

The Chair
CABINET ECONOMIC DEVELOPMENT COMMITTEE

REVIEW OF FINANCIAL PRODUCTS AND PROVIDERS: TRUSTEE SUPERVISORY MODEL

PROPOSAL

- 1 This paper seeks agreement to the introduction of a new regime of supervision of corporate trustees, to be implemented as part of the Review of Financial Products and Providers.

EXECUTIVE SUMMARY

- 2 This paper seeks agreement to changes to the current regime for corporate trustees acting as supervisors of debt securities and collective investment schemes¹. These changes arise from the Review of Financial Products and Providers (the Review).
- 3 The proposed model retains trustees as ‘frontline’ supervisors of debt securities and collective investment schemes, but has an enhanced role for the Securities Commission, which will approve trustees and monitor them on an ongoing basis. This approval and ongoing monitoring will be a new regulatory function for the Securities Commission. I will refer to this model as the trustee supervisory model.
- 4 This paper outlines the trustee supervisory model, including the approval process, the scope of ongoing monitoring, and the penalties and remedies that will be available where a trustee is in breach of its obligations.

The ‘Supervision of Issuers’ Discussion Document

- 5 Currently the Securities Act 1978 requires the issuers of debt securities and collective investment schemes offered to the public to engage the services of a trustee corporation for the purposes of frontline supervision of that issuer. The primary instrument for this supervision is the trust deed. At present, legislation specifies certain terms which must be included in the trust deed (for example duties of the trustee). In addition, the trustee and issuer will negotiate other requirements which are appropriate to their individual duties and obligations.
- 6 In August 2006, I released the ‘Supervision of Issuers’ discussion document which focused on the role of trustees in respect of the supervisory function outlined above and discussed three aspects of the trustee role as follows:

¹ Collective investment schemes include participatory securities, unit trusts and superannuation schemes.

- a Whether trustees should continue as frontline supervisors of issuers of debt securities and collective investment schemes;
 - b Whether trustees had the necessary powers to carry out this role; and
 - c Whether there was sufficient transparency and accountability in relation to the supervisory function which is performed by trustees.
- 7 This paper focuses on the third issue noted above. The accountability and transparency of trustees directly relates to the trustee supervisory model and the proposal that trustees be licensed and supervised by the Securities Commission on an ongoing basis. This licensing and ongoing supervision will be a new regulatory function.
- 8 In relation to whether trustees should be retained, New Zealand was assessed in 2003 by the International Monetary Fund and World Bank with the Financial Sector Assessment Programme (FSAP). One of the issues they identified was that New Zealand placed heavy reliance on private supervisors (i.e. corporate trustees) and that there were insufficient checks and balances and accountability in how these people were performing their role.
- 9 In addition to the FSAP assessment, consultation undertaken by the Ministry of Economic Development identified other problems in relation to trustees as supervisors. They included: whether there are sufficient legislated entry requirements for trustees or whether inconsistent trust deed requirements and/or a lack of minimum protections in trust deeds makes it difficult for people to compare products, or may mean that consumers are lacking important protections; that trustees may need more powers in some areas to effectively carry out their role; and that transparency problems inherent in the existing trustee model mean it is hard for government to get whole-of-sector data and monitor the sector.
- 10 Despite these issues, there are benefits in the current trustee regime which can not be easily replicated in a regulator over such a wide range of different issuers. Trustees are close to the market, have a good knowledge of the areas in which they work, have good working relationships with issuers and regulators and have demonstrated capacity with a long and favourable record.
- 11 Submissions on the discussion document presented strong support for retaining trustees as frontline supervisors on the basis of these benefits. I also consider that the current regime of trustee supervision is fundamentally sound and support the continuation of their role subject to some enhancements.
- 12 In relation to whether trustees have necessary powers, I believe these powers should be enhanced. I intend to submit proposals to Cabinet in November to address these issues in relation to collective investment schemes² and issuers of debt securities. As non-bank deposit takers are a subset of debt issuers, the policy proposals which will be submitted to Cabinet in November will apply to

² Collective investment schemes include participatory securities, unit trusts and superannuation schemes

non-bank deposit takers in addition to the regulatory arrangements proposed in the accompanying paper entitled “Regulation of Non-bank Deposit Takers”.

Overview of the Trustee Supervisory Model

- 13 In reviewing the supervision of collective investment schemes and issuers of debt securities, the intention was to retain the benefits of the current trustee model, while addressing the problems that had been identified with that arrangement.
- 14 I propose that trustees be retained as the ‘frontline’ supervisors of debt security issuers, collective investment schemes and non-bank deposit takers. However, I also propose trustees now also be subject to:
 - a Registration with the Registrar of Financial Service Providers (see the accompanying “Registration of Financial Service Providers” paper);
 - b Approval by the Securities Commission to obtain a trustee licence; and
 - c Ongoing oversight by the Securities Commission.
- 15 I believe that this new trustee supervisory model and the proposed new functions will achieve the objective of retaining the benefits of the current trustee regime while effectively addressing the problems identified in the discussion document and by submitters.

Objective of the Trustee Supervisory Model

- 16 The broad objectives for the financial sector regulatory change in relation to trustees and their proposed supervision are as follows:
 - a Provide a well founded basis for consumers to rely on financial promises being kept;
 - b Encourage sound governance of institutions;
 - c Deter, detect and minimise the risk of unfair or fraudulent conduct; and
 - d Facilitate contestability, competitiveness and innovation.
- 17 The discussion document proposed a high-level objective statement specifically for the trustee supervisory model as follows:
 - a To give investors confidence that their investment is subject to supervision that effectively protects their interests, and for this purpose:
 - i Trustees have the capacity, industry knowledge, and experience to undertake effective, risk-based frontline monitoring of issuers; and
 - ii The Securities Commission has appropriate supervision and enforcement functions and powers to provide effective

accountability for the discharge by trustees of the legislative objectives.

- 18 The Commission's key role will be to ensure trustees have the capacity and capability to perform their role and to monitor whether they are carrying out the role satisfactorily; and to address any situations where a trustee's performance is not adequate. The frontline monitoring of issuers will remain the role of the trustee, not the Commission.
- 19 In any supervisory relationship there is capacity for tension between the parties to arise, particularly where interests and roles overlap, or are perceived to do so. Tensions which may arise will be subject to appeal processes discussed below.

Approvals

- 20 I propose that the Securities Commission will be provided with an expanded responsibility for approving and licensing trustees. The Commission currently has criteria in place for the approval of trustees and statutory supervisors. However, this does not cover all trustees and the criteria for approval are limited in scope. Therefore, the approval criteria I am recommending is an expanded form of the existing approach taken by the Securities Commission and will apply to all trustees who supervise issuers of collective investment schemes and debt securities to the public.
- 21 The proposed approval criteria will be flexible in order that they may be tailored to suit the trustees of various single issues of securities, or classes of securities issues. A wide variety of issuers with different characteristics are going to be supervised by trustees under this model, so a variety of trustees with different characteristics will be suitable as supervisors in different cases. In line with this flexibility, the Commission will be able to approve trustees to act for a specific issue, for a general class of securities (i.e. debt, or collective investment scheme), or on an 'all-securities' basis, as appropriate.

Registration

- 22 The trustee will need to comply with the registration requirements for entities participating in the financial services market, outlined in the accompanying paper "Registration of Financial Service Providers".

Independence of Trustee

- 23 Trustees for issuers of debt securities and collective investment schemes will need to be independent from issuers and related parties. This independence will provide assurance that there are no conflicts of interest between the trustee and issuer. As there can be an array possible avenues for a conflict of interest, the Securities Commission will need the flexibility to assess this facet on a case by case basis. An outcome of ensuring independence will be greater transparency and enhanced ability to hold relevant parties accountable.

Approval Criteria / Conditions

- 24 I propose that the legislation contain high-level approval criteria, with detail in regulation. The Securities Commission will have discretion in the application of criteria, and may impose conditions and obligations on a particular trustee if they believe it is appropriate, subject to a reasonableness requirement, and to an appeals process outlined below. The Commission will also be able to exempt applicants from a requirement where it is inappropriate in the particular circumstances.
- 25 The criteria that the Securities Commission will have to consider are:
- a. **Appropriate Experience:** The trustee must have the appropriate skills, qualifications, and experience to supervise the particular issue or class(es) of issues. The requirement should be assessed at both an individual and board level, as appropriate.
 - b. **Satisfaction of “Fit and Proper” Character Requirements:** For FATF purposes, directors and senior management must meet “fit and proper” criteria including those related to competence and integrity. This assessment will be undertaken by the Securities Commission. In addition, the FATF Recommendations also require that measures be implemented to prevent criminals and their associates from holding or being the beneficial owner of a significant or controlling interest or holding a management function in a financial institution. I propose to address this latter requirement through the “negative assurance” checks that will be undertaken by the Registrar of Financial Service Providers as part of the registration process outlined in the accompanying paper, “Registration of Financial Service Providers”.
 - c. **Infrastructure:** The Securities Commission will assess structural elements of an applicant trustee, such as adequate staff (in terms of numbers and experience and skill) and other resources. This assessment will also look at whether the applicant needs to outsource any of its duties to an external body, and if so, why, and what procedures are in place to ensure the proper performance of those functions.
 - d. **Appropriate Governance Standards:** The trustee will need to have appropriate governance standards in place, including procedures for addressing conflicts of interest and issues arising in relation to independence.
 - e. **Capital Adequacy:** The trustee must have the capital and financial strength to carry out its role as a trustee for a particular issue or class of issue. Trustees must maintain a certain level of capital and financial strength in order to manage their obligations in times of crisis. They may need to incur costs, and in some cases this expenditure will not be recoverable. It is important that trustees are able to shoulder this burden and work in the best interests of investors without financial constraints playing a significant role in decision-making.

- f. **Monitoring Systems and Procedures:** The trustee will be expected to provide details of the procedures it will follow in carrying out its functions, such as reporting and communication channels with the issuer and security holders, the frequency and methodology with which it will carry out its risk assessments, and the level of supervision that will apply to particular issues or classes of issue. The Securities Commission will keep in mind the particular risks of the products supervised and give its approval only when satisfied that a trustee's procedures are adequate for the risks posed by the issue.
 - g. **Professional Indemnity Insurance:** Trustees must demonstrate that they have adequate professional indemnity insurance.
 - h. **Corporate form:** All trustees must have corporate form in order to clarify legal and accounting separation of assets.
 - i. **New Zealand Residency Requirement:** There will be a requirement that a trustee is a New Zealand resident. However, as with the rest of the approval criteria, the Securities Commission will be able to exempt a trustee from the requirement, for example, where the issuer is in New Zealand, and the Securities Commission is satisfied that the trustee is sufficiently supervised in another jurisdiction (such as Australia).
- 26 The Governor-General will have the power to make regulations prescribing fees and charges in connection with the application and approval procedure. There will be consultation on any fees.³

Appeals from Approval Process

- 27 Trustees need some protection and avenues for redress in the approval process. If the Securities Commission declines an application, it will be obliged to give the applicant its reasons for doing so. If an applicant is dissatisfied with the decision to decline or with any terms and conditions placed on their approval, the Securities Commission's action will be subject to judicial review and an appeal process.
- 28 The applicant, however, will first be required to bring their case back to the Securities Commission for reconsideration. The Securities Commission will provide an opportunity for the applicant to be heard.
- 29 If the applicant is still dissatisfied, along with judicial review, there will be a right of appeal to the High Court, on both law and merits. This is in recognition of the fact that the decision to decline an application may have serious implications for the applicant's livelihood.

Offences for providing services without a licence

- 30 A person who acts as a trustee for any class or classes of securities issued to the public without a licence will commit an offence and be subject to penalties for

³ This power will be equivalent to the current s 70A(2) of the Securities Act.

that offence. The offence provisions will adopt a similar framework to those already contained in the Securities Act 1978.

Ongoing Monitoring by the Securities Commission

- 31 The Securities Commission will be responsible for the ongoing monitoring of trustees once they are approved. The Securities Commission will monitor whether the trustee continues to meet the criteria necessary for approval and will also monitor whether the trustee is meeting its obligation to supervise issuers.
- 32 The monitoring of compliance is an area where tensions need to be balanced. The trustee supervisory model is designed to allow room for both the Securities Commission and the trustees to effectively undertake their roles. The Securities Commission needs the ability to monitor and enforce a trustee's compliance with its obligations. On the other hand, the trustee has to be able to exercise its discretion and judgement in how it deals with issuers, without fear of being second-guessed. The structure of the model needs to be designed with the aim of minimising any tensions that may arise. Provisions for the kinds of situations where tensions may arise are outlined below.

Periodic Reporting

- 33 To ensure the Securities Commission has sufficient information to monitor the trustee, the trustees will be required to report to the Commission on a regular basis. The default frequency will be annually, but the Securities Commission will have the ability to specify a more frequent reporting regime where appropriate. The reports will be designed to reveal:
 - a **Ongoing satisfaction of approval criteria/conditions:** For example, information on financial strength to show that any capital adequacy requirements are being maintained.
 - b **Ongoing fulfilment of trustee responsibilities:** To meet their responsibility to effectively supervise issuers; and
 - c **Statistical Data:** For example, information to contribute to a high-level overview of the financial sector such as how many issuers and issues are being supervised, or how many issuers have defaulted in a particular year.

- 34 The requirements for the contents of periodic reports will be set out in regulations. There will also be scope for the Commission to add to the list for a particular trustee. Gathering statistical data will not be without cost to the trustee, so any requirements will only be put in place after consideration of the necessity of the information, and whether the trustee is the best source.

Event-based Reporting

- 35 The trustee must report to the Securities Commission upon the occurrence of any breach of its particular approval requirements or its supervisory responsibilities, and outline to the Commission how it is addressing the breach.

- 36 The trustee must also report any material changes that fall short of a breach of the approval criteria.

Complaints

- 37 I propose the Securities Commission have the ability to receive and act upon complaints which arise from the approval or monitoring of trustees under the trustee supervisory model for the purpose of enforcing the regime. This is not intended to undermine any dispute resolution mechanism, but rather is aimed at enabling the Commission to act on any information it receives, relating to a complaint.

Information Gathering Powers

- 38 Currently the Securities Commission may inspect documents (including on-site inspection) if that inspection is for the purposes of the Securities Act 1978, or various other Acts. The Commission may only undertake an inspection if it considers, along with any other relevant matters, any matters relating to the necessity or expediency of carrying out an inspection. An inspection may be challenged under section 68G of the Securities Act 1978.
- 39 I propose retaining these thresholds for the trustee supervisory model to enable the information gathering powers to apply to trustee licensing and ongoing monitoring.

Confidentiality

- 40 All data given to the Securities Commission under the supervisory model will be considered to be given in confidence and kept private, except data that is amalgamated with that of other trustees in order to provide an overview of the sector. All data given in confidence will have protection from the Official Information Act 1982. This mirrors similar protections found in the Corporations (Investigation and Management) Act 1989⁴ and the Reserve Bank of New Zealand Act 1989.⁵ However, the trustee will be able to agree with the Securities Commission to release a particular piece of information.

Breaches Under the Trustee Supervisory Model

- 41 Breaches of the obligations arising under the trustee supervisory model will vary in severity. Therefore, I recommend that the Securities Commission be provided with a graduated set of powers to deal with a trustee that appears to be in breach:
- a The power to request further information from a trustee;
 - b Power to direct a trustee to fix a breach within a particular time frame, and to require the trustee to provide the Commission with details of *how* it proposes to address the breach;

⁴ Corporations (Investigation and Management) Act 1989, s 23.

⁵ Reserve Bank Act 1989, s 105.

- c Where the Securities Commission is not satisfied with the trustees proposed course of action to rectify the identified breach, the Securities Commission will have the power to direct what course of action the trustee will take with a right to be indemnified when acting under such direction;
 - d Enforcement provisions, including criminal offence provisions, where a trustee fails to meet their obligations or fails to comply with a direction of the Commission;
 - e Suspension from taking on new appointments to act as a trustee for a particular issue of securities; and
 - f In a severe situation, the ability to apply to the High Court for an order removing a trustee from a specific appointment, or revoking a trustees' licence for particular class(es) of securities. In a very severe situation, it will be possible to revoke all the trustees' licences. A court order is necessary as such a move may have severe consequences for the livelihoods of those involved.
- 42 The suspension or removal of a trustee from a specific appointment, or appointments generally, may create a vacuum. In most cases, the market will readily absorb profitable appointments when there is a trustee removal. There may be cases, however, where the issuer is unable to appoint a new trustee. In those cases, the Securities Commission could appoint an 'interim trustee' until the issuer finds a new trustee. This would be similar to the concept of a statutory role. The interim trustee could either continue to supervise the trust, or wind it up in accordance with the trust deed. The interim trustee will have assured funding, and indemnification from liability for any actions or omissions of the removed trustee. An interim trustee would not be able to profit from the appointment.

Appeals against Securities Commission use of powers

- 43 Trustees need some protection and avenues for redress for decisions made by the Securities Commission to use their powers. If the trustee is dissatisfied with Securities Commission's decision to use a specified power they will have a right to appeal to the High Court for judicial review.

Information Sharing with Registrar of Companies

- 44 Trustees currently have obligations to the Registrar of Companies under the Corporations (Investigation and Management) Act 1989, including giving notice under section 11 of their concerns in certain dire circumstances. Currently, trustees often consult with the Securities Commission prior to giving the Registrar such notice, and it is proposed that they retain this ability. Submitters supported this, but did not wish such consultation to be an obligation. It is however proposed that when a section 11 notice is given, the Registrar of Companies give a copy of this notice to the Securities Commission for the purposes of the Commission's role as general overseer of trustees.

Transition Arrangements for Existing Trustees

- 45 The Securities Commission already has a similar function in approving some trustees. Of those trustees the Commission currently approves, it considers competence and financial capacity, character, independence and accountability of trustees. Therefore it is not expected that it will be difficult for existing trustees to obtain a new trustee licence as some of the key components of the newly proposed approval criteria are based on an existing assessment framework.
- 46 As the legislation is intended to come in to force in 2010, trustees already operating in the market will have the opportunity to work with the Securities Commission to mitigate the risks that a trustee may be unable to meet the licensing criteria. In addition, as the new approval criteria will be clearly set out in legislation and ongoing consultation in regard to detail design, the trustee market will have an appropriate degree of certainty as to the factors which will be important to the new licensing framework.

Removal of Trustee Corporations' Automatic Approval

- 47 Currently, the four statutorily-approved trustees (Public Trust, Trustees Executors, Guardian Trust, and Perpetual Trust) have an automatic right to act as trustees for collective investment schemes and debt issues. I recommend that this automatic right be removed, in order to create a level playing field. Anyone wishing to be approved to act as a trustee will have to demonstrate to the Securities Commission that they meet various authorisation criteria, as outlined above. I am assured that the current statutory trustee corporations should be able to meet any of the proposed criteria.

CONSULTATION

- 48 Public consultation was undertaken by way of the "Review of Financial Products and Providers: Supervision of Issuers" discussion document released in August 2006. Around 140 submissions were received on the review as a whole, and 26 submissions were relevant to this aspect of the review.
- 49 The submissions received on the discussion document were considered in drafting this paper.
- 50 The accompanying "Overview" paper outlines the agencies consulted in the development of these papers.

FISCAL IMPLICATIONS

- 51 Some of the proposals in this paper and the accompanying papers will result in additional functions and powers for the Securities Commission. This will require additional funding for the Commission once the legislation is passed. On the assumption of only 15 trustees, we estimate the fiscal implications of the Securities Commission licensing, ongoing monitoring and enforcement of the trustee supervisory model being \$25,000 with ongoing monitoring costing approximately \$650,000 per annum.

HUMAN RIGHTS

- 52 Overall the proposals in this Cabinet paper do not appear to be inconsistent with the New Zealand Bill Of Rights Act 1990, or the Human Rights Act 1993. However, if any issues do arise, officials from the Ministry of Economic Development and the Ministry of Justice will work together to ensure that the legislation is consistent with the Bill of Rights Act. A view as to whether the proposals will be consistent with the Bill of Rights Act will be possible once the legislation has been drafted.

LEGISLATIVE IMPLICATIONS

- 53 The accompanying “Overview” paper outlines the legislative implications from these papers.
- 54 The proposals in this paper will likely require changes to the Securities Act 1978; the Securities Regulations 1983; the Unit Trusts Act 1960; The Corporations (Investigation and Management) Act 1989; the Trustee Act 1956; The Trustee Companies Act 1967; and the Trustee Companies Management Act 1975.

REGULATORY IMPACT ANALYSIS

- 55 The Ministry of Economic Development confirms that the Code of Good Regulatory Practice and the regulatory impact analysis requirements, including the consultation RIA requirements, have been complied with. A RIS was prepared and the Regulatory Impact Analysis Unit considers the RIS and the RIA analysis undertaken to be adequate. A draft RIS was circulated with the Cabinet paper for departmental consultation purposes.

PUBLICITY

- 56 This will be consistent with the “Overview” paper.

RECOMMENDATIONS

- 57 It is recommended that the Committee
- 1 **Agree** that trustees be retained as ‘frontline’ supervisors of collective investment schemes and debt security issues, subject to the approval and ongoing oversight of the Securities Commission as proposed in the trustee supervisory model outlined in this paper.
 - 2 **Agree** to the broad objectives for financial sector regulatory change in relation to trustees and their proposed supervision are as follows:
 - 2.1 Provide a well founded basis for consumers to rely on financial promises being kept;
 - 2.2 Encourage sound governance of institutions;
 - 2.3 Deter, detect and minimise the risk of unfair or fraudulent conduct; and

- 2.4 Facilitate contestability, competitiveness and innovation.
- 3 **Note** that the Discussion Document proposed a high-level objective statement specifically for the trustee supervisory model as follows to give investors confidence that their investment is subject to supervision that effectively protects their interests, and for this purpose:
- 3.1 Trustees have the capacity, industry knowledge, and experience to undertake effective, risk-based frontline monitoring of issuers; and
- 3.2 The Securities Commission has appropriate supervision and enforcement functions and powers to provide effective accountability for the discharge by trustees of the legislative objectives.
- 4 **Agree** that trustees be independent from issuers and parties closely related to issuers.
- 5 **Agree** that the Securities Commission have responsibility for approving trustees (with or without conditions) for specific issues, a general class of securities, or on an all-securities basis.
- 6 **Agree** that the Securities Commission approve trustees upon consideration of various criteria – with high-level direction in legislation, and detailed guidance in regulation:
- 6.1 Appropriate Experience;
- 6.2 “Fit and Proper” Character Requirements;
- 6.3 Capital Adequacy;
- 6.4 Infrastructure;
- 6.5 Appropriate Governance Standards;
- 6.6 Monitoring Systems and Procedures;
- 6.7 Professional Indemnity Insurance;
- 6.8 Corporate Form; and
- 6.9 New Zealand Residency.
- 7 **Agree** that the Securities Commission have the power to exempt a trustee from one or more of these criteria where appropriate
- 8 **Agree** that the Governor-General have power to make regulations prescribing fees and charges in connection with the application and approval procedure.

- 9 **Agree** that a trustee applicant who wishes to dispute a Securities Commission decision related to the trustee's approval or licence conditions, must first refer the matter back to the Securities Commission with a subsequent right of appeal to the High Court on issues of law and on the merits of the decision.
- 10 **Agree** that the Securities Commission be responsible for the ongoing monitoring of trustees once they are approved.
- 11 **Agree** that trustees be required to report to the Commission at least annually on:
- 11.1 Ongoing satisfaction of authorisation conditions;
 - 11.2 Ongoing fulfilment of trustee responsibilities; and
 - 11.3 Statistical data, to be determined by regulation.
- 12 **Agree** that trustees must report to the Securities Commission upon the occurrence of any breach of trustee obligations, and outline to the Commission how it is addressing the breach.
- 13 **Agree** that trustees be under an obligation to report to the Securities Commission any material changes that fall short of a breach.
- 14 **Agree** that the Securities Commission may also act on complaints it receives from an investor, issuer or manager.
- 15 **Agree** that the Securities Commission's powers to obtain information by summons or to inspect documents in the Securities Act be extended to include inspections related to the Securities Commission's approval and monitoring of trustees.
- 16 **Agree** that trustees have avenues for redress for decisions made by the Securities Commission to use its powers. The right will be appeal to the High Court for judicial review.
- 17 **Agree** that information passed between trustees and the Securities Commission be considered confidential, and protected from the Official Information Act 1982, unless it is aggregated and amalgamated with that of other trustees.
- 18 **Agree** that the Securities Commission have a graduated set of powers, which include but may not be limited to, to deal with a trustee that appears to be in breach of its obligations:
- 18.1 The power to request further information;
 - 18.2 Power to direct a trustee to remedy a breach within a particular time frame, and to require the trustee to provide the Commission with details of how it proposes to address the breach;

- 18.3 Where the Securities Commission is not satisfied with the trustee's proposed course of action to rectify the identified breach, the Securities Commission will have the power to direct what course of action the trustee will take with a right to be indemnified when acting under such discretion;
- 18.4 Enforcement provisions, including criminal offence provisions, where a trustee fails to meet their obligations or fails to comply with a direction of the Securities Commission;
- 18.5 Suspension from taking on new appointments to act as a trustee for a particular issue of securities; and
- 18.6 In a severe situation, the ability to apply to the High Court for an order removing a trustee from a specific appointment or revoking a trustees' licence for a particular class(es) of securities, or in very severe circumstances revoking all the trustee's licences.
- 19 **Agree** that the Securities Commission have the power to appoint a statutory trustee until an issuer can find another trustee.
- 20 **Agree** that the interim trustee be fully funded, indemnified from liability and not able to profit.
- 21 **Agree** that the Registrar of Companies must give the Securities Commission a copy of any notice given under section 11 of the Corporations (Investigation and Management) Act 1989.
- 22 **Agree** that the current automatic right of the four statutorily-approved trustees to act as trustees for CIS and debt security issues be removed, and that they instead be subject to the approval of the Securities Commission like all other trustees.
- 23 **Invite** the Minister of Commerce to issue drafting instructions to Parliamentary Counsel Office to give effect to the above recommendations.
- 24 **Agree** to delegate to the Minister of Commerce the power to make decisions on minor issues that arise during the drafting process.

Hon Lianne Dalziel
Minister of Commerce

Regulatory Impact Statement

EXECUTIVE SUMMARY

At present, issuers of collective investment schemes and debt securities to the public are required to obtain the services of a corporate trustee. The trustee model of supervision is fundamentally sound but there are some weaknesses. These are inconsistent levels of capability and expertise among trustees due to inconsistent approaches to approval, lack of appropriate transparency and accountability in the trustee role, limited government capability to take targeted action when a trustee is failing to meet its duties and failure to meet international obligations on anti-money laundering and the combating of terrorist financing.

To address the weaknesses in the trustee model of supervision it is proposed that trustees be registered as a financial service provider, approved by the Securities Commission in accordance with a specified criteria to obtain a trustee licence, and subject to ongoing monitoring by the Securities Commission to ensure compliance their licence.

ADEQUACY STATEMENT

The Regulatory Impact Analysis Unit has reviewed the RIS and considers the RIS is adequate according to the criteria.

STATUS QUO AND PROBLEM

Legislation currently applying to trustees are the Securities Act 1978, the Securities Regulations 1983, the Unit Trusts Act 1960; the Corporations (Investigations Management) Act 1989, the Trustee Act 1986; the Trustee Companies Act 1967, and the Trustee Companies Management Act 1975.

The Securities Act 1978 requires issuers of debt securities and collective investment schemes to the public to engage the services of a trustee corporation. There are two categories of entities which can act as a trustee or statutory supervisor. First are trustee corporations which are established by their own Acts of Parliament and given automatic authority to act under the Securities Act. The second group are individuals or entities holding Securities Commission approval to act as trustees or statutory supervisors. The current criteria for Securities Commission approval are based on factors such as competence and financial capacity, character, independence and accountability.

The current regime of trustee supervision for debt and collective investment schemes issuers is fundamentally sound. There are many benefits to the current model, such as the flexibility of trustee-based supervision, which means that supervision may be tailored to the risk of a particular issue or issuer. Trustees are close the market, have a good knowledge of the areas they supervise, have good working relationships with issuers and regulators, have demonstrated capacity and a long and favourable track record – none of which can easily be replicated in a regulator.

However, some problems have been identified with the trustee model. When the Financial Sector Assessment Programme (undertaken by the International Monetary Fund and World Bank) assessed New Zealand in 2004, one of the key issues identified

was the heavy reliance on trustees without proper checks and balances or accountability in the performance of their role. It is also recognised that trustees do not face sufficient entry requirements. In addition, as the monitoring is spread between a number of trustees (as opposed to a single entity), it is difficult for government to get whole-of sector data in order to monitor the sector.

OBJECTIVES

The broad objectives used are those for the Review of Financial Products and Providers and include:

- a Provide a well founded basis for consumer to rely on financial promises being kept;
- b Encourage soundly governed institutions;
- c Deter, detect and minimise the risk of unfair or fraudulent conduct; and
- d Facilitate contestability, competitiveness and innovation.

However the key focus and objective of this area of the review is to ensure that the independent third party who has the core focus of protecting the interests of investors has the requisite skills and competencies to carry out that role and conducts itself competently over time.

The specific objective for the supervisory model is:

- a To give investors confidence that their investment is subject to supervision that effectively protects their interests, and for this purpose:
 - i The frontline supervisor have the capacity, industry knowledge, and experience to undertake effective and risk-based frontline monitoring of issuers; and
 - ii The licensor of the frontline supervisors has appropriate supervision and enforcement functions and powers to provide effective accountability for the effective discharge by frontline supervisors of the legislative objectives.

ALTERNATIVE OPTIONS

Centralised government regulator

The alternative to the existing regime of trustee supervision is a government regulator. The government regulator would provide direct supervision of entities issuing collective investment schemes and debt securities to the public. This option was discounted at an early stage in the policy development process as the feedback from advisory groups established by MED and submissions on the discussion document was that the existing model of trustee supervision worked well and could be enhanced to meet the governments objectives. To adopt a government regulator would result in unnecessary costs.

PREFERRED OPTION

The preferred option is to enhance the existing regime of trustee supervision. This would entail establishing consistent minimum criteria for approval of trustees. The criteria would then apply to any trustee wanting to provide its services to issuers of collective investment schemes and debt securities to the public. Existing approvals would be revoked. In addition to establishing a criteria, the entity with responsibility for approving trustees will require the necessary powers to ascertain whether a trustee is meeting the terms and conditions of its licence on an ongoing basis. Also, it will need the requisite powers to appropriately address any breaches of the model. Making these enhancements to the trustee model of supervision would overcome the earlier identified problems and also meet the desired objective of consistent minimum levels of trustee capability and expertise over time.

For a trustee to obtain approval they must be registered and independent from the issuer or any related parties. In addition they will need to satisfy the following criteria: appropriate experience; "Fit and Proper" character requirements; infrastructure; appropriate governance standards; capital adequacy; monitoring systems and procedures; professional indemnity insurance; corporate form; and New Zealand residency requirement. A trustee will then be required to report to the Securities Commission to demonstrate ongoing satisfaction of approval criteria, ongoing fulfilment of responsibilities and to provide statistical data.

The Securities Commission will undertake the role of licensor and ongoing monitor of trustees as it already possesses the key skills required. This is because the Securities Commission is a conduct regulator (it licences and monitors the conduct of a number of entities in the securities market) and the proposed supervision of trustees is focused at a trustee's conduct.

The key risk to the model of trustee supervision relates to the Securities Commission not having adequate information to assess a trustee's capability at point of licensing and to determine whether a trustee is meeting its licensing requirements over time. To address this, the Securities Commission will be provided with appropriate powers to obtain necessary information and appropriate powers to rectify any breaches which may arise.

To minimise the costs of compliance the Securities Commission will take a tailored and risk-based approach to licensing and ongoing supervision of trustees. This will be achieved through a flexible and case by case approach by the Securities Commission assessment of whether a trustee has the necessary capability and expertise to fulfil its role. The Securities Commission will also be provided with graduated powers enabling targeted resolution to any breaches of the model by a trustee.

The new proposals for trustees will result in costs. These will primarily relate to initial licensing costs for the trustee (preparation of information and reports) and then costs involved in demonstrating to the Securities Commission there is ongoing compliance with the terms and conditions of the trustee's licence. We anticipate that licensing costs will be kept to a minimum and likely model the existing approval fees contained in the Securities (Fees) Regulations 1998. This would involve a fixed fee (currently less than \$200) plus an hourly rate (less than \$300 an hour). For existing trustees the new proposed criteria are not expected to result in significant costs or change in regard to capability and experience as they will generally already possess the key competencies

needed to obtain a licence. Where an existing trustee is not able to obtain a licence to operate there will be an appeal mechanism to enable the decision to be reheard.

The Securities Commission will also experience cost in relating to undertaking licensing, ongoing monitoring and enforcement of the trustee supervisory model. This will relate to human capital, infrastructure and time. On the assumption that there be only 15 trustees, as is roughly the case at present, the overall costs for the Securities Commission to licence trustees, on the basis of the proposed criteria, is estimated at \$25,000 with ongoing monitoring of trustees costing approximately \$650,000 per annum.

The proposals in this paper will likely require changes to the Securities Act 1978; the Securities Regulations 1983; the Unit Trusts Act 1960; The Corporations (Investigation and Management) Act 1989; the Trustee Act 1956; The Trustee Companies Act 1967; and the Trustee Companies Management Act 1975. It is also likely that portions of the Acts of Parliament established for the automatic authorisation of trustee corporations will need to be revoked.

IMPLEMENTATION AND REVIEW

The proposed legislation is intended to come in to force in 2010 along with the other areas of the Review of Financial Products and Providers. This will give trustees currently operating in the market adequate time to work with the Securities Commission to minimise the risk they will not be able to meet the licensing criteria. As there is anticipated to be less than 15 trustees this should not place undue strain on the Securities Commission.

To enable effective implementation consultation will be undertaken with the relevant parties to develop appropriate detail on further implementation strategy while also ensuring co-ordination with other legislative changes proposed through the Review of Financial Products and Providers.

CONSULTATION

Problem identification involved targeted consultation with key stakeholders to assist in the accurate identification problems and their magnitude. The key stakeholders included industry associations, market participants, consumer representatives and other government agencies.

The options development phase of The Review comprised of advisory groups both in Auckland and Wellington. Advisory group membership was determined through an application process. Each advisory group provided a cross section of industry representation and specialists to facilitate robust debate and encourage balanced conversation and options formulation.

In September 2006 the Minister of Commerce Released a discussion document "Supervision of Issuers" which outlined the overall objectives, problems and options for reform. There were no significant concerns raised by submitters with the Securities Commission supervision of trustees.

The following government agencies have been consulted on the proposals in this paper and no major concerns were raised: the Department of the Prime Minister and Cabinet,

the Inland Revenue Department, Department of Labour, Internal Affairs, State Services Commission, Retirement Commission, Ministry of Social Development, Ministry for the Environment, Te Puni Kokiri, Customs Department, Department of Building and Housing and the Office of the Privacy Commissioner, Ministry of Foreign Affairs and Trade, Commerce Commission. The Reserve Bank, Treasury, Ministry of Justice, Securities Commission and Ministry of Consumer Affairs are members of the inter-departmental working group contributing to the Review and their views are reflected in the proposals.