Regulatory Impact Statement

Financial Markets Conduct Regulations

Agency Disclosure Statement

1 This Regulatory Impact Statement has been prepared by the Ministry of Business, Innovation and Employment.

2 It provides an analysis of options for regulations required to bring the Financial Markets Conduct Bill (FMC Bill) into force. The FMC Bill governs how financial products are created, promoted and sold, and the ongoing responsibilities of those who offer, deal and trade them. It also regulates the provision of certain financial services. Before the FMC Bill is brought into force, a wide range of regulations are required. These cover matters that were considered too detailed for inclusion in primarily legislation, or where change might be required as market practices evolve.

3 When undertaking this analysis, the Ministry considered options within specific topics, rather than looking at entire frameworks as a single option. The main reason for this is that the different topics involve different considerations, many of which are technical, and conclusions on different topics do not actively impact on the decisions in others. For these reasons we believe that there is benefit in assessing the topics separately.

4 There are some limitations of the analysis undertaken:

- The analysis is based largely on impacts identified in submissions received in response to a December 2012 discussion document on the regulations. These seldom included quantitative estimates of costs and benefits of particular measures
- The analysis assumes that no changes are made to the FMC Bill, and consideration of regulatory options is confined to those that could be implemented through the Bill's regulation-making powers.

5 More general analysis of alternative frameworks was performed in the RISs accompanying the February 2011 and May 2011 Cabinet decisions on the FMC Bill. In particular, the original RIS considers the costs and benefits of different disclosure, governance and licensing regimes. The preferred options from that process, such as a product disclosure statement and relatively 'light' licensing of fund managers, have been carried through into the Bill and form the backdrop for this analysis.

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Signature Date

Status quo and problem definition

6 The Financial Markets Conduct Bill (FMC Bill) is scheduled to be passed this year, and to come into force in 2014. The FMC Bill establishes a new framework for the regulation of financial products and certain financial services.

7 Before the FMC Bill is brought into force, a wide range of regulations are required to cover matters that were considered too detailed for inclusion in primarily legislation, or where change might be required as market practices evolve. These regulations are discussed in this RIS, and are grouped into three areas:

- Disclosure, scope and offer process
- Governance of financial products
- Licensing.

8 Below we discuss the Bill, the problems it seeks to address, and the issues that are left to be dealt with in regulations.

Financial Markets Conduct Bill

9 The principal policy objective behind the FMC Bill is to facilitate capital market activity, in order to help businesses to grow and to provide individuals with opportunities to develop their personal wealth. For this objective to be achieved, investors need to be satisfied that they and their advisers have the information required to make confident and informed decisions, that there will be appropriate governance arrangements in place, and that obligations on issuers and others will be enforced. Issuers need investor participation in capital raisings to be successful, and regulation needs to achieve the desired objectives at minimum cost.

10 New Zealand's current financial markets conduct law is primarily contained in the Securities Act 1978, supplemented by the Securities Markets Act 1988, the Securities Transfer Act 1991, the Superannuation Schemes Act 1989, the Unit Trusts Act 1960 and parts of the KiwiSaver Act 2006.

11 The FMC Bill will replace that legislation, as well as amending a range of other financial markets legislation.

12 The Cabinet decisions and the regulatory impact analysis underpinning the Bill is available from the Ministry's web site:

- Cabinet Paper February 2011: http://www.med.govt.nz/business/business-law/pdf-docs-library/current-business-law-work/securities-law-review/review-of-securities-law-cabinet-paper-feb-2011483-kb-pdf.pdf
- RIS February 2011: http://www.med.govt.nz/business/business-law/pdf-docs-library/current-business-law-work/securities-law-review/review-of-securities-law-regulatory-impact-statement-187-kb-pdf.pdf
- Cabinet Paper and RIS May 2011: http://www.med.govt.nz/business/business-law/pdf-docs-library/current-business-law-work/securities-law-review/May%202011%20Cabinet%20paper%20and%20RIS.pdf

13 More general information about the Bill is available in officials' initial briefing to the Commerce Committee at http://www.parliament.nz/en-NZ/PB/SC/Documents/Advice/5/e/3/50SCCO_ADV_00DBHOH_BILL11150_1_A238083-Ministry-of-Economic-Development.htm.

Overall problem definition – for both the Bill and the regulations

14 The Bill and regulations aim to address the following issues with the current law, as identified in the previous RISs:

- **Problem 1:** The boundaries between those investors covered by the regime (retail investors) and those not (wholesale investors) tend to be principles-based and unclear. This imposes costs on issuers as legal advice is often required on the treatment of potential investors and this will often not be definitive. There are also concerns that the current exemptions are too narrow: some wholesale investors are inadvertently captured by the regime, and it is too difficult for young firms to raise relatively small amounts of money
- **Problem 2:** Current mandated disclosures – prospectuses and investment statements – fail to adequately inform investors, as they tend to be poorly structured, too long, and unclear. The impact of this is that investors cannot make informed decisions or do not participate in the market at all
- **Problem 3:** Inconsistencies in the way products are regulated and inadequate governance requirements in some cases create a risk that issuers will not act in the best interests of investors and inhibit effective monitoring and enforcement. Similar products are regulated differently, with some regulation taking a form over function approach which can also inhibit innovation
- **Problem 4:** The regulation of financial product markets (e.g. stock exchanges) is unclear and inflexible. The threshold for when a market operator and its markets are required to be registered is uncertain. Once registered, the current regulatory system is 'all or nothing', discouraging the development of low cost markets that are not completely unregulated, but which also do not impose the same high level of regulation as the main board of NZX
- **Problem 5:** The present liability regime lacks coherence and contains confusing overlaps between different instances of liability. It is unclear how the different instances of liability interact to promote the objectives of the regime.

15 The Bill goes much of the way towards addressing these problems by implementing a new regulatory regime for financial markets conduct. The problems above and the way the Bill addresses them is discussed in detail in the previous Cabinet papers and RISs, and in officials' briefings to the commerce select committee linked to above.

16 Although the Bill provides the bulk of the new regulatory regime, some matters were considered too detailed for inclusion in primarily legislation, or could require more frequent change as market practices evolve. The Bill provides a wide range of regulation-making powers to deal with these matters. The table below summarises how the Bill addresses each issue and what is left to regulations.

Problem	What the Bill provides	What's left for the regulations discussed in this RIS?
Problem 1: Disclosure exemptions narrow and unclear	A new exemption regime with more 'bright lines' and 'safe harbours' for exclusions from the need to make disclosure, in order to facilitate private offers and capital raising by small companies	Regulations will prescribe requirements for certificates and limited disclosures required to be given when issuers make use of exemptions.
Problem 2: Ineffective disclosure	A new disclosure regime, based on a pre-sale product disclosure statement (PDS) aimed at retail investors	The detailed requirements underpinning the disclosure regime will be prescribed in regulations. This will include the content of PDSs for different kinds of financial products and ongoing disclosure.
Problem 3: Product regulation and governance inconsistent and inadequate	Core conduct obligations across all financial products and services, wide-ranging changes to the governance rules that apply to managed investment schemes, and a new licensing regime for certain financial services	Further detail is required on the governance of debt securities and managed investment schemes. This includes matters such as the content of trust deeds. Additional entry criteria and conditions are needed for market services licences, and to enable disclosure exemptions for person-to-person lending services and crowd-funding.
Problem 4: Financial product market regulation unclear and inflexible	A new licensing regime for financial product markets, with provision for low cost markets with alternative rules	Regulations will provide for exemptions from the requirement to hold a financial product market licence and the alternative rules that apply to low cost markets. They also prescribe various forms and disclosure notices (not discussed in this RIS.)
Problem 5: Liability regime incoherent	Simpler and more coherent liability regime for when the Bill is breached, with more emphasis on civil remedies, and criminal offences reserved for serious misconduct	Penalty levels for infringement offences (not discussed in this RIS)

17 This RIS covers most of these regulations where the options have non-minor regulatory impacts.

18 Our regulatory impact analysis is divided into three sections, which are based around similar types of regulation and cut across the problems identified above:

- **Part 1: Disclosure, scope and offer process** – focused on the regulations relating to Problems 1 and 2
- **Part 2: Governance of financial products** – focused on some of the regulations relating to Problem 3
- **Part 3: Licensing** – focused on the rest of the regulations relating to Problems 1 and 3.

19 Excluded from this RIS are the detailed content of disclosure documents and alternative financial product market regulations. These will be dealt with in Cabinet decisions later this year. Within the broad problems identified above are more specific issues (or 'sub-problems'). These are detailed in the regulatory impact analysis sections of this RIS.

Objectives

20 The options in this RIS are measured against the purposes of the FMC Bill. Clauses 3 and 4 of the FMC Bill contain its main purposes and additional purposes.

Main, overarching purposes of the FMC Bill

To promote the confident and informed participation of businesses, investors, and consumers in the financial markets

To promote and facilitate the development of fair, efficient, and transparent financial markets.

21 A key principle of the Bill is that the regulatory regime needs to work for both investors and issuers to achieve these purposes. Some regulatory options may have immediate benefits for either investors or issuers, but may not deliver effective financial markets over the longer term – in which case both issuers and investors ultimately lose out.

22 The Bill provides additional purposes that need to be balanced against each other, in order to achieve the main purposes. In the regulatory impact analysis sections below, we consider the extent to which the options impact on these additional purposes – both positively and negatively – compared to the status quo.

Additional purposes of the FMC Bill

To provide for timely, accurate, and understandable information to be provided to persons to assist those persons to make decisions relating to financial products or the provision of financial services

To ensure that appropriate governance arrangements apply to financial products and certain financial services that allow for effective monitoring and reduce governance risks

To avoid unnecessary compliance costs

To promote innovation and flexibility in the financial markets.

23 In selecting preferred options, these additional purposes are accorded roughly equal weight. The preferred option takes into account the impacts of the option and its alternatives on these additional purposes, and reflects a judgement about which option is likely to best achieve the main purposes of the Bill.

Part 1: Regulatory impact analysis – disclosure, scope and offer process

24 Disclosure to investors about financial products is a cornerstone of the offer regime in the FMC Bill. The FMC Bill provides that a person must not make a regulated offer of financial products unless the issuer of the products has prepared a product disclosure statement (PDS) for the offer, and supplied to the Registrar the information and documents required for a register entry for the product.

25 The regime in the FMC Bill replaces investment statements and prospectuses in the Securities Act. The FMC Bill leaves the detailed presentation and content requirements for disclosure obligations to the regulations. It anticipates a high degree of tailoring of requirements for different kinds of financial products.

26 FMC Bill's disclosure regime is largely focussed on Problem 2 in the *Status Quo and Problem Definition* section. Well-functioning capital markets create financial products that direct money to its most productive uses within an economy. The financial products themselves are an intermediary or vehicle through which businesses access capital and create jobs, and individual savers earn returns to achieve their financial goals. Well-functioning capital markets rely on the availability of good information about financial products to assist investor decision making and to ensure that risk is correctly priced. The role of disclosure regulation is to ensure the supply of meaningful and reliable financial product information.

27 Disclosure regulation is traditionally intended to address information asymmetries between issuers and investors. An issuer typically has more information than an investor about the nature of its product and its associated risks and benefits. The information imbalance disadvantages the investor, and can result in poor decision making and inefficient resource allocation. In the case of better informed investors, there is less information asymmetry and a reduced benefit from regulated disclosure. For this reason, disclosure regulation tends to focus on the needs of retail investors, who lack in-depth knowledge about financial products and the ability to force disclosure of material information through other mechanisms.

28 Disclosure should assist investors to compare products and enable them to identify which products best align with their financial needs and goals. Secondary audiences should not be ignored. Retail investors often rely on information that has been collected and presented by third parties. Financial advisers, market commentators and market analysts are therefore an important audience for financial product disclosure. In addition to repackaging information for individual decision making, the market watchers perform an important service in identifying more general trends and areas of concern.

29 Other parties benefit from disclosure documents. Preparation of disclosure documents may also be a useful due diligence exercise for the issuer. It forces the issuer to consider all the circumstances of the offer, including the risks and benefits. Disclosure also assists regulators to carry out their supervisory functions, compliance and enforcement.

Key disclosure provisions in the Bill and the function of regulations

30 The FMC Bill sets broad parameters on what is required to be in a PDS and what goes on the register of offers of financial products (offer register):

- Clause 36 provides that the purpose of a PDS is to provide certain information that is likely to assist a prudent but non-expert person to decide whether or not to acquire the financial products
- Clause 45 provides that the information in the PDS must be worded and presented in a clear, concise and effective manner
- Clause 42(1)(b)(ii) requires the offer register to contain all material information relating to the offer that is not contained in the PDS. Clause 42A provides that a register entry is not required in the prescribed circumstances
- Clause 46 provides that the PDS must comply with all requirements of the regulations relating to form and presentation of the PDS.

31 The FMC Bill also contemplates the prescription of ongoing disclosure requirements for some financial products. This type of disclosure is provided on an ongoing basis after the financial product has been issued.

32 This RIS considers the general direction of disclosure content, and some other matters relating to disclosure and the offer process. It does not consider the detailed content of disclosure documents, as these will be the subject of further policy development and public consultation.

33 This section also describes related issues concerning the scope of the Bill (Problem 1 in the *Status Quo and Problem Definition* section) and the offer process. The key determinants of whether a matter is governed by the FMC Bill are the definitions of the products and services in the Bill. In addition, whether or not an offer of financial products or services is a regulated offer under Part 3 has a significant impact on the application of the Bill throughout the lifetime of the financial product. Although the FMC Bill addresses these scope issues, some of the boundaries are left to be resolved by regulations through exclusions and definitions.

34 The FMC Bill also provides for limited disclosure to be prescribed in regulations where there are exclusions from the disclosure regime under Schedule 1, such as for employee share schemes, offers by the Crown and small offers of debt and equity.

Approach to regulatory impact analysis

35 The table on the next page summarises our analysis of the various options that have regulatory impacts in these areas. It addresses, first, the general direction of disclosure, before considering some particular matters in this area.

36 The table outlines our assessment of how each of the options impacts on the objectives. Our assessments are largely qualitative and based on the information provided by submitters throughout the consultation process. As noted in the agency disclosure statement, the analysis is constrained in that very few submitters provided detailed information about quantifiable costs in relation to each of the issues.

37 We have described the impacts on the objectives as being either positive (benefit) or negative and the scale of the impact as small, moderate or high, taking taken into account (where relevant) the number of market participants that would be impacted.

38 Options in the table are compared against the ‘status quo’. The status quo varies across the options, as shown in the table section headings. Where an obligation relates to a matter not covered by the current law (i.e. Securities Act 1978), the status quo is that no regulations are prescribed in the area. In this case, the status quo is not presented as an explicit option, but would be the result if none of the options were selected. If the status quo were to be explicitly included, the ‘impact on objective’ column would be neutral (i.e., ‘-‘) in each case, as it is the comparator.

39 However, where there are requirements under the current law that are equivalent to obligations being imposed by regulations under the Bill, the status quo is defined as the current law. A similar requirement to the status quo may be proposed as an explicit option.

40 Further information on the options in the table is contained in the section after the table.

Disclosure, scope and offer process options

Options	Impact on objective: investor information	Impact on objective: appropriate governance	Impact on objective: Compliance costs	Impact on objective: Innovation & flexibility	Preferred option? (Y / N)	Comments and risks
Level of prescription – the status quo is the prospectus and investment statement under the current law						
1A. Low level of prescription for all products – issuer free to place all material matters in the PDS, subject to requirement to be clear, concise and effective and to FMA guidance.	Moderate negative	-	Small benefit	Moderate benefit	N	Not good comparability for some products, especially managed funds such as KiwiSaver. Would need to rely on significant amount of FMA guidance.
1B. Content highly prescribed for all products.	Small negative	-	Small benefit	Small negative	N	Provides more certainty for investors. Risk of misdirected prescription for some products. Heavy reliance required on FMA exemptions.
1C. Vary level of prescription according to simplicity and comparability of products.	High benefit	-	Small benefit	-	Y	Some products, such as managed funds, are fairly straightforward and comparable and are therefore amenable to a high level of prescription. There is significant benefit for investors in having comparability between these products. Other products are more complex and require a lesser degree of prescription. If disclosures are well designed, this option is unlikely to impact on innovation and flexibility.
2A. Disclosure for managed funds to be solely fund level or solely scheme level.	Moderate negative	-	Moderate negative	-	N	Considerable compliance costs on issuer if disclosure is at fund level. May lead to investor receiving inadequate disclosure, either through receiving too much information at a fund level or insufficient information if disclosure is just scheme level.
2B. Managed fund disclosure to be combination of scheme-level and fund-level material.	Moderate benefit	-	Moderate benefit	-	Y	Reduces compliance costs by enabling changeable information to be updated easily. May lead to longer documents if there are many funds under a scheme, although regulations and guidance will determine how to deal with these situations.
Director consent to lodgement of disclosure information – the status quo is the current law that all directors must sign the document						
3A. No consent required	Small negative	Small negative	Small benefit	Small benefit	N	May result in inadequate board oversight of issuance of financial products. Would provide Board flexibility to create own process of approval and may reduce compliance costs.
3B. All directors must consent and show by signing	-	-	-	-	N	Similar to existing requirements. Would ensure Board is active in overseeing issuance. However, would result in high compliance costs for issuers of managed funds as directors would have to approve many documents each year. Submitters strongly disagreed with this option.
3C. Evidence required of Board's consent. FMA to provide guidance for particular situations.	Small benefit	Small benefit	Moderate benefit	Small benefit	Y	Flexible rule to enable appropriate level of Board scrutiny in particular circumstance. Reduction in compliance costs of execution of consent.

Options	Impact on objective: investor information	Impact on objective: appropriate governance	Impact on objective: Compliance costs	Impact on objective: Innovation & flexibility	Preferred option? (Y / N)	Comments and risks
Expiry date required – the status quo is the current law that there is an expiry date based on the date of financial statements						
4A. No expiry date	Moderate negative	Small negative	Moderate benefit	Small benefit	N	Could lead to lack of oversight of disclosure with risk that disclosure becomes out of date.
4B. Expiry date prescribed	Small benefit	Small benefit	Small negative	-	N	May result in unnecessary reissuance of disclosure that is not out of date.
4C. Renewal certificate in appropriate circumstances	Small benefit	Small benefit	Small benefit	Small benefit	Y	Ensures issuer keeps disclosure up to date while limiting unnecessary compliance costs
Ongoing disclosure for debt, equity, and complex managed investment schemes – the status quo is no regulations						
5A. Continuous ongoing disclosure	Moderate benefit	Small benefit	High negative	-	N	Would impose significant costs on issuers.
5B. Targeted event-based disclosure for debt, equity and more complex managed investment schemes and quarterly ongoing disclosure for managed funds	Moderate benefit	Small benefit	Small negative	-	Y	Issuers only required to disclose the most important information to investors. Requirements can be tailored to each product. Extends current KiwiSaver requirements to all managed funds on the basis that these are analogous products. Strong benefit to investor information from receiving regular updates on fund's performance.
Limited disclosure and eligible investor and safe harbour certificates – the status quo is no regulations						
6A. Require investor relying on $750,000 exclusion to provide witnessed certificate.	Small benefit	-	Moderate negative	Small negative	N	Adds significant compliance costs to process. Requirement may narrow extent to which exemption would be used. Witnessing may give additional information to investor.
6B. Requirement for investor to acknowledge warning statement on using $750,000 exclusion.	Small benefit	-	-	Small negative	Y	Makes investor acknowledge consequences of making investment based on $750,000 exclusion. Unlikely to impose significant compliance costs on issuer.
7. Employee share scheme offers to disclose basic information.	Moderate benefit	-	Moderate benefit	Small benefit	Y	Informs employees of basic nature of offer. Significantly reduced compliance costs compared to present.
8. Small offers exclusion warning statement and notification to FMA.	Moderate benefit	-	Small negative	Small negative	Y	Informs investor of consequences of investing in reliance of this statement. Notification provides more effective oversight leading to enforcement actions, especially in relation to Part 2 of the FMC Bill.
FMC reporting entities – the status quo is no regulations						
9. Designated as FMC reporting entity if gain 50 shareholders in reliance of small offers exemption.	Moderate benefit	Small benefit	Moderate negative	-	Y	Ensures appropriate level of public accountability for these issuers given the nature of their shareholding base.

General direction: level of prescription (options 1 and 2)

41 This section covers two key issues:

- The appropriate level of prescription for disclosure documents
- Whether managed funds should disclose at the scheme level or the fund level, or a combination.

Level of prescription

42 In February 2011, Cabinet agreed that the PDS would only contain information that is essential to an investor's decision, and would usually be divided into two parts:

- A key information summary of around 1-2 pages that summarises the key features of the investment and risks associated with it
- A more detailed description of information that is essential to an investor's decision.

43 Cabinet also agreed that the content of the PDS be tailored for different types of financial product (and where appropriate, financial service) and different types of offer. Where appropriate, given the nature of the product and/or offer, the length of the PDS should be prescribed and may incorporate material by reference.

44 We identified three options concerning the appropriate level of prescription:

- Option 1A: low level of prescription for all products – issuer free to place all material matters in the PDS, subject to requirement to be clear, concise and effective and to FMA guidance
- Option 1B: content highly prescribed for all products
- **Option 1C (preferred)**: vary level of prescription according to simplicity and comparability of products.

Option	Benefits	Costs	Net impact – qualitative judgement
1A	Would allow considerable flexibility for issuers to describe their product.	However, this would not provide comparability for some products, particularly KiwiSaver and other managed funds. A significant amount of FMA guidance would be required to make this requirement effective. Could lead to longer disclosure documents, which increases compliance costs such as due diligence reviews and legal costs.	Negative net impact, as flexibility is outweighed by costs in guidance and lack of comparability for investors for some products.
1B	May be appropriate for particular products, especially managed funds, which tend to have similar characteristics – for example, investment objectives, fees and portfolio holdings – to be more highly prescribed.	This would carry the risk of there being misdirected prescription for some products and the need for a heavy reliance on FMA exemptions	Negative, due to high risk of investors receiving inappropriate information and high use of FMA exemptions.
1C	This will considerably improve the standard of disclosure for investors, including by providing for a much greater degree of comparability between products. It will provide greater clarity for issuers as to the matters that need to go into disclosure documents.	Documents for some products, such as equity, may still be lengthy.	Positive, as investors will receive information that is appropriate for each product.

45 With regard to the preferred approach (option 1C), we note in particular that some countries have adopted requirements for shorter disclosure for managed funds. In June 2012, Australia brought in a shorter PDS regime for superannuation, simple managed investment schemes and margin lending, designed to make PDSs shorter and simpler, and help consumers compare financial products more easily.

46 The European Union and Canada have also introduced simplified disclosure for managed funds. The EU has introduced a two-page Key Investor Information Document for funds offered under the EU directives on Undertakings in Collective Investment in Transferable Securities (UCITS). Similarly, Canada has introduced a new four-page Fund Facts document. These are highly standardised documents that are intended to be simple to understand and allow for easy comparability between products.

47 Products other than managed funds can pose more of a challenge for disclosure. Submitters were wary of a high level of prescription for other products, particularly offers of equity securities. The reason for this is that the returns from these products depend heavily on the success of a particular business. For this reason, disclosure needs to include detailed information to enable an assessment of the business, such as its operations, strategy and financial position.

48 Therefore, our preference is for there to be more flexibility for complex products. However, it is still appropriate for there to be some prescription around the kind of information that is required for these products in order to ensure that investors receive useful disclosure.

49 There is still an obligation under the FMC Bill for the issuer to place all material matters concerning their offer on the electronic register, which will ensure that additional issues that they consider important are still disclosed to the market. These products will still require a highly prescribed key information summary in the PDS, which will detail the most important information for an investor to be aware of.

Scheme vs fund level disclosure

50 It is common for there to be a number of different funds (e.g. conservative, balanced and growth) under the umbrella of a single scheme. A difficult issue for disclosure is how to address this situation in order to get the appropriate information to investors about a product, while not imposing high compliance costs on issuers.

51 We identified two options:

- Option 2A: disclosure for managed funds to be solely fund level or solely scheme level
- **Option 2B (preferred)**: managed fund disclosure to be combination of scheme-level and fund-level material.

Option	Benefits	Costs	Net impact – qualitative judgement
2A	No strong benefits identified. Disclosure solely at scheme level may reduce some compliance costs for issuers slightly as the volume of disclosure may be reduced. This would not be significant.	Requiring disclosure solely at fund level would require an issuer to produce a significant number of PDSs, thereby incurring significant compliance costs. Providing disclosure solely at scheme level is likely to not provide the level of detail for investors to make informed decisions about the product that they are investing into.	Negative net impact, due to potential compliance costs and poor information for investors.
2B	Provides adequate information to investors on each fund and scheme. Minimises compliance costs on issuers.	Will require FMA guidance to deal with some situations, such as where there are many funds under one scheme.	Positive, due to reduced compliance costs and investors receiving adequate disclosure.

Director consent to lodgement of disclosure information (option 3)

52 The problem that is addressed in this section concerns whether or not directors must consent to the lodgement of disclosure information. A key aspect of this issue is the level of board oversight of disclosure information.

53 We identified three options:

- Option 3A: no consent required
- Option 3B: all directors must consent and show by signing
- **Option 3C (preferred)**: evidence required of Board's consent. FMA to provide guidance for particular situations.

Option	Benefits	Costs	Net impact – qualitative judgement
3A	Can reduce costs on issuer as the rule is very flexible.	Negative impact on governance, and may result in poor information to investors.	Negative net impact.
3B	May result in increased scrutiny and accuracy of disclosure information.	High compliance costs for issuers, including costs involved in executing documents.	Negative, due to high compliance costs.
3C	Reduction in compliance costs as provides issuers with flexibility on process.	No significant costs identified	Positive.

54 Under the current law, all directors must sign prospectuses. Most prospectuses are also required to include a statement by the directors as to whether, in their opinion and after due enquiry, certain matters have materially and adversely changed since the date of the latest financial statements contained or referred to in the prospectus. The current signature requirement is intended to evidence that directors have seen and approved the contents of offer documents.

55 The Australian Corporations Act requires the consent of all directors if a prospectus or PDS is required to be lodged with ASIC. This includes most offers of equity, debt and listed managed funds. PDSs that are not lodged with ASIC, such as offers of unlisted managed funds or derivatives, do not require director consents.

56 Under the FMC Bill directors are civilly liable for false or misleading statements in a PDS, subject to defences. These defences are available if the director has, among other things, placed reasonable reliance on information supplied by another person, or the contravention was caused by someone else and the director has taken reasonable precautions and exercised due diligence to avoid the contravention (clause 482A).

57 This structure is flexible enough to allow a director to delegate the process for development of disclosure and verifying its completeness and accuracy to others, if it is reasonable to do so in the circumstances. This could include reliance on a due diligence committee comprising employees, external advisers and perhaps fellow directors. In that situation, the director's defences would focus on the robustness of the process established by the board.

58 We consider that some level of director or board approval to lodgement of the PDS is desirable. Making a regulated offer is a significant event for an issuer, especially in the case of equity and debt issues. Requiring some form of director approval supports the objectives of information disclosure and improving governance by ensuring that directors supervise capital raising. We are conscious, however, that some managed fund issuers produce dozens of offer documents a year, and gathering director signatures is costly.

59 Our preferred approach is to provide some flexibility by having a rule requiring a statement evidencing the Board's consent to lodgement (option 3C). Submitters strongly favoured a flexible rule, particularly with respect to managed funds, due to the reduction in compliances costs of this approach.

Expiry date of PDS (option 4)

60 Clause 67 of the FMC Bill provides that a PDS must, if required by the regulations, specify its expiry date. This replaces the existing provisions in section 37A(1)(c) of the Securities Act, which permit a maximum life for prospectuses of less than 18 months.

61 As a default position, the FMC Bill contains a general obligation (clause 65) not to continue to offer a product if the PDS contains a statement that is false or misleading. An issuer may update or correct a false or misleading statement in a PDS by lodging a supplementary document with the Registrar. In effect, this means that an issuer must either issue a new PDS or lodge a supplementary document if the PDS has become materially out of date.

62 In Australia, section 711(6) of the Corporations Act provides that prospectuses (used for equity and debt) must have an expiry date of no longer than 13 months. However, there is no expiry date required for PDSs (used for managed funds and other products such as derivatives). Instead, section 1012J provides a general obligation to keep the information in the PDS up to date and, like the FMC Bill, allows the use of supplementary information to update the PDS where appropriate.

63 We have identified 3 options for expiry dates:

- Option 4A: no expiry date
- Option 4B: expiry date prescribed
- **Option 4C (preferred)**: renewal certificates in appropriate circumstances

Option	Benefits	Costs	Net impact – qualitative judgement
4A	Allows flexibility and will reduce compliance costs of having to renew disclosure that is not out of date.	Could lead to disclosure not being kept up to date.	Finely balanced, but risk of lack of continued oversight leads to a marginal negative net impact.
4B	Ensures disclosure is kept up to date.	There can be substantial compliance costs in mandating an expiry date as PDSs must be reissued. For this reason, submitters did not favour this option.	Negative, due to unnecessary compliance costs.
4C	Reduction in compliance costs as PDS not required to be reissued on a regular basis. Ensures that information is up to date.	No significant costs identified.	Positive.

64 Submitters generally considered that PDSs, particularly those for managed funds, did not need an expiry date and that it was adequate to rely on the general requirement in the FMC Bill for a PDS to not be misleading or deceptive. The main reason for this was to reduce compliance costs of having to unnecessarily reissue a PDS on a regular basis.

65 As a general proposition, we consider that the default position in the FMC Bill will probably be adequate and will reduce compliance costs significantly. However, it may be appropriate in some situations, such as where a PDS contains financial information, to specify an expiry date. This will become clearer as the content of PDSs are developed.

66 However, in any event, our preference is for the Board of continuous issuers to provide a regular renewal certificate to the Registrar that the PDS and register entry are up to date (option 4C). This will avoid the compliance costs of having to reissue the PDS, while providing an appropriate level of assurance that the disclosure is still current.

Ongoing disclosure (option 5)

67 Subpart 3 of Part 4 of the FMC Bill enables regulations to be made requiring information to be made available to investors, to other specified persons, or publicly. Disclosure may be required at particular times (periodic disclosure), upon request (request disclosure) or on the occurrence of prescribed events (event-based disclosure). The Registrar must also be notified of changes to prescribed information.

68 Public ongoing disclosure is a mechanism to inform current and potential investors of matters important to their decisions to acquire or dispose of financial products or exercise rights under financial products, in particular:

- Information on the performance of the investment – ideally this information needs to be comparable both with other products of the same type and over the life of the product
- Changes or events that may affect the terms on which the investor invested, the risk profile of the investment, its likely future performance, or the costs to the investor (including non-compliance with issuer obligations).

69 This performance/risk-related information should be made publicly available. It may then be read by investors directly, or collated and disseminated through media commentators, analysts, advisers and other third parties. Where products are transferable, this information can be priced in by the market. There is a question as to the degree to which investors should also be individually provided with or alerted to this information.

70 Individual investors also need to have, or be able to easily obtain, basic information about their own holdings for the purpose of monitoring the performance of their investment, keeping track of their financial position, and making informed decisions about their actions in relation to the investment (for example, decisions whether to invest further, to sell, or to switch funds).

71 Issuers are currently subject to some general requirements to provide ongoing information to the public and investors, which should be taken into account in setting further requirements:

- The Financial Reporting Act 1993 requires all issuers of securities to file audited financial statements with the Registrar of Companies within five months of the balance date of the issuer.
- Listed equity securities, debt securities and managed investment products are subject to half-yearly and annual reports and to the continuous disclosure regime. Under the continuous disclosure regime, issuers must notify the market of material information that is not generally available to the market as it becomes aware of that information.
- Companies are required to keep the companies register up to date with changes to directors, file annual returns, and prepare annual reports.

72 We have considered the extent to which further generic reporting on performance and on changes or events affecting the investment is required, and have considered the following options:

- Option 5A: continuous ongoing disclosure
- **Option 5B (preferred)**: targeted event-based disclosure for equity, debt and more complex managed investment schemes and quarterly ongoing disclosure for managed funds.

Option	Benefits	Costs	Net impact – qualitative judgement
5A	Would provide investors and market with a considerable amount of information.	High compliance costs with having to make continuous disclosure, analogous to issuers that are listed on exchanges.	Negative net impact, due to compliance costs.
5B	Investors receive appropriate information that enables comparability between products.	Compliance costs for issuers, but unlikely to be significant.	Positive, information benefits outweigh relatively low compliance costs.

73 Under the FMC Bill, issuers will need to keep their PDS and register information up-to-date for offers that are open. For continuous issuers, this will effectively require a degree of continuous disclosure, and so may overlap with ongoing disclosure requirements for managed investment schemes and debt issuers.

74 We are not proposing a general obligation to notify material information as it arises (option 5A). We think that the considerable compliances costs of a continuous disclosure obligation of this kind would outweigh the information benefits when products are not traded on liquid markets.

75 Instead, our preferred option is a more focused obligation to notify particular events or changes. We think that the relevant events should differ according to the type of financial product in order to ensure that the requirements are tailored appropriately. Submitters generally considered that debt issuers should face limited event-based disclosure, in order to keep investors and the market informed. A majority of submitters considered that there should be no requirements for equity, although some submitters argued that there should be minimum requirements in order to provide appropriate information to investors.

76 Our preferred option (option 5B) is for debt issuers to be required to disclose particular changes or events that affect the credit risk associated with the borrower and the debt securities, and therefore the value of the debt security. Given the sensitivity of the price of equity securities to information, we also consider that there should be some minimum requirements for equity disclosure. We also consider that given the similarity of more complex (i.e. not simple managed funds) managed investment schemes to equity, they should have similar requirements.

77 We also consider that the current quarterly ongoing disclosure requirements for KiwiSaver should be extended to all simple managed funds. This disclosure includes basic information about matters such as returns, fees, assets and portfolio holdings. This significantly enhances the level of information for investors.

Limited disclosure (options 6-8)

78 Schedule 1 provides exclusions for certain offers as a whole from the disclosure requirements under Part 3 of the FMC Bill and the governance requirements under Part 4. Exclusions can be due to the nature of the offer (for example, a small offer) or the nature of the issuer (for example, an offer by the Crown).

79 Exclusions in Schedule 1 are not complete exemptions from the Bill. Even if the offer is made under an exclusion in Schedule 1, Part 2 of the FMC Bill relating to fair dealing will still apply to the conduct in respect of the offer. In addition, clause 26 of Schedule 1 provides for regulations to impose limited disclosure and other requirements for offers making use of Schedule 1 exclusions. FMA's designation powers in Part 8 of the Bill and regulations made under clause 28 of Schedule 1 can also limit the scope of the exclusions.

80 We recommend below that limited disclosure and other requirements attach to offers made under particular Schedule 1 exclusions. There is a balance to be struck to ensure that the investors receive disclosure where it would be beneficial, while not undermining the purpose or utility of the exclusions.

Requirements for offers in reliance of $750,000 exception (option 6)

81 Investments of $750,000 are exempt from disclosure as wholesale investments under Schedule 1 clause 3. This amount was increased from $500,000 in the supplementary order paper. The SOP also made an amendment that enabled an ability to prescribe limited disclosure or other requirements in respect of wholesale investments.

82 The requirement to meet this exception is for $750,000 up-front for a single transaction. It is a bright-line test set on the basis that for this size of one-off investment, the investor should have sufficient money at stake and sufficient bargaining power to negotiate with the issuer and exercise due diligence.

83 However, there have been some concerns that people may invest $750,000 or more without being aware that this exemption is being relied upon. In this case, they may be unaware that normal regulatory requirements do not apply and the implications of this.

84 We have considered two options to address this issue:

- Option 6A: investors to provide a certificate, witnessed by an independent third person, that they understand the exemption is being used and its consequences for their rights
- **Option 6B (preferred)**: require offers relying on the exclusion to identify that fact and require the investor to acknowledge a prominent warning statement about the effect of the exclusion on the investor's rights.

Option	Benefits	Costs	Net impact – qualitative judgement
6A	Would ensure that investors had time to consider the effect of the exemption on their rights. As part of acquiring the certification investors may receive advice in some circumstances.	Compliance costs (e.g. charges by a financial adviser or solicitor), time delays and inconvenience	Negative. The costs of a requirement would likely narrow the extent to which the exemption is used.
6B	Ensures that investors become aware that the exemption is being used	Will require the incorporation of the information and acknowledgement into an existing or separate document. This should be relatively straightforward and low cost.	Positive – it is important that investors are aware of the regulatory environment that applies to them, and the costs are expected to be low

85 Generally submitters did not think that additional disclosures should be required for this exemption. However, the Shareholders Association were concerned that further acknowledgements or certifications should be required for those making use of it.

Employee share schemes (option 7)

86 Clause 8 of Schedule 1 excludes offers under employee share purchase schemes from disclosure requirements under Part 3 of the FMC Bill.

87 Under the current law, exemption notices apply to employee share schemes offered by listed and unlisted companies (subject to conditions). The effect of these notices is to allow listed and some unlisted companies (where there is a market for the shares or a repurchase offer) to use an evergreen short form prospectus.

88 The intention of the FMC Bill's exemption is that it be more extensive than the current exemption notices. However, it may still be important for investors (i.e. employees, contractors etc) to receive some information about the scheme and its risks, to ensure that they make an informed decision about whether or not to join. While they may have a knowledge of the business's activities, they may not understand the full implications of receiving shares in it, nor its financial position.

89 We have considered an option to address this issue (**option 7, preferred**): limited disclosure be required, comprising the issuer's latest annual report and financial statements (if available), information about how employees can dispose of their shares, and prescribed statements about the risks of these schemes.

90 The main benefit is that it ensures that employees have information to inform them as to whether or not they should take part in the scheme.

91 This will have some costs in preparing and distributing the disclosure statement. These are likely to be minor, as the content of the disclosure statement will either be expressly set out in regulations or will be material that firms already have ready access to.

92 Overall, we consider this will have positive net benefits, with more informed employee decision-making outweighing relatively minimal costs. Submitters also generally supported the proposal for there to be some limited disclosure for employee share schemes.

Small offers (option 8)

93 Clause 12 of Schedule 1 excludes small offers from disclosure requirements under Part 3 of the FMC Bill. This exception allows issuers to raise up to $2 million from up to 20 investors. The rationale for the small offers exclusion is that some offers are sufficiently small in scale that the costs of complying with the normal requirements of the FMC Bill would outweigh the benefits obtained from making the offer.

94 The small offers exemption, along with the exemptions for relatives and close business associates, also recognises that for some offers of financial products, there is no expectation of regulatory protections or compliance (other than prohibitions against fraud). This includes, for example, a small business owner receiving a loan from an acquaintance.

95 However, the small offers exemption does have the potential to cover some more formal offers to members of the public, where there may be expectations of regulatory protections.

96 We have considered one option to address this issue (**option 8, preferred**): conscious users of the exception should provide a prescribed warning statement to investors and notify FMA that they are making a small offer. The notice to FMA could require details such as the amount being sought and the number of investors.

97 The benefits of this would be that it would ensure that investors were aware of their regulatory position. It would also help FMA to monitor small offers and also provide information on how much activity is taking place within the small offers area. This information would help assess the utility of the exception and how it is being used.

98 Costs would be incurred by issuers, who would need to prepare and distribute the statements, and provide information to FMA. We expect these costs would be relatively low.

99 We consider that this would have positive net benefits, as it would provide an appropriate balance between keeping costs low (and therefore enabling the effective use of the exemption) while informing investors of the situation that they are in.

100 There was a mixture of submissions on this issue. Some submitters suggested that there be no disclosure for these offers, while others suggested that there should be limited disclosure and notification to the FMA.

FMC reporting entities (option 9)

101 The Financial Reporting Bill is currently before Parliament. It aims to provide consistent financial reporting information to external users who have a need for an entity's financial statements but are unable to demand them. Issuers, licensees and other persons regulated under the FMC Bill will be 'FMC reporting entities' and will have to keep accounting records and lodge audited financial statements prepared in accordance with applicable financial reporting standards.

102 As a general rule, issuers making an offer in reliance on most of the exclusions in Schedule 1 will not be FMC reporting entities. However, the Financial Reporting Bill will insert Clause 27A in Schedule 1, which will allow the regulations to specify circumstances when a person who makes such offers should be an FMC reporting entity.

103 The small offers exclusion allows issuers to raise up to $2 million from up to 20 investors in a 12 month period. Given that companies could become widely held by the public as a result making offers under the small offers exclusion over a number of years, this prompts the issue of whether they should be subject to public accountability under the FR Bill.

104 We have considered one option to address this (**option 9, preferred**): if an issuer gains 50 or more shareholders in reliance on the small offers exception, then it will be an FMC reporting entity. The 50 investor number matches the threshold in the Takeovers Code for companies to be subject to additional takeovers regulation.

104 This will benefit investors in these companies by ensuring that they have access to reasonably up-to-date and reliable financial information, enabling them to value their interest, make decisions about further investments or divestments, and input more effectively into the governance of the business.

105 The costs of preparing general purpose financial statements and having them audited vary widely. For a small business, they may be tens of thousands of dollars each year. The net cost to a given business depends on to what kind of financial statements would have been prepared and what kind of assurance they would have been subject to in the absence of these obligations. We expect few companies to acquire 50 shareholders through the small offers exemption – this would require issuing to the maximum number of investors allowed under the exemption for over 2 years.

106 We consider this option provides an appropriate level of public accountability for these issuers, given the nature of their shareholding. This will be closely connected with the implementation of the Financial Reporting Bill. The detail of what is required will need to be consulted on.

Part 2: Regulatory impact analysis – governance of financial products

107 Part 4 of the FMC Bill implements governance rules for financial products. It particularly focuses on setting governance obligations for managed investment schemes.

108 Managed investment schemes in financial markets are currently governed by the parts of the KiwiSaver Act 2006, the Superannuation Schemes Act 1989, the Unit Trusts Act 1960 and the Securities Act 1978. Governance obligations differ according to the Act that applies.

109 The governance regime is focussed on Problem 3 in the *Status Quo and Problem Definition* section (product regulation and governance inconsistent and inadequate). In particular:

- Some schemes do not require external supervision, which results in uneven protection for investors' assets from fraudulent practices and inadequate mechanisms for monitoring issuers
- If the relationship between the issuers of these schemes and the investors is unclear or governance requirements are inadequate, the risk that issuers will not act in the best interests of investors significantly increases
- The differences in obligations (according to the legal form of scheme chosen) results in regulatory uncertainty and creates scope for investor confusion and for issuers to not act in the best interests of investors
- The lack of regulatory rules in some areas also creates regulatory uncertainty and inhibits effective monitoring and enforcement.

110 The FMC Bill addresses these issues by setting common governance obligations for schemes and financial products in Part 4. These apply irrespective of the legal form of the scheme or product.

111 These obligations require external supervision (except for some classes of existing schemes where the significant resulting costs would be overly burdensome). Additional statutory duties to act in the best interests of investors are set. These duties are owed directly to investors and provide remedies for investors where a breach of duty takes place. New statutory rules and mechanisms govern pricing errors, limit breaks, related party transactions, and other areas where rules are currently not set.

112 Regulations are needed for the following purposes:

- The FMC Bill sets obligations that rely on regulations to provide the detailed requirements and procedures. These include the withdrawal rules for superannuation scheme rules, controls on limit breaks and pricing errors and supporting requirements for related party transactions
- Regulations determine the extent to which some of the minimum requirements are specified by statute as compared to a regime where the supervisor and issuer are left to negotiate those matters (within the framework of their general statutory duties). These include the contents of governing documents, reporting obligations and meeting procedures
- The FMC Bill allows regulations to provide exceptions so that the governance obligations can differentiate according to the functions of different schemes or financial products.

113 The table below summarises our analysis of the various options, with a further description of each option on the subsequent pages.

114 As in the previous regulatory impact analysis section, options in the table are compared against the ‘status quo’. The status quo varies across the options, as shown in the table section headings. If the obligation is new, the status quo that no regulations are prescribed in the area. In this case, the status quo is not presented as an explicit option, but would follow from none of the options being selected. If the status quo were presented explicitly, the ‘impact on objective’ column would be neutral (i.e., ‘-‘) in each case, as it is the comparator.

115 However, where there are requirements under the current law that are equivalent to obligations being imposed by regulations under the Bill, the status quo is defined as the current requirement. In this case, a requirement similar to the status quo may be included as an explicit option.

Options	Impact on objective: investor information	Impact on objective: appropriate governance	Impact on objective: Compliance costs	Impact on objective: Innovation & flexibility	Preferred option? (Y / N)	Comments and risks
Superannuation scheme registration requirements – the status quo is no regulations						
1A. Only permit withdrawals as per KiwiSaver scheme rules.	-	Moderate benefit	Small benefit	High negative	N	Providing some prescription on withdrawal rules provides more certainty than reliance on only the sole retirement purpose test. However, there are costs to investors who cannot withdraw retirement funds they wish to access and there is a significant effect on flexibility of product design.
1B. Permit more flexible retirement rules.	-	Small benefit	Small benefit	Moderate negative	Y	The benefits in terms of governance of superannuation may be slightly lower than option 1A. Setting more flexible rules will diminish the costs for investors who wish to access retirement funds and allow a limited degree of product design flexibility. More flexible rules are reliant on individual trustee discretion.
FMA reporting obligations for Schedule 3 schemes – the status quo is the current law, which requires annual reporting to FMA, including audited accounts						
2A. Limited reporting requirements, not including audited accounts in all cases	-	Small negative	Small benefit	-	Y	Requiring financial statements to be provided gives FMA information to enable its oversight of schemes.
2B. Annual FMA reporting obligations as under current law.	-	Small benefit	-	-	N	This is effectively the status quo. Audit may provide objective oversight, but there is no requirement at present for the auditor to be licensed or independent.
Limit on pre-retirement use of funds by Schedule 3 schemes – the status quo is no regulations						
3A. General limit on pre-retirement use of funds.	Moderate benefit	Moderate benefit	Small benefit	Small negative	Y	A general limit assists investors and trustees to understand what the sole purpose retirement test means in practice, and improves the governance of the scheme as a superannuation product. Compliance costs of assessing what uses of funds are allowed are reduced, although there are costs to investors who cannot withdraw retirement funds they wish to access.
3B. Prescribed rules setting limits on pre-retirement use of funds	Moderate benefit	Moderate benefit	High negative	High negative	N	Extensive prescribed rules risk misdirection and inflexible use of the product.
Reporting of material limit breaks – the status quo is no regulations						
4A. Requiring immediate reporting of all material limit breaks	-	Moderate benefit	Moderate negative	-	N	The compliance costs risks are lower if the materiality threshold is set high.
4B. Differentiating on timing of reporting according to whether or not limit break is rectified within specified period	-	High benefit	Small negative	-	Y	Differentiating timing results in better information for supervision purposes, but also motivates issuers to having appropriate systems for early detection and rectification of limit breaks (so improving governance).
Requiring compensating and reporting of pricing errors – the status quo is no regulations						
5A. Requiring compensating and reporting of all material pricing errors	Moderate benefit	Moderate benefit	High negative	-	N	Pricing errors can be very difficult and costly to resolve, particularly if they go on for a long time. The objective is to incentivise good early detection and resolution systems. Mandating compensation where there is a minimal per unit effect would impose significant compliance costs and would require exemptions (so imposing costs on FMA).
5B. Setting steps that provide flexible rules to deal with cases where costs of taking action exceed the benefit	Moderate benefit	Moderate benefit	Moderate negative	-	Y	Achieves purpose set out in option 5A but better accounts for the scale and range of scheme by allowing more flexibility. Consequently assessed as having fewer costs to issuers. Still some regulatory costs as guidance will be needed to assist with applying general rules.

Options	Impact on objective: investor information	Impact on objective: appropriate governance	Impact on objective: Compliance costs	Impact on objective: Innovation & flexibility	Preferred option? (Y / N)	Comments and risks
Related party transaction supporting requirements – the status quo is no regulations						
6A. Requiring certificates to state nature and extent of related party benefit (and monetary value if quantifiable)	Small benefit	Small benefit	Small negative	-	Y	In view of the supervisor's ability to request other supporting evidence, this option risks fewer compliance costs than option 6B, and may result in better directed regulation.
6B. Requiring supporting valuations and evidence to accompany all certificates	Small benefit	Small benefit	Moderate negative	-	N	The additional compliance costs in option 6B are likely to be around over-requiring supporting evidence or requiring evidence that is more extensive than is needed for every case. The risk of costs depend significantly on how many related party transactions are caught by the prohibitions. Submitters considered that many transactions would be caught, particularly for registered banks.
7. Requiring explanatory memorandum to go to scheme participant meeting to approve related party transaction	Moderate benefit	Moderate benefit	Small negative	-	Y	The quality of investor information is critical where scheme participant approval is the rationale for permitting a related party transaction. These requirements are based off equivalent Australian requirements.
Regulating content of governing documents – the status quo is the current law which regulates some content (but excluding those requirements that are now included in the FMC Bill itself)						
8. Requiring particular matters to be addressed in governing documents	Small benefit	Small benefit	Small negative	Small negative	Y	Requiring matters to be included in the governing document results in them getting publicly disclosed and means that they cannot be amended without procedural steps being followed. This diminishes flexibility to change requirements to fit changing circumstances. On this basis, the matters required should be limited to matters that are material to credit risk and governance risk and should not be used purely as a means of requiring disclosure. This does not include some of the matters currently included, and includes some new matters.
9. Implying substantive terms into governing documents	-	Moderate benefit	Moderate negative	Moderate negative	Y	Most current implied terms are now included in the FMC Bill. We propose only limited implied terms rolling over current auditor implied terms and limited implied terms to deal with FMA appointees. The compliance costs that arise from implying in "one size fits all" terms depend on the content of those terms. Auditors would consider the compliance costs of the current terms to be significant. However, supervisors would consider them to have governance benefits.
Reporting by issuers to supervisors – the status quo is the current law, which sets only deposit taker reporting obligations						
10A. Setting reporting requirements for high risk areas where there are common minimum reports (deposit takers) and otherwise relying on supervisors to specify	-	-	-	-	Y	This is effectively the status quo, but is included as it is the preferred option. Supervisors are best placed to judge what reports are needed to supervise an issue. The risk of inadequate supervisor reporting can be monitored through the licensing regime.
10B. Setting reporting requirements for all schemes and debt securities	-	Moderate benefit	High negative	-	N	There is a risk in specifying reporting requirements that supervisors take the minimum reporting as being sufficient and do not design product-specific reporting requirements.

Options	Impact on objective: investor information	Impact on objective: appropriate governance	Impact on objective: Compliance costs	Impact on objective: Innovation & flexibility	Preferred option? (Y / N)	Comments and risks
Procedures and requirements for meetings of product holders – the status quo is the current law, which requires annual meetings for participatory schemes, but does not set meeting procedures						
11A. Requiring annual meetings for all schemes	Moderate benefit	Moderate benefit	High negative	-	N	The governance benefit for this option takes account of the governance benefit for equity-like schemes under option 12B. However the governance benefit for most schemes (where participation rates are low) is likely to be minimal. The compliance costs for schemes with widely dispersed investors and low participation rates are likely to be significant.
11B. Requiring annual meetings only for complex equity-like schemes	Moderate benefit	Moderate benefit	Small negative	-	Y	The compliance costs here are assessed as less on the basis that equity-like schemes are likely to require annual meetings in any case as a matter of product design.
11C. Not requiring annual meeting for any schemes	Small negative	Moderate negative	Small benefit	-	N	Reduces compliance costs for schemes (which is of significant benefit to schemes that would not otherwise have meetings but of lesser benefit to complex schemes which in many cases may require a meeting in any case).
12A. Set meeting procedures and allow variation for all matters	-	Small benefit	Small benefit	-	N	Submitters generally considered the ability to vary meeting procedures as important.
12B. Set meeting procedures and exclude variation only on minimum notice and quorum requirements	-	Moderate benefit	Small benefit	-	Y	Although product holder meetings are not common for schemes, where they are required they are likely to be on critical matters. On this basis the governance benefits of ensuring fair participation in these decisions are moderate even if they are infrequent.
12C. Set meeting procedures and allow no or minimal variation	-	Moderate benefit	Moderate negative	-	N	Submitters generally considered that mandatory meeting procedures would add costs and inflexibility for no governance benefit. We consider that there may be some governance benefits but assess these as outweighed by the costs.
Exceptions from obligation to lodge a statement of investment policy and objectives on register – the status quo is no regulations						
13. Providing exception for schemes if no regulated offer	-	-	Small benefit	Small benefit	Y	There may be a small innovation benefit for wholesale schemes to not publicly disclose the risk profile and investment policy of the fund. The costs to governance and investor information (given that it will still be available to investors on request) is assessed as neutral.
Exceptions from related party transactions – the status quo is the no regulations						
14. Exception for sale of first property into scheme, listed schemes, one common director of manager of listed schemes, and investments in Australian registered schemes	Small negative	Small negative	Moderate benefit	-	Y	There is some governance risk with the exceptions. This is limited because exceptions have been considered only where there are other governance disciplines in place or the related party transaction risk is considered to be minimal. The most significant risk is with the sale of "first property" into the scheme.
Register exceptions – the status quo is the current law, which requires auditing of each register but allows an exemption for superannuation schemes only						
15. Require auditing of each register, unless held by register company that is audited or reviewed as a total business	-	-	Moderate benefit	-	Y	An audit or review of a register business as a whole is likely to yield as good governance assurance as an audit of each register, with significant compliance cost benefits.

Obligations for which regulations need to provide detailed requirements (options 1 to 8)

116 The FMC Bill sets obligations in places that rely on regulations to provide the detailed requirements and procedures. This set of options addresses these areas.

Superannuation scheme registration requirements (option 1)

117 Under the FMC Bill, superannuation schemes open to new members will have the sole purpose of providing retirement benefits to members. Regulations are needed to set the detailed registration requirements for these schemes. In particular, regulations will determine the extent to which the withdrawal rules for schemes “lock in” retirement savings and allow withdrawals for non-retirement purposes. These requirements are intended to strengthen the “sole retirement purpose” test with prescriptive requirements, but also give certainty to providers as to when ancillary withdrawals are permitted for other purposes.

118 We have considered two options for withdrawal rules:

- Option 1A: only permit withdrawals as per KiwiSaver scheme rules
- **Option 1B (preferred)**: permit more flexible retirement rules.

Option	Benefits	Costs	Net impact – qualitative judgement
1A	Ensures that withdrawals made only for purpose of retirement, except in the limited exceptions. Increases options for government to encourage superannuation knowing that funds will be locked in for this purpose. Gives certainty to trustees applying rules, reducing compliance costs.	Significant negative impact on innovation and flexibility of product design. May result in no schemes registering in this category. Investors applying these rules may not be able to access funds when an alternative use would be a better use.	Slightly positive – the improvement over governance of superannuation probably outweighs the loss of innovation and flexibility. However, there are likely to be no schemes registering in this category in the absence of other government incentives.
1B	Ensures that withdrawals made only for purpose of retirement or for connected “transition to retirement” purposes. Allows some flexibility and innovation in product design. Increases options for government to encourage superannuation knowing that funds will be locked in for this purpose. Gives more investor choice on use of funds.	Has a small negative effect on product innovation and flexibility of design. There is no compulsion to register in this category (leaving more flexible product design options elsewhere), but it does limit options for those schemes that opt in to this category. Small negative effect possible on governance risk for superannuation schemes as rules more flexible and more reliant on trustees’ discretion.	Positive. Smaller benefits than option 1B in terms of ensuring withdrawals are made only for retirement purposes (given more flexible rules are reliant on trustee discretion), but the benefit in terms of allowing for greater innovation and flexibility is considered to outweigh this risk.

119 Submitters on the discussion document questioned the justification for “locking in” requirements and restricting product design when there are no tax benefits for superannuation savings in New Zealand. There were concerns about imposing restrictions on schemes that allow withdrawal on leaving workplaces and on investor choice.

120 Changes to the FMC Bill since the discussion document have addressed many of these concerns. The new superannuation scheme category is not compulsory for either existing or new schemes. There are alternative options for existing schemes to continue with current rules. Existing schemes may close to new members and continue as “legacy” schemes with their current withdrawal rules. They may register as workplace savings schemes or in the general “managed fund” category. The new withdrawal rules do not apply to these schemes. Schemes may also register different sections of the scheme under different categories. These changes allow more flexibility in the design of retirement schemes. As a result of the increased options for schemes, the scale of the potential flexibility costs of either withdrawal rule option is reduced.

121 Both options are referenced to KiwiSaver scheme rules, but we have looked at requirements in Australia in designing more flexible rules under option 1B.

122 Our preferred approach (option 1B) is to reduce the risk of loss of product design flexibility and limits on investors choices by allowing more flexible rules. There is a risk that more flexible rules result in the less improvement or in "second best" practice in terms of superannuation governance. The extent of this risk is dependant on the approach of trustees applying the rules. It is mitigated by the ability of FMA to provide guidance on how the rules should be applied.

Reporting obligations and implied terms for Schedule 3 schemes (options 2 and 3)

123 Schedule 3 schemes are single-person superannuation schemes, currently registered under the Superannuation Schemes Act 1989. The main use of these schemes currently is as vehicles for retirement payments under other legislation (for example, the Remuneration Authority Act 1977 authorises payments to these schemes for members of parliament).

124 These single-person schemes do not raise the same governance issues as retail managed investment schemes. As a result they are not registered under Part 4 of the FMC Bill, but only approved under Schedule 3. However, significant Crown funding is paid to these schemes under the Remuneration Authority Act 1977 and other Acts. Regulations may require schemes to report to FMA or imply terms into the trust deeds for the schemes.

125 We have considered two options for the extent of reporting to FMA:

- **Option 2A (preferred)**: limited reporting requirements, including financial statements but only auditor's opinion if other legislation required audit
- Option 2B: requiring a similar level of reporting as is currently required, including audited accounts.

Option	Benefits	Costs	Net impact – qualitative judgement
2A	Minimises compliance costs. Requirement to provide financial statements ensures FMA has key information to facilitate oversight.	Risk that no independent check of accounts automatically required.	Slightly positive – if audit is required by other legislation where it is critical, then lower compliance costs for other schemes.
2B	Provides verification of financial statements. Lower benefits however where the scheme is self-managed, rather than managed by another person on the investor's behalf.	Accounting and audit costs are highly dependant on the complexity and types of assets the scheme invests in. A sample of audit fees for these types of schemes ranged from $600 (on $1.5 million portfolio) to $1,884 (on $990,000 portfolio). No current requirement for audit to be independent lessens governance benefit of requirement.	Slightly negative – risk that imposes compliance costs (albeit not significant) with little governance benefit as no independent requirement for audit and the key benefits of audit are to verify financial statements of others managing funds on the investor's behalf.

126 Both options require financial statements to be provided. The key difference between these options is in the question of whether audited accounts should be required in all cases or only where other legislation imposes an obligation to have financial statement audited. While the data on audit costs is a sample only, these costs represent an audit expense ratio ranging from 0.04% to 0.19%. These are not significant costs. However, as there is no requirement for an independent audit and the schemes are self-managed, there is a risk that it will impose compliance costs with little governance benefits.

127 Our preferred option (option 2A) requires audited accounts to be supplied only where this obligation is imposed by other legislation. This would ensure that this additional cost is imposed only where the governance benefits under other legislation justify it.

128 The other question for the regulations is how much further to go in setting withdrawal rules. The status quo is to rely only on the sole retirement purpose test. However, some prescription is desirable to clarify the effect of the sole purpose test for members and trustees (for example, to clarify the ability to loan to the member or purchase significant assets used by the member to his or her benefit).

129 We have considered two options:

- **Option 3A (preferred)**: a general limit on the member deriving a financial benefit from the use of retirement savings except on arm's length terms
- Option 3B: prescribed rules that limit types of investment and use of funds.

Option	Benefits	Costs	Net impact – qualitative judgement
3A	Improves clarity of effect of the sole retirement purpose test for trustees and investors, and so improves the governance of the scheme as a superannuation product.	Will be compliance costs to the extent that trustees need to justify investment or use of retirement funds against the general limit, but these should not be less than cost of applying sole purpose test.	Positive.
3B	Provides certainty as to the requirements of a sole retirement purpose test, which improves governance. This also diminishes compliance costs for trustees in applying the sole purpose test.	Higher regulatory costs in formulating and enforcing rules for a wide range of situations. Significant risk that rules would not capture all situations adequately and unnecessarily restrict use of product.	Negative - The benefits in terms of increased compliance certainty do not justify the higher compliance costs for government when compared to option 3A or the risk of undercoverage.

130 The preferred option is to set, as a general rule, a term that limits the use of retirement funds for the member to derive external financial benefits except on arm's length terms (option 3A). This general rule would match an equivalent rule used for KiwiSaver schemes. This is considered sufficient to give trustees and investors clarity about the effect of a sole retirement purpose test. It also does not have the cost to government of formulating specific rules to cater for a wide range of investment situations. The risk of increased compliance costs for trustees in applying this test could be mitigated through FMA guidance.

Reporting of material limit breaks (option 4)

131 Limit breaks are breaches of limits on the asset allocations set in a scheme's statement of investment policy and objectives (SIPO). The FMC Bill requires reporting of material limit breaks to the supervisor or FMA. FMA will determine through its frameworks and methodologies when a limit break is material.

132 The main question for the regulations is the timing of this report. Not every material limit break has the same significance for compliance. A breach of the SIPO may occur for reasons that are beyond the control of the manager and so occur without the manager's immediate knowledge. Reporting requirements should be meaningful for the action that the supervisor or FMA may need to take in response to a limit break.

133 We have considered the following options:

- Option 4A: requiring immediate reporting of all material limit breaks
- **Option 4B (preferred)**: differentiating timing of reporting of material limit breaks according to whether or not the limit break is rectified in a specified period.

Option	Benefits	Costs	Net impact – qualitative judgement
4A	Enables immediate oversight of all material limit breaks.	Depending on the frequency of limit breaks and materiality threshold, may result in significant compliance costs. Risk that may (indirectly) result in the SIPO becoming a more "high level" document, so resulting in less effective oversight of limit breaks.	Positive. However, the risk as to compliance costs is significantly lowered if FMA set a higher level of materiality for limit break reporting.
4B	Requiring immediate reporting if a limit break is not rectified will provide supervisors with necessary information to enable them to monitor rectification. Deferring other reporting to a quarterly report will result in better information in terms of compliance trends. Differentiating timing may also motivate issuers to have better early warning and rectification systems (so improving governance).	Likely to be slightly lower compliance costs for issuers. May be a risk that even if rectified a material limit break may require immediate oversight by the supervisor.	Positive, and expected to be slightly more positive than option 4A.

134 Submitters were divided. Some favoured immediate reporting of quickly rectified limit breaks on the basis that the risk of over reporting is mitigated by the fact that only material limit breaks must be reported. Others considered that limit breaks that are rectified quickly do not need to be immediately reported.

135 The choice between options depends in large part on how FMA sets the criteria for determining which limit breaks are "material". If a low threshold is set and all material limit breaks must be immediately reported, the risks of significant compliance costs and over-reporting significantly increase. If a high threshold is set, then immediate reporting of all limit breaks has fewer costs. In this context it is difficult to assess the net impact of the options.

136 On balance we consider that the potential direct benefits (more useful information) and indirect benefits (better incentives to rectify breaks quickly) of option 4B outweigh the risk that there are matters on a material limit break that require immediate oversight even if it is rectified.

Requiring compensation and reporting of pricing errors (option 5)

137 Pricing errors are errors in the pricing of a unit issued under a scheme or non-compliance with a scheme pricing methodology. Errors may have a variety of causes, for example incorrect valuations, administrative recording errors, incorrect accounting or tax policies. They may arise either in the scheme or in underlying schemes. The effect on scheme participants (both on exit/entry and ongoing scheme participants) may be large, particularly if the discovery of the pricing error is delayed.

138 The FMC Bill mandates the correcting of the pricing error, its reporting to the supervisor or FMA, and the taking of the prescribed steps (e.g., to compensate for the pricing error and inform scheme participants).

139 The FMC Bill applies these steps to material pricing errors. FMA will set the materiality threshold. It may choose to measure materiality on percentage of unit price affected, on the nature of the error, or on whether adequate pricing policies have been followed. As a result, it is possible that the steps will apply even where the per unit effect of the error is not significant.

140 The question for the regulations is what steps issuers must take to compensate for pricing errors and inform FMA and investors. Mandating compensation is a means of focussing managers on formulating pricing policies and monitoring for pricing errors, as early detection will be important to minimise the compensation they may be liable for. Early discovery and prompt rectification of pricing errors are also critical to minimising their impact on investors.

141 We have considered two options:

- Option 5A: setting steps that require compensating and reporting of all material pricing errors
- **Option 5B (preferred)**: setting steps that provide flexible rules to deal with cases where costs of taking action exceed benefit.

Option	Benefits	Costs	Net impact – qualitative judgement
5A	Ensures fuller compensation and investor information about pricing errors. The obligations will incentivise issuers to ensure pricing policies and systems are appropriate to manage risk.	Will impose higher compliance costs on scheme, in some cases where minimal individual benefit to the scheme participant. Wide range of scheme-types and circumstances increases risk of poorly directed rules or overly burdensome compliance costs. In reality, FMA exemptions will be required to provide exceptions to obligations (increasing regulatory cost to FMA).	Uncertain - Very hard to know the current scale of the problem and assess the likelihood of many errors coming within the “minimal benefit” category. In this context it is difficult to assess the likely net impact. However, in principle “hard and fast” rules seem likely to impose costs in excess of the benefits to the individual participant in some cases.
5B	Ensures obligations to compensate and inform investors apply in most circumstances. The proposed steps will be based on Australian good practice guide with which some of the large managed funds will already comply.	Lessens compliance costs as does not require exhaustive steps to be taken (or exemptions to be sought). Will be less certainty as to the extent of obligations. Some regulatory cost to FMA as likely that guidance will be needed to support principles-based rules.	Uncertain, but in principle the objective of incentivising good early detection and resolution systems is likely to be achieved as well as under option 5A, but with fewer costs to issuers.

142 The preferred option (option 5B) was widely supported by submitters who considered that compensation should not be required if the pricing error results in a minimal impact on a per unit basis and that the rules should be sufficiently flexible to cater for difficulties with finding former scheme participants and other variations in circumstances. The risks of formulating rules that are too flexible or difficult to apply under option 6B can be mitigated by basing the rules on the APRA and ASIC good practice guide (with which many larger managed funds are already complying) and by the use of FMA guidance.

Related party transaction supporting requirements (options 6 and 7)

143 Related party transactions are prohibited by the FMC Bill on the assumption that transactions of this nature may be improperly influenced by the interests of the related party and not in the best interests of scheme participants. The general duties which require managers to act only in the best interests of scheme participants continue to apply under the FMC Bill. However, the FMC Bill backs up those general duties with an obligation on the issuer to positively demonstrate that the transaction is not improperly influenced by the related party connection.

144 A related party transaction is permitted under the FMC Bill if it is on arms' length terms or meets scheme participant or supervisor consent requirements. To rely on these permissions, the manager or supervisor must give a certificate stating the grounds on which the transaction is permitted and the basis for its reliance. The certificate requirement requires the manager or supervisor to justify this reliance and gives visibility and oversight of the permitted transaction. The certificate must comply with any prescribed requirements.

145 The question for the regulations is how much supporting evidence or other requirements to impose in relation to reliance on these permissions.

146 We considered two options in relation to certificate requirements:

- **Option 6A (preferred)**: requiring certificates to contain only basic information as to the nature and extent of related party benefit (including monetary value if quantifiable) and relying on supervisors to request other information if need be
- Option 6B: setting requirements in the regulations for supporting valuations and evidence to accompany certificates.

Option	Benefits	Costs	Net impact – qualitative judgement
6A	Provides some key information to investors and supervisors. Requiring this information indirectly requires issuers to be able to support certificates with some evidence.	Does not mandate particular levels of objective evidence, and so some risk of poor governance over related party transactions. Heavily reliant on supervisor to "look behind" the certificate. Imposes compliance costs on issuers (mitigated by ability to use general certificates).	Slightly positive – likely to be sufficient transparency and information provided to supervisor to ensure that the objective of improving governance over related party transactions is better met without unnecessary compliance costs.
6B	Provides minimum requirements in the regulations for objective evidence, and so lowers risk of inadequate governance over related party transactions.	Higher compliance costs likely if over-require supporting evidence or require evidence that is more extensive than is needed in every case. Will diminish ability to use general certificates. Imposes regulatory cost in terms of defining the appropriate valuation requirements for many different types of transactions.	Uncertain, but likely to be slightly negative. Given the likely scale of the coverage (particularly that there is no materiality threshold for related party transactions), risk of causing unnecessary compliance costs is high.

147 Submitters considered that for some market participants (particularly registered banks) costs of compliance with certificate requirements are likely to be very high and would increase significantly if supporting valuations are required for every related party transaction. Most submitters considered that the requirements should be sufficiently flexible to allow certificates to cover a range of types of transactions.

148 We preferred option 6A on the basis that it was better directed to the nature of the problem. Requiring these details to be stated would impose a de facto requirement for some supporting evidence. In addition, the core function of the certificate requirement is to ensure the supervisor has the necessary information to carry out the oversight function. In this context, setting mandatory supporting evidence requirements, with the associated compliance costs, is not justified.

149 We also considered an option for additional requirements for transactions that are permitted on the basis that they are approved by scheme participants (option 7). Under the status quo no minimum information is required. However, both NZX listing rules and Australian equivalent provisions require an explanatory memorandum to be provided for a meeting to approve a related party transaction.

150 We have looked at an option based on Australian provisions (option 7), under which the explanatory memorandum must be provided to the supervisor for its comment before the meeting and then included, with the supervisor's comments, in the notice of meeting. The explanatory memorandum should include all information known to the manager or its directors that scheme participants would reasonably require to decide whether it is in the scheme's interests to pass the resolution. At a minimum this should include the nature and monetary value of the benefit (if it is quantifiable) or the extent of the benefit, the relevant related party and the nature of the related party relationship.

151 The benefit of this option is that it provides in-depth information to investors that forms the basis on which approval is given. This should result in better governance over related party transactions that are approved by investors. There are likely to be moderately high costs in preparing the explanatory memorandum. However there would need to be an explanatory memorandum prepared in any case for such a meeting. In addition, not many transactions are likely to need approval on this ground (given the alternative grounds that the transaction is at arm's length or that the supervisor has approved it). If this ground is relied upon, we consider it critical that investor information is good and the transaction is fully justified to investors with the supervisor's comments. We consider the net impact of this option to be positive.

Areas where regulations specify minimum requirements rather than relying on supervisor negotiation (options 8 to 12)

152 There are further areas under Part 4 of the FMC Bill where the choice is between using regulations to specify minimum requirements and relying on the negotiation of the governing document by the supervisor and issuer.

Regulating content of governing documents (options 8 and 9)

153 The governing document is the key means, outside of the FMC Bill, for setting the governance requirements for an issue of debt securities or a managed investment scheme. It contains the terms on which the supervisor agrees to take on the supervisory role in relation to the issue (e.g., any financial covenants from the issuer).

154 The governing document is negotiated by the supervisor and issuer. However, there are 2 options available to control its content:

- Option 8: requiring particular matters to be addressed in governing documents: this results in those matters being publicly disclosed in the governing document on the register and means that they cannot be amended without procedural steps being followed. This goes one step further to protect investors than disclosure
- Option 9: implying substantive terms into governing documents: doing so provides minimum substantive investor protections.

Option	Benefits	Costs	Net impact – qualitative judgement
8	Ensures the matters are addressed and negotiated by the issuer and supervisor. Applies procedural protections to those matters so that they cannot be changed too easily.	Limits flexibility to adapt governance arrangements to suit changing circumstances. Risks imposing standard contents when irrelevant to some schemes given high amount of variation between schemes.	Slightly positive – risk of overly imposing standard contents can be mitigated by not mandating that particular contents always be set (but only that, if set, they are included in the governing document).
9	Can be used to set substantive investor protections that guarantee a basic level of investor protection. Can be used to set a standard requirement where issuers and supervisors may not be able to agree an outcome.	High risks of a "one size fits all" requirement being imposed that is either not fit for purpose or imposes unnecessary compliance costs.	Slightly positive – regulatory risks need to be mitigated by only imposing rights or duties where the case for their imposition is strong.

155 We have considered both these options for controlling the content of governing document and have reviewed existing requirements in considering their use. There is overall less need to rely on the content of the governing document to provide investor protections than under the existing law. Many of the duties currently implied into governing documents are now stated as statutory duties in the FMC Bill. The FMC Bill also already controls the content of governing documents for debt securities and (more extensively) for managed investment schemes. We have assessed using options 8 and 9 to provide some additional control for each type of financial product.

156 Neither option was well-supported by submitters. Most submitters considered that standard contents would result in too little flexibility given the variation between types of schemes and the risk profile of schemes.

157 Our preferred option is to generally adopt option 8. This is on the basis that option 8 imposes lower risks of a “one size fits all” solution and allows more flexibility than option 9. These risks are further mitigated by ensuring that the content requirements under option 8 are set reasonably flexibly. We have adopted option 9 however on matters where the governance risks of not including actual implied terms are assessed as significant (outweighing the loss of flexibility that result).

158 For debt securities, it is proposed that the following matters be covered by the governing document under option 8:

- Any financial covenants given by the issuer in favour of the holders of the debt securities or the supervisor (if any)
- Any prohibition or restrictions on related party transactions (if any)
- Provisions governing the appointment and removal of the supervisor
- The frequency and content of reports by the issuer to the supervisor
- Changes to the prescribed meeting procedures for product holders
- Any other matters that materially affect the rights and duties of holders of the debt security or the powers, rights, and duties of the issuer or supervisor.

159 The FMC Bill already sets most content matters for managed investment schemes. It is proposed to adopt option 8 to require the governing document to cover issuer reporting to supervisors and changes to prescribed meeting procedures under the regulations.

160 Option 9 is adopted to deal with two matters:

- Currently terms are implied in governing documents to require half-yearly audits and for auditors to report for the benefit of supervisors of deposit takers. Submitters expressed strong opposing views on these implied terms reflecting the disagreement between supervisors and auditors as to the role of auditors, the nature and scope of audits, and the extent to which supervisors should be able to rely on audit reports without a separate engagement. Auditors consider that these requirements impose significant compliance costs. Supervisors consider that they impose important governance benefits. The New Zealand Institute of Chartered Accountants has begun an initiative to develop an industry-wide solution to this disagreement. The Reserve Bank is also reviewing the prudential regime for deposit takers, including the role of supervisors. This option is adopted for these terms only as an interim measure. The implied terms will need to be reassessed if there is an outcome from these other projects.
- In addition this option is adopted to ensure that FMA appointee can takeover from a retiring supervisor without any doubt as to the transfer of rights and obligations. In these circumstances the governance risks of not being able to transfer these rights or obligations (eg, the transfer of access to bank accounts) are considered significant and assessed as outweighing any diminished flexibility that may result.

Reporting by issuers to supervisors (option 10)

161 It is generally impractical for investors in debt securities or managed investment schemes to assess and monitor the issuer's governance systems. Under the FMC Bill it is the role of the supervisor to assess and monitor the financial condition of the issue to ensure that promises made to investors can be kept.

162 The supervisor's ability to obtain timely and appropriate information from the issuer about its governance systems is key to their performing this monitoring function and promoting good governance. The FMC Bill already provides the supervisor with powers and mechanisms to obtain this information. FMA is also able to monitor supervisor activity through the supervisor licensing regime.

163 In addition, regulations can impose periodic or event reporting requirements. The question is whether regulations should set, as a default, minimum reports that must be made by the issuer to the supervisor or whether this should be left to the supervisor to negotiate.

164 We have considered two options:

- **Option 10A (preferred)**: set these reporting obligations only for high risk areas where there are common minimum reports and otherwise rely on supervisors to negotiate appropriate reporting requirements
- Option 10B: set these reporting obligations for all products and schemes.

Option	Benefits	Costs	Net impact – qualitative judgement
10A	Likely to result in reporting that is more fit for purpose and better designed for the risk profile of each product. Encourages active standard-setting by supervisor.	Risk that supervisors will under-require reporting.	Slightly positive – risks of under-requiring of reporting can be mitigated through supervisor licensing regime.
10B	If reporting requirements are set well by regulations, then will ensure adequate minimum reporting.	Risk that only minimum reporting will be required and that supervisors will not require additional reporting needed for particular products. Also high risk that reporting requirements will not be designed appropriately for all products and schemes. This would likely result in misdirected rules and unnecessary compliance costs for issuers.	Uncertain – scale and range of different types of schemes and products increases risk that reporting requirements would not be fit for all purposes.

165 Option 10A is preferred on the basis that reliance on the supervisory model is likely to result in better governance outcomes and creates less risk of misdirected rules and associated compliance costs. The risk that supervisors under-require reporting can be mitigated by monitoring reporting requirements through the supervisor licensing process. Submitters generally supported this approach.

Procedures and requirements for meetings of product holders (option 11 and 12)

166 Regulations may set requirements and procedures for meetings of product holders. If no regulations are made, the governing document will apply to the extent not inconsistent with the FMC Bill.

167 The FMC Bill already entitles the supervisor, the holders of 5 per cent of the value of the financial products, or any other person authorised by the governing document or regulations to call a meeting of product holders. The first question for regulations is whether to impose any other requirements for regular meetings.

168 We considered three options for imposing regular meeting requirements:

- Option 11A: requiring annual meetings for all schemes
- **Option 11B (preferred)**: requiring annual meetings for complex equity-like schemes only
- Option 11C: not requiring annual meetings for any schemes.

Option	Benefits	Costs	Net impact – qualitative judgement
11A	Annual meetings provide an opportunity for investors to comment on an annual report and financial statements, and require the manager to be answerable in an open forum. This gives governance benefits.	Very low participation rates are likely for most debt issues and schemes. We understand that holding meetings is costly, particularly where schemes are widely held.	Negative (given the range of scheme-types) – the requirement would be onerous in terms of compliance cost for most schemes, and the low participation rate would mean that governance benefits were negligible in most cases.
11B	The same benefits as option 11A. In complex equity-like schemes these benefits are more significant as dissatisfied investors do not have an obvious means of exit.	Participation rates for these schemes are not known. However, it is more likely that regular meetings would be required for schemes of this nature in any case as part of product design.	Slightly positive – the governance benefits are judged sufficiently significant to outweigh the compliance costs for these schemes.
11C	No compliance costs imposed by regulation for holding meetings where they would not otherwise be held.	No minimum governance discipline imposed on equity-like schemes.	Slightly negative – the cost arising from the lack of governance discipline is difficult to determine, but we assess this as outweighing the marginal compliance cost benefit.

169 Submitters agreed that for most managed funds there was little benefit in terms of governance, and there would be significant compliance costs, with an obligation to hold an annual meeting. The option of imposing an annual meeting obligation on schemes that are more “equity-like” gained limited support from submitters.

170 Option 11B is preferred on the basis that it seeks to impose governance disciplines on a clearly defined set of schemes which are more “equity-like” and where investors have no obvious means of exit and so there is no alternative governance discipline imposed. The costs of holding meetings will be mitigated to some extent by ensuring that the default procedures allow for electronic participation.

171 The second issue for regulations on meetings is the extent to which procedures are set in the regulations and can be varied by the governing document.

172 Approval by product holders is required for particular matters under the FMC Bill. These matters are few, but may be value-critical (for example, approval of a related party transaction). It is important that all product holders have an equal opportunity to participate in meetings to approve these matters.

173 We considered the following options for meeting procedures:

- Option 12A: set the meeting procedures under the regulations but allow the governing document to vary all procedures
- **Option 12B (preferred)**: set the meeting procedures under the regulations and allow the governing document to vary all procedures other than the minimum requirements for notice of meetings and quorums
- Option 12C: set the meeting procedures under the regulations and allow no or minimal variation.

Option	Benefits	Costs	Net impact – qualitative judgement
12A	Default meeting procedures lower transaction costs for schemes and provide some benchmarking of standards (even if they are not mandatory). Allowing full variation means that there are no compliance costs for schemes.	There is a risk that the procedures will be varied in such a way that product holders will get inadequate notice and the quorum will be set too low so that special resolutions will be unrepresentative.	Negative – meetings will not be commonly required, but those matters where product holder approval is required are value critical. It is important that product holders have an equal right to participate in meetings on these matters. This cost is assessed as outweighing the benefits of low compliance costs.
12B	The benefits of default meeting procedures apply also under this option. There is also the benefit to governance of ensuring that minimum investor participation rights are established.	Compliance costs may arise from setting a 25% quorum. This is mitigated by allowing those present at the second meeting to form the quorum.	Positive – ensuring minimum investor participation rights on key decisions under the Bill is assessed as being of high importance, and outweighing the resulting compliance costs of having (in some cases) to hold a second meeting. However, the scale of the problem is difficult to assess in the absence of data on meeting costs and how often second meetings are likely to be required.
12C	Same benefits of default meeting procedures as option 12B with perhaps some governance benefits arising from including additional investor safeguards in procedures.	High risk of compliance costs arising from inflexible procedures that do not take account of needs of particular schemes.	Negative – given the few number of meetings and low participation rates of investors there would be little benefit in setting overly rigid rules.

174 Submitters supported the meeting procedure proposals in general but some only on the basis that they can be varied without restriction in a governing document or are “opt in” only (option 12C).

175 The preferred option (option 12B) takes a very targeted approach to impose mandatory minimums only where considered strictly necessary to achieve the governance benefits of equal and fair investor participation. This approach should minimise the compliance costs.

Exceptions from statutory obligations (options 13 to 15)

176 The third area for regulations under Part 4 is to provide exceptions from the governance obligations. This enables differentiation according to the function of schemes and financial products.

Exceptions from SIPO lodgement obligations (option 13)

177 The FMC Bill requires issuers to lodge the statement of investment policy and objectives (SIPO) with the register. This ensures that this document is publicly available. The SIPO sets the risk profile of a fund and informs investment decision-making by prospective investors.

178 We have considered an option of an exception from the SIPO lodgement obligation for schemes if there is no regulated offer (option 13). Under this option, the SIPO would still be required to be available to investors and FMA on request and notice of the SIPO and changes would need to be lodged.

Option	Benefits	Costs	Net impact – qualitative judgement
13	May be small innovation benefit for schemes to not publicly disclose the risk profile and investment policy of the fund.	Neutral effect, given that general public cannot invest in scheme and investors can obtain SIPO on request	Slightly positive.

179 The direct compliance costs of lodging the SIPO and any changes are unlikely to be significant. But the key costs are the risk of diminishing innovation and flexibility for funds that do not wish their investment model to be publicly available. Where there is no regulated offer in a managed investment scheme, there is little benefit perceived in requiring the SIPO to be publicly available. We consider the costs of imposing the requirement outweigh the very limited benefits that would apply. The risk that investor information is diminished can be mitigated by requiring the SIPO to be made available on request and notices of its existence or any changes to it to be lodged with the registrar.

Related party exceptions (option 14)

180 The need for exceptions from related party transaction rules is diminished by the "in principle" grounds that apply under the FMC Bill for these transactions to proceed. While there is value in bright-line exceptions, our preferred approach was to rely on the "in principle" grounds unless there were significant compliance costs and the risk of mischief was low. This was on the basis that there is little benefit gained from specifying additional exemptions that are within the "in principle" ground in any case.

181 There were 3 areas where we propose exemptions under option 14. In each case we considered the option to exempt against the status quo of no exemption:

- *Sale of first property into a scheme*: Investors sometimes subscribe on the basis of an initial, or initial series of, transactions. There may be little benefit in requiring further consent. There is some risk to governance over related party transactions if this exemption is applied too widely. We would seek to mitigate this risk by limiting the exemption to the sale of the "first property" into the scheme and by imposing appropriate conditions to ensure adequate disclosure of the transaction

- *Listed scheme exclusion:* listed schemes transactions if the transaction is entered into in compliance with listing rule requirements for related party transactions. There are significant overlaps between the FMC Bill's requirements for related party transactions and those in the NZX listing rules. These requirements have the same overall policy objective but differ in various ways. The overlap creates significant costs for listed schemes by requiring double compliance (for example, a special resolution would be required to approve a transaction under the FMC Bill rather than an ordinary resolution under the NZX listing rules, and explanatory memoranda for the meetings would need to comply with 2 slightly different sets of requirements)

- *Investments in Australian registered schemes:* acquisitions or disposals of products in managed investment schemes registered under the Australian Corporations Act 2001 should be permitted transactions on the basis that these schemes have equivalent safeguards to registered schemes (for which a permission also applies). Consequently the governance risk is assessed as low.

Option	Benefits	Costs	Net impact – qualitative judgement
14	Lowers compliance costs for these transactions: - significant benefit for exemptions b and c - likely to be moderate benefit for exemption a	Risks of losing governance disciplines over related party transactions: - risks likely to be higher with exemption a - risks in exemption b depend on the content of the alternative listing rule requirements. However, submitters assess NZX requirements as robust. - risks seem lower with exemption c	Positive – the risks for exemption a need to be mitigated however by ensuring that disclosure of the initial transactions is adequate. The risks in exemption b should be mitigated by limiting the extent to which the exemption is applied to other licensed markets.

182 Submitters were in favour of each of the proposed exceptions, although submitters were divided on exemption b. The exceptions were preferred over the status quo in each case because either the risks of the costs was assessed as minimal (exemption c) or the benefits in reducing compliance costs were assessed as significant (particularly exemption b).

Register exceptions (option 15)

183 The FMC Bill requires issuers to keep registers of financial products. These registers form the basis of title to a financial product and enable the public to ascertain ownership of financial products.

184 The status quo under the FMC Bill is that each register must be separately audited. We considered the status quo against an option where an issuer places its registers with a business that keeps registers for a number of issuers (option 15). In this case, we consider that the marginal benefit of obtaining an individual audit of each register is likely to be outweighed by the cost of the audit. We consider that an audit or review of the business as a whole gives sufficient governance assurance as to the systems and so accuracy of the register

Part 3: Regulatory impact analysis – licensing

185 The FMC Bill includes a licensing regime for a number of financial services. Some of the detail of this licensing regime has been left to regulations, which are the subject of this section.

186 The licensing regime is implemented in Part 6 of the FMC Bill. The following service providers are to be licensed by the Financial Markets Authority (FMA):

- Managers of registered managed investment schemes
- Independent trustees of restricted schemes
- Providers of discretionary investment management services
- Derivatives issuers who make regulated offers of derivatives
- Prescribed intermediaries, including person-to-person lending services and crowd-funding platforms.

187 The financial services to be licensed under the FMC Bill are not currently licensed, with the exception of derivative issuers. The majority of derivatives issuers are currently licensed by FMA as "authorised futures dealers" under the Securities Markets Act. In addition, many providers of discretionary investment management services are required by the Financial Advisers Act to employ authorised financial advisers to perform these services.

188 The FMC Bill's licensing regime is largely focussed on Problem 3 in the *Status Quo and Problem Definition* section (product regulation and governance inconsistent and inadequate). In particular:

- Inadequate oversight of managed investment schemes creates a risk that issuers will not act in the best interests of investors and inhibits effective monitoring and enforcement
- Discretionary investment management services are regulated very differently to managed funds, even where they perform very similar functions and create similar regulatory risks.

189 It also addresses aspects of Problem 1 (disclosure exemptions narrow and unclear). The Bill provides a new disclosure exemption for issuers using prescribed intermediary services, such as person-to-person lending services and crowd-funding platforms. For the exemption to be used, these intermediaries need to obtain a licence. This is intended to ensure that investors receive adequate information through the service, and the service is fair, orderly and transparent.

190 The FMC Bill's licensing regime tries to address these issues through two main mechanisms: eligibility criteria and licensing conditions.

191 Eligibility criteria are the minimum standards that service providers must meet before they are granted a licence. The previous Cabinet papers and RISs note that the licensing regime is intended to be relatively 'light' for fund managers and related services such as discretionary investment management services and independent trustees of restricted schemes. The main eligibility criteria in the Bill for all licensees are:

- The applicant's directors, senior managers and proposed directors and senior managers are fit and proper persons to hold their respective positions
- The applicant is capable of effectively performing that service (having regard to the proposed conditions of licence)
- There is no reason to believe that the applicant will not comply with the market services licensee obligations.

192 Conditions are the ongoing obligations that licensees must abide by. The Bill provides that FMA can impose conditions that limit the services that are covered by the licence, and also conditions that relate to the eligibility criteria (for example, conditions to ensure the eligibility criteria remain satisfied).

193 The Bill provides for additional eligibility criteria and conditions to be introduced through regulations, where these are warranted. Where regulations specify conditions of a licence, they can either be standard conditions that apply to all licences, or regulations can specify the kinds of conditions that FMA can impose.

194 Broadly, the licensing regulations are intended for the following purposes:

- The FMC Bill omits some detailed conduct requirements that were envisaged in the original policy and were intended to be dealt with in regulations. These include various detailed reporting requirements, insurance requirements and (for some derivatives issuers) capital adequacy and liquidity requirements
- Certain functions of the FMC Bill, such as providing for licensed intermediaries (e.g. person-to-person lending providers and crowd-funding platforms) require regulations to operate.

195 More specific information about the problems that particular options are intended to deal with is provided in the subsections below.

196 The table on the next page summarises our analysis of the various options, with a further description of each option on the subsequent pages. The table provides information about, first, requirements applying to all licensees and then those that might apply to particular types of licensed service. As with the tables in earlier sections, these impacts are rated as positive or negative, and may be small, moderate or high depending on how much they impact on the objectives and on how many market participants they affect.

197 Because the licensing regime is new (there are no existing licences other than derivatives issuers) and would function to some extent without additional regulations, options in the table are generally compared against a status quo of no regulations being prescribed in each area (unless otherwise indicated). This status quo is not presented as an explicit option, but would follow from none of the options being selected. If the status quo were presented explicitly, the 'impact on objective' column would be neutral (i.e., '-') in each case, as it is the comparator.

Licensing options

Options	Impact on objective: investor information	Impact on objective: appropriate governance	Impact on objective: Compliance costs	Impact on objective: Innovation & flexibility	Preferred option? (Y / N)	Comments and risks
Requirements applying to licensees generally – the status quo is no regulations						
1A. FMA can require licensees to hold adequate liability insurance.	-	Small benefit	Small negative	-	Y	Costs and risks will be influenced by FMA's approach to insurance requirements and what level of coverage applicants currently have. FMA's practice in respect of existing licensees suggests these costs will be low, but there is a risk this changes over time.
1B. Prescriptive liability insurance requirements in regulations.	-	Moderate benefit	High negative	Small negative	N	Would ensure wide coverage. Likely to result in many licensees requiring additional insurance, or renegotiation of their existing insurance, and may be a costly barrier to entry. We understand the insurance market is relatively thin.
2. FMA checks that directors and senior managers of authorised bodies are fit and proper persons.	-	Moderate benefit	Moderate negative	-	Y	Ensures that the character and capability of persons actually performing the service is tested, and reduces the risk that fit and proper requirements are avoided by using a related company as the primary licensee. Cost will vary according to the elements that FMA decides to assess as part of the test, but may be high in more serious cases.
3A. Prohibit contracting out of duties and enforce liability for outsourced functions.		Moderate benefit	Small negative	Small negative	Y	Would be consistent with the approach of the FMC Bill more generally. Risks preventing efficient risk transfer to outsourced providers and investors – unclear to what extent this is a problem.
3B Restrict contracting out only in particular categories of licensees, such as DIMS and prescribed intermediaries		Small benefit	Small negative	Small negative	N	Not clear that problems around contracting out of duties are necessarily confined to particular classes of licensees.
Additional requirements applying to discretionary investment management services– the status quo is no regulations						
4A. Impose conditions on incidental advice, to ensure those giving it are appropriately trained and act in the interests of investors.	-	Small benefit	Small negative	-	Y	Helps to ensure that incidental advice is given by appropriately qualified and supervised persons. Increased licensing costs and ongoing monitoring.
4B. Impose particular requirements on the giving of incidental advice		Moderate benefit	Small negative	Small negative	N	
5. Ensure investors can terminate DIMS contracts within a reasonable period without penalty, and on termination licensee deals appropriately with wholesale products.	-	Small benefit	Small negative	-	Y	The ability of investors to exit DIMS and take ownership of assets is fundamental to the lighter regulation of DIMS compared with managed investment schemes. Some risks to flexibility if DIMS are offered with highly illiquid wholesale assets that cannot be transferred or redeemed for months or years, although this depends on how the provision is drafted.
Additional requirements applying to independent trustees of restricted schemes – the status quo is no regulations						
6A. Obligation to report dissenting votes to FMA.	-	Small negative	-	-	N	May give the independent trustee undue influence over decision-making, and would disrupt collaboration of the board. Could generate false positives, as well as missed alerts where a vote does not occur.
6B. Whistleblowing obligation in case of serious problems.	-	Small benefit	-	-	Y	Helps to ensure FMA is informed of issues in schemes. May still create frictions among trustees, but the threshold for reporting would be quite high.
Additional requirements applying to derivatives issuers – the status quo is no regulations, with the exception of capital adequacy and liquidity requirements						

Options	Impact on objective: investor information	Impact on objective: appropriate governance	Impact on objective: Compliance costs	Impact on objective: Innovation & flexibility	Preferred option? (Y / N)	Comments and risks
7A. Robust, prescriptive requirements for investor suitability and leverage limits.	Moderate benefit	-	Small negative	Moderate negative	N	Would simplify investor decision-making and reduce risks, but would inhibit flexibility. There would be additional costs to implement.
7B. Provide FMA with discretion to set criteria around investor suitability and leverage.	Small benefit	-	Small negative	Small negative	Y	Similar to existing powers in respect of authorised futures dealers, but specifying in regulations may encourage greater use of powers in respect of these matters. Costs and risks will be influenced by FMA's approach to these requirements and what applicant's current approaches to these issues are.
8A. High capital adequacy and liquidity requirements – e.g. $5 million net tangible assets.	Moderate benefit	Moderate benefit	High negative	Moderate negative	N	Could be a significant barrier to entry for smaller providers, as well as being costly for many providers to retain significant excess capital and/or liquid funds. Would further reduce counterparty risks and simplify investor decision-making.
8B. Provide FMA with discretion to impose capital adequacy and liquidity requirements.	-	-	-	-	Y	Similar to existing powers in respect of authorised futures dealers. FMA is expected to take a similar approach, but there is a risk that these requirements become more onerous over time.
9. Require ongoing client reporting.	Moderate benefit	Small benefit	Small negative	Small negative	Y	
Person-to-person lending - the status quo is permitting person-to-person lending, but with no other requirements in regulations						
10. General requirements that the platform be open and neutral, and key processes be fair, orderly and transparent.	Moderate benefit	Small benefit	Small negative	Small negative	Y	Overarching eligibility criteria. Also applicable to crowd-funding. Limits potential services and increases licensing and monitoring costs.
11. Prohibit recommendations of particular borrowers.	-	Small benefit	-	Small negative	Y	Reduces opportunities for conflicts of interest. Also applicable to crowd-funding.
12. Required to have robust mechanisms for establishing the identity and creditworthiness of borrowers.	High benefit	Small benefit	Moderate negative	Moderate negative	Y	Ensures that lenders have reasonably robust information on which to make decisions. Would not allow for other models of person-to-person lending where the intermediary had a lesser role.
13. Disclosure to investors about the service.	Moderate benefit	Moderate benefit	Small negative	-	Y	Ensures investors have an opportunity to understand how the service works and the costs and risks involved before making loans. Many providers would do this anyway.
14. Required to have adequate arrangements to ensure the orderly administration of customers' contracts in the event that it ceases to operate	-	Moderate benefit	Small negative	Small negative	Y	Reflects reliance of investors on the intermediary to process payments and recover debts. A flexible approach from FMA will be necessary to ensure that arrangements are appropriate for new and small operators.
15. Cap on amount that can be lent by retail investors.	Small benefit	Small benefit	-	Moderate negative	N	Mitigates risks to investors. Relegates person-to-person lending to a marginal part of many investors' portfolios, preventing effective competition with deposit-takers.
Crowd-funding - the status quo is no regulations						
16A. Introduce flexible crowd-funding regime with significant FMA discretion.	Moderate negative	-	High benefit	High benefit	Y	Allows for the development of different crowd-funding models. Risk that the regulator takes a risk adverse approach.
16B. Introduce narrow crowd-funding regime with more prescription.	Small negative	-	Moderate benefit	Moderate benefit	N	Makes it more likely that crowd-funding licences are given without onerous conditions, as well as more protection against misuse of the exemption. Could lock New Zealand market into an inefficient or ineffective model.
17A. Fixed per-issuer cap on investments of $30,000.	Small benefit	-	Small negative	Small negative	N	Reduces investment flexibility. Does relatively little to protect investors with low income or wealth.

Options	Impact on objective: investor information	Impact on objective: appropriate governance	Impact on objective: Compliance costs	Impact on objective: Innovation & flexibility	Preferred option? (Y / N)	Comments and risks
17B. Income/asset-related per-transaction caps on investments	Moderate benefit	-	Small negative	Moderate negative	N	Would relegate crowd-funding to a marginal part of many investor's portfolios, and create strong incentives for investor avoidance. If not based purely around self-certification, may be costly for crowd-funding platforms to verify.
Licensed supervisors – the status quo is no regulations imposing duty to accept FMA appointment						
18. Impose a duty to accept appointments unless good cause not to (analogous to "cab rank rule" for lawyers).	-	High benefit	Moderate negative	-	Y	There are risks of compliance costs to supervisors through business disruption and effects on future business. But there are significant benefits to the reliability of the supervisor licensing regime, including ensuring FMA is not inhibited from removing a supervisor by the lack of a licensed replacement.

Requirements applying to licensees generally (options 1 to 3)

198 For licensees generally, regulations have been considered in a number of different areas:

- Requirements for licensees to hold insurance
- Fit and proper person requirements for authorised bodies of licensees
- Preventing contracting out of basic duties.

Requirements for licensees to hold adequate insurance (option 1)

199 A common requirement in financial services licensing regimes is for licensees to have particular insurance arrangements that cover costs and claims arising from civil proceedings, such as professional indemnity insurance. This is generally intended to address situations where licensees fail to meet their duties to investors, but lack sufficient financial resources to satisfy claims. This may result in insolvency, lack of compensation for breach of duties, and losses to investors and other creditors. Insurance may also provide a useful signal to regulators and other market participants about the ability of the licensee to comply with its legal obligations.

200 We have considered two options for insurance requirements:

- **Option 1A (preferred)**: FMA permitted to impose conditions that licensees hold adequate insurance
- Option 1B: prescriptive insurance requirements in regulations, setting out the extent of coverage needed

Option	Benefits	Costs	Net impact – qualitative judgement
1A	Ensures that consideration is given to the insurance held by licensees, which is expected to lead to a small reduction in the risk that claims against licensees cannot be compensated.	Will depend on the approach of FMA. If a self-certification approach is used, costs are expected to be low for most licensees. A small number of licensees could be required to adopt additional insurance. This approach could change over time.	Uncertain, but on balance expected to be slightly positive – probably only small benefits to the governance of licensees, but also low expected compliance costs.
1B	Ensures that all licensees have consistent minimum levels of insurance, making it more likely that claims against licensees will be adequately compensated.	Many licensees may require additional insurance, or renegotiation of their existing insurance. Could be a significant barrier to entry, and reduces flexibility of the regime.	Negative, as improvements to governance are outweighed by significant compliance costs for many licensees.

201 Submitters on the discussion document generally considered that professional indemnity insurance should be a factor that is considered in granting a licence. Some considered that professional indemnity insurance should be a consideration for particular types of services rather than being required for all licensees.

202 Our preferred option (option 1A) is a power for FMA to require that licensees hold adequate insurance. This approach is used in other licensing regimes in New Zealand and overseas, and reflects that licensees are likely to differ greatly in the nature and scale of their operations and risk exposures.

203 As noted in the table, costs and risks will be influenced by FMA's approach to insurance requirements and what level of coverage applicants currently have. For financial markets supervisors, FMA asks about applicants' processes for determining an appropriate level of insurance and requires certification that the entity has an appropriate level of insurance, rather than reviewing the level of insurance itself. It may adopt this approach for licensees under the FMC Bill also, which should avoid excessive insurance costs.

204 An alternative (option 1B) is prescriptive insurance requirements in regulations, setting out the extent of coverage needed. This would likely include professional indemnity insurance, but might extend to directors' and officers' liability insurance, and statutory liability insurance, potentially with limits on exceptions.

Fit and proper person requirements for authorised bodies of licensees (option 2)

205 Clause 398 of the FMC Bill permits FMA to authorise related bodies corporate of the licensee to provide market services covered by the licence. FMA may do so if it is satisfied that, among other things, the licensee has adequate control over the related body's provision of the service, the related body can effectively perform the service, and there is no reason to believe that the related body will not comply with its obligations. Regulations can specify additional eligibility criteria applying to related bodies (clause 398(1)(e)).

206 The FMC Bill requires that all of the directors and senior managers of the main licensee be 'fit and proper persons' to hold their respective positions. It does not impose 'fit and proper person' requirements on the personnel of authorised related bodies. This raises issues – concerns about the related body's directors and senior managers (e.g. criminal convictions for dishonesty) are likely to be at least as relevant as concerns about individuals who work for the licensee. It is also possible that an applicant could seek to avoid a person failing a good character test by becoming an authorised body with a related company as the primary licensee. The status quo would be to rely on the licensee's controls over the related body to deal with these issues.

207 We have considered one option to address this issue (**option 2, preferred**): that the fit and proper person test also encompass key personnel of any related body that is proposed to perform the service. This would include ensuring that these persons are of good character and have appropriate skills and experience.

208 This would benefit the FMC Bill's governance objectives by helping to reduce the risks that 'red flags' around good character are missed. It would also help to reduce the risk that those providing licensed services lack appropriate skills and experience, but this is already tested to some extent under other limbs of the test for authorising related bodies corporate (in particular that the related body can effectively perform the service).

209 This option would increase compliance costs (costs to FMA, but recovered to some extent from applicants), including initial and ongoing licensing costs. Such costs may be significant, particularly where FMA encounters serious concerns (although these are also likely to be the cases where the benefits of the test are most pronounced). In some cases there may be significant overlap between personnel of the primary licensee and the authorised body, in which case good character would not have to be retested. Licensees would face further costs from preparing additional information about individuals in licensing applications.

210 On balance, we consider that the benefits from fit and proper testing of key personnel in related bodies corporate will do more to achieve the FMC Bill's objectives than the additional compliance costs will detract from it. It is unclear how many licensees will seek to have related bodies authorised by FMA in any case, rather than having related bodies obtain their own licences – it may only be a handful, in which case the total benefits and costs are likely to be relatively small. We note this option was favoured by most submitters.

Preventing contracting out of basic duties (option 3)

211 Clause 133 of the FMC Bill provides that if a manager of a managed investment scheme outsources functions to other parties, the manager must monitor the performance of those functions and remains liable for their performance. The FMC Bill also provides that managers of managed investment schemes and DIMS licensees have a duty to exercise a prudent level of care, diligence and skill. There is no equivalent in primarily legislation for other licensees.

212 While duties of this sort would likely apply in any case if the contract between licensees and clients were silent on them, licensees have the ability to contract out (i.e. contracts can expressly state that these duties do not apply). Such contracting out is detrimental to the objective of ensuring that appropriate governance arrangements apply to financial products and financial services.

213 We have considered two options for addressing this issue:

- **Option 3A (preferred)**: extend these duties to other licensees in respect of retail services, to prevent contracting out – licensees could still contract out in respect of wholesale services
- Option 3B: extend these duties to particular categories of licensees, such as DIMS and prescribed intermediaries

Option	Benefits	Costs	Net impact – qualitative judgement
3A	Helps to achieve the FMC Bill's objective to ensure that appropriate governance arrangements apply to financial products.	Impacts negatively on the flexibility objective as it reduces the ability of licensees to transfer risk to outsourced providers and investors, and increases costs through more exposure to liability. These costs are expected to be low, as this option is standard practice for most licensees.	Positive, on the basis that it will promote better practices in 'outliers' where the governance risks are higher, with minimal costs for most licensees.
3B	As above, for the services covered – lower overall benefits.	As above, for the services covered – lower overall costs.	Positive, but smaller than for **3A**. There are a number of situations where negligence might occur in respect of other licensees, such as derivatives issuers, which would not be dealt with here. We were not convinced that negligence by these other licensees should be treated differently.

214 All submissions supported liability for contracted out functions in respect of DIMS, and many noted that this was usual practice, implying that the costs of including this would be low. There was some, but less, support for applying these duties also to derivatives issuers, which is our preferred option. Submissions did not identify particular problems this might cause, but a number indicated that the relationship that derivatives issuers had with clients was more limited and less likely to result in claims of negligence by the licensee or outsourced providers.

215 The alternative proposed by some submitters (option 3B) would restrict this to particular categories of licensees, such as DIMS and prescribed intermediaries. We consider there are a number of situations where negligence might occur in respect of other licensees. For example, derivatives issuers could cause loss to investors through errors in the handling of client instructions or failure to properly monitor third parties holding client funds.

Additional requirements applying to discretionary investment management services (options 4 and 5)

Incidental advice (option 4)

216 Clause 390A of the FMC Bill defines a DIMS to also include providing "financial advice in the ordinary course of, and incidentally to, providing a discretionary investment management service … for example, as to the appropriate scope of an investment mandate."

217 The Financial Advisers Act 2008 will cover advice to retail clients about whether a DIMS is appropriate and the investment options available on the DIMS. Once the client has joined the DIMS, however, the Financial Advisors Act will not apply to advice on matters incidental to the operation of the DIMS. This could include amendments to investment options (e.g. because a product is removed from the platform), or changes to how returns are reinvested.

218 This raises the issue of what requirements should apply to persons giving incidental advice. The same governance problems may arise in respect of financial advice given in the course of DIMS as those problems that arise elsewhere, such as conflicts of interest, insufficient adviser skills and knowledge, lack of due care, etc. Some of these issues are dealt with through the FMC Bill's duties on DIMS licensees that apply to the DIMS service, such as acting honestly in providing the service and a duty to comply with a professional standard of care.

219 We considered the following options:

- **Option 4A (preferred)**: permitting the FMA to impose conditions on how DIMS licensees can give incidental advice
- Option 4B: prescribe particular requirements, such as requiring persons giving the advice to comply with the Code of Professional Conduct for AFAs as if they were AFAs

Option	Benefits	Costs	Net impact – qualitative judgement
4A	Ensures that consideration is given to the incidental advice licensees will give. Makes it more likely that there are appropriate controls in place and incidental advice is given by appropriately qualified and supervised persons.	Will depend on the approach of the FMA. Some DIMS licensees are expected to have to take extra steps to ensure that incidental advice is of sufficient quality and in the best interests of investors.	Positive. This option gives flexibility to tailor requirements to individual providers, to take account of the kind of advice they are likely to be giving in the course of providing a DIMS.
4B	Gives greater certainty that there will be adequate controls on the giving of incidental advice	Likely to involve moderate compliance costs – both licensing costs and ongoing monitoring – and loss of flexibility, to some extent. It is currently unclear what 'incidental advice' will comprise, and there is a risk that requirements are not well tailored to the kind of advice that is given.	Positive, but less so than **4A**, as we consider a more prescriptive approach in the absence of information about what 'incidental' advice will comprise, may erode some of the benefits.

220 Potential requirements that could be imposed by FMA or by regulations directly include:

- Requiring persons giving the advice to be AFAs or within the scope of a QFE authorisation
- Requiring persons giving the advice to comply with the Code of Professional Conduct for AFAs as if they were AFAs (except these obligations would be enforced by FMA)
- Requiring that any advice that is given be in the best interests of the investor
- Prescribed warnings to investors
- Requiring that advice be given under the supervision of an AFA.

221 There were a range of submissions on this. Some submitters considered that the same requirements should apply as for other advice on the DIMS – in general this would mean the persons giving the advice would need to be AFAs or within the scope of a QFE authorisation. Others thought that a best interests obligation or a warning would be sufficient.

222 We have assumed under option 4A, FMA will use a range of different conditions, depending on the circumstances of the individual DIMS. For option 4B, we have assumed requirements similar to those applying to AFAs under the Code of Professional Conduct.

Termination of client agreements (option 5)

223 A particular issue for DIMS is how the client agreement may be terminated, and what then happens to the investor's assets. Because the client owns (either directly or indirectly) the assets held by the DIMS they are, in the absence of any contractual requirements, free to withdraw the DIMS providers' authority and take control of the assets. This is one of the features of DIMS that distinguishes it from managed funds, where investors have only an interest in returns from a pool of assets, not the assets themselves.

224 However, contracts with DIMS providers may restrict investors from doing so. In addition, there are likely to be circumstances when it is undesirable for investors to take control of assets or hold them in their own name – for example, when the assets are wholesale investments for which small holdings are not generally permitted, and which retail investors have difficulty exercising rights or make decisions.

225 We have considered one option to address this issue (**option 5, preferred**), that investors have an express right to terminate DIMS client agreements and take control of assets within a reasonable period to allow for transfer or liquidation. This would include client agreements ensuring appropriate treatment of wholesale assets, such as assistance by the DIMS provider to transfer or liquidate these assets.

226 Based on submissions, this is best practice at present and we have not been made aware of specific situations where termination of client agreements has caused problems. It is therefore expected to have only minor benefits in respect of improving the governance of DIMS, though it reduces the risk that termination of client agreements is a problem in future.

227 This also means it should have only minor impacts on costs and flexibility for most DIMS. Costs may come from the need for small revisions to client agreements to accommodate the way this requirement is drafted. There is also some risk that it inhibits flexibility to offer DIMS with highly illiquid wholesale assets that cannot be transferred or redeemed in the short term, depending on how it is drafted – although a 'reasonable' period for transfer or liquidation might be argued to be months or years in some cases. We are not been made aware through submissions of any DIMS presently operating such that requirement along these lines would be problematic. We would look to mitigate this risk by seeking feedback on an exposure draft of the regulations before they are finalised.

228 Overall we consider there is benefit in including this requirement. The ability of DIMS clients to take control of assets is a key assumption of the more relaxed regulatory environment for DIMS compared to managed funds (such as no requirement for a supervisor). This requirement will help to ensure that the governance arrangements around DIMS reflect this assumption.

Additional requirements applying to independent trustees of restricted schemes

229 The FMC Bill provides reduced regulatory requirements for many industry and employer sponsored managed investment schemes. These are called 'restricted schemes' in the FMC Bill. Restricted schemes are not required to have a licensed fund manager and a separate licensed supervisor. Instead, one of their trustees must be an independent trustee licensed by FMA. The purpose of the independent trustee is to bring a level of professionalism to the board. Independent trustees also have some individual duties, such as certifying that a related party transaction should be permitted (clause 159).

Whistleblowing (option 6)

230 The trustees of restricted schemes have a collective duty to report serious problems in the scheme, such as a contravention of the FMC Bill, to the FMA. Generally trustees must act unanimously, unless the trust deed provides otherwise. However, individual trustees may not have a strong understanding of their obligations, and there are also obvious disincentives towards making such reports, such as trustees becoming liable. This creates a risk that problems are not reported to FMA and adequately dealt with in a timely manner.

231 We have considered two options for addressing this issue, through the independent trustee:

- Option 6A: independent trustees be required to report to FMA when they are the only person to vote against a resolution, or only the independent trustee and members vote against a resolution that is subsequently passed
- **Option 6B (preferred)**: independent trustees report to FMA where they have reasonable grounds to believe that there is a serious problem in the scheme – for example, trustees are likely to breach their obligations in a material respect or if the scheme is likely to become insolvent.

Option	Benefits	Costs	Net impact – qualitative judgement
6A	Will inform FMA about matters that may indicate governance issues within schemes. Does not require judgement on the part of independent trustees as to whether or not to report.	Would result in false positives – independent trustees may well have other reasons for voting against a resolution (aside from governance problems). It may give the independent trustee undue influence over decision-making and disrupt collaboration of the board. It would also mean that FMA might not be alerted to serious problems that do not result in a vote.	Neutral, not clear that this would be beneficial to scheme governance overall – the additional reporting from independent trustees may not be of sufficient benefit to outweigh the negative impacts to trustee collaboration.
6B	Increases the likelihood that scheme governance problems are reported to FMA and remedied. Better targeted than **6A**.	May still create frictions among the trustees of restricted schemes but the threshold for reporting would be high. Compared to **6A**, it would require significant judgement on the part of independent trustees about what to report.	Positive net benefit, flowing from better scheme governance and little effect on the independent trustee's relationship with the rest of the board in most cases.

232 The FMC Bill does not provide that independent trustees have any special duties to report problems in schemes to FMA. We sought feedback on option 6A, on the basis that voting against a resolution by the independent trustee might indicate governance issues within the scheme.

233 Whilst some submitters agreed with this proposal, others raised the concerns indicated in the table above. This resulted in us considering an alternative suggested by some submitters, option 6B, that independent trustees report to FMA where they have reasonable grounds to believe that there is a serious problem in the scheme. We subsequently adopted this obligation because we consider it would reduce governance risks with relatively little effect on independent trustees' relationship with the rest of their boards in most cases. This would be similar to the obligations placed on auditors, investment managers, administration managers, custodians and actuaries by clause 183.

Additional requirements applying to derivatives issuers (options 7 to 9)

234 Derivatives issuers are the only category of licensees with a similar existing licence regime, in the form of authorised futures dealers under the Securities Markets Act. The Securities Markets Act gives FMA a broad terms and conditions power, which they use to impose conditions on authorisations. These commonly include financial requirements (such as capital adequacy and liquidity), and obligations around record keeping and disclosure.

Product appropriateness and leverage limits (option 7)

235 There are a range of requirements currently imposed on derivatives issuers, or potentially able to be imposed, that act to restrict the activities of licensees and reduce risks to investors.

236 Product appropriateness requirements place obligations on issuers to ensure that products they offer are suitable for investors, even where they are not giving personal advice. These requirements are a feature of a number of overseas regulatory regimes for more complex products such as derivatives, including the EU, Hong Kong and Singapore.

237 Leverage limits restrict the amount of leverage that investors are exposed to. Leverage limits apply to derivatives contracts that involve a small up-front margin payment being used to support a much larger exposure to an underlying asset or variable. For example, a contract for difference might give an investor exposure to the gains and losses from $100,000 worth of shares, with a $5,000 margin paid up-front (i.e. a 5% margin). This feature of contracts is referred to as leverage, and has similarities with the leverage that investors obtain by borrowing money to invest in other assets with a small initial deposit. These limits are used in a number of countries, including the US, Singapore, Hong Kong and Japan.

238 Product appropriateness requirements and leverage limits are a response to investors who have a limited understanding of the risks that they are taking on – especially when considering complex and highly leveraged products – and for whom disclosure alone will not result in informed decisions. Anecdotally, this appears to be an occasional issue in New Zealand.

239 FMA does not currently impose product appropriateness obligations or leverage limits, though in principle it could under the existing law. The status quo under the FMC Bill is that this discretion would be removed.

240 Two options we have considered are:

- Option 7A: prescribing product appropriateness requirements and leverage limits
- **Option 7B (preferred)**: retaining FMA discretion over product appropriateness and leverage limits would allow it to respond to activities that were of particular concern.

Option	Benefits	Costs	Net impact – qualitative judgement
7A	Would reduce the extent of losses that were inadvertently incurred by inexperienced investors	Shifting to particular rules for product appropriateness would be likely to impose significant costs and difficulties, particularly if an assessment of investor knowledge and the giving of advice is mandated. Would reduce flexibility in the derivatives market and the overall volume of transactions, with the biggest impact on licensees who offer derivatives through online platforms. The impact of leverage limits would depend on what level they were set at. We understand that some existing providers allow significantly more leverage than would be permitted in, for example, Singapore.	Negative – the negative impacts on compliance costs, flexibility and innovation may not be compensated by the benefits, as there is limited evidence that inexperienced investors taking excessive risks is a significant problem at present.
7B	Benefits will be influenced by FMA's approach to these requirements and what applicant's current approaches to these issues are. Where services fall short of 'best practice' these may reduce the extent of losses that were inadvertently incurred by inexperienced investors – though to a lesser extent than **7A**	Appropriateness requirements are expected to be low cost for many derivatives issuers, as they perform this at present. May be result in compliance costs and loss of flexibility, depending on how FMA approaches this.	Slightly positive – similar to existing powers in respect of authorised futures dealers, but specifying these in regulations may encourage greater use of powers in respect of these matters.

241 Under option 7A, regulations would prescribe product appropriateness requirements and leverage limits. We have assumed these would be along the lines of those applied in other regimes. For example, Singapore has the following requirements:

- Intermediaries must assess the knowledge and experience of their customers, and inform customers if they do not possess sufficient knowledge or experience. If the customer still intends to proceed with the transaction, the intermediary must provide advice to the customer. Safeguards, such as a lower trading limit than what the intermediary would otherwise have imposed, must also be put in place before the customer is allowed to proceed with the transaction.
- Minimum margin requirements range from 2 per cent of the notional value of the transaction for contracts for difference (CFDs) on foreign exchange, to 5–20 per cent for CFDs on equity, and 20 per cent for CFDs on any other underlying assets.

242 Under option 7B we have assumed, based on their existing practices that FMA would respond to activities that were of particular concern and work flexibly with licensees, without imposing prescriptive across-the-board requirements.

Capital adequacy and liquidity requirements (option 8)

243 Financial requirements, such as maintaining adequate capital and liquid assets, are a feature of the authorisation notices of many futures dealers who offer services to retail clients. They are largely aimed at governance risks (Problem 3). They provide a financial buffer that decreases the risk of a disorderly or non-compliant wind-up if the business fails. Requiring minimum levels of equity also ensures that shareholders have incentives to avoid failure.

244 Robust requirements may also aim to address information problems within the derivatives market (Problem 2). Derivatives are often complex products with many inherent risks deriving from the structure of contracts (e.g. use of leverage) and volatility in the instruments or variables that underlie them (e.g. underlying foreign currency, commodities, or financial products). On top of these risks, there are counterparty risks – the risk that the issuer defaults on their obligations – which are akin to those associated with investment in a debt security. By reducing, to a limited extent, counterparty risks, disclosure can be simplified, and investors can put more focus on the benefits and risks of the products, rather than the financial stability of the issuer.

245 FMA currently determines financial requirements of authorised futures dealers on a case-by-case basis and commonly imposes conditions that they maintain minimum levels of capital or liquid assets. These requirements are not proposed for prudentially regulated bodies, such as banks.

246 We have considered two options:

- Option 8A: a set of robust, across-the-board capital adequacy and liquidity requirements
- **Option 8B (preferred)**: FMA continues its current treatment with discretion as to the extent of these requirements.

Option	Benefits	Costs	Net impact – qualitative judgement
8A	Reduces counterparty risks and simplifies investor decision-making.	Would be a restrictive barrier to entry, reducing innovation and flexibility. Excessive requirements would result in high compliance costs to some providers. By inhibiting competition, they would also be expected to increase the prices (commissions and spreads) paid by clients.	Uncertain, but risks being negative overall if it is accepted that entry of new, small derivatives issuers is beneficial to the financial markets.
8B	Compared to **8A**, this allows FMA to take into account a wider range of factors than a fixed formula is able to accommodate.	Costs from monitoring capital and liquidity levels. Potential lack of transparency – currently there is no framework that specifies the objectives of financial requirements for derivatives businesses, how stringent these should be, or how they should be operationalised. With the formalisation of capital and liquidity requirements in regulations, FMA may look to bring more guidance and greater transparency to financial resource requirements.	Neutral – essentially the same as the status quo.

247 Option 8A would be in line with international practice. Internationally these requirements range from fixed minimum net assets (e.g. in the US, US$20 million) through to complex formulae that account for the nature of the business and their assets and liabilities (e.g. in Australia and Singapore). Many submitters advocated for one of these approaches or some variant of them.

248 Option 8B is that FMA continues its current treatment with discretion as to the extent of these requirements.

Ongoing client reporting (option 9)

249 While some derivatives issuers enter into contracts with investors on a one-off basis, others offer ongoing services to investors. Common features of these ongoing services are that:

- Investors frequently hold a number of derivative positions with the issuer at any one time
- The contracts do not expire, but must be closed out
- The issuer continually holds investor funds – these may be partly allocated to margins, while the rest is available for investors to withdraw.

250 For some of these services, some ongoing client reporting obligations may be warranted.

251 We have considered one option to address this issue (**option 9, preferred**) that each investor would be able to request, either in hard copy or through an electronic facility, information such as:

- A record of their transactions
- Information about their derivative positions (e.g. a list of open positions and their current value)
- The cash held in their account and allocated to margins (if applicable).

252 If an electronic facility was not available to the investor on a substantially continuous basis, the investor would be provided with a quarterly report containing the above (either delivered in hard copy or through electronic means). Investors could expressly opt-out of receiving these reports or could request that they be sent less frequently.

253 These reporting requirements are expected to improve investor information and encourage better internal governance within providers.

254 There are expected to be costs to provide this information. However, if the circumstances when licensees would have these obligations were well specified, the costs of requiring this information to be disclosed is likely to be minimal for most providers, who will already comply. There is a risk that the way the requirements are specified results in providers having to make more expensive changes to reporting systems – we would look to mitigate this risk by seeking feedback in an exposure draft of the regulations before they are finalised.

255 Overall, we consider these requirements would have net benefits to markets, by ensuring consistent minimum standards of reporting to investors, with relatively minimal costs.

Person-to-person lending services (options 10 to 15)

256 Part 6 of the FMC Bill specifies that a person may hold a market services licence to act as a provider of prescribed intermediary services. Offers of financial products made through a licensed intermediary are exempt from the main disclosure and governance requirements in the FMC Bill.[1] The types of intermediary services for which a licence can be obtained, and the regulation of those services, has been left to regulations.

257 Cabinet has agreed that person-to-person lending services will be one of the intermediary services for which a licence may be issued. Person-to-person lending services facilitate loans by matching potential borrowers to one or more lenders, usually through an internet-based platform. There are a number of major overseas person-to-person lending services, such as Prosper, Lending Club and Zopa. However, services of this kind have not been able to operate in New Zealand as they are not provided for in the current Securities Act.

258 Unlike other categories of licences proposed in the FMC Bill, prescribed intermediary licences will be voluntary. A person may act as a provider of a person-to-person lending service without obtaining a licence. However, if the person is unlicensed, the borrowers who make use of the service would have to either comply with Parts 3 and 4 of the FMC Bill (i.e. lodge a PDS and appoint a trustee) or make offers that are covered by one of the other exclusions in Schedule 1 (e.g. small offers).

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[1] Clause 6 of Schedule 1

259 The principle behind permitting person-to-person lending services is that the service can provide oversight over borrowers that substitute for the usual direct regulation of borrowers under the FMC Bill. It is envisaged that person-to-person lending services would be responsible for matters such as:

- Establishing the identity and creditworthiness of borrowers
- Ensuring that investors receive adequate information upon which to base their decisions
- Managing ongoing payments between lenders and borrowers, with responsibility for pursuing borrowers in the event of default.

260 Regulations are needed to provide for the eligibility criteria and conditions of licence

261 Below we discuss a number of proposals to give assurance that licensed providers adhere to this role. These have been approached largely as 'best practice' requirements deriving from existing overseas services, and we have not considered a range of alternative options for each:

- Option 10: general requirements that the platform be open and neutral, and key processes be fair, orderly and transparent
- Option 11: prohibiting the platform from recommending particular borrowers
- Option 12: requirement to have adequate processes to establish the identity and creditworthiness of borrowers
- Option 13: disclosure of information about how the service works
- Option 14: adequate systems for the orderly administration of customers' contracts in the event that the licensee ceases to operate the service.

Option	Benefits	Costs	Net impact – qualitative judgement
10	Helps to ensure that investors have confidence in the way that services operate. Reduces the likelihood that platforms are created specifically to promote particular lenders at the expense of informed investor decision-making.	Limits services to more transparent platforms, rather than a service that facilitates private deal-making. Also results in licensing and monitoring costs.	Positive net benefits flowing from better information and governance over platforms. Mainly ensures that services are consistent with the proposed scope of the exemption and adopt best practice in this respect.
11	Reduces conflicts of interest with the platform's role as a 'neutral broker'.	Negative impacts on fund-raising flexibility – limits fund-raising opportunities where more intensive promotion is required to 'sell' offerings. Careful drafting will be needed to ensure this achieves its purpose without interfering with the service's ability to report on the creditworthiness of borrowers, or promote itself more generally.	Positive net benefits flowing from more reliable and neutral information, but only if it does not interfere with legitimate promotion of the service and communication of information about borrowers.
12	Significantly improves the information available to investors and reduces the likelihood of fraud.	Impacts negatively on flexibility and innovation, as it confines the types of person-to-person lending services that are supported by the regulations. It would not be compatible with a service where, for example, individual lenders were solely responsible for verifying the authenticity and creditworthiness of potential borrowers and the intermediary had no role.	Positive net benefits, and consistent with the services envisaged in Cabinet's earlier decisions. Supporting other types of person-to-person lending services would require revising much of the proposed approach to person-to-person lending.

13	**Helps to ensure investors are adequately informed about the risks they are taking.**	**Providers will incur costs in preparing this information, however this is likely to be modest, as most credible services will provide this kind of information in any case.**	**Small positive net benefits, mainly ensuring that services adopt best practice in this respect.**
14	Greatly reduces risks to lenders from the licensee failing or otherwise ceasing to operate the service.	Depending on how this requirement is met, these are expected to have some costs associated with them.	Positive, reflecting the reliance of investors on the intermediary to process payments and recover debts. This assessment assumes FMA adopts a flexible approach to ensure that arrangements are appropriate for new and small operators.

General requirements that the platform be open and neutral, and key processes be fair, orderly and transparent (options 10 and 11)

262 We propose that an overarching requirement that a person-to-person lending service be that its platform operates in a way that is fair, orderly and transparent. This is equivalent to the proposed statutory requirement for an operator of a financial product market: “to the extent that is reasonably practicable, do all things necessary to ensure that each of its licensed markets is a fair, orderly and transparent market” (see clause 312 of the FMC Bill).

263 The implications of this will vary according to the design of the service. For many person-to-person lending services this will mean that the processes through which lenders are matched to borrowers and interest rates are determined are clear and consistently adhered to. If there is an auction-type mechanism for setting interest rates, the processes through which bids are entered and matched will be well documented and not subject to manipulation.

264 A further step (option 11) would be to prohibit the platform from recommending particular borrowers.

265 These considerations apply equally to crowd-funding platforms, discussed below.

Establishing the identity and creditworthiness of borrowers (option 12)

266 The making of any loan requires the lender (or an intermediary) to be confident of the identity of the borrower – without which it is impossible to enforce payment. It is also necessary to have information about the creditworthiness of the borrower to decide whether to bear the risk of default, and whether the interest rate adequately compensates for it.

267 When a person-to-person lending service matches lenders and borrowers who are strangers to each other, part of the service is generally verifying the identity and creditworthiness of borrowers. If lenders are either not provided with sufficient private information about borrowers (noting that borrowers do not have the statutory obligations of disclosure normally imposed by securities law) or are not competent in assessing their creditworthiness, they are likely to become reliant on the provider performing this service. In some services borrowers are anonymous, so this reliance is complete.

268 The preferred option is that where lenders are reliant on the provider, providers must have adequate mechanisms for establishing the identity and creditworthiness of borrowers as a criterion for obtaining a licence. This would be assessed by FMA when a licence is granted. All submitters agreed with this approach.

Disclosure of information about the service (option 13)

269 For investors to make informed decisions about participation in a person-to-person lending service, they will need access to information about how the service operates, their rights, and the risks involved. The information that users need to understand includes:

- How the borrowing and lending processes work
- How creditworthiness of borrowers is assessed
- How their funds are handled by the service provider
- How loan contracts are concluded
- How loans are serviced
- Processes for the recovery of missed payments
- The fees and charges that apply
- How borrowers and lenders can make complaints.

270 The FMC Bill provides for a "service disclosure statement" that must be given to customers before providing the service. Regulations can specify the content of this. However, where person-to-person lending services are internet-based, an alternative is to allow providers to provide the information required in relevant places on their websites. This may make the information more accessible and likely to be read than if it is in a single document that is presented to investors as part of a sign-up process.

271 Submitters generally agreed with this proposal and did not indicate any particular costs or problems with it.

Orderly administration of customers' contracts in the event that the licensee ceases to operate the service (option 14)

272 The closure of a person-to-person lending service, if not well managed, has the potential to cause significant harm to existing lenders and, to a lesser extent, borrowers. The service provider may have been responsible for collecting payments of interest and principal from the borrower and transferring these to the lender. The service provider may be the only person with the borrower's contact details, and will hold records of the credit contract, what the borrower owes and the amount paid to date. The service provider is also likely to be in possession of a significant amount of lender and borrower money (which should be held in a trust account, in accordance with the Financial Advisers Act 2008).

273 To address this risk, it is proposed that one of the eligibility criteria for person-to-person lending services be that they have adequate arrangements to ensure the orderly administration of its customers' contracts in the event that they cease to operate the service. Submitters have identified a number of ways that this requirement could be met in practice.

Lending caps (option 15)

274 A separate and difficult judgement is whether caps should be placed on the amount that can be lent by retail investors through a person-to-person lending service, and if so, what size and how these caps would be enforced.[2] Caps are an 'investor protection' mechanism, designed to reduce the risk that investors commit more than they are able to afford.

275 We considered the option of placing a cap on the amount that an investor could invest through a person-to-person lending service (option 15), but this is not the preferred option.

276 The benefits of a cap on the amount that can be invested through a person-to-person lending include:

- It reduces the amount of investment that is made through a less rigorous disclosure regime without mandated governance, enhancing the overall information and governance environment for investors
- It reduces the risk of large scale investor losses that damage the credibility of the regulatory regime as a whole.

277 On the other hand, these benefits may be small – the requirement that person-to-person lending services have robust systems for assessing borrower creditworthiness means that information asymmetries should be significantly reduced. There is no per-investor amount cap on use of the small offer exemption, for which significantly less disclosure is proposed.

278 Caps are likely to come with significant costs in terms of compliance and inhibiting flexibility and innovation.

279 A cap on the amount that investors could loan in total would relegate person-to-person lending to a marginal aspect of many investors' portfolios, inhibiting innovation and preventing person-to-person lending from competing effectively with banks and non-bank deposit-takers.

280 A per-transaction cap would be less problematic in the latter respect, but as noted above, most services are expected to have borrowing limits, which would mean that the amount that an investor can loan to any one borrower would be limited in any case.

Crowd-funding platforms (options 16 and 17)

281 Another type of licensed intermediary that has been proposed is a crowd-funding platform. Crowd-funding refers to the process of pooling a large number of small contributions to fund a business or project. Again, this will often involve an internet-based platform, but crowd-funding models are less established internationally than person-to-person lending services.

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[2] Caps in respect of wholesale investors would not generally be considered, on the basis that this would be inconsistent with the approach to wholesale investors in other parts of the Bill (i.e. no or very minimal mandatory disclosure).

282 Most crowd-funding overseas and in New Zealand currently provides in-kind benefits and rewards to those who contribute to projects. As a result, this activity is not regulated by existing securities law or the FMC Bill. For example, a musician might obtain funding to record an album, and those who contribute a minimum amount are promised a signed copy of the completed album or a voucher to attend a live performance.

283 A more recent movement has been the development of platforms for investment-oriented crowd-funding. Websites such as CrowdCube in the United Kingdom facilitate investment in businesses that pay contributors with financial returns rather than in-kind benefits.

284 The United States has recently introduced a crowd-funding exemption from its Securities Act, as part of the Jumpstart Our Business Startups Act ("JOBS Act"). This exemption would allow capital raising through registered internet "funding portals" or through registered broker-dealers. The exemption is subject to a number of conditions relating to, for example, limits on the maximum amount an issuer can raise, and the amount that each investor can contribute.

Should a broad and flexible concept of crowd-funding be adopted, or a particular crowd-funding model? (option 16)

285 Specifying 'crowd-funding platform' as a second category of prescribed intermediary services under the FMC Bill would enable providers of crowd-funding platforms to obtain a licence. As with person-to-person lending services, issuers making offers through the crowd-funding platform would be exempt from registering a PDS.

286 A key consideration is whether regulations around crowd-funding should be flexible, in the sense that they can support a wide range of crowd-funding models, or should initially be more targeted at a particular form of crowd-funding intermediary.

287 As with person-to-person lending, a crowd-funding platform needs to deal with a number of issues:

- The responsibilities of crowd-funding platforms to vet and assess issuers, and hold investor funds
- Requirements for disclosure to investors by issuers using the platform
- Interactions between issuers and investors, such as question and answer forums
- How offers and structured, and whether issuers are required to meet minimum investment amounts before receiving money.

288 Crowd-funding platforms could conceivably take quite different approaches to these issues. For example, some platforms may focus on third-party valuation of issuers (e.g. by the platform, or by lead investors), with issuers disclosing relatively basic information to the public at large. Others may put much more emphasis on individual investors making their own assessments, with issuers disclosing more comprehensive information up-front.

289 Two broad approaches are to either:

- **Option 16A (preferred)**: permit a wide range of potential crowd-funding platforms, subject to FMA satisfying itself as to the investor protections available
- Option 16B: regulations enable particular forms of crowd-funding that are more prescriptive in the above respects.

Option	Benefits	Costs	Net impact – qualitative judgement
16A	Frees up capital raising options considerably. Maintains flexibility for crowd-funding to evolve into ways that best facilitate capital raising.	Places considerable reliance on FMA's approval of crowd-funding platforms. This comes with its own risks and places the regulator in the difficult position of responding to applicant proposals on a case-by-case basis. If FMA adopts a risk averse approach to approving crowd-funding platforms, this may inhibit flexibility and innovation and raise costs to the platform and issuers. On the other hand, if FMA adopts an overly permissive approach to crowd-funding, it risks undermining disclosure in the equity markets as a whole.	Uncertain as equity-based crowd-funding is still experimental, but expected to be positive (potentially highly positive) for New Zealand's capital markets.
16B	Provides FMA with more certainty, ensures both a minimum level of disclosure to investors and makes it less likely that licences come with unexpected or onerous conditions.	Inhibits the emergence of new, potentially better, models of crowd-funding.	Positive net benefits compared to the status quo. However it is not clear that specific rules would strike a better balance than FMA would reach on its own. As crowd-funding platforms are a new mechanism for firms to raise capital, it is difficult to anticipate what forms of crowd-funding will prove most beneficial and what regulatory problems they will pose.

290 In the case of person-to-person lending, we have proposed to enable a specific form of the service, based on existing overseas models.

291 Our preferred option for crowd-funding, however, is a broader and more flexible regime (option 16A). Under this proposal, the crowd-funding platform would be required to meet a high-level disclosure standard, with approval by FMA. The standard would be along the lines of "the crowd-funding platform provides facilities for investors to receive information sufficient to make an informed decision about whether or not to invest in issuers on the platform". Disclosure will be expected to be proportionate to the amount of money being raised by issuers, and will form part of the platform's conditions of licence.

292 The specific requirements on crowd-funding platforms under this option would be relatively minimal, and would include:

- Conducting basic background checks to exclude offers by issuers where there is evidence that directors or senior managers are not of good character and reputation
- Disclosing information about how the service works, including checks and assessments made of issuers, how any investor funds are handled by the service provider, the fees and charges that apply and how investors and issuers can make complaints
- Having investors affirm that they understand the risks involved, such as risk of entire loss of investments, and that they could bear such a loss.

293 This option was most favoured by submitters.

294 The alternative (option 16B) would be to only enable particular forms of crowd-funding. For instance, there might be:

- A standard list of items that all issuers would have to disclose
- Requirements that the platform provide an open question and answer forum for each offering as the main channel of communication between issuers and investors
- A requirement that issuers set specific fund raising targets, with the platform holding investor funds and repaying them unless fund raising targets were met.

295 The alternative option substitutes FMA judgement for rules set at the outset.

Investment caps (option 17)

296 As with person-to-person lending, a difficult judgement is whether a cap should be placed on the amount that can be invested through a crowd-funding platform, and if so, what size and how these caps would be enforced.

297 Caps could apply to individual issuers (a ‘per-issuer cap’) or could apply to each investor’s total portfolio (a ‘per-investor cap’). The United States crowd-funding exemption has a per-investor cap[3] that varies according the income or net worth of the investor. Investors can invest the following, each 12 months:

- For investors with an annual income and net worth less than $100,000, the greater of $2,000 or 5 per cent of the annual income or net worth
- For investors with an annual income or net worth of more than $100,000, 10 per cent of investor annual income or net worth, up to a maximum of $100,000.

298 Compared to person-to-person lending, there is a stronger rationale for a cap on the amount that an investor can invest in a given company through crowd-funding, as the information that investors receive is likely to be more variable. There may be greater uncertainty about what, if any, returns will be received from any given investment and the time horizons for receiving returns are also likely to be longer.

299 Two options we have considered are:

- Option 17A: a fixed per-issuer cap on investments of $30,000
- Option 17B: a per-investor cap that scales according to income or net worth (i.e. along the lines of the US law).

[3] The JOBS Act also provides an equivalent per-issuer cap that is enforced by individual issuers. Issuers cannot raise amounts in excess of the cap in reliance on the crowd-funding exemption.

300 Neither option is preferred at this stage, but we consider the options should be subject to further consultation through the exposure draft of the regulations. We also recommend that any cap be subject to review in the context of the evaluation of the FMC Bill.

Option	Benefits	Costs	Net impact – qualitative judgement
17A	Would encourage diversification. Reduces the risk that large-scale investor losses damage the credibility of equity-based crowd-funding and the regulatory regime as a whole – though not if there are systemic problems with the listings on a particular crowd-funding platform. Also would do relatively little to protect less wealthy investors, for whom the cap would be quite large.	Negative impact on investment flexibility. Difficult to enforce – investors may attempt to circumvent limits by creating multiple user accounts or investing off-platform in the businesses that are listed.	Uncertain, but possibly negative. Whilst limiting investment flexibility, it is not clear that failure to diversify will be a serious problem in crowd-funding.
17A	Improve disclosure received by retail investors by narrowing the range of investments for which investors received low levels of disclosure – however, provides relatively little protection to less wealthy investors for whom the cap may appear quite large.	Significant negative impact on investment flexibility – would relegate crowd-funding to a marginal aspect of many investors' portfolios. Caps that vary by income or wealth adds complexity to the regime. Unless levels of income and net worth were ascertained entirely through investor self-certification, they would likely add considerable cost and inconvenience for investors and platforms to evidence and verify income and wealth. Difficult to enforce – investors may attempt to circumvent limits by creating multiple user accounts, using multiple crowd-funding services or investing off-platform in the businesses that are listed.	Highly uncertain, but probably negative. The impact here is in some respects the mirror of the impact of permitting crowd-funding. If crowd-funding has high net benefits, a cap on the amount each investor could commit would likely have a negative impact.

Licensed supervisors

301 The FMC Bill will enable FMA to appoint a replacement supervisor from among all available licensed supervisors and require an indemnity from the resigning supervisor (to cover fees and costs of the replacement supervisor) as a precondition of the appointment.

302 FMA may have difficulty in getting licensed supervisors to take these appointments, even with an indemnity from the resigning supervisor. There is a partial alternative if a licensed supervisor refuses to accept the appointment. It allows FMA to appoint another person (such as an accounting firm) to act as the supervisor, which can be used if no licensed supervisor agrees to act. However, this is primarily intended to cover, for example, winding up situations. We have considered a further option to ensure that there is no gap in supervision of financial products where FMA thinks a licensed supervisor is important.

303 Under this option (option 18), supervisors would have a duty to accept an appointment by the FMA, unless there is good cause not to do so. Good cause would cover, for example a conflict of interest. We assess the costs and benefits of this option as follows:

- *Benefits:* There are governance benefits in ensuring that there are no gaps in licensed supervision of financial products. Without this assurance, FMA's ability to act quickly to remove a supervisor may be undermined, with resulting costs to the reliability of the licensed supervisor regime
- *Costs:* Supervisors will be indemnified for their direct fees and costs for the appointment and there is a pool of supervisors to share appointments by FMA. However the option would have business costs for supervisors appointed under it, including disruption to business and possible effects on future appointments.

304 We assess the net impact of this proposal as positive on the basis that the risks of the FMA not being able to appoint a licensed supervisor are significant. These risks could undermine reliability of the supervisor regime. However, we propose to consult supervisors on our analysis of this option.

Consultation

305 The FMC Bill has been subject to a continual stakeholder engagement process since June 2010. This has included:

- A June 2010 discussion paper
- An August 2011 exposure draft of the FMC Bill
- Select committee submissions on the FMC Bill during 2012
- A December 2012 discussion paper on the regulations
- Targeted consultation with market participants throughout the process.

306 The December 2012 discussion paper sought views on all aspects of the regulations to be made under the Bill. The responses to this document, and subsequent targeted consultation, are reflected in this RIS.

307 In general, there was a high level of agreement with the proposals in the discussion paper and between submitters. Where there was a significant divergence of opinion this is noted in the RIS.

308 Ministry officials have worked closely with FMA on the development of the regulations. FMA has been included in the internal meetings and workshops in which submissions were analysed and preferred options developed.

309 There has also been standard inter-departmental consultation on Cabinet papers, plus additional inter-agency consultation on specific issues where relevant.

Conclusions and Recommendations

310 In this paper we recommend options across a wide range of regulation-making powers under the FMC Bill.

311 For the regulations relating to disclosure, scope and the offer process, we recommend:

- Varying the level of prescription of disclosure according to the simplicity and comparability of the products
- Disclosure for managed funds be a combination of scheme-level and fund-level material
- Evidence be required of the board of the issuer's consent to lodgement of disclosure
- Renewal certificates for disclosure in appropriate circumstances
- Ongoing disclosure in some circumstances
- That there be requirements for limited disclosure with regard to the $750,000 wholesale exclusion, employee share schemes and small offers.
- Cash and term PIEs issued by subsidiaries of registered banks and simple currency hedges be excluded from disclosure under Part 3 of the FMC Bill
- An issuer be an FMC reporting entity if it gains 50 shareholders in reliance on the small offers exclusion.

312 For the regulations relating to governance of financial products, we recommend:

- Withdrawals be permitted from superannuation schemes as per KiwiSaver scheme rules, but also allowing early retirement and transition to retirement withdrawals
- Schedule 3 schemes be subject to annual FMA reporting obligations, including audit only when required under other legislation, and a general limit on pre-retirement use of funds
- The timing of limit break reports be flexible where the limit break is rectified within specified period, and steps on pricing errors need be set to allow flexibility to deal with cases where costs of taking action exceed the benefit
- Related party transaction certificates be required to state the nature and extent of related party benefits, and an explanatory memorandum must be provided where scheme participant meetings are held to approve related party transactions
- Additional exemptions be provided from related party transaction rules in a number of high benefit or low-risk situations
- Governing documents be required to address particular matters, with some standard terms also being implied into governing documents
- Regulations set standard requirements for reports to supervisors only in high-risk areas and otherwise rely on supervisors to specify these requirements
- Annual meetings of scheme participants be required for equity-like schemes only
- Setting standard procedures for meetings of scheme participations, but allowing governing documents to vary them, apart from minimum notice and quorum requirements
- An exception be provided from the obligation to lodge a statement of investment policies and objectives on the register for schemes if there is no regulated offer of managed investment products

- Issuer registers be individually audited, unless they are held by a registry company that is audited or reviewed as a total business.

313 For the regulations relating to licensing, we recommend:

- FMA be able to set conditions around insurance for costs and claims relating to civil proceedings, and be satisfied that key personnel of authorised bodies are fit and proper persons
- Licensees have duties of care and remain liable for outsourced functions
- DIMS licensees be subject to conditions on incidental advice, and investors be able to terminate DIMS contracts within a reasonable period without penalty
- Independent trustees of restricted schemes have whistleblowing obligations
- Licensed derivatives issuers be subject to conditions around investor suitability, leverage, capital adequacy and liquidity and ongoing client reporting
- Person-to-person lending services and crowd-funding services be required to operate an open and neutral platform and be required to provide disclosures to investors about their services
- The regime for person-to-person lending services include robust mechanisms for establishing the identity and creditworthiness of borrowers, and a requirement to have adequate arrangements to ensure the orderly administration of customers' contracts in the event that the provider ceases to operate the service
- A flexible crowd-funding regime be introduced, with a high level of FMA discretion
- A duty for licensed supervisors to accept FMA appointments unless there is good cause not to do so.

Implementation

314 An exposure draft of the regulations is intended to be released in late 2013. This will give an opportunity for further stakeholder feedback on the regulations.

315 The Bill and regulations are expected to come into force in the first half of 2014. There is expected to be a transition period of up to two years to comply with the new disclosure and governance requirements.

316 The Bill and many of the preferred options for the regulations involve FMA having significant decision-making discretion. The successful implementation of the Bill will therefore be reliant on FMA's development and implementation of numerous operational policies and an extensive body of market guidance.

317 Another significant operational challenge will be MBIE's creation of a new offer register and managed investment schemes register. There will also be changes to the Financial Service Providers Register to accommodate new types of licensed and unlicensed services.

Monitoring, Evaluation and Review

318 The regulations discussed in this RIS will be monitored and evaluated as part of the overall review of the effectiveness of the FMC Bill. The Ministry will undertake this review within five years of its enactment. This will be informed by information gathered by the FMA as part of its market surveillance function, the information in the FMA's annual reports and the post-implementation review of the FMA.

319 Further information about monitoring and evaluation of the FMC Bill is contained in the RISs accompanying the February and May 2011 Cabinet decisions:

- RIS February 2011: http://www.med.govt.nz/business/business-law/pdf-docs-library/current-business-law-work/securities-law-review/review-of-securities-law-regulatory-impact-statement-187-kb-pdf.pdf
- Cabinet Paper and RIS May 2011: http://www.med.govt.nz/business/business-law/pdf-docs-library/current-business-law-work/securities-law-review/May%202011%20Cabinet%20paper%20and%20RIS.pdf