

MEMORANDUM

TO: Investment Law Team, MED

FROM: Sir Grant Hammond, President, Law Commission

DATE: 5 September 2011

SUBJECT: Financial Markets Conduct Bill Exposure Draft

1. This memorandum outlines the key issues staff and I have identified, largely by reference to the Legislation Advisory Committee Guidelines, in the Exposure Draft of the Financial Markets Conduct Bill.
2. The body of the memorandum outlines the substantive points we have noticed, divided as per the Parts of the Bill for ease of reference, while the final page covers any, more minor, queries and drafting notes that we had.

Part 1

3. No issues identified.

Part 2

4. No issues identified.

Part 3

5. In clause 31, the territorial scope for the purposes of Part 3 (offers of financial products) disclosure is broad and does not depend on New Zealand residency. In clause 23, the scope for the purposes of Part 2 (misleading or deceptive conduct) is narrower in only applying to conduct in New Zealand or by a New Zealand connected person. There could be issues about whether conduct is in New Zealand (ie if internet related) - should clause 23 be more consistent with clause 31?
6. In clause 78, a defence for publishers to the advertising restrictions is introduced. The defence requires the publisher to prove lack of knowledge - does this raise issues about the presumption of innocence and introduce a reverse onus? An alternative option would be to allow publishers to rely on the issuer's authorisation that the advertisement complies.

Part 4

7. No issues identified

Part 5

8. Clause 333(1)(c) allows regulations to specify additional "market provisions", the contravention of which could give rise to civil remedies under clause 368. The LAC guidelines suggest that offences of a serious nature and significant penalties (criminal and civil) should be included in primary legislation. Depending on how

the additional “market provisions” are classified, breach of these could be punishable by a pecuniary penalty order of up to \$5 million. Arguably, therefore, this is not appropriate in secondary legislation.

9. In clause 345(2)(c), is it necessary to retain the public interest element? The purposes of the Act should now express the relevant public interests at play and so reference to the purposes of the Act under (a) and contravention under (b) may be sufficient.

Part 6

10. In clause 394, should the limit on self-incrimination be extended to include civil penalties as well as criminal offences?

Part 7

11. Clause 432 is a somewhat confusing and ambiguous provision, and this is exemplified in the example given, which can be read in two ways depending on whether the first sentence of the fourth paragraph is introducing new facts. If it is introducing new facts, then it accords with the clause. However, if it is not, and instead the suggestion is that the consent of director A to the contravention (paragraph 2) means that both A and ABC Limited have the required knowledge, then this would seem to go beyond what the clause intends. It may be that the example would be clearer if it referred to a specific contravention and offence.
12. Since the Cabinet Papers in February and May 2011, the categorisation of offences and civil remedies has changed. Originally, the idea was to have 6 tiers of “liability”, with tier 1 strict liability offences, tier 2 and 3 civil penalties, and tier 4 to 6 “full” criminal offences that required intentional or reckless breaches of more serious securities law obligations.
13. However, in the draft Bill civil remedies have been separated out from the tier structure, which is now restricted to tier 1 infringement offences and tier 2 to 4 “full” criminal offences. This may, however, still prove to be confusing to non-lawyers, as the absence of a conviction entered for tier 1 infringement offences perhaps places them more akin to a civil remedy.
14. The general liability structure is now as follows:
 - a. The contravention of a provision in the Bill typically results in a civil remedy and/or a tier 1 infringement offence (but see clause 471, referred to below, which limits to an extent when both can be used), neither of which require a mental element to be proved. These are supported by various enforcement powers (Subpart 1), which enable the FMA to act quickly to make stop orders, direction orders and unsolicited offer orders, and the ability to apply to the High Court for an injunction (Subpart 2).
 - b. For serious contraventions, in addition to civil liability these will also be a criminal offence if they were committed knowingly or recklessly, and indeed in some instances if committed without reasonable excuse (clauses 180(3), 353, 402(1) and 446(2)). Further, in one case criminal liability is imposed without any mental element at all (clause 482 “contravening a management banning order”, a provision carried over from the Securities Act 1978 (s 60C)). The various mental elements for criminal offences are set out in more detail below.

15. In terms of civil remedies (clauses 451 to 472), these are extensive and wide-ranging and it is noted that there is no restriction on the number of civil remedy orders that can be made for the same conduct (clause 469). While this is unproblematic in itself, what may be of concern is that there is no requirement for the court to take into account the monetary value of other civil remedy orders already made when making a further civil remedy order, which could lead to considerable awards against defendants. For example, a pecuniary penalty order seemingly does not need to take into account any compensatory order already made (clause 459). This can be contrasted with the prohibitions on multiple pecuniary penalty orders for the same conduct (clause 470) and on a pecuniary penalty order and a fine for the same conduct (clause 471).
16. Confusingly, also, in addition to the general civil remedies overview (Subpart 3), the actual substantive civil liability provisions are found at the end of each Part of the Bill, as opposed to the end of each section that they relate to. This may make it difficult for users to navigate around the Bill and ascertain what potential punishment, if any, they face for contravening the Bill's provisions.
17. As also highlighted in Part 3 above (with respect to clause 78), the defences to civil liability come from the Australian Corporations Act 2001 and follow the structure of existing defences (for example, clauses 234 to 236, 245 to 246 and 250) and apply a reverse onus of proof.
18. In terms of criminal offences, the stated intention of Cabinet has been that, as a general principle, the criminal law will be reserved for conduct where there is knowing or reckless behaviour (MED Request for submissions and commentary, para 36). However, as stated above, the Bill is not entirely consistent in the mental element it requires across each tier.
19. For tier 2 offences (maximum penalty of 3 years' imprisonment and/or a fine of \$200,000 (individuals) or \$600,000 (non-individuals)), the following mental elements are used:
 - a. Clause 68(3) "Offering financial products in entity that does not exist" – knowledge.
 - b. Clause 147(3) "Failing to ensure that a suitably qualified actuary examines the financial position of a defined benefit scheme" – knowledge.
 - c. Clause 180(3) "Supervisor refusing or failing to comply with an FMA direction" – no explicit mental element, instead uses "without reasonable excuse".
 - d. Clause 187 "False or misleading statements to supervisors" – knowledge.
 - e. Clause 353 "Licensed market operator refusing or failing to comply with an FMA direction" – no explicit mental element, instead uses "without reasonable excuse".
 - f. Clause 402(1) "Licensee refusing or failing to comply with an FMA direction" – no explicit mental element, instead uses "without reasonable excuse".

- g. Clause 446(2) “Person refusing or failing to comply with an FMA direction” – no explicit mental element, instead uses “without reasonable excuse”.
 - h. Clause 482 “Contravening management banning order” – no mental element.
20. For tier 3 offences (maximum penalty of 5 years’ imprisonment and/or a fine of \$500,000 (individuals) or \$2,500,000 (non-individuals)), the following mental elements are used:
- a. Clause 32(2) “Making or distributing a regulated offer without appropriate documentation” – knowledge or recklessness.
 - b. Clause 37 “Failing to give a product disclosure document” – knowledge or recklessness.
 - c. Clause 222 “Insider conduct” – knowledge.
 - d. Clause 242 “False or misleading statement or information” – knowledge.
 - e. Clause 247 “False or misleading appearance of trading” – knowledge.
 - f. Clause 479 “Contravening other provisions relating to defective disclosure” – knowledge or recklessness.
21. For tier 4 offences (maximum penalty of 10 years’ imprisonment and/or a fine of \$1,000,000 (individuals) or \$5,000,000 (non-individuals)), the following mental elements are used:
- a. Clause 478 “Contravening prohibition on further offers where defective disclosure in PDS or register entry” – knowledge or recklessness.
22. As can be seen, the number of “full” criminal offences in the Bill is quite restricted, with the preference being that where the criminal law is to be involved it will be by way of tier 1 infringement offences (“speeding tickets”), which do not require any mental element to be proved. These carry a maximum penalty of \$50,000 if proceeded with summarily, or an amount to be determined by regulation (not exceeding \$20,000) if by infringement notice (clause 504(1)(d)). It is noted that these penalties are contrary to the LAC guidelines, which suggest an infringement offence should generally carry a penalty less than \$500, and perhaps an indication that they are seen as being a fast alternative to seeking a civil remedy and will be targeted at companies.
23. Finally, it is noted that all offences are to be proceeded with summarily, notwithstanding that the LAC guidelines suggest that if an offence is punishable by more than 1 year’s imprisonment it should generally be categorised as an indictable offence. The various offences set out in the Bill have maximum penalties of 3 years, 5 years and 10 years imprisonment, which suggests that it may be more appropriate for them to be indictable offences triable summarily.

Part 8

24. Part 8 of the Bill deals with regulations and exemptions. In terms of the former, a reoccurring theme is that these can be made to include or remove matters that would otherwise be covered by the Bill. For instance, clause 502(1)(a)(i) allows regulations to be made that exempt conduct from being insider conduct that would otherwise fall within the provisions of the Bill.

25. Similarly, the exemption provisions allow the FMA to exempt any person or class of persons or any transaction or class of transactions from the provisions of the Bill (clause 509). However, the FMA must not do this unless the exemption is necessary or desirable in order to promote the main purposes of the Bill and it cannot be broader than is reasonably necessary (clause 510).

Part 9

26. Part 9 deals with miscellaneous provisions in the Bill, such as appeal rights (a general right of appeal to the High Court against specific FMA decisions under Part 6 (clause 544) and an appeal on questions of law only against certain other decisions (clause 545)), repeals, amendments and transitional provisions.

Queries

1. In cl 58, should notice that is given to the Registrar also be given to the FMA?
2. In cl 95, should any change to the Trust deed also require the supervisor's consent as well as FMA's?
3. In cl 116(4), should the manager notify the supervisor, or should FMA notify the supervisor?
4. In cl 122(1)(a), should the supervisor's consent also be required?
5. In cl 136(2), should the custodian be expressly required to ring-fence the assets from other property the custodian may hold on trust for others?
6. In cl 166, should the novation provision expressly apply in the case of a court ordered change of manager under cl 183, and to a temporary manager? Is a novation provision also required in relation to a change of supervisor where the supervisor holds scheme assets?
7. In cl 170(2), should the manager also notify the supervisor?
8. In cl 171(3), should the Registrar also notify the supervisor?
9. In cl 187, should the offence be broadened to include documents or information provided to the FMA, scheme participants or to the court?
10. In cl 341, should provision be made for the FMA and the Takeovers Panel to be able to share such information with each other if it would assist the others functions?
11. In cl 389(b), should the grounds for cancellation be broadened to include incapacitation?

Drafting points

1. Could clarify in cl 47 that another PDS is one that is not subject to cl 46.
2. In cl 122(1)(b), clarify that the court is the High Court?
3. Suggest that clauses 131 -133 be moved under the earlier heading "Role of the manager"
4. In cl 158(2)(f): clarify that the Commissioner is the Commissioner of Inland Revenue?
5. In cl 176(1), change "or a registered schemes" to "or registered scheme".
6. Change the heading to cl 177 to "duty of **supervisor** to report...". Should the heading to cl 187 also refer to supervisor in the singular?
7. In cl 181(1)(c), delete "is" in the first line.
8. In cl 182(1), insert "the" before " application" (for consistency with cl 183).
9. In cl 479(a)(iii), delete the reference to (iii).