OFFICE OF THE MINISTER
OF COMMERCE

The Chair
Cabinet Business Committee

Financial Markets Conduct Regulations Paper 2: Disclosure and General Matters

Proposal

1 This is the second in a series of four Cabinet papers in which I am seeking policy decisions on the regulations required to bring the Financial Markets Conduct Bill (FMC Bill) into force. In this paper I seek decisions on disclosure documents, adjustments to the scope of the FMC Bill, the offer process, financial product markets and infringement fee amounts.

Executive Summary

2 Disclosure to investors about financial products is a cornerstone of the FMC Bill regime. 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.

3 I propose decisions in this paper with respect to the direction of the content of disclosure documents. This paper also addresses a number of other disclosure-related issues, such as the appropriate level of disclosure for offers that operate under exclusions in the FMC Bill.

4 In addition, I propose decisions with respect to regulations in the following areas:

- matters concerning the scope of the FMC Bill and the offer process. This includes exclusions concerning the products covered by the FMC Bill and the way that issuers should deal with investors during the offer process.
- the operation of financial product markets. Most regulations in this area are to be rolled over from the existing regime.
- the level of infringement fees that need to be prescribed for low-level contraventions of the regime. I propose four tiers of fees that are proportionate to the nature of the obligation in question.

Disclosure

5 Disclosure to investors about financial products is a cornerstone of the FMC Bill regime. Well-functioning capital markets rely on the availability of good information about financial products to address information asymmetries, 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.

6 A key intention of the FMC Bill is to provide more effective disclosure for investors. The approach that I propose under the FMC Bill is consistent with that taken recently with regard to the regime for KiwiSaver periodic disclosure, which comes into force on 1 July 2013.

7 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 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 1978. The FMC Bill leaves the detailed presentation and content requirements for disclosure obligations to the regulations. The FMC Bill also provides for service disclosure, limited disclosure under Schedule 1, and on-going disclosure.

8 Cabinet agreed in February 2011 that the content of the PDS be tailored for different types of financial product (and where appropriate, financial service) and different types of offer.

9 It is premature for Cabinet to consider the detailed content of PDSs and other disclosure documents. Due to the complexity of this issue, it is essential that officials undertake additional industry consultation before Cabinet makes final decisions. This additional work will involve consulting on templates for PDSs and other disclosure documents (e.g. on-going disclosure and disclosure for discretionary investment management services), as well as consumer testing. There is a significant risk of having to revisit Cabinet decisions if detailed policy is agreed on too early in the process.

10 I seek authorisation for me to approve content requirements for disclosure documents required under the FMC Bill for the purposes of consultation. I intend to use this authorisation to instruct Parliamentary Counsel to prepare draft disclosure requirements at the appropriate stage in the process and to consult on them before seeking final Cabinet approval. I am likely to seek that approval around the end of this year.

11 However, I consider that it is desirable to set the direction of this work. There are also a number of disclosure-related issues that it is preferable to make decisions on now, and this paper addresses these matters.

Presentational issues and level of prescription

12 A key requirement for disclosure under the FMC Bill is that it must be “clear, concise and effective”. The FMC Bill provides for the ability to prescribe presentational requirements for disclosure documents. This is an important aspect of disclosure as good presentation assists with comprehension of the information within offer documents.

13 There is a balance to be struck on this issue between what is prescribed by regulation, what is dealt with by Financial Markets Authority (FMA) guidance, and what is left to issuers’ 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.

14 To the extent possible, I propose that this issue be dealt with by relying on the clear, concise and effective standard in the FMC Bill, FMA guidance and issuers’ judgement. This will ensure that there is adequate flexibility to allow issuers to distinguish their products from others, while providing a baseline minimum standard that FMA can enforce.

15 Some issues do require prescription. 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.

16 This is a key presentational requirement that will assist investors in a material way. In addition, Cabinet agreed that 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. I propose that each PDS should begin with a prescribed key information summary of no more than 2 pages.

Managed investment schemes (MIS)

17 Although the detailed content for each product will be the subject of further consultation, I propose in principle that the PDS for managed funds, such as basic unit trusts and KiwiSaver products, should be subject to a high level of prescription. Paper 3 in this series, on governance, describes in more detail the distinction between managed funds and more complex MIS.

18 This will include a length restriction when printed (it is important that this rule is flexible enough to cater for PDSs provided over new forms of technology). These are relatively straightforward financial products that are amenable to standardised disclosure. Other jurisdictions, including Australia, Canada and the EU, have also introduced short and simple disclosure documents for these products that enhance comparisons between products.

19 It is common for there to be a number of different funds (e.g. conservative, balanced and growth) under the umbrella of a single scheme. I propose that the PDS for these MIS be a mix of scheme-level and fund-level disclosure. The PDS will be accompanied by the most recent periodic disclosure for each fund. I consider that having this combination of fund-level and scheme-level disclosure will provide an appropriate balance between providing adequate information to investors on each fund and not imposing significant compliance costs on issuers. It also enables information that changes frequently (e.g. fund performance) to be in on-going disclosure documents and the online register rather than in the PDS, which will reduce costs to issuers

Discretionary investment management services (DIMS)

20 DIMS involve a provider managing a client's investments under an investment authority. They range from a personalised service provided as part of financial advice to a wholly class service where investors sign up to a model portfolio of investments.

21 Before an investor signs up to a DIMS, the FMC Bill requires that they be given a service disclosure statement (SDS). This serves a similar purpose to a PDS, but is not lodged on the online register.

22 The SDSs for both personalised and class DIMS would usefully include information on matters such as fees, conflicts of interest, details of custodial arrangements, how the client may give instructions on corporate actions and what will happen on the termination of the client agreement.

23 Where a provider offers a class service based on a model portfolio, there may be additional information that it is relevant around matters such as past performance and asset allocation. I propose that, where appropriate, this disclosure be aligned with the PDS for a managed fund. This would allow investors to compare what is offered under the DIMS with managed funds, as well as ensuring that disclosure of matters such as fees conformed to common standards.

Other products

24 More complex MIS and equity are similar in that the investment is typically in a single company or a small number of assets. Specifying the exact information that investors need before making a decision in respect of these products is not simple. I propose that PDSs for these other financial products comprise prescribed information, but be subject to a lesser degree of prescription in terms of form and presentation than for managed funds. I accept that greater flexibility will be needed to enable the issuer to adequately describe its business, risks and reasons for seeking capital.

25 I note that there is still an obligation under the FMC Bill for the issuer to place all other material information concerning its offer on the online register, which will ensure that additional information that it considers is material to an investor's decision is still disclosed to the market. I propose that debt products and derivatives follow a similar pattern.

26 I consider that where there are particular requirements concerning page or other length limits, supporting rules such as minimum font sizes and preventing the use of supplementary PDSs will be necessary. This will ensure that those offering financial products cannot render length limits ineffective by cramming information into fine print that is difficult for investors to read. The right size would be determined following testing of mock-ups of PDSs during the formulation of the content of these documents.

Consent by directors

27 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.

28 Under the FMC Bill, directors are civilly liable for false or misleading statements in a PDS and register entry, 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.

29 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.

30 I consider that some level of director or board consent to lodgement of the PDS and register entry 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. However, I am conscious that some managed fund issuers produce dozens of offer documents a year. Requiring all directors to sign all documents in this situation is a significant compliance cost. In addition, I note that given their decision-making structure, local authorities present particular difficulties in terms of approval to lodgement.

31 For this reason, I propose that there should be a rule requiring a statement evidencing the Board's consent to lodgement. This would be met by a consent to lodgement signed on behalf of all directors by two directors (or by a sole director if the entity only has one). This is consistent with the requirement for approval of financial statements. There would also be flexibility to provide a consent to lodgement in any other way that demonstrated board approval. FMA guidance would set out acceptable alternative forms of consent.

Expiry dates for PDSs

32 The FMC Bill provides that a PDS must, if required by the regulations, specify its expiry date. This replaces the existing provisions in the Securities Act, which permit a maximum life for prospectuses of less than 18 months.

33 As a default position, the FMC Bill contains a general obligation not to continue to offer a product if the PDS contains a statement that is false or misleading. This means that an issuer must issue a new PDS or lodge a supplementary document if the PDS has become materially out of date, or else risk severe liability consequences.

34 I note that the content of disclosure documents is yet to be determined. It is possible that some PDSs may be required to contain financial information. In this situation, it would be appropriate to have an expiry date. In other cases, I consider that this general discipline is adequate as a general rule and that, in principle, no expiry date is required. However, I consider that it would be a useful discipline for the Board of continuous issuers to provide a regular confirmation (probably at 18 month intervals) to the Registrar that the disclosure documents remain correct.

Use of term 'secured' in debt products

35 The description of security in relation to debt products is one of the most difficult areas to convey in a way that is meaningful and informative to investors. Current disclosure often provides considerable detail on the security for the debt product on issue. However, it can fail to give the investor a sense of how far that security will go to cover losses arising out of failure.

36 The term 'secured' can be misleading. While it has a particular legal meaning, the ordinary meaning of 'secure' implies something that is safe and reliable. 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.

37 I consider that it is desirable to regulate the use of the term 'secured' and related terms. In Australia, in some contexts the use of the term 'secured' is only permitted where the security is likely to be sufficient to cover the amount secured. This corresponds to the ordinary meaning of the word. I propose that New Zealand adopts a similar approach to ensure that investors may not be misled by the use of inappropriate language.

On-going disclosure for debt and equity issuers

38 Public on-going 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
- 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.

39 There are currently no on-going disclosure requirements for debt and equity issuers outside of the requirements for securities that are listed on registered exchanges.

40 I consider that it is appropriate for debt issuers to be required to disclose particular changes or events that affect the credit risk associated with the borrower and the debt securities, and therefore the value of the debt security. In particular, this disclosure should include the following matters:

- changes to credit ratings
- changes to guarantors of the issuer
- significant changes to the terms of the trust deed
- material changes in ownership of the issuer
- appointments of a receiver, manager, or liquidator for any debt held by the issuer.

41 Given the sensitivity of the price of equity securities to information, I also consider that it is appropriate that there be some minimum requirements for equity disclosure. I propose that this information include:

- the annual report that is required to be prepared for companies under the Companies Act 1993
- significant changes in the business, including major transactions
- significant changes in shareholdings.

42 I consider that given the similarity of more complex MIS to equity securities, they should also have similar requirements, including a requirement to prepare and lodge an annual report for the scheme if it is not already subject to that requirement.

43 This event-based disclosure would be placed on the online register. 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 relevant product was quoted on a licensed market and therefore subject to continuous disclosure under the listing rules of the market.

44 I note that in addition to this public on-going disclosure, investors will receive confirmation notifications in respect of particular transactions that they make. These will be provided electronically unless the investor seeks a paper copy.

On-going disclosure for managed funds

45 A new periodic disclosure regime for KiwiSaver funds will take effect from 1 July 2013. This will ensure that KiwiSaver providers give investors information each quarter on key information concerning their fund's performance, such as returns, fees and portfolio holdings.

46 I propose that a similar requirement be extended to all managed funds, which are analogous in nature to KiwiSaver. This will ensure that investors in these funds receive a high level of information that will enable them to make informed decisions about their investments. I note, however, that there may be exceptions for some types of funds. Officials will consult to ensure that the appropriate requirements apply in all cases.

Limited disclosure situations

47 Schedule 1 of the FMC Bill provides exclusions for certain offers 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).

48 Exclusions in Schedule 1 are not complete exclusions from the FMC Bill. Clause 26 of Schedule 1 provides for regulations to impose limited disclosure and other requirements for offers making use of Schedule 1 exclusions. I propose that limited disclosure be required in some of these situations, and highlight some particularly important instances below.

Wholesale investors, close business associates and relatives

49 There are exclusions for offers to wholesale investors, close business associates and relatives. Some wholesale investors will sign certificates before investing and I propose below that those certificates include warning statements that set out the effect of coming under these exclusions. The regulations could require limited disclosure or other certificates to be used in other circumstances such as offers to relatives.

50 I noted in the Cabinet paper approving the SOP to the FMC Bill in April 2013 that in some circumstances an explicit acknowledgement from the investor may afford a sensible protection. It may not, however, 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.

51 Offers where the minimum investment is $750,000 come under the wholesale exclusion. I propose that offers in reliance on this exclusion should be required to identify that fact and give a prominent prescribed warning statement about the effect of the exclusion on the investor's rights that must be acknowledged by the investor at the point of sale. This will ensure that these investors are aware of the situation that they are in.

52 Over the next period I propose to continue to consider whether investor certificates should be required for any of the other exclusions. Any requirements will need to be carefully designed to ensure that they are targeted effectively, and that the regulatory impacts are properly considered.

Eligible investor and safe harbour certificates

53 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 DIMS. An eligible investor 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. They do not receive the full protections of the FMC Bill, including disclosure under Part 3.

54 There is also a safe harbour certificate for any other type of wholesale investor 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, then the issuer of the financial products or provider of the market service is entitled to rely on the certificate.

55 The regulations may prescribe the form and content of these certificates. I propose that these certificates include warning statements noting that the full protections of the FMC Bill will not apply to these offers. I consider that this is important to ensure that investors turn their mind to the consequences of certification.

Employee share schemes

56 Schedule 1 excludes offers under employee share purchase schemes from the normal disclosure requirements under the FMC Bill, due to the ability of the employee to access information about the offer and the issue. It is important to facilitate these schemes, which have benefits in particular for start-up companies, while ensuring that the employees receive some basic information about the investment decision they are making.

57 I propose that the disclosure for employee share schemes be much more limited than at present. I consider that requirements should include providing:

- the latest annual report and financial statements to the extent available
- information about exit
- generic statements about risks of these schemes.

Small offers

58 Schedule 1 excludes small offers from disclosure requirements under Part 3 of the FMC Bill. This new exclusion allows issuers to raise up to $2 million from up to 20 investors over a 12 month period.

59 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. The small offers exemption also recognises that for some offers of financial products, there is no expectation of regulatory protections or compliance (other than prohibitions against false or misleading representations or fraud). This includes, for example, a small business owner receiving a loan from an acquaintance.

60 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. For this reason, I propose that conscious users of this exception should provide a prescribed warning statement to investors and notify FMA that they are using it.

Same class financial products

61 Schedule 1 excludes offers of financial products of the same class as quoted financial products on a licensed market 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.

62 I consider that there should be some minimum regulatory requirements for these offers to ensure that there is an appropriate level of transparency. A notice should be provided to the relevant licensed market:

- 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 of its continuous disclosure and financial reporting obligations
- setting out any information that is excluded information for the purposes of continuous disclosure as at the date of the notice
- 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.

63 A key issue to consider is what ‘same class’ means in the case of debt products. The Bill provides for regulations to prescribe the circumstances when debt products with different redemption dates or interest rates are still considered to be of the same class. I consider that the prescribed circumstances should be that the only difference is the specified interest rate or the specified redemption date. This means, for example, that a debt product that gave the issuer the ability to reset the interest rate or extend the redemption date is in a different class to products with fixed interest rates or redemption dates.

Banking products and currency hedges

64 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
- prescribed currency forwards that are issued by a registered bank or by a subsidiary of a registered bank.

65 Category 2 products are defined by the Financial Advisers Act 2008 and its regulations, and are generally less complex financial products. Due to their relative simplicity, I consider that it is appropriate to prescribe cash and term portfolio investment entities (PIEs) issued by subsidiaries of registered banks as excluded under clause 20, so long as the underlying investments of the PIE are also very simple banking products.

66 I also propose to prescribe simple currency forwards under clause 20 where settlement takes place within 12 months, given their relatively simple nature and routine use by businesses.

67 I consider that regulatory capital products and any other non-standard investment products issued by registered banks should be subject to limited disclosure requirement, e.g. preference shares and subordinated debt products. I propose that banks should have to provide a document to investors that meets the PDS requirements for the relevant product with any necessary changes, including lodging it with the Registrar.

Crown and Public Trust

68 Finally, the Crown and Public Trust are exempted under clause 21 of Schedule 1 from governance and disclosure requirements that apply to regulated offers. I consider it appropriate that they have a limited disclosure obligation to provide a document to investors that meets the PDS requirements for the relevant product. This is similar to the existing Securities Act requirement, which requires, for example, the Crown to provide an investment statement but not produce a prospectus or have a trust deed.

Scope and offer process

69 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.

70 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. These boundary issues are addressed below.

Exclusion from obligation to give PDS

71 Central to the FMC Bill is the rule that an investor must receive a PDS before making an investment in a financial product covered by the FMC Bill. This ensures that the investor has adequate information about the investment. However, exceptions to this rule may be made in the regulations. I consider that there are several instances where it is appropriate for this to occur.

72 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. 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.

73 I propose that an exclusion be created based on an Australian provision to allow relief in the situation where the issuer has taken specified steps to ensure that the investor has received or has access to all of the information in the current PDS. This would provide greater certainty for issuers seeking to rely on this exclusion. This would only apply to existing investors making a further investment in the same kind of financial product.

74 I also consider that it is appropriate to create an exclusion for investments in simple deposit-based products. There can be considerable compliance difficulties for issuers caused by telephone investments and other investments where the investor wishes to acquire the product immediately without receiving the PDS. I propose to give timing relief from the PDS obligation based on similar relief under the Australian Corporations Act. There is a risk with this kind of relief that it may increase the potential for pressure selling. However, the risks are lowered by the simple nature of the products allowed under this exclusion.

Ancillary offer process obligations

75 The FMC Bill contains many requirements concerning the way that the offer process works. A number of regulations are required to flesh these requirements out.

76 Clause 64 of the FMC Bill outlines how the offeror must deal 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. Clause 68 of the FMC Bill deals with the situation where an application for a financial product is received after a PDS expires. These clauses give the offeror options including repaying money to investors and providing supplementary disclosure.

77 Both clauses require the offeror to comply with any prescribed requirements. I propose that regulations on this matter should include a requirement for the offeror to act as soon as possible under these clauses to ensure that investors are apprised of their situation. They should be notified in writing, with the notice including information such as a summary of the situation and the options open to the investor.

78 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. I consider that the regulations should require the money to be held in a separate account with a registered bank or other appropriate overseas bank.

FMC reporting entities

79 The Financial Reporting Bill (FR 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.

80 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. FMC reporting entities will have to keep accounting records and lodge audited financial statements prepared in accordance with applicable financial reporting standards.

81 As a general rule, issuers making an offer in reliance on most of the exclusions in Schedule 1 are not FMC reporting entities. However, the FR Bill will insert a clause in Schedule 1 that will allow the regulations to specify circumstances when a person who makes such offers should be an FMC reporting entity.

82 I consider that there are circumstances where a person who makes an offer in reliance on these exclusions should be subject to a level of public accountability such that it should be an FMC reporting entity. The small offers exclusion allows issuers to raise up to $2 million from up to 20 investors in a 12 month period with limited disclosure in certain limited circumstances. I consider that issuers relying repeatedly on the small offers exclusion be subject to this public accountability. For example, a company could become widely held as a result of making offers under the small offers exclusion over a number of years.

83 For this reason, I propose that if an issuer gains 50 or more shareholders in reliance on the small offers exception, then it should be deemed to be an FMC reporting entity. The 50 investor number matches the threshold in the Takeovers Code for companies to be subject to additional takeovers regulation.

Prescribed 'future time' for derivatives

84 The FMC Bill provides a definition of "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
- that future time is not less than the prescribed time after the agreement is entered into
- 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.

85 The purpose of the second condition is to exclude ordinary spot contracts for the purchase of financial products and currency from the definition of derivative. For example, a foreign exchange spot transaction may not be settled for a number of days after it is agreed. 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.

86 I propose that the relevant time period for this section should be based on the equivalent Australian provision, which provides for the future time to be three working days for foreign exchange contracts and one working day for any other agreement. I consider that these timeframes are generally appropriate to distinguish ordinary spot contracts from derivative contracts.

87 Submitters on the discussion paper for the FMC Regulations have noted that in some circumstances contracts that are regarded by market participants as spot contracts may have slightly longer settlement times – for example, where there is a public holiday in the foreign market where the settlement is to occur. These issues will be worked through in drafting.

Financial product markets

88 "Financial product markets" is the term used by the FMC Bill to include stock exchanges, listed debt markets, futures exchanges and other markets in which financial products are traded. Part 5 of the FMC Bill and its associated regulations regulate how these markets operate.

89 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.

90 For this reason, most of the regulations with respect to financial product markets will be carried over with necessary modifications into the new regime. However, there are some matters of new policy that I describe below.

Exemptions

91 The FMC Bill requires that financial product markets be licensed by FMA. This is a shift from the existing law, where registration is generally voluntary with the Minister of Commerce having a 'call-in' power. The new regime means that a number of existing unregistered trading platforms will need to be either licensed or exempted.

92 There is an automatic exemption from this requirement where:

- the number of transactions on the market each year does not exceed 100 transactions, or
- the aggregate value of the transactions on the market each year is less than $2 million.

93 Additional exemptions can be made by regulations or by FMA. Cabinet has previously agreed that the Minister of Commerce determines the details of initial registrations and exemptions for existing unregistered exchanges, in consultation with existing exchanges and FMA.

94 The discussion paper on the FMC Regulations asked whether there should be a general 'wholesale market' exemption, where all persons trading through the market were wholesale investors and the market does not quote products that are quoted on another licensed market or issued under a regulated offer (e.g. NZX-listed securities). This would be on the basis that wholesale investors do not require the protection of the regulatory regime and their trading activities do not impact on other persons

95 There was some support for a wholesale exemption in submissions. However, no particular wholesale markets requiring this exemption were identified. There are a range of wholesale markets that are licensed or exempted in Australia. Where markets are exempted, there are usually conditions attached – such as a requirement that the market remains regulated by an overseas regulator.

96 There are some risks from a broad class exemption. Exempt markets are not subject to general obligations to ensure the market is fair, orderly and transparent and conflicts of interest are adequately managed. Trading on the market would be exempt from the FMC Bill's prohibitions on market manipulation. Particular concerns may arise where prices from wholesale markets are used as a reference by other markets and persons outside of the market. These risks need further consideration.

97 I propose that wholesale markets continue to be exempted on a case-by-case basis. This may be reconsidered if it becomes clear that there are a number of wholesale markets that would be more efficiently exempted as a class.

Disclosure by directors and senior managers

98 The FMC Bill requires that when directors and senior managers of an issuer trade in the issuer's securities, they must disclose this fact within 5 working days. There are a number of situations where prompt disclosure is less important, and 20 working days are allowed:

- an acquisition under an employee share purchase scheme
- an acquisition under a dividend reinvestment plan
- an acquisition under a share top-up plan
- an acquisition or a disposal that results from an amalgamation under Part 13 of the Companies Act 1993
- an acquisition or a disposal that results from an arrangement approved under Part 15 of the Companies Act 1993.

99 Regulations can add to this list.

100 I propose that 20 working days be permitted for disclosure of additional situations where the timing of the transaction is known in advance and disclosure has relatively little information benefit for the market. This would include, for example, share consolidations or subdivisions.

Unsolicited offers – FMA exemptions

101 Regulations concerning unsolicited offers have recently been made. I propose that minor adjustments be made to these to reflect FMA exemptions made in respect of the regulations and technical compliance issues that have arisen in their implementation.

Disclosure of equity derivative positions

102 Cabinet agreed in April 2012 [CAB Min (13) 12/17] 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. Regulations will prescribe how the number of underlying securities associated with the derivative position should be calculated.

103 I propose that the regulations specify formulas for calculating the number of underlying securities where the derivative has a linear relationship with the underlying securities and for other straightforward cases. In more complex situations (e.g. where the relationship changes with price), the regulations should rely on FMA frameworks and methodologies.

104 A consequential change to the Takeovers Code to require disclosure of long equity derivative positions in a takeover situation is also desirable. This change has been recommended by the Takeovers Panel and will align the Takeovers Code requirements with substantial product holder disclosure. I expect that this change would be included with other consequential changes to the Takeovers Code that will need to come into force with the FMC Bill.

Infringement fees

105 Cabinet agreed in February 2011 [CBC Min (11) 4/3] and May 2011 [CBC Min (11) 6/9] to introduce a new liability regime for breaches of securities law. The existing regime lacks coherence and is difficult to understand for those who are subject to it or who wish to seek remedies. The new regime in the FMC Bill is coherent and consistent. It is based on an escalating hierarchy of liability, with the consequences of a contravention being proportionate to the importance of the obligation in question.

106 At the top end of the spectrum, Cabinet agreed that egregious contraventions of the most important obligations may result in up to 10 years' imprisonment. Most mid-level contraventions will result in potential liability for large civil pecuniary penalties and compensation orders. Cabinet also agreed to introduce an infringement notice regime in the bottom tier of liability.

107 The FMC Bill enables the FMA to issue infringement notices for relatively minor contraventions of the FMC Bill, such as failing to file certain important notices on time. The FMC Bill provides that the underlying infringement offences carry a maximum penalty of $50,000, with a maximum infringement fee of $20,000. The infringement notice amount for each offence must be set in regulations.

108 There is a difference in importance of the obligations within the infringement offence category. For example, a contravention of the obligation on issuers to allow accounting records to be inspected is more serious than a licensed financial market failing to have its market rules available for public inspection. To allow for this variation, I propose that there be four tiers of infringement fees in the regulations that are proportionate to the nature of the obligation in question:

- $5,000 for the lowest level 'compliance' type contraventions.
- $7,500 for relatively minor contraventions.
- $12,500 for more serious contraventions, where a medium level of deterrence is required.
- $20,000 for the most serious contraventions, where non-compliance may cause significant harm and strong deterrence is required.

109 I propose to classify the infringement offences into the appropriate category in the regulations.

Transition to full implementation

110 The FMC Bill provides for issuers to have a transitional period of up to 2 years after commencement. For this period, KiwiSaver schemes, unit trusts, and superannuation schemes continue to be registered under the old law and offers may continue to be made under the old law. But transitional regulations are needed to determine exactly how the old law and the new law interact over this period.

111 The purpose of the transitional period is to allow issuers to continue under the old law in relation to securities still being offered under that law. But issuers will actually be operating under both regimes for some purposes. Some aspects of their offerings will be dealt with by the new law.

112 I propose that transitional regulations should implement the following:

- The core former Acts (ie, the Securities Act 1978, Superannuation Schemes Act 1989, parts of the KiwiSaver Act 2006, and the Unit Trusts Act 1960) should continue to apply to schemes and securities during the transitional period as if the Acts had not been repealed by the FMC Bill. This will mean, for example, that a superannuation scheme continues to have only a "principal purpose" of retirement and is not required to appoint a supervisor until it transitions to the FMC regime.

- Issuers' actions under the core former Acts should be effective for the purposes of other laws (even where new terminology and amendments have taken effect).

113 For example:

- An issuer of debt under the Securities Act 1978 will appoint a "licensed supervisor" (the new concept) rather than a "securities trustee" (the old concept).
- A requirement to give a PDS (the new concept) under the KiwiSaver Act 2006 will be met if the issuer gives the investor an investment statement (the old concept).

114 Other parts of the new law should also take effect immediately, but modified to apply to all securities and schemes, whatever regime they are in, and facilitate the transition. For example, the Financial Service Providers (FSP) register should contain both the new categories of financial services and the old versions. Similarly, issuers may need to be able to continue to use old exemptions until they are fully transitioned at the end of the transition period.

Consultation

115 The Financial Markets Authority, Treasury, Reserve Bank, Ministry of Justice, and the Inland Revenue Department were consulted on this paper. The Department of Prime Minister and Cabinet has been informed.

116 The proposals in this series of papers have been subject to public consultation, both during the development of the FMC Bill and via a public discussion document on the regulations.

Financial Implications

117 This paper has no financial implications.

Human Rights

118 This series of papers has no human rights implications.

Legislative Implications

119 The proposals in this series of papers will require the making of regulations under the Financial Markets Conduct Bill once it is passed.

Regulatory Impact Analysis

120 The Regulatory Impact Analysis requirements apply to the proposals in this series of papers. A Regulatory Impact Statement for all of the papers has been prepared and is attached.

Quality of the Impact Analysis

121 The General Manager, Strategic Policy Branch and the Ministry of Business, Innovation and Employment Regulatory Impact Analysis Review Panel have reviewed the attached Regulatory Impact Statement (RIS) prepared by the Ministry of Business, Innovation and Employment, and consider that the information and analysis summarised in the RIS meets the criteria necessary for ministers to fairly compare the available policy options and take informed decisions on the proposals in this paper.

Publicity

122 The Ministry of Business, Innovation and Employment will post a copy of this paper on its website.

Recommendations

It is recommended that the Committee:

Disclosure regulations

1 **note** that a key objective of the Financial Markets Conduct Bill (FMC Bill) is to provide more effective disclosure for investors via product disclosure statements (PDS), disclosures on an online register, service disclosure, limited disclosure, and ongoing disclosure (disclosure documents)

2 **note** that the FMC Bill leaves the detailed content and presentation requirements for disclosure documents to the regulations

3 **note** that in February 2011 [CBC Min (11) 4/3], 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

3.1 a key information summary of around 1-2 pages that summarises the key features of the investment and risks associated with it

3.2 a more detailed description of information that is essential to an investor's decision.

4 **agree** that all PDSs should begin with a prescribed key information summary of no more than two pages

5 **agree** that PDSs for managed funds be highly prescribed, and comprise a balance of fund-level and scheme-level information and a maximum length

6 **agree** that the service disclosure statement for class discretionary investment management services be aligned, where appropriate, with the PDS for a managed fund

7 **agree** that PDSs for most other financial products comprise prescribed information, but be subject to a lesser degree of prescription than for managed funds

8 **agree** that PDSs should not be required to contain all other material information relating to the offer, which should instead be on the online register

9 **agree** that information that changes frequently (e.g. fund performance) should generally be in ongoing disclosure documents and the online register rather than in the PDS

10 **agree** that there should be a rule requiring a statement evidencing the consent of the issuer's board of directors to lodgement of the PDS and register entry

11 **agree** that in principle no expiry dates are required for PDSs, but that continuous issuers must provide a regular confirmation to the Registrar that the disclosure documents remain correct

12 **agree** that the term 'secured' and related terms may only be used where there is adequate security to cover the amount secured

13 **agree** that there should be periodic disclosure requirements analogous to the KiwiSaver periodic disclosure regime for all managed funds

14 **agree** that there should be on-going disclosure requirements for issuers of debt, equity and more complex managed investment schemes to inform investors of matters important to their decisions in respect of financial products

15 **note** that Schedule 1 of the FMC Bill provides exclusions for certain offers from the disclosure requirements under Part 3 and the governance requirements under Part 4 of the FMC Bill

16 **agree** that limited disclosure should be required for employee share shares, small offers, dividend reinvestment plans, non-banking products issued by a registered bank, and offers of the same class as quoted financial products on a licensed market

17 **note** that the FMC Bill provides for regulations to prescribe the circumstances when debt products with different redemption dates or interest rates are still considered to be of the same class

18 **agree** that the prescribed circumstances referred to in recommendation 17 should be that the only difference is the specified interest rate or the specified redemption date

19 **agree** that offers in reliance on the $750,000 exclusion should be required to identify that fact and give a prominent prescribed warning statement about the effect of the exclusion on the investor's rights that must be acknowledged by the investor at the point of sale

20 **agree** to include warning statements in eligible investor and safe harbour certificates noting that the full protections of the FMC Bill do not apply

21 **agree** that simple cash and term portfolio investment entities (PIEs) issued by subsidiaries of registered banks, and simple currency forwards issued by a registered bank or its subsidiary where settlement is within 12 months be prescribed under Schedule 1 as excluded from full disclosure requirements

22 **agree** that the Crown and Public Trust be required to provide a disclosure document to investors that meets the PDS requirements for the relevant product

23 **note** that officials will continue to consult with stakeholders and relevant agencies on the detailed content requirements for disclosure documents under the FMC Bill

24 **authorise** the Minister of Commerce to approve, for the purposes of consultation, content requirements for disclosure documents that are consistent with these decisions

Scope and offer process

25 **note** that although the key determinants of whether a matter is governed by the FMC Bill are the definitions of products and services covered by the FMC Bill, some of the boundaries are left to regulations

26 **agree** that a PDS does not need to be given to an investor where the issuer has taken specified steps to ensure that the investor has received or has access to all of the information in the current PDS

27 **agree** that there should be an exclusion from the need to provide a PDS for investments in simple deposit-based products

28 **agree** that offerors should inform investors promptly of their options in the situations where

28.1 a minimum subscription condition or listing condition stated in the PDS is not fulfilled or there has been another type of defective disclosure

28.2 an application for a financial product is received after a PDS expires

29 **agree** that until a product is issued, an issuer or offeror must hold any money paid to them by investors in a separate account with a registered bank or other appropriate overseas bank

30 **note** that exchange-traded derivatives are excluded from disclosure requirements if traded on a prescribed overseas market and issued by a prescribed person

31 **agree** to prescribe overseas exchanges with equivalent requirements that apply to New Zealand licensed markets for the purposes of this exclusion

32 **agree** that an issuer that gains 50 or more shareholders in reliance on the small offers exception should be an FMC reporting entity

33 **agree** that the 'future time' for the purpose of distinguishing between derivative contracts and spot contracts should be three working days for foreign exchange contracts and one working day for other agreements

Financial product markets

34 **note** that many regulations with regard to the operation of financial product markets will be carried over from existing legislation

35 **note** that Cabinet has agreed that the Minister of Commerce may determine the details of initial licences and exemptions to existing registered and unregistered exchanges

36 **note** that a class exemption from financial product market licensing for 'wholesale' financial product markets has been consulted on, but is not proposed at this time

37 **agree** that there be a longer period of 20 days for disclosure of transactions made by directors and senior managers in relation to offers where

37.1 the offer is made to all shareholders on an equal basis; and

37.2 the timing of the transaction is known in advance and prompt disclosure after the transaction is less important than ordinary disclosure by directors and senior managers

38 **agree** that minor adjustments be made to the unsolicited offer regulations to reflect FMA exemptions and technical compliance issues that have arisen in their implementation

39 **note** that the regulations will prescribe how the underlying securities associated with an equity derivative position are calculated for the purposes of substantial product holder disclosure

40 **agree** that regulations referred to in recommendation 39 should specify formulas for calculating the number of underlying securities for use in straightforward cases and rely on FMA frameworks and methodologies in more complex cases

41 **agree** that the Takeovers Code be amended to require long equity derivative positions to be disclosed by relevant parties to a takeover transaction

Infringement notice fees

42 **note** that the FMC Bill introduces an infringement offence regime

43 **agree** that four tiers of infringement notice fees that are proportionate to the nature of the obligation in question be created, at the following levels

43.1 $5,000 for the lowest level ‘compliance’ type contraventions.

43.2 $7,500 for relatively minor contraventions.

43.3 $12,500 for more serious contraventions, where a medium level of deterrence is required.

43.4 $20,000 for the most serious contraventions, where non-compliance may cause significant harm and strong deterrence is required.

44 **authorise** the Minister of Commerce to classify the infringement offences in the FMC Bill into the appropriate tier in recommendation 43 above

Transition to full implementation

45 **agree** that regulations apply the existing law and the new law on the following basis during the transitional period:

45.1 the core former legislation continues to apply to a security or scheme as if it was not amended or repealed by the FMC Bill, but with modifications needed to enable the legislation to work with the FMC Bill and associated legislation; and

45.2 the amendments made to other legislation by the FMC Bill apply immediately, but with modifications needed to enable the legislation to work with the core former legislation.

Hon Craig Foss
Minister of Commerce

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