecessary and could create significant issues in the New Zealand market:</p> <ul style="list-style-type: none"> <li>there are a limited number of independent custodians with sufficient scale to take on what would be significant influx of client assets</li> <li>the transitional costs of moving client portfolios from existing custodians to new (independent) custodians would be significant</li> <li>requiring independent custodians will reduce the number of competitors in the market, affecting customer choice and buying power.</li> </ul> <p>Further to our comments above, we submit that requiring an independent custodian is unnecessary in terms of client protection, and the benefits gained would be disproportionate with the costs involved.</p> <p>Client assets are protected in a variety of ways:</p> <ul style="list-style-type: none"> <li>the assets are held on trust for the client</li> <li>the assets are often in a subsidiary or related body corporate, “ring-fenced” from the assets of the DIMS licensee</li> <li>the combination of these arrangements means that client assets have a high degree of protection in the event of insolvency of the DIMS licensee.</li> </ul> <p>We therefore strongly believe that the requirement for an independent custodian should be removed.</p>

Clause number	Clause heading	Submission
		In addition, we would also not support any carrying over of this requirement to any DIMS provided under the FAA (it was unclear from the summary notes appearing on pages 323-325 whether the requirement for the custodian to be independent was to be carried over to the FAA).
426(3)		<p>We do not support the suggestion that a DIMS licensee should be jointly and severally liable with the custodian for the holding of investor property.</p> <p>This concept:</p> <ul style="list-style-type: none"> <li>• is inconsistent with the separation of functions as between the DIMS provider and the custodian</li> <li>• does not recognise the fiduciary nature of a custodian, accompanied by the holding of investments by the custodian on bare trust for investors, which provide adequate consumer protection (as discussed above) rendering the extra layer of joint and several protection redundant</li> <li>• would fundamentally alter market norms for custody agreements, with DIMS providers looking to manage their responsibility liability with “back to back” arrangements with custodians (which will either not be entertained by custodians, or if they are, at a cost which would ultimately be borne by the investor)</li> <li>• would result in increased insurance premia for the DIMS provider (as it is another liability being assumed), which again would be borne by the investor.</li> </ul>
<b>Part 7</b>	<b>Enforcement and liability</b>	
<b>Clause 462</b>	<b>Compensatory orders</b>	
		<p>We submitted in relation to clause 41 that the scope of statements for which consent is required and to which liability might be attached should be carefully considered and, most particularly, should not include credit ratings / credit rating agencies or rating agencies for funds. If this is done, then the liability for makers of statements in section 462(4)(b)(v) should not be too problematic.</p> <p>In relation to the extension of liability to “underwriters”, there are two issues.</p> <p>The first is the difficulty of defining who underwriters are in this context (please see our submissions on section 6 “underwriter”).</p> <p>The second is that, although the requirement may have some benefits in prompting a raising of due diligence and</p>

Clause number	Clause heading	Submission
		<p>underwriting standards, it will also almost certainly increase the costs of retail offerings and therefore has the potential to exacerbate the 'adverse selection' issues that have afflicted the New Zealand retail markets (whereby low quality / high risk issuers who have no practical funding alternative will participate in the market regardless – unless crowded out by more high quality / lower risk issuers, but those higher quality issuers who do have a choice will rationally assess the costs, benefits and risks of each market available to them). We submit that this is a significant issue in terms of striking the right balance in the domestic market and achieving the primary objective of the legislation in section 3(a) and we urge close consideration and consultation on this matter in the context of the Select Committee process.</p>
<b>Clause 474</b>	<b>Infringement offences</b>	
		<p>In our submission, the "infringement offence" provisions are not an advance on their predecessor (section 60 of the Securities Act). Section 60 was clear in its application to individuals acting within corporate entities, which does not appear to be the case with the infringement offences.</p>
<b>Part 8</b>	<b>Regulations and exemptions</b>	
<b>Clauses 512-513</b>	<b>Designation of financial products</b>	
		<p>The FMA's designation powers are much broader than even the powers originally envisaged. In addition to being able to declare that particular things are / are not financial products or financial products of a certain type, the FMA may also declare that a product exempted from disclosure requires disclosure (otherwise than under the regulation-making framework for limited disclosures set out in clause 24) and make declarations about the extent of the licensing regime (sections 512 &amp; 513). There are no rights of appeal from or review of such decisions, only the right of the affected to be consulted (refer section 545 – appeals limited to questions of law and do not extend to decisions under Part 8).</p> <p>In relation to securities law, as with any other area of commercial law, certainty is important. We further submit that it is problematic to have such broad regulatory powers affecting private transactions framed in compliance with law, with few if any practical means of redress.</p>

## 5.0 CONCLUSION

5.1 We look forward to further positive engagements with officials in developing the Bill and in relation to the equally significant task of producing the regulations that are required to complete the regulatory package. Once again, we thank you for the opportunity to contribute our submissions to this very important reform initiative.

Should the MED have any questions in respect to any of the above, please contact:

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