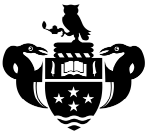

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8 September 2011

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Financial Markets Conduct Bill – Exposure Draft

The New Zealand Law Society (Law Society) welcomes the opportunity to make a submission on the Exposure Draft of the Financial Markets Conduct Bill (Exposure Draft).

The Law Society commends the practice of releasing exposure drafts of impending legislation. This practice allows for constructive engagement on the intention and drafting of legislation in a way that is not practicable during the formal legislative process.

However, the Law Society is troubled by the tight timeframe for consultation. The Exposure Draft is a very substantial and complex document. The legislation will bring about historic changes to New Zealand's securities laws, which have a material impact on many businesses and on the economy in general. Given the nature of the reforms, the Law Society would have preferred an extended timeframe to allow it to consider the Exposure Draft in more detail and with careful thought. The timeframe available for consideration has meant the Law Society is able to provide high-level comments only, but not necessarily to provide detailed comments on all aspects of the Exposure Draft. In addition, in the time available, the Law Society has not had the opportunity to consider and reach a view on a number of the specific query notes in the Exposure Draft where the Ministry has requested inputs. Since the detail of the legislation will be vital to its success, we respectfully request further opportunities for submissions at later stages of development of the legislation.

Preliminary comments on a number of the specific query notes in the Exposure Draft are attached as an Appendix.

Part 1

We submit that it would be useful for the legislation to either contain a definition of the term "*prescribed*" or for the usage of that term to be qualified when it is used (e.g., "*prescribed by the Act*" or "*prescribed by the Act and the Regulations*"). There are numerous references to prescribed information (e.g., clause 44), prescribed circumstances (e.g., clause 51(2)), and prescribed manner (e.g., clause 55). It is not always clear as to whether "prescribed information" refers to both the enactment itself and also the Regulations, or only to the Regulations. It would be useful to clarify this.

We note that the definition of "debt security" is broad and captures securities that may be better treated as equity or as managed investment products. For example:

(a) redeemable shares in a company; or

(b) redeemable units in a unit trust,

other than those that provide for mandatory redemption by the issuer or enable the holder to require redemption, in either case, for a fixed or determinable amount may be better treated as equity securities or managed investment products than as debt securities. In either case, both the policy and the drafting appear to require further thought.

We believe it is important to correctly categorise these investment products at the design stage of the Exposure Draft, rather than leaving this issue to be dealt with by the Financial Market Authority's designation power, which may lead to market uncertainty and unnecessary cost.

We note that while the definition of "Distribute" refers not only to an internet site but also to other form of electronic means, other provisions in the Exposure Draft refer only to an internet site – for example section 21(1). We suggest that in the interests of technical neutrality, reference to "Communication Technology" (more akin to the Copyright Act 1994) and an associated definition may be worthwhile.

We note the definition of "Voting Product" refers to a "body" as opposed to an "entity" or other term used more consistently in the Exposure Draft.

In relation to clause 9(2), we agree that most property purchases should fall outside the definitions of regulated products, but that certain types of property syndicates should be subject to the securities law regime. We would prefer, however, that these issues be addressed in the primary legislation, rather than contemplating a partial exemption along the lines of the Securities Act (Real Property Developments) Exemption Notice 2007.

Part 2

In relation to clause 21, we note that the Exposure Draft does not define the terms "*newspaper*", "*magazine*", or "*broadcasting*". We note that these terms are defined under the Fair Trading Act 1986, on which this Part of the Exposure Draft is based.

Part 3

We support the objectives behind the Product Disclosure Statement (PDS) regime. However, the success of the PDS regime (and in particular, the Exposure Draft's direction that PDSs should be clear and concise) will largely depend on the regulations taking a disciplined approach to ensuring that the prescribed contents of PDSs are quite limited (with other information being placed on the register). If the regulations prescribe complex or highly evaluative standards for PDS disclosure then some of the benefit of the new regime will be lost.

The Law Society's views on clause 40 are addressed in detail in the appendix to this submission. In the Law Society's view, there are significant difficulties associated with applying the option A test of materiality to certain types of financial products. Accordingly, the Society leans towards option B, notwithstanding the arguments that could be raised in respect of option A.

Part 4

We have a number of concerns in relation to the provisions dealing with the governance of financial products. While the Ministry has requested submissions primarily on drafting issues, rather than policy questions, we wish to make these high level points:

(a) We are concerned that the 10% threshold for investors calling a meeting is too high. In our experience it can be very difficult to achieve the 5% threshold that applies under the Companies Act 1993, let alone achieving a 10% threshold. We suggest that 5% would be an appropriate threshold.

(b) The Exposure Draft does not fully reflect the protections provided to members of superannuation schemes under the Superannuation Schemes Act 1989 and case law under it, and in some cases departs from these protections. We believe that the Exposure Draft should be amended to reflect the protections in the current law, which have been put in place based on the issues that actually arise for these schemes. In particular the existing law has a much more detailed regime applying to changes to superannuation schemes that protects contingent beneficiaries as well as members who contribute to the schemes, and requires unanimous consent to certain amendments that could adversely affect such persons.

Part 5

Part 5 largely retains the existing law relating to behaviour by participants in public securities markets (including insider trading, market manipulation, substantial security-holder disclosure, and continuous disclosure). The Law Society considers this appropriate given the recent overhaul of a number of these provisions.

Part 6

In the time available for review, the Law Society has not had the opportunity to consider the new licensing regime in detail. The Law Society also notes that, while the Exposure Draft provides a framework for the licensing regime (including the ongoing obligations of licensees and the powers of the Financial Markets Authority for a breach), much of the licence criteria and conditions attaching to licences will be prescribed in regulations. For this reason, comments about the workability of the licensing regime will need to await the detail of the regulations.

Part 7

The Law Society endorses the policy decision that, as a general principle, the crimes which carry a sentence of imprisonment under the Exposure Draft will be reserved for knowing or reckless misconduct.

Clause 462 seems to be out of step with what the Law Society understands to be the policy underpinning the new approach to liability issues – that of moving the focus to the issuer rather than primarily being on the directors of the issuer. As presently drafted, the definition of "relevant person" in clause 462 pins liability for defective disclosure in PDS or register entry on:

(a) the offeror and every other person who contravened;

(b) each director of the offeror at the time of the contravention;

(c) the issuer;

(d) 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;

(e) if the contravention is caused by the inclusion of a statement in the PDS or register entry (statement A), a person named in the PDS or register entry with the person's consent as having made—

(i) statement A; or

(ii) another statement on which statement A is based.

A similar formula is used for defective ongoing disclosure.

The Law Society does not understand the policy justification for including underwriters in clause 462.

In turn, the term "contravene" is defined very widely and has an aiding and abetting element – which could bring into the liability net an even wider range of persons. The accessory liability regime under the Exposure Draft will be wider than the current Securities Act, and similar to the Securities Markets Act and the Australian regime. The Australian experience has, the Society understands, generated US-style class action litigation. The Law Society is concerned that this risk will add to the costs of all those involved and may cause some parties to have second thoughts about capital-raising in the New Zealand market. In the Law Society's submission, the potential costs of extending liability should be weighed against the objectives of the new regime, which relevantly include promoting and facilitating New Zealand's capital markets. While there may be a case for having such a wide range of "relevant persons" capable of being brought into the liability net in the case of primary offers of equity and debt securities, the Society is not convinced that this is the case for managed funds – where it suggests that the focus of attention should continue to be the manager and its directors.

We also have concerns about clause 463, which introduces a rebuttable presumption that materially adverse misstatements have caused a product's loss in value. We question the rationale for this presumption: it is not a normal economic inference (i.e., many factors may affect the price of a security) and is contrary to normal civil law principles (which require the plaintiff to establish its loss). The statement that it is close to the model adopted in the US does not add to our comfort level, particularly when considering both the breadth of the net cast by the definition of 'relevant person' and the need to explain to overseas parties (e.g. underwriters) the extent of their potential liability in relation to a New Zealand offer and the relative novelty of the legislative regime that will be used to measure.

We note that the structure of Part 7 is somewhat unclear. We suggest that the legislation should set out the Tiers of offence, indicating in each case the offences falling under each Tier.

Schedule 1

In relation to clause 4(3) of Schedule 1, we would prefer that the issuer should be permitted to rely upon certification by the investor as to the factors giving rise to being a close business associate under clause 4(3). This should be subject to a carve-out where the issuer knows (or ought to have known) that the certification is incorrect (c.f., clause 38 of Schedule 1).

We agree with the exclusion in clause 11 for offers of financial products for no consideration. We note that there may be complications where a "free" financial product is attached to another financial product which is not free (e.g., "options" attaching to an equity security acquired for value). We simply raise this issue for consideration. In the time available we are not able to suggest recommended amendments.

We support the exclusion in clause 14 of Schedule 1, as drafted. In our view, limiting the exclusion of offers to a single purchaser would undermine the exclusion (since it is likely that another exclusion would already apply in those circumstances; e.g., the wholesale investor exclusion).

Clause 22 of Schedule 1 would exempt from disclosure an offer of an interest in a contributory mortgage by a solicitor. There are a number of issues which arise in relation to this provision.

(a) Mortgages in contributors' names

The term 'contributory mortgage' is defined in clause 22(2) and is limited to situations where the mortgage is taken in the name of a nominee company. However, from time to time lawyers arrange contributory mortgages which are taken in the names of the contributors themselves. This is recognised in regulation 39 of the Lawyers and Conveyancers Act (Trust Account) Regulations 2008. This regulation addresses contributory securities taken for the purposes of investment other than through a lawyer's nominee company. It requires the lawyer to ensure that the provisions of all applicable rules relating to lawyers' nominee companies are complied with.

In these circumstances, it is submitted that the definition of 'contributory mortgage' needs to be extended to include a mortgage of land granted in favour of more than one person. This could be achieved by amending clause 22(2)(a) to read along the following lines:

> "*secures money owing to two or more persons or to a nominee company on behalf of two or more persons*"

(b) Related person or entities – lawyer trustee

Subclause (1)(a) and (b) excludes from the exemption mortgages where the solicitor concerned is the mortgagor or receives the benefit of the mortgage advance.

It might be considered desirable to extend this exclusion to situations where the mortgagor or recipient is a related person or entity of the solicitor concerned. The expression "related person or entity" should be given the same meaning as in section 6 of the Lawyers and Conveyancers Act.
Conversely, where the solicitor is a trustee with no beneficial interest in the mortgaged property and receives no benefit from the money lent, it would seem unnecessary for the exclusion to apply. It is submitted that the exclusion should be modified accordingly.

(c) Incorporated law firms

The Lawyers and Conveyancers Act permits law firms to incorporate and a significant number of law firms have done so.

An offer by an incorporated law firm of interests in a contributory mortgage does not appear to fall within clause 22 because an incorporated law firm is not a "solicitor".

This difficulty could be overcome by providing that for the purposes of clause 22, an offer by an incorporated law firm is deemed to be an offer by the directors of that firm. The Law Society submits that the clause should be amended accordingly.

(d) Mortgage of land

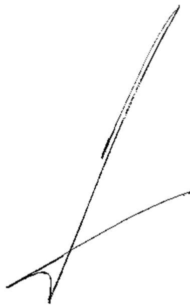
The expression "contributory mortgage" is limited to a mortgage of land. The expression 'land' does not appear to be defined in the Exposure Draft. We submit that a definition is desirable, at least for the purposes of contributory mortgages. We suggest a definition based on the Property Law Act 2007 (namely: "***Land*** *includes all estates and interests, whether freehold or chattel, in real property*").

(e) Joint tenants

Clause 22(3) provides that for the purposes of the definition of contributory mortgage, money owing to not more than five persons as joint tenants is to be treated as being owed to one person. We question the rationale for this limit on the number of persons who are joint tenants. There are occasions when moneys may be held by more than five joint tenants. An example of this would be a trust with more than five trustees. It is submitted that the limitation should be removed.

The Law Society would be happy to discuss these matters with the Ministry directly. Contact in the first instance can be made through the secretary of the Law Society's Law Reform Committee, Vicky Stanbridge (DDI: 04 463 2912; or by email vicky.stanbridge@lawsociety.org.nz).

Yours sincerely



Andrew Gilchrist
Vice President

Appendix

Clause 7 – Relationship between derivatives and the Gambling Act 2003

1. The Law Society agrees that there should be an equivalent to section 40 of the Securities Markets Act. We also consider that, of the three identified alternatives for clarifying the intersection between derivatives and gaming, the middle ground identified by Ministry (Option C – derivatives issued by a licensed derivatives issuer or a derivatives issuer who is exempted from the licensing obligation) has the dual attraction of being both workable and closest to the current regime. The Law Society's assessment of workability is based on a preliminary review of the new regime proposed for regulating derivatives – and includes the comments below about clause 10 of the Exposure Draft.

Clause 9(1) - Definition of managed investment schemes

2. As a starting point, the Law Society follows the requirement that, in order to fall within the definition of being a managed investment scheme, there must be a contribution of money or money's worth in the expectation of financial benefits. We also support the policy decision to exclude schemes, such as marina berths, stadium seating packages and so on that provide communal facilities and collective buying / marketing arrangements that do not, of themselves, provide an expectation of a financial benefit.

3. The Law Society also supports the requirements that the financial benefits must be principally from the efforts of someone else and that participants lack day-to-day control.

4. The Law Society does however have some reservations about the absence of a pooling / common enterprise requirement. If the primary driver for excluding a factor that accords with what the Law Society believes to be the view of one of the hallmarks of a managed fund shared by both the investment community and the investing public, simply to address the difficulties around the case of discretionary investment management services (DIMS) – then we question whether this should be addressed in the context of DIMS. Similarly, as noted below in relation to clause 9(2), we also question whether the management of participants' individual, stand-alone interests in property, could be addressed in the narrow context of those real property schemes that, it is intended, will remain under the regime created by the Exposure Draft.

Clause 10 - Definition of 'issue' and 'issuer' for a derivative

5. The Law Society supports the policy decision to follow the Australian approach for defining when a derivative is issued (and the approach taken in the Exposure Draft to the definition of a derivatives issuer).

6. Where there is intermediation of over-the-counter contracts, in order to address the point highlighted by the Ministry, the Law Society is attracted to the idea of adding a clarifying statement to dispel the possibility of what would appear to the Law Society to be a strained view of the contractual effect being adopted. From a practical viewpoint, this approach appears better than creating a separate definition to apply and risk the outcome that appears to have been achieved in Australia whereby multiple persons are designated as issuer (requiring further exemptions to be granted).

7. The Law Society does however note that this is a complex and rapidly evolving area and would encourage the Ministry to consider the inputs being provided from the industry participants who made submissions on the June 2010 discussion paper.

Clause 28 and Clause 29 - Treatment of options and convertibles

8. The Law Society understands the reasons for treating:

   (a) options, under clause 28, as an offer of the option only (and requiring a PDS for a primary issue of options to include disclosure covering both the option and the underlying – and for the PDS to meet the relevant regulatory disclosures for the underlying); and

   (b) convertibles, under clause 29, as an offer of both the convertible and the underlying (so that the election to convert is treated as being offered at the time the PDS is given, accepted when the subscriber elects to convert and issued on conversion).

9. The Law Society also supports a continuation of the approach taken in the existing class exemption[1] as the most appropriate method of providing investors with up-to-date information at the time of exercise – by providing them with ongoing disclosures during the period that the right / convertible / option can be exercised. Requiring the PDS to be kept up-to-date would not be an attractive policy change.

Clause 33 - Purpose of the PDS

10. For the reasons noted below in relation to the Law Society's comments on clause 40, there is some discomfort with the "prudent but non-expert" formula.

11. In the same way that the Law Society urges further consideration of the Australian experience on disclosure document content, we question whether the benchmark could not be more clearly set at the retail investor with some investment experience – rather than a hypothetical (and difficult to pinpoint) inexperienced person.

Clause 40 - Meaning of material information

12. In keeping with a number of other responses in this submission, the Law Society is attracted to the idea of being able to draw on the deeper pool of experience and market practices in Australia. For this reason, the benefits of using Option A to define 'material information', in terms of benchmarking with the continuous disclosure do not appear to overcome the potential difficulties of trying to apply the test to untraded financial products – as is the case with many managed funds.

13. The Law Society notes that, in Australia, a hybrid model is used which appears to recognise that different materiality standards should apply to different types of investment product.

Clause 109 - Need to register managed investment scheme for regulated offer of managed investment product

14. As a general statement, the Law Society supports the demarcation suggested by the Ministry that follows from the policy setting that underpins the Financial Reporting Act whereby entities that have 'external users' of their financial statements are required to make those financial statements publicly available (by filing). It appears logical that those managed investment schemes that weigh up the benefits of registration and decide to raise funds from the (retail) public should publicly file audited financial statements.

15. For reasons of comparability, the halfway house of only including those registered schemes that make regulated offers subject to a requirement to comply with IFRS in full (while other

[1] Securities Act (Rights, Options, and Convertible Securities) Exemption Notice 2002

registered schemes only have to prepare and file GAAP accounts) does not hold immediate appeal.

Clauses 125 & 126A – General duties applying in exercise of manager's functions

16. The Law Society notes:

    (a) the derivation of clause 125 (the proposed duties of the manager of a registered scheme) including the comparison with the KiwiSaver Act; and

    (b) the extension in clause 126A of a subset of these duties to directors and senior managers of the manager.

17. Given the derivation and the influence of practices and developments arising out of the Australian managed funds industry – the Law Society anticipates that there may be a strong push for harmonisation with Australian law in the case of the duties of officers. This may be an area where the views of market participants should drive the policy setting.

Clause 211 - Price vs value in tests of materiality

18. The Law Society is in favour of continuing the Securities Markets Act treatment of referring to information that is expected to have a material effect on price (rather than following the Australian drafting to refer to price or value as alternates) and suggest that the focus should continue to be on the price effect, if the insider trading provisions are to extend to unquoted instruments such as derivatives. The Law Society is not aware of any Australian cases where it has been necessary to argue that the materiality issue was demonstrated by reference to value, and agrees:

    (a) with what it understands to be the Ministry view – that unquoted instruments such as derivatives are capable of being priced; and

    (b) if the value alternative was to be provided – there would need to be more guidance than appears on a plain reading of the relevant provisions of Part 7.10 of the Corporations Act on how 'value' is to be determined.

Clause 218 – Prohibition on insider conduct

19. In response to the questions raised by the Ministry, the Law Society notes that:

    (a) other comparable jurisdictions (most notably Australia) appear to prohibit trading in a wider range of financial products – such as non-quoted derivatives which are tradeable in a financial market. The Australian definition appears to contemplate 'over the counter' facilities but exclude services which merely provide information as well as the activities of 'market makers' (who are required to be licensed) as well the treasury operations of corporates.

    (b) subject to the comments that follow, it is broadly comfortable with the effect of section 6A of the Securities Act and section 13 of the Securities Markets Act being carried forward in the Exposure Draft – because each applies in an identifiable context (secondary sales or dealings in quoted securities). However, it does not see the need for a wider prohibition on insider trading in non-quoted financial products.

20. The Law Society notes that section 13 of the Securities Markets Act is very wide-reaching as it applies to both quoted and unquoted securities and to all dealings in securities and there are no

relevant defences to liability. For this reason, the Law Society endorses the proposal to limit the carry forward (in clause 239 of the Exposure Draft) to quoted financial products.

Clause 220 – Information insider must not disclose information

21. The Law Society agrees with the view that the 'tipping to hold' prohibition in section 8D(b) of the Securities Markets Act is unlikely to be used and notes the Ministry's comment that the mischief would appear to be covered by the prohibition in clause 221 on advising or encouraging a person to continue to hold financial products.

22. The Law Society also supports the conclusion that clause 221 does not need narrowing on the basis that the consent requirement in some company share trading protocols (and similar compliance measures) do not amount to advice or encouragement. The clarity provided by the adjustment to clause 237, to ensure that employee share purchase schemes fall within the defence for fixed trading plans, is also welcomed.

Clause 225 - Exception for disclosure in connection with preparing PDS or disclosure Document

23. The Law Society notes the reasons given by the Ministry for providing the exemption contained in clause 225. However, the Law Society notes that the very limited market experience of such secondary sales in New Zealand requiring disclosure and the few pieces of Australian experience gathered by Law Society members would tend to indicate that the exemption still may not be enough to encourage the issuer or its advisers to venture further into a zone that appears to provide the issuer and its directors with acute discomfort.

24. As a result, absent the sort of backstop (indemnity protection) that may be available in the case of (say) the sale of central or local government assets, clause 225 may open the floodgates to issuer cooperation in such sales processes.

Clause 235 - Inside information obtained by independent research and analysis

25. Notwithstanding the fact that clause 235 is a carry-over from section 10A of the Securities Markets Act, the Law Society has concerns that a separate defence of this nature appears inconsistent with the insider trading regimes in comparable jurisdictions (notably Australia).

26. Other jurisdictions appear to rely on the 'Chinese wall' defence (and the fact that research based on publicly-available information is not, by definition, 'inside information'). As a result, a defence based on information that is likely to be inherently non-public seems to make New Zealand an outlier when compared with the comparable regimes of our major trading partners. This, the Law Society suggests, brings into question whether the defence is needed (or perhaps wanted – on policy grounds).

Clause 278 - Directors' and officers' disclosure

27. The Law Society supports the proposal to restate the requirements for directors' and officers' disclosure, by:

    (a) limiting the persons who are subject to the disclosure obligation to directors and senior managers (the latter having the same definition as under the Financial Service Providers (Registration and Dispute Resolution) Act 2008); and

    (b) narrowing the range of financial products for which holdings and trades must be disclosed to interests in the quoted financial products of the listed issuer and quoted derivatives in which the underlying is a financial product of the listed issuer (or a related body corporate),

(c) limiting disclosure to holdings and trades in the quoted financial products for which the director or senior manager may be information insiders.

28. The Exposure Draft incorporates into primary legislation a number of exemptions from directors' and officers' disclosure currently found in regulations and class exemption notices.

29. The Law Society also notes the Ministry proposals to incorporate a number of existing exemptions into the Exposure Draft to allow (as is presently the case) for longer periods to disclose some transactions and aggregate more transactions into a single notice.

Clause 291 - Statutory exemptions from licensing of a financial product market

30. As a policy issue the Law Society accepts that there may be cases where markets that are only accessible to 'non-retail' investors should be licensed (or the subject of an exemption) for the reasons noted by the Ministry – including the need for certain conduct rules.

31. The Law Society suggests that market participants in the finance sector are best-placed to provide the Ministry with input on the size thresholds (and the types of wholesale markets that should be automatically exempt) for the bright line tests suggested.

Schedule 1, Clause 14 – Offers of controlling interest where there are five or fewer investors

32. The Law Society welcomes the proposal to exclude disclosure for offers of majority stakes – where there are a small number of investors acting jointly or in concert who are able to obtain from the offeror the information that will enable them to assess the merits of the offer and the adequacy of any information provided. In short, the Law Society believes this proposal is timely not only for the reasons identified by the Ministry but also because it could have scope for fostering greater M & A activity in circumstances where the purchaser is not able to fund all of the acquisition by cash.

33. The Law Society is also supportive of the idea of keeping this exception relatively broad and questions whether there needs to be a limit of five participants, particularly in light of the other conditions (acquisition of a majority stake and access to adequate information). In addition, the Law Society suggests that it may be useful to clarify that the limit on the number of investors does not include persons who would not otherwise require disclosure (i.e. wholesale investors, those in a close relationship, etc.)

Schedule 1, Parts 3 and 4 - Exclusions from governance or supervision requirements for debt securities and managed investment schemes

34. The Law Society's initial response to two alternatives proposed for disclosure for certain issuers and / or financial products that would otherwise be exempt from disclosure requirements (e.g. the Crown or registered banks offering category 2 products) is that:

(a) whilst the idea of term sheet type disclosure is an attractive one for what may be a rather short list of issuers and / or financial products – the ease of comparison provided by standardisation must also be considered;

(b) to this end, the ready market acceptance of the simplified disclosure prospectus provides a useful benchmark that streamlined disclosure built around a disclosure format with which issuers and investors already have some familiarity leads to speedy market acceptance;

(c) as a result, the Law Society would urge the importance of obtaining input from market participants not only about lowering the compliance burden but also the desirability of

requiring disclosures for some of the most commonly issued financial products and the most regular issuers to be built (on a reduced scale) around a common core; and

(d) the Law Society accepts that this approach would involve a greater up-front input from the Financial Markets Authority and the market (in terms of requiring additional exemptions and / or special rules) but expects that the types of issuers and / or products to be in an narrower range than (say) those currently exempted by section 5 of the Securities Act.