

The Chair
CABINET ECONOMIC DEVELOPMENT COMMITTEE

**LOCAL AUTHORITIES EXEMPTION FROM THE SECURITIES ACT 1978
DISCLOSURE REGIME**

PROPOSAL

- 1 This paper seeks Cabinet approval for the reinstatement, with qualifications, of the Local Authorities exemption in section 5(3)(b) of the Securities Act 1978. This section was previously repealed in 1996, with effect from 1998.

EXECUTIVE SUMMARY

- 2 The policy objective of the Securities Act 1978 is to promote investor confidence in the capital markets by reducing risk in ways that are considered to be cost effective. The policy tools that are used to achieve this objective are a regime of information disclosure (to fully inform investors of the securities product being offered and of the current position and future prospects of the provider), together with a regime of civil and criminal liability (to promote the provision of accurate information).
- 3 As such, the premise underlying the Securities Act and the objectives behind the disclosure regime for securities offerings are to ensure that investors receive full, accurate and timely disclosure from issuers of information material to their investment decisions. Concurrently, issuers should have cost-effective access to capital from the public. Therefore the disclosure regime should not impose any unnecessary compliance costs, and ensure that issuers can raise capital from either public or private sources.
- 4 After due consideration of the level of disclosure that local authorities currently operate under with regard to their finances, plans and prospects, I propose an exemption for local authorities from certain disclosure requirements by amending the Securities Act. This will grant local authorities reduced disclosure requirements when issuing debt securities to the public in line with similar existing exemptions for the Crown, the National Provident Fund Board, the Reserve Bank and Housing New Zealand Corporation.

- 5 I propose to do this by reinstating the exemption for local authorities that was provided in the Securities Act prior to 1996. This would reduce the disclosure requirements of local authorities by requiring them to produce only an investment statement with a certificate (set out in Regulation 17 of the Securities Regulations 1983 for advertisements) signed by two councillors. This would serve to alleviate the procedural complications associated with the current signature and liability provisions of the Securities Act which requires all directors (councillors) to sign the prospectus.
- 6 Further, the issuing authority would have the discretionary power, as is currently the case under s12 of the Local Government Act 2002, to charge a rate or rates revenue as security for the issue on offer, or to allow market forces to determine the risk premium applicable to the particular offer.
- 7 I propose that these amendments be made in a Securities (Local Authorities) Amendment Bill to be passed, if possible, in 2007. There is no current place on the legislation programme for this Bill but as it is a short Bill of low complexity that will significantly and quickly expand the avenues by which local authorities can raise capital, I propose it proceed with some urgency.

BACKGROUND

Policy rationale for the application of the Securities Act 1978

- 8 The Securities Act is investor protection legislation. The premise underlying the Securities Act is that the best protection of investors lies in full, timely and accurate disclosure of information material to investors' investment decisions. This allows investors to make an informed decision on the potential risks and returns of their investment choices and to take responsibility for their own investment decisions.
- 9 I recognise that the disclosure regime imposes costs on issuers. I want to ensure that these costs are only imposed if they are outweighed by the benefits the disclosure regime provides to investors. To achieve this, I propose reinstating an exemption for local authorities that will provide them with a reduced disclosure regime due to the significant disclosure requirements they already meet under the Local Government Act 2002 (Part Six and Schedule 10).

History of previous Local Authority exemption from the Securities Act 1978

- 10 Until 1998, local authorities were exempted from the provisions of the Securities Act relating to the issuing of securities to the public.
- 11 The basis for the exemption was that local authority borrowing was heavily regulated under the Local Authorities Loans Act 1956 which, in particular, limited to whom local authorities could issue debentures and also provided that a special local authority rate was created as security for the repayment of any loan. In these circumstances the general provisions of the Securities Act were seen as unnecessary and inappropriate.

- 12 The Local Government Amendment Act (No.3) 1996 significantly reformed the borrowing powers of local authorities. The Local Authorities Loans Act 1956 was repealed and local authorities were provided with the same general powers to borrow as companies and other corporate entities. The exemption from Securities Act requirements was repealed and local authorities were therefore subject to the same obligations under the Securities Act as companies and other corporate entities.
- 13 However, this 'level playing field' approach did not take into account the significant differences in the reporting regimes and legal frameworks of local authorities and corporate entities.
- 14 The net effect of the removal of the exemption from the Securities Act has been the withdrawal of local authorities from the public debt securities market. Since 1998 only one local authority – Auckland City Council – has issued debt securities to the public. With that exception all local authority borrowing, which is used primarily for infrastructure development, has since been sourced from financial institutions.
- 15 Infrastructure assets are long term investments and borrowing helps spread the cost over the life of the asset. Consequently, financial decisions by local authorities raise important issues of equity, including inter-generational equity and affordability. Section 101(3) of the Local Government Act places local authorities under a statutory obligation to consider this inter-generational equity principle (along with community wellbeing) when making funding decisions.

Outline of and rationale for proposed exemption from the Securities Act 1978

- 16 The proposed reduced disclosure requirement would exempt local authorities from the current regime which requires the production of both an investment statement and a prospectus, including full sign-off by all Councillors of the prospectus, for the offer of any debt securities to the public.
- 17 Instead local authorities would be required to produce only an investment statement, which in the terms of the Securities Act is an advertisement, and therefore requires a certificate to be signed by two directors (councillors) under regulation 17 of the Securities Regulations 1983. There is also the option available to the local authority to charge a rate or rates revenue as security for any issue of debt securities to the public.

Exemption from Disclosure Regime

- 18 Currently the cost of preparing disclosure documents and having them audited can be prohibitive for entities issuing other than large debt issues. This potentially excludes smaller local authorities, some of whom are facing significant challenges with water and sewerage infrastructure development, from raising capital via public debt issues. (Local authority long-term plans show that local authorities are undertaking some \$30.8 billion in capital works – network or community infrastructure - in the 10 years to June 2016).¹

¹ Source: Hansard, *Questions for Oral Answer*, 7 November 2006; note that due to potential 'frontloading', 50% of this amount could be required by 2009.

- 19 Local authorities by their statutory obligations effectively operate in a manner that achieves the policy objectives of the Securities Act as stated above. They are public bodies that cannot be wound up for default, and have powers to support their financial commitments through a mandatory tax (ie. rates).²
- 20 Nevertheless, the ability of local authorities to charge rates and spend rate payers' money is a key reason why disciplines on their expenditure and ability to borrow are necessary. In the past there have been concerns about local authorities getting into debt and their ability to replay their obligations. However, the Local Government Act 2002 addressed this issue by introducing the current reporting regime.
- 21 Local authorities operate under significant disclosure requirements with regard to their finances, plans and prospects.³ They are required to produce annual planning and reporting documents that include audited financial statements that comply with Generally Accepted Accounting Practice and Financial Reporting Standard 42. Therefore they cover the primary information required in a prospectus for debt securities concerning the present financial position and performance of the issuer.
- 22 They are also required to produce an independently audited Long-Term Council Community Plan that covers details of all services and capital works proposed, and associated funding arrangements. Included in this Plan are 10 year prospective statements of financial performance, financial position, cash flows and movements in equity. As a consequence there is a substantial degree of duplication between the Local Government Act disclosure requirements and those in the Securities Act and Regulations.
- 23 My intention to require local authorities to produce only an investment statement would bring them into line with similar existing exemptions for the Crown, the National Provident Fund Board, the Reserve Bank of New Zealand and Housing New Zealand Corporation.
- 24 The issuing authority would also have the discretionary power, as is currently the case under s12 of the Local Government Act, to charge a rate or rates revenue as security for the issue on offer, or to allow market forces to determine the risk premium applicable to the particular offer.
- 25 If the local authority is guaranteeing the securities, it is required to state in clause 10, (Schedule 3D of the Securities Regulations 1983) that it has charged a rate or rates revenue as security for the issue on offer, and explain in clause 12 the consequences in the event of default by the local authority on the issue. In the unlikely situation that a default happens when a rate or rates revenue has been charged as security for a particular offer, then compliance with section 115 (rates as security) of the Local Government Act 2002 will apply.

² Local Government Act 2002, s115 'Rates as security'.

³ Local Government Act 2002, Part Six & Schedule 10.

Exemption from the Signature and Liability Provisions

- 26 The signature and liability provisions in the Securities Act also present a problem for local authorities. The current requirement under the Securities Act that all elected members sign the prospectus, in effect means that *unanimous* support for a project, and the issuing of debt to fund that project, is needed for a local authority to issue debt securities to the public.
- 27 While company directors tend to operate under the principle of collective responsibility, no such obligation exists within local government. One of the constitutional principles of local government is that elected members are not liable (at law) for decisions and actions they do not support.
- 28 Therefore, in line with local authorities being granted reduced disclosure requirements under the Securities Act, I propose that the investment statement accompanied by a certificate signed by two councillors (as required for advertisements under regulation 17 of the Securities Regulations 1983) be sufficient assurance that the information disclosed is an adequate and accurate account of the specific issue on offer. Note also that this requirement is likely to be further eased in proposed changes to the Securities Regulations whereby two officers of an issuer would be able to sign on behalf of the two directors (councillors).

CONSULTATION

- 29 This paper has been prepared in consultation with the Treasury, the Securities Commission, the Department of Internal Affairs, and the Ministry of Justice.
- 30 Officials' identification of this issue and the development of this proposal were also informed by expert advisory groups comprising people from key industry and professional groups through the Review of Financial Products and Providers, including Local Government New Zealand.
- 31 The Ministry of Economic Development released a discussion document in September 2006 on securities offerings as part of a wider series of discussion documents relating to this Review. The discussion document included a section considering possible exemptions for local authorities. It was widely publicised and was also made available on the Ministry web-site. Approximately 140 submissions were received, fifteen of which were directly relevant to the proposal in this paper.
- 32 Therefore the proposal in this paper is presented on the basis of an inclusive consultation process. Two questions were asked: should local authorities have an exemption from i) the disclosure regime, and ii) the requirement for all councillors to sign the offer document? Half of the submitters agreed that both exemptions be granted.
- Two submitters disagreed with the first exemption for reduced disclosure, but approved of an alternative mechanism to meet the signatory requirements – the added complexities of implementing the latter without the disclosure exemption would unnecessarily exacerbate the offer process.

The arguments of those opposed to granting local authorities either exemption were:

- that all issuers should have the same disclosure obligations – not a strong or relevant argument given that other exemptions exist; and
- that it would provide local authorities with an unfair market advantage – there is no evidence to support this argument, from the above analysis of the reporting and legal differences between local authorities and companies the opposite seems to be the case.

FISCAL IMPLICATIONS

33 No fiscal implications for government would result from this proposal.

COMPLIANCE

34 The proposals in this paper appear to be consistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993, and the Treaty of Waitangi.

35 The proposals in this paper raise no privacy issues, and international standards and obligations are not specifically applicable. However, New Zealand's general disclosure regime complies with international practice.

36 This is a minor amendment to the Act re-enacting a pre-existing exemption which is not in conflict with the LAC Guidelines.

LEGISLATIVE IMPLICATIONS

37 Change is required to section 5(3)(b) of the Securities Act 1978 to restore the previous exemption for local authorities. It is proposed that this change will form the Securities (Local Authorities) Amendment Bill. A stand-alone Bill is required as there is no other current legislation that fits the timeframe and scope of this proposal.

38 Further this Bill has no current place on the legislation programme, but as it is a short Bill of low complexity that will significantly and quickly expand the avenues by which local authorities can raise capital, I propose it proceed with some urgency. It intended to have the legislation in force in the 2007-2008 financial year.

39 Therefore Cabinet approval is sought for the inclusion of this Bill in the 2007 legislative programme (with a legislative priority of 'Category 3: to be passed if possible this year') with an aim to have the Bill brought into force on enactment since no transition period is required. It is desirable that this Bill be included in the 2007 legislative programme to ease the process for local authorities to raise capital via public debt issues for the significant funding challenges they currently face for infrastructure development.

40 Legislative amendment is needed to allow the recommended policy to be brought into effect. This exemption cannot be provided for in regulation and there may be significant impediments to the Securities Commission being able to grant an administrative exemption for individual cases given the current policy of the Securities Act.

- 41 There are no specific regulations required for the implementation of this proposal, and since the Crown already has an exemption from the Securities Act the proposed amendment does not impact on the provision for the Act to be binding on the Crown.
- 42 The following is a tentative work programme for the passage of the necessary legislation. It is dependant on resource pressures in respect of drafting.

Action to be Undertaken	Date
Cabinet Committee	13 June
Final Drafting Instructions to PCO and Min of Justice BORA	By 30 July
Legislation Cabinet Committee	9 August
Cabinet	13 August
Introduction	15 August
Select Committee	Aug - Nov
Enactment	December 2007

REGULATORY IMPACT ANALYSIS

- 43 The Ministry of Economic Development (MED) 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 MED 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

- 44 Once Cabinet has reached a decision on this proposed exemption, I propose an announcement be made at the Local Government Forum 2007 and a media statement released to signal to the public Cabinet's decisions in this area.

RECOMMENDATIONS

- 45 It is recommended that the Committee
- I. **note** that until 1998 local authorities were exempt from the provisions of the Securities Act 1978 relating to the issuing of securities to the public
 - II. **note** that the Local Government Amendment (No 3) Act 1996 removed the exemption (from 1998) and significantly reformed the borrowing powers of local authorities
 - III. **note** that the net effect of the removal of the exemption has been a significant reduction in local authorities from the public debt securities market
 - IV. **note** that this relative absence has apparently occurred due to the added cost to local authorities of preparing disclosure documents and having them audited, and the difficulty of implementing the associated signature and liability provisions

- V. **note** that under the Local Government Act 2002 local authorities currently have significant disclosure requirements covering their finances, plans and prospects
- VI. **agree** to the proposal in this paper to reinstate the previous local authorities' exemption from the requirements to produce a prospectus under the Securities Act 1978 with the effect that:
 - a) local authorities are required to produce only an investment statement, and
 - b) may charge a rate or rates revenue as security and if they do s115 of the Local Government Act will apply
- VII. **agree** that local authorities be exempted from the signature requirements for a prospectus set out in the Securities Act, and that a certificate for an advertisement, covering the investment statement, be signed by two councillors in accordance with Regulation 17 of the Securities Regulations 1983.
- VIII. **note** that the Securities (Local Authorities) Amendment Bill will implement the proposal as outlined in this paper.
- IX. **approve** the inclusion of the Securities (Local Authorities) Amendment Bill in the 2007 legislation programme, with a priority 3.
- X. **note** that drafting instructions will be provided to the Parliamentary Counsel Office by 30 July 2007.
- XI. **note** that the Bill should be introduced no later than 15 August 2007.
- XII. **note** that the Bill should be passed no later than December 2007.
- XIII. **direct** officials from the Ministry of Economic Development to provide drafting instructions to the Parliamentary Counsel Office.
- XIV. **invite** the Prime Minister/Minister to announce the government's decision on this exemption at the Local Government Forum in the third week of June this year, and to release a media statement following the announcement.

Hon Lianne Dalziel
Minister of Commerce

Regulatory Impact Statement

EXECUTIVE SUMMARY

The Review of Financial Products and Providers has identified some issues concerning the current disclosure regime of the Securities Act 1978 that with clarification could improve the consistency of application of the Act, and help to reduce compliance costs for issuers.

With regard to local authorities, currently the cost of preparing disclosure documents and having them audited can be prohibitive for those issuing other than large debt issues. Also the signature and liability provisions of the Act which require all elected members to sign a prospectus have been identified as a problem.

Consideration of the level of disclosure that local authorities currently operate under covering their finances, plans and prospects, has led to a proposal to provide an exemption for local authorities through an amendment to the Securities Act. This will grant local authorities reduced disclosure requirements in line with similar existing exemptions for the Crown, the National Provident Fund Board, the Reserve Bank and Housing New Zealand Corporation.

This paper recommends that the previous exemption for local authorities to have reduced disclosure requirements be reinstated. This would exempt local authorities from producing a prospectus, but would be required to produce an investment statement with the requirement that a certificate, as set out in Regulation 17 of the Securities Regulations 1983 for advertisements, be signed by two councillors covering the investment statement disclosure.

The local authorities would retain the discretionary power, as set out in s12 of the Local Government Act 2002, to charge a rate or rates revenue as security over an issue to the public. The main impact of this amendment will be to reduce compliance costs by easing the process for local authorities to offer securities to the public while expanding the investment options for retail investors.

ADEQUACY STATEMENT

The Ministry of Economic Development (MED) 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 MED considers the RIS and the RIA analysis undertaken to be adequate. A draft RIS was circulated with the Cabinet paper for departmental consultation purposes.

STATUS QUO AND PROBLEM

Currently local authorities operate under the same general powers to borrow as companies and other corporate entities and are therefore subject to the same restrictions under the Securities Act. However there are some significant differences in the reporting regimes and legal frameworks of local authorities and corporate entities.

Currently the cost of preparing disclosure documents and having them audited can be prohibitive for entities issuing other than large debt issues. This potentially excludes smaller local authorities, some of whom are facing significant challenges with water and sewerage infrastructure development, from raising capital via debt issues to the public. (Local authority long-term plans show that local authorities are undertaking some \$30.8 billion in capital works – network or community infrastructure - in the 10 years to June 2016).⁴

The signature and liability provisions of the Securities Act also present a problem for local authorities. The current requirement under the Securities Act that all elected members sign a prospectus, in effect means that *unanimous* support for a project, and the issuing of debt to fund that project, is needed in the local authority in order to issue debt securities to the public.

While company directors tend to operate under the principle of collective responsibility, no such obligation exists within local government. One of the constitutional principles of local government is that elected members are not liable (at law) for decisions and actions they did not support.

Subsequently, the net effect of the removal of the earlier exemption for local authorities from the Securities Act has been the withdrawal of local authorities from the public debt securities market. Since 1998 only one local authority – Auckland City Council – has issued debt securities to the public. With that exception, all local authority borrowing has since been sourced from financial institutions.

Local authorities operate under significant disclosure requirements with regard to their finances, plans and prospects.⁵ They are required to produce annual planning and reporting documents that include audited financial statements that comply with Generally Accepted Accounting Practice and Financial Reporting Standard 42. Therefore they cover the primary information required in a prospectus for debt securities concerning the present financial position and performance of the issuer.

They are also required to produce an independently audited Long-Term Council Community Plan that covers details of all services and capital works proposed, and associated funding arrangements. Included in this Plan are 10 year prospective statements of financial performance, financial position, cash flows and movements in equity. As a consequence there is a substantial degree of duplication between the Local Government Act disclosure requirements and those in the Securities Act and Regulations.

Finally, financial decisions by local authorities raise important issues of equity, including inter-generational equity and affordability. Section 101(3) of the Local Government Act places local authorities under a statutory obligation to consider this inter-generational equity principle (along with community wellbeing) when making funding decisions. Infrastructure assets, which are the primary recipient of local authorities funding, are long term investments and borrowing helps spread the cost over the life of the asset.

⁴ Source: Hansard, *Questions for Oral Answer*, 7 November 2006; note that due to potential 'frontloading', 50% of this amount could be required by 2009.

⁵ Local Government Act 2002, Part Six & Schedule 10.

OBJECTIVES

It is important to ensure that compliance costs are only imposed if they are outweighed by the benefits the disclosure regime provides to investors. The reporting regime currently required of local authorities provides significant disclosure, meaning that compliance with the full disclosure regime of the Securities Act produces duplication of information and added costs.

The objectives behind the disclosure regime for securities offerings are to ensure that investors receive full, accurate and timely disclosure from issuers of information material to their investment decisions. This allows investors to make an informed decision on the potential risks and returns of their investment choices and to take responsibility for their own investment decisions.

Concurrently, the regime seeks to provide issuers with cost-effective access to capital from the public, therefore the disclosure regime should not impose any unnecessary compliance costs and ensure that issuers can raise capital from either public or private sources.

The reinstatement of an exemption for local authorities would provide local authorities with a reduced disclosure regime due in part to the disclosure requirements they already meet under the Local Government Act 2002 (Part Six and Schedule 10). This would help to reduce compliance costs and ease the process for local authorities to offer debt securities to the public while expanding and diversifying the investment options for retail investors.

ALTERNATIVE OPTIONS

The options available are full compliance with the disclosure regime of the Securities Act or to grant an exemption. Given that the former has been identified as a problem the following are sub-options available to progress an exemption:

- *Apply to the Securities Commission for an exemption:* there may be significant impediments to the Commission being able to grant an administrative exemption given the current policy of the Securities Act. This is therefore not considered a preferred or likely option.
- *Proceed with the inclusion of an exemption in the RFPP legislation process:* Such an exemption is being considered for other groups of issuers that are currently required to disclose significant material information through other documents.
 - For local authorities this would require the production of a 'transaction-specific document' with a certificate of compliance signed off by the Chief Executive of the local authority. This document would provide a reduced disclosure requirement that is consistent with the RFPP proposed single offer document regime.
 - An option for local authorities to charge a rate or rates revenue as security under section 12 of the Local Government Act 2002 would be retained.

This option is dependent on the proposed new single offer document disclosure regime which is due for Cabinet consideration later this year with a likely enactment date of 2010. This timeframe does not suit the local authorities' need for significant capital expenditure due by 2009.

PREFERRED OPTION

Propose urgent stand-alone local authority legislation, to meet prospective funding demands sought by 2009: This would mean creating a suitable legislative vehicle to facilitate the amendment and it would require alignment and consistency with the later RFPP proposals.

The proposed reduced disclosure requirement would exempt local authorities from the current regime which requires the production of both an investment statement and a prospectus, including full sign-off by all Councillors of the prospectus, for the offer of any debt securities to the public.

Instead local authorities would be required to produce only an investment statement, which in the terms of the Securities Act is an advertisement, and therefore requires a certificate to be signed by two directors (councillors) under regulation 17 of the Securities Regulations 1983. There is also the option available to the local authority to charge a rate or rates revenue as security for any issue of debt securities to the public.

MED proposes this stand-alone option as the preferred option. It meets the aims of the Ministry's overall review of financial regulation by reducing compliance costs and the cost of raising capital while maintaining appropriate standards of disclosure. Also due to the fact that it is a reinstatement of a previous exemption, it can be implemented simply and quickly.

MED proposes an announcement by the Prime Minister/Minister at the next Local Government Forum informing the authorities and the marketplace of the proposed amendment. This would help enable the local authorities to structure their immediate debt with a view to the proposed changes.

IMPLEMENTATION AND REVIEW

Change is required to section 5(3)(b) of the Securities Act 1978 to restore the previous exemption for local authorities. It is proposed that this change will form the Securities (Local Authorities) Amendment Bill.

There is no current place on the legislation programme for this Bill but as it is a short Bill of low complexity that will significantly and quickly expand the avenues by which local authorities can raise capital, it is proposed that it proceed with some urgency. It will be able to come into force upon passage as there will be no transition issues.

CONSULTATION

This paper has been prepared in consultation with the Treasury, the Securities Commission, the Ministry of Justice, and the Department of Internal Affairs.

Officials' identification of this issue and the development of this proposal were also informed by expert advisory groups comprising people from key industry and professional groups through the Review of Financial Products and Providers, including Local Government New Zealand.

The Ministry of Economic Development released a discussion document in September 2006 on securities offerings as part of a wider series of discussion documents relating to this Review. The discussion document included a section considering possible exemptions for local authorities. It was widely publicised and was also made available on the Ministry web-site. Approximately 140 submissions were received, fifteen of which were directly relevant to the proposal in this paper.

Therefore the proposal in this paper is presented on the basis of an inclusive consultation process. Two questions were asked: should local authorities have an exemption from i) the disclosure regime, and ii) the requirement for all councillors to sign the offer document? Half of the submitters agreed that both exemptions be granted.

Two submitters disagreed with the first exemption for reduced disclosure, but approved of an alternative mechanism to meet the signatory requirements – the added complexities of implementing the latter without the disclosure exemption would unnecessarily exacerbate the offer process.

The arguments of those opposed to granting local authorities either exemption were:

- that all issuers should have the same disclosure obligations – not a strong or relevant argument given that other exemptions exist; and
- that it would provide local authorities with an unfair market advantage – there is no evidence to support this argument, from the above analysis of the reporting and legal differences between local authorities and companies the opposite seems to be the case