OFFICE OF THE MINISTER OF COMMERCE

The Chair
Cabinet Economic Growth and Innovation Committee

Financial Markets Conduct Bill: Approval of Supplementary Order Paper

Proposal

1. This paper seeks approval of a supplementary order paper to the Financial Markets Conduct Bill. It also seeks approval of some matters of policy contained in the supplementary order paper.

Executive Summary

2. The Financial Markets Conduct Bill (FMC Bill) seeks to provide an enduring financial market conduct regulatory regime that will help to deepen New Zealand's capital markets and promote confident and informed participation by businesses and investors in financial markets.

3. This is a significant regulatory reform that will provide a step-change in the quality of regulation of the capital markets. Because of its regulatory importance, passing the FMC Bill is one of the main initiatives included in the *Building Capital Markets* progress report on the Business Growth Agenda.

4. Over recent months, the Ministry of Business, Innovation & Employment has been working with the Financial Markets Authority (FMA) and external stakeholders such as the Shareholders Association, issuers, law firms and banks to identify changes that should be made to the FMC Bill by supplementary order paper (SOP).

5. The vast majority of changes proposed in the SOP are consistent with the policy in the FMC Bill approved by Cabinet. Most are purely minor or technical matters. A few are, however, significant enough to lead me to seek Cabinet policy approval through the policy recommendations in this paper.

6. The accompanying SOP gives effect to the changes. There will be separate SOPs relating to dividing the FMC Bill into a Financial Markets Conduct Bill and a separate Financial Markets (Repeals and Amendments) Amendment Bill (or similar name). This paper seeks approval to release the SOPs.

Context

7. The FMC Bill seeks to provide an enduring financial market conduct regulatory regime that will help to deepen New Zealand's capital markets and promote confident and informed participation by businesses and investors in financial markets.

8. The FMC Bill seeks to achieve these objectives by:

   a. Ensuring that investors are provided with understandable and accurate information to guide their decision making, including by requiring standardised and comparable product disclosure statements.

   b. Ensuring that governance arrangements in respect of financial products available to the public are robust, including by requiring fund managers to be licensed.

c. Minimising compliance costs for those raising capital by removing unnecessary processes, including by providing new exclusions for listed issuers that seek to raise additional capital.

d. Promoting innovation and effective competition, including by facilitating lower-cost public listed markets.

9. This is a significant regulatory reform that will provide a step-change in the quality of regulation of the capital markets. Because of its regulatory importance, passing the FMC Bill is one of the main initiatives included in the *Building Capital Markets* progress report on the Business Growth Agenda.

10. The reforms in the FMC Bill are predominantly supported by industry. It was reported back with unanimous approval by the relevant select committee in 2012, and had strong support at its second reading early in 2013.

    [Withheld under section 9(2)(f)(iv) of the Official Information Act 1982].

11. Cabinet approved the policies reflected in the FMC Bill in February 2011 [CBC Min (11) 4/3] and May 2011 [CBC Min (11) 6/9]. Cabinet approved the Bill for introduction in October 2011 [LEG Min (11) 22/4].

Supplementary order paper development

12. The FMC Bill is a large and complex reform. The version reported back by the select committee is more than 650 pages long. Over the last few months officials from the Ministry of Business, Innovation & Employment have been working with FMA, Parliamentary Counsel and external stakeholders such as the Shareholders Association, law firms and banks to identify changes that should be made to the FMC Bill by SOP. Some changes have resulted from responses to the consultation on the FMC Regulations, for which submissions closed on 1 March 2013.

13. It is inevitable with such a large Bill that there will be matters that require consideration and possible amendment. It is also important that a line is drawn at some point and the Bill enacted. In my view we have reached that point. The FMC Bill should now proceed through its final stages, subject to the amendments in the SOP.

14. The SOP has been prepared as a *revision-track SOP*, comprising a mark-up of the entire Bill showing the proposed changes. The resulting document is long, but this format will make the proposed changes much more discernible for members and the public.

15. The vast majority of changes proposed in the SOP are consistent with the policy in the FMC Bill approved by Cabinet. Most are purely minor or technical matters. A few are, however, significant enough to lead me to seek Cabinet policy approval. These matters are discussed below. All the changes are described in the explanatory note at the beginning of the SOP.

16. There will also be a separate SOP containing a motion to divide the Bill. That SOP will split out Part 9 and Schedule 4 of the FMC Bill into a separate Financial Markets (Repeals and Amendments) Amendment Bill (or similar name) and a connected SOP that changes headings in Part 9.

Policy approvals

17. The issues noted below require policy decisions. I consider that they are all essential in order to further the aims of the FMC Bill and to make it work effectively on entry into force.

Purpose clauses of related legislation

18. The FMC Bill's overarching purposes are set out in clauses 3 and 4. The main purposes 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.

19. The FMC Bill's additional purposes include timely, accurate and understandable disclosure, appropriate governance, avoiding unnecessary compliance costs, and innovation and flexibility.

20. These purposes are consistent with the objective and functions of FMA, as they were developed with them in mind. These purposes are not, however, exactly the same as the particular purposes of the other core financial markets legislation enforced by FMA, being the:

    - Auditor Regulation Act 2011
    - Financial Advisers Act 2008
    - Financial Markets Supervisors Act 2011 (currently named the Securities Trustees and Statutory Supervisors Act 2011)
    - Financial Service Providers (Registration and Dispute Resolution) Act 2008
    - Part 4 and Schedule 1 of the KiwiSaver Act 2006.

21. In my view these purpose clauses should be reviewed for consistency with the main and additional purposes of the FMC Bill, and changes made, where appropriate, to align the purposes of these Acts with the FMC Bill. Consistency has the benefit of signalling to FMA, investors, market participants and the courts that the individual parts of the regime contribute to the same broad outcomes.

22. In the SOP I propose that the Financial Advisers Act 2008 and Financial Markets Supervisors Act 2011 be amended to identify that the overarching purposes of the FMC Bill are also purposes of these Acts. I believe that it is important to do this now, because those Acts are closely integrated into the FMC Bill's regulatory regime. I intend to consider whether changes should be made to the purposes of the Financial Service Providers (Registration and Dispute Resolution) Act 2008 as part of the amendments to that Act being progressed through the Consumer Credit and Financial Services Law Reform Bill which is currently being drafted.

Exclusions from disclosure – $500,000 threshold and Schedule 1 disclosure

23. The FMC Bill provides exceptions from the normal disclosure and governance requirements for particular kinds of offers of financial products in Schedule 1. The exceptions are intended to facilitate 'private offers' to investors who do not require a product disclosure statement (PDS) because they are sophisticated or related to the issuer, or the investor can access the information that they need about the issuer without a PDS.

24. I propose increasing one of the thresholds in Schedule 1 and widening the scope of the regulation-making powers that enable limited disclosure and other safeguards to be imposed where offers are made in reliance on Schedule 1 exclusions.

25. Cabinet in its February 2011 decisions agreed to carry over some existing exclusions from the Securities Act 1978 into the FMC Bill, including the private placement exception [CBC Min (11) 4/3 paragraph 32.5 refers]. This exception applies if the minimum amount payable on acceptance is at least $500,000. It is important to note that this rule requires the payment of $500,000 up front for the same products, and does not apply to discretionary investment management services (DIMS).

26. The private placement exclusion has attracted recent media and industry comment. The Shareholders Association, in particular, is concerned that this exclusion and other carried-over Securities Act exclusions such as those for relatives and close business associates should not be carried over into the FMC Bill. The Shareholders Association has proposed replacing those rules with requirements that investors expressly opt out of the regime in a certificate and for those certificates are confirmed by an independent person.

27. The first question is whether there should be a threshold, and if so what should it be. I believe that it is appropriate to set bright line tests for wholesale investment. Such tests reduce costs of capital raising by providing an objective test. Further, I am not aware of evidence that suggests that the current test in the Securities Act has been misused.

28. Replacing the threshold with an opt-out would allow almost any retail investor to opt out of the regulatory protections of the Bill through a witnessed opt-out certificate. On its own, an opt-out provides little protection against misuse and it is not a sufficient basis for avoiding disclosure to investors. There is too great a risk of unsophisticated investors being induced to sign such a statement to gain access to investments offered to them under terms that require certification. At the same time, a blanket requirement for investors to obtain certificates may unnecessarily interfere with and impose undue extra costs on transactions that are “truly” wholesale, such as funding arrangements for large corporate entities.

29. A recent Ministry of Business, Innovation & Employment discussion paper on the content of regulations to be made under the FMC Bill (FMC regulations discussion paper) sought submissions on the $500,000 amount, and asked whether it should be increased to $750,000 or $1 million. There was little industry support for a change, with submitters believing that there were few problems with the current level, alignment with Australia (which currently also uses $500,000, although the Australian Government has consulted on increasing the amount), and that increasing the amount would likely lead issuers to rely on other exceptions instead.

30. The starting point is that all offers, whether or not made under the exclusions, are subject to the fair dealing provisions of Part 2 of the FMC Bill (see below). This provides strong incentives for market participants to comply with the spirit and intention of the wholesale investor framework. It also means that misleading and deceptive conduct and false representations are actionable even if the disclosure is not required under Part 3 of the FMC Bill.

31. In my view, the amount should be set at a level at which it is reasonable to expect an investor to seek advice and undertake due diligence on the target investment. It should be an amount that is out of the reach of a retail investor who might otherwise be encouraged to put all his or her eggs in one basket. It should not be set so high as to make the exclusion meaningless in light of the other exclusions in the FMC Bill.

32. I propose that the amount be increased to $750,000. While the threshold is arbitrary, this level places it significantly above the median house price in all regions in New Zealand, but is a realistic amount to expect for a private placement. It reflects that significant time has passed since the original $500,000 amount was set in Australia before being adopted in New Zealand. I note that the amount is able to be subsequently increased by regulations.

33. The second issue is whether investors should have to consciously decide that they are content to invest without the full protections of a regulated offer under the FMC Bill. There is an underlying concern that some investors who come within the exclusions may not have made a conscious choice to invest in an excluded offer.

34. The FMC Bill also provides for the additional safeguards described in clauses 26 and 28 of Schedule 1 to be implemented through regulations even if offers are made under the exclusions. These provisions only apply in circumstances that may be prescribed in regulations. As a result, issuers using exclusions can be required to make limited disclosure to investors and to comply with governance and other requirements. Alternatively, the exclusion might not to apply in certain circumstances. Accordingly, the FMC regulations discussion paper sought submissions on whether the regulations should require a “term sheet” for employee share offers or a warning to investors under the small offer exclusion.

35. At present, however, clauses 26 and 28 of Schedule 1 do not extend to all the wholesale investor exclusions in Schedule 1, and there is no explicitly provision for acknowledgements or other forms of certificate to be obtained from the investor.

36. I believe that in some circumstances an explicit acknowledgement from the investor may afford a sensible additional protection. I am not, however, convinced that it will always be useful. For example a requirement to obtain a certificate will have little support for transactions between large corporates, and it may be unrealistic to expect family members to consider securities laws before making a loan.

37. I therefore recommend an amendment to clauses 26 and 28 of Schedule 1 of the FMC Bill. The amendment would broaden the scope of these provisions so that regulations can be made to cover all wholesale exclusions. I also recommend that the provisions are changed to ensure that investor certificates can be required in the circumstances prescribed in regulations.

38. I consider that regulations are the best place to implement these requirements. This ensures that sufficient consultation can be undertaken before they are finalised and will allow them to be adapted over time to changing market practices. The requirements will need to be carefully designed to ensure they are targeted effectively, and that the regulatory impacts are properly considered. In the case of investor certificates, it will be important to identify the circumstances when a certificate should be required and the detail of how the certificate should be given.

39. My officials have consulted the Shareholders Association, which has indicated that this approach should resolve the issues it has raised.

Exclusions from disclosure - local authorities and lawyers' contributory mortgages

40. The FMC Bill currently provides an exception for offers of financial products by local authorities. This exclusion replaces an exclusion in section 5(3A) of the Securities Act. Under the current exclusion 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.

41. The main driver for the section 5(3A) exemption was that it was problematic getting all council members to sign the prospectus as required by the Securities Act. These difficulties were 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.

42. Under the proposed FMC Bill exclusion, 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.

43. 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.

44. The FMC regulations discussion paper sought submissions on the local authority exemption. There was little support for its retention, with most submitters considering that local authority debt products should be treated the same as those of other issuers.

45. On that basis, I recommend that the SOP amend the FMC Bill to remove the exclusion for local authorities. My officials have discussed this matter with the Department of Internal Affairs, Auckland Council and Local Government Funding Agency. I am advised that they are all comfortable with the recommendation provided that there is no requirement that all councillors are required to sign the disclosure document.

46. Lawyers have for a number of years operated contributory mortgage broking services under a longstanding Securities Commission exemption from the Securities Act. The FMC Bill elevated that regulator exemption to Schedule 1 on the basis that it seemed to be effectively a permanent exemption.

47. FMA recently undertook a review of all exemptions under the Securities Act that were due to expire in 2012, the lawyers contributory mortgages exemption being one of those. FMA concluded that there was no principled reason going forward for treating contributory mortgages offered by lawyers differently from those offered by other brokers and, in particular for exempting lawyers offering those products from the disclosure requirements under the FMC Bill.

48. FMA wrote to the Law Society outlining its views on 12 December 2012 and informed it that FMA was in discussions with my officials about removal from the FMC Bill of the exemption for lawyers offering contributory mortgages. I understand that FMA and the Law Society's engagement is constructive and ongoing. The Law Society has not sought to raise matters with me.

49. Given that the continuation of the lawyers exemption is uncertain, and seems likely to end, I propose that the exclusion is omitted from the FMC Bill. I note that FMA has power to grant exemptions equivalent to its current powers, so could make continue the existing exemption if that proves desirable.

Financial Advisers Act changes relating to custody and DIMS

50. The FMC Bill relies on regulation of brokers in the Financial Advisers Act (FAA) to ensure that custodians in respect of DIMS are properly regulated. Under the FAA, custody is a subset of broking services. Custodians must be registered on the Financial Service Providers Register and comply with certain requirements under the FAA, including those prescribed in regulations.

51. The main alternative to the FAA would have been to license custodians under the FMC Bill, but Cabinet intentionally stopped short of licensing in its February 2011 decisions that led to the FMC Bill [CBC Min (11) 4/3 refers].

52. The FMC regulations discussion paper sought submissions on regulation of custody under the FMC Bill. Those submissions showed strong support for greater regulation of custody, with a particular focus on ensuring assets are segregated and accounted for, clients are reported to, and there is appropriate audit and assurance.

53. There was also support for licensing of custodians. However, I do not propose changing the FMC Bill to license custodians at this stage in the process. This is because licensing would impose significant costs and would require careful policy design and public consultation.

54. I believe, however, that changes should be made to clarify and enhance the FAA's custody regime, including those relating to DIMS provided under the FAA, custodians for wrap platforms and custodians for wholesale services.

55. I propose the following changes in the SOP relating to custody:

    - Clarification that custodians are "brokers" for the purposes of the FAA. This makes it clear that a custodian must be registered on the FSP and is subject to broker regulation in the FAA.
    - Inclusion of a new regulation-making power that enables FAA requirements to hold client money and client property on trust for *retail clients* to also apply to custodial services provided to *wholesale clients*.
    - Widening and improving the regulation-making powers under the FAA to provide for effective regulation of custody and other broking services, including by providing for audit and assurance and client reporting, and for enforcement of those regulations.

56. DIMS are currently wholly regulated under the FAA. The FMC Bill moves the regulation of most DIMS that are provided to retail clients to the FMC Bill. It does however permit authorised financial advisers (AFAs) to continue to provide limited personalised DIMS services to their retail clients under rules that align to some extent with the FMC Bill.

57. I consider there is a need to even more closely align regulation of DIMS provided under the FMC Bill and the FAA to limit the risk of regulatory arbitrage and ensure that the services are appropriately regulated. The SOP does this by:

- providing that FMA will only authorise AFAs to provide DIMS (or other particular types of financial adviser services) if FMA is satisfied the AFA meets any requirements prescribed in the regulations;
- providing for the conditions and conduct obligations for AFAs who offer DIMS under the FAA to match the requirements under the FMC Bill;
- requiring custody to be independent of the AFA unless the FMA's authorisation specifically allows;
- providing for regulations to restrict the scope of DIMS that can be provided by AFAs under the FAA;
- removing the residual ability of qualifying financial entities to provide DIMS under the FAA, so that the only corporate licence for DIMS is under the FMC Bill;
- clarifying that DIMS licensees will be acting as brokers under the FAA to the extent that they receive investor money, and that these broker obligations can be enforced under the liability regime in the FMC Bill.

58. These proposals do not in themselves add significant new costs, given that they predominantly extend regulation-making powers. Proposals to make regulations would follow the usual consultation and policy approval process, which would include consideration of regulatory impacts. If the changes are approved, I anticipate that the process for developing any regulations would be developed in parallel with regulations under the FMC Bill.

Fair Trading Act and Part 2 FMC Bill interaction

59. Part 2 of the FMC Bill contains fair dealing rules that are equivalent to the fair dealing rules in the Fair Trading Act. These rules include prohibitions on misleading and deceptive conduct and false representations, the main differences being:

- The FMC Bill is limited to conduct in respect of financial products and financial services, whereas the Fair Trading Act applies to conduct in trade in respect of any goods and services. This results in complete overlap between the two laws, which could result in the problem of unnecessary compliance costs if businesses have to comply with two similar laws.
- The primary regulator under the FMC Bill is FMA, which will have broad powers to grant exemptions, issue guidance and undertake not to take action in certain circumstances. The Commerce Commission is the primary enforcer of the Fair Trading Act and is not affected by what FMA may do under the FMC Bill. This gives rise to the problem that financial markets participants cannot fully rely on the decisions of FMA as the Commission could take a different view.
- The FMC Bill's liability regime is predominantly civil with relatively high pecuniary penalties (e.g. $5 million or more for a body corporate). The Fair Trading Act has a mixture of civil and criminal liability, with relatively low fines of up to $200,000, increasing to up to $600,000 for a body corporate under the Consumer Law Reform Bill, which is currently before the House. This could result in a double jeopardy problem because a person could be fined and receive a pecuniary penalty for the same conduct.

60. The introduction version of the FMC Bill sought to deal with these issues by limiting the overlap between the provisions. Cabinet [CBC Min (11) 6/9 refers]:

"25 **Agreed** that a person does not contravene the following provisions of the FTA if they have contravened the comparable provisions of the new securities legislation:

25.1 the general dealing misconduct provision (section 9 of the FTA);

26.2 the prohibition on false or misleading statements (section 13 of the FTA)."

61. The relevant Cabinet paper [CBC (11) 33] also noted two alternative options:

- Provide for a general carve out from the FTA for matters that are regulated under securities law. While providing clarity, this option runs the risk of leaving gaps in the regulatory framework under securities law that are currently filled by the FTA.
- Leave both securities law and the FTA applying to certain kinds of conduct. While avoiding the risks of gaps in the regulatory framework, this would leave uncertainty around which regulator was responsible for taking action in respect of conduct regulated under both securities law and the FTA. It would also leave the relationship between certain provisions in securities law and the FTA unclear.

62. The Cabinet paper suggested that the then preferred option would have a number of advantages. First, it was thought that it would encourage the FMA rather than the Commerce Commission to take proceedings, by giving securities law precedence where there is a direct overlap with the FTA. Second, it was thought that it would provide assurance to stakeholders that in areas of overlap, securities law takes precedence. Third, it was thought that it would avoid the need for a carve-out from the FTA as a law of general application. Fourth, it was thought that it would avoid the current uncertainty under section 5A of the FTA about what conduct is regulated under the Securities Act and the Securities Markets Act.

63. Submitters to the select committee were unconvinced that Cabinet's agreed approach had these advantages. The select committee sought to provide additional clarity through a carve out (i.e. the first alternative option noted above). The FMC Bill as reported back provides that the relevant provisions of the Fair Trading Act do not apply in relation to financial products or services (because equivalent provisions apply under Part 2 of the FMC Bill). The select committee also made changes so that the Commission can investigate breaches and take enforcement action under the FMC Bill, with FMA's consent.

64. However, following further engagement between my officials, the Commission and FMA, I am satisfied that both these approaches have significant risks. At the start of an investigation it can be unclear whether conduct does or does not relate to a financial service due to the broad meaning of that term in the FMC Bill. In investigating a complaint where there is an overlap, the Commission would have to run a parallel process of gathering and assessing evidence against the Fair Trading Act (under criminal standards of proof and procedure) and the FMC Bill (under civil standards of proof and procedure) which it will be less familiar with.

65. There are real risks that these complexities will cause the Commission or FMA to not take worthy proceedings, or if it did take action, for there to be lengthy, relatively pointless and costly pre-trial hearings to determine which law applies. I therefore propose rescinding Cabinet's previous decision instead adopting a modified version of the second alternative option noted above. Under the changes in the SOP:

- The provisions of Part 2 of the FMC Bill are amended to ensure they are as close as possible to the equivalent Fair Trading Act provisions, including by adding prohibitions on unsubstantiated representations in the same terms as proposed in the Consumer Law Reform Bill. If the substantive law is the same, the problem of the cost of complying with overlapping laws is minimised.
- If the Commerce Commission considers that an investigation is in relation to financial products or services, it may take proceedings under the Fair Trading Act. However, the Commission may take the proceedings only with FMA's consent. In considering whether to give its consent, FMA must have regard to various matters (for example, any guidance that it has given in relation to Part 2). This gives FMA precedence over conduct relating to financial products and services, removing the reliance problem, while allowing the Commission to take cases under law it is familiar with where appropriate.
- A provision has been included to provide that a person cannot be ordered to pay a pecuniary penalty, or be liable for a fine, under the FMC Bill and be liable for a fine under the Fair Trading Act 1986 for the same conduct. This removes the double jeopardy problem identified above.

66. I consider that this option will best achieve the objectives of Cabinet and the select committee and that it overcomes the problems identified in the earlier Cabinet paper.

Unfair contract terms

67. As noted above, the SOP replicates new rules proposed in the Consumer Law Reform Bill in respect of unsubstantiated representations. It does not replicate that Bill's rules relating to unfair contract terms. Those rules are wholly new in a New Zealand context. I understand that in Australia, the equivalent rules have had limited application to the types of investment products that the FMC Bill is primarily focussed on. The main application to financial markets relates to terms of home loan agreements which fall primarily within the scope of the Commerce Commission's responsibilities as the regulator under the Credit Contracts and Consumer Finance Act 2003.

68. For these reasons I consider that at this stage unfair contract terms rules are best placed with the Commerce Commission to enforce under the Fair Trading Act.

Directors treated as contravening disclosure requirements

69. Under the FMC Bill, if an issuer's or other person's disclosure document is defective the body's directors are treated as having contravened the disclosure requirement. They are civilly liable to pay pecuniary penalties and compensation unless they can make out one of the defences in the Bill. Deemed civil liability for directors is a key part of the liability framework in the Bill. It ensures directors have appropriate incentives to be involved in the due diligence process relating to preparation of offer documents.

70. There may, however, be circumstances where the costs of deeming directors to be liable for the failings of the issuer are not outweighed by the benefits. I propose that regulations should be able to provide that the deeming provision (currently clause 509A) does not apply in certain circumstances. Regulations would only be able to be made if the Minister is satisfied that the regulations are necessary or desirable to promote any of the purposes of the Bill (for example, to avoid unnecessary compliance costs) and where the exclusion is not broader than is reasonably necessary. The regulations would not affect the criminal liability of a reckless director or the civil liability of a director who was actively involved in the issuer's contravention.

71. An example of where, in future, the regulations could be made would be to align with developments in Australia. In respect of the equivalent provision in the Australian Corporations Act 2001, the Australian Government has proposed removing deemed liability for directors in connection with offers of simple listed corporate bonds. The basis for the proposed change is that deemed liability for directors inhibits issuance of corporate bonds to retail investors. Complying with the liability requirements adds extra expense, for example because deemed directors' liability entails a lengthy due diligence process by directors.

72. Another situation where deemed liability could potentially be undesirable are offers by local authorities and, possibly, other public bodies. Under the FMC Bill, councillors are treated as directors of a local authority, and the deemed liability provision makes each councillor civilly liable even if staunchly opposed to the offer. That deemed liability may not be appropriate in all circumstances.

Workplace savings schemes and superannuation schemes

73. The role of superannuation schemes is uncertain at present with KiwiSaver increasingly replacing traditional superannuation schemes in workplaces and elsewhere. Many of the current superannuation schemes are closed to new members, or serve particular industries or employers. Workplace superannuation schemes are often, in reality, a mechanism for providing additional remuneration and non-retirement savings, which members access upon ceasing employment with that employer.

74. The FMC Bill makes subtle changes to the regulation of superannuation schemes to reflect the changing market. In future, superannuation schemes open to new members will have the sole purpose of providing retirement benefits to members. Under the Bill as reported back, those schemes must be restricted to New Zealand residents or be "locked-in schemes" which will need to comply with regulations that lock members into the scheme until retirement.

75. The FMC Bill currently provides two significant exceptions to these rules:

- Schemes that are closed to new members will be able to continue to operate in the same way as they do now in respect of payment of benefits. Most current schemes have the payment of retirement benefits as the "principal purpose". This means that in some situations funds can be withdrawn from the scheme before retirement.
- Workplace savings schemes will continue to be able to operate in a way that allows benefits to be paid on leaving employment with the relevant workplace or industry. This exception reflects that the scheme may have been provided as part of the person's employment or industry association arrangements, it may be inappropriate for that person to stay in the scheme after that arrangement ends, and there may be limited opportunity for the member to transfer to another scheme.

76. Having looked at these provisions again, I believe that there is merit in making changes to simplify the structure and provide a clear "brand" for superannuation going forward. I recommend that:

- The distinction between schemes limited to New Zealand residents and "locked-in schemes" is removed. Given that both these types of scheme must be for the sole purpose of retirement, this distinction does not serve a purpose and both types of scheme should be subject to lock-in and other rules prescribed in regulations.

- "Workplace saving schemes" are taken out of the definition of superannuation schemes, but their current recognition in the FMC Bill is retained. This has the effect of reserving the term "superannuation scheme" to schemes that are locked-in until retirement, or have been carried over as legacy schemes.
- Workplace savings schemes will be treated as "retirement schemes" for the purposes of other enactments, but subject to regulations which may adjust the meaning of that term if it is not appropriate that it extends to schemes that are not solely focussed on retirement benefits.

Disclosure of equity derivative positions

77. Normally persons who hold 5% of a listed issuer's shares are required to disclose their holding to the market, and any subsequent movements of 1%. These "substantial product holder" disclosure requirements are part of current securities markets law, and are carried over into the FMC Bill.

78. The Takeovers Panel has recommended that these provisions be amended to add a requirement to disclose long equity derivative positions that are referenced to securities of listed issuers.[1] The Panel made its recommendation on 29 November 2012 under section 8(1)(a) of the Takeovers Act 1993 following public consultation. The Panel envisaged that the changes could be made in the FMC Bill.

79. I agree with the Takeovers Panel's recommendation. A person's long equity derivative position combined with a corresponding hedge position held by the derivative writer in underlying securities may provide an opportunity for undisclosed stake building during the period leading up to a takeover bid. This provision will force disclosure of such positions and will also deter insider conduct and market manipulation, in keeping with the purpose of substantial product holder disclosure under the FMC Bill.

80. New clause 269A of the FMC Bill gives effect to the recommendation, while regulations will prescribe matters of detail relating to the new rule.

Self-incriminating statements in reports

81. The FMC Bill requires that issuers and others self-report certain contraventions of the FMC Bill in certain circumstances. This self-reporting requirement is potentially inconsistent with the privilege against self-incrimination in some circumstances. As a result, the FMC Bill currently states that the person making the report is not required to provide information in such reports that would be likely to incriminate that person for an offence punishable by a fine or imprisonment.

82. After further discussions with FMA I consider it preferable that this rule is reframed as a restriction on the use that can be made of the report. Instead of not being required to provide the incriminating material, the report itself would not be admissible in a criminal proceeding against the person making the report. This change ensures that managers of schemes and others are required to report contraventions of their obligations so that steps can be taken to remedy the contravention, but gives them the comfort that their statements will not be used against them in criminal proceedings.

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[1] See http://www.takeovers.govt.nz/assets/assets/Takeovers-Panel-Recommendations-to-the-Minister-Derivatives.pdf

Consultation

83. Consultation on the SOP and the recommendations in this paper has taken place with relevant government departments or other public bodies: the Treasury, Financial Markets Authority, Inland Revenue Department, Reserve Bank of New Zealand, Ministry of Justice (on the self-reporting obligation), Department of Internal Affairs (on the local authority exclusion), and Commerce Commission (on the Fair Trading Act interaction).

84. Matters covered by the SOP reflect matters raised by key stakeholders, including the Shareholders Association, and major law firms and financial markets participants. The exclusion of the local authority exclusion has been discussed with the Auckland Council and the Local Government Funding Agency.

Financial Implications

85. None

Regulatory Impact Analysis

86. Regulatory impact statements were prepared in accordance with the necessary requirements and submitted at the time that Cabinet approval of the policy relating to the FMC Bill was sought [CBC Min (11) 4/3 and CBC Min (11) 6/9 refers]. A separate regulatory impact statement is not provided for the SOP because the changes proposed in it do not materially affect the analysis in the previous statements.

Compliance

87. I am satisfied that the SOP complies with:

   a. principles of the Treaty of Waitangi;

   b. rights and freedoms contained in the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993;

   c. principles and guidelines set out in the Privacy Act 1993;

   d. relevant international standards and obligations; and

   e. LAC Guidelines: Guidelines on Process and Content of Legislation.

Binding on the Crown

88. The FMC Bill includes a provision that the Act will be binding on the Crown.

Publicity

89. I will arrange for appropriate public statements about the SOP and the passing of the FMC Bill as it progresses through the House. I will also arrange for a copy of this paper to be published on the Ministry of Business, Innovation & Employment's website.

Recommendations

It is recommended that the Committee:

1 [Withheld under section 9(2)(f)(iv) of the Official Information Act 1982].

2 **note** that the FMC Bill implements Cabinet decisions that seek to provide an enduring financial market conduct regulatory regime that, in line with the Government's Business Growth Agenda, will help deepen New Zealand's capital markets and promote confident and informed participation by businesses and investors in financial markets;

3 **note** that over recent months, the Ministry of Business, Innovation & Employment has been working with the Financial Markets Authority (FMA) and external stakeholders such as the Shareholders Association, issuers, law firms and banks to identify changes that should be made to the FMC Bill by supplementary order paper (SOP);

Policy approvals

4 **agree** that the purpose statements of core financial markets legislation should be reviewed for consistency with the overarching purposes of the FMC Bill, and that changes should be made through appropriate legislative vehicles to align the purposes of financial markets legislation with the FMC Bill;

5 **agree** that the Financial Advisers Act 2008 (FAA) and Financial Markets Supervisors Act 2011 should accordingly be amended to identify that the overarching purposes of the FMC Bill are also purposes of these Acts;

6 **note** that Cabinet in February 2011 agreed that there would be specific exceptions for different kinds of sophisticated investor, including persons making investments of over $500,000 [CBC Min (11) 4/3 paragraph 32.5];

7 **agree** to increase the amount referred to in paragraph 6 from $500,000 to $750,000;

8 **agree** to broaden the scope of the clauses 26 and 28 of Schedule 1 of the FMC Bill (which provide for regulations to require limited disclosure and other requirements for offers made under the exclusions, and for limitations on exclusions) to cover all wholesale exclusions and to enable regulations to require investor certificates;

9 **agree** to omit the exclusions from disclosure in Schedule 1 of the FMC Bill for local authorities and lawyers offering contributory mortgages;

10 **agree** to changes to the regulation of custody under the FAA to:

10.1 clarify that custodians are "brokers" for the purposes of the FAA to make it clear that a custodian must be registered on the FSP and is subject to broker regulation in the FAA;

10.2 include new regulation-making powers that will enable FAA requirements to hold client money and client property on trust for retail clients to also apply to custodial services provided to wholesale clients;

10.3 widen and clarify the regulation-making powers in the FAA to enable effective regulation of custody and broking services, including by providing for audit and assurance and client reporting, and provide for the enforcement of the regulations;

11 **agree** to changes to the regulation of discretionary investment management services (DIMS) under the FAA to:

11.1 provide that FMA will only authorise AFAs to provide DIMS (or other particular types of financial adviser services) if FMA is satisfied the AFA meets any requirements prescribed in the regulations;

11.2 provide for the conditions and conduct obligations for AFAs who offer DIMS under the FAA to match the requirements under the FMC Bill;

11.3 require custody to be independent of the AFA unless the FMA's authorisation specifically allows;

11.4 provide for regulations to restrict the scope of DIMS that can be provided by AFAs under the FAA;

11.5 remove the residual ability of qualifying financial entities to provide DIMS under the FAA, so that the only corporate licence for DIMS is under the FMC Bill;

11.6 clarify that DIMS licensees will be acting as brokers under the FAA to the extent that they receive investor money, and that these broker obligations can be enforced under the liability regime in the FMC Bill;

12 **note** that Cabinet in May 2011 agreed, in respect of the interaction between the FMC Bill and the Fair Trading Act 1986, that:

12.1 a person does not contravene the following provisions of the FTA if they have contravened the comparable provisions of the new securities legislation [CBC Min (11) 6/9, paragraph 25]:

12.1.1 the general dealing misconduct provision (section 9 of the FTA) [CBC Min (11) 6/9, paragraph 25.1];

12.1.2 the prohibition on false or misleading statements (section 13 of the FTA) [CBC Min (11) 6/9, paragraph 25.2]."

13 **agree** to recommend that Cabinet rescind the decisions referred to in paragraph 12 above; and instead

14 **agree** to:

14.1 amend the provisions of Part 2 of the FMC Bill to ensure they are as close as possible to the equivalent Fair Trading Act provisions, including by adding prohibitions on unsubstantiated representations in the same terms as proposed in the Consumer Law Reform Bill;

14.2 require that, if the Commerce Commission considers that an investigation relates to financial products or services, it may take proceedings under the Fair Trading Act 1986 but may take the proceedings only with FMA's consent, and that in considering whether to give its consent, FMA must have regard to various matters (for example, guidance that it has given in relation to Part 2).

14.3 provide that a person cannot be ordered to pay a pecuniary penalty, or be liable for a fine, under the FMC Bill and be liable for a fine under the Fair Trading Act 1986 for the same conduct;

15 **agree** to enable regulations to provide that the deeming provision for director liability (currently clause 509A of the FMC Bill) does not apply in circumstances that may be prescribed in regulations, provided that regulations would only be able to be made if the Minister is satisfied that:

15.1 the regulations are necessary or desirable to promote any of the purposes of the FMC Bill (for example, to avoid unnecessary compliance costs); and

15.2 the exclusion is not broader than is reasonably necessary;

16 **agree**, in relation to regulation of superannuation schemes under the FMC Bill, that:

16.1 the distinction between superannuation schemes limited to New Zealand residents and “locked-in schemes” be removed;

16.2 “workplace saving schemes” are taken out of the definition of superannuation schemes, but their current recognition in the FMC Bill be retained;

16.3 workplace savings schemes should be treated as “retirement schemes” for the purposes of other enactments, but subject to regulations which may adjust the meaning of that term if it is not appropriate that it extends to schemes that are not solely focussed on retirement benefits;

17 **agree** to amend the substantial product holder disclosure provisions in the FMC Bill to add a requirement to disclose equity derivative positions that are referenced to quoted securities of listed issuers;

18 **agree** that issuers and others who are required to self-report contraventions of the FMC Bill should not omit information that would be likely to incriminate the person making the report, but that a report that included such information should not be admissible in a criminal proceeding against that person;

Approval of SOPs

19 **note** that the attached SOP gives effect to paragraphs 5 to 17 above and makes other minor or technical changes approved by the Minister of Commerce and that all the changes are described in the explanatory note at the beginning of the SOP;

20 **note** that there will be a separate SOP containing a motion to divide the Bill into a Financial Markets Conduct Bill and a separate Financial Markets (Repeals and Amendments) Amendment Bill (or similar name) and a connected SOP that changes headings in Part 9;

21 **approve** the release of the SOPs;

22 **note** that stakeholders may raise additional minor or technical changes that may be required following release of the SOPs;

23 **authorise** the Minister of Commerce to make further minor or technical changes to the FMC Bill prior to enactment.

24 **note** that the Minister of Commerce will arrange for a copy of this paper to be published on the Ministry of Business, Innovation & Employment’s website.

Hon Craig Foss
Minister of Commerce