Ministry of Business, Innovation & Employment

Financial Markets Conduct Regulations

Discussion Paper

December 2012

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Request for submissions

This discussion paper seeks submission on regulations and registers to be made under the Financial Markets Conduct Bill. It is divided into six chapters:

Chapter 1 – Disclosure

Chapter 2 – Registers

Chapter 3 – Scope, exclusions, and offer process

Chapter 4 – Governance

Chapter 5 – Dealing in financial products on markets

Chapter 6 – Licensing

The Ministry of Business, Innovation and Employment seeks submissions on the questions asked in this discussion paper. The focus of this consultation is on the regulations to be made under the Financial Markets Conduct Bill rather than the policy in the Bill itself.

When preparing your submission, please:

- use the submission template provided (which sets out all the questions)
- direct your comments to specific questions
- provide electronic submissions in both .pdf format (for publishing and filing) and an editable format such as Word (to assist compilation of submissions).

This will help your comments to be processed, understood and taken into account.

Please send comments to investment@mbie.govt.nz.

The closing date for submissions is **Friday 1 March 2013**.

Publication of comments, the Official Information Act and the Privacy Act

The Ministry intends to publish all submissions on its website, other than submissions that may be defamatory. The Ministry will not publish the content of your submission on the Internet if you state that you object to its publication when you provide it.

However, your submission will remain subject to the Official Information Act 1982 and may, therefore, be released in part or full. The Privacy Act 1993 also applies. When making your submission, please state if you have any objections to the release of any information contained in your submission. If so, please identify which parts of your submission you request to be withheld and the grounds under the Official Information Act for doing so (e.g. that it would be likely to unfairly prejudice the commercial position of the person providing the information).

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Introduction

What does the Financial Markets Conduct Bill do?

1 The Financial Markets Conduct Bill will govern how financial products are created, promoted and sold, and the ongoing responsibilities of those who offer, deal and trade them. It will also regulate the provision of certain financial services.

2 Regulation plays an important role in ensuring capital markets operate efficiently. Regulation has costs, often directly to businesses and ultimately borne by investors. Smart regulation minimises these costs while enabling capital markets to operate as efficiently as possible.

3 The principal policy objective behind the FMC Bill is to facilitate capital market activity, in order to help businesses to fund growth and individuals to reach their financial goals. This objective is reflected in clauses 3 and 4 of the FMC Bill:

> **3 Main purposes**
> The main purposes of this Act are to—
> (a) promote the confident and informed participation of businesses, investors, and consumers in the financial markets; and
> (b) promote and facilitate the development of fair, efficient, and transparent financial markets
>
> **4 Additional purposes**
> This Act has the following additional purposes:
> (a) to provide for timely, accurate, and understandable information to be provided to persons to assist those persons to make decisions relating to financial products or the provision of financial services:
> (b) to ensure that appropriate governance arrangements apply to financial products and market services that allow for effective monitoring and reduce governance risks:
> (c) to avoid unnecessary compliance costs:
> (d) to promote innovation and flexibility in the financial markets.

4 Regulation needs to work for both issuers and investors. Investors must have confidence in the integrity of financial markets. This includes receiving accessible information to make informed decisions, and being satisfied that investments will be well-governed and obligations enforced. Regulation should also assist businesses in bringing good investment opportunities to market. Regulations made under the FMC Bill need to support these purposes.

5 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.

6 The FMC Bill replaces this legislation with one new, shorter Act. It also amends other financial markets legislation including the Financial Advisers Act 2008, Financial Service Providers (Registration and Dispute Resolution) Act 2008, Securities Trustees and Statutory Supervisors Act 2011 and Financial Markets Authority Act 2011.

7 The FMC Bill will also result in two new public registers: a register of offers of financial products and a register of managed investment schemes. These will replace at least six registers currently maintained by the Registrar of Companies and FMA. The new registers will make offer documents and information relating to public offers much more accessible to investors, their advisers, market analysts, and commentators.

What's happened so far?

8 Cabinet made policy decisions on the review of securities law in February and May 2011, following public consultation on a discussion document released in June 2010.

9 An exposure draft of the FMC Bill was released in August 2011, with a request for submissions on the technical detail prior to the Bill being finalised.

10 The FMC Bill was introduced to the House on 12 October 2011 and referred to the Commerce Select Committee after its first reading on 7 March 2012.

11 The Committee received written submissions from 62 submitters and heard 37 oral submissions. The Committee recommended amendments to the FMC Bill in its report dated 7 September 2012. The second reading of the FMC Bill commenced on 25 October 2012.

12 The following key documents are available:

- Policy development documents: http://www.med.govt.nz/business/business-law/current-business-law-work/review-of-securities-law
- Parliamentary stage documents: http://www.parliament.nz/en-NZ/PB/Debates/Debates/c/0/d/50HansD_20121025_00000028-Financial-Markets-Conduct-Bill-Second-Reading.htm
- Financial Markets Conduct Bill: http://www.legislation.govt.nz/bill/government/2011/0342/latest/versions.aspx.

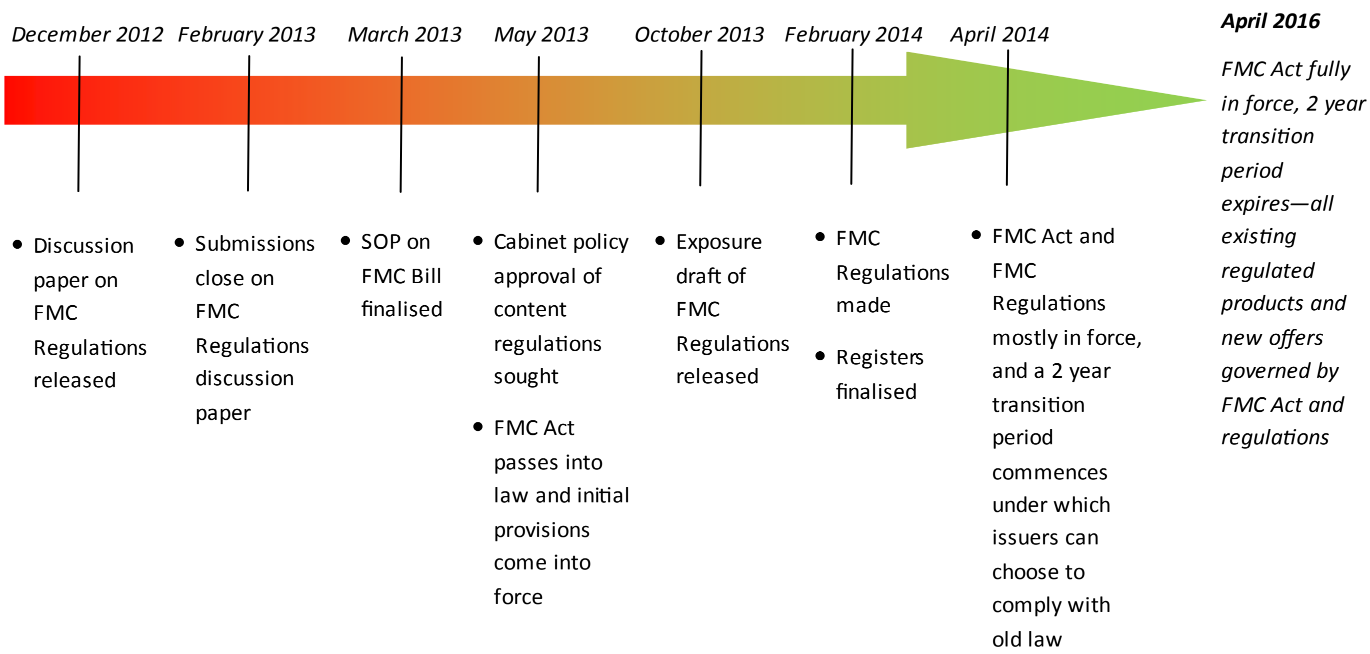
What will the regulations cover?

13 A substantial body of regulations need to be made under the FMC Bill:

- The regulations will set out detailed requirements for the timing, form and content of initial and ongoing disclosure for financial products, including limited disclosure for products offered under exceptions. Disclosure regulation is intended to improve the quality of disclosure and the ability for investors to compare products. Well-designed disclosure regulation can reduce the costs to business when raising capital, as businesses will rely less on expert advice and guidance from the regulator.
- The regulations will set out licensing criteria, standard conditions and the conditions the regulator can impose for licensed services under the FMC Bill (e.g. acting as a manager of a KiwiSaver scheme or operating a stock exchange). Prescribing criteria and conditions reduces licensing costs and uncertainty by guiding the regulator's discretion and focusing applications and licensees on the requirements that matter.
- The regulations will provide exceptions to the general rules in the FMC Bill, including: exceptions from making disclosure immediately prior to purchase; from the need to obtain a licence to operate a financial product market; and from the related party transaction rules. This allows the FMC Bill to set general rules, while placing less reliance on the regulator to make exemptions than under the current law.
- The regulations will set additional governance rules for some financial products, such as procedures for meetings of product holders, lock-in rules for superannuation schemes, implied terms in trust deeds such as those relating to auditor reporting, requirements to send reports to supervisors and the regulator, and rules for reporting and correcting pricing errors.
- The regulations will deal with myriad other matters, such as search criteria for public registers, interest rates for late repayment of moneys held on trust, forms and procedures and fees.

What's happening next?

14 The FMC Bill is expected to be enacted in the first half of 2013 and is expected to begin to come into force in the first half of 2014. The current working timeframes are:



15 This timeframe is ambitious, and there is a possibility of slippage. The Ministry recognises that it is important to remain flexible and realistic. While industry supports the reforms in the FMC Bill, it is important that the regime is implemented smoothly and goodwill is maintained.

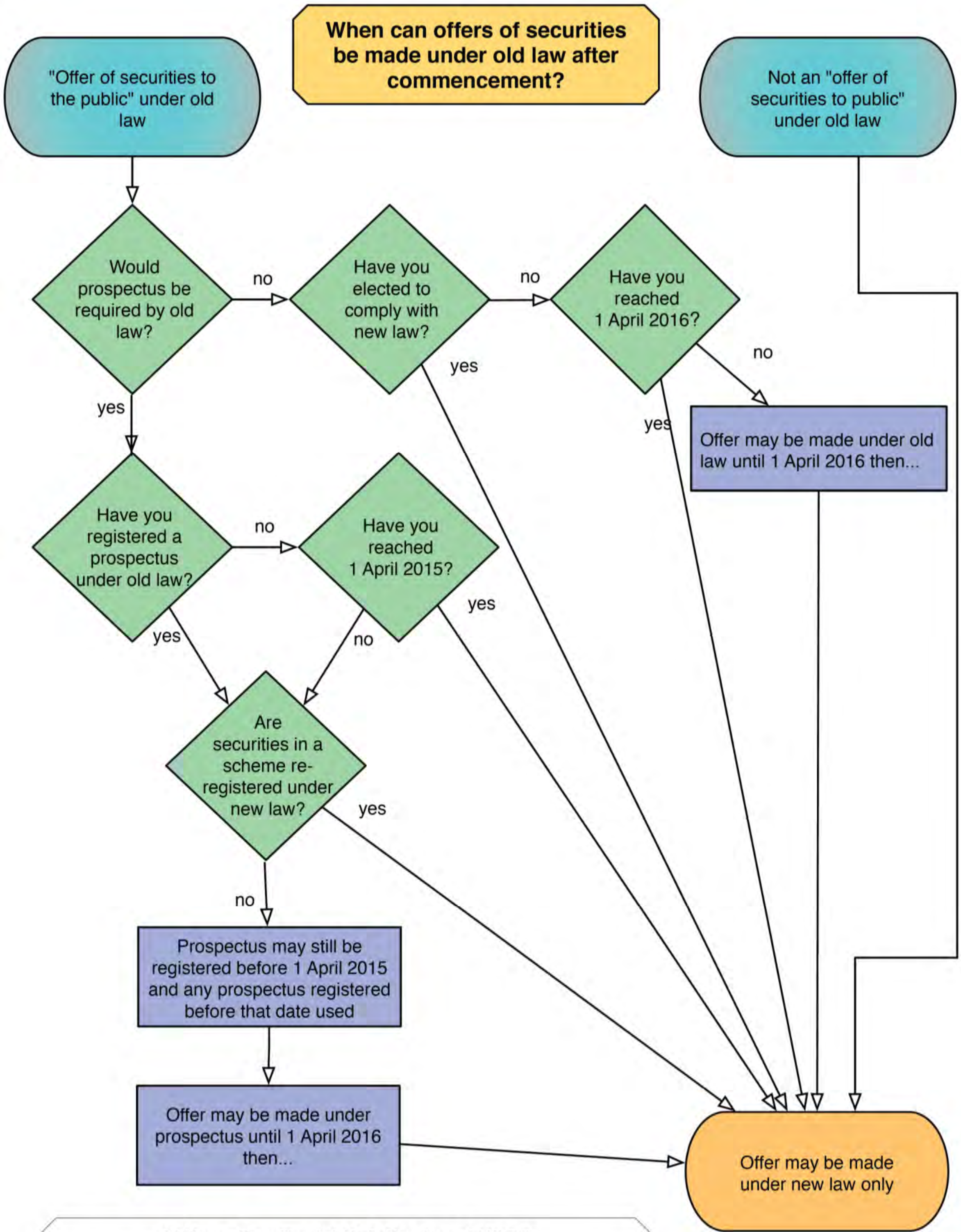
16 The Ministry is conscious that this discussion document contains a significant amount of detail. We anticipate releasing an exposure draft of the regulations around October 2013, which will provide a further opportunity for public consultation on the issues raised in this document. We also intend to undertake consumer testing on the form of disclosure documents.

How will the transition to the new regime work?

17 The FMC Bill allows for a two-year transition period during which issuers can choose to comply with the old law.

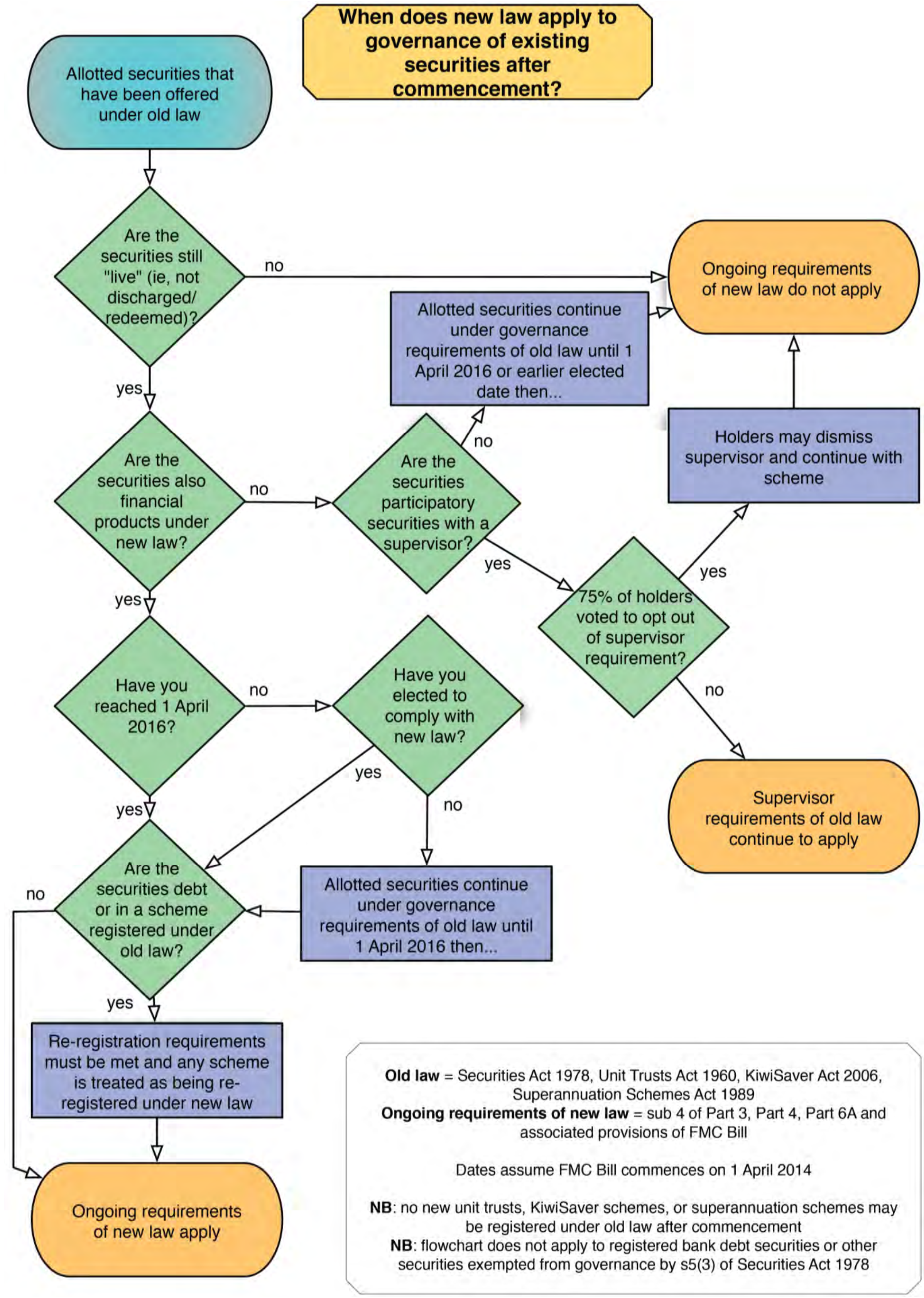
18 The flowcharts on the following pages are intended to assist users' understanding of when and how those choices may be made:

- The first chart sets out when offers of securities that have not been completed before, or begin after, the commencement of the FMC Bill may be made under the Securities Act 1978. The chart assumes that the securities/financial products would require disclosure under both the FMC Bill and the Securities Act 1978.
- The second chart sets out when the new law applies to the governance of securities that have been allotted under the Securities Act 1978 before commencement of the FMC Bill or in the transition period. This will affect the ongoing disclosure requirements, the governance requirements, and financial reporting requirements for those securities.
- Both charts are simplified versions of the transitional provisions and so should be read in conjunction with Schedule 5 of the FMC Bill.



Old law = Securities Act 1978, **New law** = FMC Bill
Dates assume FMC Bill commences on 1 April 2014

Nb: no new unit trusts, KiwiSaver schemes, or superannuation schemes may be registered under Unit Trusts Act 1960, KiwiSaver Act 2006, or Superannuation Schemes Act 1989 after commencement



Old law = Securities Act 1978, Unit Trusts Act 1960, KiwiSaver Act 2006, Superannuation Schemes Act 1989
Ongoing requirements of new law = sub 4 of Part 3, Part 4, Part 6A and associated provisions of FMC Bill

Dates assume FMC Bill commences on 1 April 2014

NB: no new unit trusts, KiwiSaver schemes, or superannuation schemes may be registered under old law after commencement
NB: flowchart does not apply to registered bank debt securities or other securities exempted from governance by s5(3) of Securities Act 1978

Ministry of Business, Innovation & Employment

Financial Markets Conduct Regulations - Discussion Paper

Chapter 1 – Disclosure

December 2012

Contents – Chapter 1

1. Introduction

1 Disclosure to investors about financial products is a cornerstone of the offer regime in the FMC Bill, and is the focus of this chapter.

2 The FMC Bill provides that a person must not make a regulated offer of financial products unless the issuer of the products has prepared a product disclosure statement (PDS) for the offer, and supplied to the Registrar the information and documents required for a register entry for the product. The regime in the FMC Bill replaces investment statements and prospectuses in the Securities Act. The FMC Bill leaves the detailed presentation and content requirements for disclosure obligations to the regulations. It anticipates a high degree of tailoring of requirements for different kinds of financial products. This chapter discusses:

- generic content and presentation requirements for PDSs
- basic PDS content for the four categories of financial products regulated by the Bill – debt securities, equity securities, managed investment products and derivatives
- shorter PDS content for some offers of financial products (e.g. offers by listed issuers or offers to existing holders)
- ongoing disclosure to keep investors informed after the products are issued
- limited disclosure for offers that do not require a PDS due to exclusions in Schedule 1.

3 We considered New Zealand and overseas material in developing this chapter, including:

- existing disclosure requirements under the Securities Act
- FMA's guidance note ***Effective Disclosure***
- Australian disclosure requirements, including ASIC guidance
- disclosure in other jurisdictions, including the European Union.

4 The discussion in this chapter envisages a disclosure model significantly different to the existing regime. Designing disclosure that is effective is challenging, but is critical to the successful operation of the FMC Bill.

5 The intention of this chapter is to start a policy dialogue on this issue and we welcome feedback on any of the issues discussed here. Following this stage, we intend to develop model documents for industry and consumer testing before finalising the regulations.

1.1 Role of disclosure regulation

6 Well-functioning capital markets create financial products that direct money to its most productive uses within an economy. The financial products themselves are an intermediary or vehicle through which businesses access capital and create jobs, and individual savers earn returns to achieve their financial goals. Well-functioning capital markets rely on the availability of good information about financial products to assist investor decision making and to ensure that risk is correctly priced. The role of disclosure regulation is to ensure the supply of meaningful and reliable financial product information.

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

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

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

1.2 Key disclosure provisions in the Bill and the function of regulations

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

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

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

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

2. PDS – basic structure and presentation

2.1 Introduction

13 This section discusses options and proposals for the basic structure and presentation of the PDS. This includes issues such as structure, length, appearance and the type of language used. Some of the content of this section will be familiar from the ***Securities Law Review*** discussion document and material associated with the development of the FMC Bill.

14 The approach that we have adopted throughout the development of the FMC Bill is that the PDS would be short and highly prescribed for mainstream products. The Capital Market Development Taskforce recommended that government "replace the investment statement and prospectus with a new, two-part disclosure document that aids understanding and comparability. The first part should be one to two pages long, and much more standardised in content and presentation than the investment statement."

15 The intention is to enable comparability between similar products and offers, while ensuring that the most relevant information is provided to investors. As discussed above, other material information must be disclosed on the offer register.

16 While the primary focus of this chapter is on the content and method of disclosure, good presentation assists with comprehension of the information presented in offer documents. As noted in the introductory section to this chapter, a common complaint concerning the current regime is that documents are too long and complex to be useful to investors.

17 FMA's guidance note ***Effective Disclosure*** released in 2012 also highlighted many of these issues. The guidance note was premised on the need for disclosure to be "clear, concise and effective". As we describe above, this is now a statutory requirement in the FMC Bill. We expect the guidance note to have even more relevance once the FMC Bill comes into force.

18 There is a balance to be struck between what is prescribed by regulation, what is dealt with by FMA guidance, and what is left to issuer judgement. Much of the research into the relationship between document presentation and comprehension can be distilled into a number of common factors that affect the readability of documents, principally vocabulary, structure, font, headings and length. We propose to prescribe the most influential of these and rely on FMA's guidance and issuers' judgement to complete the picture for investors.

2.2 Basic structure and length of the PDS

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

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

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

21 Some countries have adopted requirements for shorter disclosure, particularly for managed funds. In June 2012, Australia brought in a shorter PDS regime for superannuation, simple managed investment schemes and margin lending, designed to make PDSs shorter and simpler, and help consumers compare financial products more easily. The key features of these PDS requirements include:

- a maximum page length of 8 A4 pages (for superannuation and managed investment schemes) and 4 pages (for standard margin loans) with a minimum font size
- prescribed section headings to make it easier for consumers to find important information in the PDS and compare across products
- key content requirements to ensure that consumers are provided with the key information they need to make an investment decision
- provision for other material to be located outside the PDS document itself, but form part of the PDS through incorporation by reference
- provision for inclusion of additional information within the PDS, provided the prescribed length is not exceeded.

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

23 We intend to impose a reasonably constrained total length for the PDS for most products – particularly those that can be considered to be 'straightforward' or 'simple'. The maximum length will vary depending on the nature of the product, but will generally be in the range of 6–20 pages. We consider that this is adequate to convey the key information that prudent, non-expert investors need to know for the majority of financial products.

24 We acknowledge, however, that this approach may not be desirable for more complex products, or products that rely on relatively sophisticated analysis to make well-informed decisions, such as initial public offerings of equity securities (IPOs). We discuss the particular context of IPOs in the section on equity later in this chapter. This is not a simple matter and we are interested in feedback on this issue.

25 Given the proposed length restrictions, the content of the PDS must be restricted to enable issuers to meet the proposed length constraints. This would mean that only material prescribed by the regulations should be included in the PDS. PDSs are not generally required to contain "all material matters". We do not, however, propose to place restrictions on the information that may be uploaded to form the register entry.

1.	Are there product types that should be subject to a lesser degree of prescription in the PDS? If so, which ones, and why?

2.3 Key information summary

26 In line with the Cabinet decision and the international trends noted above, we propose that all products be required to have a key information summary at the front of the PDS. The key information summary will be highly prescribed and summarise the most important parts of the PDS. In general, we favour restricting the length of the summary to two pages. We consider that this will considerably aid investor comprehension of the key points of the product. Given its limited length, the summary will have reference to other information.

27 The opening text of the key information summary is the most important element of the PDS because it is the first, and perhaps only, disclosure that a potential investor will read before subscribing to an offer. Some investors may only get through a sentence, some a paragraph, others a page. What they see there will hopefully lead them to consider the remainder of the PDS if they are interested in the product and, if they are really keen, to look at the information on the offer register.

2.4 Font

28 Page limits may create incentives to use smaller and more compact fonts than would otherwise be selected. If the font used in the PDS is too small, there is a risk of it being difficult to read or dismissed by investors as unimportant 'legal small print'. For this reason, we propose to impose minimum font sizes for PDSs.

29 The Australian shorter PDS regime prescribes different minimum font sizes for different information. For simple managed investment schemes, the minimum font is 8 points for name, address and so forth, while the minimum font is 9 points for all other text. The EU has a more general obligation for UCITS funds, requiring characters to be of a readable size. We are attracted to the Australian model, but are interested in feedback on this issue.

30 We do not propose to restrict the typeface (e.g. Helvetica) or the font colour. The Ministry is conscious that these can have an adverse impact on readability in extreme situations, but the general requirement that the PDS be clear and effective should address this issue.

2.	Should we include a minimum font size for text in the PDS? Is the Australian model, which combines 8 and 9 point, appropriate?

2.5 Branding

31 Issuers will want to use branding, such as logos and colour schemes, in the PDS. This branding is a component of the issuer's corporate image. It allows investors to rapidly identify the issuer and may aid their understanding of the issuer's business, as well as improving the attractiveness of the PDS.

32 We do not propose to prevent the use of branding by the issuer in the PDS. We note, however, that in the UCITS context the EU requires branding to not distract the investor or obscure the text. We see some value in including a similar provision, and are interested in feedback on this issue.

3.	Is it helpful for issuers and investors to permit issuer branding and logos in the PDS? Should they be subject to any restrictions?

2.6 Additional presentational, promotional or explanatory material

33 Current disclosure documents include material that is not strictly required to comply with disclosure requirements. In some cases this is presentational material, such as photographs. Some documents include additional promotional or explanatory material, including welcome letters, extended descriptions of product benefits, and decision-making guides.

34 There is potential benefit from the inclusion of presentational material – it can make disclosure documents more attractive, and increase the likelihood that they are read. If extra promotional material is permitted in the PDS, it is more likely that the PDS will be used in the promotion of the offer. There is potential benefit from this, as it creates stronger incentives to give the PDS (including the mandatory information) before the investor makes their decision, rather than as a mere compliance measure at point of sale. It also means that the issuer faces more scrutiny and greater liability for false statements in the advertising material included in the offer document than it would for separate advertising.

35 However, extra material can obscure or distract from the information needed to satisfy mandatory disclosure requirements, making the latter less accessible to investors. In some cases promotional material is given more prominence than mandatory information. In addition, it results in much longer documents.

36 On balance we think that the PDS should be limited to information required to meet the statutory requirements. This may be achievable by simply requiring the statutory information to come first and limiting the overall length of the document. Alternatively, there could be a rule that only material prescribed by regulations can appear in the PDS. We seek comments on how restrictive the PDS regulations should be in this respect.

4.	Should the PDS contain only information required to comply with the disclosure requirements? If so, how is this best achieved? If not, should the use of additional material be restricted in some other way?

2.7 Language

37 Effective communication of financial information is difficult. A lot of jargon is used in finance, and investors have varying degrees of financial literacy and understanding. FMA's ***Effective Disclosure*** guidance note provides guidance on the use of plain language in offer documents. The guidance relates to the existing disclosure regime of prospectuses and investment statements, but the same principles apply to the presentation of offer documents under the FMC Bill given the clear, concise and effective requirement.

38 The Australian Corporations Act applies the same requirement to its PDS regime. ASIC has issued guidance, including ASIC Regulatory Guide 168 - Disclosure: Product Disclosure Statements (and other disclosure obligations). Other jurisdictions, including the United Kingdom and the EU, have also adopted plain language requirements.

39 We consider that the "clear, concise and effective" requirement and FMA guidance is sufficient regulation of language in PDSs.

40 A related presentational issue is how technical terms, where they are unavoidable, should be explained in the PDS. Common solutions include attaching a glossary, using footnotes, or 'call-outs' (similar to speech bubbles). A risk with a glossary is that it requires the reader to be aware of the glossary and to locate it, and creates a risk that the reader loses their place in the document. Footnotes or call-outs avoid this issue. Call-outs may be more consumer-friendly and less academic or legalistic in appearance.

5.	How are technical terms, where unavoidable, best explained in a PDS (e.g. glossary, footnotes or call-outs)?

2.8 Director authorisation or consent

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

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

43 Clause 47 of the FMC Bill deals with the supply of prescribed information and documents on lodgement of a PDS. Clause 47(1) requires the issuer to supply the prescribed information and documents on lodgement of the PDS. Clause 47(2) explains that this may include a copy of a prescribed person's consent to lodgement, which could include directors.

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

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

46 We consider that some level of director or board approval to lodgement of the PDS is desirable. Making a regulated offer is a significant event for an issuer, especially in the case of equity and debt issues. Requiring some form of director approval supports the policy objective that directors should supervise capital raising. We are conscious, however, that some managed fund issuers produce dozens of offer documents a year. It is possible that a lesser standard of approval should be required in that type of situation.

47 There a number of options for providing for consent:

- Require that all directors consent to lodgement. This is the Australian approach, but PDSs for most managed funds and derivatives are not required to be lodged.
- Adopt an approach based on the approval of financial statements in section 10(1) of the Financial Reporting Act 1993. This requires financial statements to be signed on behalf of the directors by two directors (or by the sole director if the entity only has one).
- Adopt the current approach to approving advertising under regulation 30 of the Securities Regulations. This is similar to the Financial Reporting Act requirements but is a personal statement of the directors and allows for agents to sign.
- Adopt an approach based on the method for entering into deeds (for example section 180(1)(a) of the Companies Act 1993). This would enable an issuer to appoint an attorney to sign on the company's behalf.
- Not specifically require directors or the issuer to consent to lodgement, and allow lodgement to be completed by any person who is authorised by the issuer.

48 In terms of form of the certifying statement, there are many options including:

- certification that disclosure meets the regulatory requirements
- certification that the directors have exercised due diligence in relation to the offer document
- certification that the financial condition of the issuer has not materially deteriorated since the date of the financial information referred to in the offer documents
- a combination of the above elements.

49 The Ministry does not have a preferred position on these issues at this time.

6. Should a director's consent be required to be lodged with offer documents? If yes, how many directors should consent, and what should their certification say?

2.9 Expiry date of PDS

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

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

52 We are interested in feedback as to whether we should prescribe an expiry date for PDSs in regulations. We are conscious that in some situations, for example continuous issues of some managed investment products, the default position in the FMC Bill will probably be adequate and will reduce compliance costs significantly. For other products, such as debt offers, there may be value in ensuring that the issuer regularly renews the PDS.

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

7.	Is there a need to specify an expiry date for PDSs? If so, what should it be and should we distinguish between products?

2.10 Other basic structure or presentational requirements

54 We welcome feedback on any additional issues that you think we should address.

8.	Are there additional presentational requirements that we should address in regulations?

3. Timing and default disclosure

55 In sections 4–7 below we focus mainly on the disclosure that would be required for 'simple' products in four categories: debt securities, equity securities, managed investment products and derivatives. The approach has been to seek to standardise disclosure to maximise comparability and ensure that disclosure is clear, concise and effective.

56 This approach may not be suited to all products. In addition, it takes time to develop good quality standardised disclosure, particularly as consumer testing is necessary.

57 In other jurisdictions, notably Australia, the drive towards standardised, shorter disclosure has been gradual and started with simple or higher priority products. A gradual approach allows development of standardised documents to be stretched out over time. This minimises the risk of reworking the requirements later.

58 A gradual approach would require default disclosure requirements. These default requirements would apply unless a specific PDS was prescribed for that product. We expect that even with a gradual approach, the initial regulations would include PDS requirements for some products, with the first chosen being those for which product disclosure is most advanced at the time the FMC Bill starts to come into force.

59 Given the limited resources of government and industry, a gradual approach could allow the initial focus to be on ensuring the FMC Bill is implemented smoothly and the subsequent focus being on unhurriedly designing the disclosure documents. This may be a more assured method of meeting the ambitious implementation timeframes discussed in the introduction section of this discussion document. The default requirements might also be necessary in cases where FMA has exercised its designation power under Part 8.

60 There would be downsides if only default disclosure was initially prescribed. There would be a cost to issuers of complying with a generic set of requirements initially, and then redesigning disclosure to comply with the specific requirements. Issuers could delay moving to the new regime to limit these costs – although other factors may have a bigger influence.

9. If government has to choose between commencing the FMC regime without a complete suite of PDS requirements (and so rely on default requirements for at least some products) and delaying commencement, which should it choose?

10. Which products should government prioritise when developing PDS requirements? Which products need to be prescribed at a minimum?

61 There are at least 3 possible approaches to prescribing default PDS disclosure.

3.1 Question and answer format – like an investment statement

62 The regulations could prescribe default disclosure comprising a series of generic questions ("What sort of investment is this? What returns will I get? What are my risks? What are the charges?") under which specific information would be required to be set out. This is the approach currently required for investment statements under the Securities Act 1978.

63 At its simplest the FMC regulations could copy the investment statement requirements, rename it a PDS and make such changes as are necessary to reflect the FMC Bill.

64 This approach has its attractions. The audience for investment statements under section 38D of the Securities Act matches that of a PDS in clause 36 of the FMC Bill. The disclosure requirements for investment statements are familiar to issuers and investors. FMA guidance on investment statements would be easy to adapt to PDSs.

65 If it were chosen, we would still need to prescribe requirements for financial information and all other material information to be included on the offer register.

3.2 Principles-based disclosure – like an Australian prospectus

66 The Australian Corporations Act does not prescribe detailed disclosure requirements for prospectuses for an offer of equity securities or debt securities. Instead, a prospectus must comply with a general disclosure test in sections 710. This test is that the prospectus must contain all the information that investors and their professional advisors would reasonably require to make an informed assessment of:

- the rights and liabilities of the securities offered
- the assets and liabilities, financial position and performance, profits and losses and prospects of the body that is to issue the products.

67 The prospectus must also contain specific disclosures, including the terms of the offer, interests and fees of certain people.

68 This principles-based disclosure in the legislation is supplemented by guidance from the regulator in the form of regulatory guides.[1] The guides include, for example, guidance on how financial information must be presented.

69 A disclosure test is attractive for default disclosure as it sets a flexible test for what must be disclosed and it would enable the regulations to be made relatively easily. However, its emphasis on the financial position and performance of the issuer may not be well suited to disclosure for managed investment products or derivatives.

70 In practice this approach leaves a lot of work to the regulator – in some respects it just shifts the work from the regulations to the regulator. The work of setting out what disclosure should contain would still need to be done.

71 The Australian general prospectus disclosure test significantly overlaps with, but is not the same as, the meaning of "material information" in clause 43 of the FMC Bill. Using a different test here could create confusion. This is not the preferred option.

3.3 Requirements-based disclosure – like an Australian PDS

72 The Australian Corporations Act takes a different approach to disclosure in the case of product disclosure statements, which are required for other financial products including managed funds and derivatives. It sets out a list of requirements in section 1013D(1), with a general disclosure test specified in section 1013E. Rules affecting the requirements are also set out in sections 1013C, 1013D(2) to (4), 1013DA and 1013F. The default legislative requirements are then adjusted by the Corporations Regulations for specific products.

73 The Ministry is wary of applying the Australian PDS principles-based test – essentially that the PDS must contain "information that might reasonably be expected to have a material influence on the decision of a reasonable person, as a retail client, whether to acquire the product". Again, this is slightly different to the all material information test in the FMC Bill.

74 Having said that, the Australian PDS requirements are an alternative starting point for default disclosure, with adjustments to reflect the different "material information" test in clause 43. The regulations could make use of the offer register, by requiring the PDS to contain specific information, with other material information to be disclosed on the offer register.

[1] See ASIC regulatory guides at http://www.asic.gov.au/asic/asic.nsf/byheadline/Regulatory+guides?openDocument.

75 This is similar to the approach to incorporation by reference used in the short form documents prescribed in the Corporations Regulations and the approach taken for other products in this discussion paper.

11.	If default disclosure is prescribed, should it be based on the current requirements for investment statements, or on Australian requirements for prospectuses or product disclosure statements? What adjustments to these requirements might be needed?

4. Debt securities

4.1 Introduction

76 A debt security is defined in the FMC Bill as a right to be repaid money or paid interest on money that is, or is to be, deposited with, lent to, or otherwise owing by any person. The borrower is the "issuer" of the debt security and is obliged to prepare the PDS.

77 In developing ideas for the content of the debt PDS, we have assumed that prospective investors will need to assess three things:

- the credit risk associated with the borrower and the securities being issued
- whether or not the credit risk is appropriately priced
- based on the above, whether the debt securities are suitable for them.

78 Non-expert investors are unlikely to perform the kinds of credit analysis that would be undertaken by a professional investor to ascertain credit risk. More realistically, non-expert investors will make investment decisions based on a relatively limited assessment of the risks involved or on the basis of external advice. External advice may be formal personalised advice (e.g. from an authorised financial adviser), or informal or class advice through media commentary, broker recommendations, etc. Where investors perform their own assessment of risk, this is likely to take into account their pre-existing perceptions of the financial strength of the issuer (based on, for example, familiarity with the issuer's brand) and credit analysis performed by others (such as credit rating agencies).

79 For many investors, the function of the PDS may be to raise 'red flags': aspects of the issuer or securities that mean they should give careful consideration to the offer, conclude the offer is unsuitable for them, or seek advice. We consider it important that the PDS identifies the areas in which such issues arise and presents them in a prominent manner.

80 The PDS proposals below also aim to provide reasonably comprehensive information from which an assessment of credit risk could be undertaken. This will include disclosure of information relating to:

- the capacity of the issuer to make the required payments, including its financial position and trends (e.g. in liquidity, profitability and leverage)
- the business of the issuer and the key drivers of its performance and repayment capacity
- the nature of the securities being offered, including seniority/subordination, and the robustness of any guarantees, collateral and other credit enhancement mechanisms
- the character of senior management and their ability to execute the business' planned activity over the repayment period.

81 An alternative would be for some of this information to be omitted from the PDS and entered into the offer register for use by more sophisticated investors and analysts.

82 We welcome views on what the debt PDS can realistically achieve for its target audience of prudent, non-expert investors, and how this should shape our design of the document.

12.	Do you have any comments of the overall objectives and approach of the debt PDS? What information is it realistic to assume that non-expert investors will be able to take into account in deciding whether or not to invest in debt securities?

4.2 Different types of debt products

83 There are a wide variety of debt products, ranging from straightforward, 'simple' debt securities to more complex products. The regime described in this chapter is primarily targeted at simple products, with some allowance made for variable interest rates and maturity dates, different levels of subordination, etc. We seek feedback on whether this approach is flexible enough to deal with all debt products. Is there a line where 'simple debt' crosses into 'complex debt' where these proposals will not work?

84 One potential example of more complex debt is the presence of a conduit issuer.[2] The special purpose vehicle is likely to be the issuer in law and be subject to the disclosure obligation. In this case the PDS should probably contain information on that entity as well as the issuer. This may simply require the length of the PDS to be increased, if the other aspects of the product are straightforward.

85 Other examples of more complex debt where the proposed PDS contents may not be appropriate could be convertible securities, or products that are designated as debt under FMA's powers in Part 8. Preference shares that are treated as debt securities may be on the boundary – the matters on which these products vary from more simple debt products may be quite simple to explain.

86 One option is to clearly differentiate PDSs between 'simple debt' which must use the highly prescribed documents, and 'complex debt' products which are able to diverge from the more prescriptive requirements in this chapter but must carry warnings that they are more complex and require them to outline how they differ from simple debt.

87 As debt securities issued by registered banks are excluded by clause 20 of Schedule 1, these requirements do not apply to banks except to the extent that the limited disclosure requirements adopt any of the same requirements (see below).

13. Do you consider that the approach outlined in this chapter is suitable for all debt products? If not, is there a point where 'simple' debt products become 'complex' debt products? What requirements should apply to 'complex' debt products?

4.3 Overview of proposed PDS content

88 In this section we propose that the PDS will cover the following matters: title, product description and warning message, issuer description, purpose of the issue, key terms of the offer, security, subordination, financial information, future vulnerabilities and risks, credit ratings, directors and senior management, trust deed, guarantees, taxes, issuer contact details, how to apply and other available information.

4.4 Title, product description and warning message

89 The first part of the key information summary is crucial, as it is the section that consumers are most likely to read. For this reason, the Ministry considers that the first sentences should contain essential information on the fundamental nature and risks of the debt product.

90 The fundamental characteristic of debt products is that they are a right to be repaid money or paid interest on money that is lent to another person. The Ministry considers that it is crucial for investor understanding that this is clearly explained at the outset.

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[2] For a definition of conduit issuer, see section 4A of the Financial Reporting Act 1993. At a basic level, a conduit issuer is a company that raises money and passes the money raised on to another company.

91 One option is for this statement to be based on a set of principles that issuers put into their own language. Another option is to prescribe language. We propose that this section consist largely of prescribed information, which may be tailored to the product in question.

92 We consider that a prescribed warning statement would be useful to investors. A statement ensures investors are aware that all debt products carry a risk that they may not be repaid if the issuer and guarantors run into financial distress.

93 We are conscious that the warning statement should not be so strong as to scare investors off the product. However, it must convey the basic risk of debt products in a simple and understandable way. More detailed information on risks of the particular product can be found further on in the PDS.

94 As discussed in section 2.1 above, we expect to refine any prescribed text on the basis of submitter feedback and consumer testing. Our initial proposal is that the PDS begin with a heading, “[name of issuer] [name of product] – key information”. Immediately below this, the following paragraph would be included, setting out in plain terms the nature of the product:

> This [name of product] is a debt security issued by [issuer]. A debt security is a loan that you give to [issuer]. In return, [issuer] promises to pay you interest and give back your money at the end of the term.

95 The second sentence may be varied by the issuer if it is not correct in the case of the product (e.g. zero-coupon bonds, perpetual notes).

96 Below this would be a prescribed warning statement:

> By investing in this product, you are relying on the creditworthiness of [issuer] [and the guarantees granted by [list of guarantors]]. If [issuer] and the guarantors get into financial trouble, then you might lose some or all of the money you invested.

14. Do you agree with our proposed approach to the opening paragraph of the debt PDS? Is there additional information that we should consider including in the first few sentences?

4.5 Issuer description

97 The PDS provides an opportunity for the issuer to provide relevant information about itself to investors. This information can play a crucial role in decision-making by investors. For this reason, the Ministry proposes that the PDS contain a description of the business of the issuer, including:

- what its business is and how long it has been undertaking this kind of business
- substantial security holders: the Ministry proposes that the issuer should list shareholders who hold 20 percent or more of the company’s voting securities before the issue
- a brief description of the activities of the members of the borrowing group during the five years prior to issue.

98 These requirements largely exist in current regulations concerning prospectuses and investment statements.

99 We consider that a one or two sentence description of the issuer’s business should also be included in the key information summary. For example: “XYZ Limited is issuing these bonds. XYZ is New Zealand’s largest manufacturer of widgets, with exports to Australia and Asia.”

15. Do you agree with the proposed approach to the description of the issuer of a debt product? Is there additional information that we should consider including in this section?

16. What information about the issuer of a debt product should be included in the key information summary?

4.6 Purpose of the issue

100 Closely connected with the description of the issuer is the purpose of the issue. We propose that the PDS include a section that describes the purpose of the issue and how it relates to the activities and plans of the business.

101 Again, we consider that a one to two sentence summary of the purpose of the issue might be included in the key information summary. For example: “XYZ Ltd intends to use the money received from this offer to pay off existing debt.”

17. Do you agree with the proposed approach to the purpose of the issue of the debt product? Is there additional information that we should consider including in this section?

18. What information about the purpose of the issue should be included in the key information summary?

4.7 Key terms of the offer

102 This is a crucial part of the PDS, as it sets out the key terms of the offer that the investor needs to know about. We propose that the information in this section be presented in a simple two-column table. We do not propose to prescribe the detailed contents of this table in the body of the PDS, although there may be merit in specifying that some terms must be included to avoid them being relegated to later in the document. Examples of such terms could include:

- any requirement for the investor to make further payments
- any fees that may be deducted from the investor’s contribution.

103 We propose that some terms also be included in a two-column table in the key information summary. These would be confined to the most essential elements of the product, for example:

Type of product	A description of the type of debt product, e.g. “Unsecured note”
Maturity	Date of maturity. If it is not a simple date, explain any terms, e.g. perpetual. If the product may be redeemed before maturity by the investor, state this and summarise the conditions under which this can occur.
Interest rate	Initial interest rate. If the debt security does not have a fixed rate of interest over its life, explain briefly how it is calculated. Identify resets if applicable.
Offer closes	Date, or identify that it is continuously offered.
Fees	If applicable, note that certain fees may be payable by the investor. Refer to further information in PDS.
Minimum investment	Minimum investment size.
Amount being sought	The minimum [if applicable] and maximum amounts being sought.

104 There may be a need to allow the inclusion of any unusual terms that must be disclosed to avoid the prescribed terms of the offer being misleading or deceptive, e.g. if interest payments may be avoided by the issuer in particular circumstances, or if the issuer has the option to redeem before maturity.

105 For relatively long-term debt (e.g. five or more years until maturity), one particular term that might need to be highlighted is whether or not the debt is proposed to be listed. The Ministry considers that the key information summary is the most appropriate place for prescribed statements concerning the ability to redeem or trade the product.

106 We propose that if a long-term product will not be listed on a regulated market, the key information summary should include a statement:

> We do not intend to list this product. The trading market for [name of product] is likely to be limited and you may not be able to sell your [name of product] before maturity.

107 If the product will be listed, we propose the key information summary include a statement:

> This product is intended to be quoted on [name of licensed market]. This means that you can sell it on the [name of market] before the end of the term if there are buyers for it.
>
> The price you get may vary depending on factors such as the financial condition of [issuer] and movements in market interest rates. You may receive less than the full amount that you paid for it. If you sell the debt, then you will receive no further payments of interest.

19. Do you agree with the proposed approach to the description of key terms in the debt PDS? Is there additional information that we should consider including in these tables?

20. Do you agree with the proposed inclusion of statements in the key information summary concerning listing of the debt? If not, are you able to provide an alternative that presents this information in a clear, concise and effective way?

4.8 Security

108 The description of security and subordination in relation to debt securities is one of the most difficult areas to convey in a way that is meaningful and informative to investors. Terms such as “first-ranking” or “secured” can be confusing to investors. We acknowledge that it is difficult to convey this information, but there may be methods of making disclosure in this area simpler to understand.

109 Current disclosure often provides considerable detail on the security for the debt product on issue. Regulation 27 of the Securities Regulations 2009 requires issuers to describe the nature and ranking in point of security of the debt. However, disclosure can fail to give the investor a sense of how far that security will go to cover losses arising out of failure.

110 The term “secured” itself can be misleading. While it has a particular legal meaning, the dictionary meaning of “secure”’ is “untroubled by danger or apprehension; safe against attack, impregnable; reliable, certain not to fail or give way.”[3] Some investors could apply the term ‘secured’ in this sense to financial products, which is obviously problematic. Some investors in failed finance companies appear to have taken more comfort from the description of their investments as ‘secured’ than was warranted in the circumstances.

111 One option is to restrict the use of ‘secured’. ASIC restricts the use of ‘secured note’ to situations where the repayment of investor money has been secured by a first ranking security interest over property of the issuer or guarantor, and the value of that property is reasonably likely to be sufficient to repay the secured notes and any other liabilities that rank equally or in priority to the secured note.[4]

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[3]The Concise Oxford Dictionary, Seventh Edition, p 950.
[4] See ASIC Regulatory Guide 69 and Class Order 12/1482.

112 In essence, this only allows the use of the term ‘secured’ where the security is likely to be sufficient to cover losses to investors. While this ties in with the common meaning of the word ‘secured’, ‘likely to be sufficient’ may actually be a fairly low threshold in practice. For example, it may mean that a 50 percent chance that the security will be sufficient is adequate. This would leave a substantial risk that it would not be sufficient.

113 Other options are not to impose restrictions or to impose stricter requirements than Australia. For example, the threshold could be raised to only allow ‘secured’ to be used when it is near certain that the security is adequate to cover all losses. At the far end of the spectrum, the use of the term ‘secured’ could be banned completely.

114 The Australian option is the Ministry’s preferred approach. We consider that this strikes an appropriate balance between reducing the possibility that investors may be misled and allowing issuers to describe their products in a technically correct way.

115 The Ministry also considers that the disclosure provided to investors should succinctly describe the assets that secure the debt. An essential element is information on the extent to which the security will actually cover losses in respect of the debt product. Where possible, this should be depicted visually. The Ministry is interested in feedback on ways that such a visual depiction would be possible.

116 There is limited space available in the key information summary to describe issues concerning security. For this reason, the Ministry proposes that the key information summary should raise the issue, and refer to further information contained later in the PDS.

21. Do you agree with our proposed approach to restricting the use of the term ‘secured’?

22. Do you agree that the key information summary contains only a simple statement raising the issue and noting that further information can be found in the PDS? If not, is there a concise way to summarise security for the purposes of the key information summary?

4.9 Subordination

117 Subordination is another aspect of debt product disclosure that appears to confuse investors. Accurate information on ranking is important for decision-making as it links to the risk that the investor will be taking on. Presently, clause 13 of Schedule 2 of the Securities Regulations 2009 provides that information must be provided in a prospectus on any securities that are secured over any assets of the borrowing group that rank ahead of the debt being offered.

118 In relation to the PDS, the Ministry is interested in feedback on simple methods of depicting subordination in a visual manner. Is there a simple method of describing where in the queue an investor would be if the issuer failed?

119 Many technical terms, such as ‘first-ranking’ or ‘subordinated’ are commonly used. We consider that these terms should be used sparingly and only in connection with simple explanations. It is crucial that investors get an accurate picture of what these terms mean in practice, and the implications should the debt product fail in any way.

120 The Ministry proposes that information on ranking should continue to be provided in the key information summary. However, like security, this is a complex issue. Again, the Ministry considers that this should consist of a brief sentence or two raising the issue, and refer to further information later in the PDS. The text could be a prescribed statement. It should identify if the issuer can issue further debt that ranks higher or equally with that offered.

23. Do you agree with the Ministry’s proposed approach to the presentation of subordination? Are there simple ways of depicting this issue visually that would better aid investors?

4.10 Financial information

121 Investors need financial information concerning the issuer in order to make an assessment of the risk of the debt product. Currently, clause 8 of Schedule 2 of the Securities Regulations 2009 provides that summary financial statements for the preceding five accounting periods must be included in a prospectus for debt products. There is no requirement to include financial statements in an investment statement.

122 FMA highlights information about debt securities that may be material in its guidance note ***Effective Disclosure*** (pages 46-50). This includes financial ratios and other information.

123 Financial statements can be difficult to understand and interpret for many investors, especially those without significant business experience. For this reason, we consider that the PDS should only contain essential financial information, and that more comprehensive financial statements should be contained on the offer register.

124 However, deciding on what is the most useful information for investors is not easy. There are a number of options for financial information in the PDS and offer register. Under any option, the Ministry proposes that the previous five years of information continue to be provided in order to give investors a sense of trends in the issuer's performance.

Option 1: All financial information on the offer register

125 The first option is to leave all financial information to the offer register, and for the PDS to just refer to the offer register. The Ministry considers that this is an unattractive option as it leaves investors with no sense of the financial performance of the issuer.

Option 2: Selected financial ratios only

126 Another option is to identify key financial ratios and require these be disclosed in a table, along with an explanation of their significance.

127 In the United States, one of the first items in a debt prospectus is a ratio of earnings to fixed charges. The SEC provides a list of items to be included in fixed charges, such as interest expensed and capitalised. Various items are included or subtracted from earnings. If the proceeds of the issue will be used to repay any of the outstanding debt and the change in the ratio would be ten percent or greater, the issuer must also include a ratio showing the application of the proceeds (the pro forma ratio).

128 A simpler interest coverage ratio (EBIT/interest) would fill a similar purpose. Other examples of ratios that could be included are an equity/total assets ratio (or alternatively a debt/assets ratio or debt/equity ratio) and a liquidity ratio.

Option 3: Selected financial information

129 A third option is to provide selected financial information from the financial statements.

130 The EU prospectuses contain up to three years of "selected historic financial information" that "must provide the key figures that summarise the financial condition of the issuer".[5]

[5] Commission Regulation (EC) No 809/2004

131 In the United States, equity and debt prospectuses must include selected financial information comprising up to five years of: net sales or operating revenues, income (loss) from continuing operations, income (loss) from continuing operations per common share, total assets, long-term obligations and redeemable preferred stock (including long-term debt, capital leases, and redeemable preferred stock) and cash dividends declared per common share. This is followed by "Management's discussion and analysis of the financial condition and results of operations" that provides a narrative discussion of trends and uncertainties.[6]

132 If this option were adopted, the selected financial information could be prescriptive (as in the United States) or more flexibility could be given to the issuer (as in the EU).

Option 4: Selected financial information and ratios

133 A fourth option is to prescribe selected financial information and extract these into some simple ratios. The Ministry is attracted to this option, as it provides some key financial information in a format that gives the investor an impression of the state of affairs of the issuer. An example of how this could look would be the following table:

SELECTED FINANCIAL INFORMATION AND RATIOS		31 March 2012	31 March 2011	31 March 2010	31 March 2009	31 March 2008
		$000	$000	$000	$000	$000
Total assets		11,000	10,300	9,600	8,900	8,200
Total liabilities	a	6,000	5,500	5,000	4,500	4,000
Shareholders equity	b	5,000	4,800	4,600	4,400	4,200
Debt/Equity Ratio	**a÷b**	**120%**	**115%**	**109%**	**102%**	**95%**
Definition - determines an entity's borrowing relative to shareholder's contribution. The higher the percentage, the more reliant the entity is on external funding and any associated interest expense burden.						
Earnings before interest and taxes	c	1,000	950	900	850	800
Interest expense	d	500	450	400	350	300
Interest coverage ratio	**c÷d**	**200%**	**211%**	**225%**	**243%**	**267%**
Definition - determines the ability of the entity to pay interest on borrowings. The lower the percentage, the lower the ability of the entity to pay interest						
Cash & cash equivalents	e	2,000	1,850	1,700	1,550	1,400
Total current liabilities	f	1,000	950	900	850	800
Liquidity Ratio	**e÷f**	**200%**	**195%**	**189%**	**182%**	**175%**
Definition - determines an entity's ability to pay off its short term debts. The higher the percentage, the higher the ability to cover short term debts.						
Net profit after tax		200	200	200	200	200

134 It may be useful to also include some cash flow information in such a table, e.g. cash flows from operating activities.

[6] Regulation S-K, Item 301 & 303.

Option 5: Summary financial statements

135 Another option is to provide for the use of summary financial statements in the disclosure documents. While this would provide more comprehensive information than the options identified above, this information may be the most difficult for many investors to understand, as well as the most lengthy.

Alternative information for non-bank deposit takers

136 Non-bank deposit takers (NBDTs) have minimum requirements in respect of some ratios in their trust deeds. These requirements provide useful benchmarks for disclosure. It may be useful if NBDTs disclosed quantitative information relating to their capital ratio, liquidity requirements, related party exposure, and loan portfolios in PDSs. The Ministry is interested in feedback on how the risk profile of an NBDT loan portfolio might be measured.

24. What is the most effective way to convey financial information about debt issuers in the PDS? What financial information should be included in the key information summary?

25. Some investors and analysts may expect to see more extensive information about the financial situation of NBDTs than other debt issuers. Some of this information may be better included on the offer register. We are interested in feedback about disclosure of financial matters for NBDTs.

26. What would be an effective method of measuring the risk profile of an NBDT loan portfolio? Is additional information on financial matters required for NBDTs?

4.11 Future vulnerabilities and risks

Form of risk disclosure

137 It is standard for disclosure documents to contain information concerning risks facing the issuer. However, risks in investment statements and prospectuses are often phrased generally. It is common to see risks expressed in terms similar to the following: “Liquidity risk – This is the risk that we encounter difficulty in raising funds at short notice to meet commitments associated with our debentures or other financial instruments. We mitigate this risk by ensuring that we have sufficient cash and other liquid assets to meet our commitments as indicated by forecasts and historic requirements.”

138 While it may be useful to identify that liquidity risk exists, this description fails to convey information about the issuer’s circumstances that may adversely affect liquidity. For example:

- Recent deterioration or other trends in the issuer’s liquidity position, such as “Our liquidity position has deteriorated in the past 24 months. Unless this is reversed through greater profitability, over the medium term we will need to sell assets or obtain new financing to maintain an acceptable liquidity position and avoid default.”
- Known and reasonably likely future events that will impact adversely on the issuer’s liquidity, such as “We have received a $5 million loan from XYZ Bank that is maturing on 31 November 2013. We expect this loan to be rolled over, but if we do not return to profitability there is a significant risk that it will need to be refinanced from other sources – such as through a further public issue of debt securities. If it is not refinanced in full, our cash position will deteriorate to the extent of any shortfall.”

139 In other words, the usual approach lacks information that would enable an assessment of how likely or unlikely it is that the risk event arises and how serious it would be. Moreover, its generality (liquidity risk is a risk for all issuers) and lack of connection to the issuer’s circumstances make it more likely to be disregarded by investors, rather than prompting them to examine this aspect of the issuer’s financial information.

140 In order for risk disclosures to inform an assessment of creditworthiness, they need to be specific to the issuer and the debt securities on offer and identify specific circumstances that might not otherwise be known to potential investors in the issuer.

141 We note that FMA's ***Effective Disclosure*** guidance note provided extensive comment on risk disclosure. The Ministry endorses FMA's approach to this issue and considers that FMA guidance will continue to play a strong role in this area.

142 The Ministry proposes that the debt PDS contain an "Issuer vulnerabilities and risks" section. The first part of this will provide a description of aspects of the issuer's business and activities that make it vulnerable to being unable to meet its obligations under the debt security. Each vulnerability must:

- be described in terms specific to the issuer, and not in terms that could apply to issuers of debt securities generally
- specify the circumstances of the issuer that give rise to the vulnerability, including any trends or known or likely future events that will increase the risk of the issuer failing to meet its obligations
- enable an assessment of the likelihood of the risk arising and the magnitude of the impact on the issuer's creditworthiness, to the extent reasonably possible.

143 The second part would discuss any additional risks not related to the issuer's ability to meet its obligations. These could potentially include "risks" relating to the nature of the product (e.g. subordinated, no ability to redeem early), or to some classes of investors (e.g. adverse tax treatment). However, while these factors form part of an overall assessment of the risks of the investment, they might be better disclosed elsewhere in the PDS where they can be explained in context – such as in the sections on subordination or tax.

Number of risks disclosed

144 Another difficulty with risk disclosure is the number of risks that are disclosed and how they are ordered. The investment statement is required to include "principal risks". The debt prospectus is not required to include a risks section, but must include "other material matters relating to the offer" which is generally taken to mean that "material risks" must be included.

145 Issuers are sometimes reluctant to judge which risks should be disclosed in the investment statement as principal risks and so repeat all risks from the prospectus in the investment statement. Many risk sections contain risks that are remote or, even if the event occurs, are unlikely to have a significant impact on the issuer's ability to meet their payment obligations. These risks may not be material, but issuers may include them just in case. The inclusion of these risks can distract investors from the more serious risks being disclosed – especially if careful attention is not paid to the order in which they are presented. They also contribute to longer disclosure documents.

146 The number of risks that will be disclosed in the PDS will be constrained by the requirement that it be clear, concise and effective, any overall length limit and by focusing the risk disclosure on specific issuer vulnerabilities. We would be interested in whether there are any additional steps that should be taken to limit the number of risks disclosed.

Inclusion of risks in the key information summary

147 As well as disclosing risks in the main body of the PDS, we consider that there should, if space permits, be some form of risk disclosure in the key information summary. This would point investors to the most important risks, give them an appreciation for the kinds of risks that they may be exposed to, and signal that further information on risks is contained in the body of the PDS.

148 An obvious difficulty is providing this information in a sufficiently concise form. One option is to limit the amount of information that is provided on each risk – perhaps to a single bullet point sentence. The number of risks could also be limited, with issuers required to make a judgement about what the most significant risks are. In considering how serious a risk is, the issuer would need to have regard to the likelihood of the risk arising and the magnitude of the impact on the issuer's creditworthiness.

27. Do you agree with the proposed focus of the future vulnerabilities and risks section? Apart from risks to the issuer's ability to meet their obligations under the debt securities, are there any other risks that should be disclosed in this section (rather than elsewhere in the PDS)?

28. Are there any additional steps that should be taken to reduce the number of risks disclosed in the PDS?

29. What risk disclosures should be included in the key information summary?

4.12 Credit ratings

149 Not every issuer will have a credit rating. However, if the issuer has a rating from an approved agency, the Ministry proposes that this information should be disclosed in the key information summary. The Ministry also considers that the absence of a rating is information that investors should be aware of. Ratings may be for the issuer or for the specific issue of debt securities.

150 The Reserve Bank currently approves credit rating agencies in respect of ratings for NBDTs, banks and insurers. The regulations could specify that another organisation, possibly FMA, could approve credit rating agencies for corporate issuers. Alternatively, there could be no approval for these agencies, with disclosure of the name of the agency in the PDS being the only requirement.

151 Many investors are unfamiliar with the terminology of credit ratings. For this reason, we consider it important that an explanatory statement accompanies the rating, and that the rating is depicted in a visual manner that provides context concerning its strength. We provide an example of this in the box below (for a Standard and Poor's rating).

A credit rating is an independent opinion of the capability and willingness of a financial institution to repay its debts – in other words, its financial strength or creditworthiness. It is not a guarantee that the product being offered is a safe investment. A credit rating should be considered alongside all other relevant information when making an investment decision.

These bonds have been rated a AA+ by Standard and Poor's. Standard and Poor's gives ratings from AAA through to CC.

<table>
<tr><th>Rating</th><th>AAA</th><th>AA</th><th>A</th><th>BBB</th><th>BB</th><th>B</th><th>CCC</th><th>CC</th></tr>
<tr><td>Strength</td><td>Extremely strong</td><td>Very strong</td><td>Strong</td><td>Adequate</td><td>Less vulnerable</td><td>More vulnerable</td><td>Currently vulnerable</td><td>Currently highly vulnerable</td></tr>
<tr><td>Historic likelihood of default over 5 years</td><td>1 in 600</td><td>1 in 300</td><td>1 in 150</td><td>1 in 30</td><td>1 in 10</td><td>1 in 5</td><td colspan="2">1 in 2</td></tr>
</table>

152 If there is no rating, then a prescribed short statement would be used, such as “Company X’s financial strength has not been assessed by an approved rating agency. This means that it has not received an independent opinion of the capability and willingness to repay its debts from an approved source.”

30.	Do you consider that the proposed approach to credit ratings is appropriate? Is there an alternative approach that you consider would be better suited to debt disclosure?

4.13 Directors and senior management

153 FMA noted in its ***Effective Disclosure*** guidance note that investors will often need to judge the capability of an issuer’s directors and senior management. The Ministry agrees that this is important information that should be disclosed. This provides the issuer an opportunity to introduce the credentials and experience of its key personnel to potential investors.

154 Clause 5 of Schedule 2 of the Securities Regulations sets out the current requirements for information that should be provided in prospectuses concerning directors. The requirements include providing their names and information concerning bankruptcy, insolvency and dishonesty convictions over the preceding five years. FMA’s guidance note provides information to issuers on how to interpret these requirements.

155 The Ministry considers that the current requirements should be clarified and extended to cover senior managers. In particular, the Ministry proposes that the current requirements concerning disclosure of negative events should be strengthened to give investors a clear picture of the background of the relevant personnel. However, the Ministry is conscious that historic events may not always be relevant to the current position or activities of the individual or issuer in question, and that caution is required to not over-emphasise these events. The Ministry is interested in feedback on whether the requirements should be strengthened.

156 There are a number of options for strengthening these requirements. The current disclosure of bankruptcy, other insolvency-related events and relevant criminal convictions is restricted to the previous five years. This time period could be extended to the previous 10 years or by requiring disclosure if the events in question have ever occurred. The requirements could be strengthened by requiring disclosure of additional events, such as being a director of an entity that failed due to insolvency, any disciplinary action by a professional body, and criminal convictions generally.

157 The Ministry’s preferred option is to require disclosure if the most serious events have ***ever*** occurred. These would be if the person in question has been adjudged bankrupt or insolvent, convicted of a crime involving dishonesty, or been prohibited from acting as a manager or taking part in the management of a body. The Ministry proposes that less serious matters should be disclosed if they have occurred within the previous 10 years. These would include where a director or senior manager has:

- been a director or senior manager of a company or business that failed due to insolvency, and their role was current at the time or within two years before that event
- had their membership of a professional organisation refused, suspended or cancelled
- been subject to civil penalty proceedings or other enforcement proceedings concerning financial markets legislation
- been the subject of disciplinary action by a licensed market or other authority responsible for regulating securities markets
- been convicted of an offence or required to pay a pecuniary penalty in respect of conduct performed as director or senior manager of an entity.

158 An issue of particular interest is the extent to which individuals should be required to disclose involvement in entities that have entered into liquidation, receivership and other forms of winding-up. Commercial entities may be wound up for many reasons, not all of which involve insolvency. The Ministry considers that disclosure requirements should target the situation of entity failure due to insolvency.

159 A further issue concerns changes to directors and senior managers. This is an area of particular interest to continuous issuers, which may wish to use a PDS for an extended period. Currently, issuers note in their investment statements that directors may change, and that up-to-date information may be found on the Companies Office website.

160 The Ministry anticipates that this practice will continue under the new regime, and that issuers would only change the PDS if the change of director or senior manager was material. The Minister notes that it proposes that the names of these individuals will also be accessible via the offer register (in the case of company directors by ‘clicking through’ to the companies register). This may provide sufficient incentive to ensure the PDS is kept up to date in respect of material changes to personnel.

31. Do you consider that the proposed approach to disclosure of information concerning directors and senior managers in the debt PDS is appropriate?

32. What adverse information about directors and senior managers should be in the PDS?

33. What should happen when the directors or senior managers change? Is it sufficient to refer to up-to-date information available through the offer register?

4.14 Trust deed

161 The FMC Bill envisages a continuation of the current regime whereby debt securities require a trust deed. Currently, clause 14 of Schedule 2 of the Securities Regulations 2009 sets out the prospectus disclosure requirements in relation to information concerning trust deeds.

162 The Ministry proposes the PDS should include:

- a standardised paragraph setting out what the trust deed and trustee do
- the date and particulars of the parties to the trust deed
- a brief description of any terms of the trust deed that impose limitations: on the creation of new mortgages or charges ranking in point of security ahead of, or equally with, any mortgage or charge securing the securities being offered; or any ratio of liabilities, or any class of liabilities, to assets, or any class of assets, of the issuer
- a note that a copy of the trust deed is held on the offer register.

163 The trust deed itself will be held on the offer register. This will provide those who are interested with the opportunity to examine this document.

34. Do you agree with the content of the proposed section on the trust deed?

4.15 Guarantees

164 Debt issues may be guaranteed. If this is the case, it is important investors are aware of the nature of the guarantee to be able to factor this into their risk assessment of the product. Investors need to have a good understanding of who the guarantor is and their ability to be able to pay the guarantee if called on.

165 Clause 4 of Schedule 2 of the Securities Regulations 2009 sets out the current requirements for disclosure in prospectuses in relation to guarantors. The Ministry considers that the existing requirements target the necessary information fairly accurately, and proposes to carry over the essence of these requirements. The Ministry is interested in feedback on whether this is the appropriate information to be disclosed in this area.

166 We propose that this section should contain the following information:

- name of the guarantor
- nature and amount of the guarantee
- whether or not the guarantee is subject to conditions and, if so, the principal conditions
- whether or not the guarantee is secured by a mortgage or other charge and, if so, the nature and amount of the charge
- if the guarantor and the issuer are associated persons, a statement to that effect and the nature of relationship
- amount of the net tangible assets of the guarantor in its most recent financial statements
- whether there are contingent liabilities that could materially affect those net tangible assets
- whether the financial statements of the guarantor are available and, if so, where.

35.	Do you consider that the proposed approach to disclosure of guarantees in the debt PDS is appropriate?

4.16 Taxes

167 The Ministry considers that it is important that investors are aware of taxation issues that may affect the return on their investment. The Ministry proposes that the PDS should contain one or two sentences stating how taxes may affect returns, and a reference to the Inland Revenue Department website where additional information may be obtained.

36.	Should the PDS contain a short statement on taxation?

4.17 Issuer contact details

168 It is likely that some investors may want to contact the issuer. For this reason, it is important that the PDS contain the contact details of the issuer. The Ministry proposes that these be the phone number, mail address, website and email contact details of the issuer. This section should also include information about any relevant dispute resolution schemes.

169 The Ministry proposes that contact details for others involved in the offer, such as directors, auditors and solicitors not be contained in the PDS. It is not clear that contact details for these people and entities are useful for investors. However, the Ministry is interested in feedback on this approach.

37.	Should the PDS contain contact details for the issuer? Should it contain contact details for others involved in the offer? Is the offer register the appropriate location for this information?

4.18 How to apply

170 It is crucial that investors know how to apply for the product in question. The Ministry proposes that the PDS contain a short statement setting out how to apply for the product. In most cases we expect an application form will be attached to the PDS to take advantage of the presumption in clause 39 of the FMC Bill that the investor has received the PDS.

38.	Should the PDS contain information on how to apply for the product? Will an application form always (or almost always) be attached to the PDS?

4.19 Other important information available

171 We consider that that it would be useful for the PDS to identify where investors may find some other key documents. We propose that the PDS lists items that the issuer is required to make publicly available, along with a short statement that identifies where the documents may be accessed. The Ministry considers that the most relevant information would be:

- ongoing event and periodic disclosures
- information required to be made available to investors on request
- the information available on the offer register
- financial statements.

39.	Do you consider that it is useful for the PDS to contain a list of other important information? If so, is there any other information that should be referred to?

4.20 Is any additional information required in the PDS?

172 We are interested in feedback on whether additional items should be included in the PDS. Please describe how these additional items would be useful to retail investors and indicate whether they should be referred to (or placed in) the key information summary.

40.	Should the debt PDS contain any additional items? Should they be placed in the key information summary or the body of the PDS?

4.21 Content of the offer register

173 As described above, the FMC Bill envisages that a significant amount of material will be contained on the offer register. Chapter 2 discusses different approaches to including information from the PDS on the offer register so that it can be searched, filtered and extracted. Along with information from the PDS, the offer register will contain information and documents specified by regulations, and all additional material information relating to the offer that is not contained in the PDS.

174 The Ministry has identified some information that it considers should be contained on or linked from the offer register. This is fundamental information concerning foundation documents or other material matters concerning the issuer, but which is either too technical or not of high enough importance to be in the PDS. Many of these come from existing requirements for prospectuses:

- the trust deed for the debt product
- a statement from the trustee that the offer of securities complies with any relevant provisions of the trust deed and that the trustee does not guarantee the repayment of securities or payment of interest on the securities
- a link to the issuer's constitution and a description of any restrictions it places on the business of the issuer
- financial statements and financial information or links to them – we propose that the existing requirements in clauses 8 and 16-18 of Schedule 2 of the Securities Regulations be continued for the purposes of this aspect of the offer register
- details of material contracts over the preceding two years – this reflects the existing requirements in Regulation 18 and clause 10 of Schedule 2 of the Securities Regulations

- a description of the costs and expenses associated with making the issue
- an auditor's report based on the existing requirements in clause 22 of Schedule 2 of the Securities Regulations, including statements on:
  - work done by the auditor
  - the scope and limitations of the audit
  - whether in the auditor's opinion proper accounting records have been kept
- any consents and certificates from the directors required by the regulations
- information concerning an NBDT's compliance with prudential requirements relating to capital ratios, related party exposures and liquidity.

175 The Ministry is interested in feedback on the items that should be specified as having to be included on the offer register.

41.	What information and which documents should be required to be placed on the offer register?

5. Equity securities

5.1 Introduction

176 The Ministry noted in its August 2010 discussion paper ***Review of Securities Law*** that specifying the information that an investor needs before making a decision on whether to subscribe to an offer of equity securities is not an easy task.

177 Returns rely on the success of the issuer as a whole, not just on its ability to deliver a particular service (as with an offer of managed investment products) or to meet specific obligations (as with an offer of debt securities). Its success depends on a wide range of factors, including its business model, competitive strategy, management capability, and the economic conditions in the relevant industry and wider economy.

178 If the offer is an IPO, disclosure documents should not only discuss the offer itself and the financial position of the business, but also present the firm's value proposition, future plans, competitive threats, and other inputs into its valuation.

179 The non-expert investors who are the intended audience of the PDS are, by definition, not equities analysts. Non-expert investors may make a limited assessment of the prospects of the issuer, but are likely to be somewhat reliant on commentary, valuations, investment decisions and advice from others. Often these broader market mechanisms will mean that securities issues are fairly priced, and outright 'dogs' fail to attract minimum subscriptions. However, non-expert investors are vulnerable to mispriced offerings and may misread signals such as the prominence and longevity of the issuer's brand.

180 We consider that the PDS for equity securities should attempt to provide a reasonably comprehensive basis for an investment decision. It is difficult to specify in advance what is needed for any given investor to make an informed decision for any given offer. For this reason, the Ministry considers that the PDS for equity securities will often need to be longer than for other financial products, particularly for an IPO.

181 In section 8 below we discuss the possibility of shorter documents for offers to existing investors or further offers of listed securities.

42. Do you have any comments on the overall objectives and approach of the equity PDS? What information is it realistic to assume that non-expert investors will be able to take into account in deciding whether or not to invest in equity securities?

5.2 Options for the content of an initial public offering PDS

182 The overarching standard in the FMC Bill for disclosure to be clear, concise and effective applies to IPOs as it does to all products. However, it is challenging to create disclosure documents for IPOs that are concise and yet still provide enough information to decide whether or not to invest. At present, it is common for IPOs to be offered through combined investment statements and prospectuses with extensive additional material. The resulting documents are lengthy – often well in excess of 100 pages. Producing them is time-consuming and expensive.

183 The Ministry is conscious that New Zealand PDSs may be used for overseas offers through mutual recognition arrangements. In these cases, the PDS must meet market expectations and requirements in other countries.

184 The Ministry considers that these factors, along with the considerations discussed in the introduction, mean that the PDS for an IPO will necessarily be longer than for other product types. However, we consider that as a general proposition, equity securities should be subject to the basic disclosure structure that we have outlined in this chapter – a PDS (including a short key information summary) targeted at prudent, non-expert investors, with additional information on the offer register.

185 There are a number of options for the content of the PDS for IPOs, including:

- adopting requirements similar to the current investment statement
- adopting requirements similar to the current equity prospectus
- combining and cherry-picking from current investment and prospectus requirements
- adopting an approach based on the prospectus disclosure required in Australia or by the EU in the EU Prospectus Directive.

186 The last option involves longer documents analogous to the current New Zealand prospectus requirements. In the case of Australia, the prospectus' target audience is investors and their professional advisers.

187 The Ministry's initial view is that cherry-picking current investment and prospectus requirements is likely to be the option that is most effective for IPOs, but is interested in feedback. Whatever approach is taken, a key information summary will be required to provide a snapshot summary for investors.

43.	What should the basic approach to disclosure be for equity IPOs? Should there be a prescribed length for IPO disclosure documents?

5.3 Overview of proposed PDS content

188 In this section we propose that the PDS will cover the following matters: title, product description and warning message, issuer description, purpose of the issue, key terms of the offer, future vulnerabilities and risks, key financial information, credit rating, directors and senior managers, capital structure, dividend policy, taxes, other important information available, issuer contact details and how to apply.

5.4 Title, product description and warning message

189 In line with the proposal for debt above, we propose that PDSs start with a short key information summary. Again, we note that the first part of this is crucial, and the Ministry considers that the first sentences should contain essential information on the fundamental nature and risks of the equity product in question.

190 In the case of equity, we consider that a fundamental characteristic is that the investor receives a stake in ownership of the company. We also consider it important that the statement include a description of the nature of potential returns from equity.

191 In line with the section on debt, our initial proposal is that the PDS begin with a heading "[name of issuer] [name of product] – key information". Immediately below this, the following paragraph would be included, setting out in plain terms the nature of the product:

> These are [***name of product, e.g. ordinary shares***] in [***issuer***]. [***Product***] give you a stake in the ownership of [***issuer***]. You could receive a return if [***issuer***] becomes more valuable, and you may also receive dividends, if it decides to pay them.

192 Below this would be a prescribed warning statement:

If [***issuer***] runs into financial difficulties and is wound up, shareholders will only be paid after all other creditors have been paid resulting in you losing some or all of the money you invested.

193 Again, we expect to refine any prescribed text on the basis of submitter feedback and consumer testing.

44.	Do you agree with the proposed approach to the first section of the equity PDS? Is there any additional information that we should consider including in this section?

5.5 Issuer description

194 As we noted in the equivalent section on debt, the PDS provides an opportunity for the issuer to provide relevant information about itself to investors. This is even more essential for equity issues, where the investor is buying a stake in the ownership of the company. The Ministry proposes that the PDS contain a description of the business of the issuer, including:

- what its business is and how long it has been undertaking this kind of activity
- the substantial security holders: we propose that the issuer should list shareholders who hold 20 percent or more of the company's voting securities before the issue
- a description of activities of members of the issuing group in the five years prior to issue.

195 These requirements largely exist in current regulations concerning prospectuses and investment statements. We also consider that a one to two sentence description of the issuer's business should also be included in the key information summary.

45.	Do you agree with the proposed approach to the description of the issuer? Is there additional information that we should consider including in this section?
46.	What information about the issuer should be included in the key information summary?

5.6 Purpose of the issue

196 The purpose of the issue is crucial to investor decision-making – how is the equity being raised from investors going to be used, and how will this improve the issuer's ability to generate returns? In line with the debt section, we propose that the PDS describes the purpose of the issue and how it relates to the activities and plans of the issuer.

197 We also consider that the key information summary should include a one to two sentence summary of the purpose of the issue. For example: "XYZ Ltd proposes to use the money received from this offer to expand its factory to enable it to increase production for export."

47.	Do you agree with the proposed approach to the description of the purpose of the issue in the equity PDS? Should additional information be included?
48.	Should the key information summary include information about the purpose of the issue?

5.7 Key terms of the offer

198 The Ministry proposes to follow the same pattern as the debt PDS in relation to the key terms of the offer. Again, the Ministry proposes that this information be contained in a table to aid comprehension by investors. The table should contain the terms of the offer that can be presented in a standard form, including: the class of the equity securities, the price, the offering period, investor eligibility, any fees that apply, the amount being raised and the minimum subscription.

199 The Ministry considers that there is additional information on the offer that should be included in this section outside of the table. This includes information on whether or not the product will be quoted on a licensed market. If the offer is for shares that are not intended to be listed, we consider the implications of this need to be made clear.

200 Given the importance of this information, we propose that some terms also be included in a two-column table in the key information summary. These would be confined to the most essential elements of the product, for example:

Type and class of product	A description of the class of the share on offer and any special features of that class
Price	A description of the price or other consideration to be paid or provided for the securities being offered, if this is a fixed amount. If this is not a fixed amount, a description of the manner by which that amount will be determined.
How much is being raised?	How much is the issuer raising?
Who is offer being made to?	Describe who is eligible to participate in the offer. This line may be omitted if the offer is available to investors in New Zealand generally.
Fees	Describe any fees payable by the investor. This line may be omitted if the investor will not have to pay any fees.
How to sell or exit the product	If the product may be redeemed, state the conditions under which this can occur.

201 There are some key terms we do not propose to include in the key information summary, although they must be known by investors in order to participate in the offer. These include the dates over which shares will be offered, issue date, listing date and the minimum investment.

202 Our reasoning is that investors will need to find out much of this information to participate and will have strong incentives to source it from the body of the PDS, whether or not it is highlighted in the summary. It is less important for weighing the risks and potential returns of the shares on offer, and so its inclusion in the summary may be an unjustified use of scarce space. A contrary argument would apply where a term is so important for gaining an overall appreciation of the nature of the offer that its omission from the key information summary will be detrimental to investors making sense of the summary.

49. Do you agree with the proposed approach to the description of key terms in the equity PDS? Is there additional information that we should consider including? Are there terms that should be omitted from the PDS, and left to the offer register?

50. What terms should be included in the key information summary?

5.8 Risks to the business and its plans

203 Risk disclosure is one of the most important and challenging sections of the equity securities PDS. The current equity prospectus must include “material information that may be relevant to [the] trading prospects” of the issuing group. This includes “a description of all special trade factors and risks that are not mentioned elsewhere in the prospectus; and are not likely to be known or anticipated by the general public; and could materially affect the prospects of the issuing group”.[7]

204 In the United States, prospectuses must include “a discussion of the most significant factors that make the offering speculative or risky”. SEC rules state:

> This discussion must be concise and organized logically. Do not present risks that could apply to any issuer or any offering. Explain how the risk affects the issuer or the securities being offered.[8]

205 The EU Prospectus Regulation requires “Prominent disclosure of risk factors that are specific to the issuer or its industry in a section headed ‘Risk Factors’”.

206 The Ministry’s proposal for this section is similar to the “Future vulnerabilities and risks” section in the debt PDS. It is important that investors have an understanding of the basic risks facing the company so that they can accurately judge the risk they would be taking.

207 The Ministry proposes that the equity PDS contain a section headed “Risks to the business and its plans”. This will provide a description of aspects of the issuer’s business and environment that pose a material risk to its future performance or to its stated plans. As with debt, we consider that to be useful, these must identify specific circumstances that might not otherwise be known to potential investors in the issuer. We propose that each risk must:

- be described in terms specific to the issuer, and not in terms that could apply to issuers of equity securities generally
- specify the circumstances of the issuer that give rise to the risk, including any trends or known or likely future events that will increase the risk in question
- enable an assessment of the likelihood of the risk arising and the magnitude of the impact on the issuer’s performance, to the extent reasonably possible.

208 With regard to the number and order of risks that should be disclosed, the Ministry notes the discussion in the debt section above. The number of risks that will be disclosed will be constrained by the clear, concise and effective requirement, any overall length limit and by focusing the risk disclosure on specific issuer vulnerabilities. We would be interested in whether any additional steps should be taken to limit the number of risks disclosed.

209 As with our proposals on debt, we consider that there should be some form of risk disclosure in the equity key information summary. Again, this would point investors to the most important risks, give them an appreciation for the kinds of risks that they may be exposed to, and signal that further information on risks is contained in the body of the PDS.

51. Do you agree with the proposed focus of the risks section?

52. What risk disclosures should be included in the key information summary?

[7] Securities Regulations 2009, Schedule 1, clause 10.
[8] Regulation S-K, Item 503, http://www.ecfr.gov/cgi-bin/text-idx?c=ecfr&rgn=div5&view=text&node=17:2.0.1.1.11&idno=17#17:2.0.1.1.11.6.31.3.

5.9 Key financial information

210 Schedule 1 of the Securities Regulations contains the current requirements for providing financial information in prospectuses. These requirements include summary financial statements for the last five accounting periods, and prospective information in the case of IPOs. The summary financial statements must comply with FRS-43, apart from omitting certain comparative information and events occurring after the balance date of a period.

211 The Ministry's proposals for equity correspond with those proposed for debt. For the reasons noted in that section, we consider that comprehensive financial statements are generally best placed in the offer register. The Ministry proposes that only key financial information be placed in the PDS.

212 It is challenging to identify the financial information that is most important to an investor's assessment of company's financial performance and prospects. As with debt, the existing summary financial statement requirements are a possibility, but shorter and more selective financial information may be desirable.

213 We identified some potential options in relation to debt securities above which may also be applicable to offers of equity securities:

- having all financial information in the offer register and none in the PDS
- including selected financial ratios in the PDS
- including selected financial information in the PDS
- including selected financial information and ratios in the PDS.

214 We seek feedback on the financial information that should be included in equity PDSs, including the content of this information and the time periods for which it should be offered. The selected information for equity securities may differ from debt securities. For example, we propose that historic dividend yields, earnings per share and price earnings ratios would be required.

53. What financial information should be included in an equity PDS?

54. What financial information should be included in the key information summary for an equity security?

5.10 Directors and senior managers

215 Investors in equity securities place significant reliance on the ability of directors and senior managers to run the company in a manner that will make their investment worthwhile. For this reason, the Ministry considers that it is essential that the PDS contain information on the background of directors and senior managers.

216 The Ministry described its proposed approach on this issue in the debt PDS section above. The Ministry considers that this approach should also be employed with respect to the equity PDS, but is interested in feedback from submitters on whether it is appropriate.

55. Do you consider that the proposed approach to disclosure of information concerning directors and senior managers in the equity PDS is appropriate?

5.11 Capital structure

217 The Ministry considers that it is crucial that potential investors understand the rights and priority (in liquidation) of the equity securities on offer, compared to other equity securities that have been issued or that may be issued in future.

218 The Ministry proposes that the PDS should contain a description of the effect of the offer on the issuer's capital structure. This would allow the investor to get a before-and-after understanding of the impact of the issue on the capital structure of the issuer.

219 We propose that this section should identify, in the case of an offer of voting products, any person who proposes or is likely to hold 20 percent or more of the securities following the issue. This requirement enables existing and prospective investors to consider whether to invest when someone may gain significant influence as a result of the offer. The thresholds would be aligned with the 20 percent threshold under the Takeovers Code.

220 The Ministry also considers that the essence of the current requirements in clause 14 of Schedule 1 of the Securities Regulations in relation to options should continue. This would require issuers to provide a description of any options that have been granted to, or that are proposed to be granted to, other people.

56. Do you agree with the proposed approach to capital structure disclosure for an equity PDS?

57. Should the PDS include information about persons who may gain a significant influence as a result of an offer, based on Takeovers Code thresholds?

5.12 Dividend policy

221 The payment of dividends can play a significant role in investor decision-making concerning investment in equity products. The Ministry proposes that the PDS should contain a short description of the issuer's dividend policy, including a summary of future intended dividend payments. If the issuer does not intend to pay dividends, then this should be stated.

58. Do you agree with the proposed approach to disclosure of the issuer's dividend policy?

5.13 Taxes

222 As with the debt PDS, the Ministry proposes that the PDS should contain one or two sentences stating what taxes may affect returns, and a reference to the Inland Revenue Department website where additional information may be obtained.

59. Do you consider that the PDS should contain a short statement on taxation?

5.14 Other important information available

223 The Ministry considers that the PDS should identify where investors may find additional key documents. In line with our proposal for the debt PDS, we propose that the PDS should list items that the issuer is required to make publicly available, along with a short statement that identifies where the documents may be accessed.

224 The Ministry considers that the most relevant information would be:

- ongoing event and periodic disclosures
- information that is required to be made available to investors on request
- a description of information that is available on the offer register
- financial statements.

60. Do you consider that it is useful for the equity PDS to contain a list of other important information that is available? If so, what are the appropriate documents?

5.15 Issuer contact details

225 This section aligns with the equivalent section in the debt PDS. The Ministry proposes that the phone number, mail address, website and email contact details of the issuer be listed in the PDS, together with details of any relevant dispute resolution schemes.

61.	Should the PDS contain contact details for the issuer? Should it also contain contact details for others involved in the offer? Is the register the appropriate location for this information?

5.16 How to apply

226 The Ministry proposes that the PDS should contain a short statement setting out how to apply for the product.

62.	Do you consider that the PDS should contain information on how to apply for the product? Will application forms be used for equity?

5.17 Is additional information required in the PDS?

227 We are interested in feedback on whether additional items should be included in the PDS. Please describe how these additional items would be useful to retail investors and indicate whether they should be referred to (or placed in) the key information summary.

63.	Should the equity PDS contain any additional items?

5.18 Content of the offer register

228 The FMC Bill envisages that a significant amount of material will be contained on the offer register. Chapter 2 discusses different approaches to including information from the PDS on the offer register so that it can be searched, filtered and extracted. The offer register will also contain information and documents specified by the regulations, and all additional material information relating to the offer that is not contained in the PDS.

229 The Ministry has identified information that it considers should be contained on the offer register. Many of these come from existing requirements for prospectuses:

- a link to the issuer's companies or other register details
- financial statements and financial information or links to them, based on the existing requirements in clauses 9-12 and 22-24 of Schedule 1 of the Securities Regulations
- details of material contracts over the preceding two years, based on the existing requirements in regulation 18 and clause 17 of Schedule 1 of the Securities Regulations
- a description of the expenses associated with making the offer
- an auditor's report based on the existing requirements in clause 28 of Schedule 2 of the Securities Regulations

230 The Ministry is interested in feedback on the items that should be specified as having to be included on the offer register, and whether the existing requirements noted above should continue.

64.	What information and which documents do you consider should be required to be placed on the offer register for equity PDSs?

6. Managed investment products and DIMS

6.1 Introduction

231 Managed investment schemes usually operate by pooling money from a number of investors, which is invested by a fund manager. Investors benefit from the expertise of the fund manager and from the economies of scale that come from dealing with a larger pool of assets. Having a larger amount of money to invest also means the fund manager can access investment options that might not be available to an individual investor. KiwiSaver schemes and unit trusts are familiar examples of managed investment schemes.

232 Depending on how a managed investment scheme is structured, it may hold a single pool of assets on behalf of all its investors, or its assets could be divided into multiple funds, with each held by a different set of investors.

233 As noted in the introductory section of this chapter, a number of countries and jurisdictions, including Australia, Canada and the EU, have prescribed new disclosure requirements for managed investment schemes. Many of these require shorter and simpler disclosures for investors that ease comparisons between products. We have drawn on these developments and recent policy development with respect to KiwiSaver periodic disclosure where appropriate.

234 Chapter 4 of this discussion document contains further information and proposals on regulations concerning governance requirements for managed investment schemes. As there are many links between governance and disclosure requirements, we recommend that this section and Chapter 4 be read in conjunction with each other.

6.2 General issues

Differentiation between types of managed investment products

235 Our basic philosophy for managed investment disclosure is that, where possible, the PDS requirements will be relatively prescriptive. This will include specified headings and ordering, prescribed content, and page limits. We anticipate that this will be most pronounced for 'vanilla' schemes, such as most KiwiSaver schemes.

236 However, when considering options for managed investment disclosure, there is potential to differentiate requirements for different kinds of managed investment schemes. Our motivation here, as elsewhere, is to ensure that disclosure requirements are appropriately tailored to products, so that the information presented is relevant to investors and readily comparable within a class of similar products.

237 There are a number of ways that these product classes could be defined.

238 Australia has developed a shorter PDS regime for superannuation, simple managed investment schemes and margin lending. Simple managed investment schemes are defined as registered managed investment schemes that invest at least 80 percent of their assets in certain liquid assets.[9] Other managed investment schemes continue to comply with the generic PDS requirements in the Corporations Act Part 7.9 (comparable to our current investment statement requirements).

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[9] Certain bank accounts or deposits, or in investments which the responsible entity can reasonably expect to realise at their market value within 10 days. See http://www.asic.gov.au/asic/asic.nsf/byheadline/Shorter-PDS-regime--Superannuation-managed-investment-schemes-and-margin-lending?openDocument.

239 Our starting point is to differentiate between open-ended (continuously offered and redeemed at net asset value) managed investment products and closed-ended (largely one-off) investments. Many unit trusts, superannuation, and KiwiSaver schemes would fall within the open-ended class. Forestry partnerships and property syndicates are common examples of closed-ended schemes, but so are some listed unit trusts that hold mainly financial assets. The precise boundary may be more easily defined once proposals for disclosure requirements are formulated.

240 From this starting point, regulations are likely to differentiate PDS requirements further within a class. In this section, we propose generic disclosure requirements for a vanilla open-ended managed investment product and highlight areas where customised requirements could apply. We would particularly appreciate feedback on the best approach to defining product classes and options for customising the PDS.

65. Should we customise disclosure requirements for different classes of managed investment product? What basis could we use to distinguish between classes of managed investment product, and even within classes?

Scheme-level vs fund-level disclosure

241 A key issue is in what circumstances PDS disclosure for managed investment products should cover an entire managed investment scheme, and in what circumstances a PDS should be restricted to covering one or more individual funds within a scheme. Before discussing this issue, there are some tricky conceptual distinctions that need to be made.

242 The FMC Bill requires that a PDS be prepared for an “offer” of financial products (clause 35) and be given before the products are applied for, issued or transferred (clause 37). These financial products include a “managed investment product”, which is defined as a right to participate in, or receive, financial benefits from a managed investment scheme (clauses 8(1B) and 9(1)). A managed investment product is generally “issued” to a person when it is first issued, granted or otherwise made available to a person (clause 10(1)). However, a managed investment product that is an interest in a superannuation or KiwiSaver scheme is issued when the person becomes a member of the scheme (clause 10(2)).

243 The implication of this is that a “managed investment product” could be taken to refer to:

- an interest in an individual fund of a managed investment scheme
- package of funds within a scheme, or
- the scheme as a whole.

244 Similarly, regulations can prescribe that each PDS will cover a single fund, part of a scheme, or the scheme as a whole.

245 Where possible, we think that fund-level disclosure is preferable to scheme-level disclosure, as it is likely to result in shorter and simpler disclosure documents with a better defined scope.

246 However, for superannuation and KiwiSaver schemes, all funds are taken to be issued to the person at the time they join the scheme. This implies that, for superannuation and KiwiSaver schemes at least, the investor will need to receive a PDS, or PDSs, that relate to the scheme as a whole before they join.

247 One option is to produce separate PDSs for each fund. However, there would be significant duplication of information for PDSs relating to different funds within a scheme. And where a product includes options for switching between funds (or automatic switching in a lifecycle fund), PDS disclosure purely at a fund level would seem inadequate for potential investors.

248 One potential solution is to provide short disclosures for the individual funds (perhaps based on the most recent periodic disclosure), along with information about the scheme as a whole.

249 Another option is for the PDS to include information about the scheme and one of the funds, with information about the other funds incorporated by reference and available on the offer register. This is the Australian approach – where the PDS for a simple managed investment scheme must include information about the balanced fund by default (see Schedule 10E of the Corporations Regulations 2001). However, not having information about the other funds may result in a misleading presentation of the scheme and the options available, especially for schemes where there is not a dominant fund (unlike superannuation schemes in Australia, which often have balanced funds as the default and most prominent option).

66. Are there examples of types of managed investment products that obviously require disclosure at fund or scheme level? If a PDS is required to be at a scheme level, how are the overall content principles best met (e.g. short key information summary, and clear, concise and effective overall)?

Relationship between PDS and ongoing disclosure requirements

250 We set out proposals for ongoing disclosure by managed investment schemes below. The kinds of things that could be disclosed in the ongoing disclosure statements (returns, fees charged, assets) are equally important for pre-sale disclosure in the PDS.

251 This opens up the opportunity to leverage off the ongoing disclosure obligations to reduce the burden of PDS requirements for certain product classes. One option is to set many of the content requirements to be the same, so that information from the periodic disclosure statements can be copied into the PDS without modification.

252 A more ambitious option is to make the PDS disclosure requirements include a requirement to give certain prescribed pre-sale disclosure information and the latest periodic disclosure statement. Under this approach, the PDS would be a stapled disclosure document comprising initial and ongoing disclosure.

253 Whether these options are practical depends on decisions made on the preferred content of the PDS and ongoing disclosures, which are discussed in the following sections.

67. Where do you see potential to align initial and ongoing disclosure requirements? Are there practical problems with the PDS for an open-ended scheme to comprise information about the fund together with a quarterly or annual disclosure statement?

6.3 Overview of the content of the managed investment product PDS

254 This section discusses options and proposals for the content of the PDS. It is mainly designed for interests in open-ended managed investment schemes. However some of it is likely to be relevant to closed-ended schemes also. As with the products noted above, we have tried to identify the most important information that investors should be aware of.

255 This section discusses the content of a fund-level PDS. We do not make proposals for how this information would need to be organised where a PDS covers multiple funds in a scheme. This will depend on how the structural issues discussed above are resolved.

256 We propose that the PDS cover: title, product definition, and warning, fund manager, product description, fees and costs, taxation, risk, past performance and how to apply.

6.4 Title, product definition, and warning

257 The opening text of the PDS is the first information that potential investors will read, and will shape how they approach the rest of the document. We propose the following prescribed headings and text:

> The PDS will begin with a title "[***name of issuer***] [***name of product***] – key information"
>
> Immediately below this, a prescribed product definition, setting out in plain terms the nature of the product:
>
> "This is a managed investment product. Your money will be pooled in a fund with money from other investors. The manager invests the money in assets, which are described in this document. You will have a right to financial benefits from these assets."
>
> Followed by a prescribed warning statement:
>
> "By investing, you are relying on the performance of the assets in which the fund invests. The value of these assets may go down as well as up."

68. Is the proposed approach to the first section of the PDS appropriate?

6.5 Fund manager, key personnel and other parties involved in the fund

258 The manager of the scheme is the "issuer" of the managed investment product. A description of the issuer and its business is likely to be less detailed and prominent for a managed investment product than for debt and equity securities. For debt and equity, the risks and benefits faced by a potential investor are closely related to the nature and prospects of the issuer's business. In the case of a managed investment product, the returns come from assets managed by, but separate from, the issuer.

259 However, we consider that the PDS will still need to explain who is involved in providing the product, including:

- the name of the issuer and, if it is a subsidiary, its ultimate holding company
- key personnel – the directors and employees of the manager who are likely to have the most significant influence on investment decisions (unless the investment strategy provides no discretion for how money is invested)[10]
- issuer contact details – phone number, mail address, website and email (see discussion above in relation to debt)
- the other parties involved in the management and administration of the scheme, including investment managers, the custodian, administration manager, and supervisor.

260 The information should also include whether the issuer is a member of a dispute resolution scheme that covers disputes relating to the products, along with the procedure for making a complaint.

261 Other information that could be included in the PDS, but which we do not propose above, includes:

[10] A similar requirement is included in the draft KiwiSaver (Periodic Disclosure) Regulations, but requires some refinement for the PDS.

- information about all the directors, senior managers and other persons connected to the issuer (e.g. promoters)
- auditor, registrar, lawyers and other professional advisers.

262 Chapter 6 proposes that for a fund manager to obtain a licence, directors, senior managers and potentially other connected persons must be of good character and reputation. This arguably makes the requirement in the Securities Regulations 2009 that the prospectus discloses bankruptcy, criminal convictions for dishonesty, etc. redundant.[11] Some other persons like auditors, registrar and professional advisers are required to be named by the current Securities Regulations.[12]

263 We propose that the key information summary provide the name of the manager only, along with a reference to where further information can be obtained in the body of the PDS.

69.	What information about the manager, key personnel and other parties involved in the fund should be included in a managed investment scheme PDS? What should be listed in the key information summary?

6.6 Product description

264 The PDS needs to provide a description of the fund. This includes:

- its investment strategy
- the assets it invests in
- the form of returns and other benefits – regular income distributions, redeemable on demand at net asset value, lump sum at a future date
- participation – how to become a participant and how to withdraw, and any restrictions
- the form of contributions – one-off purchase of units, regular contributions
- legal structure
- a description of unusual and material terms of issue or features of the governing document.

265 For the investment strategy, we consider that the issuer should include a summary of the statement of investment policy and objectives, and the means by which changes can be made. The PDS could refer to how the statement of investment policy and objectives can be obtained.

266 We propose the intended asset mix of the fund and, for an established fund, the actual asset mix be disclosed. The draft KiwiSaver (Periodic Disclosure) Regulations present the former in a table and the latter as a pie chart, along with a list of the top 10 individual assets in the fund. This may be a desirable approach for open-ended funds, and some closed-ended funds holding mainly financial assets or a diversified portfolio.

267 If the fund is proposed to hold undiversified non-financial assets (e.g. direct holdings of real estate) a different approach to the assets is likely to be warranted. This could comprise a description of the current assets of the scheme, the development of the scheme over the past five years, proposed acquisitions and disposals, how the assets are to be managed and how a return will be provided to investors.

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[11] Securities Regulations 2009, Schedule 4, clause 2.
[12] Securities Regulations 2009, Schedule 4, clause 3.

268 Some funds have unusual terms, either as terms of the offer or in the governing document, that ought to be disclosed in this section as integral features of the fund. The Securities Regulations 2009 provides for disclosure of any liability that may be imposed on unit holders in a unit trust (other than in respect of the purchase price of units).[13] In some cases, the returns of the fund may be guaranteed. In this case, information along the lines of clause 10 of Schedule 4 of the Securities Regulations 2009 might be required.

269 We propose that much of information be principally located in the key information summary. For some kinds of schemes, parts could be omitted from the key information summary. For example, for a KiwiSaver scheme, the form of returns and contributions and the legal structure are standardised. The assets of a non-diversified closed-ended fund, and any unusual and material terms might need only a brief mention, with fuller details in the body of the PDS.

70. Do you agree with the proposed approach to the product description section of the PDS? What other information should be included in this section? What should be placed in the key information summary?

71. How could the product description section be customised for different kinds of managed investment products?

6.7 Fees and costs

270 The Ministry considers it critical that investors are aware of the fees and costs involved with their product. Fees and costs can have a significant impact on returns, meaning that this is an important factor in comparability between products.

271 For the key information summary, the challenge is to set out categories of charges that can be readily compared across products (i.e. apples with apples). For this reason we prefer the use of aggregated charges (such as percentage net asset value (NAV) per annum) that are readily understandable and comparable. However, there will also be a need for the body of the PDS to go into a more detailed breakdown of fees and methods of calculation.

272 There are any number of fees and expenses that a fund might charge investors, and any number of ways that costs might be apportioned across the participants in a scheme. For the purposes of this discussion, the proposed KiwiSaver periodic disclosure regulations are a good starting point, although they naturally assume that the scheme is already established.

273 Clauses 23-28 of the exposure draft of the KiwiSaver (Periodic Disclosure) Regulations propose disclosure requirements across four broad categories of fees and costs:

- Fund fees and costs: these amounts are deducted from the fund in proportion to each member's interest in the fund. These include investment fees such as performance fees, consultant fees, research costs, costs attributed to underlying funds, administrative and operating costs such as trustee fees, marketing, accounting and corporate overheads and tax paid by the fund. These are expressed as a percentage of the average NAV of the fund.
- Membership fees: these are expressed as a dollar amount per member.
- Individual fees: these include establishment, withdrawal, contribution, and special request fees. Expressed as dollar amounts and a total as a percentage of the average NAV of the fund.

[13] Schedule 4, clause 7.

- Trading expenses such as brokerage fees, spreads and the other actual costs of buying and selling investments are excluded due to the difficulty of measuring or estimating them. These are not specifically disclosed, but returns are net of trading expenses.
- Managers must also disclose a total expense ratio: the ratio of the fund fees and costs to the average net asset ratio of the fund.

274 We propose that for managed investment products that are analogous to simple managed funds, such as KiwiSaver funds, the fees and costs section of the key information summary should mirror the KiwiSaver quarterly disclosure statements for fees and costs. Within the body of the PDS there would be a more detailed breakdown of these fee categories, and the manager could have more discretion about how individual fees are labelled and described.

275 For managed investment products more generally, the disclosure requirements for fees and costs initially need to be more generic. One option is to split the charges into the following high level categories:

- regular fixed or base charges applied to every member regardless of membership activity (e.g. management or entry fees), expressed as a percentage of NAV per annum or in dollars per annum
- variable or individual charges applied to individual members engaging in discretionary activities (e.g. early withdrawal, switching, contribution) – usually a dollar amount triggered by an action but could also be a percentage
- (where the scheme has been in operation for more than a year) the actual fees and expenses for the last financial year expressed as a percentage of NAV.

276 In addition, the PDS should note whether fees are subject to change. Potentially, the issuer could disclose when there was last a fee increase and whether there is a process for changing fees and where this process is set out.

72. Do you agree with the proposed approach to categorising fees in the key information summary and body of the scheme PDS?

73. Should we distinguish between different types of managed investment products for the purposes of fee and cost disclosure?

6.8 Taxation

277 Tax disclosure from the point of view of investors should be simple if the managed investment product relates to a portfolio investment entity. However, in other cases, the tax treatment of the financial benefits generated by a managed investment scheme is likely to be quite complex.

278 Where the scheme is not a portfolio investment entity, we consider that the PDS should include a description of potential tax treatment similar to what is prescribed by the existing Securities Regulations 2009: “a statement as to which of the following (if any) will, or is likely to, affect the returns: (i) taxes or duties: (ii) reserves or retentions” (Schedule 13, cl 9(1)(d)).

279 The tax treatment of the product can be complicated and difficult to disclose succinctly or be readily compared between products, so there seems to be little benefit in attempting to include a tax description in the key information summary. We propose that if the scheme is a portfolio investment entity, the key information summary should include a prescribed statement on PIEs and a link to the IRD website. If the scheme is not a portfolio investment entity, then it should contain a reference to further information in the body of the PDS.

74. Do you agree with the proposed approach to taxation?

6.9 Risk

280 Risk is one of the most difficult investment concepts to communicate. All investment carries risk, but investors require disclosure that will enable them to identify whether they are comfortable with the risks specific to a particular product, in the context of expected returns.

281 The current investment statement includes a description of the principal risks of: the money paid by a subscriber not being recovered in full; a subscriber not receiving the returns referred to; and a subscriber being required to pay more money in respect of a security than that disclosed. While comprehensive, this description typically runs to several pages with little consistency as to which risks are included and how they are expressed.

282 We consider that the approach identified for debt and equity would be appropriate for managed investment schemes. In the case of managed investment schemes, we anticipate that these risks would most likely be associated with the nature of the investment (e.g. the type of assets the fund invests in). Again, a short bullet point summary could be provided in the key information summary with a fuller description of risks in the body of the PDS.

283 An alternative option for open-ended funds is to include a risk indicator and an explanation of what that means. The Australian shorter PDS for simple managed funds includes a Standard Risk Measure developed by the Association of Superannuation Funds of Australia (ASFA) and the Financial Services Council (FSC).[14] Also of interest are the EU UCITS model (1-7 scale with a methodology based on volatility) and the Canadian Fund Facts model (5-step Low to High scale with a self-assessment methodology – note though that many funds use a volatility based methodology provided by an industry body).

284 Under this alternative, volatility-based risks would be disclosed through the risk indicator. Additional non-volatility-based risks would need to be disclosed separately.

75. Should we further consider the use of risk indicators, particularly if customising disclosure requirements for specific classes of managed investment product?

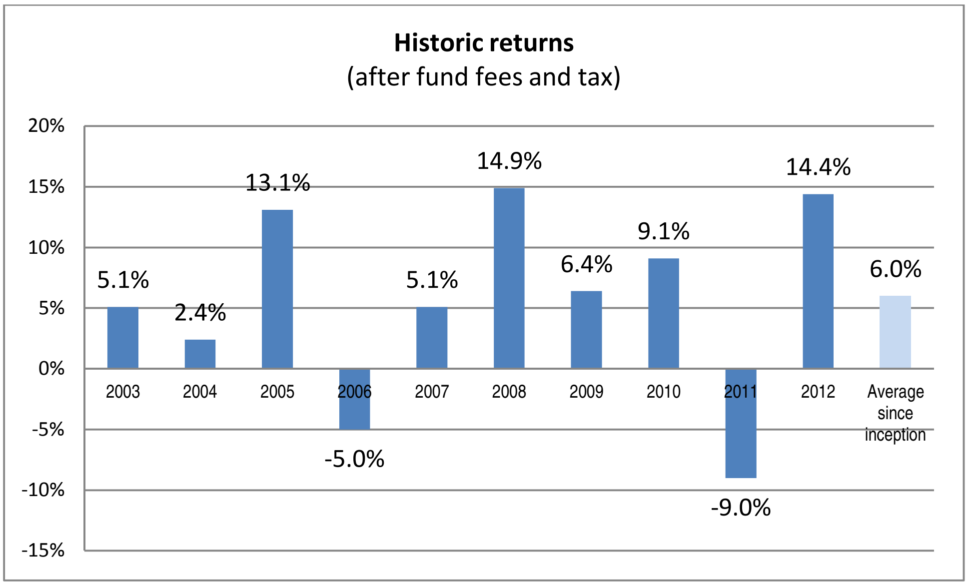
6.10 Past performance

285 We consider that past performance can be useful information for investors to the extent that it illustrates the volatility of returns or is related to consistent drivers, such as fees. However, past performance is often driven by unpredictable market fluctuations and non-repeated events or trends, and so may not be a reliable indicator of the future performance of a fund.

286 This section is only relevant to schemes that have been in operation and that are open to new investors or further investment from existing participants. We consider that for such open-ended offers, there should be an ability to leverage ongoing disclosure requirements as discussed earlier in this section.

287 Again, the proposed requirements for KiwiSaver periodic disclosure are a good starting point for considering this issue. The draft KiwiSaver (Periodic Disclosure) Regulations require a graph that discloses annual returns over the past ten years (or since inception, if the fund is less than 10 years old) and average returns since inception. We consider that similar information should be graphically presented, such as in the example below.

[14] https://www.asic.gov.au/asic/asic.nsf/byheadline/Shorter-PDSs--Complying-with-requirements-for-superannuation-products-and-simple-managed-investment-schemes?openDocument.



288 Alternatives include a line graph of cumulative returns or a table-based presentation (e.g. a table showing returns over the last quarter, last year, last 3 years, last 5 years and since inception).

289 We also consider that a descriptive example of historical returns could be a useful tool for explaining returns to investors. Canadian Fund Facts includes an example such as "A person who invested $1,000 in the fund on August 19, 2008 now has $1,227 on June 30, 2012. This works out to an average of 5.44 percent a year."

290 It may be useful for disclosure on this issue to indicate past performance relative to the product's performance benchmark. We would be interested in feedback on this issue.

76.	What approach should be taken to reporting a scheme's past performance?

6.11 How to apply

291 As with other products, we consider that the body of the PDS should include information about how to apply to invest in the managed investment product.

6.12 Is any additional information required in the PDS?

292 We are interested in feedback on whether additional items should be included in the PDS. Please describe how these additional items would be useful to retail investors and whether they should be referred to (or placed in) the key information summary.

77.	Should the managed investment product PDS contain any additional items? Should they be placed in the key information summary or the body of the PDS?

6.13 Content of offer register

293 Chapter 2 discusses different approaches to including information from the PDS on the offer register so that it can be searched, filtered and extracted. The offer register will also contain information and documents specified by the regulations, and all additional material information relating to the offer that is not contained in the PDS.

294 We consider that the following additional information should be provided on the offer register:

- a link to the governing document on the register of managed investment schemes
- the statement of investment policy and objectives

- details of certain policies, such as the scheme's trade execution, trade allocation and proxy voting policies
- name and contact details of supervisor
- financial statements

78.	What information and documents should be required to be placed on the offer register?

6.14 Disclosure for DIMS

295 Related to disclosure for managed investment schemes is disclosure for discretionary investment management services (DIMS) by a licensed DIMS provider or financial adviser providing DIMS under the Financial Advisers Act 2008.

296 DIMS range from highly individualised investment authorities to services that operate, and may have a very similar effect for investors, as a managed fund. They are not managed investment schemes under the FMC Bill because the client retains the legal or beneficial ownership to an individual portfolio of financial products. They may combine the services of managing those portfolios, operating a custodial or broking service, and giving personal advice on investment plans or strategies.

297 This section should be read together with section 6 of Chapter 6, which deals with licensing requirements, client agreements, ongoing client reporting, and other governance and compliance requirements for DIMS provided under the FMC Bill.

298 The PDS and register requirements do not apply to DIMS. Instead subpart 4 of Part 6 of the FMC Bill and section 22 of the Financial Advisers Act 2008 requires there to be a service disclosure statement given to each investor before an investment authority is granted. These enable ongoing disclosure to be prescribed on a periodic, event, or request basis.

299 The initial service disclosure statement may need to be individualised for DIMS depending on the nature of the service offered in each case. However there are common issues with DIMS that we think need to be covered.

300 Our starting point is that initial service disclosure statements should contain similar information to that suggested for managed investment schemes, but adapted to focus on particular issues for DIMS, including:

- a title, prescribed generic definition of what DIMS involves, and warning
- a description of the DIMS provider and custodian, information on key personnel and issuer and custodian contact details
- a service description that covers the nature and scope of the investment mandate and strategy, how assets are held, how to give instructions on corporate actions and on the financial products in the client's portfolio, and how to confer and terminate the investment authority and receive assets back
- a statement that the client must enter into a client agreement with you before the investment authority may be granted
- fees and costs, including service fees, individual fees, and other expenses that may be incurred, together with a historic total expense ratio for other clients of the service
- taxation
- information about significant risks arising from the investment strategy or investing through the DIMS (which may include, for example, potential conflicts of interest)
- past performance of the service.

301 Replicating elements of the managed investment schemes disclosure in DIMS creates the opportunity for investors to compare the two services directly. However, we note that DIMS may vary more widely in their nature. Some of the information we propose for managed investment schemes may be more appropriate for a class DIMS than a personalised DIMS, for example past performance of the service (although there may be ways in which this can be usefully disclosed even for a personalised DIMS).

302 The disclosure may overlap with the content of the individual client agreement for the DIMS. Nonetheless, requiring disclosure that is comparable with other DIMS and with managed investment schemes enables more informed choices to be made by investors.

303 As DIMS are not financial products, they will not be on the offer register or have register content. This prompts the question of whether the disclosure should also include all other material information that a reasonable person would expect to influence an investor's decision to proceed with the DIMS by the provider.

79. What distinctions should be drawn between different kinds of DIMS, for the purposes of disclosure?

80. What information from the managed investment schemes disclosure should be included in the DIMS service disclosure statement? Should DIMS disclosure include all other material matters?

7. Derivatives

7.1 Introduction

304 As with the other products discussed in this chapter, with derivatives there is a wide variety of products, some of which are more complex than others. Some derivatives present risks to investors that are not experienced with most other financial products – for example, losses can be incurred beyond the initial amount invested and investors can become liable for significant sums. Despite their challenging nature, the Ministry considers that these products are amenable to the general approach to disclosure outlined in this chapter, so long as there is an appropriate degree of flexibility in the requirements.

305 There are strong links between the disclosure requirements for derivatives and the proposed licensing requirements for derivatives issuers outlined in Chapter 6. It is possible to address the regulatory risk of certain elements of derivatives in a number of alternative ways, including by imposing direct regulation to mitigate the risk (e.g. prescribing how client funds must be dealt with), by requiring disclosure of the risk to investors, or a hybrid approach (e.g. disclosure of whether the issuer practice meets a particular standard on how the issuer compares against a benchmark). The Ministry proposes to take different approaches on this issue depending on the nature of the risk in question.

306 The Ministry also notes at the outset of this chapter that some issuers provide a range of different types of derivative products – both in contract form (forwards, options, swaps, etc.) and the underlying instrument (foreign exchange, equities, interest rates, commodities). The Ministry anticipates that some of these products will have elements in common and will be able to be covered by the same PDS. However, there will be instances when an issuer may need to create more than one PDS to cover its products to avoid documents becoming too long and complex.

7.2 Overview of PDS content

307 In this section we propose that the PDS for derivatives cover the following matters: title, summary and warning message; description of each type of product covered by the PDS; risks associated with the products offered; order process; description of how derivatives expire or are closed out; description of returns, pricing, fees and charges; description of margins or collateral requirements; altering terms and termination; transfers; the derivatives issuer and dispute resolution; and financial statements.

7.3 Title, summary and warning message

308 This initial section, to be contained in the key information summary, follows the same pattern that we propose for the other categories of product noted above. We propose that the issuer's name and a list of all derivative products covered by the PDS be noted in the first section of the key information summary, along with prescribed warning statements (see below).

309 We have identified particular aspects of derivative products that we consider should have clear warnings for investors. We consider that given the nature of the risks of derivative products, it is important that these warnings appear early in the key information summary.

310 We propose that the content of these warnings is largely prescribed in the regulations to ensure consistency across issuers. This creates a risk that, for some derivatives, the prescribed warnings may be incorrect. We propose to deal with this by (a) explicitly allowing issuers to omit some parts of the warnings if they are not applicable, and (b) allowing issuers to modify the standard warnings, but only if the prescribed form would be likely to deceive, mislead or confuse clients.

311 These warnings must be included in the key information summary, as bullet points under a prominent heading “WARNING”. The wording suggested below is indicative only and will change following feedback from submitters and consumer testing.

312 The first warning should be included at the start of all key information summaries apart from where the derivative is intended to be entered into exclusively for hedging purposes:

> Derivative contracts entered into for investment purposes are speculative and risky investments. Changes in the value of the underlying instruments (e.g. [***relevant examples***]), on which the value of the contract is based, may lead to magnified losses. Unlike other kinds of investments, you may end up owing significant amounts of money to [***issuer***]. Carefully read the section of this PDS on how payments and returns are calculated.

313 The second warning should be included in all PDSs for which margin or collateral payments are required to be paid by the investor prior to settlement or expiry of the contract, in response to a change in the underlying:

> These derivative contracts will require you to make additional payments ([“margins” or “collateral”, as applicable]) to maintain your position when the value of the underlying instruments moves against you. These payments may be required at short notice and can be substantial. Carefully read page [***page relating to margins or collateral***].

314 A third potential warning relates to counterparty risk. Counterparty risk is a significant issue, especially for over-the-counter (OTC) derivatives where there is no central counterparty, the derivatives issuer is lightly capitalised, and where investors make payments to the derivatives issuer prior to settlement or expiry. Any material counterparty risk should always be disclosed. However, whether counterparty risk is severe enough to warrant an upfront warning depends, in part, on how stringent licensing of derivatives issuers is, particularly client funds handling, governance and compliance arrangements and financial resources. Where there is significant counterparty risk, we propose the following warning be included in the key information summary:

> When you acquire [name of products], you are exposed to the risk that [issuer] may not honour its obligations (counterparty risk). Carefully read the section of this PDS on counterparty risk. [If applicable:] If we run into financial difficulty, the margins or collateral you provide may be lost.

81.	Do you have suggestions to improve the prescribed content of the initial warning messages for derivative PDSs? Are there situations when these messages would be inaccurate and allowances should be made?

7.4 Description of each type of product covered by the PDS

315 It is not always easy to succinctly describe derivative products. However, the clear, concise and effective standard mandates that issuers must describe products in a manner that investors can easily understand.

316 We consider that the key information summary should include a one-line description for each product covered by the PDS. Details concerning pricing, margins, collateral and the process of buying and selling will be included later in the PDS.

317 The products described may be a general group of contracts that each work in a similar way (e.g. contracts for difference) or could be more specific (e.g. currency call option).

82.	How much detail should be included in the key information summary in the description of the product covered by the PDS? What detail is best left to the body of the PDS?

7.5 Risks

318 Risk disclosure forms a key part of the PDS. This section is intended to cover the most serious risks associated with the products covered by the PDS. There are different approaches that can be taken to risk disclosure for derivatives.

319 In Australia, PDSs must include “information about any significant risks associated with the holding of the product”. A similar requirement for risk disclosure is found in the conditions of authorisation for future dealers in New Zealand.

320 This provides flexibility for issuers. However, in common with risk disclosures for other financial products, the results of these requirements have generally been unsatisfactory. ASIC’s review of contracts for difference (CFDs) PDSs found that “the explanations of the risks of trading CFDs in the PDSs were complex and relatively abstract”.

321 ASIC notes that:

> Few PDSs explained the risks using simple language or through the use of clear worked examples. Moreover, none of the risk sections could be described as stand-alone; there were numerous cross-references to other sections of the PDS or to the issuer’s website. In a few cases, risk disclosures were scattered throughout the PDS with no cross-references to the main risk section... Most of the PDS risk sections could best be described as ‘boiler plate’ lists of numerous possible risks from trading CFDs. In our view, little attempt had been made to provide retail investors with a framework to assess the likelihood and consequences of each risk for them.[15]

322 An alternative approach is standard risk disclosure, along the lines of that required by the US Commodity Futures Trading Commission, and also in the “client risk disclosure statement” used by NZX Derivatives Market participants. These tend to be, in part, “health warnings” that are intended to ensure investors know something of the risks and dissuade uninformed investors from making use of derivatives without careful consideration. Some of these types of warnings are proposed to be included in the key information summary (see section 7.3 above).

323 In line with the proposals for other categories of product, the Ministry considers that the risks identified in this section should relate solely to the risks associated with the products covered by the PDS rather than general risks. The Ministry considers it likely that there are some risks that are particularly acute with derivatives that would, therefore, frequently be disclosed in this section. To ensure that risk disclosure is well focused, we consider it is useful to classify the risks associated with derivatives into different categories.

324 First, there are risks inherent in the contractual terms of the derivatives and associated agreements. These risks arise from changes in the value of the underlying assets or variables and, depending on the amount of leverage and the type of contract, they can lead to severe losses (e.g. in trading CFDs or selling options). Closely associated are risks of margin calls and being closed out.

325 Second, there is counterparty risk. The extent of this is determined by the financial standing and risk management practices of the issuer, the presence or absence of a guaranteeing party (such as a clearinghouse), and the treatment of client funds.

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[15] ASIC, ***Contracts for difference and retail investors***, Report 205.
http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep205.pdf/$file/rep205.pdf

326 Third, there are risks associated with order execution – that is, risks that arise not from the derivative contracts themselves, but from the way in which they are created and terminated. In an OTC context, some derivatives issuers provide investors with a trading interface that is similar to a broker for a securities or derivatives exchange. Investors place different kinds of 'orders' that are 'executed' when the derivatives issuer hedges its position with a counterparty or by buying the physical underlying instrument.

327 This can give rise to risks such as 'gapping', whereby during periods of high market volatility there is a substantial time lag between order placement and execution, and the execution price may be significantly lower (or higher) than the price at which the sell (or buy) order was placed. Another risk is where a stop loss order is placed, but acts as a 'trigger price' to place a trade and the trade will not necessarily be executed at that price.

328 We seek feedback on PDS and key information summary risk disclosure for derivatives.

83. Do you agree with the proposed focus of the risk section in the derivatives PDS? Are there other kinds of risks that should be disclosed, but which we have not mentioned? What level of risk disclosure should be included in the key information summary?

7.6 Process for entering into derivatives

329 The Ministry considers that it is useful for the PDS to cover how and when investors can enter into the derivatives offered by the issuer.

330 For issuers that provide a trading interface, the Ministry proposes that this information include trading hours, and an explanation of the order placement and execution process. This should include, if relevant, explanations of potential lags in trading and order priority. It may also be useful for the PDS to include information on order types, where appropriate. This may include a reference to where further information can be found on this topic and a reference to the client trading agreement.

84. What information should the PDS contain on the process for entering into the derivatives? Should the key information summary include any information on this topic?

7.7 Description of how derivatives expire or are closed out

331 Information concerning how derivatives expire or are closed out is essential information that should be covered in the PDS. It is crucial that investors know how the contract ends and what options they have to roll over the contract or close it out.

332 The Ministry considers that where the contract does not expire, and there are limits on investors' ability to close out the contract (for example, where they can only close out through the firm that issued them even if there is a better price elsewhere) this should be made clear in the PDS.

85. What information should the PDS contain on how derivatives expire or are closed out? Should information on these issues also be included in the key information summary?

7.8 Description of returns, pricing and fees

333 The Ministry proposes that the derivatives PDS should contain information concerning returns, pricing, fees and charges.

334 The issuer could briefly explain the way in which its prices or quotes are constructed, including, where applicable, the spreads applied to the price of the underlying (the benchmark reference price). In some cases there may be particular formulae that are used; other issuers may give more discretion to staff.

335 A brief explanation could be given of how the price of the underlying is determined. For products that aim to replicate the return of an underlying asset (perhaps with leverage, such as CFDs) this could include confirmation that the issuer seeks to identify the best possible reference price on a consistent basis for the underlying financial instruments (irrespective of whether the firm actually acquires the underlying financial instruments as a hedging mechanism).

336 Fees and charges could be set out in a table that briefly explains and sets out any other fees or charges payable by a person, directly or indirectly, to the issuer in respect of the derivatives. The table could include three columns with the following headings: fee/charge, amount/rate, when the fee/charge applies. This would also need to include a description of the rights of the issuer or any other person to alter any of the fees or charges applicable to the derivatives.

86.	What information should the PDS contain on returns, pricing and fees for derivatives? What information should be included in the key information summary?

7.9 Description of margins or collateral requirements

337 It is common for derivatives to have margin or collateral requirements, which may result in investors having to make additional payments on short notice. In addition to the prescribed warning statement described above, the Ministry considers it important for the PDS to contain a description of the relevant requirements associated with the products on offer.

338 We propose that the description should cover the following matters:

- when margins may be required
- how much the margin requirements are
- the consequences for the investor of not meeting margin requirements on time.

339 Given its importance, the Ministry considers that a summary of this information should also be included in the key information summary.

87.	Do you agree with the proposed approach to margin and collateral requirements in the derivatives PDS? Should this issue also be addressed in the key information summary?

7.10 Altering terms and termination

340 There could be situations where an investor wishes to change the terms of the derivative. There may also be situations where the issuer is able to change the terms of the derivative. The Ministry proposes that the PDS contain a description of the parties' rights to alter the terms of the derivatives. This section should also include a description of the parties' rights to terminate, cancel, surrender, or otherwise make or obtain payment of any amounts or returns in respect of the derivatives, other than as described in the earlier sections.

88.	Should the PDS contain information on altering terms?

7.11 Transfers

341 OTC derivatives usually have restrictions on the ability of the investor to transfer the derivative to another person after entering into it. We propose that the PDS contain a statement concerning whether a person is entitled to transfer his or her interest in the derivatives to another person and whether there is an established market for such transfers.

89.	Do you consider that the derivative PDS should contain information on product transfers?

7.12 The derivatives issuer and dispute resolution

342 Licensed derivatives issuers will also be registered financial service providers under the Financial Service Providers (Registration and Dispute Resolution) Act 2008. This means that they are required to be members of a dispute resolution scheme.

343 The Ministry considers that details of the issuer and dispute resolution would be useful information for investors.

90.	Do you consider that the PDS should contain information about dispute resolution?

7.13 Financial statements

344 The Ministry does not propose that financial statements be included in the PDS. However, we consider that the following information should be included in the PDS:

- a statement to the effect that other information about the issuer is contained or referred to in financial statements of, or relating to, the issuer
- a statement describing where a copy of the most recent financial statements of the issuer can be obtained
- if the issuer is a registered bank, a reference to the registered bank's current disclosure statement published pursuant to the Reserve Bank of New Zealand Act 1989.

91.	Do you consider that the PDS should contain statements concerning where to find further information on financial statements and current disclosure statements?

7.14 Is any additional information required in the PDS?

345 The Ministry is interested in feedback on whether additional items should be included in the PDS. Please describe how these additional items would be useful to retail investors and indicate whether they be referred to (or placed in) the key information summary.

92.	Should the derivatives PDS contain any additional items?

7.15 Content of the offer register

346 Chapter 2 discusses different approaches to including information from the PDS on the offer register so that it can be searched, filtered and extracted. The offer register will also contain information and documents specified by the regulations, and all additional material information relating to the offer that is not contained in the PDS.

347 We have identified some additional information that we consider should be contained on the offer register, but seek feedback on whether anything else should be included. We propose that the register contain the following:

- a link to the financial statements of the issuer and the issuer’s register entry in the Companies, or other, register
- client agreement, if it is standard for a class of retail clients.

93.	Are the matters proposed for the offer register for derivatives appropriate? Should any other information be available on the offer register?

8. Short-form PDSs

348 The Securities Regulations 2009 provides for short-form prospectuses that can be used for offers of securities to existing holders. These are provided for equity securities (Schedule 7), debt securities (Schedule 8) and units in a unit trust (Schedule 9). The Securities Regulations also provides a “simplified disclosure prospectus” for offers of:

- securities of the same class as listed securities (Schedule 10)
- equity securities that rank equally with, or in priority to, listed securities (Schedule 11)
- debt securities that rank equally with, or in priority to, listed securities (Schedule 12).

349 Equivalent short-form PDSs, or removal of the requirement that the register contain all material information that is not contained in the PDS, may be warranted to the extent that the PDS duplicates information that potential investors already have, or which is required to be made available under a continuous disclosure regime.

350 The simplified disclosure prospectus in Schedule 10 is now covered by the exemption in clause 18A of Schedule 1 of the FMC Bill, which applies to financial products of the same class as listed financial products (see the discussion below on the limited disclosure that could be required for these offers).

351 Some limits on PDS or register disclosure may still be justified for financial products that rank equally with, or in priority to, listed securities.

352 The argument for short-form PDSs is weakened in cases where the PDS is already relatively short-form, and to the extent there are benefits to investors in having information from earlier disclosures updated and collected together into a single document.

353 However, we think that there should be relief from the “all material information” register requirement, so that the register need not contain material information that has already been disclosed under a continuous disclosure obligation.

354 We welcome feedback on what short-form PDSs may still be required, and what content from the original PDS they should omit or should provide a substitute for, and on the proposal for relief from the “all material information” register requirement.

94. What short-form PDSs should be required, and how should they differ from the other PDSs?

95. In what circumstances is disclosure of all material information in the register not necessary?

9. Ongoing disclosure

9.1 Role of ongoing disclosure

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

- which information must be provided and to whom
- what is the triggering requirement i.e. is disclosure periodic, event-based, on request, or a combination
- what is the delivery method.

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

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

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

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

9.2 Delivery method for ongoing disclosure

359 We propose that information, whether made publicly available or sent personally to investors, may generally be created, stored and accessed in an electronic form, unless a person entitled to the information specifically requests it in hard copy.

360 The register of financial products (offer register) and register of managed investment schemes (scheme register) will form central points where most publicly available information is stored and can be easily accessed by investors. As discussed below, most of the ongoing information that is required to be made publicly available is proposed to be held on the registers. Removing the need to send hard copies of information will help reduce costs for issuers and also promote the use of the registers to access information.

361 Where ongoing disclosures are required to be sent to investors, we consider they may be sent in an electronic form or in hard copy to the investor's last known good address. For publicly available information, such a requirement may be satisfied by sending an accessible link to the document on the issuer's web site or a register. For personal information, this may be satisfied by attaching the information in an electronic form, or by directing investors to an electronic facility for which they have an account and the information can be retrieved.

362 In principle, an investor should also be able to request disclosures directly from the issuer, although we expect that the availability on the registers and issuer web sites will reduce the need for these requests.

9.3 Generic requirements for ongoing public disclosure

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

- The Financial Reporting Act 1993 currently requires all issuers of securities to file audited financial statements with the Registrar of Companies within five months of the balance date of the issuer. Obligations for issuers to lodge financial statements and auditors' reports will be inserted in the FMC Bill by the Financial Reporting Bill.[16] This information enables a financial assessment of the performance and current state of the investment.
- Listed financial products continue to be subject to half-yearly and annual reports and to the continuous disclosure regime (with some exceptions, for example, derivatives). Under the continuous disclosure regime, issuers must notify the market of material information that is not generally available to the market as it becomes aware of that information. There are some exceptions under the current NZX rules (e.g. for incomplete negotiations).
- Companies are required to keep the companies register up to date with changes to directors, file annual returns, and prepare annual reports.

364 We have considered the extent to which further generic reporting on performance and on changes or events affecting the investment is required.

365 Under the Australian Corporations Act 2001, issuers are subject to continuous disclosure requirements, even if unlisted, if the financial products are "enhanced disclosure" securities (in essence, those that have been issued under a prospectus or PDS and where there are at least 100 holders or, for debentures, a trustee is required).[17] These obligations ensure material changes are notified to the public as they arise. Issuers of other financial products must notify investors of material changes and events that would have been required to be disclosed in a PDS, if it were prepared the day before the event or change.[18]

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

367 We are not proposing a general obligation to notify material information as it arises. We think that the costs of a continuous disclosure obligation of this kind would outweigh the benefits when products are not traded on liquid markets. Instead we are proposing more focused obligations to notify particular events or changes.

368 We think that the relevant events, and whether reporting is per event or on a periodic basis, should differ according to the type of financial product. Where disclosure is limited to key changes or events, and these are not occurring regularly, it should be sufficient to have a per event disclosure.

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[16] See the proposed supplementary order paper 93 to the Financial Reporting Bill, available at http://www.legislation.govt.nz/sop/government/2012/0093/latest/DLM4635701.html.

[17] Corporations Act 2001, section 675,

[18] Corporations Act 2001, section 1017B.

369 The need for performance-related information differs to an even larger extent according to the type of security and the extent performance is already disclosed under other requirements. We do not propose any generic requirements and address our proposals for the specific types of financial products below.

9.4 Debt ongoing public disclosure

370 There are no ongoing disclosure requirements currently applying specifically to debt issuers.

371 We propose that debt issuers be required to disclose particular changes or events that affect the credit risk associated with the borrower and the debt securities, and therefore the value of the debt security.

372 We see this type of disclosure as a limited form of the continuous disclosure that applies to listed issuers. We propose that the disclosure obligation would apply to each specified event when it arises, and require disclosure of that event within a specified period of the issuer becoming aware of it. The disclosure obligation would not apply if the debt was quoted on a licensed market and therefore subject to full continuous disclosure under the listing rules for the market.

373 The Review of Securities Law discussion document proposed that this event-based disclosure would include changes to credit ratings, changes to guarantors of the issuer and significant changes to the terms of the trust deed. Changes in the terms of issue would require limited disclosure in any case under Schedule 1. We propose that the event-based disclosure for debt securities also cover material changes in ownership of the issuer and appointments of a receiver, manager, or liquidator for any debt held by the issuer. We would like feedback on other specified changes or events that would affect the significant risks disclosed in the PDS.

374 We think that the event-based disclosure should be placed on the offer register. We are not proposing any general obligation to notify existing investors of it.

375 However, for continuous issuers, the event-based disclosure requirement will overlap with the requirement to update the PDS and information on the offer register. We are proposing relief from the obligation to re-give the updated PDS to existing investors if those existing investors are sent notice of, and access to, the event-based disclosure (see Chapter 3, section 3). This would mean that both an event-based disclosure and an updated PDS would still need to be prepared, but only one of those would need to be sent to existing investors prior to them making further investments. We are interested in receiving feedback on the extent of this disclosure overlap and alternative options for resolving this.

376 We have considered whether periodic disclosure should also be required of other matters, for example periodic updates of financial ratios or other matters disclosed in the PDS. But we consider at this stage that only on-request disclosure of these matters (if any) should be required.

96. Should debt issuers be subject to a limited form of event-based disclosure? If so, what events should be prescribed and what disclosure should be required?

97. Should debt issuers be subject to any other specific periodic or request disclosure? If so, what additional information do you suggest be disclosed?

98. Do you think the suggestion in 9.4 above is appropriate to resolve the overlap between the obligation for a continuous issuer to update the PDS and the obligation to make an event-based disclosure? Are there alternative options?

9.5 Equity ongoing public disclosure

377 There are no ongoing disclosure requirements currently applying specifically to equity products under securities law.

378 We have considered whether any more ongoing disclosure is required in addition to that applying already to issuers of equity (e.g. in annual reporting obligations for companies). If anything more was useful, we think it should relate to changes or events that affect specified matters originally disclosed in the PDS (for unlisted issuers). However, it could also include additional performance-related information. We are interested in feedback on whether public disclosure of either kind has value for equity securities.

99.	Do you agree that equity issuers should not be subject to any additional ongoing disclosure obligations? If not, please provide reasons.

9.6 Managed investment schemes ongoing public disclosure

Current requirements

379 KiwiSaver and superannuation schemes are required to produce annual reports and make them available to investors. Schedule 1A of the KiwiSaver Regulations 2006 sets out the current requirements for KiwiSaver annual reports. These include scheme information (e.g. the names of the investment manager, administration manager, custodian, and auditor), a summary of the scheme's performance and composition for the period, and any changes to the trust deed, terms of offers, and each fund's investment policy and objectives.

380 Schedule 2 of the Superannuation Schemes Act 1989 sets out the requirements for annual reports for superannuation schemes. These requirements are focused on compliance with the trust deed and other requirements and changes to the trust deed and other key matters.

381 For unit trusts, section 20(2A) of the Unit Trusts Act 1960 requires managers, when filing their annual financial statements, to attach a summary of the following matters:

- purchases and sales of property under the unit trust
- a list of all the investments of the unit trust as at the end of the period to which the financial statements relate, together with particulars of the cost and the estimated market value as at that date of the investments and other property.

382 There is no current requirement for managers of participatory schemes to produce an annual report.

Proposed periodic disclosures for open-ended schemes

383 We consider that investors in open-ended schemes will benefit from receiving access to regular periodic reports on both scheme or fund performance and on specified events or changes.

384 The exposure draft of the KiwiSaver (Periodic Disclosure) Regulations proposes periodic disclosure for KiwiSaver schemes at the fund level.[19] Managers will be required to make periodic reports on:

- performance and returns net of all fees and costs and tax

[19] http://www.med.govt.nz/business/business-law/pdf-docs-library/current-business-law-work/kiwisaver/Draft-regulations-for-consultation.pdf.

- fees and costs, including a total expense ratio
- assets and portfolio holdings, including a list of the top 10 assets of the fund
- liquidity ratios and debt ratios
- information on key personnel, changes to the fund's trade allocation and execution policies and proxy voting policies, and a ratio of related party exposures to total fund asset value.

385 This will involve one comprehensive disclosure statement, relating to the 31 March year (an annual disclosure statement) and four briefer disclosure statements each quarter (quarterly disclosure statements). The quarterly disclosure statements will in some cases (e.g. fees) include information taken from the annual statement rather than recalculating it for each quarter.

386 The Ministry's starting point is that all open-ended managed investment schemes should be required to produce quarterly disclosure of information similar to that proposed for KiwiSaver schemes to enable comparability between schemes.

387 We think other specified event or change information may also need to be disclosed. This information could include changes to statements of investment policy and objectives, further reporting on related party transactions or limit breaks, and other compliance information.

388 This additional information could also be included in the quarterly disclosures, unless there is a reason why it is better contained in a separate periodic or event-based disclosure. For example, annual reporting may be desirable for information that changes less frequently or which is more costly to produce. However, annual information can be problematic.

- In order for information to be comparable across funds, it needs to be based on the same time intervals (in the case of the KiwiSaver annual disclosure statements, year ended 31 March), whereas annual reports and financial statements are based on the scheme's own financial year – this could end at a different date. Annual reporting on the scheme's own financial year could be more relevant for any information that is tied to that financial year and where comparability across funds is not the key concern. We are interested in feedback on any such information.
- Some annual information is at a fund level (such as KiwiSaver annual disclosure statements), whereas the information in existing annual reports and financial statements is mainly at a scheme level.

389 The following are possible options for annual reporting:

- require standardised date annual disclosures at a fund level, separate from the scheme's annual report – this is how the KiwiSaver (Periodic Disclosure) Regulations are proposed to work
- require only the scheme's annual report on its scheme year – i.e. do not attempt to make annual disclosures strictly comparable across different provider's schemes.

390 Minimising duplication of information would help to reduce the costs associated with its preparation and the scope for confusion.

391 We are interested in feedback on what information proposed in the exposure draft of the KiwiSaver (Periodic Disclosure) Regulations and in Schedule 1A of the KiwiSaver Regulations 2006 is appropriate for all open-ended managed investment schemes, how frequently it should be reported, and whether it should be reported as at a standardised date to enable comparability or on a period based on the scheme's financial year.

100. What information proposed in the exposure draft of the KiwiSaver (Periodic Disclosure) Regulations 2012 and Schedule 1A of the KiwiSaver Regulations 2006 is appropriate for all open-ended managed investment schemes? How frequently should it be reported? Should it be reported at a standardised date or on a period based on the scheme's financial year?

101. Is there any other information which would be appropriate to include in the periodic disclosure for all other open-ended managed investment schemes? How frequently should it be reported? Should it be reported at a standardised date or on a period based on the scheme's financial year?

Proposed periodic disclosures for closed-ended schemes and schemes for which there is no regulated offer

392 For closed-ended schemes, we consider that it would be beneficial for investors to receive periodic information on the performance or activities of the scheme and on key changes involving the scheme. This information will inform investors' decisions on transfers of the financial product and enable them to question the manager of the scheme on performance (e.g. at an annual meeting).

393 One possibility is for an annual report that aligns with financial statement preparation, and which also covers information concerning management and governance of the scheme and refers to financial statements. This could include a summary of the scheme's performance and composition for the period, any changes to the governing document terms of the managed investment products or to each fund's investment objectives and policy, reporting on related party transactions or limit breaks, and other compliance information.

394 In some circumstances, additional periodic disclosure might be warranted. For example, if a listed closed-ended scheme holds mainly liquid financial assets, it could comply with many of the same reporting requirements as an open-ended fund. This would enable comparison of performance between the two types of fund, and inform investor decisions.

395 For schemes for which there is no regulated offer, and so there is no need for public disclosure of comparable information, we consider an annual report similar to that proposed for closed-ended schemes would be appropriate.

396 We would welcome feedback on what information should be made available and how frequently in each case.

102. Should an annual report be prepared for closed-ended schemes and schemes for which there is no regulated offer? If so, what information should be included in the annual report in each case?

103. Are any other periodic disclosure requirements warranted for some kinds of closed-ended schemes? If so, how frequent should they be and what kind of information should be included in them?

Ongoing public disclosure for DIMS

397 In section 6.9 of Chapter 6, we propose ongoing client reporting by licensed DIMS providers or financial advisers providing DIMS under the Financial Advisers Act 2008. This will include all transactions effected as part of the service, the assets held in the client's portfolio, and all revenue and expenses (including fees and charges) relating to the service.

398 There is a further issue for licensed DIMS providers as to whether public ongoing disclosure is warranted, especially for class DIMS that function similarly to managed investment schemes. Class DIMS could have quarterly disclosure of matters such as returns, fees, and model portfolio holdings. This would enable persons who are not (currently) clients of a particular service and outside analysts to access up-to-date information about the service and make comparisons across managed investment schemes and DIMS without the provider needing to update or make publicly available a service disclosure statement.

104. Should some DIMS be required to prepare public ongoing disclosure along the lines of that proposed for managed investment schemes? If so, which DIMS?

9.7 Generic requirements for personalised information

399 We consider that investors in all financial products need to have access to information on transactions that affect their holdings of financial products, as well as information about their current holdings. Transaction information may be a one-off confirmation for a single investment or, for regular investments, may be more usefully provided in a periodic, consolidated form.

400 This function is currently performed by section 54 of the Securities Act (for equity, debt, participatory securities and units in unit trusts) which requires securities certificates to be given to investors within one month of allotment or receipt by the issuer of a registrable transfer. The KiwiSaver Act also requires personalised information to be periodically sent to investors.

401 In Australia, Section 1017F of the Corporations Act and its regulations[20] require that written confirmations of transactions be provided to retail clients, including for acquisitions and disposals of financial products. These confirmations must generally contain the following information:

- identification of the issuer and the holder
- the date of the transaction
- the financial product
- a description of the transaction
- the number or amount of financial products that are the subject of the transaction
- any amount paid or payable by the holder to acquire the product (or paid or payable to the holder as a result of a disposal)
- any taxes or stamp duties payable in relation to the transaction, if known.

402 Confirmations must be sent to investors, or can be provided by means of a standing facility under some circumstances.

[20] The confirmation requirements in the Corporations Act are significantly modified by Corporations Regulations 7.9.61D to 7.9.63I.

403 Australian managed investment schemes and deposit products must also provide periodic statements to retail clients at least once a year. These must generally contain the opening and closing balances for the reporting period, details of transactions during the period, any increases in contributions during the period, the return on the investment (on an individualised basis if practical) and details of any changes in circumstances affecting the investment.[21]

Confirmation of transactions

Equity securities, debt securities and managed investment products

404 We propose that issuers of equity securities, debt securities and managed investment products be required to provide investors with at least the following basic information:

- details of any acquisition (via allotment on an issue or acquisition by way of a sale to which Part 3 applies) of financial products by the investor
- where applicable, disposals of financial products (e.g. redemptions)
- for KiwiSaver, superannuation, and regulated products to which clause 10(2)(c) applies, details of any increase or decrease in the total amount standing to the credit of the investor
- the person's holding or position.

405 We propose that the default requirement be that the issuer must provide a written confirmation to the investor on a transaction-by-transaction basis.

406 However, there are some cases (particularly where there are frequent transactions) where this information is most usefully provided in a consolidated and periodic form. If periodic personalised disclosure is either required by the regulations or provided by the issuer under the terms of issue or with the consent of the investor, the transaction-by-transaction disclosure obligation would not apply.

407 We propose at 9.8 below that the regulations require annual personalised statements for KiwiSaver schemes and superannuation schemes. Given that they are by their nature long-term investments, we consider the appropriate reporting period is annual, as is the case currently.

408 For most other products that are continuously issued we think periodic confirmations would be an optional alternative obligation – i.e. each acquisition or disposal of a financial product must be confirmed individually unless a periodic, consolidated statement is provided under the terms of issue or with the consent of the investor. Applying the obligations in this way is likely to result in the issuer selecting the most cost-effective means of disclosure. We think that is likely to also be the most useful form of disclosure for the investor in most cases.

409 The current Securities Act (Continuous Debt Issues) Exemption Notice 2012 and Securities Act (Unit Trust Certificates) Exemption Notice 2012 require periodic confirmations half-yearly. We are interested in feedback on whether this is the appropriate period for these products and for other continuously issued products.

410 We consider that investors should be able to expressly waive their right to receive this information (while maintaining the ability for investors to obtain personalised information on request).

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[21] Corporations Act, section 1017D. There is significant customisation of the personalised statements for specific products in the Corporations Regulations.

411 If investors have access to an electronic facility that provides this information (e.g. an account on the issuer's web site), we consider it sufficient for the issuer to remind the investor that this information is available from the electronic facility (either at the time of the transaction or periodically), unless they specifically request a hard copy of the information.

412 For transferrable products where the issuer keeps a register (under clause 200) and the product is transferred by one investor to another off-market, the issuer may need to make a confirmation to each party that the transfer has been completed.

105. Is confirmation information generally needed by investors in equity securities, debt securities and managed investment products to monitor their investments? Is there any other confirmation information that should be provided to investors in these financial products? Are there types of financial products for which this is not the information needed for this purpose or where costs in providing the information will exceed benefits?

106. Do you agree that confirmation information should be required per transaction, unless the issuer provides periodic consolidated confirmation information? If an issuer provides this periodic consolidated confirmation information, what is the appropriate reporting period?

107. Do you agree that the issuer should be permitted to provide this information through an electronic facility unless the investor objects? Should an investor be able to waive receipt of confirmation information altogether?

108. Should issuers who keep registers of transferable products be required to, in the event that a transfer is made between investors, send a confirmation to investors that the transfer has been completed?

Derivatives

413 In Chapter 6 we propose that some kinds of licensed derivatives issuers provide ongoing information to clients about their transactions and positions. Chapter 6 proposes that this information may be made available through an electronic facility or through periodic reporting. These requirements do not cover confirmation of transactions per se.

414 We consider that for licensed derivatives issuers generally, retail investors will require some form of confirmation of individual transactions that informs them of the transaction they have entered into and its specific terms (i.e. terms that are not covered by a master agreement or the client agreement). This will ensure that investors are aware of the contract's payment and delivery obligations and will help to avoid disputes. This seems particularly important where the contract is entered into in the course of a telephone call, or through an electronic facility.

415 We consider that confirmations may be sent on a transaction-by-transaction basis or made available through an electronic facility. We note that one submission to the select committee suggested that investors should be able to waive their right to receive confirmations altogether.

416 We seek feedback on what the content of derivatives confirmations should be.

417 The ISDA Master Agreement and other master agreements provide for confirmations that specify, among other things, the payment and delivery obligations under an individual transaction. Assuming these standard confirmations are appropriate for transactions entered into with retail investors, avoiding duplication of documentation will require that either:

- the content of confirmations required under the regulations is consistent with that used under these master agreements, or

- for transactions covered by a qualifying master agreement (e.g. an ISDA Master Agreement), the confirmation regulations do not apply so long as investors receive a copy of the standard derivative confirmation for the master agreement.

418 In Australia, derivatives appear to be required to use the standard financial product confirmations discussed in paragraph 401 above.

109. Should confirmations be required for derivatives issued under regulated offers? If so, should issuers be permitted to make them available through an electronic facility (rather than being sent to the investor?)

110. What should a derivatives confirmation be required to contain? If the derivative is covered by a master agreement, should the standard confirmation be able to be used instead? If so, what master agreements should qualify for this treatment?

Record of holdings and transactions to be provided on request

419 As well as receiving information about transactions and holdings as they occur, or periodically, investors are likely to need to obtain some of this information on request. This will be the case if they need to know their current holdings or if they have not retained, or have lost access to, their previous statements and confirmations.

420 We propose that investors in equity securities, debt securities and managed investment schemes be able to obtain, on request and free of charge, their current holdings. Investors in derivatives would be able to obtain information about any transactions with remaining payment and delivery obligations.

421 We would be interested in feedback on what historic transaction information investors should be able to obtain on request, and whether any fees should apply. Our initial thoughts are that investors should be able to obtain, for a reasonable fee, information about their acquisitions and disposals over a number of years.

422 If this information is available from an electronic facility, we consider it sufficient for the issuer to direct the investor to the facility, unless they specifically request a hard copy of the information.

Confirmations as documentary evidence of title

423 The requirement for confirmations of financial products under clause 83A of the FMC Bill has another possible function. Section 54 of the Securities Act 1978 currently requires an issuer to send a certificate to security holders evidencing their security, and so providing security holders with a documentary title.

424 We do not consider that documentary evidence of title is generally needed. The register of securities kept by an issuer is, under subpart 5 of Part 4, prima facie evidence of title. Transfers do not usually require a physical certificate to be surrendered to be effective.

425 That said, a security certificate may still be needed as evidence of title occasionally (e.g. for transactions with overseas jurisdictions). For those situations we propose an obligation, akin to that in section 91(3) of the Companies Act 1993 for shares, for an issuer to provide a product certificate to a product holder on request. We consider that this residual obligation should apply to every issuer that is required to maintain a register of regulated products under clause 200 of the FMC Bill.

111. Do you agree that there needs to be an obligation on issuers to provide a product certificate to a product holder on request as evidence of the holder's title?

112. Do you agree that investors should be able to obtain information about their current holdings of the issuer's financial products (or for derivatives, transactions with remaining payment and delivery obligations)? Are there any issuers or financial products this should not apply to?

113. What historic transaction information should investors be able to request? What fees should issuers be able to charge for providing this information?

9.8 Additional requirements for personalised information for particular financial products

426 Additional personalised investment information may be needed for an investor to understand and monitor their personal position in the case of particular types of financial products.

Current requirements

427 KiwiSaver schemes are currently required to provide annual personalised information to members concerning their investment contributions and accumulations. Section 125A of the KiwiSaver Act 2006 requires that an annual personalised statement be sent to members that includes:

- the amount of each type of contribution received by the provider of the fund or scheme (as the case may be) for the year
- the member's accumulation at the end of the year.

428 Section 119L of the KiwiSaver Act and section 17 of the Superannuation Schemes Act provide for personalised information concerning members' benefits to be provided to members upon request. For superannuation schemes, section 17(1)(iv) of the Superannuation Schemes Act enables members to request a statement of the specific interest, mortality, and other assumptions and bases of calculation applied in determining the value of the assets and liabilities of the scheme for the purposes of an actuarial examination required under section 15. Section 17(3) also allows members to request further information concerning a proposed change to members' benefits.

Proposed requirements for managed investment schemes

429 We have proposed above that KiwiSaver schemes continue to provide an annual personalised statement, and that this requirement be extended to superannuation schemes. For KiwiSaver, the statement of the member's accumulation would continue to be broken down by the type of contribution received by the fund provider. We are interested in feedback on what the annual personalised statement for superannuation schemes should contain.

430 We propose to retain the existing KiwiSaver and superannuation scheme requirements for information to be available also on request.

431 We propose that any holdings information provided to investors in other open-ended managed investment schemes (as discussed in section 9.7) include, in addition to the amount of their holdings (e.g. number of units), the current value of their holdings.

432 We consider that there is little value in providing the current value of holdings for investors in most closed-ended managed investment schemes, as their interests cannot be redeemed at net asset value.

114. Do you agree that the current requirements for annual personalised statement requirements be carried over to KiwiSaver schemes and also applied to superannuation schemes?

115. What other information may be relevant for investors in an annual personalised statement for KiwiSaver and superannuation schemes?

116.	Do you agree that no additional personalised information be provided for investments in closed-ended funds? If not, please explain why and what information should be provided.

Proposed requirements for derivatives

433 In Chapter 6 we propose that some licensed derivatives issuers will be required to provide personalised information to investors as part of their licensing requirements. This information would provide the investor with an overview of their contracts but would not include detailed information on each derivative contract – which we assume will be covered by the confirmations discussed in section 9.7 above. We are interested in receiving feedback on whether any additional personalised information should be made available to investors on request.

117.	Is there a need for derivatives issuers to provide any additional information about individual derivatives contracts on request? If so, please specify what information should be required.

9.9 Duty to notify relevant matters and provide documents and information to Registrar

434 The FMC Bill provides for the establishment of the offer register, the scheme register, and any other registers considered necessary for the purposes of the FMC Bill. Clause 80 requires issuers to update these registers in circumstances prescribed in regulations.

Requirements to notify and provide information under the FMC Bill

435 We propose above that any public ongoing disclosure should be lodged with the offer register.

436 In addition, the FMC Bill already requires issuers to notify some changes to information held on the registers as follows:

Scheme register	
clause 128(1)	The manager of a registered scheme must ensure that notice of the amendment or replacement of a governing document, and a copy of the certificate for the amendment or replacement (if any) is lodged with the Registrar
clause 152(2)	The manager must lodge any change to the statement of investment policy and objectives
clause 176(1)	The new manager must ensure that notice of the change to the manager of a registered scheme is lodged with the Registrar
clause 178(1)	The manager must ensure that notice of the change of supervisor of a registered scheme is lodged with the Registrar
clause 205(1)	Every issuer of regulated products must send a notice to the Registrar of the place where its registers under this subpart are kept and of any change in that place (this section does not apply to an issuer that is a company if its registers are kept at its registered office)
Offer register	
clause 55	Supplementary documents or replacement PDS

Proposals: notification or information to be provided to Registrar in regulations

437 Clause 3 and clause 6 of Schedule 2 identify some contents of the two registers and also allow regulations to prescribe additional content. The proposals for the additional content in the two registers are discussed in Chapter 2.

438 We propose that notifications of any changes to any register contents listed in Schedule 2 will be required to be given to the Registrar.

439 In addition, we propose that any changes to the information in the register entry that has been entered by the issuer as part of the lodgement process (e.g. name of supervisor, opening and closing date of the offer) will require notification to the Registrar. This would be done by an issuer requesting an update to the register entry.

118. Do you agree with the circumstances in which we propose issuers to notify and provide information to the Registrar?

119. Are there any other circumstances in which an issuer should notify and provide information to the Registrar?

Request disclosure in the Securities Regulations 2009

440 Section 54B of the Securities Act 1978 provides for regulations to be made to require information to be made available to investors upon request. These requirements are set out in regulation 44 of the Securities Regulations 2009. We have proposed that most of this request information be placed on the register of offers of financial products or register of managed investment schemes (or alternatively a link will be on the registers that leads through to information held on other Companies Office registers).

441 There is some information that is currently required by the regulations which we have not proposed for the registers. We are interested in feedback on whether the following information in regulation 44 of the Securities Regulations 2009 should be carried over to the new regulations:

- Regulation 44(d): copies of any guarantee of payment of any money owing in respect of the securities held by the security holder and the most recent annual or half-yearly financial statements of the guarantor.
- Regulation 44(g): if prospective information about returns on the securities held by the security holder was contained in any prospectus, disclosure statement, or advertisement, a comparison (if practicable, in the same form and for the same period as the prospective information) of the actual returns against the prospective returns.
- Regulation 44(h): if prospective financial information about the issuer (or, if the issuer is a manager or superannuation trustee, the scheme) was contained in any prospectus, disclosure statement, or advertisement, a comparison (if practicable, in the same form and for the same period as the prospective financial information) of the actual results against the prospective financial information.

120. Should the obligation to disclose information in regulations 44(d), (g) and (h) of the Securities Regulations 2009 on request be carried over to the new regulations?

10. Schedule 1 limited disclosure

10.1 Introduction

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

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

444 In this section we propose that limited disclosure and other requirements attach to offers made under some Schedule 1 exclusions. There is a balance to be struck to ensure that the investors receive disclosure where it would be beneficial, while not undermining the purpose or utility of the exclusions.

10.2 Employee share schemes

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

Current requirements

446 Two current exemption notices are applicable to listed and unlisted companies that offer equity securities through employee share purchase schemes:

- listed companies - Securities Act (Employee Share Purchase Schemes—Listed Companies) Exemption Notice 2011)
- unlisted companies - (Securities Act (Employee Share Purchase Schemes—Unlisted Companies) Exemption Notice 2011).

447 These notices exempt listed and unlisted companies (subject to conditions) in respect of equity securities issued that are offered under employee share purchase schemes from:

- section 37A(1)(c) of the Securities Act 1978
- various prospectus requirements
- various investment statement requirements.

448 The effect of these notices is to allow listed and unlisted companies to use an evergreen short form prospectus.

Proposed requirements

449 We consider that some form of disclosure is likely to be required for employee share schemes. We propose much more limited disclosure than is required at present. Offers of employee share schemes could be accompanied by a statement that contains:

- the terms of the offer
- a description of the purpose of the scheme
- a prescribed statement on the generic risks of such schemes

- a copy of the most recent annual report or financial statements (if any).

121. What disclosure, if any, should be required for offers of employee share schemes?

10.3 Dividend reinvestment plans

450 Clause 10 of Schedule 1 excludes offers of financial products under dividend reinvestment plans from disclosure requirements under Part 3 of the Bill.

451 Clause 4 of the Securities Act (Dividend Reinvestment) Exemption Notice 1998 exempts offers of dividend reinvestment plans from prospectus and investment statement requirements. Clause 5(1) sets out some conditions of the exemption and requires that an offer document is provided to investors that contains details of the dividend reinvestment plan including:

- a description of the dividend reinvestment plan and its terms and conditions
- a statement that a copy of the most recent annual report (if any) and financial statements are available.

452 We note that these are relatively minimal requirements. While they should be straightforward to comply with, we question whether they are likely to be of benefit to investors.

122. What disclosure, if any, should be required for offers of dividend reinvestment plans?

10.4 Small offers

453 Clause 12 of Schedule 1 excludes small offers from disclosure requirements under Part 3 of the FMC Bill.

454 The rationale for the small offers exclusion is that some offers are sufficiently small in scale that the costs of complying with the normal requirements of the FMC Bill would outweigh the benefits obtained from making the offer.

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

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

457 We are interested in feedback on whether there are activities within the small offer exemption that should be subject to some form of limited disclosure. This could be minimal – such as disclosing that the offer is making use of the small offer exemption and the normal regulatory requirements do not apply. Or it could be more substantive, requiring disclosure of the terms of the offer or particular kinds of risks.

458 An alternative would be to require issuers to notify FMA that they are making a small offer. This could require details such as the amount being sought and the number of investors. This information would help FMA to monitor small offers and also provide information on how much activity is taking place within the small offers area. This information would help assess the utility of the exception and how it is being used.

123. Should any classes of small offers have limited disclosure requirements or notification to FMA? If so, what would these requirements consist of?

10.5 Offers of financial products of same class as quoted financial products

459 Clause 18A of Schedule 1 excludes offers of financial products of the same class as quoted financial products from disclosure requirements under Part 3 of the Bill. In effect it replaces the simplified disclosure prospectus for offers of securities of the same class as listed securities under the Securities Act.

460 The "same class" requirement is restrictive – the products being offered must be identical to the quoted financial products. This should mean that the products will have to be treated as if they were issued under a PDS for the purposes of the FMC Bill – so that the register requirements and any ongoing disclosure requirements that apply to other products in the same class apply to the products issued under the exclusion.

461 We propose disclosure requirements under clause 18A that will be similar to the requirements under 708AA(7) of the Corporations Act 2001. These are similar to the key requirements of the simplified disclosure prospectus. This would require the issuer to give a notice to the relevant licensed market covering the following matters immediately before the offer is made:

- stating that an offer for issue or sale is being made without disclosure to investors under the exclusion
- stating that the issuer is in compliance with all 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
- describing the potential effect that the offer of the relevant securities will have on the control of the issuer and the consequences of that effect.

Debt securities differing in interest date and maturity from listed debt securities

462 For debt securities, the requirement that the securities are in the same class is very restrictive. Most subsequent debt issues of equally ranking listed debt will have a different maturity date and interest rate. Some relief may be warranted for these offers of debt securities either by amending clause 18A or providing for a short-form PDS for debt securities that rank equally with, or in priority to, listed securities (see above).

463 Amending clause 18A of Schedule 1 would enable issuers of existing quoted bonds to issue new bonds of the same seniority and rights with only limited disclosure. This could help to encourage high quality issuers to raise additional debt from retail markets, rather than wholesale markets.

464 However, there are potential problems with amending clause 18A. If an issuer is complying with continuous disclosure, this means that information is being disclosed that would materially affect the price of the listed debt securities. This will include events that affect the issuer's ability to meet their repayment obligations for those securities. It may not be necessary to disclose events that the issuer knows will occur or begin to affect creditworthiness after the listed debt securities have been repaid.

465 For example, if an issuer with bonds maturing in April 2014 has a major customer terminate its contract effective from January 2015, this would not necessarily be disclosed as it may not be material to the listed debt securities. This undisclosed information may, however, be material to additional bonds that are issued with a maturity date in April 2016. The problem is more acute if the issuer made a single issue of short-term bonds in which few events are material, and then just before maturity proposes to rely on an exemption to issue long-term bonds.

466 Some options for addressing this are:

- Requiring that limited disclosure include additional material information that is not covered by the issuer's continuous disclosure obligation. These could be prescribed as information that would have been required to be disclosed under continuous disclosure, had the maturity date of the quoted debt securities been the same as the maturity date of the securities being offered.
- Limiting the exclusion to senior debt and/or issuers with an investment grade rating from a recognised rating agency.
- Limiting the allowed differences so that the securities have similar durations.

124. Should we adopt a requirement to give a notice to the relevant licensed market for offers under the exclusion for financial products of the same class as quoted financial products? What should this notice cover? Should different requirements apply in some circumstances – (e.g. for products that are being issued as consideration in connection with a takeover offer?)

125. Should clause 18A also cover debt securities that are in the same class but for maturity or interest rate? What restrictions should apply?

126. Should the regulations provide that the ongoing requirements that apply to the other products in the class apply upon issue or transfer under the exclusion?

10.6 Offers of category 2 products or debt securities by registered banks

467 Clause 20 of Schedule 1 excludes the following products from disclosure under Part 3:

- category 2 products issued by a registered bank
- debt securities issued by a registered bank
- prescribed category 2 products issued by a subsidiary of a registered bank – see Chapter 3
- prescribed currency forwards that are issued by a registered bank or by a subsidiary of a registered bank – see Chapter 3.

468 Category 2 products are defined by the Financial Advisers Act 2008 and its regulations.

Current requirements

469 Section 5(2C) of the Securities Act 1978 exempts registered banks from prospectus requirements for debt securities and the requirement to have a trustee but not from the requirement to give an investment statement. Section 5(2D) of the Securities Act 1978 exempts call debt securities, call building society shares and bonus bonds from investment statement requirements. These products are classified as category 2 products.

Proposed requirements

470 We do not consider that normal banking products should be subject to any limited disclosure requirement. This includes call and term deposits issued by a registered bank, along with units in cash or term portfolio investment entities or in bank notice products issued by a subsidiary of a registered bank.

471 We consider that regulatory capital products and any other non-standard investments should be subject to disclosure requirements, e.g. preference shares and subordinated debt products. We propose that the disclosure requirements would be similar to those in the debt PDS with any necessary changes, including lodging with the Registrar.

472 In Chapter 3 we identify the currency forwards issued by a registered bank or its subsidiary that are proposed to be excluded from Part 3 disclosure obligations. These are vanilla currency forwards. We do not propose to prescribe limited disclosure for these products.

127. Do you agree that no limited disclosure be prescribed for call and term deposits issued by a registered bank, prescribed category 2 products issued by a subsidiary of a registered bank, and prescribed currency forwards? If not, what disclosure should be required?

128. Do you agree that the disclosure for other debt products issued by a registered bank should be similar to the debt PDS? What other obligations should apply to those products, e.g. ongoing disclosure?

10.7 Offers by the Crown and related bodies or products

473 Clause 21 of Schedule 1 excludes offers of financial products if the issuer is named in clause 21(1) or is an offer of an interest in the Government Superannuation Fund (clause 21(2)). Other than local authorities, the bodies are the Crown or close to the Crown or the relevant products are Crown guaranteed. We cover local authorities in the next section.

Current requirements

474 Section 5(3) of the Securities Act exempts any security issued by the Crown (including the Maori Trustee and the Public Trust common fund), National Provident Fund Board, Reserve Bank and Housing New Zealand Corporation from prospectus requirements and the requirement to have trustees or statutory supervisors, but not from the requirement to give an investment statement to investors.

Proposed requirements

475 We consider that where the offer would be a regulated offer but for the exclusion, the Crown, Reserve Bank, Housing New Zealand Corporation, Maori Trustee and Public Trustee should give a disclosure document to investors that is the same (subject to necessary changes) as the relevant PDS. We are less sure that the PDS should be lodged with the Registrar and do not consider that other requirements in Part 3 or 4 should apply. This essentially carries over the existing Securities Act obligations.

476 NPF is made up of a number of superannuation schemes. Overall, NPF is closed to new members but there is a limited ability to transfer between the schemes, which can give rise to a disclosure obligation. The Government Superannuation Fund (GSF) is closed to new members. We do not propose disclosure requirements in respect of the NPF schemes or the GSF. The NPF schemes will be registered schemes under the FMC Bill and will be subject to governance requirements in Part 4 and ongoing disclosure in Part 3.

129. What disclosure requirements should apply to the Crown and others covered by clause 21 of Schedule 1?

10.8 Offers by local authorities

477 Clause 21(b) of Schedule 1 provides an exception for offers of financial products by local authorities. Local authorities may be less likely to seek funds from retail investors following the establishment of the NZ Local Government Funding Agency, although the Auckland Council recently planned a retail bond offer.

Current requirements

478 Under section 5(3A) of the Securities Act, local authorities are exempt from the requirement to prepare and lodge a prospectus for an offer of debt securities. Instead, the investment statement for the offer must refer to the most recent audited financial statements of the local authority, or interim financial statements if these are more than nine months old. The offer is required to have a trust deed and comply with other securities law requirements.

479 The main driver for the section 3A and 3B exemption seems to have been that it was problematic getting all council members to sign the prospectus as required by the Securities Act. These difficulties are not as acute for approval of an investment statement. It needs a certificate signed by two councillors, although all councillors are liable for the accuracy of the content of the investment statement.

Proposed requirements

480 If no requirements are imposed, a local authority that offered debt products, derivatives or managed investment products to a retail investor would not have to prepare a PDS and lodge it with the Registrar. Nor would the local authority have to have a trust deed for the offer, appoint a licensed supervisor, maintain registers or comply with ongoing disclosure requirements. And if it did have a trust deed for the offer of debt securities that trust deed would not be regulated by the FMC Bill.

481 It is not clear that local authorities should be excluded from the FMC Bill's requirements at all. While debt securities secured by a charge over a local authority's rates and rates revenue are relatively safe products, the exception also covers unsecured products and non-debt products. The PDS approval process is unlikely to be more difficult to comply with than the current investment statement requirements – which councils currently comply with. Councils also have a trustee when they issue a debt security. Investors benefit from these protections in the same way as they do for offers by private organisations.

482 We propose to remove the exclusion for local authorities or to reduce its scope to the 'safest' local authority products - debt securities that are secured by a charge over rates or rates revenue. Like offers by the Crown, any excluded products would be subject to a requirement that a disclosure document is given to retail investors that is the same (subject to necessary changes) as the relevant PDS. We are less certain that the PDS should be lodged with the Registrar or that other requirements in Part 3 or 4 should apply.

130. Is an exclusion for local authority products desirable? Should the exclusion be limited to the 'safest' products? What disclosure and governance requirements apply?

10.9 Renewals and variations

483 Clause 23 of Schedule 1 provides an exclusion for offers of renewals or variations.

Current requirements

484 Clause 5 of the Securities Act (Renewals and Variations) Exemption Notice 2002 exempts variations of the terms or conditions of an existing security from prospectus and investment statement requirements, unless the security:

- extends the time for payment of money due, or to become due, under the existing security by the issuer, or
- changes the issuer of the existing security.

485 Clause 6 of the exemption notice requires the issuer to send a written notice to each person who is, at the time the statement is distributed or sent, a holder of the security that is to be varied containing the following information:

- the terms of the proposed variation
- the purpose and effect of the proposed variation
- the steps necessary to bring the proposed variation into effect
- particulars of any other matters that are material to the proposed variation.

486 Clause 7 of the Securities Act (Renewals and Variations) Exemption Notice 2002 provides that if the variation extends the time or is a renewal of the security, the issuer has to register a prospectus but there is no requirement for an investment statement.

487 Clause 8 of the Securities Act (Renewals and Variations) Exemption Notice 2002 provides that nothing in the notice provides an exemption from prospectus or investment statement requirements in respect of any moratorium proposal.

488 The Securities (Moratorium) Regulations 2009 set out the requirements for establishing a moratorium. A prospectus and investment statement is required along with additional information set out in the Securities (Moratorium) Regulations 2009.

Proposed requirements

489 We propose to carry over the existing exemption conditions in clause 6 for those types of variations. If the variation extends the time for payment of money due, or to become due, under the existing security of the issuer or changes the issuer of the existing security then a PDS should be required. We are considering whether the securities moratorium regulations should be carried over into these regulations.

490 We are interested in getting feedback on whether there are any other types of variations or renewals which should be subject to limited disclosure.

131.	Are there any other types of variations or renewals which limited disclosure should be required?

10.10 Exclusions for which we do not propose limited disclosure

491 We do not propose any limited disclosure requirements for:

- licensed intermediaries (clause 6)
- offers of financial products through DIMS licensees (clause 7)
- offers for no consideration (clause 11)
- offers of controlling interest (clause 7)
- offers for small schemes (clause 16)
- derivatives (clause 19).

132.	Should limited disclosure requirements be prescribed for any other Schedule 1 exclusions?

Ministry of Business, Innovation & Employment

Financial Markets Conduct Regulations - Discussion Paper

Chapter 2 – Registers

December 2012

Contents – Chapter 2

1. Introduction

1.1 Scope of this chapter

1 The FMC Bill requires the establishment of two new registers to provide information to investors, other financial market participants and regulators. These are a register of offers of financial products (offer register) made under Part 3 of the FMC Bill and the register of managed investment schemes (scheme register) made under Part 4 of the FMC Bill.

2 This chapter seeks to give future users of the offer register and scheme register a sense of what the registers might look like and how they might function. Some, but not all, of the registers' structure and functionality is dictated by the FMC Bill and regulations.

3 Development of the registers is at an early stage. We are currently developing technical requirements. Submitter feedback on this chapter will assist the development of these requirements.

4 In addition to the offer register and the scheme register, the Registrar can establish other registers required for the purposes the FMC Bill. The register provisions are contained in Schedule 2 of the FMC Bill.

1.2 Purpose and objectives of the registers

5 The Capital Markets Development Taskforce identified a number of problems with information provided to investors, including:

- information that is poorly tailored to investor needs makes wise investment decisions difficult
- investors are unable to assess and compare investment products leading to inertia and sub-optimal financial outcomes.

6 The Taskforce recommended a new approach to product disclosure. It called for the creation of a shorter and more standardised and accessible disclosure document to replace the investment statement and prospectus – which led to the development of the PDS discussed in Chapter 1. It also recommended a centralised website for all disclosure documents that would enable investors to easily compare products. This second recommendation evolved into the FMC Bill's proposed offer register.

7 The registers will play a crucial role in providing information to investors and other market participants. This can be achieved in part through the interface that it provides to the public, but also by giving third-party services access to the information, to present it in innovative ways.

1.3 Types of registers

8 The Ministry, through its Market Services Group, operates many public registers. These fall into three broad classifications:

- ***Entity registers***. Registration on these registers is evidence of the existence of a separate legal entity and contains information about it. Examples include the registers of companies, building societies, incorporated societies, and limited partnerships.
- ***Status registers***. Registration reflects a person's registration for a particular purpose or to perform a particular function. Examples include the financial service providers register (FSPR), registers of motor vehicle dealers, licensed building practitioners, approved radio engineers and postal providers.

- ***Registers of things***. These registers record the existence of personal property or that someone is doing something. They contain information about the thing, including who owns or is doing it. Examples include the registers of personal property securities, patents, trademarks, and radio frequencies.

9 These different types of registers can be linked together to reduce compliance costs and potential for user error: if an entry in a register of things leads back to the entity register and relevant status registers, the register of things does not need to be changed when something changes in those other registers.

10 Clause 2 of Schedule 2 sets out the purposes of the offer register:

- to give public notice of offers of financial products
- to enable any person to obtain PDS information and other information about offers, and compare information about offers
- to assist any person to decide whether or not to acquire financial products under an offer
- to assist any person performing a financial adviser service or comment on an offer
- to assist any person in the exercise of the person's powers, functions or duties under the FMC Bill or any other enactment.

11 The offer register is a register of things – it records that an issuer made an offer and contains information about that offer. It needs to identify the issuer and contain information about the financial products offered under that offer. It will be related to other offers of the same or similar products by the same issuer.

12 The offer register should enable the person to find more information about the issuer. It is probably not the right home for information about the issuer generally – which has a better home on a status register (e.g. the FSPR) or entity register (e.g. the companies register). But it needs to provide a direct and clear path to that information.

13 Clause 5 of Schedule 2 sets out the purposes of the scheme register:

- to give public notice of the registration of managed investment schemes
- to enable any person to obtain information about registered schemes and how to contact the managers and supervisors
- to assist any person in the exercise of the person's powers, functions or duties under the FMC Bill or any other enactment.

14 The scheme register is a status register. The schemes registered on it are established under another law, mainly in accordance with trust law or the Partnership Act 1908 or registered under the Limited Partnerships Act 2008. Some might be established under overseas laws.

15 The scheme register has linkages with the offer register, as most schemes will make offers that require an entry on the offer register. It has close links to other status and entity registers, because the manager and supervisor will be registered on the FSPR and at least some of those will be companies or other types of registered entities.

1.4 Working group to develop the registers

16 The Ministry has convened a working group to develop the technical requirements for the new registers. The working group includes representatives from FMA and the Ministry's Investment Law policy team, Companies Office and IT group. The discussion in this chapter, particularly around requirements, is early thinking and subject to change.

17 We will obtain input from potential users during the development of the registers, including feedback on this chapter of the discussion document. Later in the development process, the Ministry will conduct formal user acceptance testing of the register technology.

18 Another topic of the group’s work is decommissioning existing registers that will be replaced.

1.5 Timeline

19 The FMC Bill cannot come fully into force until the registers are established. The project team is currently working towards a deadline of early 2014. The regulations and the register will be developed in parallel, although some of the detailed requirements for the register cannot be finalised until the regulations are well advanced.

2. Content of the registers

2.1 Register of offers of financial products

20 Clause 3 of Schedule 2 identifies information that will form part of the content of the offer register. This information includes:

- the name of the issuer and the issuer's Financial Service Provider (FSP) number (if any)
- in the case of a sale offer, the name of the offeror and the offeror's FSP number (if any)
- the name of any supervisor and the supervisor's FSP number (if any)
- a copy of the PDS
- the name of the offer that is specified in the PDS and the offer number given by the Registrar on lodgement of the PDS
- the kind of financial product or products being offered, i.e. an equity security, a debt security, a managed investment product, or a derivative
- the date of the PDS
- the status of the PDS (being a status that is determined and described in the prescribed manner).

21 Clause 3(3) of Schedule 2 provides for regulations to prescribe additional information and documents. Some of this is information that is material to the offer but additional to the PDS, and omitted from the PDS in order to keep the PDS clear, concise and effective. This includes matters such as links to full financial statements and director consents. We discuss this sort information in the following sections:

- information relating to offers of debt (section 4.21 of Chapter 1)
- information relating to offers of equity (section 5.18 of Chapter 1)
- information relating to offers of managed investment products (section 6.12 of Chapter 1)
- information relating to offers of derivatives (section 7.15 of Chapter 1)
- information provided under ongoing disclosure (section 9 of Chapter 1).

22 However, to be useful to users, the register may need other structured information entered into it that is more closely linked to the information that will be in the PDS.

23 In section 4 below we discuss the user interface and third-party access to data. In order for functionality relating to searching, filtering, extracting and presenting data to be effective, information about the offer needs to be structured into a number of data fields. Our initial thinking is that for the process of submitting an offer for lodgement, a web form containing prescribed data fields would need to be completed by the issuer.

24 An important decision in the design of the register is how much information, and what kinds of information, should be provided in a structured format. This could be:

- very minimal – essentially the information required by the FMC Bill such as the name of the issuer, the kind of financial product and the status of the PDS
- selected standardised or quantitative information from the PDS – e.g. for debt securities, this might include the maturity, interest rate, minimum investment, credit rating, etc.
- a selection of both standardised and free-form information from the PDS – e.g. for a managed investment product, free-form information might include a summary of the product's statement of investment policy and objectives

- a structured version of all the information in the PDS.

25 There are trade-offs. Requiring more information to be submitted in this form is likely to have benefits to users of the information. It may be easier searched and filtered. It may be organised and presented in innovative ways, and used in a wider range of applications. However, it makes lodgement a longer and more complex process, and errors in data entry are more likely.

1.	What information should be required to be provided in data fields for the offer register?

2.2 Register of managed investment schemes

26 Clause 6 of Schedule 2 identifies information that will form part of the content of the scheme register and other information is required by the FMC Bill. This information includes:

- the name of the scheme
- what type of scheme it is (if any) (for example, whether it is a KiwiSaver scheme or a superannuation scheme or other prescribed type of scheme)
- whether the scheme is a restricted scheme, a complying superannuation fund, a default KiwiSaver scheme, a workplace scheme, a restricted employer-related scheme, or a closed principal purpose superannuation scheme
- the names of each person who is a licensed manager or licensed supervisor of the scheme and an address for service in each case
- for a restricted scheme, the name of the licensed independent trustee.

27 Clause 6(1)(f) of Schedule 2 provides for regulations to prescribe additional information and documents. We consider that the scheme register should also include core scheme documents, in particular the trust deed or other governing documents, the statement of investment policy and objectives, and financial statements for the scheme. We are also considering the extent to which compliance reports should be lodged, including certificates for related party transactions, limit break reports, pricing error reports and other compliance reports to the supervisor or FMA. The scheme register may also include some aspects of the ongoing disclosure.

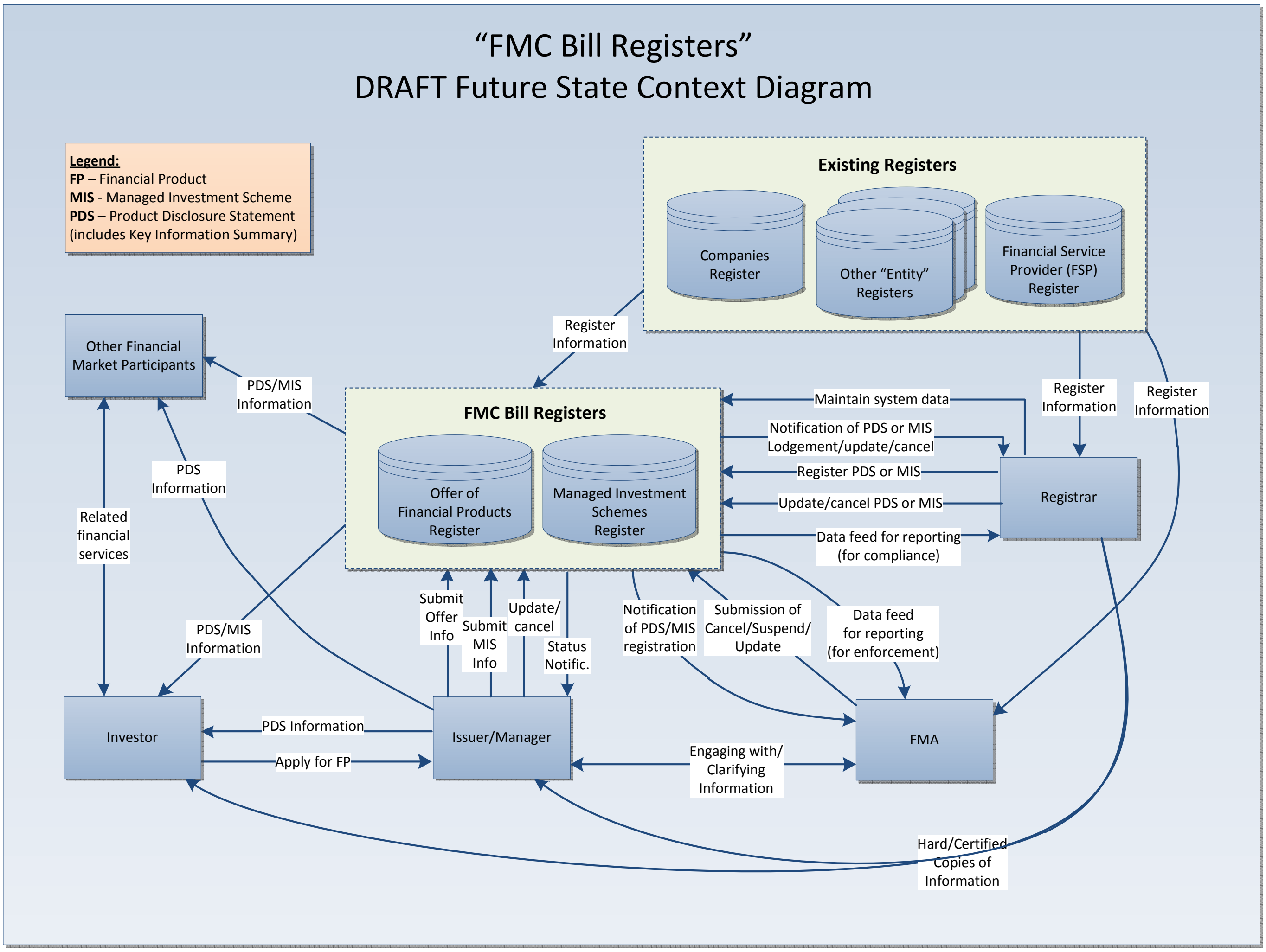
2.	What information and documents should be prescribed for the scheme register?

3. New system description

3.1 Context diagram

28 The registers will be accessible online and electronic i.e. no paper lodgement will be accepted by the Registrar.

29 The diagram below is a draft high-level depiction of the future context in which the new registers will operate. Each arrow indicates an information flow or interaction between registers and users of the registers. A brief narrative of the process summary in the diagram is contained section 0 below and some more detailed description of some of the high level requirements of particular processes are contained in section 3.4.



3.2 Summary of users of the registers

30 The following table provides a general description of the users of the registers.

User	Description
Public	A member of the public who does not need to authenticate to access the system but wishes to search for, view or compare register records. This will include both individual investors as well as financial market intermediaries/firms. We are considering the possibility of providing various ways of extracting information which users can interrogate or reproduce into reports.
Issuer of financial product	A person who is approved to submit and update the register on behalf of an organisation. This includes those who have been granted delegated authority to submit and update the register on behalf of one or more issuers, e.g. a solicitor, lawyer or accountant.
Manager of a managed investment scheme	A person who is approved to submit and update the register on behalf of an organisation. This includes those who have been granted delegated authority to submit and update the register on behalf of one or more managers, e.g. a solicitor, lawyer or accountant.
Ministry or FMA staff	An employee of the Ministry or FMA who needs to search, view, register and undertake their legislative functions for registry monitoring, compliance, maintenance and help desk support purposes.

3.3 Integration with existing systems and registers

31 We are considering ways in which the new registers can work with existing systems, processes and registers.

32 Relevant registers include entity registers (e.g. companies register and limited partnerships register) and the FSPR. Where appropriate, we are looking to leverage common data sources and information from these existing registers. For example, where information is held on another register it may be appropriate to provide a link from the new registers through to the information held on the other register, including financial statements held on an entity register, manager's contact information, names and addresses of directors. This could, if well executed, significantly reduce the need to update different registers, reducing compliance costs and improving data integrity.

33 Where appropriate, we are also considering what current systems and processes could be adopted for the new registers. For example, user account authorisation could be handled according to the current processes in place for other Companies Office registers. This includes the requirement for accounts to be registered with igovt and the ability to request and assign delegated authority for companies.

Process summary

34 The following table provides a high-level summary of register processes that we envisage will be available to users. This is early thinking and is subject to change. It may not be applicable to all use cases.[1]

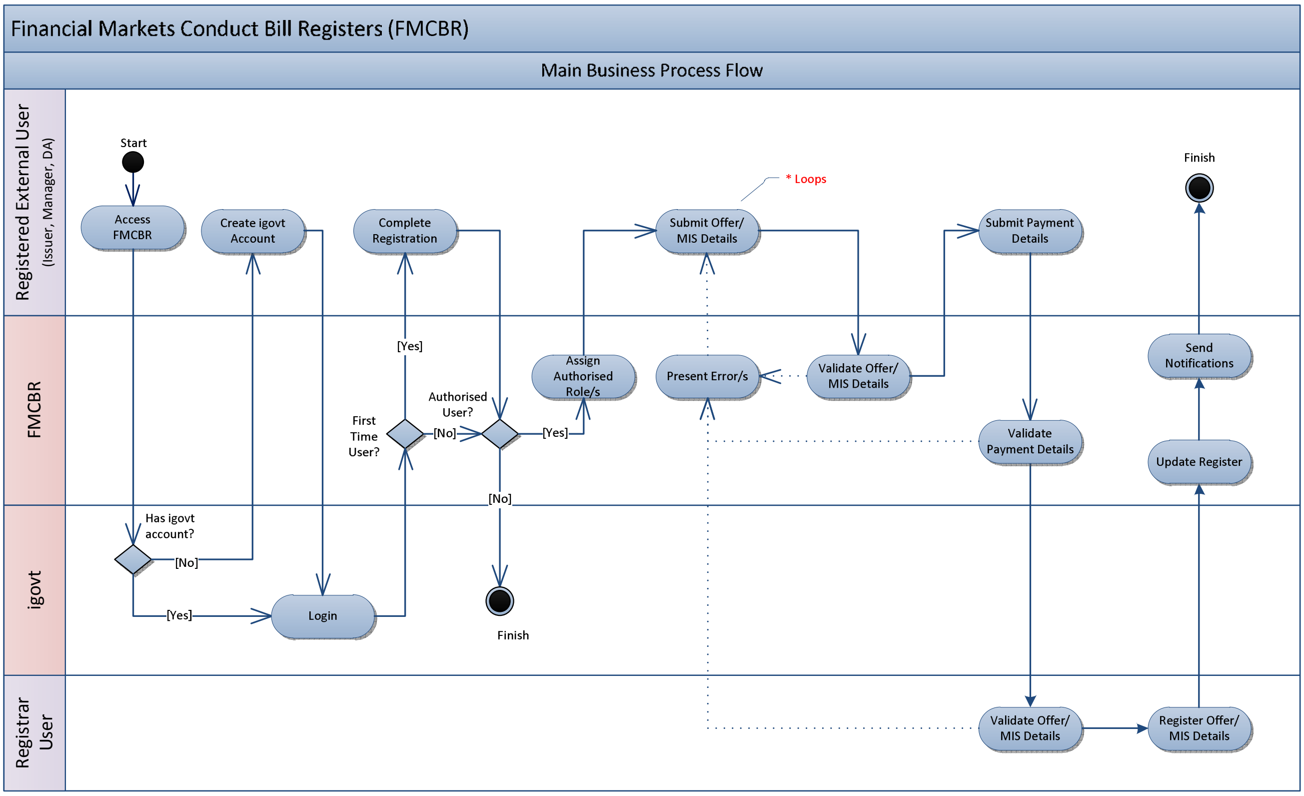
[1] For example, overseas issuers may not be registered on the FSPR.

Process Name	Description
Register new user	This process will enable a new user to register for system access and become a “registered user”. A user must first create or use an existing igovt account. For most users, we are thinking of checking against the FSPR in order to verify they are authorised to represent an organisation (this will not be possible for issuers that are not registered FSPs), and they will be assigned a role. The user account is then considered “registered”.
Log on & off system	This process will enable a registered user to log on to the system and interact with functions, for example submitting an offer for lodgement. The system will authorise the user and enable the appropriate system privileges. For example, a user authorised for the System Administrator role has unique privileges to manage reference tables/lists. The user can log off the system through the system function, ending their web-browser session, or after a predefined period of inactivity.
Submit offer for lodgement on offer register	This process will enable an issuer or their delegated authority to log on to the system and submit an offer for lodgement. The registrar will then validate the submission and, if it complies with requirements of the FMC Bill and regulations, the offer will be lodged. A notification will be sent to the registered user of the lodgement of the offer. Where the record is entered by a delegated authority, the system will send the associated issuer an email notifying them that an offer has been lodged against their account.
Submit scheme to be registered on scheme register	This process will enable a manager of a managed investment scheme or their delegated authority to log on to the system and submit a scheme for registration. The Registrar will then validate the submission and, if it complies with the requirements of the FMC Bill and regulations, it will be registered. A notification will be sent to the registered user of the registration. Where the record is entered by a delegated authority, the system will send the associated manager an email notifying them that a record has been registered against their account.
Update offer information on offer register	This process will enable an issuer or their delegated authority to log on to the system and update the register. The Registrar will then validate the update and, if it complies with the requirements of the FMC Bill and regulations, the change will be actioned. A notification will be sent to the registered user of the update. Where the record is entered by a delegated authority, the system will send the associated issuer an email notifying them that a record has been updated against their account. The issuer and their delegated authority will only be able to update records for which they are authorised. The system will keep an audit history which is visible to any user viewing the record that has been updated.

Update scheme information on scheme register	This process will enable a manager of a managed investment scheme or their delegated authority to update data attributes of a managed investment scheme record. The user will need to be logged in. The Registrar will then validate the update and, if it complies with the requirements of the FMC Bill and regulations, the change will be actioned. A notification will be sent to the registered user of the update. Where the record is entered by a delegated authority, the system will send the associated manager an email notifying them that a record has been updated against their account. The manager and their delegated authority will only be able to update records for which they are authorised. The system will keep an audit history which is visible to any user viewing the record that has been updated.
Search records	This process will enable a registered or public user to conduct a search of the registers (more discussion of searching records is in section 4). A user does not need to be logged in or authenticated to use the search function and any person with a web browser and internet access can search the register for a record. Additionally, some data will be restricted depending on the user role, for example public users will not have access to confidential records, e.g. contact information for the person who can be contacted by the registrar about the submission of an offer.
View record	This process will enable a registered or public user to view the details of a record located via a search. The user can also view the history of any changes related to fields within a record.
Compare records	This process will enable a registered or public user to select multiple records and compare them (more discussion of comparing records is in section 4).
Extract data	This process will enable a registered or public user to extract a set of data from the registers (more discussion of extracting data is in section 4).
Manage payments	This process will enable a registered or public user to make a prescribed payment for a particular service. For example paying a fee associated with lodging an offer by an issuer or paying a fee for a certified copy of a document on the register by a public user.
Maintain user account	This process will enable a registered user to log on and maintain their account details, e.g. update an email address. An issuer of a financial product or a manager of a managed investment scheme can also manage the frequency of their notifications, which are generated when their delegated authority creates or updates a record in the system.

3.4 High-level offer lodgement and scheme registration process

35 Work has begun on high-level requirements for some information flows or processes shown in the future context diagram. An example is the following process diagram which is a high-level depiction of how we envisage an issuer or manager will interact with the registers to lodge an offer or register a scheme.



36 As noted in the process summary, an issuer or manager must have an igovt account to log on to the new registers. The registered user would then be able to submit their offer for lodgement or their scheme for registration. We envisage that a web form or similar will be used to capture static data related to the submission. This process would include the ability to upload the information required under the FMC Bill and regulations. The 'loops' note in the diagram means that a user can upload more than one document and they do not need to log in each time.

37 The submission would then go through an automated validation/checking process. We think that some information, such as whether the manager is registered on the FSPR and is licensed, could be done through an automated process of cross checking against information in the FSPR. Following this, the issuer or manager would need to complete a payment process and then some form of manual validation/checks would be undertaken by the Registrar. After successful completion of this, the offer would be lodged or scheme registered and the information would then be visible on the registers.

38 As the register project progresses, detailed requirements for each part of this process will need to be developed.

39 The working group is also currently mapping high-level processes for the following situations:

- process for issuers to update the offer register
- process for FMA interaction with the offer register after an offer has been lodged through to the end of the consideration period
- process for FMA interaction with the offer register in terms of their enforcement responsibilities.

4. User interface and third-party access

40 A website interface needs to be developed to allow users to search the registers. We envisage that the search functions for the scheme register will be relatively basic, e.g. search by name, by type of scheme, for all schemes or for all active schemes. The offer register however needs to have a much higher level of search functionality. A number of search options will be considered.

41 Our initial thinking described in section 2 above is that for the process of submitting an offer for lodgement, a web form containing prescribed data fields would need to be completed by the issuer. The web interface would enable users to apply criteria when searching or filtering offers, e.g. the user could search for debt securities from an issuer with a credit rating of BBB+ or higher and a minimum investment not exceeding $10,000.

42 In addition to searching for data in prescribed fields, we consider that the PDF documents held on the register would have to be in a form by which the text is searchable. This provides more ability for users to search the register if a suitable search engine is provided.

43 We are also keeping in mind the possibility of offering users the ability to save search preferences or export search results. This type of advanced functionality would only be available to users who have logged in to the system, although registration requirements would likely be different for public users than issuers and managers.

44 We will consider a number of options for how search results can be displayed. Another consideration is the extent to which the web interface enables a user to compare information about offers, which is one of the purposes of the offer register. Some early thinking includes providing users with the ability to:

- filter results from register information
- compare information about offers
- extract data through a number of different forms.

45 Filtering can be used to create a results list of all offers that meet specified criteria. The user could click on any of the results to bring up the full register entry for the offer. Some users may wish to have a list that is displayed in a format that is readily printable.

46 The website interface could enable the user to compare specific information about offers within their results list. The Securities Law Review discussion document anticipated the ability to view comparable information, side by side, on a range of investment products. The information which could be compared may take a number of forms. If comparing PDSs, the sections and headings could form the basis of alignment of comparison, e.g. a side-by-side comparison of the historic returns or fees section. It might also be desirable to compare certain field results for multiple offers, e.g. the credit rating of a number of issuers of debt products.

47 Users may be able to extract spread sheet information or to use web services technology to extract information from the registers. From this information, users could undertake their own comparisons with the data. Web services technology allows customers to transact directly from within their own systems without needing to use the website interface (system to system connections).

48 The Ministry is responsible for a number of registers which offer web services technology, including the Personal Property Securities Register, Trade Marks Register, Design Register and Patents Register. One of the benefits of providing web services is that it reduces the burden on government to determine what and how information is provided. It enables the market to determine the suite of comparison functionality and reduces cost of accessing information from the registers.

49 There are a number of things that we consider should not be included in terms of presenting and enabling comparisons of offers through the web interface:

- comparing different types of financial products, e.g. comparing equity products with debt products
- presenting information in a way which shows a preference of one product over another
- comparing information from within the offer register (new format PDS) with information on another register (old format prospectus).

3. What should we consider in developing basic search and results display for the registers?
4. Is there a need to provide web services technology, which enables users to transact directly from within their own systems instead of using the website interface?

5. Other register matters

5.1 Decommissioning of existing registers

50 A number of existing registers will be replaced by the new registers. We are considering how to approach the decommissioning of the affected registers after the implementation of the new registers, e.g. whether information should be migrated to the new registers and whether the registers should be publically available in a read-only format.

51 We expect the schemes register will replace the:

- participatory securities register (MBIE)
- unit trusts register (MBIE)
- superannuation schemes register (MBIE)
- KiwiSaver schemes register (FMA)
- complying superannuation funds register (FMA).

52 These registers are a mix of ‘status’ and ‘things’ registers. Transitional provisions in the FMC Bill allow existing schemes to delay meeting the FMC Bill requirements for up to two years after the regulations come into force. Therefore schemes will continue to comply with requirements in respect of the old registers (e.g. filing financial statements) until they start to comply with the FMC Bill and move over to the new registers. New schemes will not be added to the old registers as they will be required to comply with the FMC Bill.

53 The offer register is new. It replaces the current practice of filing offer documents on entity registers (principally the companies register) or on the above registers.

54 The offer register will also replace the register of overseas issuers (MBIE). That register is a register of things. It is a register of offers by overseas issuers under mutual recognition arrangements. We expect overseas issuers to start lodging offer documents on the offer register once the regulations come into effect. We do not expect new information will be placed on the register of overseas issuers.

55 Contributory mortgage brokers are currently required to be registered under the Securities Act (Contributory Mortgage) Regulations 1988. These regulations will not be remade under the FMC Bill. The FMC Bill however includes a transitional provision for existing contributory mortgages which will require brokers to continue to comply with these regulations. No new contributory mortgage brokers will be registered. The register of contributory mortgage brokers will need to be decommissioned and will not be replaced by a new register.

5. Do you have any comments on the migration of data to the new registers and maintenance of the old registers?

5.2 Other matters

56 The working group is considering a number of other matters and is developing other areas of work on the registers. Matters that are currently being considered include:

- the status of offers on the offers register - including status updates such as open offer, closed offer, under consideration, offer under stop order
- thinking about further breakdowns of the four types of financial products (equity, debt, derivatives, managed investment products) into sub-types of products, which may assist with registration and lodgement processes and searching the registers
- where overseas offers will sit in the register of offers of financial products and whether and to what extent they can be compared to other financial products on the register

- naming of the registers.

57 The names for the registers used in the FMC Bill are descriptive and not particularly user-friendly. The names used for the registers need not be the same as those used in the FMC Bill. We welcome suggestions. ASIC calls its list of offer documents lodged with it "OFFERlist". The United States SEC calls its public register system the "Electronic Data-Gathering, Analysis, and Retrieval system (EDGAR)".

6.	What should we call the register of offers of financial products and the register of managed investment schemes?

Ministry of Business, Innovation & Employment

Financial Markets Conduct Regulations - Discussion Paper

Chapter 3 – Scope, exclusions and offer process

December 2012

Contents – Chapter 3

1. Introduction

1 The regulation of conduct in financial markets under the FMC Bill takes four forms:

- general standards of conduct and prohibitions of unfair practices under Part 2
- disclosure regulation on offers of financial products (Part 3) and some market services (Part 6, subpart 4)
- governance obligations for issuers of debt securities and managed investment products in Part 4, with further specific conduct obligations for investors and issuers trading securities on financial product markets in Part 5, and for providers of some market services in Part 6
- licensing of financial product markets in Part 5 and other market services in Part 6.

2 These different forms of regulation are closely connected and issuers and investors may need to interact with different parts of the FMC Bill for different products.

3 The key determinants of whether a matter is governed by the FMC Bill are the definitions of the products and services covered by the FMC Bill. In addition, whether or not an offer of financial products is a regulated offer under Part 3 has a significant impact on the application of the FMC Bill throughout the lifetime of the financial product.

4 For example, if an offer of a managed investment product is a regulated offer under Part 3, then the other forms of regulation are engaged. The manager and the supervisor must first be licensed under Part 6 (see Chapter 6) and then register the managed investment scheme under Part 4 (see Chapter 4). The issuer must make the offer under Part 3. There are ongoing governance duties and operating obligations that apply under Part 4 and requirements for ongoing disclosure under Part 3.

5 Although the FMC Bill addresses these key scope issues, some of the boundaries are left to be resolved by the regulations through exclusions and definitions. Designing these boundaries requires us to take careful account of the purposes of the FMC Bill of promoting confident and informed participation in the financial markets and promoting and facilitating the development of fair, efficient, and transparent financial markets.

6 The FMC Bill needs to be both comprehensive in its coverage and sufficiently flexible to apply appropriately to different types of financial products, offers and services. Equally it needs to interact with other law in ways that ensure a clear basis for regulator action, reduce complexity for users, and do not leave gaps in regulation.

7 This chapter examines these boundary issues in relation to Part 2 and Part 3:

- the scope of the fair dealing provisions in Part 2
- possible relief from disclosure-related obligations in Part 3 (e.g. need to give a PDS)
- the boundaries of various exclusions in Schedule 1 that determine whether or not an offer requires disclosure under Part 3
- the role of mutual and unilateral recognition of other disclosure regimes
- the application of financial reporting obligations to issuers who make offers under the exclusions in Schedule 1.

8 In addition, this chapter consults on regulations to provide the supporting detail for ancillary offer process obligations under Part 3 and the “future time” for the purpose of the definition of “derivative”.

2. Scope of fair dealing provisions under Part 2

9 Part 2 of the FMC Bill prohibits misleading or deceptive conduct in dealings in financial products or the supply of financial services in trade. The provisions closely match the equivalent conduct obligations applying generally under the Fair Trading Act 1986.

10 These provisions are primarily included to enable FMA to be the primary regulator and enforce these obligations in accordance with the liability framework of the FMC Bill.

2.1 Meaning of financial product for Part 2 fair dealing provisions

11 Financial products under the FMC Bill are equity securities, debt securities, managed investment products and derivatives. For the purposes of Part 2, the definition of financial products may be extended by regulations to cover other financial products listed in the Financial Advisers Act 2008.

12 The FMC Bill covers the financial service of acting as an insurer and financial adviser services relating to insurance, but it does not generally cover insurance contracts.[1]

13 We are considering whether to include insurance contracts as financial products governed by Part 2 of the FMC Bill. We are concerned that regulating the conduct of selling insurance products under the Fair Trading Act while the services involved in selling, advising on and performing that contract are regulated by the FMC Bill may result in artificial distinctions and inefficient dispute processes. A regulator will inevitably need to take action in relation to both the contract and the services provided under it. Ideally the primary regulator and liability framework would be the same for both the product and the services under that product.

14 Providing for FMA to be the primary regulator of insurance contracts would also be consistent with the approach adopted in Australia, where the Australian Securities & Investments Commission (ASIC) is the regulator for insurance contracts and the ASIC Act (rather than the Australian Consumer Law) regulates misleading and deceptive conduct.

1. What are the possible benefits or problems with covering insurance contracts under the fair dealing provisions of Part 2 of the FMC Bill rather than under the equivalent provisions of the Fair Trading Act?

2.2 Exclusions from prohibition on offers in unsolicited meetings

15 Part 2 of the FMC Bill also contains other fair dealing provisions. Clause 26A prohibits a person from offering financial products in the course of, or because of, an unsolicited meeting. The intent of this provision is to prevent pressure selling, whether on the phone or in person. The provision is particularly directed at boiler-room selling practices.

16 There are, however, some exclusions from the prohibition which in part recognise the reality that cold-calling is the primary mode by which professional advisers sell and advise on some financial products and that the market (including consumers) is used to these methods. Therefore an authorised financial adviser or a Qualifying Financial Entity adviser acting in the ordinary course of their business is able to continue to do so using unsolicited meetings.

[1] Investment insurance may however constitute a managed investment product.

17 If insurance contracts are included in financial products for the purposes of Part 2, the question arises as to whether or not the prohibition on offers in unsolicited meetings should apply to registered financial advisers advising on those products. Registered financial advisers are the primary advisers selling this product. We understand that unsolicited calls are the main means of selling insurance. However, registered financial advisers are not subject to the same degree of regulation (nor at risk of professional consequences to the same extent) as authorised financial advisers.

2. What are the risks and benefits of excluding registered financial advisers from the scope of the prohibition on offers in the course of, or because of, unsolicited meetings?

3. When a PDS need not be given and other regulations relating to the offer process

3.1 Introduction

18 The critical issue for the regulations is how to implement the disclosure regulation mandated by Part 3 of the FMC Bill. The proposed content of disclosure is covered by Chapter 1 and the role of disclosure in financial market regulation is discussed in detail there.

19 However, the scope of the obligation to disclose (when and to whom) and the immediate consequences of a failure to disclose are vital to both the efficacy of the disclosure regime for investors and its costs.

20 The issuer must comply with the following key obligations in making an offer:

- ***Obligation to prepare PDS and have register entry***: the issuer must prepare and lodge a PDS on the register of offers of financial products and complete a register entry for that offer. Chapter 2 deals with the register of offers of financial products and how it is anticipated it will work as a central repository of financial product offer information.
- ***Obligation to give PDS***: the PDS must be given to every investor to whom disclosure is required under Part 3. This chapter deals with how this obligation may be met and our proposals for exclusions or modifications by regulations.
- ***Obligation to hold subscription money on trust***: until financial products are allotted, the issuer must hold money received on trust for applicants. This chapter discusses how money held on trust must be dealt with.
- ***Obligation to cease offering if there is defective disclosure***: if there is defective disclosure, the FMC Bill requires the offeror to cease any offer and correct the defective disclosure. This chapter deals with how the offeror must deal with applications if there is defective disclosure in the course of an offer.

21 The regulations considered in this chapter need to define when some of these key obligations do not apply or may apply differently, and the supporting detail for these process obligations, to ensure the regime is well-directed.

3.2 When a PDS need not be given

Requirement to give the PDS and clauses that provide for relief

22 Clause 37 of the FMC Bill requires the PDS for a regulated offer to be given to each person who requires disclosure under Part 3. An application must not be accepted from the investor, or a financial product issued to the investor, unless the PDS was given to the investor before the application was made.

23 Obtaining the PDS at this time enables the person to read it and obtain advice on it before legally committing to the investment. It is critical therefore that the PDS is received by the investor and that it is received before the investment decision is made. This is the fundamental premise of the PDS disclosure regime. We do not propose regulations that would change the basic requirement to ensure disclosure has been made.

24 The FMC Bill recognises that issuers need a degree of certainty that the PDS has been received. Clause 39 provides that an investor is treated as having received the PDS if the investor uses the application form distributed with the PDS.

25 There are also particular situations where giving a PDS may be unnecessary. Clause 38 recognises that the investor may have already received the PDS or an earlier PDS that is not materially different (this will occur most often where the investor makes a further investment into an existing product). In this case the investor need not receive another PDS.

26 There are two possible approaches for regulations under the FMC Bill to give further relief in particular cases from, or to alter, the obligation to give a PDS before accepting an application for a financial product or issuing a financial product under clause 37:

- clause 10(2)(c) of the FMC Bill limits the meaning of "issue" to exclude certain further contributions or further investment scenarios, with an ability to add to these situations to a limited extent by regulations
- clause 38 provides a wider ability to exclude from clause 37 by regulations.

27 In addition, FMA exemptions could be made in appropriate circumstances.

Situations where additional relief may be justified

28 We think that there are particular scenarios that raise compliance issues that could justify changes to the way in which clause 37 operates.

Pre-existing investments where the investor is making a further investment in the same financial product

29 If there is a pre-existing investment, and the investor is making a further investment in the same financial product, there are a range of possible issues.

30 The investor may have, at least in practice, already committed to make a further investment (e.g. by granting a direct debit authority or setting up an automatic payment). In this case, there will be no application with a subsequent issue, but rather a standing instruction effectively to issue on payment of the further investment. In this case there is no, or limited, opportunity to provide the current PDS before the further investment is made and no application form is used (so the issuer cannot be certain the investor has received the PDS).

31 It is also arguable that further investments in some types of products are of a different nature from others. If an investor is making regular contributions to a superannuation scheme, for example the investor is not making a decision to invest or not with each contribution, but may wish at any time to make a decision to withdraw from the entire investment or review the amount of contributions. In this case the investor has an information need, particularly as to material adverse changes. However, the information need is not tied to the same extent to timing of each particular additional investment.

32 An aggravating compliance factor with further investments in the same financial products may be that out-of-date contact details make it more difficult for the issuer to be sure that compliance with the obligation to give the PDS has been achieved.

Time-critical or frequent investments

33 In some circumstances (e.g. if an investment is made by the telephone or made frequently) an investor is more likely to have a time-critical investment decision to make and will not want to wait to receive a PDS and apply for the financial product.

34 In the case of continuously offered products, the issuer may have a high volume of applications and wish to be able to offer products and accept applications without delay after sending a PDS.

Reliance on other parties to give the PDS

35 The KiwiSaver Act 2006 provides for disclosure documents to be given by employers and by the Commissioner of Inland Revenue. The manager of the KiwiSaver scheme has little or no control over this process, but is reliant on it.

Comment

36 In the cases above, the compliance burden for issuers in being required to ensure investors receive a PDS before the investment decision is made may be higher, and/or the benefit of the information in the PDS to the investor's decision-making may be lower.

37 These issues are most acute where there are further investments being made by existing investors. The FMC Bill provides for ongoing disclosure, which could reduce the emphasis that is placed on initial PDS disclosure. The intention is that ongoing disclosure will provide existing investors with information on material adverse changes and an update on the performance of investments. This may assist them to decide whether or not to dispose of, or cease to make further contributions to or investments in, their financial products.

38 However, these compliance problems for issuers need to be carefully balanced with the argument that an existing investor should not be in a worse position than a new investor in terms of the information available to the investor and the investor's civil remedies if there has been a material non-disclosure, including the investor's right to withdraw under clause 41. Accordingly any recognition of these compliance issues needs to be carefully targeted at the concern, and go no further than is reasonably necessary to address that concern.

3.	Are there situations we have not identified where the requirement to give a PDS before the investment decision is made will impose significant compliance costs or where there may be little benefit in receiving the PDS before the investment is made?

3.3 Clause 10(2)(c): no new issue

39 Clause 10(2)(c) replicates the current understanding under the Securities Act 1978 that a new interest in a superannuation scheme is not issued each time an existing member makes a further contribution to the scheme (and follows section 761E of the Australian Corporations Act 2001). This approach is applied under the clause to further contributions to superannuation schemes and KiwiSaver schemes.

40 The effect of 10(2)(c) is to remove the further investment or action from the PDS requirements in Part 3 altogether. The investor does not have a right to have a PDS provided with each further contribution (irrespective of whether the PDS they received on the initial investment is still up to date) and has no right to withdraw their further contribution for non-supply of a PDS under clause 41.

41 The clause may also be extended by regulations to:

- further contributions to, or investments in, other prescribed schemes
- further deposits into prescribed deposit products
- further actions specified in regulations by an existing product holder in relation to their existing financial product.

42 The question arises as to when a further investment in an existing product should come within clause 10(2)(c). A wide range of further investment scenarios, for example, any regular savings plans, could arguably be prescribed for the purpose of this clause.

43 However, we consider that clause 10(2)(c) should be used for only limited purposes because it does not require the PDS to have been previously provided or the information needs of the investor to have been otherwise met. Rather it is sufficient to come within a specified category of further investment (a per se rule).

44 We would prefer to address other questions as to whether a PDS needs to be given with a further contribution under the more principle-based exclusions proposed under clause 38.

45 We consider that clause 10(2)(c) currently recognises cases where, by their nature, the initial decision to invest includes a decision to continue to make further contributions (meaning that the investor, in making the initial investment, will have considered further investments and the PDS will have covered this aspect).

46 There are still investment decisions to be made, e.g. whether or not to withdraw from the product as a whole or decrease or increase contributions in general. However, these are decisions for which ongoing disclosure is most suited and are not transaction-critical. We consider accordingly that clause 10(2)(c) should only be extended to other prescribed schemes, prescribed deposit products, or specified further existing holder actions where this analysis also applies as a result of the nature of the scheme, product or action itself.

Further contributions or investments in other prescribed schemes

47 We consider that this criteria applies to only those schemes where all of the following apply:

- Membership in the scheme carries with it an expectation or legal obligation to make further contributions. This applies, in our view, where the investment is a long-term investment and contributions are in general regular and pre-determined.
- These characteristics are inherent in the nature of the product itself (rather than being merely the behaviour or choices of the investor as to how to access the financial product).
- There are ongoing disclosure obligations prescribed for the product.

48 At present, we do not consider that any other schemes meet these criteria, but we are interested in feedback as to when this might apply in other non-superannuation contexts.

4. Should any other membership schemes be defined, with a similar nature to KiwiSaver and superannuation, for which further investments should not be treated as a new issue under clause 10(2)(c)?

Prescribed deposit products

49 The rationale for applying clause 10(2)(c) to deposit products is similar to the rationale applying for membership schemes. In this case the initial decision to open a deposit account carries with it a decision to have a facility into which to deposit amounts, with each amount to be held on the terms applying to the facility.

50 There is already an exclusion from Part 3 disclosure in clause 20 of Schedule 1 for category 2 products issued by a registered bank. These include call debt securities, bank term deposits and bank notice products. We also propose including cash and term PIE products issued by a subsidiary of a registered bank in this exclusion.

51 This means that “prescribed deposit product” has more relevance to non-bank deposit takers than registered banks. This extension could apply where the investor obtains a facility under which:

- the investor may deposit any amount and has a right to make further deposits into the facility, and

- the issuer has an obligation to repay the value of the amount standing to the credit of the facility, in full, on the investor's demand.

52 Further limitations might be appropriate to require the deposit product to be on call, or if not on call, subject to prescribed limits on any notice or withdrawal limitations. This would make the requirements quite similar to rules for non-bank deposit products categorised as category 2 products in the Financial Advisors Act.

53 It might, however, be more practicable to provide relief pursuant to clause 38, given that exclusions through clause 10 affect the investor's right to withdraw from the product if the subsequent disclosure document is defective.

5. Should any deposit products be prescribed for the purposes of clause 10(2)(c) so that further deposits into them are not treated as a new issue? If so, how should they be defined?

Further actions by existing product holders

54 Clause 10(2)(c) also enables further actions by existing product holders in relation to their existing products to be prescribed. In principle, we consider that this provision should be used only where there is no true new investment decision being made with the "further action" and terms or conditions are not required to meet the purposes of the FMC Bill. In general, we consider that other further actions by existing holders should be dealt with, if relief is needed, by exceptions under clause 38.

6. Are there any other further investments in, or actions in relation to, existing products that should be treated as not being a new issue under clause 10(2)(c)?

3.4 Clause 38 exceptions

55 Clause 38 provides an exception from the obligation to give the PDS to an investor where the investor already has a PDS containing all the required information or the offeror believes, on reasonable grounds, that the investor already has the PDS.

56 In practice, an issuer may only be able to rely on this exception with certainty if the issuer re-sends the PDS to the investor or has confirmation from the investor that the investor has received the PDS. The FMC Bill also provides for regulations to prescribe additional exclusions.

Exceptions under the Securities Act and Australian Corporations Act

57 Under the Securities Act, the equivalent to the obligation to give a PDS is the prohibition on allotment unless an investment statement has been received (section 37A(1)(a) of the Securities Act). FMA provides exemptions from this obligation in a range of situations,[2] including exemptions for specific types of products. A number of the issues addressed by these exemptions are dealt with in other ways under the FMC Bill (e.g. through Schedule 1). However, the existing exemption notices are still a useful indicator of cases where the burden of disclosure may outweigh its value.

58 In addition, we have considered the exclusions that apply in Australia under the Corporations Act. Australia takes a slightly different approach in that application forms are mandated for most investments. However, there are exclusions from this obligation and the obligation to give the PDS before the investment is made in a range of situations, including where:

[2] For example the Securities Act (Commercial Bill Dealers) Exemption Notice 2012, Securities Act (Banks) Exemption Notice 2012, Securities Act (Cash and Term Portfolio Entities) Exemption Notice 2009), Securities Act (Co-operative Companies) Exemption Notice 2011, Securities Act (Continuous Debt Issues) Exemption Notice 2011, Securities Act (Building Societies) Exemption Notice 2002 and Securities Act (Renewals and Variations) Exemption Notice 2002

- information is duplicative of a PDS already given to the investor (as is currently set out in clause 38)
- the investor is an existing investor in the financial product and information is duplicative of a PDS and ongoing disclosure or continuous disclosure that the investor has received, has, or has access and knows that they have access to
- certain other situations, some of which are covered by exclusions that the FMC Bill already provides in other ways (e.g. through Schedule 1).

59 We propose to prescribe the following exclusions.

Duplicative information held by existing investors

60 We propose an exclusion based on section 1012D of the Corporations Act, in the case of a further investment by an existing investor, if the issuer has taken specified steps to ensure that the investor has received or has access to (and knows how to access) all of the information in the current PDS from:

- a PDS
- ongoing disclosure required by the regulations (see Chapter 1)
- continuous disclosure required by the listing rules of the relevant licensed market.

61 The exclusion would apply only to existing investors making a further investment in the same financial product (or a financial product that differed only in its term).

62 This exclusion, in practical terms, accommodates the situation where additional investments are made after a PDS has been changed or expired, particularly where those additional investments are made through existing facilities or in ways that do not allow for use of an application form. It gives relief from the obligation to give the new PDS to all existing investors before they make a further investment, which will be particularly relevant for those investments where multiple investments are common. Instead an issuer will be able to rely on previous disclosures that have been made or send the investor notice of the new PDS or supplementary document and how to access it.

63 We are seeking views on the level of action that would need to be taken by the issuer for it to rely on the proposed exclusion. Under the equivalent Australian provision, the issuer must have “reasonable grounds to believe” that the existing investor has these documents or has access to and knows how to access them. ASIC considers that, as a matter of practice, this requirement could be met by the issuer creating a list of documents relied upon and providing this list to existing investors and only updating it when there is a change to the list and resending it by a means of access (e.g. internet access) that is reasonable, convenient and inexpensive for the investor.

64 We are considering giving issuers more certainty than the equivalent Australian provision by specifically providing in the regulations that this exclusion applies if the issuer has sent the investor a list of the disclosure documents relied upon to an address specified by the investor for that purpose, and how to obtain or access those documents. Doing so, would enable issuers to know that the obligation had been complied with at the point when the PDS or notice of the disclosure documents had left the issuer. Compliance however would still have to occur before the further investment was made.

65 In this case, however, we would also need to address what should happen if the issuer received a ‘bounce-back’ or otherwise became aware that an address was out of date. For example, the issuer could be obliged to take all reasonable steps to locate the client and to send the notice or current PDS if it subsequently becomes aware of the correct address. We are interested in further feedback as to the significance of the problem of lost addresses and alternative methods of dealing with it.

7. Is the proposed exclusion from the obligation to give a PDS for existing investors who receive or have access to (and know that they have access to) other disclosure justifiable? Are the proposed terms of those exclusions workable?
8. Should there be further obligations for issuers relying on this exclusion in the case of lost addresses?

Simple products

66 We are considering the nature of any relief or change to the obligation to give the PDS that might be justified for simple deposit-based products. The Schedule 1 exclusion for registered bank products, and our proposal to exclude further investments in other on-call deposit products under clause 10(2)(c), diminishes the need for any other relief. On this basis, a PDS would need to be given only before an initial investment was made in a deposit-based product issued by a non-bank deposit taker (e.g. a call building society share).

67 There are two issues with these kinds of products. First, the key information may be very simple, reducing the need for PDS disclosure at all. Second, the methods and speed of investment may make PDS compliance difficult for both issuers and investors.

68 Section 5(2D) of the Securities Act exempts call debt securities, call building society shares and bonus bonds from the obligation to give or have an investment statement. A prospectus is still required. We think a complete exclusion under the FMC Bill from the obligation to give the PDS is too wide. Although the products are simple and the key information needing disclosure in the PDS might be very limited, we think disclosure is still of value.

69 Accordingly, our proposals focus on the compliance difficulties caused by telephone investments and other investments where the investor wishes to acquire the product immediately without receiving the PDS. These difficulties were raised by submissions on the FMC Bill. We propose to give timing relief from the PDS obligation based on similar relief under the Corporations Act. There is a risk with even this kind of relief, in that it may increase the potential for pressure selling. However, we think the risks are lowered by the simple nature of the product.

70 We propose that the obligation to give the PDS be modified if all of the following are met:

- the financial product is a deposit facility or another category 2 product
- the investor expressly instructs the issuer that they require the financial product immediately and following that instruction makes it impracticable to comply with the PDS obligation in clause 37
- the issuer advises the investor orally of their right to receive the PDS and that a cooling-off period will apply
- subsequently the PDS is sent, within a specified time, to the investor to a physical or electronic address specified for that purpose with a cooling-off period (under which the investor could withdraw from the investment) running from the date on which it is received by the investor, and
- the investor is advised in writing of the cooling-off period.

9. What are the risks or benefits in allowing the PDS to be provided subsequently (with a cooling-off period) for urgent investments in deposit facilities or other category 2 products? Is the proposed exclusion workable?

Continuous issuer exemptions

71 We are also evaluating the need for any further exemption to replicate the effect of the current Securities Act exemptions for continuous issuers.

72 We are sceptical as to whether anything more is needed, given the extent of the relief proposed above for existing investors making further investments, as we think it is these further investments that largely cause compliance cost problems for continuous issuers.

73 It may be, however, that a continuous issuer exclusion is needed to cater for new as well as existing investors or for particular reasons relating to particular products. We are interested in feedback on whether this is so, and if so, whether the number of documents, timing of disclosure, or certainty that the PDS obligation has been met is the critical compliance issue.

74 For example, depending on the justification for any further exemption, alternative PDS obligations could:

- shift the timing of the PDS obligation so that it could be sent after the application for the financial product is made or issued, but with a "cooling-off period" of at least 10 working days after receipt of the PDS in which the investor may withdraw from the product and have their money repaid
- allow continuous issuers of some types of products (e.g. co-operative companies where transacting shareholders have a higher degree of existing knowledge about the company) further relief for existing investors (e.g. only the on request obligation that applies at present under the exemption notice for co-operative companies).

75 We are interested in comments on the workability and usefulness of these conditions or any alternatives. However, it may be that anything more is more appropriately addressed by FMA in exemptions.

10.	Why might any further exclusion for continuous issuers generally or of particular types of products from the obligation to give a PDS be necessary?

KiwiSaver

76 The KiwiSaver Act provides for disclosure documents to be given by employers and by the Commissioner of Inland Revenue to new members under sections 43(a) and 50(3)(c). The manager of the scheme has little or no control over this process, but is reliant on it to comply with clause 37.

77 Section 220(2) and (3) of the KiwiSaver Act currently provide that, for the purposes of the Securities Act, the investment statement must be treated as if it had been received by the person before they subscribed even if it was not. Clause 48 of the FMC Bill is intended to replicate this effect for the PDS.

78 We are interested in whether there should be any obligations on the issuer if it becomes aware of a failure to provide the PDS.

11.	Should there be any other exclusions from, or modifications to, the obligation to give a PDS?

3.5 When register entry is not needed

79 Clause 35 of the FMC Bill requires the issuer to have supplied the information for the entry on the register of offers of financial products. Clause 42 provides that the register entry must contain all the information required by the regulations and all material information not contained in the PDS. Chapter 1 discusses the proposed content of the register entry for each type of financial product. The FMC Bill also anticipates that some offers may not need a register entry at all.

80 We have considered whether there are some offers that are of so little public interest, that a register entry is not justified. For example, there may be some types of derivatives offered where each derivative contract is truly individualised, which means that a register entry is overly burdensome. However, we do not propose general regulations to exclude this obligation at this stage.

12.	Are there any circumstances in which a register entry is not needed at all?

3.6 Ancillary offer process obligations

81 Regulations are also needed on other supporting details for the offer process.

Prohibition on lodging a supplementary document

82 An issuer may lodge a supplementary document or a replacement PDS to correct false or misleading statements, correct omissions of required information, or otherwise update or add to the PDS information. The FMC Bill does not stipulate when a replacement PDS, rather than a supplementary document, must be used. However, clause 55 prohibits a supplementary document being lodged in the circumstances set out in regulations.

83 A supplementary document may be the most effective means of correcting an incorrect figure, updating director details or making other targeted corrections. A supplementary document will ensure it is clear what change has been made to the original PDS and may be more cost-effective.

84 However, in other circumstances a supplementary document may be confusing (e.g. if there are multiple supplementary documents to which the investor must refer). It may also undermine requirements, such as a strict page limit designed to ensure that disclosure is focussed on being short and straightforward. It is not even clear how to determine whether or not a page limit is complied with if a supplementary document is used. Accordingly, in Australia a supplementary PDS cannot be used to correct or update a shorter PDS for simple managed investment schemes.

85 The page limits we are proposing for PDSs under the regulations differ. However, where a strict page limit (e.g. six pages) is prescribed, we propose that a supplementary document not be permitted. Under the current page limit proposals, this would result in a supplementary document being prohibited for a PDS for a debt security or a managed investment scheme.

13.	Do you agree that a supplementary document should not be lodged for a PDS if there is a strict page limit prescribed? Are there any alternative ways in which the supplementary document could be permitted for minor changes without undermining the page limit and other requirements for simple disclosure?

Dealing with applications in the case of defective disclosure or on expiry of PDS

86 Clause 64 of the FMC Bill gives the offeror three choices for dealing with applicants if a minimum subscription condition or listing condition stated in the PDS is not fulfilled or there has been another type of defective disclosure:

- repay the money from the applicant
- if the defective disclosure relates to the PDS, give the applicant a supplementary document or replacement PDS and one month to confirm whether or not the applicant still wishes to acquire the product, or
- if the defective disclosure relates to the register entry, amend the register entry and give notice to the applicant that the register entry has been amended and one month to confirm whether or not the applicant still wishes to acquire the product.

87 Clause 68 of the FMC Bill gives the offeror similar choices if an application for a financial product is received after a PDS expires.

88 Both clauses require the offeror, when acting under these choices, to comply with any prescribed requirements.

89 General requirements will be prescribed as to how notices must be given under the FMC Bill.

90 We also propose that the regulations provide that the offeror must:

- act as soon as practicable under this clause (as is required under clause 41A if a right to withdraw is exercised under clause 41), and
- use written notice to give the applicant one month to confirm their acquisition.

91 We propose the written notice must also:

- state the reason that clause 64 or 68 applies
- if a replacement PDS is given, state how the replacement PDS is materially different from the first PDS
- if the register entry has been corrected, identify how the register entry has been amended
- state that if the applicant does not confirm their application by the specified date, no allotment will be made and their money will be returned.

92 We have considered requiring written confirmations of a decision to acquire the products. There are risks in relying on oral confirmations. However, we are concerned that requiring written notice, particularly within a month, may be burdensome for applicants.

14. Do you agree that a requirement to act as soon as practicable and notice requirements should apply to offerors under clauses 64 or 68 of the FMC Bill? Should any other requirements apply?

15. Should an offeror should be able to rely on a confirmation from an applicant whether it is given orally or by written notice?

Money for financial products paid to issuer or offeror held on trust before applied

93 Clause 69 requires an issuer or offeror to hold on trust any money paid to them to acquire, or on account of, or as a further contribution or deposit for, a financial product. Until the financial product is issued or the money is otherwise applied for the purpose for which it was paid, or is repaid, the money must be held in the prescribed manner. The purpose of this obligation is to ensure the money is kept separate from the issuer's or offeror's other funds.

94 We consider that the regulations should require the money to be held in a separate account with a registered bank. We are also considering whether or not an overseas bank may be used, equivalent to the requirements for the holding of client money by brokers under the Financial Advisers Act.

95 We consider that the issuer or offeror should be permitted to hold all funds of this kind in one or more accounts. We do not consider at this stage that any further requirements are needed.

16. Do you agree that subscription or contribution money paid to an issuer should, before it is applied, be held in a separate account with a registered bank or any other overseas bank?

Prescribed interest rates

96 Within Parts 2 and 3 of the FMC Bill, there are four clauses which, if breached, may require a refund from the offeror to the investor. Where a refund is delayed by more than a month, the offeror must also pay interest 'at a prescribed rate'. The rate is intended to be punitive, to encourage early repayment.

97 The four clauses may trigger a refund with interest in the following circumstances:

- where an investor withdraws from a financial product because a PDS was not given to the investor (clause 41A)
- where a condition referred to in the PDS is not met or disclosure is defective and there are outstanding applications for the financial products (clause 64)
- where an application and/or payment for the purchase of a product is received after the expiry date of the PDS and there are outstanding applications for the financial products (clause 68)
- where an investor withdraws from a financial product because the financial product was offered during, or because of, an unsolicited meeting with a person otherwise than in trade in breach of clause 26A (clause 26C).

98 If the required refund is not paid within one month, interest is to be paid. The FMC Bill enables this interest rate to be prescribed by the regulations.

99 Under the Securities Act, similar disclosure breaches also trigger refunds with interest in the same manner. Regulation 47 of the Securities Regulations 2009 sets the prescribed interest rate in these cases at 10 percent per annum.

100 It is possible to set the interest rate in two ways, by either a fixed rate as in the current regulations, or via a floating rate, e.g. calculated by adding a fixed premium to a market-determined variable rate. The latter would provide a relatively constant real premium regardless of inflation rates. However, in our view, the variability of the rate would give rise to disproportionate costs of interpretation and calculation. A fixed rate provides clarity and certainty, and removes a possible point of dispute for the regulator.

101 We propose to carry the current 10 percent per annum rate over as the 'prescribed rate' for the purposes of these provisions.

17.	Do you agree that the prescribed interest rate for refunds not paid in time under provisions of Parts 2 and 3 of the FMC Bill should be set at 10 percent? If not, why not?

4. When offers do not require disclosure under Part 3

102 The general rule is that offers of products for issue require disclosure unless an exception in Schedule 1 applies and offers of products for sale require disclosure only if required by Schedule 1. The disclosure exceptions in Schedule 1 address the nature of the investor (where whether or not disclosure is required must be determined per investor) or the nature of the offer or the issuer (where certain offers or offers by certain issuers, as a whole, may be excluded).

103 Regulations are able to add to, or limit, particular aspects of some of the exclusions.

4.1 Lifting of threshold for wholesale investor exclusion

104 Schedule 1 contains a number of categories of wholesale investors. One of those categories is where the minimum amount payable for the person under the offer of financial products is at least $500,000. This category applies to offers of financial products (but not to discretionary investment management services).

105 The requirement is for $500,000 up-front for a single transaction, rather than a net assets or other wealth test. It is a bright-line test set on the basis that for this size of one-off investment, the investor should have sufficient money at stake and sufficient market power, to negotiate and exercise some degree of due diligence. This amount may be increased by regulations.

106 This amount has been carried over from the existing exclusion under section 3(2) of the Securities Act. It is the same as the amount applying under the equivalent test under the Australian Corporations Act in Australian dollars. Australia is currently reviewing this amount on the basis that it has been 20 years since the test was first set and there has been no change in the amount. Australia is considering increasing the amount to $1,000,000. We are considering whether the amount should also be increased in New Zealand.

18. Should the product value threshold for a wholesale investor be increased from $500,000 to either $750,000 or $1,000,000?

4.2 Exclusion for employee share purchase schemes

107 The exclusion for employee share purchase schemes under clause 8 of Schedule 1 applies to equity securities and other prescribed financial products. The exclusion is directed at facilitating employee ownership participation in the employer where fundraising is not the objective of the scheme. However, it may be possible that schemes of this nature are offered using financial products other than equity securities as defined in the FMC Bill.

108 We would at this stage envisage that schemes of this nature could be dealt with by FMA exemption notices.

19. Are there non-equity financial products offered under employee share purchase schemes to which the exclusion in clause 8 of Schedule 1 of the FMC Bill should apply?

4.3 Exclusions for offers of financial products for no consideration

109 Clause 11 of Schedule 1 excludes offers of financial products for which no consideration is provided (e.g. bonus shares). The exclusion does not apply to interests in KiwiSaver schemes, superannuation schemes or other prescribed schemes. In essence, an exclusion is needed for schemes where the interest acquired is membership, no consideration is necessarily paid at the outset for that membership, and membership entitles you to make further contributions to the scheme.

20. Are there schemes or products other than KiwiSaver schemes or superannuation schemes that should not be covered by the exclusion for offers of financial products for no consideration?

4.4 Exclusions for derivatives

110 Clause 19 of Schedule 1 provides exclusions from Part 3 disclosure for offers of derivatives by persons who are not derivatives issuers (that is, not carrying on a business of issuing derivatives) and for exchange-traded derivatives issued by a participant in a New Zealand licensed market. Exchange-traded derivatives are also excluded if traded on a prescribed overseas market and issued by a prescribed person.

111 The objective is to cover overseas markets with equivalent or better requirements than apply to New Zealand licensed markets. We seek views as to the markets that should be prescribed to meet this objective.

21. Which overseas markets and categories of participants on those markets do you think should be listed for the purpose of the exclusion for exchange-traded derivatives?

4.5 Offers of certain products by registered banks

112 Clause 20 of Schedule 1 excludes offers of category 2 products, debt securities, and certain currency forwards issued by a registered bank. The exclusion is also extended to prescribed category 2 products issued by a subsidiary of a registered bank. The purpose of this extension is to cover those financial products that are structured through a subsidiary but are, in economic substance, an indirect investment in category 2 products and debt securities of the bank parent.

113 We propose that the regulations prescribe those financial products that are units in cash or term portfolio investment entities or in bank notice products, along the lines of the definitions in the Financial Advisers (Definitions, Voluntary Authorisation, Prescribed Entities, and Exemptions) Regulations 2011. These schemes are managed by subsidiaries of registered banks, but invest only in products that are already exempted under clause 20(a) or (b). We propose that the schemes would need to be registered managed investment schemes.

114 Clause 20 of Schedule 1 also enables currency forwards issued by a registered bank or a bank's subsidiary to be prescribed as coming within this exclusion. The purpose of this exclusion is to ensure that vanilla currency hedges entered into routinely by businesses for their business purposes, and which are very simple products, are excluded.

115 We propose that the regulations prescribe, for this purpose, derivatives if all of the following are met:

- it is a derivative under which a party has an obligation to buy, and another party has an obligation to sell, currency at a fixed price at a date in the future
- no party to the agreement may be required to provide any other consideration
- the payments under the agreement must be made no more than one year after the date that the agreement is entered into.

22. Do you agree with the proposed exclusion for units in cash or term portfolio investment entities that are registered schemes or in bank notice products?

23. Do you consider that the proposed definition of currency forwards is appropriate for the exclusion for registered banks? If not, why not?

4.6 Requirements for eligible investor certificates and safe harbour certificates

116 Schedule 1 defines categories of wholesale investors. This definition applies for two purposes:

- the exclusions from Part 3 disclosure in Schedule 1 (see clause 3 of Schedule 1)
- the exemption from the licensing requirement for discretionary investment management services under Part 6 (see clause 387A(2)(a) of the FMC Bill).

117 Schedule 1 also enables the definition to be applied to any other prescribed transaction, but no extension is proposed at this stage.

118 The definition of wholesale investor is substantially the same for both purposes (there is one additional category for the offers definition, where the consideration payable for the financial product is at least $500,000). In both cases, the definition includes an eligible investor. An eligible investor under clause 39 of Schedule 1 is a person who has certified that the person's previous relevant experience is sufficient to allow them to judge the merits of the relevant transaction and their own information needs.

119 Clause 39 of Schedule 1 provides for persons to self-certify as eligible investors in relation to an offer of financial products for issue or sale or the provision of a discretionary investment management service.

120 There is also a safe harbour certificate for any other type of wholesale investor (other than the $500,000 consideration category) under Schedule 1. If the investor self-certifies under these provisions that the investor is one of a specified type of wholesale investor and the grounds for this, the issuer of the financial products or provider of the market service is entitled to rely on the certificate.

121 The regulations may prescribe the form and content of these certificates. The statement that needs to be certified is already set out in clause 39(2) or (3) for eligible investors and in clause 42(2) for the safe harbour certificates. However, we think there is merit in including a warning statement for the eligible investor certificate. This statement would alert investors that investor protections will not apply as a consequence of coming within the eligible investor exception.

24.	Do you consider that warning statements should be required for eligible investor certificates given under Schedule 1? Are there any other form or content requirements you think are needed for the eligible investor certificates or the safe harbour certificates and why?

5. Recognition and application regimes for offers

122 The FMC Bill essentially carries over, in subpart 6 of Part 8, the existing regime for recognition and application regimes currently in Part 5 of the Securities Act. This regime:

- provides for exemptions from the FMC Bill and the regulations so that issuers may offer financial products in New Zealand in accordance with the securities laws of designated countries
- extends the territorial scope of the FMC Bill and the regulations so that the offeror may offer financial products in designated countries in accordance with New Zealand laws, and investors in those countries may rely on and enforce those laws.

123 The Securities (Mutual Recognition of Securities Offerings—Australia) Regulations 2008 implements an agreement between the New Zealand and Australian Governments for the mutual recognition of securities offerings in their respective countries. The statutory basis for these regulations is the current Part 5 of the Securities Act.

124 We are engaging with the Australian Treasury on any changes to the regime that may need to be made as a result of the FMC Bill. We expect that any changes will be consequential, given that the FMC Bill's approach to disclosure moves closer to the Australian regime. We are mindful of the need to ensure compatibility with the Australian regime when setting disclosure requirements.

125 We have heard anecdotally that New Zealand-based issuers sometimes choose to prepare documents in accordance with the Corporations Act if they intend to make trans-Tasman offers. The reason for this might be that the disclosure document will be more familiar to the investing public in the larger market.

126 We are interested in whether there are other reasons for choosing to prepare documents in accordance with Australian laws, and how the FMC Bill and regulations might affect behaviour.

127 We are also interested in whether we should be exploring:

- mutual recognition of financial product offers with any other jurisdictions
- unilateral recognition of documents that comply with requirements in other jurisdictions (e.g. the EU or Asia-Pacific countries).

128 We propose to make changes to the way that disclosure documents are lodged in New Zealand under the existing regulations. At present Australian issuers must give an opt-in notice to the Registrar, together with copies of the relevant offer and other documents. The Registrar uses these documents to create an entry on the "overseas issuer" register, which is kept under section 66(1) of the Securities Act.[3]

129 We propose that the offers be instead kept on the register of offers of financial products maintained under Schedule 2 of the FMC Bill. This will make those offers more accessible and improve comparability with offers made under New Zealand PDSs. It would, however, mean that some additional information and updating requirements will need to be imposed on those Australian issuers.

[3] see http://www.business.govt.nz/companies/app/ui/pages/companies/otherSearch

25. Why might a New Zealand-based issuer choose to use Australian-compliant documents for an offer and use them in New Zealand under the mutual recognition regime? How might the FMC Bill affect that choice?
26. Should we be exploring mutual or unilateral recognition of financial product offers with any other jurisdictions under the FMC Bill?
27. Should offers made under a recognition regime be included on the register of offers of financial products? Are there any risks in this approach?

6. FMC reporting entities

130 The Financial Reporting Bill is currently before Parliament. Its main purpose is to improve the financial reporting system by making all general purpose financial reporting consistent with the primary objective of the financial reporting system. That objective is to provide information to external users who have a need for an entity's financial statements but are unable to demand them.

131 Another purpose of the FR Bill is to make financial reporting legislation more user-friendly by placing the substantive reporting requirements in Acts where the public might generally expect to find them. This means that the substantive financial reporting obligations for issuers and other financial market participants will eventually be included in the FMC Bill.

132 The proposed obligations are set out in a Supplementary Order Paper to amend the FR Bill.[4] The FR Bill is likely to be enacted after the FMC Bill, but it is anticipated that the FR Bill's financial reporting requirements relating to issuers and other financial market participants will come into force at the same time as the FMC Bill.

133 The main effect of the SOP is to replace Part 6A of the FMC Bill.[5] Under the new Part 6A, FMC reporting entities will have to keep accounting records and lodge audited financial statements prepared in accordance with applicable financial reporting standards. FMC reporting entities are:

- (a) every person who is an issuer of a regulated product (but see section 446C):
- (b) every person who holds a licence under Part 6 (other than an independent trustee of a restricted scheme):
- (c) every licensed supervisor:
- (d) every listed issuer (but see section 350(1)(ab)):
- (e) every operator of a licensed market (other than a market licensed under section 315 (overseas-regulated markets)):
- (f) every recipient of money from a conduit issuer (see section 446D):
- (g) every registered bank:
- (h) every licensed insurer:
- (i) every credit union:
- (j) every building society:
- (k) every person that is an FMC reporting entity under clause 27A of Schedule 1.[6]

134 New clause 27A of Schedule 1 of the FMC Bill allows the regulations to specify circumstances when a person who makes an offer in reliance on any of the exclusions in clause 4 to 24 of Schedule 1 is an FMC reporting entity.[7]

135 The SOP provides for limitations on being an FMC reporting entity:

- A company is not an FMC reporting entity if it has fewer than 50 shareholders or fewer than 50 parcels of shares that are voting products, and it is an FMC reporting entity only because it is an issuer of equity securities that are both voting products and regulated products. As a result, a company that makes a regulated offer of ordinary shares is not an FMC reporting entity because of that offer if it is not a code company under the Takeovers Code.[8]

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[4] SOP No. 93 at http://www.legislation.govt.nz/sop/government/2012/0093/latest/TMPN101CD.html
[5] The FMC Bill's Part numbers and clauses will be renumbered prior to enactment
[6] See the proposed section 446B of the SOP
[7] See clause 99U of the SOP and Schedule 1, clause 26(1) of the FMC Bill
[8] See SOP clause 99F adding new section 446C to the FMC Bill. The Financial Reporting Act 1993 has a similar rule under section 6(g) for companies with 25 or fewer shareholders

- FMA can exempt entities from being FMC reporting entities.[9]
- FMA can specify FMC reporting entities that are considered to have or not have a higher level of public accountability. The XRB must have regard to this level of public accountability when it determines which entities are in the tiers of entity that prepare statements in accordance with full IFRS.[10]

136 An issuer that ceases to be an FMC reporting entity will have the preparation and audit obligations for its entity type – so companies will come under the Companies Act rules, which will provide for preparation and audit (but not lodgement) subject to opt-in or opt-out depending on the number of shareholders.

6.1 Current requirements

137 The Financial Reporting Act 1993's definition of issuer includes every person who has allotted securities pursuant to:

> "…an offer for which, or for which but for an exemption granted by the FMA or the Securities Commission under the Securities Act 1978, an investment statement or a registered prospectus, or both, is or was required under that Act…"[11]

138 This means that companies that make offers under exemptions granted by FMA are issuers for the purposes of the Financial Reporting Act despite the exemption.

6.2 Proposal

139 The concept "issuer of a regulated product" in the SOP does not map exactly to "an offer for which an investment statement or a registered prospectus is required" in the Financial Reporting Act 1993. The exclusions in Schedule 1 of the FMC Bill are broader than the exclusions in section 3 and 5 of the Securities Act 1978. The most obvious differences are the new exclusions for small offers and employee share purchase schemes, but the scope of other exclusions are different to the current law.

140 There may be circumstances where a person who makes an offer in reliance on exclusions requires a level of public accountability such that it should be an FMC reporting entity. For example, a company could become widely held as a result making offers under the small offers exclusion over a number of years – that company would have the same need for public accountability as another company that gained its investors through a regulated offer.

141 We seek feedback on whether circumstances should be prescribed for the purposes of new clause 27A. One possibility is that a company that gains 50 or more investors through the small offers exclusion should be an FMC reporting entity. The 50 investor number is arbitrary, but matches the Takeovers Code and the test referred to above. A 50 investor threshold could potentially be aggregated with offers under other exclusions.

142 There are risks, however, if offers under some exclusions were to be included. For example, inclusion of employees under share purchase schemes might create a disincentive to offering such schemes.

28.	Should an offer in reliance on exclusions in Schedule 1 cause the issuer to be an FMC reporting entity in some circumstances?

[9] See clauses 99N and 99O of the SOP
[10] See SOP clause 99F adding new sections 446V to 446X to the FMC Bill
[11] Section 4(1)(a)(i) of the Financial Reporting Act 1993

7. Prescribed "future time" in the definition of derivative

143 Clause 8(1C) of the FMC Bill defines "derivative". In short, a derivative is an agreement that satisfies the following conditions:

- under the agreement, a party may be required to provide at some future time consideration to another person (clause 8(1C)(a)(i))
- that future time is not less than the prescribed time after the agreement is entered into (clause 8(1C)((a)(ii))
- the amount of the consideration, or the value of the agreement, is ultimately determined, derived from, or varies by reference to the value or amount of something else (clause 8(1C)(a)(iii)).

144 The purpose of clause 8(1C)(a)(ii) is to exclude ordinary spot contracts for the purchase of financial products and currency from the definition of derivative.[12] For example, a foreign exchange spot transaction may not be settled for a number of days after it is agreed (e.g. T+2). The value of the currencies involved may change over that period, but the settlement delay is not intended to result in the agreement falling within the definition of a derivative.

145 Prescribing the duration of this "future time" that divides ordinary spot contracts from derivative contracts has been problematic in both New Zealand law and overseas.

Australian Corporations Act

146 The definition of derivative in the FMC Bill is based on section 761D of the Australian Corporations Act.

147 Clause 8(1C)(a)(ii) is similar to section 761D(1)(b) of the Corporations Act. The Australian section provides that an agreement can only be a derivative if the "future time is not less than the number of days, prescribed by regulations made for the purposes of this paragraph, after the day on which the arrangement is entered into".

148 This has proven problematic because some contracts that are clearly derivatives have intra-day settlement. Therefore there is not a "number of days" after the time at which the agreement is made before payment obligations arise. Also, in some cases contracts that appear to be intra-day are automatically rolled over to the next day if not closed out.

149 The Corporations Regulation 7.1.04 states that for foreign exchange contracts, the future time must be not less than three business days after the day on which the arrangement is entered into. However, in any other case, Regulation 7.1.04(2) replaces the entire definition of derivative with one that extends to intra-day transactions. Regulation 7.1.04(2) provides that the future time in a case other than a foreign exchange contract "may be less than one day after the arrangement is entered into".

Proposal

150 In the FMC Bill, the risk that the definition of derivative is intentionally avoided by intra-day settlement or rolling over contracts is mitigated by the following measures that are not included in Australian legislation:

- A list of products is provided, which are automatically included in the definition of derivative, whether or not they meet the main definition. These include futures

[12] Most contracts for the purchase and sale of property and contracts for the future provision of services are excluded by other limbs of the definition.

contracts or forwards, swaps, contracts for difference and rolling spot contracts (clause 8(1C)(b)).

- FMA has a power to designate any arrangement used for investment or risk management as a particular kind of financial product. This can be used to ‘call in’ a particular kind of arrangement as a derivative for the purposes of the FMC Bill.

151 We consider, therefore, that the regulations need not cover every situation where a derivative could be ‘disguised’ as a spot transaction. Based on the Australian regulations, our starting point is that regulations for the purpose of clause 8(1C)(a)(ii) specify the “future time” as:

- for any foreign exchange agreement, the future time is three working days after the agreement is entered into
- for any other agreement, the future time is one working day after the agreement is entered into.

152 To deal with rolling contracts, the regulations could provide that for any agreement that is automatically rolled over at the time of settlement, the future time is immediately after the agreement is entered into.

29.	What “future time” should be prescribed for the purpose of clause 8(1C)(a)(ii) of the definition of “derivative”?

Ministry of Business, Innovation & Employment

Financial Markets Conduct Regulations - Discussion Paper

Chapter 4 – Governance

December 2012

Contents – Chapter 4

1. Introduction

1 Part 4 of the FMC Bill establishes an over-arching governance framework for regulated financial products, in particular debt securities and managed investment schemes. Many of the issues identified with the current regulatory framework relate to the variety of legal forms managed investment schemes can take and the resulting inconsistency of governance and legal obligations across those forms. Managed investment schemes can cover a range of investment structures. No particular legal form is mandated and so schemes may be trusts, partnerships, limited partnerships or contractually-established. The governance rules in Part 4 are intended to set common standards irrespective of legal form.

2 We regulate managed investment schemes in particular because of issues inherent in the governance and operation of schemes. In a managed investment scheme an investor delegates decisions about their investment portfolio to fund managers. Information and power asymmetries arise in this situation because of the characteristics of typical investors and the nature of managed investment schemes.

3 Investors in managed investment schemes rely on fund managers to have the specialist skills needed to invest successfully (or to delegate to those that do have such skills) and to act with integrity and competence. These investors may lack the time, ability, or inclination to conduct detailed research for informed investment decisions or to effectively monitor fund managers. This can leave investors vulnerable to self-interested behaviour.

4 Within managed investment schemes large amounts of assets are owned by a dispersed group of investors with incomplete information, while those assets are controlled by a fund manager with considerable ability to control flows of information. When investing in a financial product, investors often have very limited means of assessing the capacity of the issuer to meet their promises and claims.

5 Managed investment schemes may have a wide range of types of investments, including managed funds (KiwiSaver schemes, superannuation schemes or unit trusts), property syndicates and mortgage schemes.

6 Compliance with the governance requirements is mandatory where there is a regulated offer. A managed investment scheme can also opt in to the regime by registering under Part 4, even if there is no regulated offer.

7 Most notably, Part 4:

- requires the trust deed or other governing document for a debt security or managed investment scheme to meet minimum content requirements
- generally requires there to be an independent supervisor with statutory duties and requires issuers to report to supervisors and for supervisors to be empowered to perform their statutory duties
- in the case of managed investment schemes, specifies the statutory duties, functions and obligations of managers
- requires independent custody of the assets of a managed investment scheme.

8 Most of the requirements are specified in the FMC Bill. The regulations will flesh out the detail, including applicable processes, exceptions, and other particular requirements.

9 However, the regulations are important because they:

- Determine the level of prescription set under the FMC Bill – in particular the extent to which minimum requirements are specified under statute as compared to a regime where the supervisor and issuer are left to negotiate those matters (within the framework of their general statutory duties). The trade-off in crafting regulations is between the certainty provided by prescribed minimum investor protections versus potential compliance costs or the risk of poorly directed regulation.

- Within this context, ensure that the FMC Bill applies appropriately to the different types of financial products that come under Part 4.

10 Regulations are needed to:

- define particular types of schemes and their registration requirements (where the FMC Bill does not already do so)
- prescribe any required content and implied terms for governing documents set meeting procedures
- prescribe issuer reporting requirements
- prescribe various exceptions and permissions, such as exceptions from the obligation to lodge a statement of investment policy and objectives and permitted related party transactions.

2. Types of registered schemes

2.1 Types of registered schemes and other sub-categories

11 The FMC Bill establishes a register of managed investment schemes. Within the register there are the following sub-types of registered schemes:

- KiwiSaver schemes (refer clause 114)
- superannuation schemes (refer clause 115)
- restricted KiwiSaver and superannuation schemes – existing restricted KiwiSaver schemes and existing registered superannuation schemes identified by Order in Council on their reregistration through Schedule 5
- locked-in superannuation schemes –superannuation schemes that meet the additional registration requirements to be set by regulations.

12 The FMC Bill also allows for other types of registered schemes to be identified by regulations and for additional registration requirements to apply.

13 In addition, the register will record:

- prescribed workplace schemes (the criteria for prescribed workplace schemes are to be set by regulations)
- restricted employer-related schemes
- whether the scheme is a complying superannuation fund
- whether a KiwiSaver scheme is a default KiwiSaver scheme
- whether a superannuation scheme is a closed "principal purpose" scheme under clause 116(2).

Comment

14 Currently only superannuation or KiwiSaver schemes (and their sub-types) are identified as different types of schemes on the register. This is necessary because of the different legal requirements (e.g. KiwiSaver scheme rules) that apply to these types of schemes.

15 The remaining registered schemes comprise a wide range of types of schemes, including managed funds, forestry schemes and property syndicates.

16 The purpose of recognising different types of schemes is to allow for different treatment or different rules for each type. Ideally, how different types of schemes are defined on the register should flow from the legal need to differentiate the scheme. For example, disclosure or conduct obligations under the FMC Bill may need to better target the particular risks or characteristics of the scheme. However, it may also facilitate legal recognition of types of schemes for particular purposes either under New Zealand or overseas legislation. We consider this is a feature of the register that is likely to evolve over time.

17 We have been exploring whether certain types of schemes should have different disclosure requirements. As discussed in Chapter 1, Australia now provides for "simple managed funds" to do a shorter PDS. The definition of "simple managed fund" turns on whether or not the schemes holds 80% of its assets in cash or other liquid assets. Another possible test, which may fit more closely with the types of disclosure we expect to apply to these schemes, is that the scheme be continuously offered and continuously redeemed at net asset value (i.e. an open-ended scheme). We think that these characteristics drive a focus on disclosure of past performance and fees (enabling investors to readily assess the risk/reward profile of the fund). The disclosure issues have been discussed in Chapter 1.

18 Other governance rules might also differ for a fund of this nature. For example, we have asked in section 4.1 whether it is appropriate to require an annual meeting of investors for funds that are not open-ended funds (i.e. closed-ended funds or interval funds).

19 We are interested in feedback on whether there are particular types of schemes where the governance framework is not fit for purpose or where there is a different need to distinguish a particular category of scheme.

1. Do you consider that it would be useful (for disclosure purposes) to identify funds that are continuously offered and redeemed at net asset value on the managed investment scheme register? Should these be termed open-ended schemes or something else?
2. Are there any other particular types of registered schemes that you consider the regulations need to specify, and why? What would be the additional registration requirements?

2.2 Superannuation schemes and sub-types

20 The FMC Bill contains provisions to make the rules around superannuation schemes more robust.[1] New Zealand superannuation schemes have taken a more passive approach to enforcing policy around withdrawals and the retirement purpose than their overseas equivalents. From a public policy perspective, government has remained neutral because there are few or no incentives in New Zealand to divert funds to retirement schemes for tax avoidance purposes. In New Zealand, contributions and investment income are taxed but withdrawals are not (i.e. a taxed-taxed-exempt or TTE structure). However, it has become increasingly evident that New Zealand is out of step with the tests applying to superannuation schemes in other jurisdictions.

21 Accordingly, under the FMC Bill, any managed investment scheme can be registered, but the category of superannuation schemes is reserved for those schemes that meet a sole retirement purpose test.

22 There are some concessions which permit deviations from the sole retirement purpose test. These are largely derived from the historical use of superannuation schemes for wider purposes. The FMC Bill allows these schemes, within limits, to be registered or continue to be registered as superannuation schemes. However, the primary objective is to promote superannuation schemes as schemes that have retirement benefits as their sole purpose and lock-in funds for retirement.

23 Because of the concessions, not all superannuation schemes will be regulated to the same standard. We expect that, over time, New Zealand and overseas policies may not recognise all superannuation schemes for all purposes or may distinguish between them. A current example is the United Kingdom treatment of New Zealand superannuation schemes for the purposes of the Qualifying Recognised Overseas Pension Schemes regulations (QROPS). HM Revenue and Customs imposes additional requirements before it registers a New Zealand superannuation scheme as QROPS-eligible, currently limiting such schemes to mainly KiwiSaver schemes.

24 In summary, the current types of registrable superannuation scheme under the FMC Bill are:

- sole retirement purpose superannuation schemes, which must be either:
  - locked-in superannuation schemes – see section 2.3 as to the regulations setting the locking in requirements, or
  - for New Zealand residents only

[1] In particular there were concerns that offshore residents have been transferring their UK pension funds into New Zealand superannuation schemes that are QROPS approved and withdrawing the money well before retirement age thereby circumventing UK tax obligations.

- prescribed workplace schemes with a retirement purpose and an additional permitted purpose of providing benefits on ceasing employment with an employer or in an industry specified in the trust deed (see section 2.4)
- existing closed superannuation schemes that may continue with a principal retirement purpose rather than a sole retirement purpose.

2.3 Locked-in superannuation schemes

25 As discussed above, the FMC Bill recognises locked-in superannuation schemes as a specific type of scheme. The purpose of doing so is to facilitate New Zealand and overseas recognition of this type of scheme as a legitimate retirement savings scheme. Over time, these schemes may become more attractive, particularly if there are tax incentives or other formal regulatory recognition of the benefits of retirement savings. In that event, the New Zealand resident category will become superfluous and, because these schemes must meet the sole retirement purpose test, will likely be phased out.

26 Clause 118 allows for regulations to be made prescribing the registration requirements for locked-in superannuation schemes. The intention is that these registration requirements be consistent with best international practice. The category aims to complement KiwiSaver by having narrower grounds for early withdrawal (so being stricter in terms of the lock-in) but catering to the market's desire for flexibility of retirement age.

27 A further objective is for locked-in superannuation schemes to receive the same automatic QROPS recognition as KiwiSaver schemes currently have. HMRC amended the regulations governing QROPS in April 2012.[2] Under the regulations, registered KiwiSaver schemes are able to be automatically approved as QROPS. All other schemes need to meet the '70 percent rule'. This means that at least 70 percent of the amounts transferred must be set aside by the scheme manager for the purpose of providing the member with an income for life. Income for life permits a phased drawdown (with a minimum period of 10 years or earlier death). We note that HMRC does not have a formal position on what they might require and may change the regulations again in the future.

28 We are interested in whether there are other identified purposes that are relevant to this type of scheme, to ensure the rules are designed with those purposes in mind.

Rules in other countries

29 Rules applying to pension schemes, particularly in other Commonwealth jurisdictions, can provide useful guidance in developing regulations prescribing the requirements for locked in superannuation schemes.

Canada

30 Pension funds are governed by the Pension Benefits Standards Act 1985 and the Income Tax Act 1985. According to the legislation, members can withdraw their benefits at the "pensionable age", which must be set out in the terms of the pension plan. This is normally retirement age (65 years). However, early retirement benefits may be permitted in accordance with the terms of the plan (no earlier than age 50 or 55). Upon pensionable age, the member may cash out the full amount of the funds, buy an annuity or transfer the funds into a Registered Retirement Income Fund (RRIF).

31 There is an ability to withdraw funds without incurring tax liability to purchase a home (up to CAD$25,000) and to fund education (up to CAD$20,000), but any withdrawal for this purpose has to be repaid to the fund.

[2] http://www.hmrc.gov.uk/budget-updates/06dec11/pensions-draft-legis.pdf

32 Members are entitled to withdraw their funds earlier than the pensionable age for any reason. But if they do, they pay withholding tax (member contributions and investment income are exempt from tax until the point of withdrawal, unlike in New Zealand).

Australia

33 Superannuation funds in Australia are primarily regulated by the Superannuation Industry (Supervision) Act 1993 and Regulations. Superannuation funds are open to Australian and non-Australian residents. Superannuation benefits can be accessed in full at the age of 65 (regardless of whether or not you are still working), or when you reach preservation age[3] and opt to retire.

34 An employee's preservation age depends on their date of birth, so that by 2025 the preservation age will be 65 years for all Australian workers. For those born before 1 July 1960, the current preservation age is 55 years.

35 Australia also has "transition to retirement" rules. If the member reaches preservation age but has not yet stopped working, they may be paid 10% of their annual starting account balance each year as an income stream to supplement their earnings until they retire.

36 Early access to preserved benefits is permitted in other very limited circumstances, including severe financial hardship, or on compassionate grounds such as for medical treatment not available through Medicare.

Options for New Zealand requirements

37 Locked-in schemes are open to both New Zealand and non-New Zealand residents. In order to meet best international practice and ensure that these schemes will be legitimately used for retirement purposes, there needs to be robust conditions for withdrawal. The purpose of these schemes should be to provide income in retirement for members.

38 We think that Australia's regime and the rules applying to KiwiSaver schemes provide good examples of the types of rules that set appropriate conditions in general.

39 We propose that members of locked-in schemes should not be permitted to access their funds until retirement at the age of eligibility for New Zealand Superannuation (65 years). Upon retirement at this age, members would be able to access all their benefits in a lump sum or as a retirement income stream (as determined by the scheme). We do not propose that the member need actually retire at this age.

40 We consider that there should be provision for early retirement where the member ceases employment, early retirement is permitted under the trust deed, and the supervisor agrees. We consider that the earliest a scheme member could receive early retirement benefits would be 10 years prior to eligibility for New Zealand Superannuation (or 55 years). However, in the case of early retirement, we consider that the scheme should be permitted to provide benefits only as a phased drawdown or as a purchase of an annuity to provide an income for retirement until the age of eligibility for New Zealand Superannuation. At that age, members would be able to access the entire balance of their retirement savings.

41 The age at which it would be possible to access early retirement benefits is consistent with the minimum pension age under the UK pension rules. However, if this category of scheme is to obtain QROPS recognition, it is possible that there would need to be additional restrictions on access to a QROPS member's transfer value, i.e. that no more than 30 per cent of the transfer value can be accessed as a lump sum even at age 65 or older.

[3] Australians can access their superannuation when they reach the minimum age set by law. This minimum age is known as the 'preservation age' because a member's superannuation is 'preserved' until this point in their life.

42 A number of superannuation schemes have currently amended their rules to satisfy the HMRC requirement and gain QROPS status. Currently the requirement of "an income for life" is specified at a high level in trust deeds. We expect that the registration requirements for locked-in superannuation schemes will also set this requirement at a high level rather than specifying how this requirement must be delivered. We would be interested to hear how schemes are implementing this requirement in practice.

43 We are also interested in feedback on the value of permitting 'transition to retirement' payments after a member reaches the 'early retirement' age but before complete retirement. With this option there would need to be restrictions on the value of the member's benefits that could be accessed via these payments.

Exceptions to retirement rule

44 Ideally, the rules in relation to locked-in schemes should not be overly complicated. We consider that the grounds allowing access to funds prior to retirement should be limited to death, a terminal medical condition, or permanent incapacitation, and require the approval of the supervisor. In addition, the release of funds would be permitted if required under any other enactment. We would expect that these grounds would be defined in the same way as they are for KiwiSaver schemes in Schedule 1 of the KiwiSaver Act 2006. We do not think that a first home-buyer exception should be included.

45 We are considering whether or not financial hardship should not be a permitted ground for early withdrawal. This ground is easily exploited and would potentially be difficult to administer in relation to overseas residents.

46 However, a further question is whether the funds in the scheme should be accessible by the Official Assignee in the case of bankruptcy and other formal personal insolvency procedures, such as the summary instalment order. One view is that it should for two reasons. First, from a retirement savings perspective, New Zealand Superannuation remains a minimum safety net. Second, from an insolvency law perspective, bankruptcy grants the debtor the privilege of having debt written off. It is reasonable to expect the debtor to make all of their major assets available for distribution to creditors in exchange for obtaining that privilege.

47 As the schemes are designed to also cater for overseas residents, we think permanent emigration should not be a ground for early withdrawal. However, we are considering portability to approved overseas schemes.

Portability

48 It is important that members have the ability to transfer between locked-in schemes. This allows members to change schemes if they are dissatisfied with their current provider, whilst ensuring that the member's investment remains locked-in until retirement.

49 Accordingly we consider that the scheme should be required, if requested by the member and to the extent transfers are available to the relevant scheme, to transfer the member's superannuation accumulation:

- within New Zealand to a KiwiSaver scheme or another locked-in superannuation scheme, or
- outside New Zealand to an overseas scheme.

50 If a transfer is made to an overseas scheme, in order for the locked-in purpose not to be undermined, there needs to be limits around which overseas schemes are permitted to be transferred to. There are several options:

- Regulations could define the jurisdictions or types of permitted overseas schemes (based on schemes that are equivalent in terms of lock-in). This could be as simple as specifying any schemes with QROPS recognition.

- Supervisors could approve overseas schemes deemed as being substantially similar in effect to the lock-in requirements of a locked-in superannuation scheme. This approach gives greater flexibility to schemes and could allow either particular overseas schemes, or categories of schemes, to be recognised for transfer purposes. The risk is that this approach is reliant on the individual discretion of supervisors, risking the lock-in being undermined.

3. Are there other useful regulatory purposes (New Zealand or overseas) for locked-in superannuation schemes other than to satisfy QROPS requirements? If so, please detail.
4. Is there still a need for superannuation schemes (with a sole retirement purpose) limited to just New Zealand residents in addition to locked-in schemes? Please explain your answer.
5. Do you agree that members of locked-in schemes should not be able to access their funds until they reach the age of eligibility for New Zealand Superannuation? If not, why not?
6. Do you consider it appropriate to allow for early retirement (which can occur 10 years prior to retirement age) but where the money is only available as a phased drawdown? If not, why not?
7. In your experience, how is the "income for life" requirement of QROPS schemes being implemented in practice?
8. Do you consider that it is appropriate to limit withdrawals to circumstances where the member dies or can prove a terminal medical condition or permanent incapacitation? Do you consider that funds should be accessible to the Official Assignee when the member enters a formal personal insolvency procedure?
9. Do you agree that members of locked-in schemes should have the ability to transfer their funds to another locked-in scheme, superannuation scheme, KiwiSaver scheme, or another overseas scheme? If not, what other transfer regime do you consider should be used? Do you consider portability is not an issue?
10. If transfers to overseas schemes are permitted, in your view is it preferable to specify these types of schemes or jurisdictions by regulations or allow supervisor discretion? What jurisdictions would you specify other than those that have QROPS recognition?

2.4 Prescribed workplace schemes

51 Workplace schemes in New Zealand are still widespread and there is a lack of a recognised general transfer regime. Clause 116(3) of the FMC Bill allows a prescribed workplace scheme to be registered as a superannuation scheme with an additional main (rather than merely ancillary) purpose to provide benefits on ceasing employment with an employer or industry specified in the relevant trust deed. Regulations are needed to define the type of scheme that may have this additional purpose.

52 We define workplace schemes as those schemes that are offered to employees as part of their employment remuneration. Therefore, membership is conditional on continued employment with that employer. They are distinguishable from general superannuation or KiwiSaver schemes because the employer is involved in, and facilitates, the membership of the scheme. Workplace schemes can either be a standalone scheme or operate through a master trust. Importantly, both the incentive for the employer to provide this staff benefit, and the member's ability to belong to the scheme, ends when the employment relationship ends. When this occurs, the member needs to be able to withdraw their funds or transfer to another superannuation scheme.

Proposal

53 Having an additional permitted purpose allows these workplace savings schemes to continue to operate as superannuation schemes. We propose that all of the following apply to prescribed workplace schemes:

- Membership is conditional (under the trust deed and in the way it is applied) on being employed by an employer named in the trust deed, or a related body corporate, or being employed in a particular industry or belonging or being employed by an employer who belongs to a particular industry association named in the trust deed (or being an immediate family member or wholly or partially financially dependent on a person within those categories). The concept of employment may need to cover ministers of the church and other appointments that are analogous to employment.
- The employer or related body corporate, or industry association, is the provider of, or has entered into a participation agreement with the provider of, the scheme (i.e. it is either a standalone scheme or offered through a master trust).
- The scheme admits as members only those persons to whom the offer is made (by the relevant employer, a related body corporate, or the relevant industry association) to participate as part of the person's remuneration or otherwise in connection with their employment or engagement by the relevant employer, or their membership of the relevant industry association (and persons who are immediate family members or wholly or partially financially dependent on them).
- The trust deed must have the effect that each member who satisfied the scheme's requirements for a withdrawal benefit, and who elects to withdraw from membership of the scheme may transfer the member's interest in the scheme to another registered superannuation scheme or a KiwiSaver scheme (to the extent that transfers are available to those schemes).

54 The purpose of the last requirement is to facilitate the transfer of entitlements to another superannuation scheme, as opposed to withdrawal before retirement. The test is intended to apply to master trust products as well as standalone schemes.

55 This definition would require the conditional membership to be a term of the trust deed itself. It is not sufficient to merely make the offer only to employees of a particular employer or in a particular industry.

56 The definition does not, however, require the employer or industry association to have an economic interest in the scheme (for example, a fees support or other contribution requirement) other than as an employer of its employees.

57 We expect that this category would also allow the scheme to continue to hold funds for exiting members who have left an employer unless and until they find alternative investments. This is likely to be most relevant to master trust products.

11. Does the proposed definition of prescribed workplace schemes adequately cover those schemes for which an additional withdrawal purpose is justified? Is it too broad?
12. This definition may require amendments to trust deeds. What would be the costs of doing so?
13. Do you consider that this category should allow for the funds of exiting members to continue to be held prior to withdrawal? If not, what would be an alternative approach?

2.5 Registration application information and process

58 The FMC Bill sets generic application requirements for a scheme, with additional requirements to be registered as a particular type of scheme.

59 Applications for registering a managed investment scheme must be made in the prescribed manner and include the consent to registration of the manager and supervisor, a copy of the governing document, and a certificate from the manager and supervisor as to compliance with the registration requirements.

60 We think the regulations should require the application to include the matters that evidence compliance with the registration requirements (for example, the Financial Service Provider numbers of the licensed manager and supervisor).

61 If the scheme is to be registered as a particular type of scheme, compliance with additional requirements must be certified by FMA and this certificate submitted with the application for registration. The regulations do not need to specify what evidence FMA will require to give its certificate.

62 However, for KiwiSaver and superannuation schemes, we envisage that some of the evidence needed for FMA certification will be derived from the current application requirements for these types of schemes (with additions where the registration requirements are new). These requirements are set out in Part 1 of Schedule 2 of the KiwiSaver Act 2006 for KiwiSaver schemes and in Schedule 1 of the Superannuation Schemes Act 1989 for superannuation schemes.

14. Are there any considerations we should take into account in determining what information and process is required for the application to register as a scheme?

3. Governing documents

3.1 Introduction

63 The governing document is the key means, outside of the FMC Bill, for setting the governance requirements for an issue of debt securities or a managed investment scheme. It contains the rules under which the supervisor agrees to take on the supervisory role in relation to the issue. Typically, it will include any standards for the financial condition of the issuer or scheme, other provisions ensuring the issuer will meet its obligations to investors, and provisions relating to how the supervisor and issuer will deal with each other.

64 Although the governing document is negotiated by the supervisor and issuer, the current law controls the content of governing documents to ensure certain minimum investor protections apply. Control has been exerted by two approaches:

- Legislation has required governing documents to address certain matters, without regulating the substance of the terms included (for example, as is currently done by Schedule 14 of the Securities Regulations 2009 for participatory securities).
- Terms have also been directly implied into, or required to be contained in, the governing document by legislation (for example, as is currently done by Schedule 15 of the Securities Regulations 2009 for participatory securities).

65 Most of the minimum investor protections currently applied in this way will be superseded by the FMC Bill. Part 4 of the Bill sets common governance requirements, including common duties for managers of registered schemes and for supervisors of debt securities and registered schemes, reports by issuers to supervisors, and powers of supervisors (although a number of these matters require supporting regulations which we discuss in this chapter).[4]

66 As a result, there is less of a need for control over the content of the governing document to be exerted through the approaches described above. However, both approaches are still available under the FMC Bill for debt securities. For registered schemes, the regulations are able to imply terms into the governing document of the registered scheme. The FMC Bill itself (at a high level) sets the matters that a governing document must address in clause 122. The Bill could be amended to include a power to specify further matters in the regulations if that is useful.

3.2 Debt trust deeds

Required matters for the trust deed

67 Clause 90 of the FMC Bill requires the trust deed for a debt security to state that the right to enforce the issuer's duty to repay, and other duties, and the charge or security for repayment, are held on trust for the debt security holders. The trust deed must also set out any permitted indemnities of the supervisor. Regulations may prescribe additional content.

68 Requiring trust deeds to address certain matters (even if the actual terms are not prescribed) identifies whether or not these matters have been addressed, and applies the procedural protections of the FMC Bill to any changes to those matters. In addition, it enables easier comparability between trust deeds, further enhanced by the requirement to comply with FMA-prescribed frameworks and methodologies for those prescribed contents. It may provide for minimum investor protections to be addressed, depending on the level of detail required for the contents. This approach avoids the risks associated with a 'one size fits all' approach of implying terms into the trust deeds, which prevents adaptation to the relevant circumstances.

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[4] E.g. meetings of product holders, periodic reporting by the issuer to the supervisor.

69 Currently Schedule 14A of the Securities Regulations 2009 requires trust deeds to address the:

- corporate, or other, form of the issuer
- governance requirements that the issuer must comply with (if any)
- frequency and contents of reports by the issuer to the trustee
- frequency and procedure of meetings of security holders and their voting rights at meetings
- terms for appointment and removal of the trustee and the trustee's powers and duties.

Proposal

70 In the case of registered schemes, the agreed policy is that the governing document should contain the matters that materially affect the rights and duties of the issuer, supervisor, and product holders (clause 122). It is these matters that must be disclosed (by lodging the governing document) on the register, must be legally binding, and are prevented from being amended unless done in accordance with the requirements of the FMC Bill. We consider the same approach should apply to trust deeds for debt securities.

71 We consider that the following matters are material to the governance of debt issues so the regulations should require debt trust deeds to provide adequately for them:

- the financial covenants (if any) that the issuer gives in favour of the holders of the debt security or the supervisor (in addition to those required already for deposit takers by the Deposit Taker (Credit Ratings, Capital Ratios, and Related Party Exposures) Regulations 2010)
- either a prohibition on the issuer entering into transactions with its associated persons (i.e., related parties) or, if it is permitted to enter into related party transactions, the assessment and approval process that must be followed with those transactions (or other restrictions applying) to ensure that the transactions occur only on an arm's length basis (in addition to those restrictions required already for non-bank deposit takers by the Deposit Taker (Credit Ratings, Capital Ratios, and Related Party Exposures) Regulations 2010)
- the frequency and content of reports by the issuer to the trustee. Although the FMC Bill may require particular reporting under the regulations, the requirements of the regulations will be only to a minimum so the trust deed should contain any other reporting requirements
- the frequency and business of meetings of product holders and the procedure (to the extent it is not covered by the regulations)
- the provisions governing the appointment and removal of the supervisor
- any other matters that materially affect the rights and duties of holders of the debt security or the powers, rights, and duties of the issuer or the supervisor.

72 Financial covenants include financial ratios relating to an issuer's financial position and performance that the issuer agrees to maintain. This would include any liquidity ratios or debt to total tangible asset ratios. It may also include negative undertakings (for example, as to the disposal of assets). Where these covenants are given by debt issuers, they would be material to the investment and its supervision and so should be already included in trust deeds.

73 This obligation to include financial covenants agreed with the supervisor (if any) would apply to all debt issuers, but no minimum or maximum financial ratios would be set for non-deposit takers.

74 We think it is unnecessary to continue to require the trust deed to address the legal form of the issuer, or the governance requirements that the issuer must comply with. The legal form of the issuer may be a matter for disclosure but the trust deed does not need to deal with this requirement.

75 The governance requirements that the issuer must comply with are also generally a matter for disclosure. However, it could be retained if it results in additional governance standards (e.g. independent directors) being specified in the trust deed.

15. Do you agree that all trust deeds for debt securities should be required to address the matters in paragraph 71? If not, why not? Are there any other matters you consider all trust deeds should be required to address?

16. Do you agree that it is not necessary to continue the requirements for trust deeds for debt securities to address the legal form of the issuer or its governance requirements? If not, why not?

Implied terms

76 Under the Securities Regulations 2009 and the Deposit Takers (Credit Ratings, Capital Ratios, and Related Party Exposures) Regulations 2010 there are a number of terms currently implied into, or required in, trust deeds. These fall broadly into two categories.

77 The first category is the terms relating to the duties of the issuer and its relationship with the supervisor. The terms in clauses 1 to 3E, 4, 5, 7 and 10 of Schedule 15 of the Securities Regulations are now either superseded by the FMC Bill, or are to be dealt with elsewhere in the regulations. However, the following terms that apply to deposit takers may still be relevant:

- duties on the issuer to have the half-yearly financial statements audited or reviewed by a qualified auditor (clause 6)
- duties on the issuer to consult with the trustee on the appointment of auditors (clause 8)
- an obligation for the issuer to include in the terms of the auditor's appointment requirements for the auditors to report separately to the supervisor on certain matters, give its audit opinion for the benefit of the supervisor, and meet with the supervisor (clause 9).

78 The second category of terms has a prudential focus. The Deposit Takers (Credit Ratings, Capital Ratios, and Related Party Exposures) Regulations 2010 require non-bank deposit takers to include covenants to comply with minimum capital ratios and maximum related party exposures in their trust deeds. We do not propose applying those requirements to other debt issuers as we do not consider that the systemic concerns arise for them.[5]

Proposal

79 We think that the existing duty for a deposit taker to consult the trustee on the appointment of the auditor (clause 8 of Schedule 15 of the Securities Regulations 2009), should continue to be implied, and be extended to all debt issuers.

80 The opportunity for the trustee to be consulted on the auditor and have any concerns noted with the auditor is useful to ensuring the trustee's and auditor's roles are mutually supportive. This requirement will also give the trustee, if it wishes, the opportunity to engage the auditor to report for the trustee's benefit. We think that these benefits apply to not only non-bank deposit takers but debt issuers in general, and the costs are unlikely to be significant.

[5] Securities Trustees and Statutory Supervisors Regulations Discussion Document (October 2010).

81 The regulation of non-bank deposit takers has evolved rapidly in the last few years since the specific implied terms for deposit takers were included in the Securities Regulations 2009. Review of the legislation applying to deposit takers is ongoing by the Reserve Bank. In relation to the other duties applying to deposit takers, we think that the following implied terms in clauses 6 and 9 should be carried over, at least until that review is concluded:

- the duty to have half-yearly audits or reviews of financial statements in clause 6 – this is an important requirement for deposit takers
- the requirements as to the terms of the auditor's appointment in clause 9 (although some aspects have been superseded by direct whistle-blowing obligations in the FMC Bill).

82 An auditor is primarily liable to the person (for example, the issuer) who engages him or her. Redress against auditors can therefore be sought by the issuer and, if the issuer has failed, by a liquidator. FMA can also exercise an issuer's right of action against an auditor in accordance with the Financial Markets Authority Act 2011. Clause 9 alters this position by requiring the auditor's opinion to be also addressed to, and for, the benefit of the supervisor. We think that clause 9 should continue to apply to deposit takers. However, we think that, in the case of other debt issuers, this should be considered in the context of other issues concerning auditors.

83 Some submissions on the FMC Bill argued that auditor's opinions should be for the benefit of supervisors of all debt issuers and managed investment schemes. There is longstanding tension between auditors and trustees over their respective roles and responsibilities. Trustees consider that auditors do not accept their statutory responsibilities and have identified specific limitations with the current requirements. Auditors are concerned about any changes that could result in liability for an indeterminate amount and an indeterminate time to an indeterminate class.

84 Audit reliance needs to be considered alongside two closely related issues:

- Audit firm incorporation: At present, only individuals are able to become licensed auditors. This means that, unlike other market participants such as issuers and supervisors, auditors are unable to rely on limited liability. Many other countries have allowed auditors to incorporate, subject to requirements such as minimum levels of professional indemnity insurance. This matter is part of the Ministry's current work programme on which a targeted consultation has been undertaken. We plan to seek Cabinet decisions on this issue in 2013.
- Proportionate liability or liability caps: some other countries (including Australia) cap the maximum liability of auditors. Liability caps arguably justify allowing a broader class of person to rely on audit opinions. The Law Commission is currently reviewing joint and several liability, including alternatives such as proportionate liability, liability caps and contractual limitations on liability.

85 Until these issues are further advanced our current view is that we should not extend auditor's liability via the regulations under the FMC Bill.

86 We think that these are all the terms that currently need to be implied into trust deeds but would like to be made aware of any others that submitters think should be included.

17. Should all trust deeds for debt securities contain an implied term requiring the issuer to consult the supervisor, and giving the supervisor an opportunity to raise any issues, before appointing an auditor?

18. Should the other terms currently implied into trust deeds for deposit takers under clauses 6 and 9 of Schedule 15 of the Securities Regulations 2009 be continued for deposit takers? Should any other terms be implied into trust deeds?

3.3 Governing documents for registered schemes

87 Clause 122 of the FMC Bill sets out all the content required for a governing document for a registered scheme. It requires that content to comply with FMA-prescribed frameworks and methodologies. The contents are deliberately set at a high level to allow flexibility. However, we are considering recommending amending the FMC Bill to enable regulations to specify matters in detail. In addition, there is a power to imply terms into governing documents.

88 Currently, the Securities Regulations 2009 imply terms into deeds of participation for participatory securities and into unit trust deeds and KiwiSaver scheme trust deeds. Both the KiwiSaver Act 2006 and the Superannuation Schemes Act 1989 imply other terms into the scheme trust deeds also. The KiwiSaver Regulations 2006 have also been recently amended to imply a term requiring the manager to ensure that the entire benefit of a member's accumulation must be credited to the member's accumulation and not accessed as a financial advantage, external to the KiwiSaver scheme (for example, as a mortgage off-set).

Proposal

89 All of the current implied terms, other than the most recent, are now within the FMC Bill, although some require supporting regulations.

90 We consider that, for the same reasons as apply to debt issuers, it is important to require managers to consult with the supervisor prior to the appointment of the auditor and for the supervisor's concerns to be brought to the attention of the auditor. We propose that the regulations imply this term into governing documents for all registered schemes.

91 Given that the contents of governing documents for schemes have been set at a high level, there is a question as to whether additional contents of the governing document should be specified in the regulations. We are considering requiring the following matters to be addressed:

- the frequency and content of reports by the issuer to the supervisor
- the frequency and business of meetings of scheme participants and the meeting procedure, to the extent it is not covered by the regulations.

92 We are considering whether annual meetings should be required for at least some types of schemes, but if they are not required by the regulations, it may be valuable to require the governing document to at least specify the frequency of meetings. If annual meetings were required, this would likely be implemented by an implied term. We discuss this issue further in section 4.1.

93 We are interested in feedback on any other specific matters that governing documents should be required to address if a regulation-making power of this kind was included in the FMC Bill (for example, whether it would be important to require the methodology for pricing of interests in the scheme to address particular risks).

19. Do you agree that governing documents for registered schemes should contain an implied term requiring the issuer to consult the supervisor, and giving the supervisor an opportunity to raise any issues, before appointing an auditor?
20. Do you consider that any other terms should be implied into governing documents? If so, please detail.
21. Do you consider that the required contents for governing documents for registered schemes should include the matters set out in paragraph 91? What other matters do you think should be specified (if any)?

4. Ongoing governance matters

4.1 Meetings of product holders and voting

94 Meetings of product holders may be of little relevance for many types of schemes. However, they may be required for the purpose of reporting to product holders on the state of the issuer or scheme or because of instances where product holder approval is required. The FMC Bill also entitles the supervisor, the holders of 5% of the value of the financial products, or any other person authorised by the governing document or regulations, to call a meeting for any reason.

95 A number of provisions of the FMC Bill also permit or require actions in relation to an investment only if there is a special resolution of product holders (defined as 75% of the nominal value of the debt securities, or of the value of the interests in the scheme, held by those product holders who are entitled to vote and are voting). A special resolution:

- is grounds for a supervisor to consent to a change to a governing document without the need to be satisfied that there is no material adverse effect on product holders (clauses 94 and 126)
- may direct the supervisor on its functions (clauses 98 and 140)
- may remove a supervisor (clauses 108 and 177)
- may remove a manager of a registered scheme (clause 169)
- may approve a related party transaction (without it having to be shown to be in the best interests of product holders or on arm's length terms or coming within any other exception (clause 159))
- may approve a change to the type of registration, or the cancellation of registration, of a scheme (clauses 121 and 180).

96 Accordingly, special resolutions of product holders can change critical matters that then affect the value of the investment for all product holders. Ultimately product holders who disagree can withdraw or transfer the investment but this may be at an economic cost. Unless meeting procedures are fair to all product holders and give them adequate opportunity to participate in the decision, there is a risk that special resolutions could be unrepresentative.

97 Generally, holders of debt products and scheme participants in managed investment schemes are likely to be more passive than company shareholders. Even so, investors may range from needing little ability to intervene in largely passive investments to those where investors may be more actively engaged. In addition, where investors do intervene, it is likely to be on value-critical matters.

98 The FMC Bill already deals with who can call a meeting of product holders (clauses 106 and 147), the supervisor's entitlement to attend meetings, receive notices, be heard, and appoint the chairperson at meetings (clauses 107 and 148), and restricts the manager's and its associated persons' entitlement to vote if they have an interest in the resolution (clause 149). The governing document may govern the procedure for meetings to the extent that there are no regulations on the matter or the governing document is not inconsistent with those regulations.

Proposals

99 The regulations could provide for only those meeting procedures that are critical to the policy objective of ensuring an equal opportunity to participate in meetings is given to all holders and scheme participants (for example, notice requirements and quorum). However, we think that a further objective of defining meeting procedures is to lower transaction costs by determining a default set of rules that apply generally (indeed because meetings may be of

little relevance generally for schemes, it may result in inadequate attention being given to the rules in drafting governing documents). Where it does not contravene the policy objective of ensuring fair participation, we propose allowing the governing document to supplement or specify alternative default meeting procedures.

100 In reviewing the appropriate procedures, we have looked to Schedule 1 of the Companies Act 1993 on the basis that New Zealand markets are familiar with those procedures and will have established practices based on them. However, we have also reviewed the meeting procedures applying to schemes under Part 2G.4 of the Australian Corporations Act 2001. We looked to use the Australian procedures where the Companies Act requirements for shareholder meetings might be deficient for debt product holders or scheme participants, given the different nature of the investment.

Notice of meeting

101 Essential to fair participation is an adequate minimum written notice period. We think the requirement should be either 10 working days before the meeting (or any longer period set by the governing document) or 15 working days. A 10 working-day period is the same as required under Schedule 1 of the Companies Act 1993 and the 14 day period required for unit trusts under the Unit Trusts Act 1960. However, the Australian Corporations Act 2001 requires 21 days' notice and this is the period required for moratoriums under the Securities (Moratorium) Regulations 2009. On balance, we think that the longer notice period of 15 working days should be required.

102 We consider that the meeting notice should specify the place, date, and time of the meeting, the nature of the business to be transacted, and the text of any special resolution to be put to the meeting. However, given that proxies are likely to be widely used, we also consider that it should set out the right of a product holder to appoint a proxy. Note that there are also proposals that other disclosures be made at meetings to approve related party transactions (see section 5.4).

103 Schedule 1 of the Companies Act 1993 provides for waiving of irregularities of notice, for accidental omissions to not invalidate a meeting, and for waiving of the need for notice of an adjournment of less than 30 days to be announced at the meeting. These are all safe harbours that we consider would be useful to include in the regulations.

Chairperson

104 Who is chair at the meeting is significant in terms of the time allowed for discussion of matters and the conduct of the meeting. The FMC Bill provides that the supervisor has first right to appoint the chair of the meeting. We think that, if the supervisor does not do so, the product holders present at the meeting should have the default right to appoint a chair by ordinary resolution.

Quorum

105 We think there should be a particular quorum for meetings if a special resolution is proposed to be moved at that meeting or is moved without a prior proposal. Because a special resolution (as defined in the FMC Bill) is 75% of those entitled to vote and voting, we consider that the quorum for these meetings should be set at an absolute value threshold of 25% of the value of the debt securities or managed investment products of those entitled to vote (as applies under the Unit Trusts Act 1960 at present for directions to the supervisor). In our view, the Companies Act approach in insufficient. Although the quorum is 50%, if that quorum is not met the meeting is deferred and whoever is present within 30 minutes constitutes the quorum at the deferred meeting.

106 For other meetings, we propose a minimum quorum of two product holders (based on section 252R of the Corporations Act 2001), or any higher quorum set by the governing document.

Meeting method

107 We propose that meetings may be held by physical means, or audio/audio-visual/electronic means, or both, and as consistent with Schedule 1 of the Companies Act 1993.

Voting method

108 We propose that the regulations provide that product holders may appoint proxies and may appoint more than one proxy specifying the proportion or number of voting rights that each proxy may exercise (as long as the different proxies do not exercise the same voting rights). The provisions of Schedule 1 of the Companies Act 1993 make it clear that custodians may exercise voting rights according to different directions of the underlying holders.

109 The Australian Corporations Act 2001 specifies a default proportion for 2 proxies of one half each, if the notice of appointment does not specify a proportion. This may be a useful default rule to include in the regulations. We propose to model the remaining provisions on proxies on clause 6 of Schedule 1 of the Companies Act 1993.

110 We also propose allowing electronic voting, but subject to the governing document. Electronic participation in meetings in particular may be one means of promoting greater involvement. We do not think it necessary any longer to provide for postal voting other than by electronic means.

111 How a special resolution must be voted on also needs to be defined in regulations. We propose that it be voted on by a poll and that a poll may also be demanded by the supervisor, the same proportion of product holders who could call a meeting, or the chair. Votes must be counted on a poll according to the proportion of value of the debt securities or the proportion of value of managed investment products cast by each product holder present and voting. This provision does not apply to credit unions, however, where each product holder present and voting has one vote.

112 For completeness, we think that the regulations should also provide that:

- if there are joint holders, the vote counted is that of the first joint holder that appears in the register
- minutes of the meeting and any resolutions passed must be kept by the manager and that the minutes must be open for inspection by product holders, or available electronically for product holders to view, free of charge.

113 Product holders should also be able to request a copy of the minutes on payment of a reasonable copying fee. See section 5.6 on regulations under clause 213A.

Product holder proposals

114 We are considering whether product holders should be able to give notice to the issuer of matters that they wish to raise for discussion or resolution at the next meeting. In this situation, the issuer must include those matters in the notice of meeting, along the lines set out in clause 9 of Schedule 1 of the Companies Act 1993. Product holder proposals may be an important mechanism for holding the issuer to account. Their usefulness is limited by the frequency meetings are held. However, if there is either an annual meeting, or the product holders are able to generate sufficient support to reach the 5% threshold to call a meeting, this provides a means for the product holders to put matters to the meeting.

Frequency of meetings

115 This raises the question as to whether issuers of debt securities or registered schemes (or some types of registered schemes) should be required to hold annual meetings. Currently the manager of a participatory scheme must hold product holder meetings to consider the

financial statements of the scheme within six months after the end of the accounting period for those statements.

116 The enhanced governance benefits of an annual meeting need to be balanced against the costs of holding those meetings and the likely participation rates of product holders. Its usefulness may differ widely. We consider that annual meetings would be of little value with superannuation schemes, KiwiSaver schemes, or open-ended schemes (providing investors with a clear exit route).

117 However, we think mandating them for closed-ended schemes may be useful, where the opportunity to comment on the annual report and financial statements would be important. It is possible that there are other types of schemes for which this requirement would be important. We would be interested in feedback as to the defining features of the schemes where the benefits would be strongest.

Other meeting procedure matters

118 We are interested in feedback on whether we need to also provide for written resolutions in lieu of meetings (based on section 122 of the Companies Act 1993 and clause 14 of Schedule 3 of the Securities (Moratorium) Regulations 2009).

119 We do not think that the regulations need to provide for:

- how to work out the value of the managed investment product for the purposes of the definition of special resolution (although this is done in Australia by section 253F of the Corporations Act 2001).
- any additional right of any other person to call a meeting, although the governing document may confer this right.

120 If a scheme is unitised, the proportion of the value of the interest held by a product holder would be the same as their proportion of units to the total units. If a scheme is not unitised, the valuation methodology for assets of the scheme would apply to valuing interests for the purposes of voting.

Voting by interested manager

121 Lastly, the prohibition on the manager and its associated persons voting on a resolution at a meeting of scheme participants does not apply in the prescribed circumstances. Currently listed schemes are excluded from the prohibition against voting on a resolution to appoint or remove a manager. However, this exclusion does not affect any voting restrictions that apply under the listing rules provisions (leaving it to the listing rules to control, or waive, those voting restrictions).

122 The purpose of the prohibition is to prevent the manager being able to lock in its appointment through self-interested voting. At least one submission on the FMC Bill argued, however, for an exclusion for unlisted wholesale schemes that are open to investment by only a very small number of large institutions. In this situation, a single large institution could effectively remove the manager from the scheme if the manager's own voting rights are excluded. At its most extreme, there could be no one to vote on this resolution. We are considering an exclusion from the prohibition to address this concern if all of the following apply:

- there are fewer than five scheme participants, all of whom invested as wholesale investors
- the manager certifies that the voting right is being exercised in the best interests of the scheme participants
- the entitlement to vote in these circumstances is set out in the governing document for the scheme (and so was disclosed to investors).

123 However, in Australia this issue is dealt with by case-by-case exemptions by ASIC and similarly it may be more appropriate to leave this matter to exemptions by FMA.

22. Do you consider it useful to provide a default set of meeting procedures? If not, why not? Do the key matters to ensure fair participation only relate to the notice requirement and quorum or are there other minimum requirements?
23. Are there particular meeting procedures that the governing document needs to be able to vary to ensure efficiency and to cater for the needs of different schemes? If so, which procedures and why?
24. Do you disagree with any of the proposals in paragraphs 101 to 113 on the meeting requirements? If so, what is your alternative proposal? Are there any classes of debt issuers or registered scheme where you consider different default rules would be appropriate?
25. Do you think regulations are needed to determine how to value a managed investment product for the purpose of voting on a special resolution?
26. What would be the benefits of requiring annual product holder meetings? Are there types of schemes where an annual meeting should be required either for the purpose of considering financial statements or wider purposes?
27. Is it appropriate to allow a manager of a wholesale scheme to vote their interest on a resolution to remove the manager or appoint a new manager in the circumstances set out in paragraph 121? If not, are there any circumstances in which you think it would be appropriate?

4.2 Issuer reports to supervisors

Introduction

124 It is generally impractical for investors in debt products or managed investment schemes to assess and monitor the issuer's governance systems. Under the FMC Bill it is the role of the supervisor to supervise the issue to ensure compliance with the trust deed and terms of issue and to monitor the financial condition of the issue to ensure the promises made to investors can be kept.

125 The supervisor's ability to obtain timely and appropriate information from the issuer about its governance systems and to take appropriate action where there are problems is key to their performing of this function. The whistle-blowing reports and attestations are important. The FMC Bill requires the issuer and other persons (for example, the auditor) to report material contraventions to the supervisor. The supervisor is also given default powers to get from the issuer the information or reports it needs to perform its functions and to appoint experts if need be.

126 In addition, clauses 100 and 134 of the FMC Bill enable regulations to require event-based or periodic reporting. Particular reports are also required by the FMC Bill to enable supervision of certain requirements of Part 4 (for example, pricing error reports). We already propose that the governing documents must specify the frequency and nature of reports to the supervisor. This requirement will ensure that supervisors and issuers negotiate reporting requirements to be included in the governing document. However, the question is whether regulations should set, as a default, other minimum reports that must be made by the issuer to the supervisor or whether this should be left to the supervisor to negotiate.

127 Unless the need for certain reports is clearly evident and common across all schemes (or clearly defined classes of schemes), the costs of mandating particular reports may be high in terms of either overcoverage or undercoverage or both. Overcoverage results in unnecessary compliance costs for issuers. Undercoverage may result in inadequate monitoring if the supervisor takes the minimum reporting as being sufficient and abdicates responsibility for designing appropriate reporting requirements.

128 The supervisor, having negotiated the trust deed and being familiar with the product design and the risks it poses, should be the person best placed to judge what reports it needs to fulfil its functions. In addition, the degree to which a supervisor requests reports from the issuers it monitors, and its supervisory actions, form part of its licensing criteria under the Securities Trustees and Statutory Supervisors Act 2011. As a result, FMA is able to monitor the level of supervision and assess over time whether it is sufficient or whether a degree of minimum reporting should be mandated.

129 On balance we favour not specifying mandatory minimum reporting from issuers to supervisors except where there is a clearly established common set of minimum requirements and/or there is a high risk that supervisors are not requesting the right reports, or requesting them frequently enough.

Debt issuers

130 There is no minimum generic event-based or periodic reporting to supervisors currently specified for debt issuers. Instead the law leaves it to the supervisor to negotiate what reports it needs to ensure that it can supervise the issue adequately and then provide its own reports to FMA. This reflects a concern that generic reporting requirements may result in a "one size fits all" approach and reduce the onus on supervisors to design effective reporting requirements. We are considering, however, whether an alternative option is to specify default reports, perhaps with a power for the supervisor to waive particular requirements and, if so, what default reports should be required.

131 There is both event-based and periodic reporting currently required for deposit takers. Clauses 4 and 5 of Schedule 15 of the Securities Regulations 2009 require the following reports and information be provided to the supervisor:

- the monthly management report prepared for the directors
- a monthly report on the liquidity of the issuer, the asset quality of the issuer, reinvestment rates, and any breaches by members of the borrowing group of financial covenants in financing arrangements with third parties
- a three-monthly directors' certificate that the current prospectus is up to date and has not been materially false or misleading and that the issuer has complied with the trust deed
- reports on any change in ownership of the shares of the issuer that results in an effective change in control
- every change of director of the issuer.

132 We are not proposing any changes to those requirements, but we would be interested in hearing any concerns with them, such as current reporting obligations being not quite fit for purpose or that additional reporting is required.

Managed investment schemes

133 Under the current law, there is no minimum event-based or periodic reporting specified for issuers to provide to supervisors for unit trusts, KiwiSaver schemes, or participatory schemes.

134 Under Part 4 there are some statutory requirements for registered schemes for the issuer to provide reports to the supervisor. For example, reports are expressly required for limit breaks under clause 153 and for pricing errors and failures to comply with pricing methodologies under clause 154. In addition, we propose that there also be reporting obligations on entering into related party transactions under exemptions set out in clause 160. The rationale and details for these reporting requirements are covered in the discussion of the related party transactions (see section 5.4). Similarly in section 5.5 below we discuss reports on custodial records.

135 Our current view is that the regulations should not specify further minimum reporting requirements. However, we seek views on whether there are common and basic reports that supervisors should require, either for particular types of schemes or schemes generally.

28. Are there common and basic reports that supervisors should require, either for particular types of schemes or schemes generally? If so, please detail.

29. Should these reports be specified in regulations? If not, why not?

30. For deposit takers, do you consider that the reports specified at paragraph 131 continue to be the appropriate minimum reporting requirements for issuers to supervisors?

4.3 Change of manager

136 Clauses 168 to 176 of the FMC Bill deal with the process for changing the manager of a registered scheme. Under these sections a temporary manager may be appointed by the supervisor or, if the supervisor does not act or there is some other specified reason, FMA. To allow FMA to make changes to the governing document in order to secure the appointment of a temporary manager, there is a power for FMA to do so in the prescribed manner. The supervisor must consent to any amendment and FMA must also be satisfied that it has no material adverse effect on scheme participants. We do not propose any further requirements at this stage. The amendment must, as with other changes to the governing document, be lodged with the Registrar.

137 However, there is also a requirement for the supervisor or FMA to take all reasonable steps to secure, in accordance with the governing document, the appointment of a person as a permanent manager in place of the temporary manager. We could prescribe requirements for FMA to convene a meeting of scheme participants or take other particular steps. However, we think the general duty on FMA is sufficient.

138 If a new manager is appointed, the former manager is required by clause 174 to hand over all information and documents held by them that are necessary to enable the new manager to hold office. The former manager is permitted to withhold documents or retain copies - either with FMA's written consent or in the prescribed circumstances. At this stage, we consider that any issues should be addressed on a case-by-case basis by FMA.

31. Should the way in which FMA either amends a governing document or takes steps to secure the appointment of a permanent manager be specified in regulations for any reason?

32. Should the regulations permit a manager to automatically retain certain categories of information? If so, which categories should be considered?

5. Management of schemes

5.1 Exceptions from obligation to lodge statement of investment policy and objectives

139 Each registered scheme must have a statement of investment policy and objectives (SIPO). It is the SIPO that sets the risk profile of the scheme. Clause 150 of the FMC Bill requires the SIPO to cover the investment policy and objectives of the scheme and include:

- the nature or type of investments that may be made (and any limits)
- any limits on the proportion of each type of asset in which the scheme may invest
- the methodology for developing and amending the investment strategy and measuring performance against the investment objectives.

140 The manager must lodge the SIPO, and any subsequent changes, with the Registrar. The SIPO must be lodged before a regulated offer is made or, if no regulated offer is made, before issuing the managed investment products. Changes must be lodged within five working days after the change takes effect.

141 The effect of lodging the SIPO will be to make it a publicly searchable document on the register of managed investment schemes.

Comment

142 The purpose of requiring the SIPO to be lodged with the Registrar is to facilitate the supervisor's and FMA's enforcement of the manager's obligation to comply with the SIPO, and to enable investors and prospective investors to access the SIPO to assist them in their investment decision-making. There is a risk that these obligations will cause scheme providers to take investment limits out of the SIPO and put them into non-enforceable investment guidelines. The obligations may also result in limits being set with large allowances. However, the requirement for SIPOs to comply with FMA-prescribed methodologies and the need for consistency between the SIPO and the description of the scheme in the PDS may limit this risk.

143 Some submissions on the FMC Bill argued that for schemes for which there is no regulated offer, the full SIPO does not need to be publicly available on the register. We disagree on the basis that the SIPO comprises part of the supervision structure of the scheme. Registration of the scheme without the SIPO would result in incomplete monitoring. However, we are giving further thought to this possible exception on the basis that if there is no regulated offer there would be no benefit to prospective investors in having the SIPO publicly available. If this exception were included, the scheme would still be required to notify that it had a SIPO and when a change was made, and provide the SIPO to investors and FMA on request.

144 All changes to a SIPO must be notified to the supervisor before being made (except in the case of a restricted scheme where there is no supervisor). One benefit of doing so is to enable FMA and others to monitor changes so ensuring that the registered scheme stays within the risk profile set by the PDS.

145 We do not think the additional obligation to notify the actual change to the Registrar is likely to be onerous. However, this in part relies on our understanding that changes are not frequently made to a SIPO.

33. Do you agree that the SIPO for schemes for which there is no regulated offer should be available only on request to investors, prospective investors, or FMA? If not, why not?

34. In practice how often are changes made to a SIPO and what is the nature of those changes?

35.	Are there any other cases that would justify an exception from the obligation to lodge a SIPO or changes with the Registrar?

5.2 Reporting of material limit breaks

146 Clause 153 of the FMC Bill requires the manager of a registered scheme to report a material breach of the SIPO. This could be a breach of the limits in the SIPO on the nature and type of investments or a material breach of the limits on the proportion of each type of assets that may be invested in. Whether a limit break is material or not will be determined by FMA-prescribed frameworks and methodologies. However, in principle, it could be assessed not only on the nature or size of the limit break but also on all the surrounding circumstances (for example, the frequency of that type of limit break over the last period).

147 Reporting of material limit breaks is required in the prescribed circumstances and in the prescribed manner. Accordingly regulations are needed to give effect to this issuer obligation.

Proposal

148 Under clause 130 the manager has a duty to carry out its functions in accordance with the SIPO. Disclosures of material breaches of the SIPO will enable the supervisor to monitor and act, if necessary, to enforce this duty. The supervisor must also report material limit breaks to FMA if they constitute material breaches of issuer obligations under clause 187.

149 These duties enable monitoring of the fund against its disclosed risk profile and enable a supervisor or FMA to ensure appropriate action is taken if a limit break places a scheme at risk of breaching financial covenants or other issuer obligations. However, that said, disclosure needs to be meaningful.

150 While a one-off limit break may be material in its potential effect, not every limit break has the same significance for compliance. A breach of the SIPO may occur for reasons that are beyond the control of the manager and so occur without the manager’s immediate knowledge. For example, breaches may be due to the appreciation or depreciation of the scheme’s net asset value, redemptions of units, an underlying scheme acquiring investments that caused the limit break, or a market-driven event.

151 The key issue for the regulations is to define the nature of limit breaks that a supervisor needs to know about immediately. We are interested in feedback on the frequency, nature, and relative significance of limit breaks and, in particular, the defining features of limit breaks for which immediate reporting is needed.

152 In principle, we consider that early rectification of limit breaks removes the need for immediate reporting. In this case, reporting is still desirable, but the main goal of the report will be to enable the supervisor or FMA to see trends in compliance and analyse causes. For this reason, where errors are rectified early, reporting is likely to be more meaningful if it is deferred and aggregated over an appropriate period.

153 Where a limit break occurs, a manager will receive an initial alert of a possible limit break and then investigate to determine whether a reportable limit break has occurred. If the manager determines, or ought reasonably to have determined, that a reportable limit break has occurred, we consider there should be a specified period within which the manager must rectify that limit break before the reporting obligation applies. If the limit break is rectified in that specified period (e.g. 2–3 working days), we think it need only be reported to the supervisor in a periodic compliance report. We are interested in views as to the appropriate time period for rectification and the appropriate frequency of this periodic compliance report.

154 If the limit break is not rectified within this period, we propose that the manager must report it to the supervisor or (in the case of a restricted scheme) FMA.

155 We think the following details on the limit break would need to be contained in either a periodic or immediate report:

- the nature of the limit break
- the name of the scheme affected and the amount of funds under management
- the materiality of the limit break as evaluated against the criteria set by FMA-prescribed frameworks and methodologies
- the cause of the limit break
- the period to which the limit break continued
- the steps taken, or to be taken, by the manager to rectify the limit break
- if applicable, what actions have been, or will be, taken to ensure that limit breaks of this type do not occur again or to ensure early notification and rectification of this type of limit break.

36. How frequently do limit breaks occur? How would you define their materiality?

37. Do you agree that limit breaks that are rectified quickly need only be included in a periodic report rather than immediately reported? If so, what do you consider to be an appropriate time frame for rectifying limit breaks before they should be subject to an immediate report requirement?

38. What frequency do you consider appropriate for a periodic compliance report?

39. Are the details listed in paragraph 155 the appropriate details for limit break reports or should any details be excluded or added?

40. Are there any other circumstances which might justify an exclusion from the obligation to report material limit breaks to the supervisor/FMA?

5.3 Reporting of pricing errors

156 Clause 153 of the FMC Bill requires the following steps to be taken for material pricing errors or material non-compliance with the pricing methodologies set out in the governing document:

- correction of the pricing error or non-compliance
- reporting of the pricing error or non-compliance to the supervisor or (if there is no supervisor) FMA
- the prescribed remedial steps to be taken.

157 These obligations apply to the inclusion of errors in the pricing of a unit issued under the scheme or non-compliance by the manager or the person to whom the manager has contracted its functions (e.g. an administration manager). Examples include incorrect valuations by managers, administrative recording errors, and the application of incorrect accounting or tax policies. In many cases these errors may occur in sub-schemes that hold assets with complicated valuations or tax treatment.

158 Whether or not a pricing error or non-compliance is material will depend on FMA-prescribed frameworks and methodologies. Regulations are needed, however, to set out the remedial action to be taken.

159 Pricing errors and non-compliance with pricing methodologies can be of concern for two reasons. The effect on scheme participants (both on exit/entry and on the ongoing scheme participants) may be large. However, they also signal that the issuer does not have appropriate pricing policies or compliance and monitoring systems in place. So the materiality threshold to be set by FMA may depend not only on the amount involved as a

percentage of the unit price, but also the nature of the error and whether adequate procedures are in place, and have been followed, for determining the prices of units.

160 While specific policies are not currently proposed by the FMC Bill or regulations, mandating compensation is a means to focus managers on formulating pricing policies and monitoring for pricing errors, as early detection will be important to minimise the compensation they may be liable for.

Proposal

161 The governing document must contain a scheme's pricing methodologies. Those methodologies will need to comply with any FMA-prescribed frameworks and methodologies. In addition, the duties applying to a manager under the FMC Bill (particularly its professional standard of care) will affect the pricing policies and procedures it must have in place. Other duties (including the duty to treat scheme participants equitably) will inform the action it takes if pricing errors occur.

162 We understand that a number of schemes apply the joint ASIC and APRA guide to good practice in unit pricing.[6] Much of that guide constitutes good practice which may not be appropriate to specify in binding regulations. We consider that at a minimum, however, the regulations should mandate compensation to be paid to current and former scheme participants if there is a pricing error or non-compliance, unless the error or non-compliance is of minimal significance to scheme participants in terms on the percentage effect per unit.

163 We consider that a pricing error or non-compliance may be material under FMA-prescribed frameworks and methodologies (for example, because it indicates a problem with controls over pricing) but have an effect of less than a specified percentage per unit and so not require compensation. We propose that the minimum compensation level be agreed with the supervisor (or FMA if there is no supervisor) either in a policy for dealing with pricing errors or at the time the error or non-compliance is identified.

164 We consider that the following steps should be required to be taken:

- Unless the pricing error or non-compliance is below the minimum compensation level, the manager must take immediate steps to reimburse or compensate all disadvantaged current or former scheme participants.
- Reimbursement may be made by issuing more units or adjusting the price of units for ongoing scheme participants.
- Compensation may be paid to former scheme participants by direct debit to bank accounts or by cheque.
- If scheme participants have gained an advantage due to a unit pricing error, the manager may choose to bear the cost or may seek to recover the amount from those scheme participants.
- The manager must take all reasonable steps to ensure that the manager does not benefit from an error or non-compliance.

165 The manager must also report all material pricing errors or non-compliance to the supervisor (or FMA if there is no supervisor). We are interested in feedback on the appropriate timing for this report and as to whether there are any material pricing errors or non-compliance where reporting should be deferred to a periodic report. If the pricing error or non-compliance is over the minimum compensation level, we consider that reporting should also be to all

[6] ASIC & APRA, ***Unit pricing: guide to good practice***, August 2008, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg94.pdf/$file/rg94.pdf

affected current and former scheme participants, and the reports to the supervisor and scheme participants must include:

- the name of the scheme affected and the amount of funds under management
- the nature and cause of the pricing error or non-compliance
- the amount of the error or cost of the non-compliance as a percentage of the unit price
- the number and classes of current and former scheme participants affected
- the period over which the error or non-compliance occurred
- the steps taken, or to be taken, to correct and compensate for the error or non-compliance (including how compensation will be paid) and the timeframe for the steps
- whether or not policies or procedures should be changed to prevent recurrence of the pricing error or non-compliance and, if so, a plan and timeline for doing so.

41. Do you consider that the compensation obligation should not apply if the pricing error or non-compliance is minimal in terms of its percentage effect per unit?
42. Do you think that the remedial steps proposed in paragraph 164 are appropriate and will work for all schemes to which clause 154 of the FMC Bill applies? If not, in what ways should they differ?
43. What timeframe should apply for complying with the compensation and reporting obligations?

5.4 Related party transaction exceptions and certificate requirements

166 Clause 159(1) of the FMC Bill prohibits the manager (and persons to whom the manager has contracted functions) from entering into related party transactions (i.e. those that give a benefit out of scheme property or create an exposure to scheme property of related parties).

167 Related parties are the manager (and persons to whom the manager has contracted functions) and their associated persons. For restricted schemes that are employer-related schemes, non-scheme participant contributors are also related parties.

168 The provisions will apply to all transfers of value to related parties that affect scheme property, so extend beyond a mere payment to include issuing managed investment products, supplying services, transfers of property in or out of the scheme, and releases or guarantees of obligations. The provisions of the FMC Bill are modelled on equivalent provisions in the Australian Corporations Act 2001 at sections 601LA to 601LE.

169 The prohibition is based on the assumption that transactions of this nature may be improperly influenced by interests of the related party and so not be in the best interests of the scheme participants. The general duties continue to apply under the FMC Bill, particularly the manager's duty to act in the best interests of scheme participants and to act within the SIPO. However, the FMC Bill backs up those general duties with an obligation on the issuer to positively demonstrate that the transaction does not generate the mischief that the provision is directed at.

170 Accordingly, a related party transaction is permitted under the FMC Bill if:

- it is on arm's length terms (with a manager certificate) – i.e. the transaction is on ordinary commercial terms and not improperly influenced by other interests
- scheme participants' approval by a special resolution is obtained for the transaction and the supervisor consents on that basis (i.e. the scheme participants have agreed to the transaction) – current ASIC guidance on the equivalent Corporations Act exception is that this should be used where there is doubt about whether or not the transaction is on arm's length terms)

- the supervisor consents on the basis that the transaction is in the best interests of scheme participants, or
- the transaction is permitted under clause 160 or the regulations and the manager certifies to that effect – the other permitted transactions include acquisitions or disposals of interests in other registered schemes, and benefits or transactions in respect of prescribed overseas schemes.

171 In addition, clause 161 of the FMC Bill sets an additional five percent cap on in-house assets of restricted schemes to limit their exposure to related parties. The five percent cap is not a total aggregate but applies per related party and its associates. There is a three-year period within which schemes must comply under the transitional provisions. In addition, the FMC Bill provides that the 5% cap does not apply in the prescribed circumstances.

Proposal

172 Regulations are needed under the related party provisions to set certificate requirements for transactions that are arm's length or occur with scheme participants' approval, and to permit any related party transactions under the FMC Bill. In our view, current and further permitted related party transactions need to be justified on the grounds that they demonstrate that the risks to which the rule is directed have been controlled, have been disclosed and approved, have been avoided, or are plainly immaterial.

173 We think that no regulations need to be prescribed for the purposes of clause 161 in light of the change to the application of this test so that it is no longer an aggregated cap.

Arm's length exception certificates

174 The arm's length exception is the means by which the manager may demonstrate that the foreseen mischief behind the prohibition on related party transactions has been controlled, and so the prohibition is unnecessary. Under clause 160A of the FMC Bill, the certificate must state the grounds on which it is given and the basis for relying on that ground. The requirements must be sufficiently robust to demonstrate that the arm's length test is met.

175 We propose that the regulations require that this certificate must also state, to the extent that the monetary value of the property, service arrangement, or other benefit is able to be quantified, the nature and monetary value of the benefit and, in any other case, the nature and extent of the benefit.

176 A further option is to also require additional supporting evidence for the certificate, for example, a requirement for a supporting valuation of the benefit from a non-associated party who is appropriately qualified.

177 At this stage, we consider that adding particular prescribed requirements for valuations is likely to unduly diminish the flexibility of the exception, and increase the need for additional bright-line exceptions. It also would focus on only one aspect of the arm's length requirement, whereas the test requires an assessment of all the circumstances. It would also necessarily limit the ability to use general certificates. It may be justified, however, for particular types of transactions and for transactions of a particular level of materiality.

178 We propose that certificates given under clause 159 must be retained for the purposes of clause 213A of the FMC Bill and may be inspected by scheme participants. We also consider that the issuer should be required by the regulations to report to the supervisor periodically on certificates given for related party transactions and the basis on which they have been given.

179 We are interested in submitters' views on how frequently they consider that transactions will be caught by the related party prohibitions given the breadth of the provisions, their level of materiality, and the nature of the transactions. This information will assist us in assessing the appropriate certificate requirements and the frequency of any periodic reporting.

Approval by scheme participants

180 Approval by scheme participants is an alternative type of permitted transaction. Its use may be needed where the arm's length test cannot be satisfied or there is any doubt as to whether or not it may be satisfied. Its key justification is that, by this means, the potential conflict of interest inherent in the transaction is disclosed to, and approved by, those affected.

181 Accordingly we propose that there need to be specific meeting requirements to ensure adequate disclosure of the related party benefit. For meetings to obtain scheme participant approval for a related party benefit we consider that the regulations should require that the notice of meeting must contain an explanatory memorandum that sets out:

- the nature and extent of the benefit
- the related parties to whom the benefit is proposed to be given and the related party nature of the relationship
- all other information that is known to the manager and any of the manager's directors and that scheme participants would reasonably require to decide whether or not it is in the scheme's interests to pass the proposed resolution.

182 We propose that the notice of meeting, explanatory memorandum, and any other document material to the resolution that is proposed to be given to scheme participants at the meeting, must be given to the supervisor at least 10 working days (or any lesser period approved by the supervisor) before the notice of the meeting is given to scheme participants. The notice of meeting would also need to be accompanied by any comments given by the supervisor to the issuer on the explanatory memorandum.

183 In addition, clause 149 precludes the manager and its associated persons from voting on the resolution as scheme participants if they have an interest in the transaction.

Further permitted transactions

184 Given the arm's length exception, and the ability to give generic certificates on this basis, we think the threshold for demonstrating the need for other exclusions should be reasonably high. In particular, we do not, at this stage, favour permissions for particular types of transactions that are plainly within the arm's length exception in any case (unless there are compliance costs from meeting the arm's length certificate and the risk of mischief is very low). We are interested in feedback on this.

185 Below are two examples of possible bright-line tests that we have considered. In both cases we think that they do not materially add to the arm's length exception to warrant including them:

- benefits received by a related party in their capacity as a scheme participant, if giving the benefit does not discriminate unfairly against other scheme participants
- the sale of quoted financial products at a market price.

186 Benefits received by a related party in their capacity as a scheme participant could be permissible, based on section 215 of the Australian Corporations Act 2001, but we do not think it provides many benefits over and above simply applying the arm's length test. An alternative would be to require the benefit to be given on the same terms to all holders of the managed investment products in the same class. This would be a brighter line test, but may not work if the related party constituted the main, or only, holder of the managed investment products of that class.

187 An on-market sale of financial products quoted on NZX's official list is plainly within the arm's length test, but would add nothing then to that test (for example, the requirement for it to be on-market would undercut the reason for the related party transaction, which is presumably

to avoid brokerage costs). Going further is problematic, however. For example, we are concerned that there are risks with permitting off-market transactions, particularly with some quoted financial products (i.e. those which are relatively illiquid so that the market price may not reflect its underlying value).

188 However, we are considering prescribing a number of other permitted transactions.

Sale of first property into scheme

189 Submissions on the FMC Bill at select committee proposed permitting those related party transactions expressly permitted by the governing document. We do not think a generic permission of this kind is justifiable. In terms of disclosure, it is not the same as obtaining a general approval by a special resolution of scheme participants, and nor do we think that consent can necessarily be implied from the decision to invest with this permission in the governing document. We also think that, generally, the ability to obtain generic certificates is sufficient to address the compliance cost issues (and if, as a result of changing circumstances, the transactions cease, for example, to be in the best interests of the scheme participants, those generic certificates will not be effective).

190 However, we agree that there should be an exclusion where the very basis for the scheme involves an initial, or initial series of, related party transactions and investors have subscribed on this basis. Accordingly we are considering an exception for the sale of the first property into a scheme if the sale is disclosed in the PDS and permitted by the governing document. In the UK, the FSA Handbook has a similar exclusion from its conflicts of interest rules. The FSA Handbook excludes the vesting of property by a related party in a scheme under arrangements by which that property becomes the first property of the scheme and the related party becomes the first unitholder in the scheme.[7]

191 We are considering how to define the limits of this exclusion. One option is that the property be the "first property" of the scheme or that the property be specifically identified in the PDS (rather than by class). The regulations would also require a valuation of that property from a suitably qualified independent valuer. It may also be necessary to impose a time limit within which the transaction must have been entered into. The Australian Corporations Act 2001 requires related party transactions that rely on scheme participant approval to have been entered into within 15 months of the approval being obtained. We are interested in comments on the utility of this exception and any limits.

One common director only for a listed trust

192 We have also been considering the level of common directorships that give rise to a risk of related party influence. Under the FMC Bill parties are related to each other only as a consequence of sharing one common director. The NZSX/NZDX Listing Rules provide an exception on this basis in rule 9.2.3. We have considered whether an equivalent exception is justified on the ground that this level of related party interest is not sufficiently significant to create a material risk.

193 The threshold of common directorship that results in a true related party relationship is difficult to fix. The Reserve Bank does not count common directorships below 40% for the purpose of the maximum limit on related party exposures applying to deposit takers. However, that is an absolute limit and the rules in the FMC Bill are more flexible, allowing the transaction to occur if it comes within the arm's length exception. Accordingly we think a lower tolerance for common directorships is appropriate under the FMC Bill. Moreover we continue to be concerned that a bright-line test is useful to determine whether or not a person is a related party (rather than relying on the more "in substance" tests for association) While

[7] FSA Handbook, COLL 6.6.17

one common director may be unproblematic if the board has independent directors, it may not be in other scenarios.

194 Accordingly we propose that the exception applying under the listing rule 9.2.3 should apply under the FMC Bill also, but only in respect of listed schemes. In this case, the other safeguards under the listing rules (for example, a requirement for independent directors) will also apply. This ground of permitted transactions also reduces double-up with listing rule requirements.

NZX listing rules

195 We have also considered whether to give a more general exemption for registered schemes that are listed on the NZX and subject to the listing rules on related party transactions, on the basis that this is an alternative means of controlling related party risks.

196 The NZSX/NZDX Listing Rules require an ordinary resolution of scheme participants to approve any related party transaction under rule 9.2.1. There is a materiality threshold below which approval is not required. However, there is no arm's length exception. Instead, there are a number of specific exceptions and the ability to obtain a waiver from the NZX. Accordingly, although the scope of listing rule 9.2.1 is not as broad as the prohibition in clause 159 of the FMC Bill, where it applies an ordinary resolution will generally be required.

197 Applying both the NZSX/NZDX Listing Rules and the different provisions of the FMC Bill increases the compliance requirements in a case where arguably the material risks are already being sufficiently controlled through the listing rules. For example, a transaction to which listing rule 9.2.1 applies would need both an ordinary resolution of scheme participants approving it to satisfy the requirements of the listing rules and (unless a special resolution could be obtained) be certified as being on arm's length terms by the manager to satisfy the requirements of the FMC Bill. In addition, waivers of the listing rule requirements still leave managers of registered schemes having to comply with the requirements of the FMC Bill (and so potentially needing a special resolution of scheme participants).

198 The underlying policy of the NZX listing rules is not fundamentally different to that in the FMC Bill. However, the listing rules set different means to satisfy the objectives of controlling the risks. This may be appropriate for the class of schemes to which they will apply.

199 However, we think a general exemption is problematic. Both the scope of the transactions covered as well as the number of related parties covered is wider, on the margins, under the FMC Bill. However, there are significant differences in outcomes for investors for non-compliance with the related party prohibitions under the FMC Bill (entitling investors to compensation and resulting in potential civil pecuniary penalties for the issuer) compared to those under the listing rules. In addition, the coverage of the two rules differ.

200 On balance, we think the need under the FMC Bill to satisfy the arm's length exception or demonstrate to a supervisor that the transaction is in the best interests of scheme participants is not unduly onerous. It will be an additional requirement to an ordinary resolution of scheme participants to meet the listing rule requirements. Anything that gains an NZX waiver would, in our view, also be likely to satisfy these tests.

201 However, we do consider that, where feasible, complete overlap should be removed and clause 160 of the FMC Bill should reflect the NZX means of compliance with listing rule 9.2.1 as a permitted transaction. Accordingly, an ordinary resolution obtained under listing rule 9.2.1 would be an alternative compliance route for listed schemes where a transaction is both caught by listing rule 9.2.1 and clause 159 of the FMC Bill. This would remove issues with the different requirements for meetings imposed by the FMC Bill and the listing rules.

Materiality threshold

202 We do not propose including a threshold below which related party benefits are considered immaterial and where compliance with the other exceptions or the obtaining of supervisor approval is not needed. Our preference is to ensure that the arm's length exception and related certificate requirements remains sufficiently flexible that the costs are not significant where there is no mischief.

Investments in other registered schemes

203 Clause 160(b) also excludes from the related party prohibition acquisitions or disposals of managed investment products in other registered schemes or in other prescribed overseas schemes. The purpose of this exclusion is to facilitate inter-funding and promote use of registered schemes. The latter is excluded on the basis that the risks of related party transactions between schemes are sufficiently controlled by other duties to comply with the SIPO and the duty on the manager to comply with a professional standard of care. The same approach is justified for overseas schemes where there are equivalent duties and where there is likely to be a market need for the exclusion.

204 On this basis, we propose prescribing managed investment schemes registered under the Australian Corporations Act 2001 as being excluded.

44. Is there a need for limitations to be prescribed on the 5% cap for restricted schemes?
45. Do you consider that the requirements for certificates in paragraphs 174 to 179 are sufficient or should more supporting evidence be required expressly by the regulations? If so, what types of transactions do you think this requirement should apply to?
46. Do you consider that the requirements for an explanatory memorandum for meetings to approve related party transactions, and the requirement to give that memorandum to the supervisor and include the supervisor's comments, are appropriate? If not, in what ways should these requirements be changed?
47. How frequently do you consider that transactions will be caught by the related party prohibitions given the breadth of the provisions? What do you expect would be the nature of the transactions and their likely levels of materiality? What do you think the costs of complying with the certificate or meeting requirements are likely to be?
48. Do you agree with the view that there should not be a general exclusion for the sale of quoted financial products at a market price or for benefits received by a related party in their capacity as a scheme participant (on the basis that, where appropriate it is already covered by the arm's length exception)? If not, please explain.
49. Do you consider the exception proposed for the sale of first property into a scheme is justified and useful? If not, why not? What do you consider should be the limits on the exclusion?
50. Do you consider an exclusion for only one common director for listed schemes is justified and useful? If not, why not?
51. Do you agree that a broad exemption for schemes listed on the NZX is inappropriate? If not, why not? What are your views on the more limited exemption proposed in paragraph 201?

5.5 Custodial record, reports, audit and assurance requirements

205 Custody of scheme property is a significant issue for managed investment schemes. For this reason the FMC Bill requires scheme property to be held by the supervisor or another custodian who is independent of the fund manager (clause 143).

206 Clause 144 requires custodians to hold scheme property on trust separate from their own property and the property of the fund manager or any other related party of the scheme. The record-keeping obligation in clause 145 backs this obligation with an obligation to keep

records that identify the scheme property, show the date on which it was received and, if it has been disposed of, show details of the disposition. The custodian must also keep all other prescribed records. The purpose of these duties is to ensure the scheme property can be ascertained, and independently verified if need be.

207 We think those records should be in enough detail to ensure that the following can readily be ascertained:

- what investor money has been paid in and out
- what the scheme investments are, including what they consist of, where they are held, when they were acquired or disposed of, and the book value at the date of acquisition
- what other income has been paid to, or deductions made from, scheme property.

208 We expect that these records would form the basis of regular reports to go to the manager, and that these records would be regularly reconciled against the manager's transaction records and reporting of scheme property. We also consider that these custodial reports should be provided to the supervisor if the supervisor is not the custodian.

209 The custodial records would need to be sufficient to enable an audit to be undertaken to verify the scheme property and provide assurance that the custodian has controls to ensure that the scheme property is secure and has appropriate procedures for the acceptance and implementation of authorised instructions. We are considering whether the scope of this audit or assurance needs to be set by the regulations.

52. What (if any) records need to be prescribed in detail for custodians?
53. What custodial reporting should be required to the supervisor (if the supervisor is not the custodian)?
54. What is the appropriate scope of any audit or assurance in respect of the scheme property held by the custodian?

6. Governance requirements for all regulated products

6.1 Issuers' registers of financial products

210 Clauses 200 to 213 of the FMC Bill deal with the registers of financial products to be kept by all issuers. These obligations are based on the equivalent obligations for issuers of securities under the Securities Act 1978. The register forms the basis of title to a security. It also provides a mechanism for the public to ascertain ownership of financial products on issue.

211 Regulations may specify products for which the registers are not required, and alternative requirements for derivatives (for which a register is not required). The regulations may also prescribe additional content for the registers. The regulations may determine any additional manner in which it may be inspected under clause 207 (for example, electronically), limit public access to a register and prescribe fees for copies of documents.

212 The register obligations may not be appropriate for particular types of products. We consider that, for example, a public register of derivatives is not required. These are not public or transferable securities and do not, in themselves, result in control of an issuer. We propose alternative record-keeping requirements for derivatives in Chapter 6. Similarly, at present only a company needs to keep a register of debt securities.

213 We also need to consider the interaction of the register requirements with other aspects of the regulations. For example, the ability to obtain a product certificate as documentary evidence of title probably applies to those products where the issuer is obliged to keep a register. There is also interaction between the register requirements and other registers, particularly with share registers for companies.

214 The FMC Bill requires a person seeking access to information on registers to give the purpose for which they intend to use the information obtained. The person may only use the information for that purpose. Some purposes are prohibited (for example, using personal details to contact persons unless it is relevant to the holding of interests) and it is also possible for the regulations to prohibit other additional purposes.

215 It is also possible to add to the prohibited purposes by regulations. One use of registers that has been of ongoing concern has been the practice of making unsolicited offers to security holders, particularly offers below market value or on terms that effectively result in a substantial discount. We do not propose prohibiting the making of an unsolicited offer at this stage. The Securities Markets (Unsolicited Offers) Regulations 2012 have recently been made (and we propose that they be re-made under the FMC Bill with any consequential changes). These regulations take a disclosure-based approach to unsolicited offers. We will keep the use of registers for these purposes under review, however.

55. Are there any types of financial products (other than derivatives) for which a register is not needed or for which an alternative obligation should apply?

56. Should we prohibit any purposes of access to the register at this stage?

6.2 Copies of documents

216 Clause 213A of the FMC Bill requires all certificates, notices, and other documents given for a regulated product or regulated offer to be kept for 7 years and for requirements to be prescribed as to the keeping of, and public access to, those records. Many of these records will also be on the register of managed investment schemes or the register of offers of financial products. We consider, however, that existing investors should be able to inspect and copy documents kept under this section.

57. Should existing investors be able to inspect and copy documents kept under clause 213A? If not, why not?

Ministry of Business, Innovation & Employment

Financial Markets Conduct Regulations - Discussion Paper

Chapter 5 – Dealing in financial products on markets

December 2012

Contents – Chapter 6

1. Introduction

1.1 Scope of this chapter

1. This chapter seeks comments on the regulations required to implement the financial product markets regime in Part 5 of the FMC Bill. "Financial product markets" is the term used by the Bill to include stock exchanges, listed debt markets, futures exchanges and other markets in which financial products are traded. This chapter:

   - discusses the purpose and objectives of financial product market regulation
   - provides an overview of the regulations that are required under Part 5 of the FMC Bill, including matters carried over from the Securities Markets Act 1988 and new provisions
   - discusses potential exemptions from the need for a financial product market licence
   - proposes carrying over, with updates, the existing regulations relating to insider trading, market manipulation, continuous disclosure, substantial security holder disclosure, directors and officers disclosure and unsolicited offers
   - discusses options for forms for transfers of financial products.

1.2 Purpose and objectives of financial product market regulation

2. The FMC Bill specifies both main and additional purposes for Part 5. The main purposes for the FMC Bill in clause 3 are to:

   - promote the confident and informed participation of businesses, investors, and consumers in the financial markets
   - promote and facilitate the development of fair, efficient, and transparent financial markets.

3. The additional purposes are specified in clauses 4 and 224. These purposes need to be balanced against each other in the creation of regulations to achieve the main purposes of the FMC Bill. They can be summarised for the purposes of Part 5 as follows:

   - to promote fair, orderly, and transparent financial product markets (224)
   - to provide for timely, accurate, and understandable information to be provided to persons to assist those persons to make decisions relating to financial products or the provision of financial services (4)
   - to ensure that appropriate governance arrangements apply to financial products and market services that allow for effective monitoring and reduce governance risks (4)
   - to avoid unnecessary compliance costs (4)
   - to promote innovation and flexibility in the financial markets (4)
   - to encourage a diversity of financial product markets to take account of the differing needs and objectives of issuers and investors (224).

4. For financial product markets, the FMC Bill seeks to achieve these purposes through disclosure (disclosure of price-sensitive information by issuers and of trading by substantial holders, directors and senior managers) and prohibiting certain conduct (insider trading and market manipulation). Without these mechanisms, markets may be non-transparent and prone to abuse, and both issuers and investors may be dissuaded from participation. However, these mechanisms must be as low cost as practicable and applied in a way that is proportionate, having regard to the nature and scale of markets and their participants. Overly stringent or inflexible rules raise costs excessively and diminish efficiency and competition.

1.3 Status quo and problem definition

5. Many of the provisions in Part 5 are carried over from the existing law. The Securities Markets Act 1988 framework for regulating insider trading, market manipulation, continuous disclosure, substantial security holder disclosure, directors and officers disclosure and unsolicited offers has undergone substantial revision over the past decade. As a result, these provisions are largely replicated in the FMC Bill, apart from changes to fix anomalies or gaps in the current regime. This includes incorporating exemptions from regulations and FMA exemption notices into primary legislation, where desirable. Part 5 also carries over existing provisions relating to unsolicited offers and (with some modernisation) the Securities Transfer Act 1991.

6. For this reason, we propose that many of the regulations are based on the existing securities markets regulations and the Securities Transfer Act.

7. The main changes in Part 5 that require new regulations are:

   - requirements for financial product markets to be licensed
   - provision for 'stepping stone' markets.

8. The FMC Bill introduces a new licensing regime for financial product markets. Under the Securities Markets Act, markets only become regulated if they choose to register themselves (or when the Minister uses a call-in power). The FMC Bill reverses this onus. Financial product markets must be licensed, unless an exemption applies (see clause 308). Licensed markets are also subject to a higher level of oversight.

9. The new licensing regime necessitates regulations to exempt markets from licensing where the benefits of regulation are outweighed by the costs.

10. The FMC Bill also provides for 'stepping stone' markets under which disclosure requirements and conduct rules can be adapted to the particular market, issuers, and investors involved (see clause 350). The ability to tailor these requirements may also be beneficial for markets on which only certain types of products are traded, such as exchange-traded funds.

11. We do not propose alternative disclosure and conduct rules in this paper. Instead, we intend to develop regulations as required in response to proposals to establish markets that would operate under alternative rules. We envisage that proposals for regulations developed with the prospective market operator would be subject to a separate public consultation.

12. We welcome engagement with persons who may wish to operate such markets. Clause 306 sets out the principles that would guide any regulations prescribing alternative disclosure and conduct rules, along with the purposes of the FMC Bill and Part 5 in clauses 3, 4 and 224.

2. Exemptions from financial product market licensing

13. The Bill provides for three kinds of exemptions relating to financial product markets. There are exemptions from the definition of "financial product market", exemptions for prescribed wholesale markets, and other exempt markets.

2.1 Exemptions from the definition of "financial product market"

14. Clause 307(2)(d) allows regulations to prescribe that some types of conduct do not constitute a financial product market. Clause 307(2) already provides a number of exclusions from this definition, as follows.

15. An exclusion is provided for "a person making or accepting offers or invitations to acquire or dispose of financial products on the person's own behalf, or on behalf of 1 party to the transaction only (for example, a continuous issuer of financial products)". This is integral to the definition of financial product market – a financial product market must be used to match both sides of the transaction.

16. An exclusion is provided for "an issuer or a related body corporate of an issuer matching persons who wish to acquire financial products of that issuer with persons who wish to dispose of financial products of that issuer (whether at a specified price or otherwise)". This is intended to exclude markets that are operated by an issuer for use by its own investors, and also treasury operations between related bodies corporate (c.f. Australian Corporations Act 2001, section 767A(2)(b)).

17. Services covered by a market services licence are also excluded.

18. Clause 307(2)(d) allows the prescription of additional situations where a facility inadvertently falls within the broad definition in clause 307, but should not be regarded as a financial product market at all. A market operator exempted under 307(2)(d) need not be registered under the Financial Service Providers (Registration and Dispute Resolution) Act 2008.

19. As clause 307 is based on section 767A of the Australian Corporations Act, we consider that ASIC's regulatory guidance on market licences (RG 172) is relevant to interpreting the FMC Bill provision. ASIC gives examples of facilities that it considers do not fall within the definition and therefore do not require an exemption:

    - order routing systems – on the basis that offers are not made on the order routing system; they are merely transmitted, and are made on the financial market to which orders are routed
    - internet portals used to advertise the services of licensed advisers, brokers, fund managers and market operators – again, on the basis that offers for financial products are not made on the portal; it merely directs investors to other sites or services where offers are made.

20. We welcome feedback on types of facilities that may be inappropriately caught by the definition of "financial product market" when they are not, in substance, financial product markets. The case for an exemption is strongest where the purposes of regulating financial product markets do not apply to these types of facilities. A financial product market may still be exempted from the need for a licence for other reasons – see sections 2.2 and 2.3 below.

1. Are there any additional services that should be excluded from the definition of financial product market in clause 307(2)(d)? Why is it appropriate to exclude them here, rather than as prescribed wholesale markets and other exemptions (discussed in sections 2.2 and 2.3)?

2.2 Exemption for prescribed wholesale markets

21. Even if a facility is a financial product market, there can be exemptions from the need for a licence. There is an exemption in the FMC Bill for small markets, measured by either the number of transactions or the value of those transactions.

22. Clause 310(1)(b) allows for regulations to provide for a "prescribed wholesale market". Our initial view is that this would likely include markets in which both:

- trading is restricted to wholesale investors, and
- the classes of products that are traded on the market are neither quoted on a licensed market nor issued under a regulated offer.

23. Activities of wholesale investors are generally exempt from prescriptive regulation in the FMC Bill because such investors do not necessarily seek the protections of the regulatory regime and their trading activities may not impact on other persons. An argument against an exemption would be if unregulated trading on these markets could have some systemic effect which affects financial markets more broadly – such as an adverse effect on New Zealand's reputation, or on some systemically important institution.

24. More complex considerations apply if trading is restricted to wholesale investors, but either the products are traded on a licensed market, or the products traded are issued to or held by retail investors. A number of other jurisdictions regulate markets in which such trading occurs. These markets may be problematic from a regulatory perspective if, for instance, manipulation of share prices or volumes in an unregulated market could create a false impression of price or demand for securities that are listed on a regulated market.

2. Are there currently "wholesale" financial product markets that are likely to require a licence under the FMC Bill? What is the potential for their operation to have an adverse impact on financial markets in New Zealand more broadly, or on retail investors?
3. What kinds of "wholesale" markets should be exempted from the licensing regime for financial product markets?

2.3 Other exemptions

25. A financial product market that is not a prescribed wholesale market may be exempted under clause 310(1)(c). An exemption may be justifiable in a particular case, for example, if the market is small and requiring a licence would be inconsistent with the purposes of Part 5. The size threshold in clause 310(1)(a) is set at a low level (100 transactions and transactions of $2 million per annum), as any market falling below the threshold will always be completely exempt from the licensing regime, regardless of what investors are involved in it, how it is promoted or the nature of the products being traded.

26. For markets that are larger than the threshold, an exemption may be warranted if it is still small relative to the risks to the public and cost of compliance. An exemption may come with conditions. These could include, for example, that the market provides prominent disclosure to investors of its regulatory status, and the implications in regards to insider trading, market manipulation and ongoing disclosure by listed companies.

27. There may be related or other circumstances where an exemption is appropriate. ASIC's guidance indicates that it advises that exemptions be given for "electronic trading services" on a case-by-case basis. Exemptions are likely to be given where the operator of the system is also a participant in a licensed market, the electronic trading service is governed by the operating rules of the licensed market, and the volume of trades executed on the electronic trading service in any particular class of shares of a particular body corporate does not exceed 10% of the total for that class.

28. We consider that most other exemptions will be on a case-by-case basis, and may be more appropriately a matter for FMA under Part 8. We seek feedback, however, on whether there is a need for exemptions in regulations.

4.	Are there any types of markets that should be exempted under clause 310(1)(c)? What would be the costs of compliance with the licensing regime for these markets? How frequently would such an exemption be likely to be relied upon?

3. Provisions largely carried over from the Securities Markets Act

3.1 Substantial holdings

Form and method of disclosure and acknowledgement

29. Clauses 274 and 275 require that substantial holdings be disclosed in the prescribed manner, along with any related matters that are prescribed.

30. The Securities Markets (Substantial Security Holders) Regulations 2007 set out procedures and forms for substantial security holder disclosure. They set requirements for the form and delivery of event disclosures, how event disclosures can be combined, the information that must be included and the forms to be used. We propose to replicate these procedures and forms.

31. In addition, if a listed issuer receives a substantial holding disclosure it must, on the request of the sender, give an acknowledgement of disclosure. Clause 276 requires the acknowledgement to be given in the prescribed manner. The current regulations state that "if an acknowledgement of an event disclosure is requested by a person under section 28 of the Act, the public issuer must send that acknowledgement to the person by delivery, post, fax, or (if the disclosure was given by email or another electronic means) email or that other electronic means."

Manner of queries to uncover relevant interests under clauses 283, 284 and 285

32. Clause 286 allows regulations to prescribe the manner in which queries under clauses 283, 284 and 285 may be made to persons who may have a relevant interest in a quoted product. The current regulations (Schedule 3 of the Securities Markets (Substantial Security Holders) Regulations 2007) need modification to reflect the fact that the inquiry power in clause 284 is now recursive and not limited to substantial security holder purposes – an issuer can look behind multiple layers of custodial arrangements to find ultimate beneficial owners. Consequently, the person receiving the notice may not be the registered holder (as referred to in the current regulations). In other respects, we propose to replicate these regulations.

Exemptions from substantial security holder disclosure

33. We note that clause 16 of the Securities Markets (Substantial Security Holders) Regulations 2007 currently provides an exemption for substantial holdings in issuers that are listed on an exchange in certain overseas jurisdictions: Australia, Canada, Hong Kong, Ireland, Singapore, the United Kingdom and the United States. This applies if no New Zealand exchange has primary jurisdiction for the listing, the issuer is not registered in New Zealand or established under New Zealand law and the person is subject to overseas substantial holding disclosure requirements in connection with the substantial holding.

34. We could replicate this exemption, but it may be appropriate to remove the restriction to particular jurisdictions, as in the equivalent exemption for director and senior manager disclosure in clause 301 of the FMC Bill.

5. Should any changes be made to the manner in which substantial holdings are disclosed and acknowledged?
6. Should any other changes be made to the regulations covering the manner in which inquiries under clauses 283, 284 and 285 are given?
7. Is the disclosure exemption for substantial security holders in overseas listed issuers still warranted? If so, should any changes be made to it?
8. Are any additional exemptions warranted from substantial holdings disclosure? If so, what is the rationale for these exemptions and how frequently would they be used?

3.2 Director and senior manager disclosure

Application of 20 working day timeframe to director and senior manager disclosure

35. Most trading by directors and senior managers needs to be disclosed within 5 working days (clause 295(2)(b)).

36. The FMC Bill incorporates a number of partial exemptions from director and senior manager disclosure that were previously contained in the Securities Markets Act (Disclosure of Relevant Interests by Directors and Officers) Exemption Notice 2004. These exemptions permitted longer (30 day) disclosures for some types of transactions.

37. The FMC Bill has a 20 working day timeframe for the filing of these disclosure notices, which cover acquisitions under employee share schemes, dividend reinvestment plans and share top-up plans. It provides a similar treatment for an acquisition or disposal under a Companies Act 1993 amalgamation or arrangement. The effect of the extended timeframe is to allow a larger numbers of transactions to be aggregated into a single monthly notice, rather than each having to be disclosed within a 5 working day window.

38. Clause 295(2)(a)(vi) of the FMC Bill allows the 20 working day timeframe to apply to additional acquisitions and disposals prescribed by regulations. The general principle is that the extended timeframe should apply where prompt disclosure of a director's or senior manager's trading is not useful to the market and the circumstances are such that insider trading or market manipulation unlikely. These can include:

- acquisitions and disposals made automatically under a pre-existing arrangement
- acquisitions and disposals are that are participated in equally by all shareholders.

39. We note that the Securities Markets (Disclosure of Relevant Interests by Directors and Officers) Regulations 2003 includes an exemption for products acquired under an "ongoing offer", which means "an offer (including, without limitation, under a buy-back or a dividend reinvestment scheme) to all existing shareholders on an equal basis with an open period of acceptance". This exemption overlaps with the exemption notice and is partly covered by the FMC Bill's clauses relating to dividend reinvestment plans and share top-up plans.

Exemptions from director and senior manager disclosure

40. The FMC Bill has made most of the full exemptions in the Securities Markets Act (Disclosure of Relevant Interests by Directors and Officers) Exemption Notice 2004 obsolete. The FMC Bill no longer requires disclosure of interests in all financial products of a listed issuer – only interests in quoted voting products or specified derivatives.

41. This means that the exemptions are no longer required for unlisted debt securities, life insurance policies, superannuation schemes, unlisted passive funds, unlisted unit trusts, unlisted group investment funds and unlisted securities of co-operative companies. The FMC Bill also provides an exemption for overseas listed issuers that was previously provided for by the exemption notice (clause 301), and an exemption for directors and senior managers who disclose substantial holdings that was previously in regulations (clause 300).

Form and method of disclosure and further matters required to be disclosed

42. Clause 298 requires that directors and senior managers make their disclosure in a manner prescribed by regulations. Clause 297(2) requires that further matters relating to the interest or trade be disclosed.

43. We propose to replicate the relevant provisions and forms in the Securities Markets (Disclosure of Relevant Interests by Directors and Officers) Regulations 2003. One change that will need to be made is to reflect the possibility that the interest is in a specified derivative (as defined in clause 296(3)).

Interests register

44. Clause 303 sets out how an interests register is to be made available for inspection. By default, it must be made available from 9 a.m–5 p.m. on each working day during the inspection period (which is 3 to 8 working days after receipt of a request for inspection). Other methods through which the interests register must be made available for inspection can be prescribed by regulations.

45. Clause 304 requires that copies or extracts of an issuer's interests register be made available on payment of a prescribed fee. The equivalent provision in the Securities Markets Act is section 19ZA(4), which allows issuers to charge “a reasonable copy and administration fee determined by the public issuer”. Replicating this provision would align with the corresponding provision in the Companies Act 1993.

46. Alternatively, we could set particular fees – e.g. a set or hourly administration fee, plus per-page copying fee if the information is provided in hard copy. The advantage of this approach is that it ensures that the fee is not excessive due to inefficient issuer processes. However, some issuers may be able to provide the information for less cost than prescribed. A further option is to allow the fee to be reasonable, subject to a maximum cap.

9. Is the extended 20 working day timeframe for directors’ and senior managers’ disclosure appropriate for any acquisitions or disposals not already covered by clause 295(2)(a)? How frequently would these arise?

10. Are any additional exemptions warranted from director and senior manager disclosure? If so, what is the rationale for these exemptions and how frequently would they be used?

11. Should any other changes be made to the manner in which directors’ and senior managers’ interests are disclosed and acknowledged?

12. Are there any additional ways that issuers should make inspection of the interests register available?

13. What fees should issuers be able to charge persons who request copies or extracts from the interests register?

3.3 Unsolicited offers

47. Subpart 10, “Unsolicited offers”, substantially replicates sections 48DA-48DC of the Securities Markets Act. Regulations under those sections of the Securities Markets Act have recently been made, and regulate the way that unsolicited offers can be made. We propose to implement equivalent regulations under the FMC Bill.

14. Should any changes be made to the regulations required for the unsolicited offers regime?

4. Provisions largely carried over from the Securities Transfer Act

48. Subpart 9 of Part 5 “Transfer of transferable financial products”, is based on the Securities Transfer Act 1991. Subpart 9 specifies an approved manner by which listed and unlisted financial products may be transferred in New Zealand, including electronically. The process it specifies is voluntary – other transfer procedures and forms can be used if permitted by the product’s governing document. If a person follows the process in subpart 9, the transfer cannot be refused for registration on the grounds that the wrong process has been followed but can be refused on other grounds. Subpart 9 has effect despite anything to the contrary in any enactment, rule of law, constitution, deed or agreement.

49. In the absence of subpart 9, different methods for transfer are required for equity securities, debt securities and managed investment products. These methods are prescribed in legislation and in governing documents such as trust deeds and constitutions. Accordingly, subpart 9 provides three distinct benefits:

- efficiency through standardisation of forms
- reducing the documentation needed for transactions by agents
- certainty and integrity of electronic systems.

50. By approving defined forms of transfer, the subpart provides efficiencies for the parties to a transfer, and also for the parties who are registering the transfer. Transferors and transferees enjoy streamlined processes, and share registries do not need to look behind the approved form to ensure compliance with other legislation or governing documents.

51. Because transfers can be effected by or through the agency of an authorised person, the process provides practical benefits where transfer documentation would otherwise be unwieldy, for example when a lawyer or accountant is authorised generally to administer estates.

52. There are additional discernible benefits for electronic systems, as the integrity of the system itself is reliant on transfers being prompt and irreversible.

4.1 Form and information

53. Clauses 372(1)(a), 373(1)(a)(i) and 373(1)(b)(i) refer to forms that are required to be used for subpart 9 to apply.

54. The current Securities Transfer Act’s prescribed forms of transfer are a useful means to standardise securities transfers, particularly for off-market trades. They allow share registries to register a transfer without looking behind the written document.

55. However, it is not essential that the precise content of the forms be prescribed. As an alternative, a list of characteristics required for an approved form of regulation could be prescribed by regulation. The benefit of a list of characteristics over a set form is that it allows flexibility for layout and format, and for additional information to be included on a form, without the absence of any such additional information invalidating the transfer. However, it is important that such flexibility does not undermine the benefits of standardisation.

56. If prescribed forms are used, we propose to base these off the existing forms in Schedules 1 and 2 of the Securities Transfer Act. There would be some minor changes where the language of the FMC Bill differs from the Securities Transfer Act.

15.	Should regulations continue to prescribe the forms that must be used, or would it be preferable to instead prescribe the information that must be included in the form?

16.	If prescribed forms are used, are there any changes that should be made to the existing forms in Schedules 1 and 2 of the Securities Transfer Act (apart from changes in terminology to reflect the language of the FMC Bill)?

4.2 Standard transfer forms cannot be used for some transactions

57. The transfer provisions in subpart 9 do not apply to interests in a superannuation scheme, KiwiSaver scheme or derivatives or financial products of a prescribed kind – see clause 371(2).

17.	Are there any transferable products that subpart 9 should not apply to?

4.3 Authorised persons

58. To make use of the products transfer form in an off-market transfer of financial products, clause 372 requires that the financial products be disposed of in an "authorised transaction". This means a transaction in which each party is, or is acting through the agency of, any of the following persons (who are acting in the ordinary course of business):

(a) a person authorised to undertake trading activities on a licensed market

(b) a lawyer in practice on his or her own account

(c) a chartered accountant

(d) a trustee corporation (as defined in section 2 of the Trustee Act 1956)

(e) a registered bank

(f) a person prescribed for the purposes of this definition.

59. This requirement was carried over from the Securities Transfer Act 1991, and the previous Securities Transfer Act 1977. In the original 1976 Securities Transfer Bill, the standard forms could be used by any person. However, during the consideration of the Bill by the Commerce and Mining Committee, a concern arose about the opportunity for fraud in the course of private transactions for the transfer of securities (those not effected through the agency of an independent person such as a sharebroker). Consequently, the Bill was amended to provide that the form could be used only for securities sold in an authorised transaction. Other persons must make use of processes provided for in constitutions, trust deeds, etc.

60. Persons (a)-(e) are listed on the basis that they are trustworthy persons who are likely to be involved in the transfer of financial products, including transfers performed on behalf of others. Other persons can be added by regulations, for example authorised financial advisers.

18.	Should anyone else be prescribed as able to make use of the standard transfer forms?

Financial Markets Conduct Regulations - Discussion Paper

Chapter 6 – Licensing

December 2012

Contents – Chapter 6

1. Introduction

1.1 Scope of this chapter

1 This chapter consults on the regulations that will be required to implement the licensing regime created by the FMC Bill.

2 Cabinet agreed in February and May 2011 that the following service providers would be licensed:

- fund managers
- derivatives dealers
- providers of discretionary investment management services
- independent trustees of restricted schemes
- regulated intermediaries, including person-to-person lending services and crowd-funding platforms.

3 The licensing regime for these is implemented in Part 6 of the FMC Bill.

4 This chapter:

- discusses the purpose and objectives of the licensing regime
- discusses the structure of the licensing regime in Part 6 of the FMC Bill and how this differs from existing licensing regimes
- proposes options for the aspects of the new licensing regime that are common across the different types of licensees
- proposes options for aspects of the licensing regime that are specific to each type of licensee: fund managers, independent trustees of restricted schemes, discretionary investment management services, derivatives issuers, person-to-person lending services and crowd-funding platforms
- proposes options for the other regulations that will be required to implement the licensing regime under the FMC Bill.

1.2 Purpose and objectives of licensing

5 Licensing regimes are a response to information asymmetry and agency problems present in some markets, including some markets for financial services. In such markets, it is difficult for consumers to distinguish trustworthy and competent providers from unscrupulous or incapable providers, or to monitor providers once they have engaged them.

6 Consumers may be unable to tell low quality (and likely cheaper) providers from high quality (and likely more expensive) providers, resulting in the latter being priced out of the market. The market may be associated with poor consumer experiences and damaging scandals, which consumers respond to by reducing their demand from all providers, or confining themselves to large and established businesses, inhibiting the entry of new and untested firms.

7 The FMC Bill's licensing regime tries to address these issues in financial services through two distinct mechanisms: eligibility criteria and licensing conditions.

8 Eligibility criteria are the minimum standards that service providers must meet before they can be granted a licence. They may relate to the character and reputation of directors and key employees, their skills and experience, or organisational factors such as systems and processes, technology and financial resources.

9 Licensing conditions are the ongoing requirements and standards of conduct that licensees must comply with, in addition to any duties set out in legislation. These include standard conditions that all persons holding that type of licence must comply with (such as regular reporting to FMA), and also conditions that FMA imposes on a case-by-case basis. Conditions support eligibility criteria by, for example, allowing FMA to limit the range of activities that a licensee performs to those that it has sufficient capability for (i.e. without conditions FMA might be forced to reject the entire licence). Conditions also allow for the creation of more detailed or flexible rules than can be included in primary legislation.

10 Eligibility criteria and licensing conditions seek to contribute to the purposes set out in clauses 3 and 4 of the FMC Bill, such as encouraging the confident and informed participation of businesses, investors and consumers in the financial markets. Eligibility criteria and conditions are intended to exclude unscrupulous or incapable operators who have the potential to damage the reputation of whole markets or industries. Investors benefit directly from reduced risk of misappropriation or firm failure. In addition, if investors can take certain minimum standards for granted, this reduces decision-making complexity: investors can concentrate on risks and returns of products rather than on risks arising from poor conduct.

11 However, the licensing regime needs to balance these objectives against the need to keep compliance costs low and allow for innovation. While the licensing regime is intended to support greater competition and market efficiency, overly stringent or inflexible criteria and rules can raise costs excessively. It can also diminish competition, by excluding new entrants with different ways of achieving the same good outcomes. At their extreme, licensing regimes can effectively be taken over by incumbents and used to limit competition.

1.3 Key licensing provisions in the FMC Bill and the function of regulations

12 Most of the financial services to be licensed under the FMC Bill are not currently licensed. The exception is authorised futures dealers, which will be replaced by licensing of derivatives issuers under the FMC Bill (although the scope of the two regimes does not overlap precisely).

13 The new licensing regime, as agreed by Cabinet in February and May of 2011, is set out in Part 6 of the FMC Bill. Within this part, the following are key clauses concerning eligibility criteria and related regulations:

- Clause 394 states the basic statutory eligibility criteria for a licence: the licensee should be a fit and proper person and capable of effectively performing the service, with there being no reason to believe they will not comply with the market services licensee obligations (including conditions). Regulations can prescribe additional eligibility criteria.
- Clause 395 sets out the matters that FMA must consider when considering the eligibility criteria under clause 394. These include matters prescribed by regulations.
- Clause 520(1)(a) allows regulations to prescribe matters relating to the issuance of market services licences, including eligibility criteria and requirements, matters that FMA must have regard to and persons FMA must consult with in deciding whether to issue a licence.

14 The following are key clauses concerning licensing conditions:

- Clause 400 allows conditions to be imposed on licences. These include conditions imposed by FMA and any conditions imposed by regulations.

- Clause 401 sets out when FMA can impose conditions under clause 400. The FMC Bill allows FMA to impose conditions that restrict the scope of the licence, conditions that relate to the eligibility criteria in clause 394, and expiry dates. Any other conditions FMA may want to impose must be authorised by regulations.

15 The FMC Bill could function – to some extent – without regulations prescribing eligibility criteria or conditions. In this case, FMA would determine for itself whether applicants met the high level eligibility criteria in clause 394. It could impose a limited range of conditions in accordance with clause 401.

16 However, there are a number of problems with omitting eligibility criteria and conditions from regulations.

17 Due to the wide range of services covered, the FMC Bill gives relatively little guidance about the specific objectives licensing is intended to achieve. Without further specification in law, there may be a lack of transparency about what is required to hold a licence. There is also a risk of misalignment between the policy's objectives and its implementation, and the possibility of unintended over-regulation or under-regulation. As these matters are detailed and likely to evolve over time, regulations provide a more effective mechanism than primary legislation for government to specify them. An appropriate balance needs to be struck between allowing FMA flexibility and ensuring that the licensing regime reflects government's policy intentions.

18 The FMC Bill also omits some detailed conduct requirements that were envisaged in the original policy and were intended to be dealt with in regulations. These include various record keeping and reporting requirements and (for some derivatives issuers) capital adequacy and liquidity requirements. Note that, in general, liability does not attach to breaches of licence conditions. The regulations can attach civil liability to breaches of specific conditions, though this is intended to be reserved for conditions that are both objective and where a breach may cause loss to investors.

19 Finally, certain functions of the FMC Bill, such as providing for licensed intermediaries (e.g. person-to-person lending providers and crowd-funding platforms) require regulations to operate.

20 This chapter discusses a set of regulations to fill these gaps.

2. Regulation of custodians under scheme of FMC Bill

21 The FMC Bill does not require custodians to be licensed under Part 6. Instead, custody is regulated as described below.

22 By contrast, a person must hold a financial services licence to provide a custodial or depository service in Australia. Under section 766E of the Corporations Act:

> "a person (the provider) provides a custodial or depository service to another person (the client) if, under an arrangement between the provider and the client, or between the provider and another person with whom the client has an arrangement (whether or not there are other parties to any such arrangement), a financial product, or a beneficial interest in a financial product, is held by the provider in trust for, or on behalf of, the client or another person nominated by the client."

23 Custodians with a New Zealand business are a subset of 'brokers', a class of financial service provider. Brokers must register on the Financial Service Providers Register, and are subject to the conduct rules in section 77J to 77O of the Financial Advisers Act 2008.[1]

24 In the case of ***registered schemes***, custody is regulated by:

- requiring the custodian to be the licensed supervisor or, if the supervisor subcontracts custody, requiring the custodian to be independent of the manager (clause 143)
- making the supervisor responsible for custody despite any subcontracting (clause 143)
- specifying that the custodian holds the property on trust, that the property is not available for the payment of debts of the custodian and requiring the custodian to hold the property separately from its own property (clause 145)
- requiring the custodian to keep records of scheme property, including any records prescribed by the regulations, in a manner that enable them to be conveniently inspected and audited (clause 146).

25 In Chapter 4 we discuss custodial records that may be prescribed for regulated schemes and the potential for audit.

26 In the case of ***DIMS licensed under the FMC Bill***, custody is regulated by:

- requiring the custodian to be independent of the DIMS licensee or, if not independent, only in accordance with conditions in the DIMS licensee's licence (clause 442)
- making the licensee responsible for custody despite any subcontracting (clause 442)
- imposing the requirements of section 77P to 77T of the Financial Advisers Act as if the property was held for a retail investor (see below) (clause 443).

27 In the discussion on licensing of DIMS in this chapter, we propose conditions that may be imposed on the DIMS licensee in respect of custody generally and particularly where non-independent custody may be allowed, including the potential for audit.

28 ***Licensed derivatives issuers*** that hold client funds are regulated through licence conditions and regulations. This chapter discusses regulation of derivatives issuers.

29 In the case of ***DIMS and individual account services*** (e.g. platform services or wrap accounts) ***under the Financial Advisors Act*** to a retail client, custody is regulated by:

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[1] Subject to certain exemptions – see section 77C of the Financial Advisers Act 2008 and sections 7 and 8A of the Financial Service Providers (Registration and Dispute Resolution) Act 2008.

- requiring a separate body corporate that is a registered broker to be used as the custodian (section 36D of the Financial Advisers Act to be inserted by the FMC Bill)
- the ability to impose disclosure requirements in regulations (section 77D to 77I of the Financial Advisers Act)[2]
- the requirements of section 77P to 77T of the Financial Advisers Act, which include the requirement to pay client money into a separate trust account, the requirement to account for client money and client property, the requirement to keep records in a manner that enables them to be conveniently and properly audited or inspected, and restrictions on use of client money and protection of client money held on trust
- the ability to impose additional duties in relation to trust accounts and to require audit and impose other requirements relating to trust accounts in regulations (section 154(1)(l) of the Financial Advisers Act).

30 In the case of ***DIMS and individual account services*** (e.g. platform services or wrap accounts) provided by a registered broker ***to a wholesale client*** that is not part of a retail service, custody is regulated by:

- the ability to impose requirements regulating the keeping, inspection, and audit of records in connection with the receipt, holding, payment, and transfer of client money and client property and prescribing duties in relation to those records (section 154(1)(l) of the Financial Advisers Act)
- the ability to impose requirements that are necessary or desirable to ensure that persons on whose behalf client money and client property are held by brokers are informed of the money and property held and of the transactions in connection with it (section 154(1)(l) of the Financial Advisers Act).

31 Regulation of custody can limit opportunities for fraud and reduce risk to investors:

- A requirement to keep records requires an additional level of deceit to perpetuate fraud.
- A requirement for the custodian to send asset reports to the beneficial owner makes fraud by other parties more likely to be detected.[3]
- Independence of the custodian or its directors limits the scope of the fraud or requires complicit third parties.
- Audit gives a level of independent assurance that records are accurate and that control systems are appropriate.
- A requirement to use trust accounts insulates the beneficially held property.

32 We seek feedback on whether any or all of these requirements should be imposed on any types of custody arrangements to the extent they are not already. However, some of these protections (for example, audit) may be costly. We are particularly interested in whether there are classes of custodial arrangements to which some protections should not be provided (e.g. custodians that only have ‘truly wholesale’ relationships where the wholesale investors involved can ensure safe custody of assets through other means).

1. Are there any gaps in the current regulation of custodians? If so, what are they?
2. If there are gaps, what requirements (e.g. audit or reporting to beneficial owners) should be imposed on custodians? What are the likely costs and benefits of such requirements? What distinctions should be made in setting any requirements?

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[2] Broker disclosure is not currently prescribed.
[3] We understand that this is common for wrap platforms and some DIMS.

3. Requirements common to all licensees

33 This section covers the requirements that will be standard across all types of licensees – fund managers, independent trustees of restricted schemes, discretionary investment management services, derivatives issuers and regulated intermediaries. This section discusses eligibility criteria, authorisation of related bodies corporate and standard reporting requirements.

3.1 Generic eligibility criteria

34 Clause 394 sets out the basic eligibility criteria for a person to hold a market services licence. Clause 394(a) requires that an "applicant is a fit and proper person to hold the licence". There are partly overlapping requirements under clause 394(d) that the "applicant is capable of effectively performing that service" and clause 394(e) that there is "no reason to believe the applicant will not comply with the market services licensee obligations".

35 Broadly speaking, the FMC Bill allows regulations to define eligibility criteria by influencing how the statutory tests are applied, as well as specifying additional criteria under clause 394(b) and (c).

36 Similar eligibility tests are common in analogous overseas regimes, and some existing licensing regimes in New Zealand, including registered banks (Reserve Bank Act 1989), insurers (Insurance (Prudential Supervision) Act 2010), authorised financial advisers (Financial Advisers Act 2008) and trustees and statutory supervisors (Securities Trustees and Statutory Supervisors Act 2011).

37 Under the FMC Bill, the eligibility test will normally (but not exclusively) be applied to a corporate person rather than an individual sole trader. However, individuals related to the corporate person will be examined as part of the test.

38 In other corporate licensing regimes, eligibility tests commonly involve the entity and related persons meeting criteria in the following areas:

- character and reputation
- competence and capability
- financial status and solvency
- governance and compliance arrangements.

39 We recommend below that all four of these criteria form part of the licensing process for applicants. The first three criteria – character and reputation, competence and capability, and financial status and solvency – would be applied in a standard way to all licensees. We are not proposing to apply tests relating to governance and compliance arrangements to all licensees; instead, these requirements will be tailored to each category of licence. We also propose prescribing some requirements within the limbs. Some aspects of the test are of high importance and require a clear statement of standards from government.

40 We wish to define the test, and make clear the government's expectations on the eligibility of applicants, while allowing FMA to exercise practical discretion in the test's application.

41 This section draws on the licensing policies used by FMA (such as in the authorised financial advisers (AFAs) and authorised futures dealers regimes) and regulatory regimes in Australia, the United Kingdom, Ontario, Singapore and Hong Kong. These jurisdictions were chosen for their compatibility with the New Zealand regulatory framework and for their guidance on the details of the test's application to corporate persons. Further guidance on best practice for regulators has been sourced from a December 2009 report from the Emerging Markets Committee of the International Organization of Securities Commissions (IOSCO).

3.2 Amount of FMA discretion

42 An overarching issue of the test is the degree to which criteria are prescribed through regulation, or left to the discretion of FMA.

43 A complete test will require many criteria, some factual and objective, others subjective or prospective. Some elements will be of high importance, almost non-negotiable. Others will merely be useful inputs into an overall assessment. Some criteria will need to be fixed, while others will operate better if made flexible.

Foreign examples of discretion

44 Of the foreign regimes examined, each has found a different balance between regulation and the devolution of powers to regulators. Most regulators publish guidelines to add requirements and criteria in the gaps left to their discretion. Criteria are usually expressed in non-absolute terms; details are usually persuasive, but not decisive. Regulators leave room to grant licences, despite a failure to meet aspects of the test, in certain exceptional conditions.

45 In Australia, the Corporations Act directs the Australian Securities and Investments Commission (ASIC) to (among other things) ensure applicants, and their 'responsible officers', are of 'good fame and character', and specifies three rule breaches which ASIC 'must have regard to' in licensing.[4]

46 British legislation mandates the test, but does not elaborate on criteria. For instance, the Financial Services and Markets Act requires the Financial Services Authority (FSA) to examine the corporate person's connections, activities and that its affairs should be conducted 'soundly and prudently'. Unlike FMA, the FSA has statutory rule-making powers. The FSA publishes these rules in a Threshold Conditions guideline, which sets criteria at the highest level of detail and obligation of the regimes we have looked at.

47 Canada regulates its financial industry at the provincial level. Ontario's Securities Act requires the Director of the Ontario Securities Commission to consider regulations including those relating to 'proficiency, solvency and integrity', and also allows the Director to determine other relevant factors. However, regulations have never been created under this section.

48 Singapore requires a fit and proper test under the Financial Advisors Act, and specifies who the test applies to, but gives no other detail. The regulator, the Monetary Authority of Singapore, publishes guidelines setting the relatively high level of criteria.

49 The Hong Kong government provides the greatest level of prescription in legislation. An ordinance directs the Securities and Futures Commission (SFC) to examine the financial status, solvency, educational qualifications, competence, honesty, fairness, reputation, character, reliability, and financial integrity of a corporation and any of its officers. It also directs the SFC to take into account a list of decisions made by other monetary or financial authority. This high level of regulation is supported by a guideline published by the SFC, elaborating on the interconnected elements imposed on the test by the Ordinance.

[4] These are (a) serious fraud convictions in the past ten years; (b) prior licences suspended or cancelled; (c) banning or disqualification orders.

Proposal

50 We propose to provide further detail on the eligibility test in the regulations. This may include prescribing matters FMA must have regard to in determining whether an applicant meets the broad eligibility criteria in clause 394 or prescribing additional eligibility criteria. Doing so would provide a clear direction to FMA, and to applicants, of the government's intentions in respect of the test.

51 However, we intend to avoid defining all aspects of the test, which would be rigid, incomplete and impractical to apply. With a significant process required to amend the regulations, the regulator would not be able to respond in a timely manner to external changes impacting upon the test. It would be unlikely to catch all situations which would cause concern. It may force a regulator to employ a 'box-ticking' approach, expending all energy on the regulated criteria and potentially missing other red flags. The experience and expertise of a regulator are efficient tools to assess the character, competence and soundness of an applicant, as long as it has the information necessary. At the same time, the framework must be clear enough to express Parliament's intent, and robust enough to prevent 'regulatory creep', the possibility of the regulator extending the test beyond the limits originally intended.

3.	Do you have any views on the appropriate level of regulator discretion in licensing?

3.3 Reliance on applicant self-assessment

52 The FMC Bill makes clear that FMA has responsibility for the issuing of licences, and that it must be 'satisfied' that the applicant meets the criteria. This requires FMA to exercise judgement about whether a person should receive a licence. For some matters that make up the test, FMA could potentially rely on assessments made by other persons.

53 A key issue for the licensing regime is to what extent FMA will assess the various aspects of the test itself, or will delegate some of them to the applicant as a 'self-assessment'.

54 The Reserve Bank of New Zealand (RBNZ), which applies an eligibility test to deposit-taking and insurance institutions, applies three different approaches to this question when assessing a corporate person.

55 A self-assessment approach is taken in licensing insurers. The Insurance (Prudential Supervision) Act 2010 requires insurers to assess the fitness and propriety of its directors and officers, and to document this policy and the process taken on each assessment. RBNZ assesses the policy as part of the insurer's mandatory risk management programme. In lieu of conducting the test itself, RBNZ has the power to later review the process and remove people whom they consider not to be fit or proper. In effect, the onus is on RBNZ to identify undesirable appointments ***ex post facto***.

56 The Non-bank Deposit Takers Bill,[5] if passed into law, partially delegates responsibility for certifying fitness and propriety to the directors of the non-bank deposit taker. To better identify questionable appointments, the regime will require potential appointees that trigger certain criteria to be referred to RBNZ for its consideration and approval. The proposed criteria include crimes and rule breaches, bankruptcy, insolvency and other business and financial failures, and conflicts of interest which negatively impact upon the proper performance of the business. This hybrid approach is designed to direct regulatory resources towards the individuals which pose most risk to the system, without relying wholly on applicant self-reporting.

[5] Introduced August 2011; awaiting the Committee of the Whole House stage as of December 2012.

57 In contrast, when assessing a bank, RBNZ has the right to object to and block any appointment to director or senior management positions. When hiring a new director or reporting officer, while most of the information-gathering and investigating roles are fulfilled by the shareholders and board of the bank, RBNZ requires a C.V., criminal check, and favourable reports from regulators before approving each appointment.

58 At this point we assume that FMA, when licensing under the FMC Bill, will wish to do so in the same manner it licences existing licensees with relatively little delegation of investigation to the applicant.

4.	Do you have any views on the use of self-assessment in the licensing regime?

3.4 Reliance on other regulators and licences

59 The amount of resources – of both the applicant and FMA – required to confirm a licence is a relevant consideration in the design of the test. While the test should be based on principles and best practice, the issue of time and costs is likely to be of concern for larger applicants facing multiple licensing processes. Many organisations will have existing licences granted by FMA and RBNZ.

60 Clause 395(b) of the FMC Bill requires, when licensing a corporate person, that FMA have regard to whether the applicant, its directors and/or senior managers are members of a QFE group or a licenced provider under the Financial Service Providers (Registration and Dispute Resolution) Act 2008 (AFA, QFE, registered bank or licensed financial market supervisor). The FMC Bill does not mention authorised futures dealers or licensed insurers.

61 In Australia, the Australian Prudential Regulation Authority (APRA) is the prudential supervisor, while ASIC regulates market licences. This regulatory split is similar to that between FMA and RBNZ in New Zealand. ASIC's treatment of licensing applicants who are also under APRA supervision provides an example of where reliance is feasible.

62 In some limited areas, to some entities, regulation by APRA gives applicants some exemptions from meeting ASIC licensing thresholds.

63 If an applicant for a financial services licence is regulated by APRA, the Corporations Act 2001 exempts them from providing evidence on the adequacy of their financial, technological and human resources, and of their risk management systems.[6]

64 Such applicants are also exempt from ASIC's professional indemnity insurance requirements if they are a general or life insurance provider or an authorised deposit taker. ASIC will accept that responsible managers are competent to undertake their duties if they meet a relevant standard set by APRA – for example, if a person employed by a prudentially regulated insurer meets APRA's test for being a 'responsible person', ASIC will accept that the person has appropriate knowledge for dealing in general insurance products.

65 Finally, where APRA has approved the good character of directors and senior managers, ASIC does not require an applicant to provide bankruptcy checks, criminal record checks, or references for them (although these individuals and their status must be reported).

[6] Corporations Act 2001, section 912A(1)(d) and (h).

Proposal

66 In addition to the requirement in clause 395(b) that FMA have regard to the applicant's existing licences, there may be scope for more specific exemptions from requirements for licensed entities. This depends to some extent on what kinds of eligibility criteria are prescribed (see the following sections), but may include exemptions from requirements relating to character and reputation, competency and capability, and financial status and solvency. Doing so may also reduce compliance costs in the application for, and holding of, a licence, for both the applicant and FMA.

67 Some criteria are reasonably straightforward. If individuals meet good character or fit and proper requirements set by FMA or RBNZ for some other purpose, this could automatically qualify them as being of good character and reputation for the purpose of a market services licence. The argument would be that a person cannot be of 'bad character' for being the director of a bank, but 'good character' for directing a fund management business.

68 Knowledge and skills are more difficult to translate, as some are generic while others are subject specific. A person may be experienced in supervising the management of a non-bank deposit taker, but not have the specialist skills required to select an equity portfolio for a managed fund. However, if individuals have been found to have knowledge or skills in an area by an RBNZ or FMA licensing process, and these are relevant to their role in the new licensed activity, these should not need to be reassessed.

69 Applicants who are subject to prudential regulation by RBNZ could be exempt from requirements to meet financial status and solvency requirements, and any capital adequacy, liquidity or risk management requirements that apply (e.g. for derivatives issuers).

5.	How might an applicant's (or its parent's) existing licence or authorisation from FMA or RBNZ be relevant to meeting the licence criteria under the FMC Bill?

3.5 Character and reputation

70 To maintain confidence in New Zealand's financial markets, investors must be reasonably confident that service providers are not only proficient in financial management, but are also honest and responsible guardians of investments. Where the FMC Bill places a duty on providers to act honestly and in the interests of investors, it is vital that licensing provides a degree of assurance that this obligation is likely to be met.

71 Most licensing tests include consideration of the character and reputation of the corporate person and key connected individuals. Terms used to describe this component of the test in foreign jurisdictions include honesty, fairness, integrity and ethical behaviour,[7] standing[8], good fame,[9] prudence and diligence[10], and reliability.[11] As such concepts are malleable and subjective, this consideration is difficult to prescribe in certain terms, and is often left to the judgement of regulators, guided by broad indicators, and based on collectable evidence.

[7] Emerging Markets Committee of IOSCO, "Fit and Proper Assessment – Best Practice, Final Report", December 2009. http://www.coe.int/t/dghl/monitoring/moneyval/web_ressources/IOSCO_fitandproper.pdf

[8] Reserve Bank of New Zealand Act 1989, section 73(2).

[9] ASIC, "Regulatory Guide 105 – Licensing: Organisational Competence", October 2007. http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg105-Published-13-May-2011.pdf/$file/rg105-Published-13-May-2011.pdf

[10] FSA, "Threshold Conditions 2.5", November 2011. http://media.fsahandbook.info/pdf/COND/2/5.pdf

[11] Hong Kong Securities and Futures Commission, "Fit and Proper Guidelines", September 2006. http://en-rules.sfc.hk/net_file_store/new_rulebooks/h/k/HKSFC3527_548_VER10.pdf

72 The character and reputation of corporate persons are assessed mainly at the level of key individuals within the body corporate. The range of individuals within the body corporate who may be examined varies across regimes. They may include the directors, partners, senior managers, substantial shareholders, and most broadly, other persons connected to the applicant. Identifying who will be scrutinised is an important factor in the success of fit and proper regimes, and will need to be carefully tailored to New Zealand's industry conditions.

Breaches of rules

73 Character and reputation requirements are largely met by an absence of serious breaches of rules, particularly relating to criminal or dishonest conduct, by both bodies corporate and their key individuals. The most significant of these are criminal convictions, but civil breaches and discipline by regulators, tribunals or professional bodies are also often examined. In some jurisdictions, regulators also require notification of charges, proceedings, investigations, and complaints, even where the applicant is cleared of wrongdoing.

74 Enquiries into rule breaches can be broadened or narrowed by territoriality, time span and type of breach. Some regulators examine only domestic criminal convictions, while others consider convictions and other breaches from any country. The time threshold for convictions varies across jurisdictions, with some specifying a time period (usually 5 or 10 years) while others do not, enabling all convictions in a lifetime to be examined. While regulators commonly require criminal checks which reveal every conviction, some jurisdictions specify the types of convictions (e.g. serious fraud, dishonesty offences, and financial crimes) which must be considered by the regulator.

75 The narrowest tests look only at specific disqualifications and serious offences over short timeframes. For example, when registering to be a financial service provider under the Financial Service Providers (Registration and Dispute Resolution) Act 2008, for the most part only those subject to current bans (e.g. undischarged bankrupts) and those convicted of theft and fraud in New Zealand (not overseas) over the past 5 years are disqualified.[12] This provides certainty and a relatively unrestrictive registration process. However, it is unlikely to provide enough assurance as to the character and reputation of licensees.

76 The broadest tests of character and reputation specify a wider range of breaches to examine, but allow the regulator to exercise discretion in assessing the importance of available evidence. For example, the FSA lists twenty types of financial and dishonesty crimes,[13] whereas the MAS lists 15 detailed classes of rule breaches.[14] Both seek information on all domestic and foreign breaches. This breadth of inquiry allows regulators to make better-informed decisions on the character and reputation of key individuals. However, scrutiny over minor breaches may seem arbitrary and restrictive to applicants. In these regimes, clear guidance is needed from regulators on what degree of past rule-breaking will disqualify them from the licence.

77 In New Zealand, the new regime for authorising financial advisers commenced in July 2012. Section 54(b) of the Financial Advisors Act requires FMA to pay particular attention to convictions (in New Zealand or overseas) punishable by imprisonment of 6 months or more. FMA may then consider the relevance of the conviction to the applicant's fitness before deciding whether or not to licence the applicant.

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[12] Also, those convicted of money laundering or financing terrorism, and those subject to a confiscation order under the Proceeds of Crime Act 1991.
[13] FSA, "Threshold Conditions", ibid 10, COND 2.5.6.
[14] Monetary Authority of Singapore, "Guidelines on Fit and Proper Criteria – Guideline No: FSG-G01", January 2012, pp. 17 – 21.
http://www.mas.gov.sg/~/media/resource/legislation_guidelines/insurance/guidelines/17%20Jan%202012_FSG_G01%20Guidelines%20on%20Fit%20and%20Proper%20Criteria.pdf

78 Section 54(a) of the Financial Advisors Act also requires FMA to be satisfied that the applicant is of good character, but does not specify the components of the test. FMA has provided guidance on how it intends to interpret this.[15] In doing so, it has decided to take into account all criminal convictions, not only those prescribed by section 54(b). Each is considered on a case-by-case basis, taking into account the relevance and seriousness of the crime, how long ago it occurred and evidence that the applicant has been rehabilitated. Minor incidents of questionable behaviour are also given greater weight if they have occurred frequently or accumulated over a long period of time.

79 This approach has recently been tested in court for the first time. In the case of ***Wood v Financial Markets Authority***[16], an unsuccessful applicant appealed FMA's decision to refuse a licence based upon his behaviour around undeclared convictions. Judge Harrop endorsed FMA's approach to the application of the good character test in this instance. He agreed that applicants should self-disclose all convictions, as this indicates an applicant's honesty and openness with FMA, their understanding of their personal relationship to the law and the likelihood that they will comply with their AFA obligations.

Refusals, revocations and dismissals

80 In some cases, an applicant may have been dismissed, or asked to resign, from employment or a position of trust, or refused or had revoked an industry membership, permission or licence, without a confirmed breach of rules or a formal disciplinary process. Such instances raise an implication of wrong-doing, or concerns about the applicant's character, similar to those for explicit rule breaches. At its broadest, the consideration includes both the firm and its key individuals.

81 When licensing AFAs, FMA currently asks applicants to volunteer information on dismissals or requested resignations, as well as information on rule breaches, investigations and disciplinary proceedings. It does not specifically ask about refusals or revocations of memberships, permissions or licences. However, FMA asks applicants to disclose "any matters that may have an adverse impact on [FMA's] view of your character". As the court found in ***Wood***, an applicant who conceals information from FMA may be considered dishonest; this may extend to refusals or involuntary revocations.

Reputation and testimonials

82 Reputation is a valuable asset upon which a firm attracts business. While good reputations are built on quality and experience, they can also be manipulated through marketing and subterfuge.

83 Testimonials are used by regulators, including FMA, to assess the reputation of individual applicants.[17] Testimonials are an assessment of an individual's reputation, prior behaviour and record in financial services, by a person of standing with direct experience of the applicant's work. Applying this requirement to corporate persons may be problematic, but worth considering.

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[15] Securities Commission New Zealand, "AFA Authorisation Guide", November 2010. http://www.fma.govt.nz/media/143464/afa-authorisation-guide.pdf

[16] ***Wood v Financial Markets Authority*** DC Wellington CIV-2011-085-954, 13 April 2012.

[17] FMA requires testimonials from AFA applicants from two of three sources: (1) a recognised industry or professional organisation; (2) an industry peer or colleague; and (3) an existing client. Testimonial writers must have interacted with the applicant in the previous three years.

84 Collecting testimonials when hiring a firm's key individuals is an indirect, but straightforward, measure of the reputation of the corporate person. This is the approach taken by the FSA and ASIC, who require firms to implement human resource policies and systems which include consideration of each applicants reputation. Another possibility, in the case of pre-existing firms, is to require testimonials of the firm itself, from corporate clients or contractual partners. However, this would be impractical for new firms, creating an inconsistent policy.

85 Ultimately, a person's reputation can be easily misrepresented, in testimonials and elsewhere. Regulators cannot make decisions on the basis of rumour, instinct, or unsubstantiated claims. Testimonials are of limited utility as they are subjective, and need to be backed up with objective evidence of behaviour, such as rule breaches.

Cooperation with the regulator

86 Another consideration, made in some jurisdictions, is of the honesty and openness of the corporate person. This is tested by observing the applicant's interaction with the regulator during the licensing process. The UK and Singapore explicitly require applicants to have been open, honest, truthful and cooperative in all dealings with the regulator. Singapore also considers the willingness of the applicant to comply with regulatory or professional requirements in any other jurisdiction.

87 While a regulator can observe an applicant's cooperation during the licensing process, 'openness' and 'willingness' are subjective tests, relying on an interpretation on the state of mind of an applicant, and may not be reliable indicators of future behaviour on their own. An applicant's honesty may be better revealed through other licensing requirements such as reference checks and past employment history. As seen in the ***Wood*** case, a quality such as honesty is easier to prove in the negative (i.e. a breach of rules, or a concealment of history) than in the positive.

Bankruptcy

88 A final element of the financial reputation of corporate persons is the personal insolvency record of its key individuals, including use of the No Asset Procedure and bankruptcy. This is considered under "financial status and solvency" below.

Proposal

89 We propose that regulations prescribe that FMA consider the character and reputation of applicants, directors, senior managers and of any other person connected to the applicant that FMA considers relevant. A senior manager is defined in the FMC Bill as a "person who is not a director but occupies a position that allows that person to exercise significant influence over the management or administration" of the applicant. The inclusion of "any other person connected with the applicant that FMA considers relevant" would affirm that FMA may use its discretion to take into account any relationship with any person of concern, within or outside of the applicant, without limiting – or compelling – investigations into a set list of additional people. This may be able to be expressed as requiring that these persons be "fit and proper".

90 We also propose that regulations identify certain rule breaches that FMA must have regard to. These would cover instances of serious wrongdoing (such as conviction for dishonesty, fraud and financial crimes) and would not be limited by jurisdiction or timespan.

91 Beyond this, FMA should be given discretion to request further information on any other rule breaches, and to explain to applicants how these will be weighed in importance. FMA should also decide whether further explicit tests are needed to prove subjective elements of good character and reputation such as honesty.

6. Do you agree that FMA should always consider the character and reputation of applicants, directors and senior managers?
7. Should FMA have regard to the character and reputation of “persons connected to the applicant” that it considers relevant? Should these persons be more tightly defined in regulations, or is this better left to FMA guidance and application procedures?
8. Which rule breaches should regulations prescribe that FMA always have regard to? Should mandatory consideration of such rule breaches be restricted by country or time elapsed?
9. Should any other aspects of character and reputation be prescribed (e.g. revocations and dismissals)?

3.6 Competence and capability of directors and senior managers

92 The competence and capability of a body corporate is critical to licensees executing their regulatory responsibilities. Therefore we expect this to form part of FMA’s assessment of the applicant’s ability to effectively perform the service.

93 The skills, education and experience which directors and senior managers bring to a firm are the best indicators of future competence and capability. With the industry attracting employees from a wide range of backgrounds, the appropriate capabilities of each individual can be difficult to categorise. Therefore, regulators are usually given the freedom to allow applicants to satisfy this test in many different ways. Taken together, the directors and managers must hold collective skills, education and experience to satisfy the regulator that the body corporate has the knowledge and skills to navigate the industry, product and regulatory environment.

94 It is possible to narrow or broaden these criteria based on territoriality and topic of education and experience. Some jurisdictions require a few years of experience in the domestic industry to meet the test, while others count experience in any country. Similarly, some regulators (such as ASIC in Australia) require demonstrable training or experience in specific products before a person or firm can be licensed to sell them.

95 Under the current system for authorising futures dealers, FMA considers the skills, qualifications and experience of directors and senior managers on the basis of their CVs. There is no formal policy regarding minimum qualifications or minimum experience.

96 However, some New Zealand licensing regimes have specific codified training requirements. AFA applicants must prove their financial services competence to the level of a National Certificate (or equivalent level[18]) and, once licensed, undertake ongoing training.

97 A further step, taken by ASIC, is to regulate the spread of skills within a body corporate. Where a firm has only one or two ‘responsible managers’ who meet the threshold for skills and knowledge, ASIC can impose a ‘key person condition’ upon the firm. Such a firm must explicitly notify ASIC when a key person leaves, and demonstrate how those departing skills and knowledge will be replaced, in order to retain their corporate licence.

98 This rule mirrors Subpart 3 of Part 6 of the FMC Bill, which allows FMA to revoke, or make conditional, a licence where there has been a “material change of circumstances” meaning that the requirements of clause 394 are no longer met. This clause could be used to monitor, through reporting, the spread of competence and capability among directors and senior managers. However, as this is a post-licensing remedy, it provides context for assessing this criterion, but would not be included within the eligibility test itself.

[18] The National Certificate in Financial Services (Financial Advice) Level 5, or an equivalent as listed in the Code of Professional Conduct for Authorised Financial Advisers.

Proposal

99 We propose that FMA consider the competence and capability of directors and senior managers. Again, this might form part of a requirement that these people are fit and proper. This will include the applicant identifying directors and senior managers who:

- are responsible for the significant day-to-day decisions about the services to be provided under the licence
- collectively, have the competence and capability necessary to provide the services (including effective monitoring of outsourced services) and fulfil their duties and obligations in respect of those services
- individually, have the competence and capability necessary to make the decisions for which they have responsibility.

100 As the required expertise of directors and senior managers will depend on the nature, scale and complexity of the various licensees' businesses, we do not propose that regulations require a particular number of staff, or for directors and senior managers to hold particular experience or qualifications. (Note that for some specific kinds of licensees, more specific skills or experience requirements may be prescribed. These are discussed throughout the rest of this chapter.)

101 Note that this criterion relates to the operational capability of the applicant. A separate issue is the governance capability of the applicant; for example, is the applicant's board of directors capable of effectively monitoring the management of the applicant? This issue is considered under "Governance and compliance arrangements", in section 3.8 below.

10. Do you agree that competence and capability of directors and senior managers should form part of the eligibility criteria?
11. Do you agree that the focus should be on directors and senior managers with significant day-to-day decision-making responsibilities?
12. Do you agree that the detail of the competence and capability criteria should be generally left to FMA?

3.7 Financial status and solvency

102 A third set of criteria concerns the financial stability of the applicant. In the most limited test, the applicant might confirm that it is solvent and not in imminent danger of failure. More stringent tests would look at whether the applicant has strong financial management and a minimum level of financial resources above what is required to meet its current debts. A related issue is whether particular kinds of insurance or indemnities are required.

Objectives of financial requirements

103 An important determinant of the stringency of financial requirements is their aim. Potential objectives are shown below, in order of the likely stringency of the associated licensing tests. All else equal, more ambitious objectives translate into requirements for licensees to hold higher levels of financial resources (such as capital or liquid assets), more robust financial controls and more comprehensive insurance.

Figure 1: Potential objectives of financial requirements

Increasing stringency ↓	
	Protecting the reputation of the licensing regime from cases in which applicants do not have sufficient resources to operate their proposed business
	A financial buffer that decreases the risk of a disorderly or non-compliant wind-up if the business fails
	Requiring sufficient equity to ensure that shareholders have incentives to avoid failure
	Preventing business failure and investor losses

104 While there may be rationales for seeking to achieve more demanding objectives, financial requirements can be a restrictive barrier to entry. Excessive requirements are expected to inhibit entry and competition, raising the prices paid by clients. There may also be more efficient ways of achieving an objective and reducing risks than through financial requirements.

105 A further important consideration is the nature of the service being provided and the risks associated with firm failure. In some businesses, such as DIMS, failure of the service provider is not usually expected to have significant adverse effects on investors where assets are appropriately segregated and investors maintain beneficial ownership over their own assets. The risk of harm to investors may be higher in the case of, for example, some derivatives issuers, where investors are subject to significant counterparty risk.

Financial resources

106 Financial resources are currently considered by FMA in licensing authorised futures dealers and securities trustees.[19] They include requirements to maintain minimum reserves of both equity capital and liquid assets. Similar requirements are part of the prudential regimes administered by RBNZ, including capital adequacy and liquidity-related measures such as ‘mismatch’ ratios and the ‘core funding’ ratio.

107 In Australia, ASIC imposes financial resource requirements on Australian Financial Services licensees to ensure that:

- they have sufficient financial resources to conduct their financial services business in compliance with the Corporations Act (including carrying out supervisory arrangements)
- there is a financial buffer that decreases the risk of a disorderly or non-compliant wind-up if the business fails
- there are incentives for owners to comply with the Corporations Act through risk of financial loss.

108 Regulators in Singapore and the UK require applicants to disclose a wide range of information, including credit and debt records, financial planning and resources and any involvement in a bankruptcy or winding-up process. These tests examine both the corporate person and its key individuals and, in the case of the UK, any other firms connected to the corporation or individual within a year of the end of the association.

[19] Securities Trustees and Statutory Supervisors Act 2011, section 16(3)(b).

109 When testing financial status, or soundness, most regulators focus on signs of past or possible failure, rather than on prudent planning. The UK is an exception. The FSA places an onus on the applicant to demonstrate financial prudence and client protection by exceeding minimum capital and asset requirements. It requires applicants to provide substantive business plans addressing risks,[20] as well as evidence that they are likely to meet financial resource requirements. Applicants must also show that they have researched the capital needed to support its start-up period, and to protect client assets in the event of the failure of the business.

110 Other regulators limit their investigations to past insolvency processes, asking for the corporation's record on any receivership, administration, liquidation and winding-up procedures. The FSA also applies this test to key individuals, and any of their former workplaces within the past year.

Insurance

111 Another common requirement is for licensees to have particular insurance arrangements that cover liability-related costs and claims. Insurance can provide a mechanism for investor compensation in the absence of the liable parties having sufficient financial resources to satisfy claims. Insurance can also be an important signal to regulators and others in the market – for an applicant to receive a certain kind and level of insurance the applicant will often need to satisfy an insurance company of many of the same matters that are relevant to obtaining a licence, e.g. likelihood of the applicant complying with obligations.

112 At present it is a common condition of authorisation that a futures dealer "maintains adequate professional indemnity insurance for its business at all times". NZX Derivatives Market rules 4.16.2-4.16.3 require participants to take out professional indemnity insurance and director and officer liability insurance (when applicable to the legal structure of the participant) with reputable, independent insurance companies or underwriters. Such arrangements are also considered in the licensing of securities trustees.[21]

113 In Australia, Corporations Regulation 7.6.02AAA requires that all licensees providing services to retail clients hold professional indemnity insurance that is adequate, having regard to the dispute resolution schemes that the licensee is a member of, the maximum liability the licensee may be subject to, and the size and nature of the licensee's business. Exemptions are provided for insurance and banking institutions, and also for related companies provided that they are adequately guaranteed by the parent institution. A standard condition of licences for managed investment schemes is that insurance cover at least $5 million or the value of scheme property (whichever is the lesser) in claims.[22]

Proposal

114 We propose that, in general, the objectives of financial requirements be limited to protecting the reputation of the licensing regime from cases in which applicants do not have sufficient resources to operate their proposed business, and fail soon after being granted a licence. This implies confirmation of solvency and potentially a minimal level of financial resources and financial management. Beyond this, financial requirements should be set separately for different kinds of market services licensees. We do not propose imposing minimum levels of capital or liquid assets on any licensee with the exception of some derivatives issuers; this is discussed in section 7.3 below. The licensing regime is intended to be relatively "light".

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[20] The Securities Commission of Ontario also requires a business plan from applicants.
[21] Securities Trustees and Statutory Supervisors Act 2011, section 16(3)(h).
[22] ASIC Pro Forma 209 Australian financial services licence conditions, clause 29.

115 We propose that FMA consider the financial status and solvency of applicants and, where it considers relevant, the financial status and solvency of directors, senior managers and other persons connected to the applicant.

116 We propose that FMA be given discretion to set its own thresholds and level of inquiry, although the option exists to require a specific threshold of financial soundness and resources through regulation. Another option is to include reference in regulation to financial management and planning.

13. Should financial status and solvency form part of the generic eligibility criteria? If so, should the detail of the test be left to FMA? Or should certain aspects be specified in regulation?

14. Do you agree that, in general, there should not be requirements for a minimum level of financial management or resources? If not, what specific requirements should there be?

15. Should adequate professional indemnity insurance be considered within the generic eligibility criteria? Or should these arrangements be made a condition of particular classes of licence, such as derivatives issuers? Should any other forms of insurance be required or considered – e.g. director and officer liability insurance, statutory liability insurance?

3.8 Governance and compliance arrangements

117 A component of licensing tests for corporate entities is often whether the entity has systems and procedures to ensure compliance with rules or codes of ethical conduct.

118 Current New Zealand securities law requires the disclosure of relevant risks, but does not obligate issuers to have formal compliance management systems in place. However, banks, insurers, and non-bank deposit takers must have formal risk policies under prudential legislation.

Overseas regimes

119 Applicants for financial services licences in all of the other countries we reviewed must demonstrate that they have designed, and are in a position to implement, well-resourced regulatory compliance systems. Such systems must be capable of supporting and enabling compliance, deterring breaches of rules, and identifying and controlling compliance risks.

120 In some jurisdictions the risks that must be managed extend further – to legal but unethical behaviour by employees, and controlling risks that the licensee's activity and products harm consumers and the broader financial industry.

121 In Australia, standard obligations of licensees, which licensees must satisfy ASIC they comply with, include:

- doing all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly
- having in place adequate arrangements for the management of conflicts of interest
- unless regulated by APRA, having adequate risk management systems.[23]

[23] Australian Corporations Act, section 911D.

122 In addition, a standard licence condition is that "the licensee must establish and maintain compliance measures that ensure, as far as is reasonably practicable, that the licensee complies with the provisions of the financial services laws".[24] Managed investment schemes are required to have a compliance plan that is complied with and audited each year.[25]

123 In the UK, standard obligations of applicants, which they must satisfy the FSA they will be likely to and/or are complying with, include:

- having adequate resources to comply with regulatory and other risks
- proving to the FSA that the firm has taken reasonable steps to identify and measure any risks of regulatory concern
- the installation of appropriate systems and controls
- appointing appropriate human resources to measure compliance risks at all times.[26]

124 The UK also requires evidence that a corporate person has designed policies and procedures to ensure employees are "honest and committed to high standards of integrity". This requirement informs the determination of the character and reputation of a corporate person. It is satisfied through human resources policies, such as criminal and reference checks for all new hires, the monitoring and supervision of employees and enforceable codes of conduct.

125 Regulators in Australia and the UK also consider the identification and control of broader risk to be an element of competence and capability. In these countries, a corporate applicant must demonstrate that they have considered the effect of their activities upon consumers and the financial industry, and are not assuming risks without considering the consequences of irresponsible behaviour. A firm must have assessed specific market risks prior to offering a product or service (for example, by conducting market research), and put in place well-resourced risk management systems, in order to satisfy this test.

Proposal

126 We are reluctant to propose generic requirements that licensees have adequate governance and compliance arrangements or demonstrate how they will comply with all of the regulatory requirements that they will be subject to.

127 Most financial service providers have compliance and risk management policies and systems. FMA may take an interest in these under the new licensing regime – for example, where it is concerned about particular compliance risks. FMA may also choose to impose a licence condition that the licensee maintains particular systems to ensure that it continues to comply with its obligations. However, there is a danger that an explicit regulatory emphasis on these systems could result in them become more costly and being misdirected towards controlling less significant risks.

128 There is further potential for unintended consequences if applicants are required to demonstrate systems for controlling wider risks to consumers and the financial sector, as in the UK. An alternative is to approach this through more specific mechanisms (e.g. requiring adequate procedures to establish investor suitability for more complex products, as discussed in section 7.5 below).

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[24] ASIC, Pro Forma 209 Australian financial services licence conditions, clause 4.
[25] Australian Corporations Act, section 601FC.
[26] FSA, Threshold Condition 2.4.4 (2)(g), ibid no. 10.

129 At this point we propose to consider governance and compliance arrangements in the regulations specific to each type of licensee, and to focus any such requirements on addressing specific risks. We propose that FMA be able to impose conditions relating to independent reviews, for example requiring the licensee to commission appropriately qualified and experienced persons to undertake assurance engagements to review the licensee's systems.

130 We would welcome feedback on whether a more comprehensive treatment is warranted. We would be particularly interested in views from providers who have experience with these requirements in overseas licensing regimes.

16. Should the adequacy of governance and compliance arrangements be included in the licence criteria? What are the costs and benefits of doing so?

17. Where compliance arrangements are in place, how should these be monitored?

3.9 Authorisation of related bodies corporate

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

132 Related bodies are not required to meet all of the same criteria as the primary licensee. However, some of the criteria we discuss above for the licensee would seem to be relevant to the other criteria that related bodies must meet. These include the requirements that the related body can effectively perform the service and there is no reason to believe that the related body will not comply with its obligations.

Character and reputation of authorised body's directors and senior managers

133 Above we recommend that regulations prescribe that FMA have regard to the character and reputation of applicants, directors, senior managers and any other person connected to the applicant that FMA considers relevant.

134 We propose that this test should also encompass the character and reputation of directors and senior managers of any related body that is proposed to perform the service. This is on the basis that concerns about the related body's directors and senior managers (e.g. serious criminal convictions for dishonesty) are likely to be at least as relevant as concerns about individuals in the licensee. This test also relates to the statutory requirement that there be "no reason to believe that the related body corporate will not comply with the market services licensee obligations."

Competence and capability of authorised body's directors and senior managers

135 Above we propose that regulations prescribe that FMA have regard to the competence and capability of the licensee's directors and senior managers. This will include the applicant identifying directors and senior managers who are responsible for the significant day-to-day decisions about the services to be provided under the licence, and FMA being satisfied that they collectively and individually have the competence and capability necessary to fulfil their duties and obligations in respect of those services.

136 If a related body will be providing the service, one approach would be for FMA to have regard to the competence and capability of the relevant directors and senior managers of the related body, instead of the licensee (i.e. to ensure that the related body can effectively perform the service, as required under clause 398(1)(b)).

137 Another option would be for FMA to examine the competence and capability of directors and senior managers of the licensee to perform their role in supervising and controlling the authorised body's provision of the service (i.e. the role of the licensee under clause 398(1)(a)).

Guarantees

138 The licensee is liable for breaches of the authorised bodies' market services obligations, but not for any other liabilities incurred by the authorised body. This may be problematic in some circumstances. For example, if the licensee is required to hold minimum financial resources or insurance in order to meet potential obligations to investors, this is of limited value if the obligations to investors are instead owed by an authorised body.

139 One option would be to require that the obligations of an authorised body to investors are unconditionally guaranteed by the licensee. Alternatively the authorised body could be required to meet any eligibility criteria relating to those obligations in its own right.

18. Where a related body of a licensee is proposed to be authorised to perform a licensed service, should FMA have regard to the character and reputation of the authorised body's directors and senior managers?
19. What criteria should be met regarding to the competence and capability of an authorised body?
20. If licensees are required to have particular financial resources or insurance, how are these requirements best met by or applied to an authorised body?

3.10 Standard reporting requirements

140 Clauses 409 and 410 set out what licensees must report to FMA, and when they must do so. Clause 410 sets out when the licensee must report certain matters, including when the licensee has contravened a market services licence obligation and when a material change of circumstances has occurred in relation to the licensee.

141 Clause 409 is a more general reporting provision. It provides:

> **Licensee must deliver regular reports to FMA**
> Every licensee must, at the prescribed times or on the occurrence of the prescribed events and otherwise in the prescribed manner, send to FMA reports that contain the prescribed documents, information, and other matters.

142 This provision contemplates that a number of situations may lead to the licensee being required to report to FMA. The provision also contemplates the possibility of regular reports at set times of the year.

143 We propose that some reporting obligations will apply to all licensees and others will apply to specific types of licensees. The reporting requirements specific to types of licensees are discussed in sections 4 to 8.

144 We propose that as a standard licence condition, all licensees will report the following events to FMA, subject to FMA waiver in writing:

- the insolvency of the business or the insolvency or bankruptcy of any of its directors or senior managers
- where a receiver, provisional liquidator, liquidator or a similar officer is appointed, or any resolution is passed or order made for the liquidation or dissolution of the business
- if the business, or any of its directors or senior managers, is charged with or convicted of an offence under any crime involving dishonesty (as defined in section 2(1) of the

Crimes Act 1961), any Act referred to in Schedule 1 of the Financial Markets Authority Act 2011, and any overseas equivalent to these, or any offence carrying a maximum term of imprisonment of two or more years

- any civil litigation or regulatory action pending or taken against the business, or any of its directors or senior managers whether in New Zealand or elsewhere, or any disciplinary action pending or taken, where this is relevant to the performance of its functions under the licence
- if any director or senior manager leaves the business or if any new director or member of senior management is appointed to the business
- resignation and appointment of auditors
- major transactions (as defined in the Companies Act 1993), or any change in control, legal structure or name.

145 Another matter that might be periodically reported is a log of customer complaints received by the licensee. There would need to be a corresponding obligation to keep such a log.

21. Do you agree that all licensees should report the events listed in paragraph 144 to FMA? Are there any other events that should be reported?

22. Should a log of customer complaints be kept and reported to FMA periodically? If so, what information should be included (e.g. resolution) and how frequently?

4. Requirements specific to fund managers

146 In general, we expect the eligibility criteria and conditions for fund managers to be largely confined to the generic criteria and conditions discussed in section 3 above. There may be some additional matters that are not dealt with adequately by these provisions. Here we discuss:

- compliance management systems
- additional reporting to FMA.

23.	Are there any other specific licensing requirements that should apply to fund managers?

4.1 Governance and compliance arrangements

147 As discussed in section 3.8 above we do not propose a general, high-level licensee requirement that applicants have adequate governance and compliance arrangements.

148 However, particular kinds of licensed services have particular compliance-related risks associated with them that it is important to manage. We would value feedback that helps us to identify these risks and the methods that are used to manage them. We would also welcome views on whether adequate management of some of these risks should be a requirement for holding a fund management licence.

149 In Australia, managed investment schemes must have compliance plans. The content of these is based on the obligations imposed by the law and scheme constitutions. They must look across all these obligations and identify risks of non-compliance and establish measures to address these risks.[27] The responsible entity must comply with the plan,[28] and have their compliance audited each year. If fewer than half the directors of the responsible entity are "external directors" (no business dealings with, or material interests in, the responsible entity) a compliance committee is required.

150 Similar requirements exist in the United States. Mutual funds must adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws by the fund, including oversight of compliance by each investment adviser, principal underwriter, administrator and transfer agent of the fund. A majority of independent directors must approve the plan. A chief compliance officer is designated as responsible for its administration. The chief compliance officer's remuneration and removal is the responsibility of the board (including a majority of independent directors), and he or she submits an annual review of the compliance plan to the board.[29]

151 The situation is a little different in the FMC Bill, as some risks of non-compliance are intended to be addressed through the requirement for a licensed supervisor to monitor the fund manager and to approve some matters (e.g. providing consent to some related-party transactions). Chapter 4 of this discussion paper covers various aspects of the governance of managed investment schemes.

152 Some relevant risks that can be identified from Part 4 of the FMC Bill but which may not be directly addressed in the FMC Bill include:

- dishonesty or misuse of information

[27] ASIC, Regulatory Guide 132, Managed Investments: Compliance Plans, page 4. http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ps132.pdf/$file/ps132.pdf.
[28] Australian Corporations Act, section 601FC.
[29] SEC Rule 38a-1, http://www.law.cornell.edu/cfr/text/17/270.38a-1.

- failure to act in the best interests of investors or to meet a professional standard of care
- failure to keep FMA or the supervisor informed of matters for which reporting is required
- failure to identify or report limit breaks or pricing errors
- incorrect certification by the manager that a related party benefit has resulted from an arms-length transaction or is otherwise exempt from supervisor approval
- inadequate supervision of outsourced functions.

153 There are likely to be other areas where management of compliance risks could be a requirement for holding a fund management licence.

154 Where the granting of a licence requires that particular risks be managed, the regulations could allow flexibility about how they are managed. For example, they could simply require that the applicant have "adequate systems and procedures for managing [***a specified risk***]". The applicant would then have to satisfy FMA that their systems were adequate in that respect. Alternatively, for some risks there may be a particular system or process, or a particular standard of performance that should be used. Specifying this in regulations would reduce flexibility, but may improve certainty and transparency.

24. From the point of view of investors, what compliance-related risks is it important for fund managers to manage? Are there examples of good and bad practice?

25. Which risks, if any, should need to be managed as a requirement for holding a fund management licence? For each of these risks, should the risk management requirements be generic, e.g. "adequate systems and procedures for managing [***a specified risk***]" and assessed by FMA on a case-by-case basis, or should particular systems and processes be specified in regulations? What are the costs of these systems and processes?

4.2 Additional reporting to FMA

155 In section 3.10 above we propose that all licensees report certain events to FMA that may be material to licences.

156 For schemes where there is no supervisor, Part 4 of the FMC Bill contains additional FMA reporting requirements:

- anything prescribed by regulations referred to in clause 134 (duty of manager to provide reports to the supervisor or FMA)
- reporting serious financial problems in the manager or scheme (clause 138)
- reporting of limit breaks (clause 153) and pricing errors (clause 154)
- copy of an actuarial examination of defined benefit scheme or life benefit scheme (clause 155).

157 FMA can also require licensees to provide ongoing information to them under clause 401(3)(b) (for information relevant to verifying that licensing requirements are met).

26. Is there any additional information that fund managers should report to FMA?

5. Requirements specific to independent trustees of restricted schemes

158 While restricted schemes do not require a licensed supervisor, the FMC Bill requires that one of their trustees be a licensed independent trustee. The independent trustee of a restricted scheme has the same general role as the other trustees. However, they are intended to act as an independent voice and to ensure a degree of professionalism in the management of restricted schemes.

159 The trustees of a restricted scheme, including the independent trustee, are collectively the "manager" of the scheme. The trustees collectively have the same duties as other fund managers – to act honestly and in the best interests of investors, and similar obligations in respect of reporting limit breaks, pricing errors, etc.

160 Licensed independent trustees do have some individual duties. These include:

- in exercising any powers, or performing any duties, exercising the care, diligence, and skill that a prudent person engaged in that profession would exercise in the same circumstances (clause 131)
- certifying that a related-party transaction should be permitted (clause 159).

161 As with fund managers, we expect the eligibility criteria and conditions for licensed independent trustees to be largely confined to the generic criteria and conditions discussed in section 3 above. However, we consider there may be a case for more specific criteria relating to competence and capability, and some specific reporting requirements.

27.	Are there any other specific licensing requirements that should apply to independent trustees of restricted schemes?

5.1 Specific criteria relating to competence and capability

162 Under the proposed eligibility criteria (see section 3.6), the independent trustee will need to have the competence and capability necessary to act as an independent trustee, and fulfil their duties and obligations.

163 It may be desirable to further define the skills and experience that is needed where the independent trustee is an individual. For example, requiring that the independent trustee:

- has a minimum amount of experience in the management or supervision of a managed investment scheme
- holds qualifications relevant to acting as a professional manager of a restricted scheme.

28.	Do you consider there are any important skills, qualifications or experience that an independent trustee of a restricted scheme should hold? If so, how are these best specified?

5.2 Additional reporting to FMA

164 In section 3.10 above we propose that all licensees report certain events to FMA that may be material to licences.

165 FMA can also require licensees to provide ongoing information to them under clause 401(3)(b) (for information relevant to verifying that licensing requirements are met).

166 FMA is likely to be interested in the independent trustee reporting events that indicate governance issues in a restricted scheme. One event that may indicate governance issues is where the independent trustee is the only person to vote against a resolution, or where the independent trustee and representatives of the members vote against a resolution that is subsequently passed.

167 For independent trustees of restricted schemes, a key requirement is ensuring that the trustee continues to meet the independence requirements in clause 117(3). To assist this, the trustee could be required to report periodically that he or she continues to satisfy the independence requirements.

29. Are there any particular problems in the scheme supervision or operations that an independent trustee might need to report to FMA? Should independent trustees be required to report to FMA when they are the only person to vote against a resolution?

30. Should trustees be required to report periodically that they continue to satisfy the independence requirements in clause 117(3)?

6. Requirements specific to providers of discretionary investment management services

168 We have identified the following areas where DIMS-specific eligibility criteria and conditions could supplement the generic criteria and conditions discussed in section 3 above:

- additional requirements relating to custody of investor money and property
- use of non-independent custodians
- action that must be taken on limit breaks
- requirements for giving of incidental advice not regulated by the Financial Advisors Act
- restrictions on investments in wholesale financial products
- contents of client agreement
- related party benefits
- ongoing client reporting
- additional reporting by DIMS providers
- additional record-keeping requirements
- governance and compliance arrangements
- licensees supplying DIMS to wholesale investors.

169 Point-of-sale disclosure for DIMS and potential public ongoing disclosure is considered in Chapter 2.

31. Are there any other specific licensing requirements that should apply to DIMS providers?

6.1 Additional requirements relating to custody of investor money and property

170 Custody of assets has been a serious problem for DIMS and related services, in New Zealand and overseas. The FMC Bill tries to deal with this through requirements that investor money be held on trust, and investor property be held by an external custodian.

171 Clause 440 will require that money paid by, or on account of, an investor must be held in trust for the investor until it is invested by the provider, paid to the investor, or applied in accordance with the investor’s instructions. Regulations can prescribe how the DIMS provider must deal with the money while it is held in trust.

172 Clause 442 requires that investor property (which includes investor money) be held by an external custodian, who may be associated with the licensee under some circumstances. Clause 443 means that the custodian has the same obligations in dealing with the property as a broking service under the Financial Advisers Act 2008. That is, the custodian must pay client money into a separate trust account, account for and keep records of each client’s money and property, and use the money only in accordance with the directions of the client.

173 Given a requirement for an external custodian to hold investor property, we consider that any money and property received directly by the DIMS licensee under the DIMS service would need to be promptly transferred to the custodian. This could be clarified through a standard licencing condition that required this treatment. In addition, regulations made for the purpose of clause 440 would require money temporarily held by the DIMS licensee to be treated in the same way as money held by a broker under the Financial Advisers Act. An alternative would be to require that all investor money be paid directly to the custodian.

174 Unlike in comparable jurisdictions, the FMC Bill does not require custody businesses to be licensed. Instead, under clause 442(2)(a) the custodian selected by the manager must be "appropriate to hold, and safeguard, the investor property". This raises questions of:

- What constitutes an appropriate custodian? Should more specific requirements be met?
- What arrangements should be in place between the DIMS licensee, custodian and investors to ensure that investor property is safeguarded?

175 In Australia, custody businesses must meet standards that ensure that investor property is not exposed to unnecessary risks because of the way it is held, and there are efficient operational arrangements for holding and dealing with it. These include standards relating to staffing capabilities, the custodian's ability and resources to perform core administrative activities, arrangements for how various assets are held and custody-related financial resources – custodians must have net tangible assets of A$5 million (if the custodian is not regulated by APRA).

176 Although the design of the FMC Bill is such that a full custodian licensing regime is not contemplated, it would be possible for regulations to specify that the custodian selected by the DIMS licensee must meet some aspects of these criteria. Another option could be the DIMS licensee being required to ensure that the custodian they appoint is likely to comply with the obligations in clause 443 (certain broker obligations of the Financial Advisers Act 2008 apply under this part).

177 Another further area of concern is the possibility that arrangements between the licensee, custodian and investors may not be structured in a way that effectively realises the safeguards intended to be provided by external custody. Safeguards may be inadequate if, for example, the licensee is able to inappropriately manipulate the information received by clients on their holdings and transactions, or issue unauthorised instructions to the custodian. We are interested in feedback on what custody-related risks may remain unaddressed, and what processes licensees and custodians should have in place to manage these risks. Potential requirements could be:

- independent reporting by the custodian to investors
- regular auditing of custodian records, along similar lines to the proposals for managed investment scheme custodians in Chapter 4
- regular reporting of custodian records and/or the result of any audit to FMA.

32. How should incoming investor money be treated by the DIMS licensee?
33. Apart from the general requirement that a DIMS custodian be "appropriate to hold, and safeguard, investor property", are there any particular minimum standards that should be prescribed for custodians of DIMS?
34. Apart from the requirement that an external custodian hold the investment property, are there any custody-related processes that should be followed to ensure that investor property is adequately safeguarded?

6.2 Use of non-independent custodians

178 Clause 442(2)(b) of the FMC Bill permits a DIMS licensee to use a custodian who is an associated person of the DIMS licensee only if permitted by licence conditions and those conditions are observed.

179 We propose that regulations will specify conditions or types of conditions for custodians who are associated persons of the DIMS licensee. These conditions should be set to ensure that:

- investor property continues to be adequately segregated from the property of any other person

- investor property is safeguarded from misconduct by other persons.

180 Potential requirements are:

- board independence – A majority, or all, of the custodian's board comprises directors who are independent of the DIMS licensee
- employee independence – staff reporting to the board of the custodian, or making decisions for the custodian, do not report to any non-custodian director or employee of the DIMS licensee and do not have any responsibility for investment or trading decisions
- the DIMS licensee may not directly or indirectly take any action to coerce or manipulate custodian staff in the performance of their duties to hold and safeguard investor property
- segregation of systems – other DIMS licensee staff (particular those with investment or trading functions) do not have access to custodian's IT systems and documents relating to custody of assets, execution of licensee instructions and administration.

35. Where a DIMS licensee uses an associated body corporate as its custodian, what additional requirements should be met to ensure that investor property is adequately segregated and safeguarded? What are the costs of implementing these safeguards? Should these be specified as specific conditions or as types of conditions that FMA may impose?

6.3 Action that must be taken on limit breaks

Status quo

181 Clause 436 of the FMC Bill requires a DIMS licensee to report a material breach of the limits on the nature and type of investments set out in the investment mandate or a material breach of the limits on the proportion of each type of assets that may be invested in under the investment mandate. This provision is similar to clause 153, which applies to actions that a manager of a registered managed investment scheme must take on a limit break. (The regulations to be made in relation to clause 153 are discussed in Chapter 4.)

182 Reporting of material limit breaks is only required in the prescribed circumstances and in the prescribed manner.

Comment

183 The DIMS licensee must, under clause 435, provide the DIMS in accordance with the investment mandate set by a written investment authority granted by the investor. Disclosures of material breaches of the investment mandate will enable FMA to monitor and act, if necessary, to take enforcement action.

184 However, as with managed investment scheme limit breaks, not every DIMS limit break has the same compliance significance. A breach of the investment mandate may occur for reasons that are beyond the control of the licensee and so occur without the licensee's immediate knowledge. For example, breaches may be due to the appreciation or depreciation of the investors' assets or a market-driven event.

185 A related consideration is whether, and under what circumstances, limit breaks should need to be reported to investors. Investors in a DIMS may also have a role in monitoring the DIMS licensee, depending on what powers they are given in the client agreement. In some cases they can issue directions to the DIMS licensee.

186 The key issue for the regulations is to define the nature of limit breaks that FMA and/or investors need to know about immediately. We are interested in feedback on the frequency, nature and relative significance of limit breaks and, in particular, what are the defining features of limit breaks for which immediate reporting is needed.

187 As with managed investment schemes, we consider that early rectification of limit breaks removes the need for immediate reporting. In this case, reporting is still desirable, but the significance of the report will be to enable FMA to see compliance trends and analyse causes. For this reason, where there is early rectification, reporting is likely to be more meaningful if it is deferred and aggregated over an appropriate period. We do not propose periodic reporting of limit breaks to investors.

188 If a limit break occurs, a DIMS licensee will first receive an initial alert of a possible limit break and will need to investigate the alert to determine whether a reportable limit break has occurred. If the DIMS licensee determines, or ought reasonably to have determined, that a reportable limit break has occurred, we consider there should be a specified period within which the DIMS licensee must rectify that limit break before the reporting obligation applies. If the limit break is rectified in that specified period, we think it need only be reported to FMA in a periodic compliance report. We are interested in views as to the appropriate time period for rectification and the appropriate frequency of this periodic compliance report.

189 If the limit break is not rectified within this period, we propose that the DIMS licensee must report it to FMA and investors.

190 We think the following details on the limit break would need to be contained in either a periodic or immediate report:

- the nature of the limit break
- for a class DIMS, the name of the class DIMS affected and the amount of funds under management
- the materiality of the limit break on the materiality criteria set by FMA-prescribed frameworks and methodologies
- the cause of the limit break
- the period to which the limit break continued
- the steps taken, or to be taken, by the DIMS licensee to rectify the limit break
- if applicable, what actions have been, or will be, taken to ensure that limit breaks of this type do not occur again or to ensure early notification and rectification of this type of limit break.

36. How frequent are limit breaks and how would you define their materiality?
37. Do you agree that limit breaks that are rectified quickly do not need to be immediately reported to investors and FMA? If so, what do you consider to be an appropriate time frame for rectifying limit breaks before they should be reported?
38. How frequently do you consider that a periodic compliance report should be required?
39. Are the details listed in paragraph 190 the appropriate details for limit break reports or should any details be excluded or added?
40. Are there any other circumstances which might justify an exclusion from the obligation to report material limit breaks to investors and FMA?

6.4 Incidental advice not covered by the Financial Advisers Act 2008

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

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

193 However, this prompts the question of what requirements should apply to persons giving incidental advice? The same regulatory problems may arise in respect of financial advice given in the course of DIMS as those that arise elsewhere, such as conflicts of interest, insufficient adviser skills and knowledge, lack of due care, etc. Some of these issues are dealt with through the FMC Bill's duties on DIMS licensees that apply to the DIMS service (which includes incidental advice):

- a DIMS licensee must act honestly in providing the service (clause 431(1)(a))
- the general prohibition on misleading and deceptive conduct (Part 2)
- the DIMS licensee must not make use of information acquired through the service to gain an improper advantage for itself or any other person, or cause detriment to investors (clause 431(1)(d))
- the DIMS licensee has a duty to comply with a professional standard of care (clause 433).

194 However, some other requirements do not appear to apply to incidental advice. In particular, the requirement in clause 431(1)(c) that the DIMS licensee act in the best interests of investors would not seem to apply to incidental advice, as it may not be performed "under the client agreement or investment mandate for the service".

195 Potential requirements are:

- Requiring persons giving the advice to be AFAs. This would seem to be contrary to the FMC Bill's inclusion of incidental advice in the DIMS.
- Requiring persons giving the advice to comply with the Code of Professional Conduct for AFAs ***as if*** they were AFAs (except these obligations would be enforced by FMA).
- Requiring that any advice that is given be in the best interests of the investor.
- Prescribed warnings to investors.
- Requiring that advice be given under the supervision of an AFA.
- Allowing FMA to specify conditions on the giving of incidental advice. These conditions could encompass some of the above requirements.

41.	What requirements should there be for DIMS licensees giving incidental advice to investors in the course of providing the DIMS? What are the costs and benefits of such requirements?

6.5 Restrictions on investments in wholesale financial products

196 Clause 7 of Schedule 1 provides an exemption from the FMC Bill's disclosure and governance requirements for offers of financial products made through a DIMS licensee. This is a very broad exemption, which will allow a DIMS licensee to acquire, on behalf of a retail client, a wide range of unregulated assets. These may include unregistered schemes, equity and debt securities from unlisted companies that have not made a regulated offer and do not file audited financial reports, and unregulated over-the-counter derivative transactions. These investments can also be made in financial products offered by related parties (subject to the DIMS licensee considering that the investment is in the best interests of the client or on an arm's-length basis).

197 The rationale for this exemption is that there is no benefit to retail investors from receiving a PDS for these offers as they are not making a decision – the DIMS licensee is making the investment decision on their behalf. This is analogous to the situation in which a fund manager acquires unregulated products on behalf of the investors in a managed investment scheme.

198 However, this exemption does create risks that need to be carefully managed. Retail clients remain invested in any unregulated financial products when the DIMS investment authority ends – perhaps for years thereafter. The DIMS licensee may only act for the investor for a short time, as the investment authority could expire after a single set of transactions. The investor may then be left with a product which is subject to minimal ongoing reporting or governance requirements and/or which the investor cannot easily dispose of.

199 These risks may be managed by the general duty on DIMS licensees to act in the best interests of investors. However, the duty may be difficult to enforce (owing to the subjective judgements involved), and some DIMS licensees may have strong incentives to make such investments against the interests of investors. If the general duty is not sufficient, constraints could be placed on the kinds of wholesale assets that could be invested in by the DIMS or the circumstances under which such investments could be made. Some options include:

- restricting wholesale investments to, for example, registered schemes, listed financial products, or financial products from an issuer that has previously made a regulated offer
- restricting wholesale investments to DIMS licensees acting under an ongoing investment authority, rather than a one-off or short-term investment authority
- requiring that investors expressly opt in to invest in unregulated wholesale investment products, on a product-by-product basis.

42. Does the exemption in clause 7 of Schedule 1 (exemption for offers of financial products made through a DIMS licensee) create risks for retail investors? If so, how are these risks best managed?

6.6 Content of client agreements

200 In Australia, ASIC requires that DIMS client agreements include:

- an investment programme that meets certain requirements
- obligations to act honestly and in the best interest of the client, exercise due care and diligence, give priority to the client’s interests and not use information about the client to the providers’ advantage or to cause detriment to the client
- statements that the provider will be responsible to the client for:
  - the functions that the provider has contracted to perform
  - acts and omissions of any persons that is engaged to perform those functions, as if they were the providers’ acts or omissions
  - compliance with the conditions of ASIC’s relief, the client agreement including the investment program (except where the client has agreed in writing to a variation), and representations included in the financial services guide for the service.[30]

[30] ASIC, ***Regulatory Guide 179: Managed discretionary account services***, RG 179.38, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ps179.pdf/$file/ps179.pdf.

Prescribed content of client agreements

201 There are two ways that regulations can influence the content of client agreements. One is by specifying that the client agreement must contain particular content or address particular issues. The other is by implying terms into the client agreement.

202 We would welcome feedback on what content client agreements should be required to include. We do not consider it useful to prescribe content that will inevitably be included in any case. However, there may be items that are sometimes omitted from client agreements (especially where a DIMS provider is not well run) but which should be explicitly dealt with. This might include the following:

- agreement as to who will hold custody over the investor’s assets
- how any rights that relate to the investor’s assets (such as rights in relation to sale, consenting to corporate actions or making dividend reinvestments) will be exercised, or referred to the investor to be exercised – if relevant to any assets that may be held under the investment mandate.

Implied terms in client agreements

Terminating the client agreement

203 A particular issue for DIMS is how the client agreement may be terminated, and what then happens to the investor’s assets. For managed investment schemes, clause 169 permits scheme participants (via a special resolution) or supervisors (via a certificate of investor best interests) to remove the scheme’s manager. There is no equivalent for DIMS.

204 DIMS client agreements we have examined allow the investor to terminate the agreement in writing. Upon termination, assets are transferred to the investor or, if transfer is not possible, they are held on bare trust and potentially sold or redeemed (if reasonable under the circumstances) before being transferred.

205 An option is to imply terms regarding termination and transfer of assets into client agreements.

Changes to investment mandate

206 We also propose an implied term that no changes may be made to the investment mandate without those changes being expressly consented to in writing by the client. Although this is likely already required under clause 435(1), this would avoid doubt.

Contracting out

207 Clause 133 provides that for managed investment schemes, a manager may contract functions out to other parties (but the same duties apply) the manager must monitor the performance of those functions and the manager remains liable for their performance. There is no equivalent for DIMS.

208 We propose that if the DIMS licensee engages a third party to perform a function that it itself has contracted to perform:

- The DIMS licensee must take all reasonable steps to ensure those functions are performed in the same manner, and are subject to the same duties and restrictions, as if the DIMS licensee were performing them directly.
- The DIMS licensee must take all reasonable steps to monitor the performance of those functions.

- The DIMS licensee will be liable for any acts and omissions of any persons that are engaged to perform those functions, as if they were the providers' acts or omissions.

Representations in service disclosure statement

209 Again, to avoid doubt and potential contracting out, we propose an implied term of the client agreement be that the provider is bound by representations included in the service disclosure statement for the service.

43. Should DIMS client agreements be required to include agreement about custody over assets and how rights relating to the investor's assets (e.g. corporate actions) will be exercised?
44. What rights should DIMS investors have to terminate the client agreement, and what process should be followed to transfer assets to their ownership?
45. Do you agree that no changes should be made to the DIMS investment mandate without those changes being expressly consented to in writing by the client?
46. What should be implied as terms into a DIMS client agreement?
47. Do you agree that an equivalent to clause 133 of the FMC Bill be provided for DIMS, as an implied term of the client agreement?

6.7 Related party benefits

210 Clause 438 provides a general prohibition on DIMS licensees entering into transactions where a related party benefit is given, with a number of exemptions: where transactions are in the best interest of investors, on arm's-length terms, in registered schemes or certain registered bank investments.

211 Clauses 439 and 439A include provision for regulations relating to additional circumstances in which related party benefits are permitted, and the requirements for certifying related party benefits as being in the best interests of investors.

212 We propose that these regulations be the same as for managed investments schemes, as discussed in Chapter 4.

48. Is there any reason why regulations relating to permitted related party transactions should differ between managed investment schemes and DIMS? If so, how should they be varied?

6.8 Additional reporting to FMA

213 In section 3.10 above we propose that all licensees report certain events to FMA that may be material to licences. Section 6.1 above discusses the possibility of additional custody-related reporting. For DIMS, Part 6 of the FMC Bill also requires DIMS providers to report limit breaks (see section 6.3 above) and FMA can require licensees to provide ongoing information to them under clause 401(3)(b) (for information relevant to verifying that licensing requirements are met).

49. Is there any additional information that DIMS licensees should report to FMA?

6.9 Disclosure and ongoing client reporting

214 Initial service disclosure statements are needed to facilitate informed decision-making, particularly as to whether to use a DIMS or invest in a managed investment scheme. Chapter 2 discusses proposals for these disclosure statements.

215 Investors also need access to information about the services that DIMS licensees are providing to them and the transactions that are being conducted on their behalf. This enables them to monitor the performance of the service, keep track of their financial position, and make decisions about whether to make any changes to the service or give directions. The information investors require includes: the assets they own, the transactions that have been undertaken, the returns that have been generated, and the fees they have been charged. We propose requirements for DIMS licensees (or alternatively custodians) to provide investors with this information.

Overseas client reporting requirements

216 Australian DIMS providers have a number of ongoing reporting requirements. Each investor must be provided with either a quarterly report, or alternatively electronic access to information on a substantially continuous basis, that details transactions, the value of the assets and all revenue and expenses (including fees and charges).

217 Providers must also give to the investor within three months of the end of each financial year an annual investor statement that contains a summary of the information contained in quarterly reports, a copy of the auditor compliance reports (discussed in section 6.11 below) and a copy of an annual review of the investment programme.

Proposal

218 We propose similar ongoing requirements. Each investor would be able to request, either in hard copy or through an electronic facility:

- all transactions effected as part of the service, including any liabilities incurred in relation to those transactions
- the assets held in the client's portfolio (including cash) and their value
- all revenue and expenses (including fees and charges) relating to the service over the period requested.

219 If an electronic facility was not available to the investor on a substantially continuous basis, the investor would be provided with a regular (potentially quarterly or half-yearly) report containing the above. We propose that investors can expressly opt out of receiving these reports, or request that they be sent less frequently.

220 There may be merit in each investor also receiving a personalised annual statement (or a link to where a statement can be obtained) that summarises activity over the year. Where investors receive regular statements, this could simply be a requirement to include additional summary information in those statements each year.

221 The ongoing client reporting that we propose above could also be required for DIMS offered by authorised financial advisers. This would ensure consistent ongoing disclosure for personalised DIMS, whether offered under the Financial Advisers Act or the Financial Markets Conduct Bill.

222 Periodic reporting may not be appropriate for all services. Some personalised services may involve a one-off set of transactions. This may occur, for example, where a client instructs a financial adviser to invest money in assets of a particular type (giving the adviser a limited discretion) but the client makes his or her own decisions about management of the assets from then on. In this case there is no ongoing management of the assets by the adviser, and a single confirmation of the transaction may be all that is required.

50. What information should DIMS clients have continuous access to on request, or through an electronic facility?

51. If DIMS clients cannot make use of an electronic facility, should they be provided with regular reports? If so, how often should these be sent? Should there be provision for an express opt-out or opt-in?

52. Should DIMS clients be sent an annual statement? If so, what should it contain?

53. Should ongoing reporting be required for authorised financial advisers who offer DIMS? If so, what should this comprise?

6.10 Additional record keeping

223 As with other licensees, adequate record keeping is important for ongoing monitoring and enforcement of DIMS licensees' compliance with obligations, as well as for resolving any disputes that might arise between a licensee and investors.

224 In Australia, the Corporations Act requires that all licensees keep accounting records, and records of acquisitions and disposals of financial products, and details of all financial products held (on its own behalf, or on others' behalf). The Corporations Regulations further require records of all underwriting transactions, financial products dealt with under instruction of another person, and all property for which the licensee 'is accountable', and whether it is held in safe custody or deposited with a third party as security.

225 We propose that records be kept for a minimum of seven years that include:

- records of all acquisitions and disposals of financial products relating to the service
- all documents required to be produced by the licensee under the FMC Bill and regulations.

54. Do you agree with the proposed additional record keeping requirements for DIMS licensees?

6.11 Governance and compliance arrangements

226 As discussed in section 3.8 above we do not propose a general, high-level licensee requirement that applicants have adequate governance and compliance arrangements.

227 However, particular kinds of licensed services have particular compliance-related risks associated with them that are important to manage. For DIMS, some of these risks are managed through the requirements for an independent or segregated custodian.

228 We would value feedback that helps us to identify these risks and the methods that are used to manage them. We would also welcome views on whether adequate management of some of these risks should be a requirement for holding a DIMS licence.

229 In Australia, DIMS must:

- have and maintain adequate documented measures to ensure compliance with legal obligations
- arrange annually for an auditor to prepare a statement as to whether the documented compliance measures are adequate and have been complied with.

230 Some relevant risks that can be identified from Part 6 of the FMC Bill but which may not be directly addressed in the FMC Bill include:

- dishonesty or misuse of information
- failure to act in the best interests of investors or to meet a professional standard of care
- failure to keep FMA informed of matters for which reporting is required
- failure to identify or report limit breaks

- incorrect certification that a related party benefit is permitted.

231 There are likely to be other areas where management of compliance risks could be a requirement for holding a DIMS licence.

232 Where the granting of a licence requires that particular risks be managed, the regulations could allow flexibility about how they are managed. For example, they could simply require that the applicant have “adequate systems and procedures for managing [***a specified risk***]”. The applicant would then have to satisfy FMA that their systems were adequate in that respect. Alternatively, for some risks there may be a particular system or process, or a particular standard of performance that should be used. Specifying this in regulations would reduce flexibility, but may improve certainty and transparency.

55. From the point of view of investors, what compliance-related risks is it important for DIMS providers to manage? Are there examples of good and bad practice?

56. Which risks, if any, should need to be managed as a requirement for holding a DIMS licence? For each of these risks, should the risk management requirements be generic, e.g. “adequate systems and procedures for managing [***a specified risk***]” and assessed by FMA on a case-by-case basis, or should particular systems and processes be specified in regulations? What are the costs of these systems and processes?

6.12 Licensees supplying DIMS to non-retail investors

233 An area of potential ambiguity and risk for investors is around the boundary between wholesale DIMS offered by a licensee and their retail service. Clients of a licensed DIMS provider are likely to expect, unless there are clear representations to the contrary, that they are covered by the protections of the licensing regime. There are also some aspects of the regulatory regime that should arguably apply to dealings with all clients, regardless of whether they are wholesale or retail.

234 “Retail service” is defined in clause 33A(2) of Schedule 1 to mean a service that is provided:

- to a retail investor, or
- to a class of investors where there is at least 1 retail investor in that class.

235 This means that, for example, if the same model portfolio is offered to both wholesale and retail investors, the service will be a retail service.

236 Some of the obligations in the FMC Bill apply only where the investor is a retail investor, in particular the obligation in subpart 4 to make disclosure.

237 Many additional obligations apply to a retail service: the requirements in subpart 5 to have a written client agreement; and the requirements in subpart 6 – duties of a DIMS licensee (including directors and senior managers), agreed investment mandate, actions to be taken on limit breaks, related party transactions and custody.

238 We consider that where a licensee proposes to offer a wholesale service for which subpart 6 does not apply they should, at a minimum, be obliged to disclose this in a prominent manner to the investor. Possible further steps would be:

- requiring the licensee to gain agreement from the investor, i.e. requiring the investor to opt-in
- requiring the licensee to provide standard information to the investor explaining the consequences of this classification.

239 It is also arguable that some requirements, such as those relating to custodial arrangements, are so important to the integrity of our financial markets that they should apply to licensees regardless of whether they are offering a wholesale or retail service. We would be interested in submitters' views on this.

57. What process should DIMS licensees need to go through if they propose to offer a wholesale service to investors, to ensure those investors are adequately informed of the licensee's reduced obligations to them?

58. Are there any requirements, such as custody, that should be applied to both wholesale and retail services offered by DIMS licensees?

7. Requirements specific to derivatives issuers

7.1 Overview of regulations required for derivatives issuers

240 The FMC Bill regulates certain derivatives issuers who make offers of derivatives to retail clients. "Derivatives issuers" are defined broadly as persons who are in the business of entering into derivative contracts. The definition of derivatives issuer covers firms who are in the business of entering into over-the-counter (OTC, or off-market) derivative contracts and exchange-traded derivative contracts where the firm acts as principal in the transaction (including brokers). There are no regulatory obligations associated with being a "derivatives issuer" per se.

241 Derivatives issuers who make offers of derivatives to retail clients ("regulated offers") require a market services licence from FMA. However, there are a number of exceptions to the need for a licence. Offers of exchange-traded derivatives by a participant in a licenced financial product market or a prescribed overseas market are not regulated offers, and so will not trigger licensing. Participants in financial product markets can also be exempted from the requirement to hold a licence. Even where a licence is required, the extent of eligibility criteria and licensing conditions can be reduced in cases where the derivatives issuer is regulated under another regime – for example, where the issuer is a registered bank.

242 Like other licences, derivatives issuer licences are subject to eligibility criteria and ongoing conditions. The FMC Bill requires that the licensee is a fit and proper person, is able to effectively perform the role and will comply with their obligations as a licensee. Other specific criteria and conditions are mainly left to regulations.

243 We propose that regulations will cover:

- record keeping
- capital adequacy and liquidity
- client agreements and duties
- governance and compliance arrangements
- additional reporting requirements.

244 All derivatives issuers (including those who only deal with wholesale clients) may potentially be subject to regulations on client funds handling (Part 6, subpart 7). In practice, these requirements are mainly relevant to those who offer margined products, and only envisaged to cover those receiving margins that originated from a retail client.

245 Another matter that overseas regulations cover, but which we do not propose at this time, is minimum margin requirements.

59.	Are there any other specific licensing requirements that should apply to derivatives issuers?

7.2 Record keeping

246 Licenced derivatives issuers will be required to comply with accounting record requirements under primary legislation. However, there is likely to be merit in regulations requiring the keeping of additional records.

Existing requirements

247 Currently, the authorisation notices of futures dealers require them to keep records of dealings in derivative contracts with clients, and of client money or property received, held or otherwise dealt with in connection with dealings in derivative contracts. The Futures Industry (Client Funds) Regulations contain some more detailed requirements.[31]

Other approaches

248 The NZX Derivatives Market has detailed rules on record keeping. Trading participants must keep records of all instructions, orders submitted, associated documentation (order and deal tickets, and confirmations), margin calls and complaints – whether on NZX, other exchanges or for OTC contracts.[32] Participants must keep records (including recordings) of all communications with clients relating to orders. Participants must have policies and procedures for recording conversations, employees must not be able to disable telephone conversation recording, and only a designated compliance manager (or their agent) can access editable versions of recordings.[33] Participants with capital requirements must calculate capital adequacy daily.[34]

249 US futures commission merchants (dealers in exchange-traded derivatives or retail foreign exchange) must record all derivatives transactions, securities and property received from clients, its investment of client funds, and must compile reports on segregated funds daily.[35] Unlike New Zealand dealers, they do not appear to be required to audit client funds during the financial year. Futures commission merchants must maintain records concerning “material affiliated persons”, including their regulatory status and financial position, and a thorough documentation of risks and mitigation arising from interactions with affiliates.[36]

250 In Australia, the Corporations Act requires that all licensees keep accounting records, and records of acquisitions and disposals of financial products, and details of all financial products held (on its own behalf, or on others’ behalf). The Corporations Regulations further require records of all underwriting transactions, financial products dealt with under instruction of another person, and all property for which the licensee “is accountable”, and whether it is held in safe custody or deposited with a third party as security.

Proposal

251 We propose to include record keeping requirements as a standard licence condition, along the lines of existing requirements in authorisation notices and the Futures Industry (Client Funds) Regulations.

252 Maintaining accurate records of dealing with clients are important for the day-to-day operations of a well-run derivatives business. Record keeping failures are often an aspect of firm failures and client losses. In addition, record keeping is important for both the firm and external parties (including FMA) to be able to effectively investigate any compliance or client relations issues that arise.

253 We propose that records of dealings be kept for a minimum of seven years, in line with company and tax law.

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[31] Futures Industry (Client Funds) Regulations 1990, clause 23.
[32] NZX Derivatives Market Rule 9.7.1, 12.2.1, 12.8.1-12.8.5.
[33] NZX Derivatives Market Rule 4.23.2-4.23.6.
[34] NZX Derivatives Market Rule 4.28.1.
[35] CFTC Regulations 1.27, 1.32, 1.35, 1.36, 30.7.
[36] CFTC Regulation 1.14.

60. Do you agree with a generic requirement that licensed derivatives issuers keep complete records of dealings in derivative contracts with clients, and of client money or property received, held or otherwise dealt with in connection with dealings in derivative contracts?

61. What other records should licensed derivatives issuers be required to keep?

7.3 Capital adequacy and liquidity

Existing requirements

254 Financial requirements, such as maintaining adequate capital and liquid assets, are a feature of the authorisation notices of many futures dealers who offer services to retail clients. FMA determines financial requirements of authorised futures dealers on a case-by-case basis.

255 We propose to continue imposing financial requirements on derivatives issuers, with the exception of issuers who are already subject to prudential regulation. In particular, registered banks, non-bank deposit-takers, and insurers will be exempt from the financial requirements of a derivatives issuer licence. Additionally, derivatives issuers whose capital adequacy and liquidity is monitored by an approved derivatives market or overseas regulator will be exempt from financial requirements.

Problems identified with existing requirements

256 Currently there is no framework that specifies the objectives of financial requirements for derivatives businesses, how stringent these should be, or how they should be operationalised.

257 There have been no failures or investor losses from authorised futures dealers attributable to insufficient financial resources. However, FMA's approach has varied over time and, owing to the lack of a legislative framework, is less transparent than might be desirable.

Considerations in how stringent to set financial requirements

Objectives of financial requirements

258 As discussed in section 3.7 above, the stringency of the financial requirements depends on (a) their objective, and (b) the nature of the risks faced by the business. Financial requirements can be relatively 'light' if they have modest objectives, such as requiring sufficient equity to ensure that shareholders have incentives to avoid failure. Or they can be stronger if their objectives are more ambitious, e.g. preventing the failure of the business and investor losses.

259 There are arguments for more ambitious objectives. When considering risk, retail investors in derivatives are expected to concern themselves, primarily, with losses inherent in the derivative contracts themselves – for example, from changes in the price of underlying financial instruments. If they are also required to monitor the financial strength of the derivatives business, their decision-making process becomes more complex and demanding.

260 Additionally, in a disclosure-based regime it would be necessary for there to be adequate disclosure by the business of information relating to its financial strength. This disclosure could be extensive and would need to be frequently updated – similar to the disclosure provided by a continuous issuer of debt securities. Given the limited ability of retail investors to process information (even the more sophisticated retail investors that are likely to invest in derivatives), information asymmetries may endure, and there is a possibility of a 'market for lemons' in which robust, highly capitalised derivatives businesses are driven out of the retail market in favour of cheaper, but less financially robust firms.

261 On the other hand, requiring a high level of financial resources is a restrictive barrier to entry. Excessive requirements are expected to inhibit entry and competition, raising the prices (commissions and spreads) paid by clients.

Nature of the risks faced by the business

262 The second determinant of the stringency of financial requirements is the nature and scale of risks faced by the business in question. These risks are likely to be low if the business is relatively simple and actively avoids taking on risk – for example, a broker who only deals in exchange-traded contracts, or an OTC business that immediately offsets all client positions with holdings of the underlying assets or back-to-back derivative contracts with a well-capitalised counterparty. On the other hand, these risks may significant if the business does not offset client positions, or has other significant and risky aspects of its business, such as proprietary trading.

263 This implies that, if financial requirements reduce the risk of failure, the stringency of financial requirements can be traded off against governance and risk management practices to some extent. Businesses could choose to abide by more stringent governance and risk management licence conditions in exchange for lower financial requirements.

Overseas approaches

Australia

264 ASIC states that it does not seek to prevent derivatives businesses from becoming insolvent or failing, and capital reserves are not intended to provide compensation to retail clients who suffer a loss because the issuer fails. The capital and liquidity requirements on derivatives businesses are therefore likely to be lower than would be required to meet these objectives. Notwithstanding this, ASIC imposes requirements that seem to have the effect of reducing the risk that the business becomes insolvent: cash flow forecasting, and requiring capital to a level such that “the business has the financial strength to cope with costs and losses arising from expected and unexpected operating risks.”

265 ASIC requires that derivatives dealers generally hold surplus liquid funds of A$50,000,[37] plus adjusted surplus liquid funds of:

- A$50,000; plus
- 5 percent of adjusted liabilities between A$1 million and A$100 million; plus
- 0.5 percent of adjusted liabilities for any amount of adjusted liabilities exceeding A$100 million.

266 There is a maximum requirement of A$100 million.

267 “Adjusted surplus liquid funds” is calculated using a complex methodology that excludes or discounts various assets and liabilities.[38]

Singapore

268 Singapore enforces a tiered set of financial requirements through the Securities and Futures (Financial and Margin Requirements for Holders of Capital Markets Services Licences) Regulations.

[37] Unless client funds are below $100,000.
[38] ASIC, ***Regulatory Guide 166: Licensing: Financial requirements***, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/RG166a.pdf/$file/RG166a.pdf, page 55.

269 There is a “base capital” requirement, comprising mainly ordinary share capital, irredeemable preference shares, and reserve funds. The base capital requirement for a retail OTC derivatives firm is S$1 million. Otherwise this ranges from S$250,000 for brokers who do not carry any customer’s positions in futures contracts, margins or accounts in their own books, up to S$5 million for clearing house members.

270 There is an additional requirement that firms hold minimum levels of “adjusted net capital”. Adjusted net capital also has a complex formula that applies various discounts to different kinds of assets held by the firm. For OTC derivatives firms who are not members of a futures exchange, the amount of adjusted net capital required is the greater of S$2 million, or the sum of 4 percent of maintenance margins and 2 percent of excess margins.

Other countries

- United Kingdom – Equivalent of €730,000
- United States – US$20 million.

Proposal

271 We recognise that capital adequacy and liquidity requirements are challenging to set. At this time we are seeking feedback on the appropriate framework for these requirements.

62. What are appropriate objectives for capital adequacy or liquidity requirements for derivatives issuers?
63. What aspects of the firm’s business should capital adequacy and liquidity requirements take into account (e.g. dealing only in exchange-traded contracts, immediately offsetting all client positions, limiting proprietary trading)?
64. What capital adequacy or liquidity requirements would best meet these objectives?

7.4 Client agreements

272 Clauses 427 to 428 require that before a derivative can be issued to an investor under a regulated offer, the derivatives issuer (or authorised body) must have entered into a written client agreement with the investor. The client agreement can be comprised of multiple documents. Regulations can require client agreements to provide for prescribed matters, and imply terms into client agreements.

Prescribed content of client agreements

273 Prescribing content in client agreements can serve two purposes. It can provide for additional disclosure on top of what is required in the PDS (or reiterate that disclosure), or it can ensure that certain contractual matters are addressed that might otherwise be omitted.

274 NZX Derivatives Market advising and trading participants are currently required to have written client agreements. For advising participants these must include, among other things: the terms of business; details of the means by which the client’s instructions will be accepted; confirmation that an assessment has been conducted of a client’s suitability to engage in the trades contemplated; a statement about how trades will be novated; and a statement that only the trading and advising participant has obligations to the client. They must also include risk warnings and the contact details of the clearing participant that settles trades.[39]

[39] NZX Derivatives Market rule 6.5.1, https://www.nzx.com/files/static/Derivatives_Market_Rules.pdf

275 There may be some value in requiring some key matters from the PDS, such as risk warnings, to be replicated in client agreements. Client agreements could also remind the investor to obtain information about the derivatives from the PDS.

276 On the other hand, we note that submissions to select committee requested that any regulations setting out the required content of client agreements for derivatives should have regard to existing industry standard documentation, particularly the use of ISDA master agreements. We do not propose to require any modification to ISDA agreements, therefore any prescribed content for client agreements would need to be either (a) consistent with the content of ISDA agreements, or (b) in a separate document from the ISDA agreement.

277 We have not identified any contractual matters that should be addressed in client agreements that might otherwise be omitted, but seek feedback on this.

65. Are there any contractual matters that should be required to be addressed in derivatives client agreements (i.e. that might otherwise be omitted by some issuers)?

66. What are the costs and benefits of requiring particular matters from the PDS, such as risk warnings, to be replicated in derivatives client agreements? Should any other matters from the PDS be required to be included?

Implied terms

278 Some terms could be implied into client agreements, similar to those we propose to require for DIMS client agreements:

- if the provider engages a third party to perform a function that it has contracted to perform, the provider will be liable for any acts and omissions of any persons that are engaged to perform those functions, as if they were the provider's acts or omissions
- the provider is bound by representations included in the PDS that was given to the investor.

279 A further possibility is a duty to exercise care, diligence and skill. A number of licensees under the FMC Bill, and financial advisers and brokers under the Financial Advisers Act, have a duty to exercise the care, diligence and skill that a reasonable provider would exercise in the circumstances. Such a duty would generally apply to services provided by derivatives issuers, but could be contracted out of. It would seem to be most important that it apply to the handling of client funds, but may be warranted in other circumstances also.

67. What terms should be implied into client agreements for derivative issuers?

7.5 Assessing appropriateness of products for clients

280 New Zealand securities law currently assumes that where products are offered without personal advice, provided there has been appropriate written disclosure, retail investors are free to invest, and the issuer has no further responsibility for whether or not the products are suitable for the investor.

281 ASIC has reported that in the Australian contracts for difference (CFD) industry: "The majority of investors do not seek or receive personal financial advice prior to investing in OTC CFDs... Because OTC CFD issuers only provide factual information or general advice, the onus for assessment of the appropriateness of CFDs as an investment for an individual client rests with the client. Many investors do not appear well equipped to make this decision. As a result, OTC CFD issuers may be offering CFDs to investors for whom the product is not appropriate or suitable."[40] This likely holds in New Zealand, also – or will do as CFDs and other retail OTC derivatives become more common.

282 In contrast, the European Markets in Financial Instruments Directive (MiFID) places additional 'appropriateness' obligations on firms offering 'complex' products (including all derivatives) to retail investors without giving personal advice. Issuers are required to ask investors to provide information on their knowledge and experience (if issuers do not already have this information). Issuers consider whether the product is appropriate and the client understands the risks. If the client does not, the issuer must warn the client that the product may not be appropriate. Similarly, if the client declines to provide information, the issuer must warn the client that it is unable to determine whether the product is appropriate.[41] In the UK (which is subject to MiFID) this is codified into the Conduct of Business Sourcebook 10.[42]

283 Hong Kong's SFC also requires that those selling derivatives assess the client's knowledge. The Commission goes further than MiFID and requires that licensees assure themselves that the client understands the nature and risks of the products and has sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products.[43] In June 2011 more prescriptive requirements were introduced for OTC derivatives. Firms must characterise the client based on his or her knowledge of derivatives, and the licensee must provide advice to the client as to whether or not the transaction is suitable for the client. If the transaction is assessed to be unsuitable for the client, the licensee may only proceed to effect the transaction if to do so would be acting in the best interests of the client. The Commission notes that investors may be regarded as having knowledge of derivatives through training, prior trading experience or related work experience.[44]

284 Singapore has introduced similar requirements for all complex products. Intermediaries must assess the knowledge and experience of their customers, and inform customers if they do not possess sufficient knowledge or experience. If the customer still intends to proceed with the transaction, the intermediary must provide advice to the customer. Safeguards, such as a lower trading limit than what the intermediary would otherwise have imposed, must also be put in place before the customer is allowed to proceed with the transaction.

285 While Australia does not have equivalent appropriateness requirements in legislation, ASIC has recommended that issuers maintain and apply a written client qualification policy. This sets out the minimum qualification criteria that prospective investors will need to demonstrate they meet before the issuer will agree to open a new account on their behalf and the processes used to ensure clients meet the criteria.

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[40] ASIC, ***Contracts for difference and retail investors***, Report 205, http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep205.pdf/$file/rep205.pdf.

[41] Article 19(6) of the Level 1 Directive 2004/39/EC.

[42] http://media.fsahandbook.info/pdf/COBS/10.pdf.

[43] Hong Kong Securities and Futures Commission, ***Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission***, http://www.sfc.hk/sfcRegulatoryHandbook/EN/displayFileServlet?docno=H598. See in particular 5.1-5.3 of the Code.

[44] Hong Kong Securities and Futures Commission, ***Consultation Paper on Proposals to Enhance Protection for the Investing Public***, p. 70, http://www.sfc.hk/sfc/html/EN/speeches/consult/InvestingPublic.html.

286 These appropriateness obligations recognise that some inexperienced investors are unable to understand and appreciate the risks associated with some kinds of financial products – particularly those that are relatively complex. Therefore merely disclosing those risks will not lead to investors making informed decisions.

287 Some New Zealand derivatives issuers already conduct appropriateness assessments and provide education and assistance to new and inexperienced clients. Clients are dissuaded from taking on excessive risk and (where relevant) safeguards such as stop loss orders are recommended. These measures may be implemented to build long-term client relationships and more sustainable revenues, as well as supporting credit criteria.

288 There may be a case for requiring licensed derivatives issuers generally to implement appropriateness requirements. Alternatively, it could be argued that the PDS risk warning statements discussed in Chapter 2 on disclosure are sufficient to address these concerns.

289 There are a number of ways that an appropriateness requirement could be implemented in regulations. A prescriptive approach would set out procedures and standards that derivative issuers must apply to retail clients. However, given the variety of ways that derivatives might be provided to clients (in person, over the phone, online services, etc) a more flexible approach may be needed. An eligibility criterion for obtaining a licence could be that the applicant has adequate policies for ensuring that their retail clients have sufficient understanding of derivatives before allowing them to enter into contracts. Derivatives issuers will formulate their own policy and demonstrate to FMA that it is adequate. FMA may choose to issue guidance on appropriateness policies.

68. Should a process be required for ensuring that retail clients have sufficient understanding of derivatives before they enter into contracts? If so, how flexible should this be? Are there examples of good and bad practice?

7.6 Management of client funds

290 Derivatives issuers often hold significant amounts of money on behalf of clients, in the form of margins, other deposits and trading profits. In the absence of adequate custody arrangements for this money, clients are exposed to risk of loss if the issuer fails.

291 Exchange-traded derivatives and many kinds of OTC derivatives require clients to pay margins. For example, if the notional value of a contract is $100,000, the client may be required to pay an initial margin of 5 percent, or $5,000. This mitigates the risk that the client comes to owe money to the issuer at the end of the contract. If the client's position deteriorates, they may be required to make additional margin payments (sometimes called variation margins) to maintain this buffer.

292 Margin requirements are a feature of some retail OTC derivative contracts. For example, CFDs typically require initial and variation margins. There also exist some OTC contracts that have 100 percent margin requirements (i.e. the client must invest the full notional amount of the contract). These latter contracts are typically designed to replicate the experience of holding the underlying assets.

293 It has long been common international practice to hold margins for exchange-traded contracts in a client funds account that is segregated from the other accounts of futures dealers. This is required under the current law by the Futures Industry (Client Funds) Regulations 1990. Typically, these "segregated client funds accounts" pool client funds and money within the account is not the property of individual clients. Money can legally be paid out of the client funds account to meet obligations created by a client without regard to other clients. Therefore, although clients are protected from the failure of the issuer (provided the issuer complies with the regulations), under some circumstances they are exposed to the default of other clients.

294 These practices have also been extended to OTC derivatives that have margin requirements. Although the current client funds regulations were not written with OTC derivatives in mind, they are taken to apply to OTC derivatives also. There are some ambiguities in how exactly they should be applied to OTC derivatives, which are discussed in the next section.

Overseas failures and losses

295 The adequacy of client funds handling practices across different parts of the derivatives industry needs to be considered in light of overseas failures where client funds have been lost or threatened.

296 In the United States, the collapse in October 2011 of MF Global has raised questions about the safety of client funds segregation practices. For the first time, client funds were lost even for clients acquiring exchange-traded derivatives. In previous cases, such as the collapse of Lehman Brothers and Refco, exchange-traded derivative clients were spared by a combination of (a) intact segregation of client funds from other business funds, (b) the immediate transfer of margins to secure clearing houses, and (c) the ability of contracts to be transferred by the clearing house from one participant to another. In the case of MF Global, some client funds were held by clearing houses and positions were transferred to another clearing participant, but excess segregated funds were held in MF Global's client funds account. These funds appear to have been withdrawn, possibly in violation of Commodity Futures Trading Commission (CFTC) regulations.

297 In Australia, the collapse of MF Global had different impacts. Where clients had positions in ASX24 contracts, these could not be transferred and had to be closed out.[45] Client money held by the clearing house was to be returned to MF Global's administrators. However, at the time of writing this money (A$34 million) is still held by ASX due to a dispute between the administrators of MF Global's Australian and UK operations.[46] Margins provided for CFDs were held by a range of different counterparties – in some cases these were related companies that have also collapsed.[47]

Proposal – exchange-traded contracts

298 We propose that margins received as part of exchange-traded derivatives contracts continue to be held in a segregated account. These margins may be transferred to a trading participant, clearing participant or clearing house in order to meet margin requirements arising from exchange-traded contracts entered into by clients.

69.	Do you agree with the proposed treatment of client funds in regard to exchange-traded derivative contracts? Is there a preferred alternative?

[45] http://www.sfe.com.au/content/notices/2011/notice2011_214.pdf. ASX stated "ASX Clear (Futures) cannot accede to requests by individual clients for the transfer of positions from MF Global UK Limited to other Clearing Participants. Clients who wish to re-establish their positions need to enter into a client agreement with another ASX 24 Participant."
[46] http://www.deloitte.com/assets/Dcom-Australia/Local%20Assets/Documents/Services/CRG/Bus%20under%20admin/MF%20Global/Deloitte_MFGlobal_notice_to_clients_20Mar2012.pdf.
[47] Deloitte, Report to Creditors, 22 February 2012, http://www.deloitte.com/assets/Dcom-Australia/Local%20Assets/Documents/Services/CRG/Bus%20under%20admin/MF%20Global/Deloitte_MFGlobal_Administrators_section_439A_report_22Feb2012.pdf.

Proposal – wholesale OTC contracts

299 We do not propose that client funds regulations apply to wholesale OTC contracts. This is to avoid interfering with title transfer collateral arrangements between wholesale parties.[48]

70. Do you agree that client funds regulations should not apply to wholesale OTC contracts? If you disagree, what should apply, and what are the likely costs and benefits?

Proposal – retail OTC contracts

300 Within retail OTC contracts there are a spectrum of options for treatment of client money:

Increased protection ↓

- Segregation of client money, but allow use in hedging
- Segregation of client money, use of margins in hedging prohibited
- Full trust treatment of client money on behalf of individual clients
- Full trust treatment of both client money and unrealised gains on behalf of individual clients

301 As protection increases the derivatives issuer is required to hold greater amounts of capital. Assuming some protection of margins is justified, the spectrum above can be broken into a number of separate decisions:

- Should client money be held in a segregated pool, or held on trust for individual clients?
- Can client money be used for hedging? If so, what restrictions should be placed on this?
- Should clients' account balances as a whole, including unrealised gains, also be protected?

302 Client funds protection can also be traded off against other forms of protection – more stringent capital requirements, insurance, etc.

Segregated account or trust account?

303 There are two different ways to treat client fund accounts: accounts can be treated as a commingled pool of client funds (a segregated account); or funds can be held on behalf of individual clients and the money owned by each client individually accounted for (a trust account).

304 Trust accounts give additional protections over segregated accounts in that a client's funds cannot be used to meet the obligations of another client.

305 Countries differ in the extent to which they allow segregated accounts rather than trust accounts for OTC derivatives.

[48] ISDA, Submission to Australian Treasury on "Handling and use of client money in relation to over-the-counter derivatives transactions", http://treasury.gov.au/documents/2334/PDF/ISDA.pdf.

United States (retail foreign exchange dealers[49])	New Zealand	Hong Kong	Singapore	Australia	United Kingdom
No requirements	Segregated account	Segregated account	Segregated account	Segregated account – but currently under review	Trust account

306 Australia is currently considering a number of options to strengthen its client fund protections, including shifting to full trust treatment of client monies. If it continues to use segregated accounts, some options it is considering are:

- Prompt top up requirement — shorten the timeframe in which a licensee can temporarily use one client's money as margin for another client, therefore creating an incentive for the licensee to follow up payment of margin or close out relevant positions.
- Buffers requirement —prohibit the use of 'buffers' in a clients' segregated account that may be used by a licensee to hide misuse of client funds.
- Individual client account reconciliation — require licensees to reconcile client segregated accounts to the individual client level (currently client money is generally reconciled to the pooled level).

71. For retail OTC contracts, to what extent should a client's funds be segregated from the funds of the issuer and other clients?

72. Would any of the options being considered in Australia – prompt top-ups, prohibiting buffers, and individual client account reconciliation – be beneficial for retail OTC contracts in New Zealand? What are the costs of implementing these measures?

Use of client money in hedging

307 Once money is paid into a client account, there are generally protective restrictions on the purposes for which it can be used by the derivatives issuer. In most countries derivatives issuers are not generally permitted to use client funds for their own expenditure or investments unrelated to the activities of the client.

United States (retail foreign exchange dealers[50])	New Zealand	Australia	Hong Kong	Singapore	United Kingdom

[49] Note that most OTC derivatives may not be offered to retail clients in the US.
[50] Note that most OTC derivatives may not be offered to retail clients in the US.

No restrictions	Hedging with client funds allowed. Few effective restrictions due to contractual opt-out.	Hedging with client funds allowed. Few effective restrictions due to contractual opt-out.	Hedging with client funds allowed. Other general uses prohibited.	Hedging with client funds allowed. Other general uses prohibited.	Hedging with client funds prohibited.

308 These restrictions may be circumvented, however, by broad exemptions for uses of funds that have been approved by the client. The Australian Treasury has noted that "client agreements of licensees dealing particularly in OTC derivatives may contain a broad authorisation from clients for the licensees to make withdrawals from client money for any purpose whatsoever."

309 Given that such exemptions have the potential to eliminate the benefits of requiring client funds segregation, we propose to restrict uses of client funds to prescribed circumstances without allowing an opt-out through client agreements.

310 A commonly permitted use of client funds is for hedging the derivatives issuers' own risk as a result of entering into a derivative contract with a client. For example, a firm that issues a CFD over Telecom shares might hedge that position by buying Telecom shares, buying a Telecom shares futures contract, or buying a Telecom CFD from another derivatives issuer (a hedging counterparty). Some derivatives issuers use client funds to enter into these hedges. Other derivatives issuers have an explicit policy of not using client funds for this purpose.

311 Unrestricted use of client money for hedging purposes reduces the capital that firms need to hedge their positions. However, it exposes clients to a number of potential circumstances in which they may lose their investments:

- a hedging counterparty defaults, and the derivatives issuer does not have sufficient funds of its own to repay investors
- a derivatives issuer incurs a substantial liability with the hedging counterparty as a result of activities unrelated to the client (e.g. proprietary trading), and this is set off by the hedging counterparty against the funds posted to hedge client positions
- the derivatives issuer fails but funds held by the hedging counterparty are not returned to the derivatives issuer's clients before claims from other creditors.

312 Prohibiting the use of client funds for hedging, as in the United Kingdom, would remove these risks. However, it would increase the amount of capital firms required, as they would need to use their own funds to hedge client positions.

313 A less onerous alternative would be to permit use of client funds in hedging, but to place some conditions on its use. The Ministry is interested in feedback on what alternative measures would be most desirable in balancing effectiveness against cost of implementation. Some examples of potential conditions are as follows:

- Requiring that the hedging counterparty apply equivalent client funds protections to the licensee and an acknowledgement that the licensee's clients take priority over any other creditors of the licensee or hedging counterparty.
- Requiring that the hedging counterparty meet minimum standards of financial robustness. For example, some authorised futures dealers notices require that the hedging counterparty be a regulated domestic or overseas entity, such as registered New Zealand banks, overseas banks, Australian authorised deposit-taking institutions,

US futures commission merchants and companies that are registered as BIPRU 730k firms (Banks, Building Societies and Investment Firms) with the FSA.

73.	For retail OTC contracts, what restrictions should be placed on use of client money for hedging? If client money can be used by issuers to hedge client positions, what conditions should be met before this is permitted?

Protection for margins only or client funds as a whole including unrealised gains?

314 A further issue is what should be included in client funds. Client funds may potentially include funds received from clients, margins, realised gains and unrealised gains.

315 At present, New Zealand,[51] Australia,[52] Hong Kong[53] and Singapore[54] all appear to require protection of clients, margins and realised gains, although the language used in regulations is sometimes unclear in this respect.

316 The UK also includes unrealised gains.[55] This makes it necessary to specify how often unrealised gains ought to be calculated and the client funds account "topped up" to reflect client positions. The UK has detailed rules on client account reconciliation and requires this to occur daily.

74.	Should client money for derivatives that is protected include the client's unrealised gains? If so, how frequently should a client funds account be topped up?

7.7 Governance and compliance arrangements

317 Many of the regulations proposed for licensed derivatives issuers are intended to reduce the risk that investors lose money due to issuer misconduct or failure. These include segregation of client funds and property and capital adequacy and liquidity requirements. By making these legal obligations, there are incentives for derivatives issuers to implement systems that ensure they are complied with. However, in some areas there is likely to be a case for making these systems part of licencing criteria, or for mandating particular processes (e.g. audit) that serve as a check on compliance.

318 More generally, failures are much more likely to occur, and are far more damaging for clients, in derivatives issuers where there are poor risk management practices or inadequate internal controls. Even if risk management practices and internal controls are disclosed, most retail clients are unlikely to be able to assess them, and are unable to monitor compliance.

Auditing of client funds records

319 When authorised futures dealers handle client funds and property, futures dealer authorisation notices and the Futures Industry (Client Funds) Regulations require the associated records to be audited quarterly. The auditor must report any breaches to the dealer, FMA and any derivatives market of which the dealer is a participant.

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[51] Regulation 6 states: "All client money received by a dealer shall, immediately after it is received, be paid into a client bank account." Client money is defined to include money which "the dealer or any other person on its behalf holds for, or receives from or on behalf of, clients and which is not immediately due and payable on demand to the dealer or the other person for its own account".

[52] Corporations Act section 981A(1)(b) states that client money includes money paid by the client, by a person acting on behalf of the client, or "in the licensee's capacity as a person acting on behalf of the client".

[53] Securities and Futures (Client Money) Rules.

[54] Securities and Futures (Licensing and Conduct of Business) Regulations.

[55] FSA Handbook CASS 7 Client money rules.

320 Quarterly external auditing has some cost associated with it. However, it may be a useful discipline to help ensure that records remain accurate and, if combined with adequate internal controls, to detect contraventions early – if possible, before they threaten the viability of the firm and/or client funds.

321 We therefore propose to retain quarterly auditing of client funds records.

75. Should records associated with derivative client funds and property be externally audited? If so, how frequently? What are the costs associated with this auditing?

Filing and auditing of reports relating to capital adequacy and liquidity

322 FMA authorisation notices for futures dealers often require:

- Monthly reports to an auditor confirming that the firm has complied with its capital adequacy requirements.[56]
- Six-monthly prospective financial statements to an auditor (including a statement of financial position and cash flow forecasts).

323 The firm is, in turn, required to enter into an arrangement with the auditor to report any areas of concern to FMA, e.g. whether the licensee has breached, or is likely to breach, its obligations.

324 In the US, futures commission merchants are required to file monthly unaudited financial information, including balance sheets, income statements, compliance with minimum capital requirements, and client funds in segregated accounts. They also file the material affiliated persons documents referred to above.

325 We are interested in feedback on whether to continue FMA's current treatment of derivatives issuers in this respect. That is, where derivatives issuers have capital adequacy and liquidity requirements in their licensing conditions (see section 7.3), they would be required to engage an auditor, who will receive the following reports:

- monthly - a report on their compliance with capital adequacy and liquidity requirements
- half-yearly - a prospective statement of financial position and a prospective statement of cash flows.

326 The auditor would report to FMA if the licensee has breached, or is likely to breach, any of its capital adequacy or liquidity obligations.

327 An alternative is to require reporting of information directly to FMA. FMA would need to recover the costs of this monitoring from licensees. FMA may prove to be more expensive, or it could take a more risk-based approach to monitoring that reduces costs to licensees.

76. What information should be compiled and reported to ensure that licensed derivatives issuers comply with capital adequacy and liquidity requirements? Should the information be reported to an auditor, FMA, or someone else? What are the associated costs?

Other risk and compliance management requirements

328 We would value feedback that helps us to identify further risks and the methods that are used to manage them. We would also welcome views on whether adequate management of some of these risks should be a requirement for holding a derivatives issuer licence.

[56] NZX Derivatives Market participants must also report capital adequacy monthly, or more often if NZX requests. See NZX Derivatives Market Rule 4.28.2

329 We note that futures dealers' authorisation notices also often require a report to FMA on the extent to which the firm has complied with its obligations under the notice in the preceding financial year.

77. From the point of view of investors, what risks is it important for derivatives issuers to manage? Are there examples of good and bad practice?

78. Which risks, if any, should need to be managed as a requirement for holding a derivatives issuer licence? For each of these risks, should the risk management requirements be generic, e.g. "adequate systems and procedures for managing [***a specified risk***]" and assessed by FMA on a case-by-case basis, or should particular systems and processes be specified in regulations? What are the costs of these systems and processes?

7.8 Ongoing client reporting

330 Some derivatives issuers enter into contracts with investors on a one-off basis, with each party having settlement obligations at a defined future date. In this case, it is not clear that there would be benefit in derivatives issuers providing ongoing reporting to investors in respect of their relationship. Issuers will need to ensure that investors are made sufficiently aware of their settlement obligations. Ongoing reporting and confirmation obligations relating to particular derivative contracts are discussed in section 9 of Chapter 3.

331 Other derivatives issuers offer ongoing services to investors, in which:

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

332 For some of these services, some ongoing client reporting obligations may be warranted, similar to that proposed for DIMS in section 6.9 above. That is, each investor would be able to request, either in hard copy or through an electronic facility information such as:

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

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

79. Should some types of derivatives issuers be required to make information available to investors on an ongoing basis? If so, which types and what information?

7.9 Additional reporting

334 Licenced derivatives issuers will, like other issuers, be required to file annual audited financial statements. In section 3.10 we propose that all licensees report certain events to FMA that may be material to licences. FMA can require licensees to provide ongoing information to them under clause 401(3)(b) (for information relevant to verifying that licensing requirements are met).

80. Is there any additional information that licensed derivatives issuers should report to FMA?

7.10 Minimum margin requirements

335 A number of other jurisdictions impose minimum margin requirements for some types of OTC derivative contracts with retail investors. These include the United States, Singapore, Hong Kong and Japan. MAS states that "the margin requirements serve to ensure that the CMS licensee mitigates the counterparty risk to its customers when it enters into a CFD with the customers. They also serve as a safeguard to curtail excessive leveraging by customers."

336 We do not propose to introduce similar minimum margins for OTC CFDs and margin foreign exchange contracts. However, given their prevalence overseas we are interested in feedback on whether setting minimum margins would be desirable, and if so, which contracts they ought to apply to.

337 In the United States, the CFTC has imposed minimum margin requirements on OTC foreign exchange derivatives. The CFTC specifies a minimum 2 percent security deposit (of the notional value of the transaction) in the case of major currencies and 5 percent for all other currencies.[57] The CFTC had proposed to raise this to 10 percent.

338 In Singapore licensees that deal in CFDs are subject to minimum margin requirements.[58] The minimum margin requirements range from 2 percent of the notional value of the transaction for CFDs on foreign exchange, to 5-20 percent for CFDs on equity, and 20 percent for CFDs on any other underlying assets. In cases where the derivative dealer provides stop-loss features, the margin requirements can be lowered. MAS is considering raising the minimum margin requirement for CFDs on foreign exchange to 5 percent, and extending this to other leveraged foreign exchange contracts.[59]

339 In Hong Kong, the minimum initial margin level for leveraged foreign exchange contracts trading is set at 5 percent, while in Japan, it was raised from 2 percent to 4 percent in August 2011.

81.	Should any margined OTC derivative contracts be subject to minimum margin requirements, similar to those in the United States, Singapore, Hong Kong and Japan? If so, which contracts and what level of margin? What are the potential costs and benefits?

[57] CFTC Regulation 5.9, http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=fba210a027917b2178ba5dc72a2dfd12&rgn=div8&view=text&node=17:1.0.1.1.5.0.7.9&idno=17.

[58] Securities and Futures (Financial and Margin Requirements) Regulations, Table 18 of the Fourth Schedule.

[59] Monetary Authority of Singapore, ***Review of Regulatory Framework for Unlisted Margined Derivatives Offered to Retail Investors***, May 2012, http://www.mas.gov.sg/~/media/resource/publications/consult_papers/2012/Consultation%20Paper_28%20May%202012.ashx

8. Requirements specific to person-to-person lending services

8.1 Overview of regulations required for person-to-person lending services

340 Part 6 of the FMC Bill specifies that a person may hold a market services licence to act as a provider of intermediary services that are prescribed in the regulations. Clause 6 of Schedule 1 contains an exclusion for offers of financial products through such licensed intermediaries.

341 We propose to prescribe person-to-person lending services[60] as one of the intermediary services for which a licence may be issued. This will enable providers of person-to-person lending services to obtain a licence. Offers made through the provider will then be able to make use of the exclusion in clause 6 of Schedule 1. This means that people will be able to make offers through the provider without needing to comply with Part 3 and 4 of the FMC Bill (i.e. they will not have to register a PDS and appoint a supervisor).

342 Unlike other categories of licences in this discussion paper, intermediary services licences are voluntary. A person may act as a provider of a person-to-person lending service without obtaining a licence. However, if the provider is unlicensed, the borrowers who make use of the service would have to either comply with Part 3 of the FMC Bill or make offers that are covered by one of the other exclusions in Schedule 1 (e.g. small offers).

343 Licences for person-to-person lending services are subject to the generic eligibility criteria and ongoing conditions discussed in section 3 of this chapter. Other specific criteria and conditions will be specified in regulations, and could potentially cover:

- operating in a fair, orderly and transparent way
- mechanisms for establishing the identity and creditworthiness of borrowers
- client agreements
- handling of client funds, such as the use of segregated trust accounts
- limits on size of loans to each borrower and the amount that can be lent by each lender
- information to be provided to lenders and borrowers
- contingencies for the repayment of lenders in the event the provider ceases operating.

344 However, in considering these matters we are mindful that person-to-person lending services are relatively new, and the models used by providers may evolve over time. Regulations should avoid inhibiting beneficial innovations through over-prescription.

345 Additionally, some requirements may be self-enforcing to some extent – if there is good information about the reliability of providers (e.g. expected and actual defaults), then over time lenders and borrowers are likely to move to more reliable providers. However, other possibilities are that lenders find it difficult to determine the reliability of providers, there is a long period of unexpected losses from services, or that unreliable providers put many potential lenders off person-to-person lending altogether.

82.	Are there any other specific licensing requirements that should apply to person-to-person lending services?

[60] Person-to-person lending services – sometimes referred to as "peer-to-peer lending services" or "social lending" – provide a platform, usually internet-based, that matches individual lenders and borrowers to each other. Lenders lend money to borrowers without the intermediation of a traditional deposit-taking institution.

8.2 Definition of person-to-person lending service

346 For FMA to issue licences to person-to-person lending services, and for the exemption to apply to the activities conducted by that service, the regulations must define what a person-to-person lending service is and what activities can be covered by a licence.

347 We propose a definition along the following lines: a service that facilitates loans by matching potential borrowers to one or more lenders, in which neither the borrower nor the lenders are associated with the provider.

348 Person-to-person lending providers are distinguished from deposit-takers by payments from lenders going to specific borrowers. Repayment to the lender depends on repayment by those specific borrowers. In contrast, a deposit-taker borrows money itself from lenders, pools the proceeds, and uses them to make loans to borrowers – profiting from the difference between the interest rate it borrows at and the interest rate it lends at.

349 The latter part of the definition prevents arrangements in which the provider or a person associated with the provider lends or borrows money under the licence. For example, a finance company could not obtain a person-to-person lending service licence and circumvent normal securities laws by "matching" itself to lenders.

350 An additional consideration is whether the exempt service should be restricted to situations where the borrowers are individuals, rather than body corporates, and where the lending is unsecured. It may be more difficult to assess the creditworthiness of a body corporate, and the amount of money that is sought will often be far higher. Collateral is another complicating factor. The proposal to prescribe crowd-funding platforms as a second kind of licensed intermediary (see section 9 below), along with the small offers exemption (clause 12 of Schedule 1) may be better mechanisms for addressing small business fund raising. The rest of this section will assume unsecured lending to individuals borrowers.

83. Do you agree with the proposed definition of a person-to-person lending service?

84. Should the definition of person-to-person lending services be confined to services that provide for unsecured lending to individuals?

8.3 Operate in a fair, orderly and transparent way

351 We propose that an overarching condition of a person-to-person lending licence be a requirement to operate the service in a fair, orderly and transparent way. This would be a condition of licences under clause 400(1)(c). This is equivalent to the proposed statutory requirement for an operator of a financial product market: "to the extent that is reasonably practical, do all things necessary to ensure that each of its licensed markets is a fair, orderly and transparent market" (see clause 312 of the FMC Bill).

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

353 In light of this condition being an operating principle rather than a clear rule, we do not propose to make providers liable for breaches of it under clause 446(4)(o). However, it will be enforced by FMA through the use of its powers under Part 6, subpart 3 (e.g. censure, requiring the licensee to submit an action plan to remedy the issue, directions and the potential for suspension or cancellation of the licence).

85.	Do you agree that a condition of a person-to-person lending services licence should be to operate the service in a fair, orderly and transparent way? Should breach only have licensing consequences?

8.4 Mechanisms for establishing the identity and creditworthiness of borrowers

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

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

356 If lenders are to some extent reliant on providers, it is important that any mechanisms to verify the identity and creditworthiness of borrowers are as robust as practical.

357 In the United Kingdom, the P2P Finance Association requires that its members maintain reasonable credit assessment and anti-fraud measures including membership and reporting to anti-fraud association CIFAS.[61]

358 We propose that where lenders are reliant on the provider, providers must have robust mechanisms for establishing the identity and creditworthiness of borrowers as a criterion for obtaining a licence. This would be an eligibility criterion under clause 394(b). As these mechanisms will depend on the nature of the participants and the methods available at a given time, we do not propose to prescribe any specific standards. However, we would be open to suggestions for standards that could be required and revised over time.

86.	Should eligibility criteria for a person-to-person lending services licence require robust mechanisms for establishing the identity and creditworthiness of borrowers, where lenders place reliance on the provider? Are there any specific standards that should be required?

8.5 Client agreements

359 Under the FMC Bill, person-to-person lending services may be required to enter into a client agreement with borrowers and lenders, and regulations can require that the agreement include certain provisions, or deem provisions to be contained in the agreement.

360 The UK's P2P Finance Association operating principles state that each member's terms and conditions should cover (i) eligibility to use the platform; (ii) registration and membership set-up; (iii) how the borrowing and lending processes work; (iv) segregation of funds; (v) how loan contracts are concluded; (vi) how loans are serviced; (vii) processes for the recovery of missed payments; (viii) the fees and charges that apply; (ix) variation (x) termination; (xi) use of personal data; (xii) liability for user content posted on the platform; (xiii) limits on liability; and (xiv) complaints handling.

[61] Peer-to-Peer Finance Association Operating Principles (6 September 2011), http://www.p2pfinanceassociation.org.uk/wp-content/uploads/2011/12/Peer-to-Peer-Finance-Association-Operating-Principles-Version-3-06-09-11-Final1.pdf.

361 We consider that within the structure provided by the FMC Bill, some of the above is information best provided through other documents and web pages (e.g. “How it works”, “About us” and “frequently asked questions”) rather than in a client agreement.

362 We propose to prescribe that providers enter into agreements with borrowers and lenders, and to require those agreements to contain the following (in addition to anything that the provider includes voluntarily):

- how the borrowing and lending processes work
- segregation of funds
- how loan contracts are concluded
- how loans are serviced
- processes for the recovery of missed payments
- the fees and charges that apply.

Contracting out of functions

363 We propose an equivalent to clause 133 (contracting out of management functions) for person-to-person lending service providers. If a licensee engages a third party to perform a function:

- the licensee must take all reasonable steps to ensure those functions are performed in the same manner, and are subject to the same duties and restrictions, as if the licensee were performing them directly
- the licensee must take all reasonable steps to monitor the performance of those functions
- the licensee will be liable for any acts and omissions of any persons that are engaged to perform those functions, as if they were the provider’s acts or omissions.

87.	Do you agree that if a person-to-person lending service licensee contracts out functions, it should be subject to an equivalent of clause 133 of the FMC Bill?

8.6 Handling of lender and borrower funds

364 The obligations of “brokers” in Part 3A of the Financial Advisers Act 2008 are likely to apply to person-to-person lending services where they handle funds provided by a lender or a borrower. These include requirements to exercise care, diligence and skill, pay client money into a separate trust account, account for client money and property and keep records of client money and property.

365 We expect most funds received by a person-to-person lending service to be transferred promptly from lender to borrower and vice versa. We would be interested in feedback on what circumstances might arise that would make it necessary to hold on to lender or borrower funds for longer periods of time.

88.	Apart from the broker obligations in Part 3A of the Financial Advisers Act 2008, are there any additional requirements that should apply to person-to-person lending services when they handle funds provided by a lender or a borrower?

8.7 Limits on size of loans and the amount that can be lent

366 The licensed intermediaries regime is intended to provide for relatively small-scale fund raising, where the costs of compliance under the normal PDS regime would be likely to far outweigh the benefits of the money raised. For this reason, fund raising through a licensed intermediary would generally be subject to a size cap.

367 Many person-to-person lending services are provided primarily, or exclusively, to facilitate the making of small, personal loans. If this is the focus of the exemption for licensed person-to-person lending services, there may be a case for a relatively small cap on the size of loans – for example, $50,000 or less over a 12 month period. This would be expected to significantly reduce the degree of regulation that needs to be imposed on licensees, and directly or indirectly on borrowers, compared to if a much larger cap is adopted. Other exemptions, such as the small offers exemption (up to $2 million in a 12 month period from up to 20 persons) and an exemption for offers made through licensed crowd-funding platforms (see section 9 below) could be used for larger fund raisings by businesses.

368 A cap on the amount that any one person can lend through the service might also be appropriate – for example, $10,000 per person in a 12 month period.

369 The size of these caps could be specified in regulations, or otherwise left to FMA-imposed conditions that would be individually set.

89. What size caps should be placed on lending and borrowing through a licensed person-to-person intermediary? Should they be set in regulation, or left to FMA conditions?

8.8 Information to be provided to borrowers and lenders

370 We consider that users of person-to-person lending services will need access to information about how the service operates, their rights, and the risks involved. The information that users need to understand includes:

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

371 Some of this will be in the client agreement (see above), but it is important that users get an appreciation of these matters before seeing the agreement, and also have a resource to refer to in future.

372 The FMC Bill provides for a “service disclosure statement” that must be given to customers before providing the service. Regulations can specify the content of this. However, where person-to-person lending services are internet-based, our preferred alternative is to allow providers to provide the information required in relevant places on their web sites. This may make the information more accessible and likely to be read than if it is in a single document.

90. Apart from the client agreement, what disclosure should be required to be made to borrowers and lenders about how the service operates, their rights and the risks involved? What is the best mechanism for providing this?

8.9 Contingencies for repayment if the provider ceases to operate

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

374 We propose that one of the eligibility criteria for person-to-person lending services be that they have adequate arrangements to ensure the orderly administration of its customers' contracts in the event that it ceases to operate the service.

375 The UK's P2P Finance Association requires that its members make such arrangements, which may be implemented by the service provider or a reputable third party. These are required to include:

- sufficient manpower to administer the contracts in run-off
- a suitable collection and payment process for repayments
- a suitable disbursement process for net proceeds due to lenders
- the ability for customers to communicate with the operator
- maintenance of requisite licence approvals
- compliance with applicable law and rules
- allowance for office and sundry expenses.

91. Should an eligibility criterion for a person-to-person lending services licence include having adequate arrangements to ensure the orderly administration of customers' contracts in the event that it ceases to operate the service? If so, should the detail of these requirements be set out in regulations or left to FMA on a case-by-case basis?

9. Requirements specific to crowd-funding services

9.1 Overview of regulations required for crowd-funding platforms

376 Crowd-funding refers to the process of pooling a large number of small contributions to fund a business or project, generally over the internet.

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

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

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

380 We propose to provide an exception for crowd-funding through specifying a "crowd-funding platform" as a second category of prescribed intermediary services. This will enable providers of crowd-funding platforms to obtain a licence. As with person-to-person lending services, offers made through the provider will then be able to make use of the exclusion in clause 6 of Schedule 1. This means that people will be able to make offers through the provider without needing to comply with Part 3 of the FMC Bill (i.e. they will not have to register a PDS and appoint a supervisor).

381 As in the United States, an exception for issuers using crowd-funding platforms would require consideration of both:

- the eligibility criteria and conditions that should be applied to the platform
- the conditions that should be imposed on issuers making use of the platform.

382 Licences for crowd-funding platforms will be subject to the standard eligibility criteria and ongoing conditions (applicant is a fit and proper person to hold the licence, etc).

383 Other specific criteria and conditions will be specified in regulations.

Scope of "crowd-funding platform"

384 As crowd-funding platforms are a new mechanism for firms to raise capital, it is difficult to anticipate what forms of crowd-funding will prove most beneficial and what regulatory problems they will pose. This makes it hard to design an effective regulatory environment.

385 We consider that some limits on the likely scope of "crowd-funding platforms" are inherent in the FMC Bill. The FMC Bill already provides an exemption for "small offers" of up to $2 million from up to 20 investors each year (clause 12 of Schedule 1). These offers do not need to go through a licensed crowd-funding platform; nor does a person require a licence to intermediate these offers. Licensed crowd-funding platforms are therefore likely to be focussed on offers to larger numbers of investors, generally involving smaller amounts of money per investor.

386 In light of the above, it may be necessary to provide regulations for a narrow range of crowd-funding services in the first instance, and then look at allowing more flexibility as proposals for different kinds of services arise. For example, the regulations could initially be targeted at internet-based platforms for raising equity capital along the lines of CrowdCube. Alternatively, if a broader concept of a crowd-funding platform is adopted it may be necessary to give a greater amount of flexibility to FMA about what kinds of eligibility criteria and conditions can be imposed.

387 Depending on the scope of the crowd-funding regime, regulations could potentially cover matters such as:

- a general obligation for the crowd-funding platform to operate in a fair, orderly and transparent way
- disclosure to investors
- mechanisms for establishing the identity and investment readiness of issuers
- limits on investments in each issuer and the amount that can be invested by an investor
- investor suitability
- restrictions on activities of the crowd-funding platform.

388 Another issue is how the exemption for offers made through a crowd-funding platform interacts with the small offers exemption in clause 12 of Schedule 1.

92. What kinds of crowd-funding platforms should be a prescribed intermediary services?

93. What kinds of requirements should apply to licensed crowd-funding platforms?

9.2 General obligation to operate in a fair, orderly and transparent way

389 As with person-to-person lending services, we propose that an overarching condition of a crowd-funding platform licence be a requirement to operate the service in a fair, orderly and transparent way. This is equivalent to the proposed statutory requirement for an operator of a financial product market: "to the extent that is reasonably practical, do all things necessary to ensure that each of its licensed markets is a fair, orderly and transparent market" (see clause 312). The implications of this will vary according to the design of the service.

390 In light of this condition being an operating principle rather than a clear rule, we do not propose to make providers liable for breaches of it under clause 446(4)(o). However, it will be enforced by FMA through the use of its powers under Part 6, subpart 3 (e.g. censure, requiring the licensee to submit an action plan to remedy the issue, directions and the potential for suspension or cancellation of the licence).

94. Do you agree that a condition of a crowd-funding platform licence be to operate the service in a fair, orderly and transparent way? Should breach of this condition only have licensing consequences?

9.3 Disclosure to investors

391 Any exclusion for crowd-funding must be consistent with the purposes of the FMC Bill. While the prescribed intermediary exclusion removes the regulatory obligations associated with traditional offers of securities, the regulation of crowd-funding platforms must be consistent with the confident and informed participation of businesses, investors, and consumers in the financial markets, and the development of fair, efficient, and transparent financial markets.

392 Where crowd-funding platforms are internet based, they create new ways to achieve these purposes. Instead of individual investors making investment decisions based on an issuer-prepared PDS, crowd-funding allows open, transparent, two-way communication between the issuer and investors. Instead of due diligence processes and adviser recommendations it draws on the ‘wisdom of the crowd’ to ascertain the quality of investment opportunities and uncover risks.

393 There are a range of options for providing information to investors about issuers making use of the platform.

394 One option would be to specify a high-level standard that information facilities must meet, and give FMA discretion to approve or reject a crowd-funding platform’s proposed mechanism for information provision. For example, the standard might be that the information facility must be likely to allow potential investors to make informed decisions about whether or not to invest in the businesses on the platform. This has the advantage of allowing maximum flexibility for platforms to develop new mechanisms for information provision. However, it places a difficult task on the regulator to assess proposed mechanisms on a case-by-case basis, and may raise concerns about the regulator taking either an overly liberal or restrictive approach.

395 Alternatively, the regulations could specify more concrete requirements that information facilities must meet. For example, providing some minimum information about the business and its plans, an open forum for two-way communication between businesses and investors and providing visibility as to the funding currently pledged to each business against its fund raising goals.

Example: CrowdCube

396 UK-based CrowdCube requires fundraising businesses to provide the following information to it:

- company name, number
- owner/director contact information
- investment required, company valuation and equity offered (percent)
- description of investment opportunity
- exit strategy
- current funding sources and investments already secured
- business plan
- financial forecasts for the next three years – including cash flow, profit and loss and balance sheet
- current number of employees and estimated employees in three years
- whether or not the company had revenue and profit last year.

397 CrowdCube provides this information to investors. It also provides, among other things:

- the amount that has been invested so far, the number of investors and their usernames
- additional information about the company from the companies registry
- additional information provided by the company
- a public question and answer forum, where potential investors post questions to the company and the company responds.

95.	What approach should be taken to the provision of information through crowd-funding platforms?
96.	What information about an issuer should the issuer and the crowd-funding platform be required to provide to investors?

9.4 Mechanisms for establishing the identity and investment readiness of issuers

398 As with person-to-person lending services, investors and regulators are likely to expect a licensed crowd-funding platform to conduct certain checks on the issuers that use its services. At a minimum these might include verifying the identity of the issuer and ensuring that the directors, senior managers and substantial security holders of the issuer are of good character. Other information provided by the issuer may be checked for consistency with public sources (e.g. companies register). In the United States, the JOBS Act requires crowd-funding intermediaries to "take such measures to reduce the risk of fraud with respect to such transactions, as established by the SEC, by rule, including obtaining a background and securities enforcement regulatory history check on each officer, director, and person holding more than 20 percent of the outstanding equity of every issuer whose securities are offered by such person."

399 Some crowd-funding platforms may go much further than this – including performing some of the analysis and due diligence that investors or third parties would, in a normal offer, undertake on the basis of a PDS and their own interactions with the issuer.

400 The extent of the crowd-funding platform's role is likely to be inversely related to the amount and detail of information that needs to be disclosed by issuers to investors. The greater the role of crowd-funding platform in screening and assessing issuers and presenting information to investors, the less this role needs to be performed by issuers and the more useful and digestible the information is likely to be to individual investors.

97.	What checks should crowd-funding services be required to perform in respect of the issuers that use its platform? How far should the role of the crowd-funding platform extend in assessing the investment readiness of issuers?

9.5 Limits on investments

401 The crowd-funding exemption in the US JOBS Act is subject to restrictions on the maximum amount that may be raised by an issuer, and limits on how much each investor may contribute. The annual aggregated limit on the amount each person may invest ranges from 2 percent for people earning (or worth) up to $40,000, up to $10,000 for people earning (or worth) $100,000 or more.

402 We propose to implement investment limits to ensure that crowd-funding services are not used for large offerings for which a PDS should be prepared, or other exemptions relied upon.

403 We propose maximum capital raised per issuer of $2 million per annum, to align with the small offers exemption in clause 12 of Schedule 1 the FMC Bill.

404 Our starting point is an annual aggregated limit of $10,000 per person (i.e. similar to the maximum limit in the US). For simplicity, we do not propose to scale the limit for income or wealth.

98.	Do you consider a maximum capital raised per issuer of $2 million per annum is appropriate for a licensed crowd-funding platform?
99.	Do you consider an annual aggregated limit of $10,000 per investor is appropriate for a licensed crowd-funding platform?

9.6 Investor suitability

405 The US JOBS Act requires that funding portals ensure that each investor: (1) reviews investor education materials; (2) positively affirms that the investor understands that the investor is risking the loss of the entire investment, and that the investor could bear such a loss; and (3) answers questions that demonstrate that the investor understands the level of risk generally applicable to investments in startups, emerging businesses, and small issuers and the risk of illiquidity.

100. Should crowd-funding platforms have similar investor education requirements as JOBS Act registered funding portals in the US?

9.7 Restrictions on activities of the crowd-funding platform

406 The US JOBS Act restricts a number of activities of a registered funding portal, which can be supplemented by SEC rulemaking. Registered funding portals must not:

- provide investment advice or make recommendations
- solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal
- compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal
- hold, manage, possess, or otherwise handle investor funds or securities
- compensate promoters, finders, or lead generators for providing the intermediary with the personal identifying information of any potential investor
- allow its directors, officers, or partners (or any person occupying a similar status or performing a similar function) to have a financial interest in any issuer using the services of the intermediary.

407 These are intended to ensure that funding portals act as neutral brokers between businesses and investors without incentives to mislead investors.

408 We propose to restrict the giving of financial advice in relation to businesses listed on the platform. However, other restrictions may be covered by the proposed definition of crowd-funding (which doesn't include offers of financial products issued by persons associated with the platform), or may be otherwise unnecessary in New Zealand.

101. Do you agree that crowd-funding platforms should be prohibited from giving financial advice in relation to businesses listed on the platform?

102. Are there any other restrictions that should apply to the activities of crowd-funding platforms?

9.8 Interaction with small offers exemption in clause 12

409 As well as the exemption for offers made through prescribed intermediary services (such as crowd-funding platforms), the FMC Bill provides a separate exemption for "small offers" of up to $2 million from up to 20 investors each year (clause 12 of Schedule 1).

410 This creates a risk that an issuer using a crowd-funding platform is able to circumvent the conditions or limits placed on fund raising by asserting that some of the offers to investors using the platform are exempt under the small offers exemption in clause 12 rather than the licensed intermediaries exemption in clause 6. For example, an issuer who breaches the proposed $2 million per annum cap for a crowd-funding platform might assert that the largest 20 investments were made in reliance on clause 12 rather than clause 6. The two exemptions could be combined to raise $4 million over 12 months – double the intended cap. Another possibility is that issuers use the crowd-funding platform to identify investors to make exempt small offers to without complying with the rules of the platform. In the worst case, investors might believe that the issuer is complying with rules that it is not.

411 Some options are:

- Issuers making use of the licensed intermediaries exception not be permitted to rely on the small offers exemption for a 12-month period following an offer under the licensed intermediaries exception.
- Issuers making use of the small offers exemption at the same time as they are listed on a crowd-funding platform must disclose to investors that their offer is separate, and is not covered by the crowd-funding platform's rules.
- Any capital raised in reliance on the small offers exemption must be subtracted from the maximum size cap under the licensed intermediaries exemption, and vice versa.

103. What is the best way to deal with risks that come from issuers making use of both the licensed intermediaries exemption and the small offers exemption?

10. Issue of licences: procedural requirements

412 The FMC Bill includes a number of procedural requirements in relation to licensing that need to be spelt out in regulations. This includes the persons that FMA must consult with before making a decision to issue a licence, and who it must give notice to after issuing a licence. Proposals for these issues are addressed in this section.

Clause 395(1)(c): Requirements for FMA to consult before making licensing decision

413 Clause 395(1) sets out what FMA must do before making a decision to issue a licence under clause 394.

414 Clause 395(1)(c) allows the prescription of persons that FMA must consult with before it makes a decision. This power is designed to ensure that FMA consults with appropriate agencies or organisations that may also have an interest in the proposed licensing of the applicant.

415 The Securities Trustees and Statutory Supervisors Act 2011 (section 18(1)) contains a corresponding provision to clause 395(1)(c) in relation to the licensing of securities trustees and statutory supervisors. It obliges FMA to consult with RBNZ if the licence will cover a debt security issued by a deposit taker, and the Registrar of Retirement Villages if the licence will cover a retirement village.

416 We propose to adopt a similar approach for the licences that will be issued under the FMC Bill. In context of the licences that will be issued under this legislation, we consider that it is appropriate for FMA to consult with RBNZ if the applicant is a bank, non-bank deposit taker or a licensed insurer. This will ensure that FMA is able to take into account the views of RBNZ in respect of its experience with the applicant.

Clause 396(1)(b): notice to "prescribed person"

417 Clause 396 sets out who FMA must give written notice to of its decision to grant a licence or not. Clause 396(1) provides that notice must be given to the applicant and "every other prescribed person".

418 We consider that this provision should be treated in the same way as clause 395(1)(c). This would result in FMA having to notify RBNZ in respect of banks, non-bank deposit takers and licensed insurers. We do not propose to require FMA to notify any other agency or organisation of its decision.

104. Do you consider that FMA should be required to consult with and notify RBNZ when licensing banks, non-bank deposit takers and licensed insurers? Are there other organisations or agencies that FMA should consult with and notify?