In Confidence

OFFICE OF THE MINISTER OF COMMERCE

The Chair
Cabinet Economic Growth and Infrastructure Committee

Further detail on Financial Markets Conduct Regulations

Proposal

1 This paper seeks further policy decisions on the regulations to bring the Financial Markets Conduct Act fully into force. These comprise remaining issues around disclosure, governance and supervision, and transition.

Executive Summary

2 Implementing the Financial Markets Conduct Act (FMC Act) is one of the main initiatives in the Capital Markets workstream of the Business Growth Agenda.

3 The FMC Act is a significant regulatory reform that will provide a step-change for New Zealand's capital markets. It is the final stage in a package of reforms of this sector begun in 2008. It has been informed by the lessons of the global financial crisis, the collapse of finance companies, and the recommendations of the industry-led Capital Markets Development Taskforce.

4 Overall, the FMC Act represents a significant freeing up of capital-raising and has strong support from business, the finance industry and investor groups. It also seeks to ensure that financial markets regulation is clear, effective and reliable to achieve its purposes.

5 The first phase of the FMC Act was brought into force on 1 April this year, with full implementation of the detailed FMC Act regime beginning 1 December. Regulations are necessary for this full implementation. In particular regulations will set the detailed content of the information that needs to be disclosed to investors, and the detailed requirements around the governance and supervision of financial products.

6 Cabinet made high-level decisions on these regulations in June 2013 [CBC Min (13) 4/6, CBC Min (13) 4/7, CBC Min (13) 4/8 and CBC Min (13) 4/9]. Cabinet also authorised me to make decisions on detail and to make changes, consistent with the policy framework in this series of papers, on any issues that arise during the drafting process. However, final Cabinet decisions were deferred on the key content of disclosure, and on some governance and supervision matters, until further industry consultation had been undertaken.

7 Following intensive engagement with stakeholders through a series of workshops, exposure drafts of regulations, and other informal engagements with stakeholders, I am now seeking these final decisions from Cabinet. These decisions, together with the additional decisions on detail I will make under my authorisation from Cabinet, will enable the full implementation of the regime.

8 Most of the decisions sought in this paper concern the disclosure 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. Regulation needs to result in effective disclosure for investors. It is also important that regulation assists businesses to bring good investment opportunities to market by not imposing unnecessary compliance costs and allowing innovation.

9 The regulations proposed in this paper will assist these purposes. They include:

- fixed length limits for product disclosure statements (PDSs) for equity securities (e.g. share offers), debt securities (e.g. bond offers), other managed investment schemes and derivatives – to help ensure that they are clear, concise and effective and to reduce regulatory costs and risks to the Financial Markets Authority (FMA)
- more useful and relevant financial information to be included in PDSs
- increasing the flexibility of managed funds disclosure
- adjustments to the disclosure requirements for simple deposit products offered by non-bank deposit takers
- extending the disclosure exemption for issuers of debt securities who already have debt securities quoted on NZX

10 Appropriate governance and supervision of products is also essential to encourage participation in financial markets. The proposals in this paper also include:

- continued governance obligations for cash and term PIEs offered by registered banks
- reconciliation and audit requirements for custodians holding the property of managed investment schemes
- clarifying the roles and responsibilities of auditors and supervisors.

Background

Context to the Financial Markets Conduct Act

11 Passing and implementing the FMC Act is one of the main initiatives in the Capital Markets workstream of the Business Growth Agenda.

12 This significant regulatory reform will provide a step-change in New Zealand's capital markets. It has been informed by the lessons of the global financial crisis, the collapse of finance companies, and the recommendations of the industry-led Capital Markets Development Taskforce.

13 The FMC Act completes the comprehensive programme of reforms in the New Zealand financial sector that Government has been progressing since 2008. These reforms have included the introduction of the financial advisers regime, the licensing of trustees and statutory supervisors, and the establishment of the Financial Markets Authority.

14 The FMC Act's main purposes are to promote the confident and informed participation by businesses, investors and consumers in New Zealand's financial markets, and to promote and facilitate the development of fair, efficient, and transparent markets.

15 The FMC Act seeks to achieve, and explicitly balance, these main purposes by:

- Setting out standards of conduct expected of financial markets participants, based on the requirements in the Fair Trading Act
- Removing unnecessary compliance burdens on capital-raising
- Promoting innovation and new sources of capital, for example, by providing for lower-cost public listed markets and crowd-funding platforms
- Decriminalising conduct except where there is knowledge or recklessness, and instead providing for pecuniary penalties and a range of protective tools such as stop orders, enforceable undertakings and management bans
- Ensuring that activities within the regulatory net are properly regulated, for example through improving disclosure, licensing fund managers, and improving governance of managed funds offered to retail investors.

16 Overall, the FMC Act represents a significant freeing up of capital-raising and has strong support from business, the finance industry and investor groups. It also seeks to ensure that regulation is effective, clear, and reliable where it is imposed.

17 Cabinet approved the policies reflected in the FMC Act in February 2011 [CBC Min (11) 4/3] and May 2011 [CBC Min (11) 6/9]. Cabinet approved the FMC Act for introduction in October 2011 [LEG Min (11) 22/4], and approved a supplementary order paper for the FMC Act in April 2013 [EGI Min (13) 7/8].

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

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

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

The required regulations

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

22 Cabinet approved the release of a discussion document on the regulations in December 2012 [EGI Min (12) 28/11]. Many of the decisions on these regulations were made by Cabinet in June 2013 [CBC Min (13) 4/6, CBC Min (13) 4/7, CBC Min (13) 4/8 and CBC Min (13) 4/9]. Cabinet also delegated decisions around further detail to me, where these are consistent with the policy framework in the June Cabinet papers.

23 Final Cabinet decisions were deferred on the key content of disclosure, and on some governance and supervision matters, until further industry consultation had been undertaken. Subsequently three exposure drafts of regulations have been publicly released (October 2013, December 2013 and May 2014) and submissions received.

24 This paper covers the remaining issues on which Cabinet decisions are needed for these regulations. In addition I will be making decisions on further detailed matter under my authorisation from Cabinet. For example, I will be making decisions on the detailed content of disclosure documents, based on feedback from exposure drafts. The decisions sought from Cabinet in this paper, together with the additional decisions on detail I will make under my authorisation from Cabinet, will enable the full implementation of the regime.

25 The remaining disclosure issues covered by this paper include general disclosure issues, such as length limits applying to the PDS and requirements for disclosure of financial information. There are also a number of specific disclosure issues around debt securities, managed funds, simple deposit products by non-bank deposit takers (NBDTs) and listed issuers. These decisions significantly affect the extent of information that must be given to investors and where obligations should adjust to allow for different information needs and business structures.

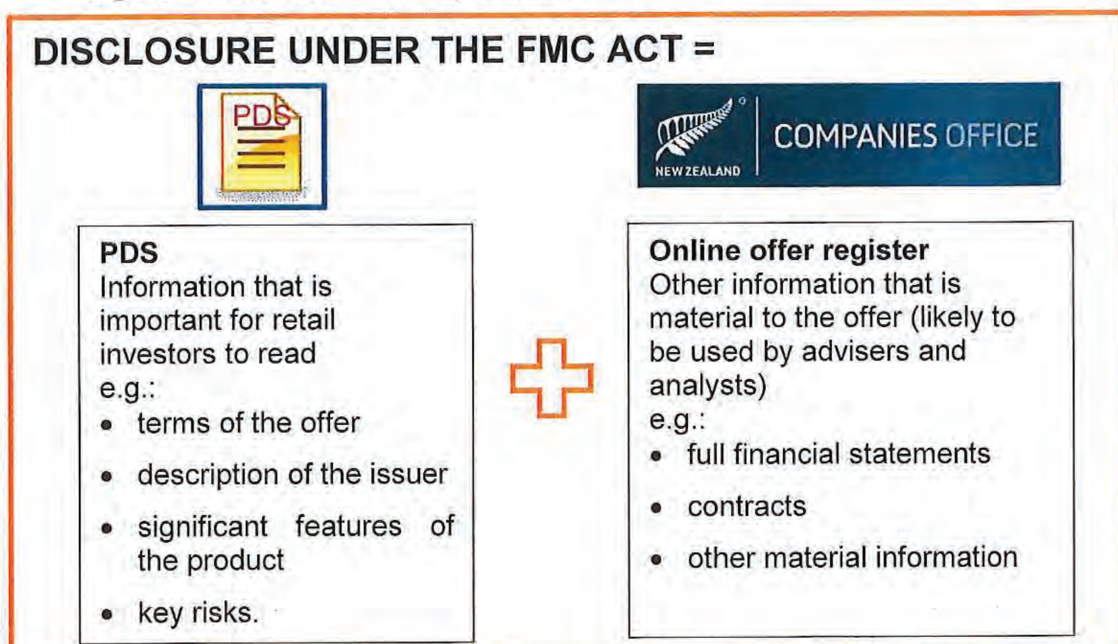
26 The remaining governance and supervision issues covered by this paper include the obligations on custodians of registered managed investment schemes, the roles and responsibilities of auditors and supervisors, and the governance arrangements for cash and term PIEs offered by registered banks.

27 I am also seeking Cabinet's agreement on transitional arrangements for derivatives issuers.

General disclosure issues

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

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



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

30 In June 2013 Cabinet made a number of decisions about the high-level content of disclosure documents [CBC Min (13) 4/7]. These decisions established the extent to which disclosure about different types of financial products should be prescribed, and the types of information that should be included in the PDS and on the online register.

31 Cabinet deferred making additional disclosure decisions however, until further industry consultation had been undertaken. Following this, the Ministry of Business, Innovation and Employment conducted a number of stakeholder workshops to develop an exposure draft of disclosure requirements. These were publicly released for consultation in October 2013. Submissions were received and incorporated into an exposure draft of regulations in May 2014. Further submissions were received on the draft regulations in June 2014.

32 The remaining issues dealt within in this paper all concern how to best make disclosure effective for investors while minimising compliance cost of the regime for issuers and promoting innovation and flexibility.

Restrictions on length of the PDS

33 Currently disclosure documents such as investment statements and prospectuses do not have any limits on length. Overlong documents (and perhaps more fundamentally, the legal compliance focus of those documents) are a significant feature of the current disclosure regime. In 2013 it was common for offer documents to exceed 200 pages. Lengthy, compliance-focussed disclosure undermines efficient and effective investor decision-making.

34 A key objective of the FMC Act is clearer and shorter PDSs. The FMC Act targets these issues through the core requirement that disclosures be "clear, concise, and effective", the introduction of an online offers register for information that is not specifically required in the PDS, and changes to the liability regime.

35 Cabinet previously decided that the PDS for managed funds should be a tightly prescribed and standardised document with a strict page limit [CBC Min (13) 4/7]. The May 2014 exposure draft of regulations included a limit of 12 pages for the managed funds PDS.

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

37 There is a continued risk that concerns about legal compliance drive issuers towards including more material and progressively longer documents over time. There is also significant risk and cost to FMA in enforcing the "clear, concise and effective" obligation to keep documents concise.

38 Three options for length limits were consulted on in the October exposure draft requirements:

a. no length limit (Option A)

b. a length limit with a reasonably generous upper limit (Option B)

c. a tighter benchmark length limit with an upper limit if the board states its reasons for exceeding the benchmark (Option C).

39 Submitters were split between these options. A minority preferred Option A (no length limit). They believe FMA's guidance in this area should suffice (in the case of equity) or because they view the page limit as unachievable for complex offerings or unnecessary on top of the changes already made by the Act and regulations.

40 Most submitters were in favour of some form of page limit, but were evenly divided between Option B and Option C. FMA submitted and expressed the strong view that a "circuit breaker" is needed. It wanted clear boundaries to be set by the regulations, to avoid over-reliance on its guidance and appeals by issuers on every offer where they consider more information is warranted. It strongly opposed Option C because it considers that approach undermines the objective of clearer and shorter PDSs.

41 On balance, I consider that a fixed length limit should be adopted. This would be a fixed limit, i.e. without the ability of issuers to vary it, apart from FMA exemption. It would be set for each product at a level that would allow all of the most important information for retail investors to be included in the PDS. This option was included in the third exposure draft of May 2014, which adopted the following limits:

a. equity securities – 60 pages

b. debt securities – 30 pages

c. other managed investment schemes – 60 pages

d. derivatives – 30 pages.

42 Such a limit would send a clear regulatory signal of what the outer limits of compliance should be. It would therefore help to reduce risk and cost to FMA in enforcing the "clear, concise and effective" obligation. I do not anticipate that it will present particular difficulties for complex offers, particularly given the ongoing availability of FMA exemptions.

Restrictions on length of key information summary

43 A further issue important to effective disclosure is the length of the key information summary in the PDS.

44 Cabinet previously decided that all PDSs should begin with a prescribed key information summary of no more than two pages [CBC Min (13) 4/7]. This is an 'at a glance' summary of the most important information about the offer, such as key terms.

45 Following submissions on the exposure drafts of regulations, I consider that for equity securities the key information summary should include more information around the key drivers of returns for the issuer and key risks. This will make the key information summary more useful for investors.

46 This will require a slight lengthening of the key information summary. I propose that the key information summary for equity securities be extended to four pages, and the key information summary for debt securities be extended to three pages. I consider the key information summary will remain short and accessible under this limit.

Financial information

47 The regulations around financial information are a particularly complex aspect of both the existing prospectus regime and the new disclosure regime. They affect both the length of the PDS and how information in the PDS should be "packaged" so that retail investors are likely to find it easier to understand and more useable.

48 Issuers of equity and debt securities are currently required to provide one year of full audited financial statements and five years of summary financial statements. All of this information needs to be prepared in accordance with generally accepted accounting practice (GAAP) (i.e. financial reporting standards and authoritative notices issued by the External Reporting Board).

49 However, the financial information currently required in offer documents is relatively lengthy and retail investors seldom examine it in detail, if they read it at all. The current requirements also bear little relationship to the information that issuers add and choose to highlight in offer documents. This additional information tends to be more directly relevant and useful to investors. However, there are few standards on the content and presentation of this information, and it is often not very comparable across issuers.

50 The costs of producing financial information in accordance with the current requirements are becoming more pronounced under the changes that were made to the Companies Act by the Financial Reporting Bill. Many companies will no longer need to produce GAAP financial statements until they become issuers. On becoming issuers, these companies would need to produce completely new GAAP financial information for the past 5 years.

51 I consider that the PDS should be more focussed on communicating key financial information to investors.

52 The exposure draft of regulations has included only selected financial information in the PDS, over shorter (3 year) period. This information includes key metrics around valuation (in the case of offers of equity securities) and credit risk (in the case of offers of debt securities). The draft regulations also permit issuers to include interim financial information, and financial information with adjustments to reflect changes to the business ("pro forma" financial information).

53 The draft regulations have provided that three years of full historic financial statements be placed on the offers register (primarily for analyst and advisor audiences) with only the most recent financial statements needing to be prepared in accordance with GAAP and audited. For equity and managed investment schemes (other than managed funds), two years of full prospective financial information is required. If non-GAAP or pro forma financial information has been included in the PDS, the register is also required to contain reconciliations of that information to GAAP, and the principal assumptions of any pro forma information.

54 Submitters on the draft regulations have generally supported this approach, including both issuers and the New Zealand Shareholders Association.

55 I therefore propose to continue this approach in the final regulations. This should deliver financial information in the PDS that is likely to be most useful for retail investors, as well helping to reduce the length of the PDS and the cost of preparing financial information. It will also ensure that information highlighted in the PDS is prepared on a consistent basis.

Material contracts

56 The online register will contain all "material information" for the offer, other than the information set out in the PDS. A key question is how much further the regulations should go in setting brightline tests for particular matters. The purpose of these brightline tests is to reduce uncertainty about what needs to be disclosed on the register, and to ensure that matters are not overlooked.

57 Currently issuers must lodge all "material contracts" with the Registrar, and provide a brief summary of their general nature in the prospectus. Material contracts are those that would be critical for analysts and other sophisticated investors to assess the pricing and risks in an offer. However, issuers identified concerns about commercial confidentiality in their submissions, and sought that, instead of being required to place the whole contract on the register, the issuer may lodge a summary of its key terms.

58 I agree that a summary of the key terms of the material contract would likely be sufficient (and in many cases, aspects of the material contract would likely have been covered as well in the PDS).

59 I propose the regulations require an issuer to include either the material contract or a summary of its key terms to the extent not already summarised in the PDS.

Debt disclosure – use of a 'ranking' diagram to show secured, unsecured and subordinated liabilities

60 Another key issue about how to most usefully package information to make it useful to investors is how to present information about the 'ranking' of debt securities. That is, if an issuer of debt securities becomes insolvent, what existing creditors of the issuer will be paid before investors, and what assets will be left to pay investors?

61 Standard debt securities may be 'unsecured', which means that creditors with security interests over assets of the issuer will be paid out before investors, in addition to creditors that are preferred by law (such as employees). It is also common for issuers to offer 'subordinated' debt securities, in which essentially all creditors of the issuer (including unsecured creditors) are paid before investors.

62 Ranking has a major impact on the outcomes for investors in the event that the issuer becomes insolvent. In some cases, the most senior creditors may be fully paid out, with other creditors losing money. In other cases, secured investors may receive small or moderate payments while unsecured investors received little or no payment.

63 To make information about ranking more accessible to investors, there appears to be general agreement among submitters that some diagrammatic representation of ranking is desirable.

64 The draft regulations have therefore included a diagram. It would likely appear similar to the diagram included in the recent (June 2014) Mighty River Power prospectus for capital bonds (which are a subordinated debt security):

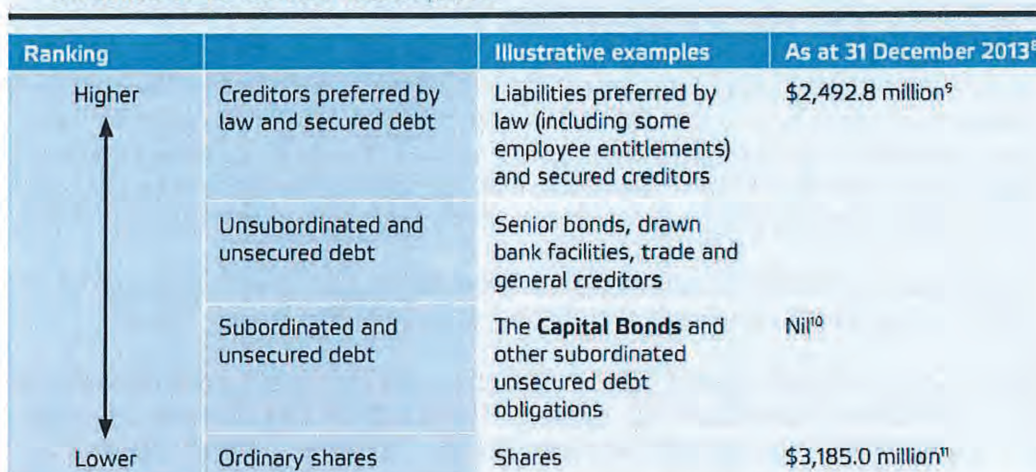


ILLUSTRATION OF RANKING OF CAPITAL BONDS ON THE LIQUIDATION OR WINDING UP OF MIGHTY RIVER POWER

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

65 However, some submitters have been concerned about the inclusion of dollar amounts in the diagram. In particular:

a. amounts are only provided for a particular point in time, and would change materially in the event of insolvency

b. amounts are likely to be complex and potentially costly to calculate accurately in some cases – particular issues have been raised regarding the impact of priority rules within the Personal Property Securities Act 1999 and in other relevant legislation, such as Schedule 7 of the Companies Act 1993.

66 Notwithstanding these concerns, amounts may be important to give investors an idea of the scale of the various liabilities. If amounts were omitted, investors would not be given information about whether, for example, liabilities ranking ahead of them were relatively small compared to the amounts that would be owed to investors (in which case investors would share in a larger pool of assets on liquidation), or were large (in which case investors may be left with a smaller pool of assets, or no assets). Any diagram would also need to be accompanied by a clear explanation that it was a point-in-time snapshot, to avoid misleading investors. The PDS would also need to state whether higher ranking instruments can be issued at a later point in time.

67 On balance, I consider that such a diagram should be included in the final regulations, including the amounts of various liabilities. Allowing issuers to omit them in circumstances where they are difficult to calculate, or where the benefits of including amounts are likely to be outweighed by the costs of preparation, will mitigate the concerns raised by submitters.

Managed funds disclosure

Structure of managed funds disclosure

68 Issues around the packaging of information also impact significantly on issuers in the context of managed funds where Cabinet has decided that the PDS should be highly prescribed [CBC Min (13) 4/7]. There are two components to managed fund disclosure: the PDS and the quarterly fund update.

69 The PDS covers one or more registered managed investment schemes. PDSs provide information about how schemes work, along with specific information about the fees and risks of the funds offered under schemes.

70 A quarterly fund update is prepared for each fund. It is based on the quarterly disclosure statements produced under the KiwiSaver periodic disclosure regime, which it replaces and extends to all managed funds. Like the PDS, the fund update contains information on fees and risks of the fund. Because it is frequently updated, it is also able to contain information about matters such as the performance and specific assets held by the fund.

71 Submitters have been concerned about how these documents will work for some types of fund managers, schemes and distribution channels. The issues include:

- The managed fund PDS is subject to a tight length limit (the exposure draft of regulations proposes 12 pages). This restricts the number of funds that it can practically contain information about. However, some managed investments schemes currently provide dozens of funds, which would require 30+ pages to fully describe. This would require fund managers to create a number of different PDSs for each scheme.
- For many fund managers and their investors, the fund update is likely to be more relevant to their clients than the PDS. This is because prospective investors will often (and arguably, should) compare individual funds offered with those offered by other managers – rather than first choosing the scheme they want to invest in, and then considering funds. Many of these prospective investors also expect to receive up-to-date information about performance and assets that is provided in the fund update but not the PDS.

72 In response to these issues, I propose to provide more flexibility for fund managers to use information from fund updates in their up-front disclosure. Managers should be able to provide a fund update rather than a PDS if the investor has already received a PDS containing 'scheme' information. I also propose that managers be able to include information from the fund update in their PDS to replace the fund-level information currently proposed to be required in the PDS.

73 This flexibility should reduce cost to fund managers, while strengthening the communication of key information about matters such as the fees and risk profile of funds. I consider that this will continue to promote effective disclosure for investors.

Treatment of "non-fund investment options"

74 A further issue is the treatment of investment options that are not "funds". A "fund" is defined as a pool of assets that are held for the benefit of a group of investors and that are managed together under a single investment mandate. For example, a KiwiSaver scheme may include a conservative fund and a growth fund.

75 However, managers are increasingly offering investors investment options and strategies that combine investments into multiple funds or automatically shift between funds. These include, for example:

- combination of funds presented as a single investment option – e.g. a manager may present a "balanced" investment option that results in 50% of the investor's money going to the conservative fund and 50% going into the growth fund

- "life stages" investment strategies that switch investors between funds as they approach retirement.

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

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

78 I propose that non-fund investment options be treated as funds for various purposes. In the PDS, the key information summary, the table of investment options, and fees disclosure would all need to cover these non-fund investment options. In addition, fund managers would need to prepare quarterly updates for these investment options.

79 This treatment was consulted on in the draft regulations, and generally supported by submitters.

Disclosure for simple deposit products

80 There are a number of key disclosure issues that concern how compliance costs for issuers should be minimised while continuing to give investors the key information that they need.

81 Banks and non-bank deposit takers such as credit unions and building societies offer a range of simple deposit products, such as transaction accounts, savings accounts and term deposits. These products are treated as "debt securities" by the FMC Act and would, by default, require customers to be given a full product disclosure statement before opening an account.

82 Currently the FMC Act provides a statutory disclosure exemption for simple deposit products offered by registered banks, and Cabinet has decided that no additional disclosure will be required for these products [CBC Min (13) 4/7]. This was on the basis that they are relatively well understood by investors, and low risk. These are the same bank products classified as "Category 2" by the Financial Advisers Act, which means that financial advisers do not need to be authorised to provide advice on them.

83 Banks are separately required by the Reserve Bank of New Zealand Act 1989 to publish quarterly disclosure statements on their web sites.

84 This has prompted submitters to raise two issues:

1. Whether non-bank deposit takers should be subject to a disclosure regime similar to registered banks in respect of category 2 products.
2. Whether category 2 needs to be reviewed and adjusted, in light of its increasing use in both the FMC Act and the Financial Advisers Act.

Non-bank deposit takers

85 A number of products offered by non-bank deposit takers are classified as "category 2" under the Financial Advisers Act. These comprise:

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

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

87 These disclosure requirements are costly to comply with, and may not be justified for category 2 products offered by non-bank deposit takers. As with category 2 products offered by banks, these products are likely to be well understood by investors. In some cases, such as transaction accounts, customers are unlikely to treat these accounts as investments, and are less likely to make effective use of the PDS. Many investors may simply rely on the prudential regulation of non-bank deposit takers and general market commentary about their soundness.

88 I propose that the PDS for these products to be made available online but not given to investors, except on request. The content of the PDS would be adjusted to be more similar to the information prepared quarterly by registered banks and, as with banks, the PDS would be updated quarterly. It would be a shorter version of the debt securities PDS, containing information about the non-bank deposit taker's business, credit ratings, financial position and performance, specific credit risks and guarantors.

89 However, placing the PDS on the register only has risks. Non-bank deposit takers have a higher risk of default than banks. For example, many credit unions, who are the main issuers of category 2 products, do not have credit ratings (due to an exemption for NBDTs with consolidated liabilities under $20 million). The four that do are rated from BB- to BB+ by Standard and Poors, which is considered below 'investment grade', and implies a degree of vulnerability. The two building societies with credit ratings are also rated BB+ by Fitch Ratings. In contrast, all registered banks have investment-grade credit ratings (BBB- and above).

90 Retail investors need to be informed about these risks, particularly where they are making significant investments.

91 Therefore I propose that, in addition to placing the PDS on the offer register, a credit risk statement must be given to investors. This would include the non-bank deposit taker's credit rating and a reference to the availability of PDS.

Redrafting scope of category 2

92 Given the increased significance of category 2, there are also questions around the scope of what constitutes a category 2 product.

93 The definition of category 2 has been adjusted by regulations over time as issuers have developed new products that, often for technical reasons, fall outside the existing definitions. Other changes have been made to deal with specific issues that have been raised with Ministers by individual providers and industry groups. This has resulted in category 2 comprising a large number of narrow and prescriptive product definitions, which are likely to require ongoing amendment.

94
This allows more flexibility and innovation in products that are equivalent in terms of risk and complexity to the existing category 2 debt products.

95 In considering more substance-based definitions of category 2 products, more fundamental questions are likely to be raised about this category.

96 In particular, most deposit products offered by building societies and other non-bank deposit takers are currently outside of category 2. This is understandable given that these include many fixed term debt securities offered by finance companies.

97 However, the Non-bank Deposit Takers Act 2013 came into force on 1 May 2014. All NBDTs will need to be licensed by the Reserve Bank by 1 May 2015. The result of this is that the regulation of NBDTs is more similar to registered banks than in the past.

98 At this stage, I consider these issues are best dealt with through the review of the Financial Advisers Act, which is required to be completed by mid-2016.

Disclosure exemption for quoted financial products

99 A similar compliance cost issue arises in the context of financial products that are already traded on NZX. The FMC Act provides a disclosure exemption for offers of financial products if the products are already traded on a licensed financial product market. This 'same class' exemption came into force on 1 April 2014 as part of Phase 1 of the FMC Act implementation and was recently used by New Talisman Gold Mines Limited to issue an additional tranche of shares to existing shareholders.

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

a. that an offer is being made without disclosure to investors under the exclusion

b. that the issuer is in compliance with all of its continuous disclosure and financial reporting obligations

c. setting out any information that is excluded information for the purposes of continuous disclosure as at the date of the notice.

101 The rationale for this exemption is that licensed markets have ongoing disclosure obligations that ensure that information about issuers is made available to investors. This information is incorporated into securities prices, which provide further information to investors about the value and risks of the securities being offered.

102 Use of this 'same class' exemption provides substantial compliance cost reductions for issuers. The exemption is also likely to give retail investors access to high-quality investments that, due to these compliance costs, would otherwise only be provided to large institutional investors.

103 A key issue is what 'same class' means in the case of debt products and how this exemption should apply to these products.

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

105 However, the rationale for the exemption would also extend to debt of different terms. The main difficulties with such an extension is that:

a. investors receiving offers may be unaware of the issuer's quoted debt, or

b. due to complexities in the way that debt is priced, investors may not be able to use the quotation to effectively assess the credit risk of the issuer and whether the interest rate offered is reasonable.

106 This would defeat the rationale for the exemption, which is that this information is already available to investors and so does not need to be disclosed in a PDS.

107 I propose to extend the same class exemption to debt with a different term to the issuer's existing debt. To assist investors to use market information on the existing quoted securities, I propose that issuers using the same class exemption for debt securities would be required to provide additional disclosure. This would, at a minimum:

a. identify the issuer's current quoted debt securities

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

i. assess the risks of the debt securities being offered

ii. assess whether the returns offered are fair.

108 Beyond offers of financial products that are the same class as quoted products, the existing Securities Regulations 2009 provide that offers of equity and debt securities that rank equal or in priority to quoted products have a 'simplified disclosure prospectus' with reduced disclosure content.

109 I propose to continue the approach, including:

a. requiring issuers to release a notice to the relevant licensed market (as applies to the same class exemption)

b. focussing the information in the PDS on key product information that differs from the existing quoted financial products

c. omitting the requirement for the register to include all material information not in the PDS.

Supervisors of debt securities and managed investment schemes

110 The FMC Act sets the key elements of the governance regime as follows:

- Schemes must have a licensed manager and an independent supervisor (except for some classes of existing schemes where the resulting costs would be unduly burdensome).
- Schemes have statutory duties to act in the best interests of investors. These duties are owed directly to investors and provide remedies for investors where a breach of duty takes place.

- New statutory rules and mechanisms govern pricing errors, limit breaks, related party transactions and other key operational matters where rules are currently not set.

111 Cabinet has previously made decisions on regulations for the governance framework that set the detail of the roles and responsibilities of the issuer [CBC Min (13) 4/8]. There were some matters relating primarily to other key participants in the governance framework on which Cabinet did not make final decisions because additional consultation was required or other initiatives to address problems were as yet incomplete. The following decisions cover these matters.

Auditors' obligations to supervisors

112 The FMC Act currently recognises that while supervisors have the primary role of supervising offers, auditors have a valuable supporting role in the supervisory framework. The Act gives auditors obligations to "whistle-blow", provide to supervisors copies of reports to issuers, and carry out various assurance roles. There has been a longstanding tension however between auditors and supervisors as to their respective roles and responsibilities.

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

114 This tension is at its worst in relation to the current obligation in the existing regulations for auditors to confirm their audit opinions for the benefit of supervisors. In June 2013, Cabinet agreed to roll over the current obligation for auditors of deposit takers, pending development of an industry-wide solution to the auditor-supervisor tension, and invited me to report back on the outcome [CBC Min (13) 4/8].

115 There has been substantial progress towards resolving the conflict. New Zealand Institute of Chartered Accountants (NZICA) has developed a model "tripartite" engagement between issuer, auditor, and supervisor. Under the tripartite engagement, supervisors engage auditors to report on the issuer's compliance with the trust deed. This provides reporting designed for supervisors' purposes and as a result it provides a contractual framework and an open dialogue that better supports the minimum obligations for auditors in the Act. The tripartite engagement has substantial, albeit not uniform, support from the supervisor and auditor industries.

116 The current obligation for auditors to confirm their audit opinions for the benefit of supervisors undercuts the use of the tripartite engagement and perpetuates reliance by supervisors on reporting that is not fit for their purposes. I do not think that it promotes the quality of the supervisory framework.

117 I propose not to continue the current obligation for auditors to confirm their opinion for the benefit of supervisors, and to modify other current obligations to further clarify roles and responsibilities.

Changes of supervisors

118 Cabinet also previously agreed in principle [CBC Min (13) 4/9], subject to further consultation and assessment of costs and benefits, to use licence conditions to impose duties on supervisors to:

a. accept an appointment by FMA, analogous to the lawyer's cab rank rule

b. give replacement supervisors all reasonable assistance to facilitate a change of supervisors.

119 This agreement reflected the longstanding principle that supervisors cannot resign from their role unless another supervisor is appointed – which ensures that a trust cannot "fail" because there is no supervisor willing to take up the role. This is a particular issue if the issuer or the trust itself is insolvent, or near insolvent, and so unable to pay the supervisor's fees. Previously Public Trust acted as "trustee of last resort" under general trust law (although recently, as a result of the Trustee (Public Trust) Amendment Act it was required to only do so if there was an indemnity covering its fees from the resigning supervisor).

120 The FMC Act removes Public Trust from sole responsibility for this role. Instead, the FMA may appoint a replacement supervisor from amongst all available licensed supervisors, and require an indemnity from the resigning supervisor to cover the new supervisor's fees. FMA may also appoint a person who is not a licensed supervisor, but would only do so on a temporary or limited basis.

121 There is still a risk that despite the additional role of supervisors and the ability to compel a fees indemnity, licensed supervisors may refuse the appointment. This may because of the business interruption costs of taking an appointment, the costs arising from taking an appointment for which they do not have expertise or the risk that there would be a shortfall and that they would not recover their direct costs.

122 I think it is appropriate that supervisors should share the burden of the trustee of last resort role, and be obliged to accept an appointment from FMA if selected. However, I think that the costs that fall on the supervisor should be addressed in two ways.

123 First, a supervisor should not be required to accept an appointment if it has good cause not to do so. Good cause would include a conflict of interest or a lack of expertise in the relevant matter.

124 In addition I do not think that particular supervisors should bear the costs of the shortfall according, purely because they are unlucky enough to be selected by FMA where the trust cannot cover its fees. In some cases (for example, where the trust is not actively trading) the shortfall costs may be minimal. In others they may be much more significant. Given that these costs must fall somewhere, I consider that it is more equitable for these costs to be met by FMA. The costs would then be shared amongst industry participants through the levy that funds FMA.

125 Accordingly I am seeking Cabinet's confirmation of its previous agreement in principle.

126 I also propose that FMA will be required to meet any costs of appointment that cannot be met by the trust or previous supervisor

Custodians of managed investment schemes

127 In the context of a managed investment scheme (such as a KiwiSaver scheme), the FMC Act requires scheme property to be held independently from the manager of the scheme by a custodian. The custodian will either be the supervisor or a third party appointed by the supervisor. The custodian holds the scheme property on trust for the scheme, separately from their own assets. Custodians that hold client assets directly on behalf of investors are generally regulated under the Financial Advisers Act.

128 The recently introduced Financial Advisers (Custodians of FMCA Financial Products) Regulations 2014 (FA Custodian Regulations) apply reporting, reconciliation, and assurance requirements on these custodians. These regulations do not apply to custodians of managed investment schemes, which are instead regulated under the FMC Act.

129 The FMC Act allows for similar requirements to apply to the custodian of managed investment schemes through regulations. Stakeholders have been broadly supportive of applying similar requirements to those in the FA Custodian Regulations, but with minor changes to better adapt them for managed investment schemes.

130 I propose that custodians of managed investment schemes should have obligations consistent with those applying to custodians under the FA Custodian Regulations, with appropriate modifications.

Governance of cash and term PIEs

131 Cash and term PIEs offered by subsidiaries of registered banks are currently subject to the Unit Trusts Act 1960, which is repealed from 1 December 2014. These are standard banking products. The banks offer them as a substitute for other deposit accounts or term investments. As they are simple, well understood products, the FMC Act exempts them from the usual requirements for disclosure.

132 However, the FMC Act leaves open the question of whether additional requirements should apply to these products to ensure they are appropriately governed. Although they are simple products that invest only into the cash and term investments of the parent bank, there remain some basic operational risks.

133 While I consider that the full governance regime is not appropriate given the simple structure of these products, some of the key elements of the governance framework are still required. In particular, I consider that case and term PIEs should be subject to the requirement to have an independent licensed supervisor and should owe some basic duties directly to investors. These requirements will address the basic operational risks of these investment and are equivalent to the obligations that apply to them currently under the Unit Trusts Act 1960.

Transitional issues

Derivatives issuers

134 The FMC Act makes such significant changes for businesses that it is critical that the implementation of the regime is carefully staged to enable businesses to move to full compliance on a planned basis. Accordingly the FMC Act provides a transition regime for most issuers of up to 2 years. Recently Cabinet made further decisions to provide for a transition regime for providers of discretionary investment management services [CBC Min (14) 2/9].

135 There are other areas, however, where the FMC Act does not yet fully provide for a staged implementation for businesses. Some of these issues will be managed by simply deferring commencement of key provisions for an interim period (for example, the compulsory requirement for all currently unregistered financial product markets to be licensed). However, the position for derivatives issuers is more complex.

136 The FMC Act will automatically treat existing authorised futures dealers and issuers as licensed under it on 1 December. Their current licence conditions are also "ghosted" across to the new regime. In practice this will mean that FMA will subsequently revise these licence conditions to better fit the FMC Act over a period of time. I understand that the staging of this revision will be clearly signalled to businesses to allow them to plan and improve systems well in advance.

137 These derivatives issuers will also be generally providing disclosure documents and related advice under their current licence conditions and managing client funds on the basis of the existing Futures Industry (Client Funds) Regulations 1990. I consider that these derivatives issuers will also need an appropriate transition to develop or change their offer documents and institute new client fund systems.

138 I propose that derivatives issuers who are currently authorised futures dealers have until 1 May 2015 (or an earlier date agreed with FMA) to adopt the new PDS and financial adviser requirements, or (for the PDS requirements) until 1 December 2015 if offer documents are already required under their licence conditions. These derivatives issuers should also have until 1 December 2015 to adopt the new investor funds and property requirements and the Futures Industry (Client Funds) Regulations 1990 should continue to apply to derivatives issuers until that time.

New obligation for brokers to segregate client money

139 There are also likely to be transitional issues around implementing the new obligation to keep client money separate from firm money under the Financial Advisers Act 2008. This duty is intended to support the obligation to keep client money in trust so as to facilitate quick identification of client money and return on insolvency of a firm. It also guards against risks that flaws in accounting systems go undetected because firm money in the client account obscures problems.

140 There are, however, some good reasons why firms may want to use a limited amount of firm money as a buffer in their client accounts. Doing so guards against settlements of transactions failing (if client funds are uncleared) and prevents client accounts going into overdraft. Given the third parties involved, there may be reasons why some brokers are not in a position to prevent this. The Securities Industry Association (SIA), in particular, has raised concerns about the practicality of all of its members being able to comply with this requirement.

141 FMA has been encouraging SIA to develop an industry-led solution to these issues, which may or may not require some sort of partial FMA exemption for brokers that have appropriate systems in place to control co-mingling of firm and client funds. FMA has recently confirmed that there has been some substantial progress towards such a solution, which it expects will be finalised in the next few months.

142 It is likely, however, that whatever the result of SIA's proposed solution, some brokers will need time to make some relatively substantial systems changes. It is unlikely that such changes could be successfully implemented by 1 December 2014. I therefore propose that existing brokers be provided a transitional period until 1 December 2015 to comply

with this requirement. The expectation is that solutions would be identified and in place early in 2015, leaving the remaining transitional period for brokers to implement. This approach is consistent with the transitional arrangements for many other services, including those relating to client funds held by derivative issuers.

Next steps

143 Following these decisions, the exposure drafts of the regulations will be revised to form a full set of regulations to apply under the FMC Act.

144 Officials will continue to engage with stakeholders during the drafting process, and that this may result in minor or technical changes to the regulations. I seek Cabinet's authorisation to make changes, consistent with the policy framework in this paper, on any issues that arise during the drafting process.

Consultation

145 The Treasury, the Reserve Bank, and the Financial Markets Authority were consulted on these papers and are comfortable with their contents. The Department of Prime Minister and Cabinet has been informed.

146 The proposals in this paper have been the subject of public exposure drafts and we have also undertaken additional consultation with Trustee Corporations Association of New Zealand Inc, New Zealand Institute of Chartered Accountants, Financial Services Federation, and the New Zealand Association of Credit Unions.

Financial Implications

147 This paper has no financial implications.

Human Rights

148 There are no human rights implications from this paper.

Legislative Implications

149 The proposals in this series of papers will affect the regulations to be made under the Financial Markets Conduct Act.

Regulatory Impact Analysis

150 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

151 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. They 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

152 This Cabinet paper and the accompanying regulatory impact statement will be published on the Ministry of Business, Innovation and Employment's web site. I also expect to release a media statement.

Recommendations

It is recommended that the Committee:

Disclosure

1 **note** that in June 2013 [CBC Min (13) 4/7], Cabinet agreed that:

1.1 all PDSs should begin with a prescribed key information summary of no more than two pages

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

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

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

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

1.6 there should be periodic disclosure requirements analogous to the KiwiSaver periodic disclosure regime for all managed funds

2 **agree** that the PDS for equity securities, debt securities, other managed investment schemes and derivatives be subject to fixed length limits that allow all of the most important information for retail investors to be included in the PDS

3 **agree** that the key information summary for equity securities be extended to four pages, and the key information summary for debt securities be extended to three pages

4 **agree** that the PDS for equity securities and debt securities include selected financial information likely to be of most use to retail investors, which covers:

4.1 three years of historic financial information, prepared in accordance with generally accepted accounting principles (GAAP) where applicable

4.2 two years of prospective financial information

5 **agree** that the offer register entry contain the following additional financial information:

5.1 for equity and debt securities, three years of historical financial statements, with only the most recent statements required to be compliant with GAAP and audited

5.2 any interim financial statements

5.3 if non-GAAP or pro forma financial information has been included in the PDS, reconciliations of that information to GAAP, and the principal assumptions of any pro forma information

5.4 for equity securities and managed investment schemes (other than managed funds), prospective financial statements covering the next two financial years, prepared in accordance with FRS-42

6 **agree** that the offer register entry contain material contracts or a summary of the key terms of material contracts to the extent not already summarised in the PDS

7 **agree** that a diagram showing the ranking of debt securities be included in the PDS, including the amounts of various liabilities, but with the ability to omit amounts in circumstances where the benefits are outweighed by the costs of preparation

8 **agree** that the information from the periodic fund updates for managed funds can be used to satisfy requirements for fund-level information at point of sale, either as a separate supplement to the PDS, or as part of the PDS

9 **agree** that investment options that combine multiple funds be treated, with appropriate modifications, as funds for the purpose of the PDS and periodic fund updates

10 **agree** that the disclosure requirements be adjusted for simple deposit products offered by non-bank deposit takers, comprising:

10.1 a shorter version of the debt securities PDS that is made publicly available but is not given to investors (except on request), containing information about the non-bank deposit taker's business, credit ratings, financial position and performance, specific credit risks and guarantors

10.2 a credit risk statement that may be given to investors instead of the PDS, which includes the non-bank deposit taker's credit rating and refers to the availability of PDS

11 **note** that the current exemption for same class listed debt securities is restricted to debt with the same term as the issuer's existing quoted debt

12 **note** that the rationale for the exemption would also extend to debt of different terms, provided that investors are able to use market information on the existing quoted securities to assess the risk and pricing of the new issue

13 **agree** to extend the same class exemption to debt with a different term to the issuer's existing debt

14 **agree** that issuers using the same class exemption for debt securities be required to provide additional disclosure to investors to enable them to use market information on the existing quoted securities to assess the risk and pricing of the new issue

15 **note** that under the existing Securities Regulations 2009, offers of equity and debt securities that rank equal or in priority to quoted securities have a 'simplified disclosure prospectus' with reduced disclosure content

16 **agree** to continue the approach in recommendation 15, including:

16.1 requiring issuers to release a cleansing notice (as applies to the same class exemption)

16.2 focussing the information in the PDS on key product information that differs from the existing quoted financial products

16.3 omitting the requirement for the register to include all material information not in the PDS

Governance and supervision of financial products

17 **note** that in June 2013 [CBC Min (13) 4/8], Cabinet previously:

17.1 agreed to roll over the current implied terms for deposit takers relating to auditors and their reporting to supervisors, pending development of an industry-wide solution and

17.2 invited the Minister of Commerce to report back on the outcome

18 **note** there has been substantial progress towards resolving the conflict between supervisors and auditors in respect of each of their responsibilities for debt issues and managed funds

19 **agree** not to continue the current implied term for auditors to confirm their opinion for the benefit of supervisors, and to modify other implied terms to further clarify roles and responsibilities

20 **note** that Cabinet previously agreed in principle [CBC Min (13) 4/9], subject to further consultation and assessment of costs and benefits, to use licence conditions to impose duties on supervisors to:

20.1 accept an appointment by FMA, analogous to the lawyer's cab rank rule

20.2 give replacement supervisors all reasonable assistance to facilitate a change of supervisors.

21 **confirm** the agreement in principle in recommendation 20

22 **agree** that FMA will be required to meet any costs of appointment that cannot be met by the scheme or previous supervisor

23 **agree** that custodians of managed investment schemes should have obligations consistent with those applying to custodians under the Financial Advisers Act 2008, with appropriate modifications

24 **note** that cash and term PIEs are currently subject to governance and supervision obligations in the Unit Trusts Act 1960, which is repealed from 1 December 2014

25 **agree** that cash and term PIEs will continue to have obligations to have an independent licensed supervisor, the core duties of registered schemes, and a governing document

Transition and other matters

26 **agree** that derivatives issuers will have until 1 May 2015 to adopt the new PDS and financial adviser requirements, or until 1 December 2015 if offer documents are already required under their licence conditions (or an earlier date agreed with FMA)

27 **agree** that derivatives issuers will have until 1 December 2015, or an earlier date agreed with FMA to adopt the new investor funds and property requirements and until then the Futures Industry (Client Funds) Regulations 1990 continue to apply to them

28 **agree** that existing brokers will have until 1 December 2015 to comply with the new obligation to keep client funds separate from firm money

29 **note** that officials will continue to engage with stakeholders during the drafting of regulations, and that this may result in minor or technical changes to the regulations

30 **authorise** the Minister of Commerce to make changes, consistent with the policy framework in this paper, on any issues that arise during the drafting process

31 **agree** to, [redacted] reframe the existing category 2 debt product definitions based on the economic substance of the products.

Hon Craig Foss
Minister of Commerce
24 / 7 / 14