MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

IN CONFIDENCE

Regulatory Impact Statement

Financial Markets Conduct Regulations – Further detail

Agency Disclosure Statement

This regulatory impact statement has been prepared by the Ministry of Business, Innovation and Employment (MBIE).

It provides an analysis of options for regulations required to bring the Financial Markets Conduct Act (FMC Act) into force. The FMC Act 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.

In June 2013 Cabinet agreed on most of the regulations needed under the FMC Act. This RIS provides an analysis of further detail that is required for the regulations. These include specific disclosure requirements (such as length limits on product disclosure statements) and further decisions around the governance and supervision of financial products.

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, and subsequent workshops and public consultation on exposure drafts of regulations over 2013 and 2014.
- These submissions seldom included quantitative estimates of the costs and benefits of the measures considered, and we have little independent quantifiable data. The submissions identified qualitative impacts which have been taken into account in our analysis.
- The analysis is confined to options that are consistent with Cabinet's June 2013 decisions.

More fundamental policy decisions concerning the FMC Act and regulations are discussed in the RISs accompanying the February 2011 and May 2011 Cabinet decisions on the FMC Act, and the June 2013 RIS on the regulations. In particular, the earlier RISs consider the costs and benefits of different disclosure, governance and licensing regimes. The preferred options from that process have been carried through into the FMC Act and drafts of the regulations and form the backdrop for this analysis.

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Signature   Date

Introduction

1 The Financial Markets Conduct Act (FMC Act) was passed in September 2013, and comes into force in two stages: from 1 April 2014 and from 1 December 2014 (expected).

2 The FMC Act establishes a new framework for the regulation of financial products and certain financial services. The principal policy objective behind the FMC Act is to facilitate capital markets activity, in order to help businesses grow and to provide individuals with opportunities to more easily achieve their financial goals and accumulate wealth.

3 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. The FMC Act replaces that legislation, as well as amending a range of other financial markets legislation.

4 The Cabinet decisions and the regulatory impact analysis underpinning the FMC Act and the regulations is available from MBIE's web site:

- Cabinet papers and RISs for the FMC Bill

February 2011 Cabinet paper and RIS May 2011 Cabinet paper and RIS	http://www.med.govt.nz/business/business-law/current-business-law-work/financial-markets-conduct-act/cabinet-decisions-2013-february-and-may-2011

- Cabinet Paper and RIS for regulations

June 2013 Cabinet paper and RIS	http://www.med.govt.nz/business/business-law/current-business-law-work/financial-markets-conduct-act/financial-market-conduct-regulations-decisions-2013-june-2013

5 From 1 April, general fair dealing obligations began under the FMC Act, the Financial Markets Authority (FMA) became able to start licensing applicants, some disclosure exemptions started, and financial reporting obligations began.

6 Phase 2 is scheduled to commence on 1 December 2014. This phase comprises the new disclosure regime, offers and managed investment scheme registers, governance regime, licensing conduct obligations, and financial product markets regime. Transitional provisions in both the FMC Act and regulations will affect how phase 2 applies to particular participants. A detailed breakdown of the implementation of the Act is on FMA's website at: https://www.fma.govt.nz/keep-updated/the-future-of-financial-markets/timeline-for-change/.

7 Before the second phase of the FMC Act is brought into force, regulations are required to cover matters that were considered too detailed for inclusion in primary legislation, or where change might be required as market practices evolve.

8 Many of the decisions on these regulations were made by Cabinet in June 2013 and are discussed in the June 2013 RIS. More detailed decisions have been made under a Ministerial delegation, such as the detailed content of product disclosure statements.

9 This RIS deals with the remaining issues that require Cabinet decisions, where options have regulatory impacts that are not minor. These comprise:

- Part 1: Remaining disclosure issues
- Part 2: Remaining governance and supervision issues.

Part 1: Remaining disclosure issues

Status quo and problem definition – disclosure

10 Disclosure to investors about financial products is a cornerstone of the offer regime in the FMC Act. 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.

11 The June 2013 RIS discusses the existing disclosure requirements under the Securities Act 1978 and the problems with these requirements. In brief, 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. At the same time, issuers incur significant compliance costs in producing and distributing disclosure documents, often in circumstances where they provide little assistance to investors.

12 Disclosure regulation is traditionally intended to address information asymmetries between issuers and investors. 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 require disclosure of information through other mechanisms.

13 Disclosure should assist investors to compare financial products and enable them to identify which products best align with their financial needs and goals. For these investors, the clear evidence from a number of behavioural economics studies is that more information does not result in better investor decision-making, but rather investors need simplified information to reduce choices to a manageable set.[1]

14 Secondary audiences should not be ignored in the disclosure process. Financial advisers, market commentators and market analysts are an important audience for financial product disclosure. In addition to repackaging information for individual decision making, these market watchers perform an important service in identifying more general trends and areas of concern. Preparation of disclosure documents may 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. Finally, disclosure assists regulators to carry out their supervisory functions, compliance and enforcement.

Disclosure issues that are already addressed by Cabinet decisions

15 The problems with existing disclosure requirements are addressed to some extent through Cabinet's earlier decisions around the FMC Act and regulations. These decisions also set the status quo for analysing further options on disclosure.

16 The FMC Act sets out the high-level objectives and requirements for disclosure. It prohibits misleading or deceptive conduct and the making of false or misleading representations.

17 The FMC Act also sets out the basic framework for disclosure. This requires an issuer of a regulated offer to prepare:

[1] See the studies cited in Lunn, P (2014) *Regulatory Policy and Behavioural Economics* OECD Publishing, pp 40 and following.

- a product disclosure statement (PDS) for the offer with the purpose of providing certain information that is likely to assist a prudent but non-expert person to decide whether or not to acquire the financial products
- other material information to be supplied to the Registrar for including in the online register of offers of financial products.

DISCLOSURE UNDER THE FMC ACT =

NEW ZEALAND COMPANIES OFFICE

PDS	+	**Online offer register**
Key information that is important for retail investors to read e.g.: • terms of the offer • description of the issuer • significant features of the product		Other information that is material to the offer (likely to be used by advisers and analysts) e.g.: • full financial statements • contracts • other material information

18 The new online register of offers of financial products and register of managed investment schemes are intended to make offer documents and information relating to financial products much more accessible to investors, their advisers, market analysts and commentators.

19 In June 2013 Cabinet made a number of high-level decisions about the content of disclosure documents:

- All PDSs should begin with a prescribed key information summary of no more than two pages.
- PDSs for managed funds will be highly prescribed, and comprise a balance of fund-level and scheme-level information and a maximum length.
- PDSs for most other financial products comprise prescribed information, but will be subject to a lesser degree of prescription than for managed funds.
- PDSs should not be required to contain all other material information relating to the offer; this information should instead be on the online offer register.
- Information that changes frequently (e.g. fund performance) should generally be in ongoing disclosure documents and the online register rather than in the PDS.

20 Following this the Ministry conducted a number of stakeholder workshops to develop an exposure draft of disclosure requirements. These were publicly released for consultation in October 2013. Submissions were received and incorporated into an exposure draft of regulations in May 2014. Further submissions were received on the draft regulations in June 2014.

Remaining problems for this RIS

21 This RIS therefore considers a number of specific disclosure issues that require further Cabinet decisions and have impacts that are not minor. These are:

- PDS length
- financial information required to be in the PDS and on the online offer register
- disclosure for simple deposit products by non-bank deposit takers (NBDTs)
- presenting information in the PDS about the 'ranking' of debt securities, compared to other liabilities of an issuer
- the treatment of investment options that are not discrete funds in the managed fund PDS
- the circumstances in which the FMC Act's disclosure exemption for financial products that are already quoted on a licensed market should apply to debt securities.

22 There are links between a number of these issues.

23 The financial information that is required to be in the PDS has a significant impact on overall PDS length. The options considered aim to give retail investors information to assist decision-making without 'overloading' them.

24 A number of the issues – financial information, information about the 'ranking' of debt securities, and the treatment of investment options in the managed fund PDS – relate to packaging information in a way that retail investors are likely to find easier to understand and more useable.

25 The options around disclosure for simple deposit products by non-bank deposit takers (NBDTs) and the disclosure exemption for financial products that are already quoted on a licensed market are both targeted at reducing compliance costs for issuers (while continuing to give investors the key information they need).

26 The specific status quo and problem definition for each of these issues is discussed separately under each issue.

Objectives

27 The disclosure options in this RIS are measured against the following objectives (from section 4 of the FMC Act):

- provides for timely, accurate and complete disclosure of information to investors
- provides for disclosure of information that investors are likely to understand and use effectively
- avoids unnecessary compliance and regulatory costs
- promotes innovation and flexibility in offers of financial products.

28 We consider that options that best achieve these objectives are most likely to meet the overall objectives of the FMC Act: to deliver fair, efficient and transparent financial markets, and to promote confident and informed participation in financial markets. The objectives have therefore been weighted equally.

Issue 1: PDS length

Status quo and problem definition

29 Currently disclosure documents such as investment statements and prospectuses do not have any limits on length. Overlong documents (and perhaps more fundamentally, the legal compliance focus of those documents) are a significant feature of the current disclosure regime. In 2013 it was common for offer documents (particularly combined investment statements and prospectuses) to exceed 200 pages.

30 Lengthy, compliance-focussed disclosure undermines efficient investor decision-making. As noted by the Capital Market Development Taskforce, current disclosures are not sufficiently standardised, concise, simple or understandable.

31 A key objective of the FMC Act is clearer and shorter PDSs. The FMC Act targets these issues through the core requirement that disclosures be "clear, concise, and effective", the introduction of an online offers register for information that is not specifically required in the PDS, and changes to the liability regime. Those decisions are further supported in the draft regulations by allowing the PDS to incorporate material by reference and use of more tightly prescribed requirements (including prescribed wording).

32 Cabinet has also decided that the PDS for managed funds should be a tightly prescribed and standardised document with a strict page limit. The May 2014 exposure draft of regulations included a limit of 12 pages for the managed funds PDS.

33 The question is whether the FMC Act and decisions on the regulations to date are sufficient to deliver a more concise and effective PDS for other products (equity securities, debt securities, managed investment schemes other than managed funds and derivatives) or whether further measures, such as length limits, are desirable.

Regulatory impact analysis

34 We have considered three options for length limits for equity securities, debt securities, general managed investment schemes and derivatives:

Option 1: No length limit (status quo)

Option 2: Short length limit (around 20 pages) for all PDSs

Option 3: Moderate, varying length limits for the PDSs of different products (around 30-60 pages) (preferred option).

Option 1: No length limit (status quo)

35 Under this option, there would be no restriction on document length other than FMA enforcing the Act's requirement that disclosures be "clear, concise, and effective".

36 A minority of submitters on the October exposure draft requirements indicated a preference for this option (with no particular pattern as to types of submitters). They consider FMA's guidance in this area should suffice (in the case of offers of equity securities) or because they view the page limit as unachievable for complex offerings (in the case of offers of debt securities) and unnecessary on top of the changes already made by the Act and regulations.

37 This option would promote flexibility in offers of financial products and make it easier to offer more complex products, and to bundle the disclosure for multiple products (for example, a number of classes of derivatives contracts) into a single PDS.

38 It avoids any risk that important information is omitted from the PDS for reasons of length. It would ease potential liability concerns that directors of issuers might have from needing to summarise information and make difficult judgements about what is material to investors.

39 However, there is a continued risk that concerns about legal compliance drive issuers towards including more material and progressively longer documents over time. FMA's enforcement of "clear, concise and effective" requires subjective judgement from both FMA and issuers, and there may be significant risk and cost to FMA in enforcing this obligation to keep documents concise.

40 This option therefore has risks that PDS lengths are not reduced, and it does not solve the issues identified with existing disclosure documents.

Option 2: Short standard length limit (e.g. around 20 pages) for all documents

41 This option would ensure that all PDSs were short documents (except where FMA provided an exemption).

42 FMA favoured this option in its submission on the October 2013 exposure draft requirements, and has expressed the strong view that a "circuit breaker" is needed. It wants clear boundaries to be set by the regulations, and wants to avoid over-reliance on its guidance, appeals by issuers on every offer where they consider more information is warranted and over-reliance on FMA's powers to issue stop orders.

43 Other submitters did not favour a tight length limit for products other than managed funds.

44 A document of this length would be expected to be read and understood by a larger number and wider range of investors.

45 However, this length limit would result in the PDS serving as a summary document for investors. It would likely result in issuers developing other offer documents to supplement the PDS, which would be treated as "advertising" by the FMC Act and would have few controls on content and presentation. If this occurred, there is a risk that the other offer documents would supplant the PDS as the main offering and selling documents. In addition, the register entry would likely also be longer and potentially a "dumping ground" for material information about the offer.

46 It is therefore questionable whether disclosure to investors as a whole (including the PDS and other documents) would be understood and used effectively. The likely omission of information from the PDS also creates doubt about whether there would be timely, accurate and complete disclosure of information to investors.

Option 3: Moderate, varying length limits for the PDSs of different products (e.g. around 30-60 pages) (preferred option)

47 This option would see length limits applied to the PDS, but targeted at a level that should allow PDSs to include all of the important information that retail investors need to make investment decisions. This is likely to vary across different products. For example, equity securities may need a longer PDS, as an investment in equity securities requires investors to consider the widest range of information about the activities and prospects of a business. This information includes an overview of the issuing group, the purpose of the offer, the terms of the offer, key features of the shares offered, selected financial information and risks to the issuing group's business and plans.

48 Page limits and equivalent word limits would be provided as alternatives. A word limit would be more suitable for PDSs made available through electronic formats (other than PDF) or where issuers wish to use greater amounts of whitespace and diagrams.

49 Submitters appear to have become more comfortable with a length limit over time. Most submitters on the October exposure draft requirements favoured some form of length limit that scaled according to the type of product, with a mix of views about the precise length restriction and the circumstances in which it might be permitted to be exceeded.

50 This option would send a clear regulatory signal of what the outer limits of compliance should be. It would create certainty that PDS lengths were reduced, and prevent length "creep" over time.

51 It would help to reduce risk and cost to FMA in enforcing the "clear, concise and effective" obligation to restraint PDS length. However, it also has a risk that the limit acts as a "target" for issuers, and disclosures remain longer than necessary. This risk means that there will need to be some continued enforcement by FMA, and the associated regulatory costs.

52 By reducing the average length of the PDS and removing outliers (such as 200+ page offer documents) it increases the likelihood that retail investors will read PDSs and use them effectively. Material information that is not generally important to retail investors would be

placed on the offer register, where it could be accessed by analysts and advisors, or by those investors who wanted further detail.

53 We consider that the length limit range proposed is realistic for providing the information that is important for retail investors, as it is consistent with our analysis of recent investment statements for listings on NZX (IPOs) where there has been a deliberate attempt (supported by FMA, including through targeted exemptions) to reduce length. For example, the recent Genesis Energy IPO investment statement was 65 pages excluding covering information and the application form (just above the proposed page-based limit of 60 pages). However, other preferred options in this RIS (in particular, for financial information) would remove the 14-page appendix of prospective financial information, and shorten the overview of financial information by several pages. Following the Genesis IPO, similar compliance with the proposed limits would be readily achievable in the investment statements for other 2014 IPOs from Gentrack, Intueri, Serko, Hirepool, ikeGPS, Scales, Metroglass and Vista Group.

Summary assessment of options against objectives

Key

✓✓ Meets the policy objectives
✓ Partially meets the policy objectives
✘ Does not meet the policy objectives

	Option 1: No length limit (status quo)	**Option 2: Short standard length limit (e.g. around 20 pages) for all PDSs**	**Option 3 *(preferred option)*: Moderate, varying length limits for different products (e.g. around 30-60 pages)**
Provides for timely, accurate and complete disclosure of information to investors	PDS would be able to include the information that investors need to make investment decisions. Avoids any concern that information is omitted from the PDS for reasons of length ✓✓	High risk that important information is omitted from the PDS, which would likely result in issuers developing other offer documents to supplement or supplant the PDS ✘	PDS would be able to include the information that investors need to make investment decisions ✓✓
Provides for disclosure of information that investors are likely to understand and use effectively	Risk that concerns about legal compliance drive issuers towards including more material over time ✘	A document of this length would be more likely to be read and understood by investors. ✓✓	While documents would be shorter and more accessible than at present, documents of this length are likely to be less accessible than under Option 2 ✓
Avoids unnecessary compliance and regulatory costs	May be significant risk and cost to FMA in enforcing "clear, concise and effective" obligation. ✘	Would require difficult judgements from issuers about what information to include in the PDS and may require exemptions ✘	Still requires some judgement from issuers as to what information to include in the PDS ✓
Promotes innovation and flexibility in offers of financial products	Makes it easier to offer more complex products ✓✓	May be an obstacle to more complex products ✘	Could make offering the most complex products more difficult ✓

54 Overall we consider the measures in Option 3 to best meet the objectives outlined above. It is possible that Option 1 and Option 3 will result in similar outcomes (i.e. PDSs much shorter and accessible than current disclosure documents, while still containing all of the information that is important for retail investors). However, Option 1 comes with greater risks that (a) FMA incurs significant costs, and (b) shorter documents are not achieved over the long term, due to issuers' legal compliance concerns. Option 3 provides more certainty that PDSs will be shorter and more accessible, with few additional costs and risks, and is therefore preferred.

Issue 2: Financial information contained in the PDS

Status quo

55 The regulations around financial information are a particularly complex aspect of both the existing prospectus regime and the new disclosure regime and a major source of cost for issuers.

56 At present this financial information is required to be prepared in compliance with generally accepted accounting practice (GAAP). GAAP requires financial statements to be prepared in compliance with applicable financial reporting standards issued by the External Reporting Board (XRB).

57 Issuers of equity and debt securities are currently required to provide one year of full audited financial statements (these cover at least two years, as financial reporting standards require the inclusion of an extra year of comparative information). They must also include summary financial statements in the prospectus, which cover the past five years.

58 For equity IPOs, the prospectus is required to include prospective financial statements covering at least 18 months. The relevant financial reporting standard requires prospective statements of financial position, profit or loss, changes in equity, cash flows and notes. It also has a number of rules around disclosure and reliability of assumptions.

Problem definition

59 The existing requirements have the following issues:

1. Relevance of information

60 One major issue is that the current requirements bear little relationship to the information that is likely to be useful and relevant to retail investors. As a result, many issuers choose to include and highlight alternative information in prospectuses and investment statements at present. This alternative information includes different financial measures – for example, market capitalisation and enterprise value, alternative earnings or debt measures, and various ratios and other metrics that assist valuation (in the case of equity) or analysis of credit risk (in the case of debt). Issuers sometimes include financial information with significant adjustments to reflect changes to the business (so-called “pro forma” financial information).

61 While additional financial information added by issuers is sometimes more directly relevant and useful to investors, there are few standards on the content and presentation of this information, and it is often not particularly comparable across issuers. This is likely to limit investors’ effective use of the information.

2. Length of information

62 The financial information required in prospectuses is also relatively lengthy and we understand that retail investors seldom examine it in detail, if they read it at all. Prospectuses often have full financial statements and notes attached, which may add dozens of pages. Even summary financial statements are relatively detailed – for example, the summary financial statements provided in Meridian’s combined investment statement and prospectus were six pages. Prospective financial statements and information about their assumptions add many more pages. There is also often a large amount of information regarding accounting policies, reconciliations of financial information to GAAP measures and other supporting information that is placed in prospectuses at present. These all contribute to the overall length of prospectuses.

3. Cost of preparing information

63 A further issue is cost. The incremental costs of producing this information are becoming more pronounced under the changes that were made to the Companies Act by the Financial Reporting

Bill. Many companies will no longer need to produce GAAP financial statements until they become issuers. On becoming issuers, these companies would need to produce completely new GAAP financial information for the past 5 years.

64 Prospective financial statements are a particularly costly aspect of IPO disclosure. We understand much of this cost arises from reviews of that information by auditors. This is proposed to be dealt with to some extent by a proposed FMA exemption from the need for SMEs listing on NZX's new growth market to include prospective financial statements, on favour of "key operating milestones".

Regulatory impact analysis

65 We have considered two options for financial information:

Option 1: Adopt a modified version of current financial information disclosure requirements (status quo)

Option 2: A more selective set of financial information for investors in the PDS (preferred option)

Option 1: Adopt a modified version of current financial information disclosure requirements (status quo)

66 Option 1 would carry forward the existing requirements for financial information with minimal changes necessary to apply these to the new disclosure regime. This option is the status quo based on existing Cabinet decisions that relevant existing regulations be carried over with appropriate modifications to ensure that they work effectively in the new regime.

67 Financial information in the PDS would consist of:

- Summary financial statements that cover the past five years – comprising a summary statement of financial position, statement of comprehensive income, statement of changes in equity and statement of cash flows, any changes in accounting policies and other requirements of financial reporting standard FRS-43
- (If the PDS is for an equity IPO) prospective financial statements that cover the past two years – comprising a prospective statement of financial position, a prospective statement of profit or loss and other comprehensive income, a prospective statement of changes in equity, a prospective statement of cash flows, a summary of significant accounting policies and significant assumptions
- Information that issuers chose to add (within any constraints on overall length). In keeping with existing practice, issuers would be given broad permission to include additional financial information in the PDS.

68 The register would contain one year of full audited financial statements.

69 This option has the advantage of all required information being compliant with GAAP. The information would therefore be robust and comparable across issuers.

70 However, this option would not address any of the issues identified above. In particular, it does not address the need for investors to be given the key information that is most relevant to their investment decision, rather than having to discern this information for themselves from a full set of financial statements or being given it on a basis that is not comparable across issuers.

71 Issuers would still be likely to supplement the required financial statements with substantial amounts of their own financial information. This additional information would have similar problems around lack of comparability to those that exist at present.

72 While the financial information in the PDS would be shorter than current prospectus financial information (because full financial statements don't need to be in the PDS), the combination of

summary and prospective financial statements, and additional issuer financial information would continue to occupy a large amount of space.

73 This option would also not help to address issues of unnecessary cost.

Option 2: A more selective set of financial information for investors in the PDS (preferred option)

74 The second option, which has been reflected in our public exposure drafts of regulations, would require issuers to include three years of selected financial information in the PDS, rather than summary financial statements. The key financial information that has been selected under this option focuses on the key pieces of financial information that issuers already choose to highlight as the most useful and relevant to investors in their decisions. Equity IPO issuers would need to provide the same information as forecasts for the following two years.

75 For equity securities, the information in the PDS would comprise:

- A table headed "Selected financial information" including, at a minimum, revenues, EBITDA (Earnings before interest, tax, depreciation and amortisation), net profit after tax, dividends, total assets, cash and cash equivalents, total liabilities, total debt, and net cash flows from operating activities. This information covers the previous three years and (if the PDS is for an IPO) the next two years.
- (If the PDS is for an IPO) a table headed "Capitalisation" including the number of equity securities being offered, the implied market capitalisation, the implied enterprise value
- (If the PDS is for an IPO) a table headed "Key investment metrics", including for the next two years forecasts of dividends per share, earnings per share, price/earnings ratio, implied enterprise value/EBITDA and implied dividend yield.

76 For debt securities, the information in the PDS would comprise:

- a table headed "Selected financial information and ratios" including, at a minimum, revenues, EBITDA, net profit after tax, net cash flows, cash and cash equivalents, total assets, total debt, total liabilities, equity, debt/EBITDA, interest and an interest cover ratio (EBIDTA/interest).
- a table of financial information on the issuer and guarantors, including total assets, total tangible assets, total liabilities and net tangible assets.

77 For general managed investment schemes, the information in the PDS would comprise:

- a summary of forecasts and projections of the scheme's income and expenses and returns to investors over the expected life of the scheme
- the value of property to be acquired and the basis for the valuation
- financial measures around borrowings, including a gearing ratio (debt/assets) and an interest cover ratio (EBITDA/interest)
- forecasts of fees for at least the next two years

78 This information has been based on the information that issuers choose to include and highlight at present, along with the other financial measures that we have developed with stakeholders to be most relevant to retail investors. The selected information would need to be prepared in accordance with GAAP, except where non-GAAP measures such as EBITDA are expressly permitted or required.

79 Under this option, issuers would only be permitted to include a very limited amount of additional financial information beyond this in the PDS.

80 The register would contain three years of full historic financial statements, along with (for equity and general managed investment schemes) two years of full prospective financial information. Only the most recent financial statements would need to be prepared in accordance with GAAP and audited.

81 This option was generally supported by submitters.

82 This option would address the issues identified above and have the following benefits:

- It should deliver and highlight financial information in the PDS that is likely to be most useful for investors. Where this information is presented across a number of years, or may be compared with financial information from other issuers, it would be prepared on a comparable basis.
- It would not require the inclusion of summary and full financial statements in the PDS, which would help to reduce the length of the PDS. This will assist in issuers meeting length limits under the preferred option in Issue 1 (PDS length).
- Based on the limited feedback we have received on cost impacts, this option should also reduce the costs of preparing financial information by limiting the amount of GAAP information that needs to be produced to a three-year period, rather than five years, and requiring only selected measures to be included in the PDS rather than full or summary financial statements with notes.

83 The main risks of this option are:

- The omission of years 4 and 5 mean that longer term trends may be less apparent.
- The financial information required in the PDS is less complete (e.g. less breakdown of assets and liabilities), which creates a risk that potentially significant information is missed by investors.
- Although it will be prepared on a comparable basis, much of the required financial information would be subject to standards defined in regulations and by FMA frameworks and methodologies rather than GAAP, which could reduce the rigour of the requirements.

84 With regard to the availability of information about longer term trends, we do not consider that lack of information about years 4 and 5 is likely to be a problem in the vast majority of cases. Submitters (including advisers and investor representatives) appear to be comfortable with 3 years. While 5 years aligns with practice in the United States, in Europe financial information is only required to cover 3 years by default, with shorter periods for smaller issuers.

85 Given the limited capacity of most retail investors to process financial information, we do not consider that adding more detailed financial information to the PDS means that retail investors are likely to be better informed about the financial condition of the issuer. The contrary risk is that investors may feel overwhelmed by the volume and complexity of financial information in the PDS. In any case, investors who are likely to benefit from further information may continue to obtain it from the offer register. Issuers will also need to add information to the PDS if it is required to avoid the selected financial information being misleading.

86 The third risk is difficult to assess. The current financial information requirements do benefit from the specialist expertise and ongoing oversight of the External Reporting Board. However, secondary regulations and regulator rule setting is extensively used to set selected financial information requirements in other jurisdictions, such as the United States and across Europe. It is also possible that over the medium term the External Reporting Board could become involved in developing financial reporting standards for some of the selected information, or in amending existing standards (such as FRS-43) to make them applicable to it. The need for this involvement should be monitored.

87 While there are some risks, overall we consider that these risks are outweighed by the benefits of providing more useful and relevant information to investors.

Summary assessment of options against objectives

	Option 1: Adopt a modified version of current financial information disclosure requirements (status quo)	**Option 2: A more selective set of financial information for investors in the PDS (preferred option)**
Provides for timely, accurate and complete disclosure of information to investors	Information required in the PDS would be robust and comparable. However, issuers would likely need to add significant addition information with few standards on content and presentation. ✓	Much of the required financial information would be subject to standards defined in regulations and by FMA frameworks and methodologies rather than GAAP. Information would be provided over shorter periods. ✓
Provides for disclosure of information that investors are likely to understand and use effectively	Required information would not be the most relevant or useful for investors. ✗	More in accordance with current practices for financial information in offer documents. ✓✓
Avoids unnecessary compliance and regulatory costs	Doesn't help to address cost. ✗	Reduction in period over which historic GAAP financial information needs to be prepared should reduce costs. May be other cost savings from requiring selected financial information rather than summary financial statements. ✓✓
Promotes innovation and flexibility in offers of financial products	Issuers decide individually what additional financial information should be included in the PDS.✓✓	Would cater to most financial products, but compared to current practice this would be more restrictive in terms of what financial information was included in the PDS. ✓

88 Overall we consider the measures in Option 2 to best meet the objectives outlined above.

Issue 3: Disclosure for simple deposit products by NBDTs

Status quo

89 Non-bank deposit takers currently give investment statements to investors for all their financial products, and register a separate prospectus. As with other issuers, these requirements will be replaced with a requirement to give investors a PDS, with further information on the offers register.

90 This means that under the status quo, non-bank deposit takers will need to give investors a copy of the PDS for all their debt securities.

Problem definition

91 The requirement to give a PDS to investors may not be justified for some simple deposit products offered by NBDTs (particularly credit unions and building societies).

92 A number of these products have recently been re-categorised as "category 2" under the Financial Advisers Act, which means that advisers do not need to be authorised financial advisers to provide opinions and recommendations to invest in them. NBDT category 2 products now comprise:

- call debt securities, including call building society shares and call credit union shares
- credit union term deposits and other credit union savings accounts.

93 This was on the basis that these products are likely to be well understood by investors. In some cases, such as transaction accounts, customers are unlikely to treat these accounts as investments, and are less likely to make effective use of the current investment statement, or the

future PDS. Many investors may simply rely on the prudential regulation of non-bank deposit takers and general market commentary about their soundness.

94 This means that some NBDTs are likely to incur unnecessary compliance costs from both:

- producing a PDS that includes substantial information around the terms and significant features of products
- providing the PDS to every investor.

95 The equivalent products (and a number of others) offered by registered banks are subject to a statutory exemption from the need to give any disclosure to investors. Instead, banks publish disclosure statements on their web sites quarterly.

Regulatory impact analysis

96 We have considered two options that would provide relief to NBDTs for simple deposit products:

Option 1: Remove the requirement for disclosure to be given to investors for category 2 products, and instead require that information be maintained on the offers register

Option 2 (preferred option): Require a 'credit risk warning' to be given to investors (rather than the PDS) when they open accounts for category 2 products, and other information to be maintained on the offers register

Option 1: Remove the requirement for disclosure to be given to investors for category 2 products, and instead require that information be maintained on the offers register

97 Under Option 1, NBDTs would be exempt from the requirement to give investors a PDS before they invest in a category 2 product and from the obligation that the register entry contain all material information.

98 A PDS would still be required to be placed on the register containing:

- a description of the product
- an overview of the issuer
- the issuer's credit rating
- the financial information normally required for NBDTs in the PDS
- information on guarantors
- a link to further information on the register about how the NBDT is meeting its prudential requirements.

99 Additional information on the register would be updated quarterly. It would provide a detailed breakdown of the non-bank deposit taker's capital, liquidity and related party exposure measures. This is the same information that is proposed to be on the register for other offers of debt securities by non-bank deposit takers. It would serve to provide transparency and promote third party comment and analysis on the soundness of these institutions.

100 Based on feedback from NBDTs, we understand this option would provide significant compliance cost savings from not needing to publish and distributed PDSs.

101 However, this option raises concerns about retail investors potentially making significant investments without being informed of the greater risks involved compared to registered banks. Prudential standards for NBDTs are lighter overall than registered banks. Many credit unions, who would be the main users of this option, do not have credit ratings (due to an exemption for NBDTs with consolidated liabilities under $20 million). The four that do are rated from BB- to BB+

by Standard and Poors, which is considered below 'investment grade', and implies a degree of vulnerability. The two building societies with credit ratings are also rated BB+ by Fitch Ratings.[2]

102 Examination of available rating reports shows that perceived enhanced credit risk is driven by factors such as:

- small absolute size, increasing susceptibility to one-off operational losses
- mutual status constraining further capital raising
- geographic concentration (e.g. credit unions and building societies focussed on a particular region)
- exposure to a low socioeconomic member segments (in the case of some credit unions)
- high exposure to a relatively small number of loans (in the case of one building society).

Option 2 (preferred option): Require a 'credit risk warning' to be given to investors (rather than the PDS) when they open accounts for category 2 products, and the PDS and other information to be maintained on the offers register

103 Option 2 is similar to Option 1. However, the key difference is that NBDTs that do not have an investment-grade credit rating would need to provide an additional risk warning to prospective investors. This would include information about their credit rating and a reference to the PDS available on the offer register.

104 This option gives more assurance that prospective investors will receive important information about relative credit risk. We anticipate that it would be incorporated into existing documentation, meaning that the compliance costs of its inclusion should be relatively low.

105 Industry groups representing NBDTs have indicated they are comfortable with this option.

Summary assessment of options against objectives

	Option 1: Remove the requirement for disclosure to be given to investors for category 2 products, and instead require that information be maintained on the offers register	**Option 2 (preferred option): Require a 'credit risk warning' to be given to investors (rather than the PDS) when they open accounts for category 2 products, and the PDS and other information to be maintained on the offers register**
Provides for timely, accurate and complete disclosure of information to investors	Information would be relatively accurate and complete, but not given to investors in a timely manner (only if they specifically seek it out). ✘	The information that investors will be required to receive when they open accounts would be less complete than if they were required to be given the PDS. ✓
Provides for disclosure of information that investors are likely to understand and use effectively	The PDS would be more tailored to simple deposit products offered by NBDTs than the standard debt PDS, but investors would not receive clear information up front ✓	Key information about credit risk would be given to investors in a form that is likely to be clearer than the PDS. ✓✓
Avoids unnecessary compliance and regulatory costs	Significant compliance cost savings from not needing to publish and distributed PDSs.✓✓	Significant compliance cost savings from not needing to publish and distributed PDSs, but need to include risk warning in documents ✓
Promotes innovation and flexibility in offers of financial products	Placing the PDS and associated information on the register means that products can be changed more easily✓✓	Same as Option 1 – Placing the PDS and associated information on the register means that products can be changed more easily ✓✓

[2] RBNZ, Credit ratings of non-bank deposit-takers in New Zealand, http://rbnz.govt.nz/regulation_and_supervision/non-bank_deposit_takers/credit_ratings/3905820.html

106 Overall we consider the measures in Option 2 to best meet the objectives outlined above.

Issue 4: Inclusion of a ranking diagram for debt securities

Status quo and problem definition

107 One complex issue that has arisen in consultation on the FMC Regulations is how to present information about the 'ranking' of debt securities. That is, if an issuer of debt securities becomes insolvent, what creditors of the issuer will be paid before investors, and what assets will be left to pay investors?

108 Standard debt securities may be 'unsecured', which means that creditors with security interests over assets of the issuer will be paid out before investors, in addition to creditors that are preferred by law (such as employees). It is also common for issuers to offer 'subordinated' debt securities, in which essentially all creditors of the issuer (including senior unsecured creditors) are paid before investors. There may be a number of different rankings and different factors affecting ranking. There are also complications introduced by subsidiaries of issuers – for example, issuers have equity interests in their subsidiaries, but the subsidiaries have their own creditors – and guarantors.

109 Ranking has a major impact on the outcomes for investors in the event that the issuer becomes insolvent. In some cases, the most senior creditors may be fully paid out, with other creditors losing money. In the finance company collapses of 2006-2010, it was common for secured investors to receive small or moderate payments (or in rarer cases, full payment) while unsecured investors received little or no payment. For example, in the case of National Finance 2000 (the first finance company collapse) $14.2 million was recovered, with secured investors owed $21.8 million and subordinated investors owed $3.0 million. Once preferred creditors, other secured creditors and other costs were paid, secured investors eventually received 49.1% of their original investments. Subordinated investors received no payment.[3]

110 At present, the investment statement is not required to specifically address these matters. Prospectuses are required to include the main terms of the offer (which would include describing the ranking of the debt securities), and amounts of specific types of liabilities such as secured debt securities and mortgages. More detailed information about ranking is in the trust deed for the debt securities. Under the status quo this information is not required to be presented in a diagram.

111 To make information about ranking more accessible to investors, there appears to be general agreement among submitters that some diagrammatic representation of ranking is desirable. These have become increasingly common in existing investment statements and prospectuses. For example, the recent (June 2014) Mighty River Power prospectus for capital bonds (which are a subordinated debt security) included the following diagram, with an accompanying explanation:

[3] PricewaterhouseCoopers, *Receivers' Ninth Report on the State of Affairs of National Finance 2000 Limited (In Receivership & Liquidation)*, http://www.pwc.co.nz/PWC.NZ/media/PwC-Images/Receiverships/National%20Finance/national-finance-receivers-ninth-report-january-2011.pdf

ILLUSTRATION OF RANKING OF CAPITAL BONDS ON THE LIQUIDATION OR WINDING UP OF MIGHTY RIVER POWER

Ranking		Illustrative examples	As at 31 December 2013[8]
Higher	Creditors preferred by law and secured debt	Liabilities preferred by law (including some employee entitlements) and secured creditors	$2,492.8 million[9]
	Unsubordinated and unsecured debt	Senior bonds, drawn bank facilities, trade and general creditors	
	Subordinated and unsecured debt	The **Capital Bonds** and other subordinated unsecured debt obligations	Nil[10]
Lower	Ordinary shares	Shares	$3,185.0 million[11]

112 However, there are concerns that certain versions of the ranking diagram may be costly to produce, or misleading, in some circumstances. Some submitters have been particularly concerned about the costs and difficulties of including amounts in ranking diagrams (as in the example above).

Regulatory impact analysis

113 We have considered two options for ranking diagrams:

Option 1: Ranking diagram showing the ranking of debt securities compared to other liabilities

Option 2: Ranking diagram showing the ranking of debt securities compared to other liabilities, and the amount of those liabilities (preferred option)

Option 1: Ranking diagram showing the ranking of debt securities compared to other liabilities

114 Under Option 1, a ranking diagram along the lines of that illustrated above would be required, but it would not include amounts.

115 This would provide some assistance to prospective investors to understand where their securities ranked in relation to other liabilities of the issuer. This would be some improvement over the status quo.

116 However, the omission of amounts means that there would be little information provided on the scale of the various liabilities. It would not tell investors anything about whether, for example, liabilities ranking ahead of them were relatively small compared to the amounts that would be owed to investors (in which case investors would share in a larger pool of assets on liquidation), or were large (in which case investors may be left with a smaller pool of assets, or no assets).

Option 2: Ranking diagram showing the ranking of debt securities compared to other liabilities, and the amount of those liabilities (preferred option)

117 The second option, which was consulted on in the exposure draft of the FMC Regulations, is to also include amounts alongside the liabilities.

118 This would have the same advantages as Option 1, in terms of assisting investors to understand where their securities ranked in relation to other liabilities of the issuer. It would also give investors an appreciation of the scale of the various liabilities, and therefore more of an idea of the impact that they might have in the event of insolvency.

119 One issue that arises is that amounts are only provided for a particular point in time, and would change materially in the event of insolvency. For example, the "shares" or "equity" portion of the diagram provides information about the "buffer" that the issuer has at present, but in the event of insolvency the equity of the issuer is likely to have been (by definition) mostly or entirely wiped out. Amounts would still be useful, but any diagram would need clear explanation to assist investors to understand the implications of the diagram and to avoid the diagram being misleading.

120 Compliance costs are another potential issue with this version of the diagram.

121 In some cases, as in the Mighty River Power diagram above, amounts can be obtained from a relatively straightforward extraction of information from financial statements. The example is for a subordinated debt security, which means that essentially all other liabilities of Mighty River Power rank ahead of the debt securities.

122 However, we understand from submissions that amounts become far more complex and potentially costly to calculate accurately in the case of unsecured debt securities, or otherwise where liabilities need to be broken down further. Particular issues have been raised regarding the impact of priority rules within the Personal Property Securities Act 1999 and in other relevant legislation, such as Schedule 7 of the Companies Act 1993.

123 We propose to mitigate this issue by permitting issuers to omit amounts in circumstances where an amount is difficult or costly to calculate. This would include disregarding liabilities that were subject to problematic provisions of the Personal Property Securities Act and Companies Act identified by submitters, or placing some of those liabilities in a particular category with a note setting out the uncertainties. Given that this approach has been adopted by some issuers already to provide more detailed breakdowns of the ranking of liabilities[4], we consider this mitigation is sufficient to address the concerns raised by submitters.

Summary assessment of options against objectives

	Option 1: Ranking diagram showing the ranking of debt securities compared to other liabilities	**Option 2: Ranking diagram showing the ranking of debt securities compared to other liabilities, and the amount of those liabilities (preferred option)**
Provides for timely, accurate and complete disclosure of information to investors	Provides basic information about rankings of liabilities, but much information about the relative importance of liabilities would be omitted ✓	Provides information about rankings of liabilities and their relative importance ✓✓
Provides for disclosure of information that investors are likely to understand and use effectively	More accessible and understandable than existing text descriptions, but investors would need to examine financial statements for further information ✓	More accessible and understandable than existing text descriptions ✓✓
Avoids unnecessary compliance and regulatory costs	Easy to prepare ✓✓	Risk that costs and difficulties in presenting amounts are not sufficiently mitigated in drafting ✓
Promotes innovation and flexibility in offers of financial products	Significantly easier to modify terms or offer new simple deposit products ✓✓	Significantly easier to modify terms or offer new simple deposit products ✓✓

[4] See, for example, TrustPower's Simplified Disclosure Prospectus of July 2012 for an offer of fixed rate subordinated bonds, http://www.business.govt.nz/companies/app/service/services/documents/773F6EE562679BA3E5E5AA4D1EAD3EF6, page 11.

124 Overall we consider the measures in Option 2 to best meet the objectives outlined above, on the basis that the costs and difficulties in presenting amounts on the ranking diagram can be sufficiently mitigated through careful drafting of the requirements.

Issue 5: Treatment of investment options that are not funds

Status quo and problem definition

125 Managed investment schemes are often divided into more than one "fund", which is a defined pool of assets that are held for the benefit of a group of investors and that are managed together under a single investment mandate. In a simple case, a scheme may be divided into a "conservative fund" and a "growth fund" with different portfolios of assets in each. The PDS provides for a number of funds to be offered as investment options.

126 In some cases, managers choose to present a combination of funds as a single investment option. For example, a manager may present a "balanced" investment option that results in 50% of the investor's money going to the conservative fund and 50% going into the growth fund.

127 Currently limited information about these investment options would be described in the investment statement.

128 Under existing Cabinet decisions, PDSs and fund updates will include information about the performance, fees and assets of funds. Cabinet has not yet taken decisions on how these "non-fund investment options" should be treated.

129 The problem with not providing specific information on non-fund investment options is that investors would have to determine for themselves the combined effect of the performance, fees, etc, of the various underlying funds that make up the investment option. This would make assessing and monitoring non-fund investment options difficult.

130 The draft FMC regulations therefore consulted on an option for non-fund investment options to be treated as funds for various purposes. In the PDS, the key information summary, the table of investment options, and fees disclosure would all need to cover these non-fund investment options.

131 An issue arises as to how far this should be taken. In particular, fund managers will need to register quarterly "fund updates" for funds. This raises the issue of whether these should be required for relevant non-fund investment options also.

Regulatory impact analysis

132 We have considered two options for non-fund investment options:

Option 1: Include non-fund investment options in the PDS, but do not require fund updates

Option 2: Include non-fund investment options in the PDS and require fund updates (preferred option)

Option 1: Include non-fund investment options in the PDS, but do not require fund updates

133 Option 1 is to include non-fund investment options in the PDS in a manner analogous to single fund investment options, but do not require fund updates for non-fund investment options.

134 This enables managers to present these options in the PDS, while minimising the ongoing compliance costs associated with providing them.

135 Through the inclusion of non-fund investment options in the PDS, investors will receive information about the risks and fees of selecting these options. This is likely to be much easier to understand than having to determine these for themselves based on the information about the

underlying funds. They also ensure that risks or fees that are specific to the non-fund investment options, and not to the underlying funds, are disclosed in the PDS – for example, any additional fees associated with selecting the investment option.

136 However, once investors had selected a non-fund investment option, they would need to examine separate fund updates for the various funds they were invested in, in order to monitor the performance and fees they were being charged on an ongoing basis. These fund updates would not cover any fees that were specific to the non-fund investment option.

137 This option would also create incentives for managers to reduce the number of funds offered, and replace them with more opaque investment options that involved investment into multiple funds. For example, some managers currently offer both a series of single-asset class funds (Australasian shares, New Zealand fixed interest, international fixed interest, property, etc) and a series of diversified funds that invest into multiple asset classes (cash, conservative, balanced, growth, aggressive, etc). The latter set of funds could, in many circumstances, be replaced by a set of non-fund investment options that simply invest various proportions of an investors' assets into the single asset class funds.

Option 2: Include non-fund investment options in the PDS and require fund updates (preferred option)

138 Under Option 2, the non-fund investment options would provide the same information in the PDS as under Option 1. This would therefore have the same benefits to investors as Option 1.

139 In addition to this, they would produce quarterly fund updates for non-fund investment options. It would also assist investors to monitor the performance of their investment option on an ongoing basis.

140 However, it would impose additional compliance costs on managers from producing the extra fund updates.

Summary assessment of options against objectives

	Option 1: Include non-fund investment options in the PDS, but do not require fund updates	**Option 2: Include non-fund investment options in the PDS and require fund updates (preferred option)**
Provides for timely, accurate and complete disclosure of information to investors	Investors receive information about the risks and fees when first selecting these options, and could in principle monitor investment options on an ongoing basis. ✓✓	Investors receive comprehensive information about non-fund investment options in both PDS and ongoing disclosure✓✓
Provides for disclosure of information that investors are likely to understand and use effectively	Information in PDS would be clear, but information in fund updates would be difficult to interpret for non-fund investment options. Risks managers switching from funds to more opaque non-fund investment options.✗	Clear and comparable information provided on non-fund investment options when first investing, and in ongoing monitoring ✓✓
Avoids unnecessary compliance and regulatory costs	Minimises ongoing compliance associated with non-fund investment options✓✓	Extra costs from producing more fund updates✓
Promotes innovation and flexibility in offers of financial products	Allows offers of non-fund investment options, but creates incentives for scheme structures that reduce the number of funds ✓	Allows offers of non-fund investment offers, but may discourage new types of such options due to costs ✓

141 Overall we consider the measures in Option 2 to best meet the objectives outlined above. We consider that the additional costs of this option are outweighed by the benefits of the information being provided to investors.

Issue 6: Application of exemption for quoted debt securities

Status quo

142 Schedule 1 of the FMC Act exempts offers of financial products from the requirement to have a PDS if the products are already quoted on a licensed financial product market. Licensed markets include the NZX Main Board and the NZX Debt Market. This exemption came into force on 1 April 2014 as part of Phase 1 of the FMC Act implementation.

143 Instead of producing a disclosure statement, issuers provide a notice to the operator of the relevant licensed market that states, among other things:

- that an offer is being made without disclosure to investors under the exemption
- that the issuer is in compliance with all of its continuous disclosure and financial reporting obligations
- setting out any information that is excluded information for the purposes of continuous disclosure as at the date of the notice (for example, information that has been withheld under exclusions for confidentiality).

144 The rationale for this exemption is that licensed markets:

- have ongoing disclosure obligations that ensure that information about issuers is made available to investors
- incorporate this information into securities prices, which provide further information to investors about the value and risks of the securities.

145 For investors in listed companies, newly issued shares have the same rights, and most of the same risks and potential returns as the company's existing shares quoted on the market. To the extent that ongoing disclosure is sufficient to inform decisions to buy shares on the market, it should go most of the way to inform decisions to purchase newly issued shares, without the need for a PDS or similar disclosure document. This is the basis for the same class exemption.

146 A key issue is how this exemption should apply to debt securities. Unlike with shares, new issues of debt securities do not typically have exactly the same terms as the existing quoted debt securities of the same issuer. For example, if a company issues a 5-year bond on 1 April 2014, it will have a maturity date of 1 April 2019. The 'same' 5-year bond issued on 1 April 2015 will have a maturity date of 1 April 2020. This difference in maturity dates would result in the two bonds being treated as different classes of securities by the market, because bonds maturing on 1 April 2019 need to be distinguished from bonds maturing on 1 April 2020. The two bonds would also have different market prices.

147 The Act provides for regulations to prescribe the circumstances when debt securities with different redemption dates or interest rates are still considered to be of the same class for the purpose of the exemption.

148 A relatively conservative approach was taken for Phase 1 from 1 April. This was that the debt securities needed to be identical in all respects apart from the specified interest rate or the specified redemption date, and they must have the same term. This means, for example, an issuer with fixed-rate 5 year bonds can issue further fixed-rate 5 year bonds. However, it cannot issue fixed-rate 4 year bonds.

Problem definition

149 This approach creates a bias towards issuers making new offers of debt with the same terms as their quoted debt securities. This is unlikely to be an optimal approach, as the appropriate term depends on the borrowing requirements of the issuer at a given time, along with market factors.

150 It is also not the case that market information on quoted debt securities is most readily applicable to new debt securities with the same term. For example, if a company issued a 5-year bond on 1 April 2014, the maturity of this bond would be very similar to a 3-year bond issued on 1 May 2016 (i.e. they would have maturity dates of 1 April 2019 and 1 May 2019 respectively). The new 3-year bond would therefore be expected to be have returns more similar to the returns on the quoted 5-year quoted bond than returns on a new bond with a 5-year term. In addition, the information disclosed to the market on the existing quoted 5-year bond would be more relevant to a new 3-year bond than a new 5-year bond.

151 The Ministry has therefore considered broadening the range of circumstances when the same class disclosure exemption can be used for debt securities.

Regulatory impact analysis

We have considered two options for extending the exemption for quoted debt securities:

- Option 1: Extend exemption to offers of debt securities with different terms
- Option 2: Extend exemption to offers of debt securities with different terms, and also require investors receive specific information around the issuer's quoted securities (preferred option)

Option 1: Extend same class debt exemption to offers of debt securities with different terms

152 Option 1 is to extend the exemption to debt with a different term to the issuer's existing quoted debt.

153 This would allow for much wider use of the exemption, with substantial compliance cost reductions for issuers. Estimates from investment banking operations suggest that legal fee savings alone from use of the exemption are expected to exceed $100,000 per offer compared to a normal retail debt offer. In addition, there are significant savings in management and board time from not preparing and verifying disclosure documents.

154 Investors would also benefit from having a wider range of corporate debt offerings available to them, which would otherwise be offered to wholesale investors only.

155 However, one of the difficulties with permitting offers of debt securities to make use of this exemption (particularly those with different terms or maturities from the quoted debt securities) is that investors receiving offers may be unaware of the issuer's quoted debt, or may not be able to use the quotation to effectively assess the credit risk of the issuer and whether the interest rate offered is reasonable. This would defeat the rationale for the exemption, which is that this information is already available to investors and so does not need to be disclosed in a PDS.

156 This situation is in contrast to an offer of shares, where:

a. it is less likely that a new investor will invest in shares without being made aware of their existing quotation, and without becoming aware of the current market price of those shares

b. the price offered is expected to be closely related to the market price of existing shares (with a possible discount to encourage investment in the offer or to reflect dilution).

157 This issue exists in the present exemption, but would be exacerbated by a relaxation on the conditions under which it could be used.

158 We have therefore considered (in option 2 below) whether some form of limited disclosure might bridge this gap for offers of debt securities.

Option 2: Extend same class debt exemption to offers of debt securities with different terms, and also require investors receive specific information around the issuer's quoted securities (preferred option)

159 Option 2 is similar to Option 1, but with an additional requirement to provide disclosure to investors to enable them to use market information on the existing quoted securities to assess the risk and pricing of the new issue.

160 The precise content of the required discloses is still to be developed, but it would at a minimum:

a. identify the issuer's current quoted debt securities

b. provide guidance to investors around the information that is available to

i. assess the risks of the debt securities being offered

ii. assess whether the returns offered are fair.

161 Public consultation has been taken on a further step of including a "comparative pricing graph" that shows how the yields on the issuer's existing debt securities compare to benchmark yields (such as New Zealand government bond yields). This gives an indication of the risk premium attached to the issuer by the debt market, which can then be used to help assess whether the margin offered by the issuer on new bonds is sufficient to compensate for the risk. While some submitters supported the inclusion of the comparative pricing graph in the PDS and in same class debt offers, others were more sceptical or did not support it. Further work needs to be undertaken to determine if it, or some other presentation of market information, can be further developed to be useful to investors.

162 In any case, Option 2 would have almost all of the benefits of Option 1 – greatly reduced compliance costs and more investment opportunities available to investors.

163 Compared to Option 1, Option 2 would reduce the risk that retail investors do not receive relevant market information, and would assist investor decision-making. It would represent an increase in compliance costs from needing to include prescribed information in offer documents and/or to ensure that prescribed information is sent to investors. These costs are expected to be modest, as the information required would be short and easy to prepare.

Summary assessment of options against objectives

	Option 1: Extend same class debt exemption to offers of debt securities with different terms	**Option 2: Extend same class debt exemption to offers of debt securities with different terms, and also require investors receive specific information (preferred option)**
Provides for timely, accurate and complete disclosure of information to investors	Complete information would be made available, but not provided to investors (who may not even be aware of it). ✘	Complete information would be made available and references to it provided to investors. ✓
Provides for disclosure of information that investors are likely to understand and use effectively	Many retail investors are likely to struggle to use the market information available to them. ✘	Provides more useful information to investors to assist informed decisions than Option 1. However, it may prove challenging to provide information that a wide range of investors can use effectively. ✓
Avoids unnecessary compliance and regulatory costs	Major reduction in compliance costs for retail debt offers. ✓✓	Major reduction in compliance costs for retail debt offers. Evidence to date is that additional compliance costs compared to Option 1 are low. ✓✓
Promotes innovation and flexibility in offers of financial products	Greatly increases flexibility for issuers with quoted debt to offer debt of different terms, and provides significant new opportunities for retail investors. ✓✓	Greatly increases flexibility for issuers with quoted debt to offer debt of different terms, and provides significant new opportunities for retail investors. ✓✓

164 Overall we consider the measures in Option 2 to best meet the objectives outlined above.

Part 2: Remaining governance and supervision issues

Status quo and problem definition – governance and supervision

165 In addition to the matters on disclosure addressed in Part 1 of this RIS, Cabinet decisions are required for additional matters relating to the governance arrangements for offers of financial products.

166 The FMC Act addresses the governance of debt securities and managed investment schemes.

167 Managed investment schemes 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. The governance of debt products is dealt with by the Securities Act 1978. Governance obligations differ according to the Act that applies.

168 The governance regime under the Act addresses the inconsistencies in the way products are regulated. Some regulatory regimes for schemes have inadequate governance requirements which create a risk that issuers will not act in the best interests of investors and these inhibit effective monitoring and enforcement. Similar products are regulated differently, with some regulation taking a form over function approach.

169 The FMC Act addresses these issues by putting managed investment schemes into a single governance framework. By applying a single governance framework, the FMC Act enables financial products to compete on function not legal form. The key elements of the framework for managed investment schemes are as follows:

- Schemes must have a licensed manager and an independent supervisor (except for some classes of existing schemes where the resulting costs would be overly burdensome).
- Schemes have statutory duties to act in the best interests of investors. 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.

170 Obligations are tiered: they are reduced where there is less governance risk but otherwise imposed consistently on products of a particular type. Reducing complexity and consolidating governance rules promotes the confident and informed participation of businesses and investors in financial markets.

171 In June 2013 Cabinet made decisions on regulations required under Part 4 to:

- set detailed requirements and procedures for matters such as the withdrawal rules for superannuation schemes and controls on breaches of investment mandates and pricing rules
- determine the extent to which minimum requirements are specified by statute rather than the supervisor and issuer being 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
- provide exceptions so that the governance obligations can differentiate according to the functions of different schemes or financial products.

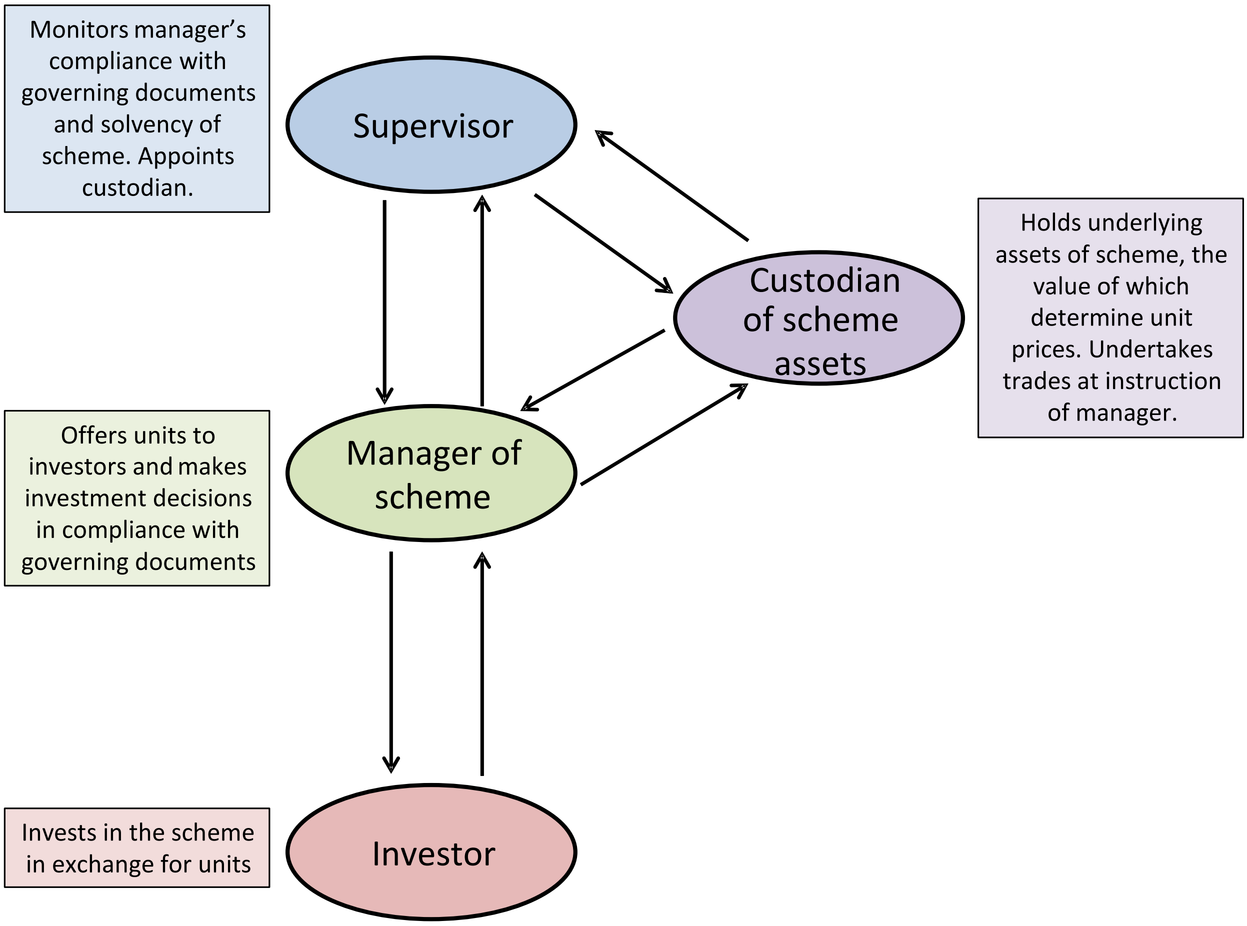
172 These decisions focussed on the role and responsibilities of the issuer. There were some matters relating to the other key participants in the governance framework on which Cabinet did not make final decisions because additional consultation was required or other initiatives to address problems were as yet incomplete.

173 This RIS therefore considers these specific governance issues that require further Cabinet decisions and have significant impacts. These are:

- the obligations on custodians of registered managed investment schemes
- the roles and responsibilities of auditors and supervisors for debt products and managed investment schemes
- the extent of the duty on supervisors to accept appointments.

174 The problem definition for each of these issues is discussed separately in the sections below.

Figure 1: Example structure of a managed investment scheme under FMC Act



Objectives

175 The options for the governance issues in the remaining parts of the RIS are measured against the following objectives (based on the objectives in section 4 of the FMC Act):

- applies appropriate governance arrangements to financial products
- avoids unnecessary compliance and regulatory costs
- promotes innovation and flexibility in offers of financial products.

176 We have weighted the application of appropriate governance arrangement more heavily than the other two objectives in the context of these issues, as we consider it to be the most element of achieving the overall objectives of the Act: to deliver fair, efficient and transparent financial markets, and to promote confident and informed participation in financial markets.

Issue 1: Custody of managed investment scheme property

Status quo and problem definition

177 In the context of a managed investment scheme (MIS) (such as a KiwiSaver scheme), scheme property is required to be held independently from the manager of the scheme by a custodian, who will either be the supervisor, or a third party appointed by the supervisor. See figure 1 for an example of the role of a custodian in the governance of a MIS. The custodian holds the scheme property on trust for the scheme, separately from their own assets or those of any related party of the scheme. Custodians usually also process transactions on behalf of the scheme.

178 Custodians that hold client assets directly on behalf of investors are generally regulated under the Financial Advisers Act. The recently introduced Financial Advisers (Custodians of FMCA Financial Products) Regulations 2014 (FA Custodian Regulations) apply reporting, reconciliation and assurance requirements on these custodians. These regulations do not apply to custodians of MIS, who are instead regulated under the FMC Act.

179 The Financial Markets Conduct Act allows for similar requirements to apply the custody of managed investment schemes as apply under the FA Custodian Regulations. In July 2013 we consulted on whether these requirements should be applied. Submitters were supported extending these requirements to custody of MIS.

180 In December 2013–March 2014 we consulted on an exposure draft of these requirements. Submitters were supportive of those obligations but made minor comments on how to better adapt them to custody of MIS.

Regulatory impact analysis

181 We have considered two options for custody requirements for MIS:

Option 1: No prescribed requirements for the custody of MIS (status quo)

Option 2: Align MIS custody requirements with FA Custodian Regulations (preferred option).

Option 1: No prescribed requirements for the custody of MIS (status quo)

182 Option 1 would not apply any further requirements to the custody of MIS beyond the basic independence and record keeping requirements in the FMC Act.

183 This would apply a lower minimum standard of protections over the custody of the assets of MIS than will apply in situations where a custodian holds assets directly on behalf of an investor. While the custodian will either be a licensed supervisor, or will be appointed by a licensed supervisor, this does not require the equivalent custody protections to be in place. FMA's preference is that the requirements be applied directly to the custodian through regulations under the FMC Act, rather than as a licence condition on supervisors of MIS.

184 We do not consider that Option 1 meets the objectives outlined above, as it applies lower minimum protections to the custody of the underlying financial products of a MIS than will apply to the custody of financial products held directly on behalf of investors. There would be no assessment of the systems or processes of custodians of MIS, beyond the requirements that are placed on the supervisor.

185 In our consultation, no submitters supported this option.

Option 2: Align MIS custody requirements with FA Custodian Regulations (preferred option)

186 Option 2 would apply a modified version of the requirements under the FA Custodian Regulations to custodians of MIS. The regulatory impact statement for these regulations can be found here: http://www.med.govt.nz/business/business-law/current-business-law-work/dims-and-custody/custody-egi-paper-and-ris.pdf.

187 One of the requirements, client reporting, would not be appropriate, because investors only hold units in a fund in the scheme and do not directly own the underlying scheme property. The custodian has no relationship with the end investor, and the detailed information about the underlying scheme property will not be relevant to that end investor.

188 The remaining requirements would be for custodians of MIS to:

- adequately reconcile records of scheme property

This is a basic requirement which would be expected of any capable custodian.

- obtain an annual assurance engagement from a licenced auditor as to whether the custodian's processes, procedures and controls are suitably designed and operating effectively.

The auditor would need to assess these processes, procedures and controls against similar control objectives as apply to other types of custody.

189 Market practice amongst professional custodians suggests that sophisticated investors see an assurance engagement as the most efficient and effective method of ensuring that custodians keep accurate records and have appropriate controls in place to protect their assets. While assurance engagements do not eliminate the risk of fraud and poor custodial practices, they do encourage those charged with governance of the custodian to establish and maintain appropriate systems to keep accurate records and to protect the scheme's assets.

190 Given that New Zealand does not have a licensing regime for custodians – unlike for other financial markets participants – mandating these engagements provides a method of ensuring that all custodians have robust systems. While supervisors are licensed by FMA, this option would apply these requirements directly on custodians, meaning that they, rather than the supervisor, have the liability for non-compliance.

191 Consultation suggested that the vast majority of custodians already broadly comply with these obligations, and that the additional costs on most custodians are likely to be minimal. There will, however, be substantial costs for those custodians who do not already obtain assurance engagements, which submitters have estimated at between $30,000 and $60,000 per annum. Submitters agreed that any additional costs would be justified by the benefits for investor confidence of ensuring a high standard of custodial practices across the industry.

Summary of options measured against objectives

	Option 1: No prescribed requirements for the custody of MIS (status quo)	**Option 2: Align MIS custody requirements with FA Custodian Regulations (preferred option)**
Applies appropriate governance arrangements to financial products	Does not provide assurance that the custodian has the appropriate systems in place to ensure that records are correct and to protect client assets against misappropriation ✘	Applies the same standard of governance requirements to the custody of MIS as apply to other types of custody. The assurance engagement ensures that an external auditor assesses the effectiveness of the custodians systems and controls ✓✓

Avoids unnecessary compliance costs	Does not introduce any additional compliance costs on custodians ✓✓	While the costs of assurance engagements can be significant, custodians are likely to already be obtaining these engagements ✓
Promotes innovation and flexibility in offers of financial products	Allows supervisors more flexibility in establishing their custodial arrangements ✓✓	Custodians will need to comply with these requirements, potentially limiting the custodians that supervisors can appoint. However, custodians will retain significant flexibility in how they meet the high level control objectives ✓

192 Overall, given that we have weighted the application of appropriate governance arrangements above the other two objectives, we consider Option 2 to be preferable. It addresses the issue of different standards applying to different types of custodial activities and provides a degree of assurance over the governance of custodians of MIS.

Issue 2: Auditors' obligations to supervisors of continuously offered debt and schemes

Status quo and problem definition

193 The FMC Act currently recognises that while supervisors have the primary role of supervising offers, auditors have a valuable supporting role in the supervisory framework.

194 The Act gives auditors obligations to "whistle-blow", provide to supervisors copies of reports to issuers, and carry out various assurance roles. There has been a longstanding tension however between auditors and supervisors as to their respective roles and responsibilities.

195 Auditors are concerned that supervisors have an "expectation gap" about what auditor reports designed for the issuer will give supervisors. The role of an auditor is to express an opinion on whether a set of financial statements has been prepared for an issuer in accordance with generally accepted accounting practice or to provide other types of assurance against particular objectives. In carrying out this role, auditors are likely to acquire much information that may be of relevance to supervisors. However, their reporting is designed for, and addressed to, the issuer's rather than the supervisor's needs. Supervisors are equally concerned that auditors try to limit their liability and do not fully accept their legal responsibilities.

196 This tension is at its worst in relation to the current obligation in the existing regulations for auditors to confirm their audit opinions for the benefit of supervisors.

197 The tension between auditors and supervisors has reduced recently somewhat as a result of an initiative by New Zealand Institute of Chartered Accountants (NZICA) to develop a model "tripartite" engagement between issuer, auditor, and supervisor. Under the tripartite engagement, supervisors engage auditors to report on the issuer's compliance with the trust deed. This provides a contractual framework and an open dialogue that better supports the minimum obligations in the Act. However, the tripartite agreement has not adopted uniformly by auditors and supervisors.

198 Under the status quo, the current obligation for auditors to confirm their audit opinion for the benefit of supervisors would be continued. However, the current obligation creates a number of problems. The most significant problem is that audit quality, and so the supervisory framework, is undermined for the following reasons:

- *Undermines auditor reporting for supervisor purposes:* If the audit is not designed with the interests of the debt holders in mind it will not address those key issues where the interests of debt holders differ from those of the shareholders of the issuer. If supervisors passively rely on the audit opinion, additional reporting needed for their purposes will not be undertaken.
- *Conflict with other obligations for auditors:* The current obligation is in conflict with auditors' obligations under audit and assurance standards. The premise of those standards is that auditors only provide assurance on matters for which the assurance was designed (i.e. to shareholders). The obligation to extend that assurance to a third party for whom the assurance was not designed gives rise to concern by auditors that they are in conflict with audit and assurance standards.
- *Undermines co-operation between auditors and supervisors:* In practice, auditors do not comply with the obligation or comply nominally with extensive limitations on the reliance that can be placed on the opinion. This undermines co-operation between auditors and supervisors, particularly making it less likely that auditors and supervisors will adopt the model tripartite agreement.

199 The objective of achieving appropriate governance over financial products in this context would be met if audit quality in relation to financial products was improved and if supervisor engagement in the audit process was increased. This would increase the effectiveness of supervision.

Regulatory impact analysis

200 We have considered two options:

Option 1: Continue the obligation but remove the conflict with audit and assurance standards

Option 2: Remove the obligation entirely

Option 1: Continue the current obligation but remove conflict with audit and assurance standards

201 Option 1 would continue a modified obligation to provide supervisors with confirmation that the audit of the issuer's financial statements had been completed in accordance with audit and assurance standards. The primary purpose would be to give supervisors the ability to sue on behalf of holders of the financial product if the audit was in fact negligently done (in the same way as an issuer can sue on a negligent audit on behalf of shareholders).

202 Modifying the obligation would address current problems with the conflict with audit and assurance standards (by clarifying that auditors need not confirm that the audit opinion was fit for supervisors' purposes). It would clarify the limits of the practical benefit that the audit opinion provides. It is possible this would increase the incentives on supervisors to engage auditors separately to ensure the auditors consider matters that are important for the interests of debt holders, which may lead to better reporting for supervisor purposes. The obligation would have little additional impact on direct compliance costs for auditors because they are already required by law to carry out the engagement in accordance with the auditing and assurance standards and the terms of engagement.

203 The modified obligation would also provide supervisors, on behalf of bondholders, with an opportunity to recover some of the bondholders' loss from the auditors where that negligence contributed to bondholders' loss. In this case, there may be some improved outcomes for investors in some circumstances. In our consultation with them, supervisors advocated this approach for this reason.

204 However, we think this option has, at best, little impact on audit quality and may indeed undermine audit quality. This option would not in itself provide supervisors with any further

information or result in better reporting designed for their purpose. It also would not resolve the current expectation gap around reporting as there is a high risk that supervisors continue to "rely" on the audit opinion and that auditors continue to engage in defensive and risk adverse behaviour.

205 Importantly auditors and the External Reporting Board strongly advocated in consultation that this option would merely result in a transfer of risk from supervisors, at no cost, to auditors. This has compliance cost and risk management implications for auditors. We think increased exposure for auditors may make some auditors reluctant to accept appointments for "high risk" issuers. This could diminish options as to which auditors an issues may appoint (and also potentially to audit quality).

Option 2: Remove obligation (preferred option)

206 This option would discontinue the current obligation. The effect of this would be that auditors would provide a copy of their audit opinion to supervisors, but that supervisors may not be able to recover losses to bondholders due to auditor negligence. If supervisors wanted additional reporting for their purposes, which might form the basis for any loss recovery, they would need to directly engage auditors to do this work or engage their own accountants. It is appropriate that supervisors pay auditors for undertaking these engagements if they expect them to be liable to them for the accuracy of the audit.

207 This largest benefit of this option would in improving supervisor engagement with auditors. By removing the default position of allowing reliance on the audit opinion, it would increase incentives on supervisors to actively engage with auditors, both by placing their concerns before auditors and by directly engaging them to carry out additional reporting under a tripartite engagement. It is this active engagement that will contribute most directly both to audit quality and to the effectiveness of supervision generally.

208 In our consultation, supervisors raised the concern that this option would increase the cost of supervision by effectively requiring the statutory audit to be repeated. However, removing the requirement would not affect the supervisor's ability to monitor the issuer's financial position as it would not diminish the value of the audited financial statements – the auditor's certificate to the shareholders can still provide supervisors with reasonable assurance that the financial statements have been prepared in accordance with GAAP.

209 Further, the supervisor need only pay additional services to the extent their information needs are not met by the statutory audit. The tripartite agreements developed by NZICA should reduce the cost of supervisors doing so.

Summary assessment of options against objectives

	Option 1: continue the current obligation but remove conflict with audit and assurance standards	**Option 2: remove obligation (preferred option)**
Applies appropriate governance arrangements to financial products	Increases incentives on supervisors to actively engage with auditors and/or obtain other expert advice by making practical scope of benefit of obligation clear.✓	Has benefits of option 1. In addition, removes risk that top tier audit firms refuse engagements because of additional exposure to liability risk that is not compensated for. ✓✓
Avoids unnecessary compliance costs	Reduces compliance costs on auditors and supervisors from current uncertainty of obligation, but may increase those for supervisors. ✓	Removes compliance costs for auditors. Any additional costs for supervisors should be mitigated by tripartite audit agreements.✓✓

Promotes innovation and flexibility in offers of financial products	Some improvement in flexibility over status quo as supervisors more likely to engage directly on appropriate audit arrangements on a risk basis and design arrangements fit for the purpose of the particular offer. ✓	Same benefits as option 1.✓

210 Overall we consider the measures in option 2 to best meet the objectives outlined above.

Issue 3: Changes of supervisors

Status quo and problem definition

211 Supervisors of financial products are, and will continue to be, licensed under the Financial Markets Supervisors Act (FMSA). Supervisors of debt products and registered schemes are also trustees. It is a core concept of both supervision of financial products and general trust law that there cannot be a vacancy in the role of the supervisor/trustee. For this reason both the current law, and the FMC Act, prevent a supervisor/trustee from resigning from that position without a new supervisor/trustee being appointed to that role.

212 Until last year, Public Trust was legally required, under the Trustee Act, to step in and accept an appointment, as the "trustee of last resort" when ordered to do so by the High Court. This issue is most likely to arise if the issuer or the trust itself is insolvent, or near insolvent, and so unable to pay the supervisor's fees. This situation arose last year when Public Trust was appointed by the High Court under this duty in place of Perpetual Trust over the failed issuer Capital + Merchant Finance.

213 In response, Parliament enacted the Trustee (Public Trust) Amendment Act 2013 (TPTAA). The TPTAA addressed a concern that Public Trust would, under this provision, potentially be required to take up a large number of appointments for financial product trusts with a resulting exposure for Public Trust if the trust itself could not meet Public Trust's fees. The TPTAA provided that the High Court could only appoint Public Trust to a financial markets supervisory role if there was an indemnity covering its fees from the resigning supervisor.

214 The TPTAA was an interim solution that was intended to apply only until the FMC Act came into force. Under the FMC Act, the FMSA will be amended to enable FMA to appoint a replacement supervisor from among all available licensed supervisors (not only Public Trust) and require an indemnity from the resigning supervisor as a precondition of the appointment. FMA may also appoint a person who is not a licensed supervisor, but would only do so on a temporary or limited basis.

215 In June 2013 Cabinet agreed in principle that, in order to limit this risk that all that licensed supervisors refuse an appointment, supervisors should share a responsibility to accept these appointments unless they have good cause not to do so. Cabinet noted, however, that these proposals should be subject to further consultation before they are finalised.

216 Further consultation with supervisors and with FMA has been undertaken on this duty. The key issue raised by supervisors has been the compliance costs associated with an unplanned appointment for which they potentially do not have expertise and for which they are not compensated if there is a shortfall and neither the trust nor the resigning supervisor meet their costs.

Regulatory impact analysis

217 We have considered three options for ensuring a financial product issue always has a supervisor:

Option 1: Not impose a duty to accept an appointment (status quo)

Option 2: Impose a duty to accept an appointment unless the licensed supervisor has good cause not to do so

Option 3: Impose a duty to accept an appointment and for FMA to meet the costs of the licensed supervisor if there is a shortfall (preferred option).

Option 1: Do not impose a duty to accept an appointment (status quo)

218 Option 1 would rely on the ability of FMA under the FMSA to either persuade a licensed supervisor to accept an appointment or its ability to appoint an unlicensed supervisor.

219 However, this option does not address the core problem that, if there is no clarity that there will be funding to pay for the costs of the supervisor for the appointment, no person will be willing to take on the appointment. Although the risk of a shortfall of this kind is not high, in these circumstances, FMA advise that they are concerned that both licensed and unlicensed supervisors would refuse to accept an appointment. This would have uncertain and potentially costly effects because the result could be that there is no-one to act as trustee of a trust.

Option 2: Impose a duty to accept an appointment unless the licensed supervisor has good reason not to do so

220 Option 2 would impose a duty on licensed supervisors to accept the appointment unless the licensed supervisor had "good cause" not to do so. This option would addresses the core problem that a person must be found to fill the supervisor role. However, there are significant compliance costs associated with this option for the supervisor selected by FMA to take up the appointment.

221 In our consultation, supervisors have raised three key costs associated with this duty:

- the costs arising from an appointment for which they do not have expertise (e.g., a forestry trust where normally they are appointed for managed funds)
- the business disruption from taking an appointment
- liability for the direct costs of any shortfall.

222 This option may address the first of these costs if it is sufficient to constitute good cause under the regulations. Good cause to not accept an appointment would include inexperience or a lack of expertise in the subject matter of the trust (as well as the obvious problem of an existing conflict of interest).

223 Under the option, however, the second and third costs would fall on the unlucky supervisor chosen by the FMA. We have not been able to obtain reliable quantification of these costs. However, the costs are likely to be very fact specific. For example, the current appointment of Public Trust over Capital + Merchant Finance under the existing law currently has very low costs as little is required in relation to the trust until existing litigation is progressed. Much more significant costs would be expected if the trust were actively trading.

Option 3: Impose a duty to accept an appointment unless the licensed supervisor has good reason not to do so and for FMA to meet the costs of the licensed supervisor if there is a shortfall (preferred option)

224 Option 3 is the same as Option 2, but adds a proviso that FMA must meet the direct costs of the supervisor if there is a shortfall and neither the issuer, nor the trust, nor the resigning supervisor meets those costs.

225 The supervisors' costs must fall somewhere. This option smooths those costs, enabling them to be met by the FMA if there is a shortfall. These costs would then be shared amongst industry participants through the levy that funds the FMA – so under this option the industry as a whole pays the costs rather than the supervisor that FMA chooses. We also consider that the risk that a shortfall arises is reasonably remote in the future.

226 This option would reduce the compliance costs of particular supervisors for particular appointments and spread the risks associated with these costs. The security of funding would also likely result in supervisors being comfortable with accepting appointments. The FMA would only pay the costs that it was satisfied were reasonable in the circumstances.

Summary assessment of options against objectives

	Option 1: not impose a duty to accept an appointment	**Option 2: impose a duty to accept an appointment unless the licensed supervisor has good cause not to do so**	**Option 3: impose a duty to accept an appointment unless the licensed supervisor has good reason not to do so and for FMA to meet the costs of the licensed supervisor if there is a shortfall (preferred option)**
Applies appropriate governance arrangements to financial products	Does not address risk that governance arrangements fail for lack of a supervisor. ✘	Removes risk that governance arrangements fail for lack of a supervisor. ✓✓	Removes risk that governance arrangements fail for lack of a supervisor. ✓✓
Avoids unnecessary compliance costs	There will be significant costs and uncertainty for a financial product trust if it lacks a supervisor. ✘	Leaves compliance costs to be borne by particular supervisor if there is a shortfall. Although a shortfall is reasonably rare, the extent of costs in this case are highly case-specific. As a result they are difficult to estimate and may apply unevenly as the "luck of the draw". ✘	Shares the compliance costs of any shortfall amongst industry participants through the levy. This reduces the uneven and unpredictable nature of those costs, and reduces the compliance costs of accepting an appointment for particular supervisors. ✓✓
Promotes innovation and flexibility in offers of financial products	No regulatory impact identified.	No regulatory impact identified.	No regulatory impact identified.

227 Overall we consider the package of measure in option 3 to best address the issues identified and to best meet the objectives outlined.

Conclusions and recommendations

Part 1: Remaining disclosure issues

228 We consider that the preferred options outlined in Part 1 of this regulatory impact statement address the problems identified and help to ensure that the disclosure regime under the FMC Act achieves its purposes in effectively informing investors and the market. These options are to:

- Impose page limits on PDSs for equity securities, debt securities, general managed investment schemes and derivatives, with varying length limits for different products (around 30-60 pages).
- Include a more selective set of financial information for investors in the PDS based on market practice, rather than the full summary and prospective financial statements required at present.
- Require a 'credit risk warning' to be given to investors in non-bank deposit takers when they open accounts for simple deposit products ("category 2" products under the Financial Advisers Act 2008). Other information (including a tailored version of the PDS) would be maintained on the online offers register.

- Require the debt securities PDS to include a "ranking" diagram showing the ranking of the debt securities offered compared to other liabilities of the issuer, and the amount of those other liabilities.
- Require the managed fund PDS to include investment options that are not discrete "funds" (such as investment options that comprise combinations of two or more funds), and require quarterly fund updates for these investment options.
- Extend the disclosure exemption for offers of quoted debt securities with different terms, and also require that prospective investors receive specific information about the issuer's quoted securities.

229 These options will help to deliver clear, concise and effective disclosure. This should in turn improve investor decision making and the overall performance of financial markets.

Part 2: Remaining governance and supervision issues

230 The preferred options in Part 2 of this regulatory impact statement will address the problems identified by ensuring that appropriate governance requirements are in place for the custodians, auditors and supervisors. These options are to:

- Align MIS custody requirements with the FA Custodian Regulations, including requiring reconciliation of holdings and assurance engagements.
- Remove requirements for issuers to include, in the terms of appointment for an auditor, a requirement for the auditor to confirm its opinion on the financial statements for the benefit of the trustee.
- Impose a duty on licensed supervisors to accept appointments for resigning supervisors, and for FMA to meet the costs of the licensed supervisor if there is a shortfall.

231 These requirements complement the decisions that Cabinet has already made in respect of issuers. They help to ensure that there is a comprehensive regulatory framework in place, which should help to promote public confidence in financial markets.

Consultation

232 The FMC Regulations have been subject to a continual stakeholder engagement process since December 2012 (running alongside the FMC Bill consultation, which ran from June 2010–May 2013). This has included:

- a December 2012 discussion paper on the regulations
- a series of stakeholder workshops from August–October 2013 on the content of the PDS and offer register
- based on the stakeholder workshops, a draft of detailed disclosure "requirements" released for general public consultation in October 2013
- three main exposure drafts of regulations released in October 2013 (licensing and exemptions), December 2013 (governance and financial product markets) and May 2014 (disclosure) – together these covered the vast majority of the significant issues to be addressed in the regulations
- targeted consultation with market participants throughout the process.

233 Responses from these consultation processes have been taken account of in subsequent rounds of consultation, and are reflected in this RIS.

234 In general, there has been a high level of agreement with the proposals that been included in the exposure drafts and with the preferred options in this RIS. Where there has been disagreement or a significant divergence of opinion between submitters this is noted in the RIS.

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

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

Implementation

237 The regulations are expected to come into force on 1 December 2014. There will be a transition period of up to two years to comply with the new disclosure and governance requirements.

Monitoring, evaluation and review

238 The regulations discussed in this RIS will be monitored and evaluated as part of the overall review of the effectiveness of the FMC Act.

239 The FMC Act will be subject to an outcome evaluation after 5 years (in 2019). The purpose of the evaluation will be to measure the short-to-medium-term impacts of the new Act on businesses seeking capital and on investors seeking to provide it. A particular focus of the evaluation will be on whether the changes to the investment regime:

a. minimise compliance costs for firms seeking investment capital

b. promote innovation and flexibility in the financial markets

c. allow New Zealand firms to access the capital they need more efficiently

d. provide a wider range of investment opportunities, and

e. make investors feel “confident and informed” in relation to new products, and in relation to financial markets as a whole.

240 The evaluation will cover a selection of the intended outcomes of the Act, focussing on the impacts that are key priorities and where the Ministry has the most leverage. The approach taken will not focus on FMA’s performance as a financial regulator and will exclude areas that FMA are most involved in, such as enforcement.