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PRIMARY MARKETS

Background

What is financial markets law?

- Can be seen as an extension of company law, in a way it is, once a company gets big enough to raise money from the public (big companies)
    - Does this by issuing shares to the public
    - Doesn't only apply to listed companies, also finance companies who issue bonds
- **Applies to any entity that goes to the public to raise money**
- Primarily a response to peoples call for protection, especially in light of multiple crises (investment failures shape the law that we have today)
- Economists might say it is to further market inefficiency, by requiring disclosure by the company with civil and criminal penalties
- Prudential supervision, government regulatory oversees the sector

Key themes

1. <u>Regulation carries with it costs</u>
    a. With no financial markets law, would markets be more or less efficient? Probably less, but some people think it would be more, because financial markets law is a barrier to doing business (can be time consuming and costly)
    b. This cost is borne by the financial consumer (person using the service)
    c. Other costs:
        i. Moral hazard cost – complacency out of reliance on the regulator.
        ii. The cost of the regulator
        iii. Cost of inhibiting innovation

2. <u>Securities markets are difficult to regulate</u>
    a. People are greedy, people will cheat others and businesses will cut corners, all these issues need to be addressed. A balance needs to be struck between interests of investors who want protection and businesses who want limited costs

History of Financial Markets Law in NZ

A series of failures and losses to investors led to legislative change.

The Securities Act 1978 (background)

- Anyone who wanted to raise money from the public had to advise the public of all material information relevant to the proposal
- All details of material matters had to be set out in the prospectus
- The Securities Commission set out securities regulations, and could grant exemptions (important because disclosure not appropriate in some circumstances)
- There were sanctions for misstatements in prospectus

- The Securities Commission also recommended NZ get a takeover code, and recommended insider trading rules (NZ did not have either at this stage)

The Securities Act 1978 (issues)

- Over time the disclosure regime was not working that well, the GFC highlighted a number of issues
    - Disclosure documents were too long and complex for most investors to understand
- Some investors would fall outside the protection of the SA (led to the FMCA 2013) which led to a new disclosure system and a new set of rules for offers and giving the FMA more powers
- If there was an offer of a security to the **public**, the offer was regulated, full disclosure required. "To the public" was not defined, led to lots of litigation
    - The "to the public" threshold was dropped in the FMCA (all offers of financial products are caught unless an exemption applies)
- Defined "security" as *any interest or right to participate in any capital, assets, earnings, royalties, or other property of any person;*
    - This was really broad, and people could apply for an exemption from the Securities Commission, and lots were granted
    - Lots of issues with products falling outside the Act and therefore lacking protection.
    - Securities that came within this definition were called "participatory securities"

1987 Sharemarket Crash

- In early 1990s NZ got the Companies Act 1993, the Financial Reporting Act 1993 and Takeovers Act 1993
- One of the purposes of the Companies Act 1993 was to make it easier enforce directors' duties

Underlying purpose of these reforms

- The government was concerned about the future, and wanted to encourage people to save for retirement to relieve the burden from the state
- The government wanted to make investments more accessible and fair to the investing public
    - To achieve this the Securities Act disclosure was extended further, and an "investment statement" was introduced, which was intended to be a short plain English document that made investors aware of the risks of the investment
    - These statements became long and complicated, not what they were intended to be

2008 Global Financial Crisis Consequences

- Financial advisors now faced a licensing regime, had to be qualified and make disclosures to clients
- Trustees and debt securities were regulated
- Finance companies became subject to prudential
- The Securities commission came under scrutiny (wasn't really their fault but the government took a strong stance on supervision of the financial sector)

- Prospectus and investment statement regime weren't really working, a new disclosure system was introduced

Cases under the Securities Act 1978

R v Smith

Investors argued the scheme was a property proportionate ownership scheme (to get protection under the general definition of securities in the Securities Act)

Facts

- Goldcorp advertised to purchase no allocated metal, purchaser agreed to buy gold and the company agrees to store it an insure it and would provide the gold if the purchaser requested it
- Goldcorp didn't have enough gold to meet all the obligations, and had made untrue statements about storage and insurance
- Purchasers claimed this was a security, and Goldcorp did not comply with advertising requirements under the SA (then they would be able to attach personal liability to the directors)
- Issue was whether the arrangement was *an interest or right to participate in any capital, assets, earnings, royalties, or other property of any person* (whether it was a participatory securities)

Held

- Purchasers did not get any right in the property, only a contractual right to call for the delivery of the gold
- Participation required some sort of continuing activity shared by a number of persons (this was not the case, so no security)
- The decision was criticised for being too narrow (on the fact of it this looked like an investment scheme, people bought into the scheme to buy and sell the gold later for a higher price).
- If it has been structured as a company and shares were brought, then clearly a security
- Decision used to highlight the shortcomings in the CA

Hickman v Turner and Waverly Ltd

Facts

- Investors entered into a sale and purchase arrangement and committed to purchase the completed property which allowed the developer to get finance to construct the properties.
- Old people were convinced to mortgage their homes to finance the project. Blue Chip offered high return investment based on expectation of continued demand for the properties (expecting they will go up in value).
- Properties stopped selling, Blue Chip collapsed, could not fulfil its lease guarantees or pay the investors, who lost a lot of money.

Held

- Investors argued the arrangement was a debt security

High Court and Court of Appeal

- HC and CA said they were not a debt security, because there was no element of repayment, and it concerned an interest in land (and there was an exemption in the SA for interests in land)
- While the Act had an investor protection element, there needs to be an element of repayment, this arrangement did not have this, so can't be seen as a security

Supreme Court

- The SC took a substance over form approach, found the interests were debt securities, taking a broad approach, found Blue Chip were like a borrower, in effect, the investors were financing Blue Chip to build the apartments
- There was the issue of the interest in land exemption, the SC got around this by looking to US law, said the land ownership element was of peripheral significance, got around the exemption for interests in land
- Result = was a security and investors protected under the SA

Both the arrangements in *R v Smith* and Hickman seem to be arrangements where members of the public gave money expecting a return (but the Securities Act did not apply for some technical reason)

- This was one of the reasons why the FMCA was structured to be as broad as possible

Derivatives

[**Definition**]: Are a financial investment, the value of which relies on an underlying security

[**Examples**]

- A futures contract (contract involving buying something at a specified future date for a price agreed on today)
    - X agrees to sell 1 ton of milk power on a date 1 year from now, on a price agreed to today
    - Traded on an exchange
- A forward contract (a contract agreed on by 2 parties, purchaser agrees to buy X in 6-months' time for a price agreed on today)
- Options – one person pays the money today for a right to buy or sell something in the future (pay $500 now, and someone has to agree to buy the thing 6-months later)
- A swap – people have different financial instruments, and agree to swap them
- Derivatives are generally used to manage risk, not to make money
- There was an issue of whether the Securities Act applied to derivatives
- Rise of contracts for difference being offered to the public

The Financial Markets Conduct Act 2013

Purpose of the Act (ss 3 and 4)

The main purposes of this Act are to:
(a) promote the confident and informed participation of businesses, investors, and consumers in the financial markets; and
(b) promote and facilitate the development of fair, efficient, and transparent financial markets.

This Act has the following additional purposes:
(a) to provide for timely, accurate, and understandable information to be provided to persons to assist those persons to make decisions relating to financial products or the provision of financial services:
(b) to ensure that appropriate governance arrangements apply to financial products and certain financial services that allow for effective monitoring and reduce governance risks:
(c) to avoid unnecessary compliance costs:
(d) to promote innovation and flexibility in the financial markets.

What is an Offer?

- An offer is an offer under contract law (one capable of forming a relationship between parties on acceptance)
- An offer can include an invitation to treat (such as an invitation to subscribe to an investment)
- Only applies to financial products being offered for the first time
    - Not offers for sale/ on-sales – things that have been put in the marketplace before)

Financial Products

(see section 7 and section 8 for definitions)

Debt Security

- A right to be repaid money or paid interest on money that is owed
- **Includes**: a debenture, bond, or note a convertible note, a redeemable share in an entity that would otherwise be an equity security
- **Does not include**: a derivative or a unit, proportionate interest, or membership interest in a registered scheme.

Equity security

- **Includes:** a share in a company
- **Does not include:** a debt security.

A Managed Investment Product

(see section 9 for definition)

[a scheme to which each of the following applies]:

1. The purpose or effect of the scheme is to enable persons taking part in the scheme to contribute money, or to have money contributed on their behalf, to the scheme as consideration to acquire interests in the scheme; and

2. Those interests are rights to participate in, or receive, financial benefits produced principally by the efforts of another person under the scheme (whether those rights are actual, prospective, or contingent, and whether they are enforceable or not); and

3. The holders of those interests do not have day-to-day control over the operation of the scheme (whether or not they have the right to be consulted or to give directions).

Does not include:

1. A scheme that only involves the management of separate and direct interests in underlying property
    a. A scheme under which each participant takes part in the scheme only by holding 1 or more interests in property if, in respect of each interest, —
        i. it is an interest in separately identifiable underlying property; and
        ii. either the participant holds both the legal and beneficial interest in the property or the legal interest in the property is held on a bare trust for the participant; and
        iii. the value of the interest is not substantially dependent on contributions being made by other participants or the use of other participants' contributions:

2. Discretionary Investment Management Services (DIMS)
    a. A discretionary investment management service supplied by a DIMS licensee or by an authorised financial adviser who is authorised to provide that service under the Financial Advisers Act 2008:

3. Insurance Contracts
    a. A scheme that would be a managed investment scheme only because it involves pure risk contracts of insurance:
        i. Pure risk contract of insurance means a contract of insurance that does not, and never will, have a value on its cancellation or surrender that is greater than the sum of premiums paid to the insurance
    b. A scheme that would be a managed investment scheme only because it involves life insurance policies (within the meaning of section 2(1) of the Securities Act 1978) that were issued before this section comes into force.

- 'Sharesies' – not a DIMS or a financial advisor service, is only a platform allowing investment in the sharemarket. Not a MIS either, all the shares are held on bare trust for you

Identifying a Managed Investment Scheme

Covers:

- Unit trusts
  - Where a trust deed allows investors to buy a unit in the trust, giving them a share of the profits
- Superannuation schemes
- Investment-linked life insurance
- Participatory securities

[If you have an arrangement that involves pooling of contributions by several persons who put their money in with the intention of receiving a gain, the property of the scheme is managed by a third party and there is separation of ownership between investors and the underlying property, then it may well be a managed investment scheme]

A Derivative

- **Includes**: An amount payable in the future that relates to the value of an underlying asset, rate, index or commodity
- **Does not include:** An agreement for the future provision of services.

Declaring a Security a Financial Product

What is a "security?" (section 6)

- An arrangement or a facility that has, or is intended to have, the effect of a person making an investment or managing a financial risk
- If you have an <u>investment</u> you have a security, if you have a security the FMA can declare it to be a financial product

Section 562

The FMA may:

(a) declare that a security that would not otherwise be a financial product <u>is a financial product</u> of a particular kind:
(b) declare that a financial product is, or is to become, a financial product of a particular kind (whether or not it was previously a financial product of a different kind):
(c) declare that a security that would otherwise be a financial product of a particular kind is not a financial product:

When doing this the FMA must consider: (s 563)

- Whether the declaration is necessary or desirable in order to promote either or both of the main purposes of this Act

What Offers are Regulated under the FMCA?

Section 39

An <u>offer</u> of <u>financial products</u> for <u>issue</u> requires disclosure to an investor under this Part (pt 3 - disclosure) unless an <u>exclusion</u> under Part 1 of Schedule 1 applies.

- Section 39 applies if there is an offer of a financial product, which needs to be for issue

- **If at least 1 investor requires disclosure, then the whole offer is a regulated offer (regulated offers being subject to pt 3 disclosure requirements)**
- If you want to avoid pt 3, every single investor needs to be covered by an exclusion

Exclusions (when pt 3 disclosure is not required)

Rationale

- Exclusion regime is important because the FMCA is so broad
- Disclosure is a market inefficiency, needs to be warranted (usually is because of information asymmetry)
- It is more economic to require the offeror to disclose all the material information up front, the government also has a vested interest in making it as easy as possible to save for retirement using investments – disclosure helps this

Who might not need full disclosure?

- A difficult line to draw
- Under the Securities Act the courts figured this out (who was "the public" but this is dropped in the FMCA)
- Wholesale investors would not need disclosure – these investors don't need the same amount of protection as other investors due to their experience/ position

Lawrence v Registrar of Companies

Facts

- Securities were offered to the public for investment, Lawrence was sole director and shareholder, company involved in property development.
- Money was raised for these projects by offering securities to the public, raised money from 106 investments, these offers were structured to fall outside the SA (did not want to have to comply with the SA).
- Investments failed, charges brought under the SA against Mr Lawrence, who claimed none of the investors were "members of the public" but had a relationship with "C", who knew all of these investors who had been their investment clients.

Held

- Certain investors do not need disclosure:
  - This might be because of their level of <u>expertise</u> (like professional investors)
  - Or because of their <u>relationship with the issuer</u> (either because they can get all the information themselves due to their closeness with the issuer **or** because the issuer would not want to deceive them – like relatives; but this is an assumption which may not always hold true)
  - Demonstrates the competing policy aims, for these people the cost of disclosure outweighs the benefit received
- These exceptions remain in the FMCA

The FMA May Grant Exemptions

The issuer may apply to the FMA for an exemption for a particular issue

- The FMA has a discretionary power to grant an exemption under s 556 of the FMCA

- Any person can apply for an exemption from compliance with any provision of Parts 2-7 of the FMC Act (particularly disclosure)
- There are some restrictions on this power (see s 557):
  - In particular, the FMA must be satisfied granting the exception is necessary or desirable in order to fulfil the purposes of the Act (s 3 and 4 of the FMCA)
  - Issuer needs to persuade the FMA that the purposes of the Act will be met by the exemption

Different to the s 562 designation power

- That relates to declaring something that would not otherwise be a financial product a financial product
- Section 556 (above) relates to granting an exemption to parts of the Act

Exclusions in the FMCA – Schedule 1

Schedule 1, Part 1 overview:

- Some offers do not require disclosure <u>when made to particular persons</u> (cls 3-11)
- Some offers do not require disclosure at all (cls 12-24)
- In some cases <u>limited disclosure</u> obligations apply (cls 25-28)
- FMA can declare that an offer requires disclosure (cl 2, s 562)

Rationale for the exclusion of offers to wholesale investors

- This covers experienced investors, and other investors who are deemed capable of looking after their own interests
- FMCA spells out who is an experienced investor, Schedule 1, Part 3, contains the definitions

Types of wholesale investors

Investment businesses (cl 37)
[an entity whose principal business consists of 1 or more of the following]:

- investing in financial products; or
- acting as an underwriter; or
- providing a financial adviser service in relation to financial products; or
- providing a broking service relation to financial products; or
- trading in financial products on behalf of other persons.
- <u>Includes</u>: Banks, licensed insurers, a manager of a registered scheme, or a discretionary investment management service, that holds a market services licence, a derivatives issuer that holds a market services licence and a QFE or an authorised financial adviser.

Investment Activity Criteria (cl 38)
[An individual or an entity can meet this criteria]:

- Own a large investment portfolio ($1M+, of complex investments); or
- Are engaged in large investment activities (carried out a transaction to acquire financial products worth $1M+); or

- Have worked for somewhere for 2 years within the last 10 years that deals with large investments

Large investors (cl 39)

- Someone with net assets or turnover of +$5M (large companies)
- These investors are always "wholesale" no matter what type of offer is made

Government Agencies (cl 40)

Safe Harbour Certificates

- A certificate can be given under cl 44 stating that is for certain a wholesale investor
- Can't be given if the offeror knows the investor is not wholesale or has not been procedural done correctly
- This is known as a "safe harbour certificate"

Wholesale investors for a particular offer

Eligible investors (cl 41)

Are able to self-certify that they are an eligible investor, and no disclosure is required:

- <u>Self-certification requirements:</u>
    - Confirmation of the certificate by a third party is required
    - The investor must certify that he/she has previous experience
    - There are limitations on self-certification in cls 42 and 43)
    - It is an offence to give false certificate (cl 47)
- You can 'opt in' to being a wholesale investor through being an eligible investor, but cannot 'opt out' of being a wholesale investor.

Other wholesale investors:

- If the minimum amount payable is at least $750,000 (cl 3)
    - <u>But see</u> sch 8, cl 3 of the FMC Regulations (Offeror must provide warning statement and obtain acknowledgement– limited form of disclosure)
- Underwriting agreements (cl 3)
- Derivatives over $5 million (cl 49)
- [These investors can be "wholesale" in relation to that offer]

Exclusion for offers to persons in "close relationship"

Close business associates of the issuer (cl 4(2) or 4(3))

- Could be your accountant, lawyer or client of the issuer
- Some uncertainty as to the scope, whether the relationship allows the person to assess the merits of the offer

Relatives of the issuer

- Defined in cl 5
- Looking at relatives of the directors of the company if a company is the issuer
    - Issuer = someone issuing the product (usually also the offeror) this is the person who is liable to repay the money being invested

Overview
Both close business associates and relatives of the issuer are not required to provide disclosure under pt 3 of the FMCA. There is an argument that this might be too wide (there could be the potential for abuse, might capture people who are in need of disclosure). Either way the exemptions reflect the reasoning in *Lawrence v Registrar of Companies*.

The rationale in *Lawrence* was that some people don't need disclosure

- There are competing policy aims at play, weighing up the cost of disclosure and investor protection. In the case of **relatives,** the "social constraints in the familial situation" are deemed sufficient to not require disclosure [27]
- In the case of **professional investors** these people are assumed as being able to protect themselves and therefore do not need protection under the Act [32].

Exclusion for Small Offers

Requirements (cl 12)

1. Only applies to <u>"personal offers"</u>
    a. An offer made to persons who have had previous contact with the issuer; or
    b. An offer to people who earn more than $200,000 p/a regardless of any relationship
2. Only applies if the product is <u>equity</u> or <u>debt</u> offers
3. There must not be more than <u>20 investors</u>
4. A maximum of <u>$2M</u> can be raised

Exclusion for Offers by Small Schemes

Requirements (cl 16)

1. Relates to managed investment products
2. The scheme must have 5 or fewer participants; and
3. Must not be promoted by a professional promoter

FMC Regulations (cls 16, 17 and 18)

- Offeror must give notice to the FMA (see cl 17 for what needs to be in that notice)
- There needs to be a warning provided (see cl 18 for the what the warning must say)
- ***Watch out for this**

Other exempted offers

- Employee share purchase schemes – Sch 1, cl 8
    - See FMC Regulations (sch 8, cl 9)
- Dividend reinvestment plans – Sch 1, cl 10
    - See FMC Regulations (sch 8, cl 13)
- If no consideration – Sch 1, cl 11
- Same class as quoted securities – Sch 1, cl 19
- Exemptions for some derivatives – Sch 1, cl 20
- Offers of certain products by banks – Sch 1, cl 21
- Offers of interests in retirement villages – Sch 1, cl 23

Offers Through Licensed Intermediaries

- Offers of financial products through licensed intermediaries are exempt (if providing intermediary services) – Sch 1, cl 6

- This is because these licensed intermediaries will have their own disclosure requirements
- But see FMC Regulations (sch 8, cl 6):
    - Offeror must not breach $2 million aggregate limit

Crowd funding and peer to peer lending

- Intermediaries (e.g. Pledge Me) exist between the person offering the product and the investor.
- These platforms only accept a small amount of crowd funding platforms, as they want their reputations to be upheld and want a genuine offer with a good prosect of success
- **Clause 6, sch 1** is the relevant exception for a crowd funding situation

Offers of financial products through DIMS licensees– Sch 1, cl 7

- DIMS = Discretionary investment management service
- Investors go to a DIMS (like Craigs), and give the DIMS authority to put money in various investments, the DIMS has discretion to manage the money how they wish (on your behalf)

Limited Disclosure - Financial Markets Conduct Regulations 2014

- See sch 1, cls 25 – 28
- Can be activated by **regulation** (see the Financial Markets Conduct Regulations 2014, schedule 8 for the details of alternative disclosure required)
- **Regulations require limited disclosure for a number of the exclusions above:**
    - Wholesale investor because of $750,000 minimum amount payable under sch1, cl 3(b) of the FMCA

- Misleading disclosure cannot be made in a limited disclosure document (cl 27)
- There is an obligation to inform the offeror of deficiencies in disclosure (cl 28)
- Note:
    - Regulations can override exclusions (sch 1 cl 29)
    - FMA has the power under s 562 to declare that an exempted offer requires disclosure (even if an exception applies)

Disclosure (Part 3 FMCA)

Background/ Rationale

- The Securities Act was based on disclosure, the philosophy at the time was based on full disclosure – through a prospectus (in the SA 1978).
    - The prospectus was a long and complicated document (not very user friendly).
- Plain English version was needed, in 1990s the SA was amended introducing the investment statement regime (designed to address all the important questions an average investor might have)
    - Worked ok, but over time evolved into marketing documents, would get lots of marketing material with the Q&A at the back, or the investment statement would be too detailed and ended up like the prospectus
    - Ended up not serving the purpose of making investors aware of the risks of the investment

- Issuers needed to prepare both the prospectus and the investment statement, getting things wrong (misleading information) had harsh consequences which made offerors put more and more information into the documents for fear of missing things out
- MBIE undertook a review of how to have effective disclosure, revamped the requirements

Disclosure in the FMCA – Product Disclosure Statements

Product Disclosure Statements

- A PDS needs to be provided by the issuer, the content of a PDS is prescribed by regulation, PDS needs to be given before an investor invests and must be lodged on the register of securities

Two Parts:

1. The key information is in Part A (Key Information Summary (KIS))
2. More detailed information is in Part B

All other "material information" not otherwise disclosed needs to be lodged on the register (s 59)

- "Material information" is defined in s 51 as information "a reasonable person would expect to, or to be likely to, influence persons who *commonly invest in financial products* in deciding whether to acquire the financial products on offer; and
- This information must relate to the particular financial products on offer or the particular issuer, rather than to financial products generally or issuers generally.
- However, material information does not include—
    - (a) information about the specific terms of a financial product that have been customised for a particular investor; or
    - (b) information about an identifiable investor.

Purpose of a PDS

- The purpose of a PDS is to provide certain information that is likely to assist a prudent but non-expert person to decide whether or not to acquire the financial products.

If PDS is misleading after lodgement

- A supplementary or replacement PDS must be lodged
- The offeror must make an amended disclosure
- Civil and criminal liability can arise if security is offered with defective disclosure

Failing to give a PDS

- Investor can withdraw and get their money back (1 year from the security being issued – s 54)
- Lodging needs to be by the registrar, FMA then needs to approve it (but only looks at whether there are any obvious problems – doesn't ensure compliance.

Extra Requirements for Debt Securities (Part 4 FMCA)

If the issuer is offering debt securities, they must comply with extra requirements:

1. Issuer needs to enter into a trust deed; and
    a. This deed must contain certain things (s 104)

2. Must appoint a trustee (a licensed supervisor) (s 103))
    a. The licenced supervisor needs to get a licence from the FMA, who monitors supervisors

Trustees Role and Duties

- Supervises the issuer on behalf of investors (s 111)
- Must be licensed under the Financial Markets Supervisors Act 2011(previously called the STSS Act 2011)
- Issuer provides regular reports and other on-request information to the trustee
- Trustee ensures trust deed is not breached, and in particular watches whether issuer's assets are sufficient to meet liabilities
- Duty of care (to act honestly, etc) – s 112
- Standard of care (professional standard) – s 113
    - Is a professional standard of care (standard is against the expected standard of a prudent person engaged in the business of acting as a supervisor– high standard)
- Can engage experts and require meetings of security holders to be called
- Trustee must report serious financial problems to the FMA – s 204

→ Overall: Supervises the issuer and monitors the financial situation

Requirements for Managed Investment Schemes

Interests in managed investment schemes are regulated securities

Requires Part 3 disclosure

- Unless all the investors have an exception

Requirements under Part 4, Subpart 2:

- The issuer must register the scheme with the FMA (and must meet certain conditions in order to get registered)
- There must be licensed supervisor (usually trustee) and licensed manager
- Governing document (usually a trust deed) must comply with FMCA
- Contents of trust deeds are contained in s 135
    - Detailed requirements in the Act about what needs to be in the trust deed
- Property is to be held in name of the supervisor or a custodian
- There are special requirements for KiwiSaver schemes and other superannuation schemes

Role of the manager of a managed investment scheme

- See s 142
- The manager offers **and** issues the product
- Manages the investments and administers the scheme
- The duty of care they owe is a professional standard of care
- They must report to the supervisor or sometimes the FMA, especially if there are serious financial problems
- Must have a SIPO (statement of investment policy and objectives) which sets out the guideline for what the manager will invest the money in for the Scheme (s 164)

Role of the supervisor of a managed investment scheme

- See ss 152 - 163
- The supervisor acts on behalf of investors
- Supervises the manager's performance and compliance
- Reviews financial position of scheme
- Holds scheme property or appoints custodian
- Duty of care and professional standard of care
- Can engage experts and request meetings
- Usually is a trustee appointed under a trust deed

A critique of disclosure

- Is the notion of disclosure flawed because of factors such as low levels of financial literacy and the influence of irrational behaviour?
- Investors might not read the disclosure, or understand what they say
- All the issuer has to do is provide disclosure, does this really protect investors?
- Investors don't act rationally anyway, even if given the information
- Is it possible to design disclosure to make the average investor aware of the risks?
- Should we target financial advisors, so they can advise the person on the street.
    - This puts reliance on having a good financial advisor industry, and expects people to use financial advisors

Fair Dealing (Part 2 FMCA)

Background

- Are contained in pt 2 of the FMCA
- Rules are based on the Fair Trading Act 1986
- Apply to all offers, regulated or otherwise
    - Offers to wholesale investors are subject to pt 2

Key Sections

Section 19

A person must not, in trade, engage in conduct that is misleading or deceptive in relation to any dealings in financial products or the supply of a financial service

Section 20

Must not engage in conduct liable to mislead as to the nature or suitability of financial products

Section 22

Must not make false or misleading representations (for example, concerning the need for a product)

These sections only apply when a person is acting "in trade"

- "In trade" has been given a very wide interpretation
- See for example *Jagwar Holdings v Julian* (s 9 in the FTA could apply to a one-off transaction between experienced busines people, so all the FTA law is relevant for the misleading conduct provisions in the FMCA)

What is misleading or deceptive?

- This has been the subject of case law in a Fair Trading Act context
    - If in relation to an issue of financial product, enforcement is with the FMA
- Breach leads to civil liability under pt 8 of the Act

Test

- Objective test
- Must look at all the circumstances
- No intent to mislead is required
- No need to prove anyone actually misled
- Literal truth can be misleading
- Silence can amount to misleading conduct
- An opinion can be misleading if not honestly held or no reasonable basis for it
- *Red Eagle v Ellis* leading case for s 9

[Overall test: Would a reasonable person in the claimants' situation, with characteristics known to the defendant (or of which the defendant ought to have been aware) have likely to have been misled or deceived?]

Special rules for newspapers, broadcasters, financial commentators, etc (see s 29)

- There is a defence under s 30 for publishers (if they didn't know it was likely to be misleading)

Unsubstantiated representation prohibition (s 23)

- Makes it easier for the FMA to establish liability, all they have to establish is that the person making the representation did not have reasonable grounds for making it, irrespective of whether it is false or misleading

Special rules for offers make in the course of an unsolicited meeting (s 34 imposes a general prohibition with some exceptions)

- Some exceptions, some people can cold call etc
- Contravention of Part 2 gives rise to civil liability

Summary of Fair Dealing Rules

- General prohibition on misleading conduct in relation to the provision of financial products and services
- This applies to all offers, regulated or unregulated
- Prohibitions extend to misleading representations (see s 22 about what misrepresentations must not be made)
- Law based on the Fair Trading Act 1986
- New prohibition on making unsubstantiated representation (whether or not misleading)
- Limited defences available for newspapers and other publishers
- General prohibition on making offers in the course of an unsolicited meetings
- Breach leads to civil liability

If a misleading statement in a PDS

- That action will likely be caught by pt 2 (but that's for more generic type advertising), but there are specific rules in **pt 3** that apply to PDS with harsher consequences

Advertising of Regulated Offers

Starting point

- There can be no advertisement for a regulated offer unless the rules in pt 3 are complied with (s 89)
- You are able to distribute a PDS and a copy of any part of the register entry or of any document that is contained in the register entry (s 90)

What can you distribute?

Before the PDS is lodged

- There are special rules for advertising **before** the PDS lodged. You are able to advertise in relation to the offer/ intended offer, provided the advertisement contains a statement that: (s 91)
    - No money is being sought
    - Investors cannot currently apply for the product
    - Any offer must be made in accordance with the Act)

After the PDS is lodged

- **After** PDS lodged you are able to advertise, provided the advertisement contains a statement that: (s 92)
  - Identifies the issuer
  - Indicates how the PDS can be obtained
  - The advertisement does not contain anything that is materially inconsistent with the PDS

→ These rules apply **in addition** to the Part 2 fair dealing rules

Enforcement (Part 8 FMCA)

Background

- The FMA has a clear focus on enforcement, the regime forms pt 8 of the FMCA, which gives the FMA a wide range of low level enforcement actions
- There is a clear hierarchy of liabilities
- Liabilities range from low level enforcement actions to an extensive 2-tiered civil penalty regime, as well as some criminal offences
  - Civil liability is imposed when something less serious than egregious activity
  - Making offers in the course of unsolicited meeting is a lower level of civil liability
  - Breachers of s 20-23 give rise to liability at the high level

Hierarchy of liabilities

FMA's enforcement powers

- Stop orders
- Direction orders

High Court's enforcement powers

- Injunctions
- Banning orders (can ban a director)
- Protection orders (stop people moving assets etc)
- (+ Any order the FMA could have made)

Infringement offences

- FMA can issue infringement notices
- For "infringement offences"
- Not giving notice of a change in supervisor is one

Civil liability

- **Section 485 identifies the civil liability provisions:**
  - Part 2 fair dealing provision:
  - Part 3 offer provision:
  - Part 4 governance provision:
  - An unsolicited offer provision:
  - Section 479(1) (failing to comply with FMA's orders):

- The High Court can order a declaration of contravention, compensatory orders and pecuniary penalties

- Section 38 identifies the provisions in **part 2** that give rise to civil liability
    - Sections 19 – 23 and s 34 or s 36

- Section 101 identifies the provisions in **part 3** that give rise to civil liability
    - [go to section and see what is relevant]

- Under s 486 the court may make a declaration of contravention. This enables investors to bring an action for compensation without having to prove a breach
- Under s 489 the FMA can apply for a pecuniary penalty order
    - Which is a fine (2 levels under s 290 of what level of penalty)
    - Standard of proof is a BOP (FMA must prove on BOP that there has been a breach)

Defences Available for Civil Liability

- There are defences available (ss 499-503):

<u>Section 499</u>

- If the person who the proceeding is being brought against (person A's) contravention was due to reasonable reliance on information supplied by another person; **or**
- A's contravention was due to the act or default of another person, or to an accident or to some other cause beyond their control; **and**
- A took reasonable precautions and exercised due diligence to avoid the contravention
- **Another person** does not include a director, an employee, or an agent of A.

<u>Section 500</u>

[If the statement is false or misleading or that is likely to mislead (a contravention of section 82, 99, or 427(2) or (6) or clause 27 of Schedule 1) it is a defence if A proves that A]:

- Made all inquiries (if any) that were reasonable in the circumstances; **and**
- After doing so, believed on reasonable grounds that the statement was not false or misleading.

[If there is an omission from a disclosure document or register entry (a contravention of section 82, 99, or 427(2) or (6) or clause 27 of Schedule 1) it is a defence if A proves that A]:

- made all inquiries (if any) that were reasonable in the circumstances; **and**
- after doing so, believed on reasonable grounds that there was no omission from the disclosure document or register entry in relation to that matter.

Accessory liability

- The relevant sections are ss 486, 489, 497, 533, 534
- Applicable for civil liability
- Liability extends to persons "**involved** in a contravention" (defined in s 533 as):
    - Aided, abetted, counselled, or procured the contravention; or
    - has induced, whether by threats or promises or otherwise, the contravention; or

    - has been in any way, directly or indirectly, knowingly concerned in, or party to, the contravention; or
    - has conspired with others to affect the contravention.
- Directors and senior managers will be caught by this
- Directors are expressly included in case of defective disclosure in the PDS or register entry (s 534)

Criminal Liability

- Criminal liability **for knowingly or recklessly contravening prohibition on offers where defective disclosure in PDS or register entry** (s 510)
    - Needs to have breached s 82 and have knowledge or recklessness of the statement being false or misleading or knows or is reckless as to whether there is an omission
    - A person who commits an offence under subsection (1) or (2) is liable on conviction, in the case of an individual, to imprisonment for a term not exceeding 10 years, a fine not exceeding $1 million, or both; and in any other case, to a fine not exceeding $5 million.

- Sections 511 and 512 relate to misleading statements in other documents
- There is no statutory defence to the criminal provisions

Other Forms of Liability

- *Tallentire v R* – criminal charges under s 220 (3 directors of a finance company were prosecuted under s 220, the trust deed said the company was restricted from entering into related party without the trustees' consent, to establish liability under s 220, was a case of directors using funds in their control in breach of covenants in the trust deed
- Also accessory liability under Crimes Act for persons who assist with a crime (s 66)
- Note criminal liability under **Companies Act** (criminalisation of certain directors' duties - s 131 and s 135).
    - Also potential for liability under s 138A (you need bad faith and know the conduct will cause serious loss) and under s 380 (need to carry on business with intend to defraud creditors)
- Note also s 34 Financial Markets Authority Act (FMA can enforce duties which amount to something less than criminal behaviour). Some procedural requirements and proceedings need to be in the public interest, but where the company was the public issuer the FMA could take action
- **Also have s 242 Crimes Act**
    - Publishing a false statement (statement that the person making the statement knows is false) with the intention of inducing someone to acquire financial products
    - High intent threshold

Finance Company Cases

R v Moses (the "Nathans Finance case")

Facts

- Nathans was a finance company, subsidiary of VT. Raised money from the public by issuing debentures
- 2007 receivership, owed $174 million to investors
- Purpose of Nathans was to raise money to fund parent company, VTL (business of vending machines). VTL couldn't get funding from the Bank, set up Nathans to attract public funds
- Common directors of both VTL and Nathans
- Disclosure documents issued December 2006, alleged misleading
    - Prospectus and investment statement were at issue
- Section 58 Securities Act created criminal liability for untrue statements in a disclosure document - *strict liability*, but with some **defences:**
    - If the misleading statements were immaterial or the directors had reasonable grounds to believe, and did believe the statements to be true

Securities Act, s 55

A statement included in an advertisement or registered prospectus is deemed to be untrue if:
(i) it is misleading **in the form and context** in which it is included; or
(ii) it is misleading by reason of the **omission** of a particular which is **material** to the statement in the form and context in which it is included.

- Was a huge lending from Nathans to VTL (inter-company lending ($11.65 million → $108.5 million) – no interest was repaid, in effect the public put their money to Nathans which went straight to VTL
- About 80% of the loanbook was VTL debt on concessionary terms (directors knew this)
- One director wanted "risk" section *"toned down"* (Directors wanted the risk section changed, discussed what to say in the prospectus, they wanted to not make it appear Nathan had such large exposure to its parent company (VTL) also at issue were the possible conflict of interests).
- The risks of the inter-company lending were downplayed in the documents

Held

- The test was: whether statement untrue or not is to be viewed through the eyes of a notional investor. **That notional investor is the prudent but nonexpert investor.**
    - Objective test, omissions have to be "material".

- In relation to the "**materiality**" issue, the court asks – would the omitted information have made a difference to the notional investor's decision to invest?
- What the disclosure documents in fact said
    - Said at [186] that the company has a strong profit result, no bad debts, has robust credit processes, provides loans to a broad range of commercial entities, advances made to VTL were made at commercial arms-length basis

    - All very positive statements, significant lending to VTL that is due within a year
- What impression that gave (as found by Court) [108] – what a notional investor would have taken the statements to mean
    - False impression (no disclosure of the debts being rolled over or repayment of the debts being unlikely)
    - No reasonable prospect of repayment by VTL (unless it sold some of its business)
    - Literal truth not an answer (still gave a misleading impression)
    - The non-disclosed information would have made a difference to decision to invest (clearly relevant to investment risk, making it a material omission)
    - Any defence available?
        - (Did the directors believe in the truth of the statements and have reasonable ground to believe in the truth of the statements?)
        - No, court assessed 5 misleading statements [405] and asked whether it was reasonable to believe these were true. All directors had access to papers that revealed the company's true position, they had a duty to ensure the disclosure document was not misleading.
    - All directors had access to information about VTL
    - Non-delegable duty to form own opinion on the disclosure documents and impression they gave
        - Can't say they relied on someone else, no reasonable grounds to believe the impression given was not misleading

Result

- Directors found guilty of distributing disclosure documents containing untrue statements
- Their actions were described as gross negligence
- Two of the directors were sent to jail, the third got home detention
- Appeals against sentences were dismissed
- Heath J spoke to directors about his decision in this case on 2013, was criticised for sending professionals to prison, said the directors didn't think hard enough about what was going on, the fact that they had a honest belief that VTL would succeed was not the same as believing the statements in the disclosure document was true

***R v Moses* comments on law**

- [65-66] court discusses what a notional investor is (3 steps/ requirements)
- "Materially adverse" (in terms of s 82) court said it was material if it would have made a difference to the decision whether to invest [48, 49 and 51] – what court would draw on to work out what materiality means (from the perspective of a prudent but non expert investor)
    - Different to what has to be disclosed on the register/ register entries ("all other material information" - defined in s 57, and is a higher standard)
- Need to point out that there is no case law but a court would likely draw on R v Moses
- Relevant when you know what the omission is

How might the case have been decided under the FMCA?

<u>1. Need to work out what obligation might have been breached under the FMCA</u>

- Obligation to prepare a PDS (ss 48 and 57)
- Obligation to prepare a register entry (s 57)

In *R v Moses* there was an offer of financial products (regulated offer) was an omission of precise and accurate information in the PDS about the exposure to the parent company (breach of s 82)

- Omission needs to be *materially adverse* (would the information influence the notional investor in their decision to invest or not?)

No defence would apply under the FMCA in *R v Moses*

- Directors would likely be liable under accessory liability provisions in *R v Moses*

If there is a misleading statement or omission of information, then you have a potential breach. In Nathan, the omission was about the inter-company lending.

- **The FMC regulations say what the PDS requires to state about inter-company spending in schedule 2** – would be a "key risk" needs to be disclosed in "key risk" and also "specific risk" section

R v Graham (HC)

<u>Facts</u>

Involved Lombard (finance company) which was put into receivership, with losses to creditors (total owed was $127M, $110M to unsecured creditors who got nothing back. Proceedings focused on a prospectus which raised 10M from the public. Charges brought under s 58 of the SA, Crown alleged there were material omissions about liquidity risk. High profile directors (former ministers). Strict liability offences (s 58 – no mental element required). Honesty of directors was not disputed by the Crown. In this period finance company industry under stress, failures led to loss of public confidence, less public investment into these companies. Borrowers were defaulting on their loans (not paying them back). Lombard had a heavy concentration of lending risk (relying on 5 major borrowers who were struggling to meet their repayments). Loan repayments delayed, loan managers said not to worry.

What the prospectus said (see [87-92]), went into some detail about how the liquidity risk was managed. **But** the prospectus said the BOD was confident Lombard could refund all repayments to investors as and when repayments were due. Prospectus said a further loss of confidence could see less investors investing, and if this happened then might not be able to repay (some sort of warning)

What impression did that give? Court found the overall impression was that the directors were not concerned that adverse circumstances were imminent (investors should rely on directors judgement without anything more needing to be disclosed) – court rejected this. At [109] the court rejected this, not in line with policy of the disclosure regime, full disclosure had to be made, can't expect investors to rely on directors judgement.

The directors did not vet reasonableness of loan managers' assessments, directors knew the company was "Sailing close to the wind", knew there was a risk. Liquidity position set out at [104] – wasn't looking good.

<u>Held</u>

- Anything material to the decision to invest must be disclosed and investors should be given full story (disclosed in the prospectus).
- Tight liquidity situation and reliance on loan managers was material and omitted
- What the prospectus should have said (see [121]- [123])
- Should have disclosed about the reliance on loan repayments and reliance on the loan managers
- Directors said investors should rely on directors' commercial judgement (court said no, investors should have the information so they can make the decision whether to invest, not having to rely on the directors)

<u>Defence raised</u>

- Directors claimed defence of an honest belief, but this needs to be based on reasonable ground.
- Not reasonable based on the grounds the directors put forward
- If a reasonable director would question the reliability of what they are told then cannot rely on that material
- Directors said they needed to be positive to protect
- Can't rely on outsider (loan managers) not saying anything
- Convicted, community work imposed

Jefferies v R **(CA)** (same as R v Graham but at the CA) (the "Lombard case")

[Same facts]

<u>Held</u>

- Directors signed the prospectus, but no criminal charges necessary
- What constitutes "Material" and "notional investor" upheld from Moses and the HC
    - CA confirmed that a material omission is one that could have made a difference to the decision to invest
- Liquidity dependant on getting in loan repayments
- Loan managers' assessments had been unreliable (not reasonable to rely on these)
- Board had serious concerns, but prospectus said Board "remains confident" (this conveyed a misleading impression)
- General impression was despite difficulties, directors remained confident → not accurate
- No reasonable basis for belief in the truth of the prospectus (**defence** failed)
    - Douglas argued the best interests of the company was to carry on business as usual, suggested the prospectus needed to be issued to raise money from the public to pay existing investors, if the prospectus was overly pessimistic, then existing investors might claim against the company
    - CA rejected this argument, said the SA overrode the CA duties (Victoria thinks this is dodgy)

    - The duty to act in the best interests of the company can't justify breaching another statutory duty

<u>3 key matters not disclosed:</u> (it was misleading not to reference these matters)

1. Delays in repayment
2. Discrepancies in timing of repayments
3. Downward trend of cash in bank

<u>Criticism</u>

- Directors were in an impossible situation, were unlucky and should have been able to use their commercial discretion
- Directors shouldn't be punished in hindsight when they could have done things differently
- Victoria thinks the decision is about the importance of disclosure, even if that means less money is going to come in to investors

How would *Jeffries v R* be decided under the FMCA?

What sections have been breached?

- Breach of s 82? (disclosure document can't be misleading)
    - Either false statement or an omission (either case needs to be materially adverse)
- Need to look at the FMC Regulations for what has to be in a PDS
    - Liquidity risks have to be disclosed (wasn't in *Jeffries v R*)
    - It could be a key risk (part A) (Key Information Summary)
    - Or a specific risk (Part B)
- Would the omission of this information have been materially adverse?
    - Omission about liquidity would trigger liability under s 82 if it was materially adverse
- Would it influence the prudent but non expert investor in their decision to invest?
    - (It would be, as it would influence a prudent but non expert investor in relation to their decision to invest)

Civil or criminal liability?

- Breach of s 82 is a civil liability section (see ss 484-489, 534 against the finance company)
- Against the directors "involved" in the contravention (485-489)
- Defences (499-501) – unlikely to succeed
- Would be civil liability (pecuniary punishment on directors)
- Criminal liability? (s 510) – directors need to have knowledge the statements were misleading or were reckless as to the fact
    - Directors didn't know, were they reckless? (arguable case here, directors knew there were a risk, went ahead with the issue anyway)
- **Remember liability under the Crimes Act** (s 242 – requires quite a high level of intent)
- Under the Companies Act (s 138A and 380) – neither would apply in *Jeffries* (138A you need bad faith and know the conduct will cause serious loss) and under 380 (need to carry on business with intend to defraud creditors)

    - Would mostly focus on the FMCA though

Houghton v Saunders

Facts

Feltx carpets and the disclosure that was made to investors when they made an Initial Public Offering (IPO) in 2004. Investment statement and prospectus made selling all the remaining shares to the public, as well as new shares being issued. Public were offered the opportunity to buy into Feltex, shares then to be listed on the NZX. Mr Houghton bought shares in the IPO (paid around $20,000) and more shares shortly after the IPO (another $10,000). Share price initially $1.70 per share. In September 2006 receivers were appointed, shares then worth nothing. Feltex liquidated December 2006, shareholders left owing between $30-40M, said they purchased shares in reliance on the prospectus. Shareholders brought legal action (class action/ derivative action). Securities Commission inquiry did not find the prospectus was misleading.

Financial affairs declined very quickly, so it was thought the investment statement and prospectus must have been misleading.

<u>HC</u>

- Said [13] of course the investors will take issue with the investment statement and prospectus must have been misleading, but said the risks were adequately described in the investment statement and prospectus.
- Houghton said the prospectus contained an overall positive tone that was misleading (HC said that was not specific enough, needs something specifically that was misleading)
- Not prepared to look at the overall impression the prospectus made (unlike in the other cases)
- Also found the directors could use the due diligence defence

<u>CA</u>

- Houghton focused on 5 apparently misleading statements
- CA rejected overall impression argument (both courts required Mr Houghton to prove that specific statements were misleading)
- Said whether the statement was misleading depends on how it would be understood by the notional investor
- Also said a notional investor should seek professional advice if they were unsure

<u>SC</u>

- Whole focus was on the revenue forecast (Houghton not running the overall impression argument)
- The Supreme Court was asked to consider if a forecast and a projection in the prospectus amounted to misleading statements
- Forecast was to give the best probable assumption on the future revenue forecast for the coming month
    - The sales were less than expected, directors knew there would be a shortfall in the sales figures than what the forecast said, and decided not to amend the prospectus.

    - There was a misleading statement
- SC said you need to establish only a misleading statement, does not have to be **material**. Only needs to be a misleading statement in the prospectus.
- But → needs to be a link between the untrue statement and the loss suffered in order to get damages
    - Left to another hearing as to whether there was causation
- Thought the due diligence might not apply (if they knew the assumptions in the prospectus were not reasonable, could not have had reasonable grounds for believing the statement to be true

How would Houghton v Saunders be decided under s 82 of the FMCA

- There was a statement in the PDS that was misleading
- Was it materially adverse from the point of a notional investor?
    - Would be tricky to work this out, would a forecast of projected revenue influence a notional investor in their decision to invest?
- Revenue forecast = statement about a future matter (see para 2)
- Defences (s 501, 502)
- **Section 496** → could be helpful, the investor must be treated as having suffered loss or damage because of the contravention unless it is proved that the decline in value was caused by a matter other than the relevant statement, omission, or circumstance (onus is on the defendant to prove this)

→ **Relevant for s 82**

Section 82

> (1) [An offeror must not **offer**, or continue to offer, **financial products** under a **regulated offer** if] —
>
> (a) there is:
>
> (i) **a statement in the PDS**, any application form that accompanies the PDS, or the register entry **that is false or misleading or is likely to mislead**; or
>
> (ii) **an omission from the PDS**, or the register entry, of information that is required to be contained in the PDS, or the register entry, by this Act or the regulations; or
>
> (iii) **a circumstance that has arisen since the PDS was lodged** with the Registrar that would have been required by this Act or the regulations to be disclosed or otherwise contained in the PDS, or the register entry, if it had arisen before the PDS was lodged, **and the circumstance is not so disclosed or otherwise contained in the PDS or the register entry**; and
>
> (b) [in each case] the matter referred to in paragraph (a) **is materially adverse** from the point of view of an *investor* (being a prudent but non-expert investor –*R v Moses* at [215]).

→ Go through each of the requirements of s 82

1. If there is a misleading statement or omission of information, then you have a potential breach.

2. The misleading statement or omission of information must be materially adverse from the point of view of a prudent but not-expert investor

- Remember we are not certain on who a notional investor is as there is no law under the FMCA, but it is likely the courts would consider it a prudent but not-expert investor
- That is the law from *R v Moses* at [215] under the SA and in line with Australian authority

What a PDS must contain is set out in the Financial Markets Conduct Regulations

Must include (R5):

- A Key Information Summary (KIS) which must include the **key risks affecting the investment**

Consequences of a Breach of s 82

- **Section 82 is a part 3 offer civil liability provision – see s 101**
  - Civil liability provisions apply –see s 485, 486 - 496 and s 534 in particular may be relevant (civil proceedings brought by the FMA)
  - Strict liability, no mental element required

- **Defences are available**
- Under s 499 (if the director placed reasonable reliance on another person), or s 500 (if defendant made all reasonable inquiries), or s 501 (when person took all reasonable and proper steps)

Criminal liability under s 82

Section 510: Offence of knowingly or recklessly contravening prohibition on offers where defective disclosure in PDS or register entry

(1) An **offeror** that contravenes section 82 commits an offence if the offeror—

(a) **knows that, or is reckless as to whether**, the **statement** referred to in section 82(1)(a)(i) is false or misleading or is likely to mislead; or

(b) **knows that, or is reckless as to whether**, there is an **omission** as referred to in section 82(1)(a)(ii); or

(c) **knows of, or is reckless as to whether** there is, a circumstance of a kind referred to in section 82(1)(a)(iii).

(2) If an offeror contravenes section 82, **a director of the offeror commits an offence if**—

(a) the offer, or the continuing of the offer, of the financial products under the regulated offer **takes place with the director's authority**, permission, or consent; and

(b) the director—
  (i) knows that, or is reckless as to whether, the statement referred to in section 82(1)(a)(i) is false or misleading or is likely to mislead; or
  (ii) knows that, or is reckless as to whether, there is an omission as referred to in section 82(1)(a)(ii); or
  (iii) knows of, or is reckless as to whether there is, a circumstance of a kind referred to in section 82(1)(a)(iii).

(3) A person who commits an offence under subsection (1) or (2) is liable on conviction,—
  (a) in the case of an individual, to imprisonment for a term not exceeding 10 years, a fine not exceeding $1 million, or both; and

  (b) in any other case, to a fine not exceeding $5 million.

Recklessness = Knowing there is a risk something might happen but going ahead anyway (objective test, person must have known in fact there was a risk but went ahead anyway)

Section 82 TEST

1. Start with s 82

- Needs to be a statement in the PDS that is misleading;
- Or an **omission** from the PDS, or the register entry, of information that is required to be contained in the PDS, or the register entry, by this Act or the regulations (would be an omission in this case)
- This imposes the duty on the company, how do we attach liability to the director? (Look to accessory liability provisions)
  - If the director was **involved** in the contravention (s 534)
  - Director still has the **defences** available under s 499-501 (look at each and see if it might apply)
- If you find accessory liability, then civil liability provisions apply
- Criminal liability? (see s 510 – did director know the statement was misleading or reckless?)

2. Once established the PDS is misleading

- Then work out whether it was in relation to a matter that was **materially adverse** from the prospective of the notional investor
- Needs to have influenced the notional investor in their decision to invest

[What needs to be disclosed in a PDS?] (Look to regulations)

- Should know what the requirements for a PDS is for each type of financial product
- PDS has two parts (A – summary of key risks) (A – details of specific risk)
- Examples of risks:
  - Exposure to related party lending
  - Business risks
  - Liquidity risks
  - Any particular risk to that business
  - (these part A or Part B?)

3. What about s 82(2)?

- Statement about a future matter without reasonable grounds for making it
- Will depend what was in the offer document
- Whether that statement was materially adverse
- Having two reports, one positive and one negative (would that influence the notional investor in their decision?) – depends on factors and background material

Consequences (see 1:10pm)

- Section 101
- Section 484

Steps to go through:

1. Breach of s 82?
2. Omission of information required to be disclosed?
3. Materially adverse?
4. Relevance of law around statements about a future matter?
5. Accessory liability for directors
6. Might any of the defences apply?
7. What civil penalties might be imposed?
8. Criminal liability

SECONDARY MARKETS

Background

What the Secondary Market involves

- There are rules around trading in securities, when the financial product is on-sold
- Mostly relates to trading in listed **shares** (can also be **debt** or **units** in unit trusts)
- Securities are traded on the **NZX** (largest securities exchange), consists of NZSX (main market) and NZDX (trading in debt securities)
- All exchanges are regulated by the FMA under the FMCA

What is Regulated

- Regulation of the **exchanges** themselves
- **Dealing misconduct** is regulated (**insider trading** and **market manipulation** in particular)
- There are **disclosure** obligations, especially continuous disclosure
- **Takeover** activity is regulated

Rationale for Regulation

Investors more likely to invest in a fair market

- Regulation is primarily to promote investor confidence through having rules that require fair behaviour in the market place
- In addition, the government wants to foster local confidence and attract overseas investment
- Previous law was in the Securities Markets Act 1988
    - That law was largely carried over into the FMC Act
    - Some changes, role of the FMA as supervisor of the NZX became more formalised

Insider Trading Background

What is insider trading?

[Where the directors or senior management of the company have access to information about the company (information which could be good or bad) and that person either buys or sells shares in the company and makes money before the information is made publicly available].

Background to insider trading

- There were no insider trading laws at all until 1988
- The insider trading laws enacted in 1988 were largely in response to the 1987 share market crash (designed to restore public confidence in the share market)

The 1988 Regime

- Was brought in by the Securities Amendment Act 1988
- This regime was based on principle of “fiduciary duty”

    - If a person who had confidential information that was material to price and was obtained by reason of **special relationship** with issuer (or had obtained in confidence) then they were insiders and couldn't trade.
- There were no successful prosecutions under this regime
    - But there were two large settlements in 2004 and 2007 (defendants paid $27M with no admission of liability)

Definition of an "insider" under the 1988 regime

An 'insider' was:

- The public issuer (the one who's shares have been traded);
- Any person who by reason of being a principal officer, employee, company secretary or shareholder of that company had inside information (A) or their directors (B)
- Any person who received information in confidence from A (C)
- A principal officer of C (D)
- A person who received information in confidence from C or D (E)
- A principal officer of E

The Fletcher Challenge Inquiry

<u>Facts</u>
Fletcher Challenge, a listed company, was considering a merger, and that merger would push the share price up if it went ahead. One employee received a **draft** announcement in **confidence** about the merger and accidentally forwarded it to **all staff** at Fletcher Challenge (discussion not advanced enough to warrant disclosure).

A, an employee, saw the message and sent it to her flatmate thinking it was a public announcement. A did not trade. **Coincidentally**, A's husband traded. The shares were jointly owned but the husband and A (A had not disclosed any information to him).

The flatmate then bought shares and later sold them when the price went up when the merger was another. Another person (C) visited the flat and saw the email while they were alone in the room. C also bought and later sold shares. C also took a copy of the email and gave it to a journalist to write an article about it which was intended to inflate the price of the shares even more.

B and C both made money but were not within the definition of insider so no liability (too many steps away from someone in a fiduciary relationship of the issuer). A was an insider but did not trade herself. Technically she could have been liable because her husband traded without the information (jointly owned shares). The fact that B and C were outside the regime illustrated problems with the 1988 regime.

Think about how the fletcher challenge inquiry would be decided under the FMCA

- People traded and had certain info but fell outside the regime

Haylock v Patek

[The one major case under the Securities Act, *Haylock v Patek* (Crown unsuccessful)]

Facts
Involved a takeover of Southern Petroleum (listed company involved in oil and gas exploration) by Fletcher Challenge in 1995. There was a small public shareholding (15%) in Southern Petroleum. Some of the public shareholders sold their shares to Fletcher Challenge. The public shareholders alleged they had been persuaded to sell their shares by directors who knew information that made the shares a lot more valuable (directors were told about a promising report of gas reserves and then shareholders were offered a price based on an evaluation without the information of the gas reserves. Patek was alleged to have known and encouraged the shareholders to sell their shares. To establish liability the public shareholders had to establish several elements, that Fletcher Challenge had the information because of Southern Petroleum, that Patek had the info because he was a director, that he used the info to encourage the shareholders to sell their shares, and in particular whether the information in question was **material** to the price.

Held
Expert evidence was called about the capacity Fletcher Challenge had the information in (this element no longer relevant). Also evidence as to the materiality of the price (had to be proved the information would influence the share price by more than 15%). The evidence showed the normal volatility of the share price and the court said the information had to influence the price outside the normal range of share price fluctuation (court found no, it wouldn't have influenced the share price by more than 15%). Mr Patek, the director who persuaded the shareholders to sell was found not to be an insider.

Insider Trading under the FMCA

General information

- A new insider trading regime was introduced in Feb 2008
- There is no need to establish a connection or special relationship between the insider and the public issuer
- The regime introduced criminal liability
- The FMA is the primary enforcer (not the shareholder)

Insider trading prohibitions now cast a much wider net (this has necessitated long list of **exemptions** so legitimate trading activity is not caught)

- No connection with the issuer of fiduciary relationship necessary
- Overall purpose of the exemptions is to ensure legitimate trading activity is not caught
- Aligned closely with Australian regime

FMCA Part 5 - Prohibitions

[Anyone who is an "**information insider**" cannot]:

- **Trade**: (s 241)
- **Disclose** to another who will, or is likely, to trade (or advise or encourage a third person to trade or hold): (s 242)
- **Advise or encourage** another person to trade or hold: (s 243)
- **Advise or encourage** another person to advise or encourage a third person to trade or hold: (s 243)

"Information Insider"

[See s 234]

> A person is an information insider of a listed issuer if that person—
>
> (a) has **material information** relating to the listed issuer that **is not generally available to the market**; and
>
> (b) knows or ought reasonably to know that the information is material information; and
>
> (c) knows or ought reasonably to know that the information is not generally available to the market.

The information insider does not need to have any special connection or relationship with the issuer

Consequences for a breach

[Civil and **criminal** liability (s 244)]

- For **civil liability** to attach, you can use the objective tests:
  - The person ought to have known the information was material and not generally available to the market.
- For **criminal liability** to attach the insider must have **actual knowledge** that:
  - 1. the information is material and
  - 2. the information is not generally available

Process

1. The Crown must establish no **exception** applies
   a. Need to work out whether an exception applies
   b. The FMA has the burden to prove no exception applies
   c. The defendant must establish any defence raised

2. The Crown must also establish materiality of information and that it's not generally available to the market
   a. Needs to establish that the person advising knew the person the advised or encouraged would trade

Some common "information insider" situations

- A director or an employee knows about merger plans or plans to sell the company's business (and company has listed shares on NZX)
- A lawyer (or another adviser) is told by client about a client's plans to merge with another company or to sell up (and client is a listed company)

- An employee of a listed company tells their partner who tells their friend about the company's plans (plans that are not yet made public) to sell part of business or to buy another company

Material Information

(See s 231 of the FMCA)

What is it?

- Information that a **reasonable person** would expect, if it was generally available to the market, to have a material effect on the price of the issuer's shares.
- The information must relate to particular securities and a particular issuer, rather than to financial products generally or listed issuers generally.
- Whether information is material is an **objective test.** The person must expect that if the information was public it would have a material effect on the price of the issuer's shares.

Who is the reasonable person?

- This is likely to be someone with experience trading on the sharemarket (we are able to assume a certain degree of knowledge).
- This is the standard adopted in Australia, and drawing on s 59 of the FMCA (meaning of material information in pt 3 disclosure).

How to determine materiality

- Materiality can be difficult to establish.
- It often requires experts to determine whether a reasonable person would expect the information to have a material effect on the price of the shares if made available generally.

R v Rivkin

<u>Facts</u>

R was selling their house; M was the prospective purchaser. M told R in a phone conversation his offer was conditional, as he was trying to sell his business to Qantas. M was the CEO of Impulse Airlines, which was merging with Qantas. M told R – you cannot buy Qantas shares because of what I have told you. R bought Qantas shares, and made profit Court had to work out what was meant by the phrase 'a reasonable person would expect it to have a material effect on the price (or value) of securities' (if made generally available)

<u>Held</u>

In Australia, information is deemed to have a material effect on the price of shares if it would *likely influence people who invest in securities* (don't have a deeming provision like this in NZ)

<u>Factors</u> court looked at in *Rivkin* to decide whether the information was material:

1. The **reliability** and source of the information (the less reliable the source the less material the information)

2. Evidence of **actual movements in price** after the information was released (no price movements means less material the information).

3. Whether **the information already factored into the price** by the market?

4. Expert evidence on **price sensitivity of the information** was important (expert evidence often needed to establish this).

5. What was **the price volatility of the shares**? (to be material the information needs to influence the price beyond that range)

→ Similar test would be applied in NZ Victoria thinks

- An NZ court is likely to ask – would the information influence persons who commonly invest in securities in deciding whether to buy or sell the relevant shares?
- Relevant as to whether the info will have an effect on the price of the shares.

Basic Inc v Levinson (1988) (US case)

On "materiality" of information:

- There needs to be a substantial likelihood that a reasonable shareholder would consider the information important; and
- Ask whether a reasonable investor would consider that disclosure would have significantly altered the total mix of the information available?

→ Can also draw on this case to determine whether information is material

Whether information is material [TEST]

1. A reasonable person would consider the information material if the information would influence persons who commonly invest in securities in deciding whether to buy or sell the relevant shares (*Rivkin*)
2. Look to the Rivkin factors
3. Might also consider whether there was a substantial likelihood a reasonable shareholder would consider the information important, and whether a reasonable investor would consider that disclosure would have significantly altered the total mix of the information? (*Basic v Levinson*)
4. Essentially you are looking at whether the information is important to the price of the shares

Generally Available to the Market

<u>[See s 232]</u>

A). Has the information been made known in a manner that would, or would be likely to, bring it to the attention of those who commonly invest; **and** since it has been known, has a reasonable period for dissemination has expired? **or**

B). It is likely that persons who commonly invest can readily obtain the information (whether by observation, use of expertise, purchase from other persons, or any other means); **or**

C). Does the information consists of deductions, conclusions or inferences made or drawn from either or both of the above kinds of information?

Note: If information is made available under a **continuous disclosure obligation**, then generally available immediately to the market.

Internet

- If the information is on the internet, then it is readily available (paragraph b)
- If it is not on the internet, there needs to be a reasonable period of dissemination before it is available to the market

Insider Trading Exceptions

[There is a list of exceptions when insider conduct prohibitions do not apply contained in ss 245-256 FMC Act]

- All exceptions allow conduct that is necessary **in ordinary course of business (find section)**

Section	**Exception**
245	Not a breach if trading is **required by another law**
246	Not a breach if **disclosure required by another law or by the FMA**
247	Not a breach if **disclosure necessary in order to prepare offer documents** eg a PDS
248	Not a breach if disclosure or trading **relates to an underwriting agreement**
249	**Knowledge of own activities or intentions** is not a breach (also covers advisers to that person)
250	Certain **trades in derivatives** are exempt
251	Not a breach if the trading was done by **an agent executing a trading instruction only**
252	Section 241 does not apply in relation to **trading** in relation to **takeovers*** (see section)
253	Sections 242 and 243 don't apply in relation to **disclosure** and **advice** in relation to **takeovers**
254	Not a breach if relates to a **scheme of arrangement under the Companies Act**
255	Exception for **redemption of units in a managed investment scheme** (if the price is calculated by reference to the underlying value of the assets).
256	**Reserve Bank** exception

NOTES:

<u>Section 248</u>

- An underwriting agreement might be relevant when an issuer makes an issuing of shares to the public, will often enter into an underwriting agreement with a 3P as a form of insurance (3P agrees to take the shares if the public won't).

<u>Section 249</u>

- If you are a lawyer advising the client, can give advice and not be caught by the prohibitions
- Not a breach if acting on trading instructions (if client tells you something, and you know inside information about the trade, and sell the shares etc)

<u>Section 251</u>

- Not a breach if you are acting on trading instructions (for example, a client tells you something, and you know inside information about the trade, and then sell the shares etc)

→ The burden is on the FMA to establish that none of these exceptions apply

Insider Trading **Defences**

→ Defences available are contained in ss 257-261 of the FMCA

→ **A defence must be proved by the defendant on balance of probabilities**

Section	**Defence**
257	If person **did not know** and could not reasonably be expected to know **that they traded**
258	If information **obtained by research and analysis** (ie: planned investigation) and not obtained directly by the listed issuer concerned
259	If **both parties knew or ought to have known the same information**
260	If the person traded under **fixed trading plan** (as defined in the section)
261	**Chinese Wall** defence (see section)

NOTES:

<u>Section 260</u>

- If the trading plan fixed for a period of time that gives investor no right to withdraw and is not subject to influence by the investor before trading begun

Chinese Wall defence

- If the defendant (a corporate entity) can prove it had arrangements in place to prevent the information spreading to parts of the business that engage in trading or advising (Chinese Wall defence).
- The entity needs to ensure people doing the trading don't have the information about confidential client plans
- Essential parts of the business that have confidential information don't pass that on to other parts that are advising on trading

Chinese Walls should:

- Record arrangement in writing
- Educate employees
- Isolate price-sensitive information within divisions of the business
- Allocate responsibility for determining if information is price sensitive
- Have physical separation of business areas
- Restrict access to information on computer systems

Who is the defence available to?
To a corporate entity (or the partners) (the employer) that is a defendant facing allegations of insider trading (employees' actions are attributed to it)

Lawyers and fiduciary obligations
Lawyers should be aware of fiduciary issues – they need to tell clients that potentially not all relevant information will be disclosed to them.

An argument could be made lawyers should disclose all information relevant to their business. It is tricky when you have clients involved in a transaction that you have information about and have been told. Should put it the client contract (terms of engagement) that you are a lawyer can't give information that is confidential or received from other clients.

ASIC v Citigroup Global Markets

<u>Facts</u>
There was a trading side of business and an investment banking side of business. The company had Chinese Wall arrangements in place. An employee on the public side (public trading) bought shares when the private side (who enter into specific arrangements with big clients) of the business was involved in a merger. The employee was told to stop buying shares ("I would advise you not to buy any more shares in the company"). He was not told that the company was involved in a takeover)

<u>Held</u>
It was not a communication of inside information; the Chinese Wall arrangements were deemed adequate. The employer had to prove adequate protections were:
1. in place and;
2. Were working (there was no transfer of information)

The issue in the case was whether the information told to the public employee was public information. He did not draw any inference of there being a takeover going on, so not inside information. The market already knew some information that a big deal was going on, only confidential information was that the city group was acting for the employer **(shows the importance of looking specifically at the information).**

Another issue raised was whether the actions of the trader (public employee) could be attributed to the company (the employer).

- **Look to ss 535-536 of the FMCA**, to attribute an action to an employer, all you need to prove is the agent was acting within their authority when conducting that act.

Insider trading penalties

Criminal liability only attaches if the person has actual knowledge that information is material and actual knowledge that information is not generally available (s 244).
→ The Crown brings the action for a criminal offence

Civil liability attaches if objectively the person ought reasonably to have known that information is material and actual knowledge that information is not generally available

- Civil liability arises **under Part 8, subpart 3** (see s 385 which makes all the insider trading prohibitions **pt 5 Market Provision**) - penalties at the higher rate that can include:
    - Declaration of contravention
    - Compensatory orders
    - Pecuniary penalties

→ FMA would bring the action

Attributing individuals' actions to a corporate entity

The FMA will go for the **employer** (the corporate entity) of the individual insider if the insider trading was done **in the course of their employment**

<u>Section 535 FMCA</u>

- To attribute **knowledge** to a body corporate, you need to show the director or employee of the body corporate had the requisite state of mind and was acting within the scope of their actual or apparent authority

<u>Section 536 FMCA</u>

- To show the body corporate did a particular **act**, you need to show the act was done on behalf of the body corporate within the scope of the individuals actual or apparent authority.
    - In a partnership, each partner is an employer, and employees' actions are attributable to every partner

Insider Trading Test

1. What information does the person have?

2. What did the person do with the information?

3. [Was the person an information insider?]
    a. Did they have material information?

    b. Was the information generally available to the market?

4. If they are an insider, have they breached a prohibition?
    a. Will depend on what was done with the information

5. Can the FMA establish that no exceptions apply?

6. Are there any defences available? (Onus on the defendant)

7. Attributing individuals' actions to the body corporate

8. Penalties

To add:
- Case law factors
- Breaches

Market Manipulation under the FMCA

What is it?
Where a person's conduct creates a false impression of what is happening in the financial markets. For example, this could be a false impression of price movements or about the affairs of a listed issuer.

Prohibition introduced in 2008
- Against conduct described as "market manipulation"
- The prohibition includes **disclosure-based manipulation** and **trading-based manipulation**

Disclosure-based manipulation (section 262)
- Where someone puts out false or misleading information about the value or trading volume of a listed security

Trading-based manipulation (section 265)
- Where you engage in trading in such a way that creates a false impression about what is going on in the market
- The intent of perpetrator is irrelevant (focus is on the likelihood of the information inducing another person to trade or a false impression being created)
    - But see *FMA v Warminger*, intent may be the threshold for culpability

Examples:
Matched order transactions → buying and selling shares to create interest without exchanging beneficial ownership of the shares

Wash sales → where a trader buys and sells shares giving a false impression of genuine trading interest

Upticking → where a trader repeatedly buys shares at higher prices than the same trader paid in the last trade, inducing others to buy, pushing up the price

(see *Warminger* for other examples)

Civil and criminal liability

- CAriminal requires **actual knowledge** on the part of the defendant that the act or omission created a false impression of the extent of trading activity (s 264)

Defences available

- If the trading was **in conformity with accepted market practice** and for a **proper purpose** (s 268)
- Transferring shares from old trustees to new trustees is not market manipulation

Short selling (s 266)

- Where a trader sells an asset that they don't actually at the time own (borrows to sell it in the expectation the price will go down, then buy it back to make a profit)

Crossing (s 266)

- When a person acts both as buyer and seller in the sale

[Both are legitimate forms of trading, but can amount to market manipulation if the conduct creates a false impression of trading]

FMA v Henry

Facts:
Action brought under Securities Markets Act 1988 (law very much the same under the FMCA). Action was bought by the FMA. Henry was the director and CEO, resigned but continued to hold an interested of the company. In 2010 he bought and sold shares in large volumes and moved the price that these shares were trading, artificially inflating the price. (Trading-base manipulation). He admitted his conduct amounted to market manipulation.

Held
Pecuniary penalty imposed, taking into account both the serious nature of the offence but the small profits made (made to pay a $30,000 penalty)

FMA v Warminger

Facts
Also brought under Securities Markets Act 1988. FMA claimed Warminger was attempting to manipulate the market by placing small trades on the market in one direction, then a large one-off trade in the other direction.

Held
A pecuniary penalty was imposed on Warminger, who was found to have breached s 265 (FMCA) equivalent in the SA.

To establish a civil breach the court said the FMA had to prove:

- Warminger traded in a certain way

- At the time those trades were made they were likely to have the effect of creating or causing the appearance of a false or misleading market and that he knew or ought to have known his trading would have this effect
- Warminger had to pay $400,00 and a was subject to a 5-year management ban

Trader's purpose
The case raised interesting issues around relevance of **"trader purpose"**

- The court decided that a purpose of creating the appearance of a false or misleading market is **not a prerequisite** to market manipulation, but it will be a **relevant consideration** (see [61] of the case)
- If a person has done something that creates a false or misleading appearance of trading, but had no intention of doing that, this case suggests that is where you draw the line between market manipulative behaviour that is acceptable, and market manipulative behaviour which is **culpable**
- Look to the context of the trade to determine the purpose (see [70])

→ <u>Intent/ purpose may be the threshold for culpability</u>

Other cases

- Recent case of *Oceania Natural Ltd* – one to watch, FMA actively involved in market manipulation
- *Spear v Jackson* (US) used false information to pump up share price then sold his shares later on for $3M profit (disclosure-based manipulation)

Disclosure obligations

All <u>listed companies</u> must disclose material information to the market in accordance with the Listing Rules (s 270)

- Listing rules are the rules a company must sign up to when they list their shares on the stock exchange (contract between the issuer and the NZX)
- If the continuous disclosure obligations in the listing rules are breached, the FMA can also bring civil proceedings (as well as the NZX)
- There is legislative backing of one provision of the NZX listing rules (rule 3 of the listing rules – see below)
- A breach of s 270 can lead to civil sanctions via ss 385 and 485 of the FMCA (applies not only to the company, but also directors and anyone else "involved" in the contravention - see s 533 to work out who is "involved")

[Rule 3 of the listing rules]

<u>3.1 Disclosure of Material Information (continuous disclosure)</u>

3.1.1 Once an Issuer becomes Aware of any Material Information (defined per s 231 of the FMCA) relating to it, the Issuer must:
(a) promptly and without delay release that Material Information through Market Announcement Platform, and;
(b) not disclose any Material Information to the public, any other stock exchange (except as provided for in Rule 3.26.2(d)) or any other party without first releasing that Material Information through MAP.

<u>3.1.2 Rule 3.1.1 does not apply when</u>**:**
(a) one or more of the following applies:

(i) release of the information would be a breach of law,
(ii) the information concerns an incomplete proposal or negotiation,
(iii) the information contains matters of supposition or is insufficiently definite to warrant disclosure,
(iv) the information is generated for internal management purposes, or
(v) the information is a trade secret,

(b) the information is confidential and its confidentiality is maintained, and
(c) a reasonable person would not expect the information to be disclosed

Directors and senior managers of listed companies with a "relevant interest" must disclose holdings and trades in company's securities (s 297)

- Purpose of this is to promote good corporate governance and to deter insider conduct and market manipulation
- "Relevant interest" is defined under s 235. It includes legal ownership, beneficial ownership, controlling rights. Extends to agreeing to act in concert with another person (s 237).
- "Director or senior manager" includes someone who occupies the position of director, even if they are not properly appointed as a director (can be de facto). Senior manager would include CEO and CFO.
- Backed by civil sanctions leading to penalties

Substantial product holders must disclose fact of 5% (or more) ownership and movements (of 1% or more) in holding (ss 276/277)

- This is to enable the NZX to access information about who has significant voting rights, to prevent insider trading and stealth takeovers
- The person who begins to have a substantial holding has to disclose that (s 276)
- A person who has a substantial holding must disclose any movement of 1% or more of those holdings (s 277)
- Those who have the voting rights must disclose they have voting rights

How does this help the market?

- It helps to reduce insider trading. If the information is out there in the market, it is no longer insider information. This creates a fairer (more informed) market.
- It also allows for trades to be checked against when the information was made publicly available.
- Can be directors, senior managers etc, not only legal owner?

Disclosure obligations test

1. **Start with s 270**
    a. All listed issuers must disclose material information to the market in accordance with the listing rules
        i. Rule 3 requires disclosure of material information
    b. Breach of this leads to civil liability on the issuer
    c. Directors can also be liable if they are involved in the contravention (s 533)

2. **Is there a defence?**
    a. Is there a safe harbour from disclosure per rule 3.1.2 of the Listing Rules?

b. Directors have defence under s 272 if they took all reasonable steps to ensure the issuer complies with disclosure obligations
c. Also a general defence under s 503 for reasonable reliance on information supplied by another person and all reasonable steps taken

3. **Consider breaches of other sections**
    a. There might also be breaches of other sections, such as the market manipulation provisions and potentially the fair dealing provisions in part 2

Takeovers

Background

- There was no Takeover Code until 2001, small shareholders were vulnerable to takeovers
- The Companies Amendment Act 1963 was easy to circumvent as people could gain control by making an offer not in writing or to less than 6 shareholders
- The Securities Commission pushed for a takeover code to ensure equality of treatment to all shareholders (all shareholders should be offered the same price for their shares in a takeover)
    - An example of the unfair nature of takeovers was the LD Nathan takeover, where one shareholder who owned 35% of shares paid $9.30 per share, and all the other shareholders offered were between $5-6 per share.
- New Zealand had a **poor international reputation** due to the lack of takeover regulation (was very unregulated)
- Debate on whether takeovers should have a code (some thought its more efficient not to have one, securities commission wanted equality for all shareholders).

The Battle for Montana Group

What happened?

Lion Nathan wanted to take over Montana Group. Lion Nathan wanted 51% of the shares to obtain controlling rights of the BOD, so it could then carry out an ordinary resolution and replace the directors. Wanted to purchase more shares, but another company (Allied) was interested in buying all the Montana shares at a higher price than Lion Nathan. Lion Nathan then increased its offer to higher than Allied, told brokers to pressure shareholders to sell their shares so they don't miss out selling at Lion's price. The brokers could control who could sell at the higher price and would look after the important clients. The tight timeframe meant shareholders were not treated equally or given time to consider the offer.

The Takeover Code

Background

- Is Schedule 1 of the Takeovers Regulation 2000
- Takeovers Code is overseen and enforced by the **Takeovers Panel**

- Takeovers Code is backed by range of enforcement actions including criminal penalties
- Takeovers Code provides **six** means by which persons can increase shareholdings above 20% in a code company
- The code also limits the defensive tactics the target company can use when faced with a takeover offer

<u>Two main objectives of the Code</u>
1. To ensure all shareholders are able to participate in a takeover offer
2. To ensure all shareholders are treated equally

Fundamental Rule (Rule 6)

Situations where a code-regulated mechanism is required:
1. Where someone with no existing shareholding wants to acquire more than 20% of the voting rights in a Code Company unless a <u>code-regulated mechanism is used</u> (these are in rule 7)

2. Where someone with existing shares wants to increase their shareholding to more than 20%.

3. Where someone already holds over 20% and wishes to increase their shareholding further (called effecting a change in control).

[In each of these situations, there needs to be a formal takeover offer made to all shareholders. With the same price being offered on the same terms].

Situations where a person(s) can get "voting rights"
1. If a person and any other person or persons <u>acting jointly or in concert together</u> become the holders or controllers of voting rights, that person is deemed to have become the holder or controller of those voting rights:

2. A person or persons together hold or control voting rights and <u>another person joins that person</u> or all or any of those persons in the holding or controlling of those voting rights as associates, the other person is deemed to have become the holder or controller of those voting rights:

3. Voting rights are held or controlled by a person together with associates, any increase in the extent to which that person shares in the holding or controlling of those voting rights with associates is deemed to be an increase in the percentage of the voting rights held or controlled by that person.

"Code Companies"
The Code only applies to takeovers of "Code Companies". A "Code Company" means (per Rule 3A):

1. A **listed company** (excluding companies with only non-voting shares); or

2. Any company **with 50 or more shareholders** with **50 or more share parcels** that is at least medium-sized
    a. "Share parcels" = joint owning of shares

3. To be **medium-sized the company** must completed 1 or more accounting periods, with have either or both:
    a. Total assets of $30M; and/or
    b. Revenue of $15M in the last accounting period)

Assessing how many shares a person holds

[Test is whether a person "<u>holds</u> or <u>controls</u>" 20% or more of the voting rights in the target company]

1. Does the person hold 20% or more of the voting rights?
2. Do they control 20% or more of the voting rights?
    a. The definition of "control" in Rule 3 includes having directly or indirectly, effective control of the voting right
    b. The Takeovers Panel has said that the definition of control is an open one that will depend on the facts of each case

[When assessing whether 20% threshold is reached, you must aggregate the bidder's shareholdings with others]

- Shares held by offeror are to be **aggregated** (put together) with shares held or controlled by an **associate** of the offeror.
- The takeovers panel has a broad power to aggregate shareholdings, and issue guidance on how to interpret these provisions.

"Associate" (Rule 4)

(1) <u>[A person is an associate of another person if]</u>
(a) the persons are **acting jointly or in concert**; or
(b) the first person acts, or is accustomed to act, in accordance with the wishes of the other person; or
(c) the persons are related companies; or
(d) the persons have a business relationship, personal relationship, or an ownership relationship such that they should, under the circumstances, be regarded as associates; or
(e) the first person is an associate of a third person who is an associate of the other person (in both cases under any of paragraphs (a) to (d)) and the nature of the relationships between the first person, the third person, and the other person (or any of them) is such that, under the circumstances, the first person should be regarded as an associate of the other person.

(2) A director of a company or other body corporate is not an associate of that company or body corporate merely because he or she is a director of that company or body corporate.

* **"In concert"** = an understanding between the parties as to a common purpose

6 permitted ways to make a takeover/ Exceptions to the fundamental rule (Rule 7)

1. **Full offer** under the Code
2. **Partial offer** under the Code
3. **Acquisition** approved by **ordinary resolution** of the target company
4. **Allotment** approved by **ordinary resolution** of the target company
5. **Acquisition** by person who already **controls 90%** of the voting shares
6. **Acquisition** by person who holds **between 50% and 90%** (of not more than 5% of shares) in a twelve-month period.

Full Offers (Rule 8)

1. The offeror must make an offer **for all the voting securities of the target company** that are not already held by the offeror.
2. The offer must be for **all shares of each class** (ordinary and preference shares)
3. The offeror must provide **same price** and **same terms** for voting shares (or shares within a class)
4. If there are different classes of shares (voting and non-voting), the terms as between classes must be **fair and reasonable** (independent adviser's report on this aspect required)

Partial Offers (Rule 9)

[Is an offer for less than all the voting securities of the target company]

1. The offer must be made to **<u>all</u> holders of voting securities,** on the same terms
2. If there is only 1 class of voting shares, the offer **must specify what percentage** the offeror is trying to acquire.

[Percentage worked out by]

$$\frac{\text{number of voting securities of the particular class sought by offeror}}{\text{number of voting securities of that class not already held or controlled by offeror}} \times 100$$

3. If the offeror receives excess acceptances, then they must scale back acceptances proportionately (can't pick and choose what shares to accept)
   a. For example, if the offeror wants 51% of the shares, and 100% of the shareholders sell to them, then every shareholder is entitled to sells some shares, getting an even % (proportionately).
      - You want 75% of the total shares, someone offers you 100 shares, then you get 75 shares

4. Generally, an offeror must hold more than 50% of the shares
   a. Different rules apply if they do not – see Rule 10

Procedure for full and partial offers (Part 6)

1. The Bidder gives notice to the target company with prescribed information (this notice also goes to the Panel and NZX)
   a. What must be in the notice is set out in Schedule 1

2. This information is made public and all shareholders notified (either by NZX if it is a listed company or the target company if it is another type of code company)

3. The Target company responds with the details of shareholders (before the formal offer is made)

4. The Bidder prepares an **"offer document"** which is sent to all the shareholders
   a. The details of what an offer document must contain are set out in Rule 44 and Sch 1)

5. The offer remains open 30-90 days

6. Target company has an obligation to get an **independent adviser's report** on merits of the offer (Rule 21)

7. The Target company must prepare a **formal statement in response to offer,** which is sent to all shareholders (content prescribed by Sch 2)
   a. Statement includes (for example) directors' recommendation and the independent adviser's report

8. Shareholders then decide on merits of the offer

Delegat's Wine Estate Ltd v Takeovers Panel [2006]

Facts
Yealands and Delegat's were competing for control of Oyster Bay Vineyard. Both had offered $4/ share to shareholders. Oyster Bay Vineyard issued its target company statement which included certain information about the Oyster Bay Vineyard (including information about the land, shareholders wanted to know the assets the company had as this was relevant to the assessment of the shares.

The land was encumbered, as it was subject to an arrangement with Delegats, so the Oyster Bay Vineyard directors thought it would be misleading to put the unencumbered value of the land, factored it into the value but didn't tell shareholders why they did this. The unencumbered value of the land would have resulted in $8/ share (instead of $4/ share).

Held
Takeovers Panel found this was material information that should have been disclosed to shareholders, that was omitted from target company statement. Focused on the target company statement (details contained in schedule 2). Panel said the directors were wrong to prejudge the shareholder's ability to assimilate that information. In order to be "**material**" the information needs to have been significant enough to influence the decision whether to accept or reject the offer.

The Panel directed Oyster Bay Vineyard not to register the share transfers it has received as a consequence of shareholder's deciding to sell their shares. The Panel directed that a new statement be issued (information about the unencumbered land was material, shareholders

needed to be fully informed about the value of the land). High Court agreed with the Panel's approach. Illustrates importance of getting the target company statement right.
Common theme – more disclosure required rather than less.

Acquisition approved by ordinary resolution

- Target company's shareholders approve of the takeover
- Must be on fully informed basis (Rule 15)
- Bidder and persons intending to sell cannot vote
- Full information must be provided to all shareholders (independent advisors report)

Acquisition by allotment approved by ordinary resolution (same rules as above)

- The Target company can allot new voting shares to the person looking to increase their shareholding, but only if the shareholders of the target company approve on a fully informed basis.

Acquisition by a person who already holds 90% of shares

- This shareholder is called the "dominant owner"
- They must give notice to Panel and NZX
- The takeover can be compulsory (the automatic right to acquire the remaining shares) or a voluntary sale

Acquisitions between 50%-90%

- These are called **"creeping acquisitions"**
- Anyone who owns between this number of shares can acquire up to 5% in any 12-month period without using a Code procedure

Defensive Tactics

Background

- Usually, directors will be hostile to a bidder who wants to replace them
- Directors might also genuinely believe it is not in the best interests of the company
- Because of this there are limits on what directors of target company can do if hostile to the offer

Rule 38 (Starting point)

If a code company has received a takeover notice or has reason to believe that a bona fide offer is imminent, the directors of the company must not take or permit any action, in relation to the affairs of the code company, that could effectively result in:

(a) an offer being frustrated; or

(b) the holders of equity securities of the code company being denied an opportunity to decide on the merits of an offer.

(2) This does not prevent the directors of a code company taking steps to encourage competing bona fide offers from other persons].

Rule 39 (Exceptions)

The directors of a code company may take or permit the kind of action referred to in rule 38(1) if:

(a) the action has been approved by an **ordinary resolution of the shareholders** of the code company; or

(b) the action **is taken or permitted under a contractual obligation** entered into by the code company, or in **the implementation of proposals approved by the directors** of the code company, and the obligations were entered into, or the proposals were approved, **before the code company received the takeover notice** or became aware that the offer was imminent; or

(c) If paragraphs (a) and (b) do not apply, the action is taken or permitted for reasons unrelated to the offer with the **prior approval of the Panel.**

The Panel's Guidance Note (9 Sept 2019) also says:

a. Nothing prevents the directors of a target company from taking steps to encourage competing bona fide takeover offers from other persons.
b. The Panel considers that it is not a defensive tactic if the directors of the target company, with good reason to do so, recommend that an offer be rejected.

Examples of Defensive Actions

The Panel's Guidance Note (9 Sept 2019) gives examples of types of actions that may be regarded as "defensive" and therefore in breach of the Code:

a. Acquiring or disposing of a major asset;
b. Incurring a material new liability or making a material change to an existing liability (this could include, for example, the variation of existing contracts to include clauses that would be triggered by a takeover)
c. Declaring an abnormally large or unusual dividend or other form of capital distribution;
d. Undertaking material issues of new shares or repurchases of existing shares, or material issues of convertible securities.

Misleading or deceptive conduct (Rule 64)

- A person must not engage in any misleading or deceptive conduct in relation to a takeover offer
- The Panel has very broad powers, set out in the Takeovers Act. If the panel considers rule 64 is breached, the Panel can (under s 32):
    - Hold a meeting with the directors
    - Make a temporary restraining order
    - Make a permanent compliance order
- What is considered misleading or deceptive is similar to s 19 of the FMCA
- Case law on s 9 Fair Trading Act is relevant
- See also the **Takeover Panels April 2018 guidance note** for what the panel considers misleading or deceptive conduct
    - https://www.takeovers.govt.nz/assets/GuidanceNotes/Misleading-or-Deceptive-Conduct/2294cf7b9c/Guidance-Note-on-Misleading-or-Deceptive-Conduct-4-April-2018.pdf

Radius Properties case (Takeovers Panel 1/3/2013)

Facts
Radius Properties was not listed by had 50 or more shareholders, so it was a code company. Radius Properties owned or leased out real estate in the aged care sector. Another company (Radius Care) held 19.9% of voting rights in Radius Properties. Radius Care leased properties from Radius Properties. Radius Care wanted to buy Radius Properties' assets. After a meeting was held, another company (M) gave notice of an intention for a partial takeover offer (50% of shares).

Neither the target company (Radius Properties) nor M notified shareholders about the competing offer for assets from Radius Care – this could have been done when the shareholders were notified of the receipt of intention to make a takeover offer or in the bidder's offer document

M wanted to acquire through purchase of shares, Radius Care wanted to acquire through acquisition of its assets

Issue
Was there a breach of Rule 64? (was there misleading or deceptive conduct?)

Held
The decision turned on the facts of the case. The Court had to work out whether M knew about the discussions between Radius Properties and Radius Care. M did not know about the discussions with Radius Care (so any information they conveyed to shareholders could not have been misleading).

Did Radius Properties think they had a genuine offer from Radius Care? - No genuine offer in December, so it was not misleading to not tell the shareholders of the offer.

The case gives us the two-stage test:

1. **Is the conduct in question within the scope of Rule 64?**
    a. Did the allegation relate to engaging in conduct (which can include omitting to do something): and
    b. Was the alleged conduct related to an event or transaction regulated by the Code? (if it is relating to a takeover where someone is trying to get more than 20% then yes, regulated by the code).
    c. If yes to both, then first stage is satisfied.

2. **Did the conduct in question breach Rule 64?**
    a. Did the conduct in question have the capacity to mislead or deceive the hypothetical reasonable person in the target audience?
        i. When deciding whether the conduct is misleading is objective, the Panel must determine the characteristics of the target audience (more sophisticated people are harder to mislead).
        ii. If a person was in fact misled, then that is evidence that the conduct was misleading
        iii. An omission can be misleading if there was a reasonable expectation by the shareholders that material information would be disclosed.

Role of the Takeovers Panel

- Receives copies of all takeovers notices, offer documents and target company statements and reviews these for compliance with the Code.
- Can grant exemptions from the code when strict technical compliance is not appropriate or necessary as long as the underlying purpose of the Code is fulfilled
- Enforcement role is people not acting in compliance with the Code
- Guidance notes: On what is control, defensive tactics and more.

Financial Adviser Regulation

Background

- The law is contained in the Financial Advisors Act 2008 and the Financial Service Providers (Registration and Dispute Resolution) Act 2008
- However, the law is about to change, the Financial Advisors Act 2008 is about to be repealed and form part of the FMCA
- Finance companies were very lightly regulated prior to Financial Advisers Act 2008
  - Anyone could hold themselves out as a financial adviser, no qualifications needed
  - Some voluntary industry self-regulation but no requirement to belong to this
- **Limited** disclosure was required, plus some "on request" disclosure (Investment Advisers (Disclosure) Act 1996)
  - Advisers dad to say if they had been convicted of a crime or made bankrupt
  - If the client asked they had to make certain disclosures, such as if they had any relationship with the organisation they are investing in etc, or whether they had any qualifications or experience

Legislative change and issues

- A 2004 review conducted by Internation Monetary Fund led to the Task Force on Financial Intermediaries being appointed 2004.
- The task force reported 2005 and identified 3 key areas where reform needed:
  1. No qualifications for advisors were required and competency standards variable
  2. Disclosure requirements were minimal
  3. No easy system for redress or complaints

→ Wasn't in line with international best practice

- Some improvements to were made to the disclosure regime in 2008 (mandatory disclosures required)
  - From 2008 investment advisors had to give a written statement giving information about the advisor and say whether they were receiving any commission
- The finance industry collapse provided real impetus for change
- **Financial Advisers Act was enacted 2008**
- There were further major reforms to the 2008 Act in 2011 (hadn't got the 2008 Act quite right, reformed it)

A recent review of the 2008 Act revealed further problems

- The current rules we have are quite complex, the 2011 regime has problems, in particular there are onerous obligations on authorised financial advisors (AFAs) whereas a registered financial advisor has less obligations, so more people want to be a RA, not an AFA because no training is required
- Personalised vs class advise (personalised advice has more obligations than class advice which doesn't take into account a personalised situation) so advisors were incentive to fit advise into class advice
- RAs did not have to put the interests of clients first
- Existing regime did not allow personal Robo advice (advice from automated programme), required personal advice from a natural person

Financial Services Legislation Amendment Act

- Passed in April 2019, was expected to come into force in June 2020, now coming into force in **March 2021** (because of COVID delays)
- This repeals the Financial Advisers Act and puts the law into the FMCA and makes major changes to how advisers are regulated

Background to financial adviser reforms

- There are benefits of encouraging financial intermediation, including:
    - Stronger market engagement by retail investors
    - Education makes more rational investing
    - All assumes that the advisers are competent and honest

The Law from March 2021

- Difficult to regulate financial advice, some advisors act for themselves and give advice in regard to multiple products, others as an employee of certain providers.
- Some give advice as part of ordinary course of business but not as a profession (like lawyers)

"Financial Advice" – Section 431(C)

The definition of "financial advice" is key

- New law is going to apply when someone gives "financial advice"

"Financial advice" means (per s 431(c)):

- Making a recommendation or giving an opinion about acquiring or disposing (or not acquiring or disposing) of a **financial advice product**, or;
- Designing an investment plan for a person based on analysis of their financial situation and investment goals, including a recommendation as to how to meet those goals.
    - **The new definition** in the FMCA also includes "makes a recommendation or gives an opinion about switching funds within a managed investment scheme" (s 431C of the FMCA).

There are lots of exclusions in 431C(2) and in (3). Only **regulated financial advice** is subject to the regime.

- Regulated financial advice is advice given in the ordinary course of business

- This <u>can be any business</u>, just has to be in the course of A's business (not just mate to mate or friend to friend)
- The business does not have to be giving financial advice

Financial advice product

[Includes]:
(a) a financial product (as defined in section 7 FMCA);
(b) a DIMS facility;
(c) a contract of insurance;
(d) a consumer credit contract; or
(e) any other product declared by the regulations to be a financial advice product; or
(f) a renewal or variation of the terms or conditions of an existing financial advice product

→ Extends to insurance contracts (unlike the definition of "financial product" in the FMCA)

Types of natural persons providers

[Any person that carried on a business of giving regulated financial advice must hold a **market services licence** (unless exempt)]

<u>Two types of persons can give advice on behalf of a financial advice provider:</u>

1. A **financial adviser**
    a. To be a financial adviser more training requirements and more personal liability can be incurred); or

2. A **nominated representative**
    a. They take no responsibility themselves; it falls on the employer

- Both types of persons have duties to the customer (and are subject to the code of conduct)

The Exemptions

General

- Exemptions are contained in the new schedule 5 to the FMCA
- Certain types of **communications** are exempt
- Certain types of **occupations** are exempt
- If giving advice is **ancillary** to carrying on certain types of business it is exempt

→ If an exemptions applies then the advice is NOT regulated financial advice

New schedule 5, Clause 7 (Exclusions from definition of financial advice)

<u>A person does not give financial advice merely by doing 1 or more of the following:</u>

(a) **providing factual information** (for example, information about the cost or terms and conditions of a financial advice product, or about the procedure for acquiring or disposing of a financial advice product):

(b) **carrying out an instruction** from a person to acquire or dispose of, or not to acquire or dispose of, a financial advice product for that person:

(c) **making a recommendation** or **giving an opinion** about a kind of financial advice product **in general** rather than a particular financial advice product (for example, an opinion about shares generally rather than shares of a particular company):

(d) recommending that a person obtain financial advice:

(e) **passing on financial advice given by another person** (unless the person holds out that the financial advice is the person's own advice):

(f) giving or making available any of the following:
(i) a disclosure document:
(ii) information from a register entry:
(iii) an advertisement referred to in section 89:
(iv) any other document or information that the person is required by law to give or make available:
(v) a document or information prescribed by the regulations:
(g) carrying out a prescribed activity.

Schedule 5, Clause 8 (Exemptions for Occupations)

(2) Financial advice is not regulated financial advice if the person giving the advice—
(a) carries on one of the following occupations:
(i) conveyancing practitioner
(ii) journalist:
(iii) lawyer:
(iv) lecturer
(v) qualified statutory accountant:
(vi) real estate agent:
(vii) registered legal executive:
(viii) registered valuer:
(x) teacher; AND

(b) gives the advice
(i) in the **ordinary course of carrying on that occupation**); and
(ii) **as an ancillary part of carrying on the principal activity of that occupation** (carrying out activity that is not a financial service and in doing that they give financial advice) being an activity that is not the provision of a financial service.

Schedule 5, Clause 8 (Exemptions for Ancillary Services)

(1) Financial advice is not regulated financial advice if it is given **by an incorporated law firm** (as defined in section 6 of the Lawyers and Conveyancers Act 2006)
(a) in the **ordinary course of its business**; and
(b) **as an ancillary part of providing legal services** or conveyancing services (as defined in section 6 of that Act). …

(3) Financial advice is not regulated financial advice if—
(a) it is given by a person who is not an incorporated law firm and is not carrying on an occupation referred to in subclause (2)(a); and

(b) **it is given only as an ancillary part of a business** whose principal activity is not the provision of a financial service (any business that's principle business is not providing a financial service)

(4) Financial advice is not regulated financial advice if it is given by a director of an entity in the person's capacity as a director.

→ This section applies for firms that are run as companies and not partnerships

Schedule 5, Clause 9 (Exemption for Credit Providers)

(1) Financial advice is not regulated financial advice if—

(a) it is **given in connection with providing credit** under a credit contract; and

(b) the credit is provided, and the advice is given, **as an incidental part of a business** the principal activity of which is not the provision of a financial service.

(2) In this clause, something is an incidental part of a business if it is carried on to facilitate the carrying out of the business or is ancillary to the business.

***[See also s 10 for exemption for lenders]**

Other exemptions:

- Crown entities and Crown-related entities
- Trustee corporations (for certain services)
- Not for profits organisations (budget advisors) (for no charge)
- Employers to employees in relation to a workplace product

Retail and Wholesale

Wholesale

- Meaning of a retail investor is contained in cl 36 of sch 1 FMCA
- Important to keep in mind that there are less obligations if the customer is **wholesale**
- Wholesale customer can opt out of being wholesale

The wholesale/retail test is aligned with the FMCA.

- Investment business
- Investment activity
- Large investors
- Government agencies and eligible investors
- Someone in the business of a product provider

Retail

- Meaning of a retail investor is contained in cl 35 of sch 1 FMCA
- The duty on financial advisers to ensure standards of competency met, the duty to ensure the client understands the nature of advice and the duty to comply with code of conduct are **only for retail customers**

Accountability

[See s 431H]

- If the **employer** breaches a duty, that can attract civil liability (both employee and employer can be liable). Employer has some additional duties imposed on them.
- If a **financial adviser** (natural person) breaches a duty, that can attract disciplinary action (and deregistration) for the adviser and civil liability for the employer.
- If a **nominated representative** (natural person) breaches a duty the consequences fall only on the employer

[Breaches a Duty]	Civil Liability	Disciplinary action
Financial Advice Provider	✓	X
Financial Adviser	X	✓
Nominated Representative	X	X

Duties on Financial Advisers

Duty to meet standards of competence, knowledge, and skill

- Sections 431I:
    - This is an important duty for all advisers who give advice to **retail clients** to meet the standards of competency set out in **the code.**

Duty to ensure client understands nature and scope of advice

- Section 431J:
    - Reasonable steps need to be taken to ensure the client understands the nature and **scope** of the advice (applies to **retail clients** only)

Duty to give priority to client's interests

- Section 431K:
- When advice given to **retail or wholesale** clients, if the advisors knows or ought to know of a conflict, the adviser has a duty to put the client's interests first.
    - This does not mean the adviser has to act in the best interests of the client, only they have to put the client's interests first **if there is a conflict**
    - Is a different between putting clients interesting first and acting in client's best interest

Duty of care, diligence and skill

- Section 431L:
    - This is important for advice on insurance products which is currently very lightly regulated.
    - Includes considering the **suitability** of the product for the client
    - This section is the main tool the FMA uses to catch advisers
    - Applies to **wholesale** and **retail**

Duty to comply with code of conduct

- Section 431M:
  - This requires financial advisers to comply with the standards of ethical behaviour, conduct, and client care required by **the code of conduct (below)**.
  - Applies to **retail clients**
  - Code of Conduct includes:
    - Minimum Standards of Ethical Behaviour
    - Minimum Standards of Client Care
    - Minimum Standards of Competence, Knowledge and Skills
    - Minimum Standards for Continuing Professional Training
  - https://www.fma.govt.nz/assets/Guidance/Code-of-Professional-Conduct-for-AFAs-2.pdf

Duty to make prescribed information available

- Section 431O:
  - A person who gives regulated financial advice to a client must make the prescribed information available in the prescribed manner when required to do so by the regulations.
  - Applies to **wholesale** and **retail**

Additional duties on financial advice providers and interposed persons that engage others to give advice

Persons engaging others to give advice have a duty to ensure compliance with duties

- Section 431Q
  - A financial advice provider that engages another person (A) to give regulated financial advice must take all reasonable steps to ensure that A complies with sections 431I to 431P

Duties of persons who engage nominated representatives

- Section 431R:
  - A financial advice provider (P) that engages 1 or more nominated representatives to give regulated financial advice on P's behalf must have in place processes and controls that:
  - (a) limit the nature and scope of the advice that the nominated representatives give; and
  - (b) allow P to regulate what advice is given and the circumstances in which it is given.
  - The processes and controls must ensure that the advice given by a nominated representative is commensurate with their competence, knowledge, and skill.
  - The provider must not give, or offer to give, to any of its nominated representatives any kind of payment or other incentive that is intended to encourage, or is likely to have the effect of encouraging, a nominated representative to engage in conduct that contravenes any duty under sections 431I to 431P.

Things for lawyers to note

- The exemption from the FMCA (and the FA Act) applies when advice is given in the **ordinary course of business**

- But the **Law Society's Client Care Rules** impose obligations on all lawyers
    - As a lawyer you are a fiduciary, and there are minimum standards, including competency obligations and promoting the client's interests, not putting yourself in a position where you are your clients interest conflict
- Need to be extremely careful in giving financial advice, **shouldn't** do it as a lawyer

Financial Service Providers (Registration and Dispute Resolution) Act 2008

- This requires all **financial service providers** to register on a public register (not nominated representatives)
- This could be an entity or an individual

Criteria for registration

1. Must not be disqualified (must not be bankrupt of convicted or prohibited from being a director)
2. Must have a licence if that service requires a licence (if the service they are providing is subject to a licensing regime)

Dispute Resolution Schemes

- Registered financial service providers who provide financial services to **retail clients** and whose primary business is providing financial services are required to belong to a dispute resolution scheme
    - 4 schemes you can choose from
    - It costs the person who is a member to be a part of the scheme, but the consumer can make a complaint to the scheme for free
- The purpose of having these schemes is to enable the public to be able to access information on financial service providers, facilitates dispute resolution for consumers of financial services
- Need to be operating in NZ to be a part of the scheme

Process for complaints:

1. Start with the financial service provider's internal DR scheme
2. Then go to the external DR scheme that they belong to (which can impose a final decision)
3. The consumer can then take the complain to court if they wish
4. Could also go to the FMA (but they would likely just refer it back to the DR scheme)

Comparative analysis of financial adviser regulation

- Australia and the UK have both undertaken reviews of financial adviser regulation in the last 11 years
    - Advisers were largely found to be incompetent
    - Advisers were found to have failed to comply with best interests of clients. There is a conflict between selling the product and the clients getting the most suitable product for them (advisers being remunerated by the provider creates problems)
- EU Directive – MiFID 2004 – conduct of business requirements, including a "best interests" requirement
    - Full disclosure of conflict of interests
    - Best interests requirement has roots in common law fiduciary relationship

    - Appears to require positive steps are taken to ensure the clients best interests are achieved
- UK and Australia have rules on how "best interests" requirement is to be met

Situation in the UK

- Law is in the Conduct of Business Sourcebook (COBS)
- For personal recommendations to retail clients, receipt of commissions is **prohibited** (can only be paid by the client)
- Where advice is about a "retail investment product" – broadly defined
    - Advise on shares outside of the regime
- This was a cornerstone of the FSA's Retail Distribution Review

Situation in Australia

- Future of Financial Advice Reforms prohibited receipt of **conflicted remuneration** from 2013
    - I.e. where the adviser receives a benefit that could reasonably be expected to influence the choice of financial product recommended to the client
- This applies to personal and general product advice
- This was a response to concerns that commissions creates real conflict of interests and provide incentives to give advice that is not in the best interests of the client

NZ just has "put client's interests first"

- This will apply to all persons who give **regulated advice**
- No definition of what "put client's interests first" means
- FMA 2014 report concerned with compliance with this requirement
- Advisers receiving payment by someone other than the client, might have a relationship with the product provider, or have been offered incentives to sell the products (gets a benefit from promoting a certain product whether or not it is the best one for their client)
- "Independent" advisers are not remunerated by commission

What does the Code of Conduct say?

- New code of conduct doesn't say anything about what "put client's interests first" means
- Does say you need to act with integrity (have to manage conflict of interests)
- **Disclosure** of commissions is required (but is this enough?)
    - In Australia they had a similar thing and this did not work, consumers didn't understand despite the disclosure requirements
    - Australia decided that the potential for the product provided to bias the advice because of the commission could not be dealt with by disclosure alone

Why is New Zealand not following the trend?

- As in the UK and Australia, the role of financial advisers in New Zealand is blurred – are they advisers? Or are they product distributors?
- We have proposed s 431K (have to put interests of clients first)
- There is the code standard of acting with integrity and managing conflict of interests (not yet in force)
    - This sets standards of ethical behaviour and client care standards

    - Nothing specifically about putting client's interests first
- **Is it likely to address the problem?**
    - Lots of room to debate what this actually requires
    - Until there is a complete ban on conflicted renumeration, advisors will be influenced by their ability to get commission

If adviser acting for a bank or an insurer, might be subject to new law

- Conduct review of banks and life insurers in 2018, proposed law reforms that includes regulations that restrict the payment of incentives to intermediaries

TEST for Financial Advisers Regulation

1. Is this a financial advice situation?

- Look at what they did and figure out whether it was financial advice
- Only financial advice if it comes within s 431C (so needs to be about a financial advice product or about switching funds within a managed investment scheme or designing an investment plan)

<u>Financial Advice Product includes:</u>

- Financial products in the FMCA, but also includes:
- a DIMS facility; or
- (c) a contract of insurance; or
- (d) a consumer credit contract; or
- (e) any other product declared by the regulations to be a financial advice product

2. The advice needs to be <u>regulated</u> financial advice

- Only regulated if it is given in the ordinary course of the business **and** none of the exclusions apply

3. Who is giving the advice?

Any person that carries on a business of giving regulated financial advice must hold a market services licence unless exempt

<u>Two types of persons can give advice on behalf of a financial advice provider:</u>

- A **financial adviser** or;
- A **nominated representative**
    - Both types have duties to the customer
    - Financial advisers have more accountability for their actions
- Situation with a bank, insurance company or a financial advice firm, the people who give advice need to be a FA or NR, they don't need to get the licence themselves, the business does (but they do need to register)

4. Is the advice covered by any of the exclusions?

- See new Sch 5 to the FMCA
- Certain types of **communications** are exempt (factual information or carrying out instructions)
- Certain types of **occupations** are exempt
    - Journalists, lawyers, lecturers etc (as long as when they give the advice they are acting in the ordinary course of the occupation)

- If giving advice is **ancillary** to carrying on certain types of business it is exempt
- Certain Crown entities, trustee organisation, employers are also exempt

5. Is the client retail or wholesale?

- Important to keep in mind that obligations are less if customer is wholesale
- Duty to ensure standards of competency met, duty to ensure client understand nature of advice and duty to comply with code of conduct **are only for retail customers**
- Wholesale/retail test is aligned with the FMCA but wholesale customer can opt out of being wholesale

6. Duties imposed on Financial Advisers

- See sections 431I to 431P for **all advisers**
- Section 431Q and 431R impose additional duties on **financial advice providers** (ie the employer)
- Some duties **only** apply when advice is given to a retail client

7. Registration and Dispute Resolution requirements

- All financial service providers are required to register on public register
- Most registered financial service providers are required to belong to a dispute resolution scheme

The Financial Markets Authority

Background

- Commenced in 2011
- Took over role of Securities Commission:

Securities Commission rose out of concern about lack of enforcement of securities regulation

- Market participants are always finding new ways to make money outside of the regime, because compliance is expensive and attracts liabilities, so the law tries to keep up with the changing practices of the marketplace.
    - Insider Trading and takeover activity is a good example of this
    - The Securities Commission came under criticism after the finance company collapse

FMA has an expanded role (larger than the SC did)

- Has a role in relation to the following Acts:
    - FMCA
    - Anti-Money Laundering Act
    - Financial Advisers Act (until it is repealed next year)
    - Financial Reporting Act
    - Companies Act
- Took over lots of what the Registrar of Companies did
- Large now, with a broader range of powers then the SC did

What the FMA does <u>not</u> do

- Does not deal with complaints about anti-competitive trade practices,
- Doesn't register companies or maintain a registrar of financial service providers,
- Doesn't get involve in individual disputes
    - But can pass on information to DR schemes though and take an action on behalf of someone
- Doesn't provide investment advice
- Doesn't supervise banks, finance companies or insurance companies (the Reserve Bank does this)

FMA's Role

- Reviews and can suspend or cancel offer documents
- Administers regulatory regime for financial advisers and licenses financial advisers
- Administers and enforces all financial markets law in the FMCA
- Surveillance role over NZX
- Public education role (issues warnings and guidance notes, investigates scams
- Investigates investment scams etc).
- Licenses all financial market participants:
    - Eg: financial advisers, trustees/statutory supervisors, managers, exchanges, brokers
    - Monitors all these participants who have a licence
- Assists with compliance with AML laws
- Reviews financial reporting of issuers (Under Financial Reporting Act)
- Issues exemptions and guidance notes, notices warnings and directions
- Can take action in an investor's name under any financial markets legislation: see s 34 Financial Markets Authority Act

Investment Scams

- FMA manages scams and provides warnings and information about investment scams
- If an offer seems too good to be true, it is likely a scam. If you receive an email offering you something fishy, ignore or refer to the FMA
- FMA released a warning recently about cold calls regarding transferring funds overseas
- Time pressure, discouraging seeking professional advice etc are signs it's a scam

Ponzi schemes

- Money from new investors used to pay existing investors to make the investment appear successful
- Collapses eventually, first few investors do well but the later investors don't as their money is being used to pay off earlier investors
- Ross Asset Management a notable example

FMA annual report

- Took a review of retail banks and life insurance providers
- FMA involved in the amendment act and prepping for the licencing of the new regime etc
- Putting emphasis on treating customers fairly, previously FMA through of customers as investors, but now broader to include financial service users

Financial reporting

Background

- All **issuers** to the public/ listed companies must file audited financial statements on a public register, that comply with Generally Accepted Accounting Practice (GAAP)
- The relevant law is in the FMCA (Part 7) and the Financial Reporting Act 1993
  - One of the measures to restore confidence after the sharemarket crash
  - Statements to be prepared in accordance with approved standards
  - Now have International Financial Reporting Standards
  - ASRB approves standards

After the GFC lots of changes were made to reporting, there were issues with reporting standards and the standards of auditing

- Now we have the FMC Act, Part 7, supports the financial reporting requirements in the FR Act
  - All issuers must keep proper accounting records and have financial statements audited
    - **Auditors** now must be licensed (Auditor Regulation Act 2007)
    - Important role, they are independent checkers of the issuers financial position
  - Statements need to be filed
- FMA has oversight role in relation to auditing profession

→ In the past, there was room for different interpretations of the reporting requirements, with issuers being able to masking the true state of their affairs (creative accounting)

Reporting cases

MED v Feeney

Facts

- Another Feltex Carpets case (like *Houghton v Saunders*)
- Financial statements did not comply with financial reporting standards
  - Statements were in breach, not disputed there was a failure to disclose banking statements.
  - Also incorrectly classified debt as non-current
- Directors were prosecuted under Finance Reporting Act; but
- Defence if directors took “all reasonable and proper steps” to ensure Finance Reporting Act was complied with
- Courts’ attitude to financial literacy standards required of directors has moved on since this case
  - Courts were overly lenient on the directors in this case
  - Higher standards on directors now, this decision was one of time and place and does not set the standard of expectations

Held

- Directors were entitled to rely on advice of expert advisers
- First report under IFRS (Feltex Carpets was the first under the new standards, maybe why the judge was lenient on directors)

- Directors not required to be acquainted with IFRS themselves
- Compare with attitude of Court in *R v Moses*
    - Directors expected to be financially literate and understand the statements themselves

ASIC v Healey

- Directors argued they had taken all reasonable steps – Court rejected this
- Non-executive directors subject to same high standards and duties as executive
- So - high level of financial literacy expected of finance company directors and public company directors (needed to know what current liability meant)
    - Directors are well paid, respected, should have knowledge of financial accounting can't rely on experts

→ **High level of financial literacy required by the courts now**

Anti-Money Laundering

Background

- The AML laws effect **all issuers of securities to the public**
- Imposes obligations on all issuers of securities as well as other professionals like lawyers
- The legislation was put in place to meet international obligations (the Financial Action Task Force)
    - FATF aims to prevent and detect money laundering and financing of terrorist activity
    - NZ needed to comply with the FATF's recommendations to uphold its international reputation

What is money laundering?

- Is when criminals put the proceeds of crime through the financial system in order to disguise its origins and to make it 'clean money'
- Often involves a complex series of transactions, designed to mask the origins of the money
- Common to use nominee companies or have money move in and out of investment schemes
- Criminals put dirty money into an account, withdrawn and then put into another, making it hard to know when it came form
- Buying gambling chips in a casino is a common way to launder money as well

AML laws

- **These laws put obligations on financial institutions and others to ascertain where money has come from**
    - By requiring institutions taking in a large deposit to certify and report suspicious transactions etc.
    - This involves <u>verification of identity</u> and reporting of suspicious transactions

- Need to be aware of this if providing a financial service and taking in large sums of money from clients (i.e. more than $10,000)

Who do the AML laws apply to?

- **All financial institutions and casinos** (unless an express exclusion applies)
    - This overs all banks, stock exchanges, money market dealers, money changers, **issuers of securities to the public**
- Has recently been extended to cover non-financial businesses at risk of being targeted, eg: **lawyers**, real estate agents and accountants

Obligations if AML/CFT Act applies

If the AML laws apply to you (e.g. you are the issuer of securities to the public), you have an obligation to:

- Find out **who** is making the deposit
- To perform customer **"due diligence"** (when issuing securities, need to perform customer due diligence on the investor)
    - Due diligence can be **standard** (common one for issuer issuing securities), **simplified** or **enhanced** due diligence
    - Due diligence is required by a bank for **any new customer** – for any amount of money

Due Diligence

- "Simplified" due diligence for customers who are listed companies or are **lower risk**)
- "Standard" for new customers or one-off transactions
- "Enhanced" due diligence for customers who may be from **overseas** from certain countries or **unusually large or complex transactions** (trust, non-resident or certain types of companies, or unusually large or complex transaction)
- <u>If difficult to see where the money has come from → extra obligations apply</u>

Other obligations on reporting entities

- **Suspicious transactions** must be reported to the Police
- Prescribed transactions must be reported (cash deposits over $10,000)
- Risk assessment required by each reporting entity to assess the risks it faces of money laundering (must appoint compliance officer, etc).
- Need internal mechanisms in place to ensure all the obligations are upheld
- Three supervisors which monitor compliance with AML Laws
    - **FMA** supervises most securities issuers (trustee company, managed investment scheme etc).
    - **DIA** monitors Casinos
    - Banks, life insurers and finance companies are monitored by the **Reserve Bank**

"Suspicious transaction"

- This generates a suspicious transaction report
- A transaction that is inconsistent with the client's usual activities or what you would usually except from that client

- Large or usually complex transactions, or activities with no apparent legal or business purpose
- Difficult to know a lot of the time, perhaps lawyer should err on the side of caution

AML Application to lawyers

AML laws apply is lawyers who:

- Manage clients funds, account securities or other assets (lots of the work they do is this)
- Act as a nominee director or shareholder
- Providing a registered office or business address
- Providing conveyancing services

What do they need to do?

- Designate a compliance officer
- Assess the money laundering risks the firm faces
- Establish a compliance programme that sets out how the firm will detect and manage money laundering risk
- Verify the identity of clients before providing certain services (if it's a trust or the entity behind the client is not apparent, need to ask for more information about the transaction)
- Submit transaction reports to the police for certain cash transactions (over $10,000) and suspicious transaction reporting
- Monitor client accounts
- Prepare an annual report to the DIA and have that report audited
- **Legal professional privilege remains:**
  - Don't need to disclose privileged communication (but this is carefully defined in the AML Act)
  - **Not** privileged communication if it is being made or prepared for a dishonest purpose or if it is information about money kept in the lawyer's trust account
  - Bit of a grey area about what you have to disclose

Prudential Supervision (Banks)

General Prudential Supervision Background

What is "prudential supervision?"

- Prudential supervision means having a government regulator that:
  - (1) issues a licence to entities that carry on certain businesses and;
  - (2) does on-going monitoring of financial condition of the entity
- Certain criteria must be met in order to get the licence, including for example:
  - Competence of management, capital adequacy of the business and whether it will be able to carry on business in a prudential manner
- The regulator has powers to act in case of financial stress (can take over management etc).
- The Reserve Bank Act and the Insurance Prudential Supervision Act main important acts

Why have it?

- Prudential supervision provides barrier to entry into that field of business
- It also operates as an early warning system in the event of financial distress, the regulator can facilitate and assist with an orderly exit from market place if needed (protect investors)
- Prudential supervision does **not** ensure businesses will not fail
- NZ has prudential supervision for **banks**, **finance companies** and **insurance businesses** (Reserve Bank is the regulator)
- Any business that wants to be a bank, finance company or an insurer, needs to meet with the bank and meet entry criteria, with ongoing compliance requirements

Background for prudential supervision regulation of banks

Rationale

- The rationale for having prudential regulation of banks is that a major bank failure could cause major disruption to the economy.
    - If one major bank failed, would be a huge loss of investor confidence which could have flow on effects to other banks, which could disrupt the whole payment system in the economy.
- The government would have to rescue the bank, which would cost the taxpayer a lot of money
- Payment system includes EFTPOS, credit cards etc, which depend on banks being up and running

The Global Financial Crisis

- For a long time in the US credit was easily available without much security needed
- A mortgaged backed security and collateralised debt arrangement involved the debt obligations of homebuyers being bought by financial institutions
- When property values went down, these securities were worth less, causing huge loses to financial institutions – who then failed because the invested too much into these manufactured securities
- Financial institution failures led to investors trying to draw all their money out at the same time, banks don't have this much money at any one time
- In NZ our banks are mostly Australian owned, were not at risk of collapse because they had not invested heavily in the mortgaged backed securities, but public perception was that banks were in trouble
- The government NZ a guarantee was put in place to back up the banks

Prudential supervision regulation legislation and requirements

Banks have exemption from FMCA disclosure rules for many of their financial products

- Banks offering certain products ("prescribed financial products" – not sure what these are yet, coming with the FMA regulations) are not required to perform pt 3 disclosure.
- "Prescribed financial products" are expected to be term deposits (for example).
- Instead of the FMCA disclosure rules, banks are subject to regulation under the **Reserve Bank of New Zealand Act 1989**

Requirements of the Reserve Bank Act

[Banks must]:

- File quarterly disclosure statement
- Display a Key Information Summary
- Supported by attestations by bank's directors
- Sanctions for non-compliance
- Reserve Bank uses this information to manage the financial condition of each bank

Other requirements

- All banks must register under the Reserve Bank Act (cannot call themselves a "bank" otherwise)
- They must apply for registration and meet certain criteria

Branch vs Incorporation

- Sometimes overseas banks operate by **branch** or a **separately incorporated subsidiary** company)
- Overseas banks must incorporate here in certain cases:
  - For example if they a systemically important bank (if NZ liabilities exceed $15BN) or;
  - If there are inadequate rules in home country (if an Australian bank with a branch in NZ goes insolvent, Australian depositors get a preference, so now incorporation is required).
- If the RB considers supervision of the Bank in home country inadequate, then requires incorporation
- All the major 4 Banks are Australian owned, KiwiBank and TSB are the only major New Zealand owned Banks
- See list of registered banks on Reserve Bank website.

Reasons for requiring local incorporation

- It is important to have a NZ company because the company is then subject to NZ laws
  - Needs a BOD with NZ directors
  - NZ Companies Act and NZ insolvency law applies
- Incorporation also makes it clear which assets are attributable to the NZ business and not the offshore business
  - It is easier to shift assets out of NZ when it is run as a branch

How do you become registered as a bank?

[There are certain criteria that must be met before you can register as a bank in NZ]

- Business must be primarily banking
- Ownership structure must be suitable (in particular, the Reserve Bank needs to be satisfied the Banks's parent will stand behind the subsidiary)
- A certain amount of capital required (at least $30M)

Criteria

The Reserve Bank must be satisfied the bank will carry on business in a prudent manner (see list of criteria for this on Reserve Bank website). Includes:

- Includes the capital adequacy requirements will be met
- Bank has policies for risk exposure

- Banking business is separate from other business
- Corporate governance requirements on the BOD (5 board members, half need to be independent and reside in NZ) – needs to have objective scrutiny on the bank
- Directors and senior managers assessed for integrity and experience
- International standing and reputation are important
- Must have current **credit rating** from approved rating agency:
    - No level required, but it is made public, so you need a good one for people to deposit money
    - Credit rating enables customers to assess the risks of investing in banks, provides incentive on bank, assist the RB in its supervision
    - Standard & Poors the most common rating, AA+ is the best you can get
- Generally, see "Statement of Principles on Bank Registration and Supervision" (July 2014) on RB website

Once the Bank is Registered

- Once registered the bank must make quarterly financial disclosures to the Reserve Bank
- Directors must attest that the information in the disclosures is correct

What can the Reserve Bank do:

The Reserve Bank has certain powers if it has concerns about a bank. It can:

- Request more information
- Get information audited
- Conduct searches
- Investigate the bank's affairs
- Recommend registration be cancelled
- Require the bank to draw up action plan to improve financial situation (eg. to improve capital adequacy)
- Can direct bank to carry on business in a certain way or replace directors
- Can put bank into statutory management (manager put in place to run the business, used very rarely)

Crown Guarantee Scheme

Background

- New Zealand implemented a Crown retail deposit guarantee scheme 2008-2010 (came just after Australia)
- No one expected the Crown guarantee to be called on, the risks on it being called on were considered very remote
- Banks applied to be a part of the scheme, all major banks were automatically a part of it, banks had to pay a fee which generated quite a bit of money for the government

Crown guarantee of Finance Companies

- **Finance companies** were included in the scheme, which resulted in massive liabilities for the Crown
- The Finance company sector was in a lot of trouble at this time, there was a lack of public confidence in finance companies, excluding them from the scheme would have reduced this confidence even further

- Little fees were payable by these companies to be in the scheme, but then once they were guaranteed lots of money came in and some fees were payable
- Lots of investment money went into the finance companies (higher return rates than money in the bank – both guaranteed by the Crown)

What happened?

- Many of these companies failed, $1.84BN had to be paid out by the Crown (South Canterbury Finance being the largest). Net loss was around $500M (including the fees and what recovered by the liquidators)
- Response to potential banking crisis? Government showed a willingness to step in and save major banks

Payment guarantee options

- The Reserve Bank **does not** guarantee repayment by any bank to depositors,
- Introduction of **Crown Guarantee** in 2008 compromised Government's position on "no guarantee"

Going forward

- The Reserve Bank is working on ways to limit Government's exposure in event of major bank failure.
- The rationale for changes is that the perception that the Crown will rescue investors is a moral hazard. It makes investors less cautious about their decisions, and financial institutions are more willing to take risks.

Options

- Deposit insurance is one option, this would require banks to pay a premium into a scheme, so a pool of money is available if the bank collapses
- Another option (preferred by the Reserve Bank) is **open bank resolution**, where depositors can access their deposits (after the bank goes insolvent).
  - This allows bank to keep operating as a distressed bank. The losses fall on shareholders and creditors.

What is happening now

- The government has decided to introduce a deposit protection/ insurance regime
  - Considers NZ an outlier for not having one, would increase confidence etc
  - Only OECD country without such a scheme
  - Consultation process is ongoing - $50,000 limit per bank per customer
- There would also be a government backstop behind the scheme

Prudential Supervision (Finance Companies)

Background

The finance company industry collapse

- In NZ, National Finance 2000 Ltd failed in 2006, had too much debt, not enough assets, trustee put it into receivership.
- Provincial Finance then failed out of a loss of confidence
- 14 finance companies failed in 2007, including 2 large, safe reputable finance companies. Millions of dollars owed to investors, who very little back.
- 15 failed in 2008, including Lombard (owed $127M)

How did this happen?

- Finance companies rely on money coming in from the loan book, and new investors bringing in new funds
- A slowdown of the economy and loss of confidence led to failure (less repayment of loans, and less money coming in from investors)
- The Crown Deposit Guarantee Scheme included finance companies. The government stepped in and saved finance company sector in NZ

Trustee obligations

- Securities offered by finance companies are debt securities, so must have pt 4 FMCA governance requirements
- Registrar of Companies report (2007/2008 Financial Review of the Ministry of Economic Development, Report of the Commerce Committee) considered the trustee supervision was not working, trustees not being diligent about their work, failing to monitor what was going on
    - Trustees were private business, competing for business (which led to issues)
    - Trustees persuaded all was well and failed to act until too late
    - Other factors too were cited as being responsible for the failure (including excessive related party lending, reliant on one industry)

Legislative changes

- Trustees were given enhanced powers in the 2007 amendment to the Securities Act
- Trustees must now be **licensed** under Financial Markets Supervisors Act 2011, are supervised by the FMA
- To become a licenced finance company, need to appoint a trustee (statutory supervisor) who supervisors the finance company

Trustee is still the "front line" supervisor, the Reserve Bank has a regulation role behind the trustee

Formal Prudential Supervision

Stage One

Stage One (from 2009/2010) introduced the need for finance companies to have:

- Credit rating requirement
- Two independent directors
- Risk management programme
- New obligations on trustees to report to the Reserve Bank
- Empowered **regulations** and various regulations passed (included regulation of related party exposures, liquidity, capital ratios)

Stage Two

Stage Two (from 2014) introduced the need for finance companies to have:

- A full formal licensing system
  - See the Non-Bank Deposit Takers Act 2013 (requires all non-bank deposit takers to be licenced)
- Directors who meet competency standards (need to for the finance company to be licenced)
- Satisfied the Reserve Bank that company can meet all prudential requirements
- On-going reports to Reserve Bank
  - Trustee still front-line supervisor
  - RB has distress management powers behind trustee

→ There is now comprehensive prudential regulation via a licencing system since 2014

The Finance Company Sector today

What has happened to the finance company sector since the introduction of the new regulatory regime?

- Non-bank lending sector is declining in size
- UDC Finance was NZs biggest finance company, and it is no longer a finance company anymore
- There has been a growth of private funders financiers (people not taking money from the public, not regulated by the FMCA or licenced)

2019 financial stability report

[The Reserve Bank conducted a report in 2019 that found]:

- Households and dairy farms losing money, which presents a risk for banks
- Non-bank deposit taking sector only accounts for 0.6% of deposits in NZ (only 21 non-bank deposit takers in 2019)
- Very few finance companies left to regulate (different from finance entities that don't take money from the public)

Overall → The finance company industry has changed, the regulation that was introduced no longer as relevant as it once was

Prudential Supervision (Insurance Companies)

Background

Rationale for prudential regulation of insurance companies

The nature of insurance contracts means that prudential supervision is necessary

- Insurance contracts have special features. For example insurance is often a long term product (especially life insurance)
- Consumers don't expect a return for a long time, and it is difficult to withdraw and to switch providers
- Calculating liability under insurance policies is difficult, requires actuarial calculations, hard for consumers to know if what they are paying is appropriate or not
- **Also** → There was very little prudential regulation of insurance companies prior to 2010
    - New Zealand did not meet **international best practice standards**

Different types of insurance

- Home and contents insurance is **general insurance** (risk based insurance only, not investment element)
- Health insurance is purely risk based also, as the policy holder usually stays with the same provider
- Life insurance: Can be pure risk life insurance "term life insurance", where you pay a premium and are insured for one year (usually rolled over year after year); or **investment linked life insurance**.
    - Insurance companies can only offer investment products if they have a life insurance component to them

What is covered by the FMCA?

Risk-only insurance not subject to Part 3 disclosure under FMCA

- No disclosure and governance requirements needed
- Outside of the definition of managed investment scheme
- Pure risk insurance is a financial advisor product though

Investment-linked life insurance is covered under the FMCA

- Covered by disclosure and governance requirements of the FMCA (because there is an investment element)

→ **All** types of insurers are subject to the **prudential** supervision regime (all insurers need to get a licence from the Reserve Bank)

Insurance (Prudential Supervision) Act 2010

- The Insurance (Prudential Supervision) Act 2010 introduced a full scale prudential supervision regime.
    - The Act covers life insurers, general insurers, health insurers, re-insurers and all other insurers

  - There are some exemptions, for example if the business is overseas based and regulated by their own country (still need a licence but exempt from some of the Act)
- **All insurers must get licence from Reserve Bank** (some exceptions to compliance with the detail)

Requirements under the Act

- All insurers carrying on an insurance business in New Zealand must **get a licence from the Reserve Bank**
- **To get the licence they must meet solvency standards** (defined by solvency standards)
  - Can be hard to work this out sometimes
  - Banks = "capital adequacy" Insurers = "solvency" (same thing pretty much, but worked out differently)
- Must also have **current credit rating**
- Directors and senior officers **must meet "fit and proper" criteria**
- Must have **risk management programme**
- Must **have appointed actuary** who assesses the amount necessary to pay liabilities and audit the financial statements
- **Must prepare annual financial condition report**, prepared by the actuary which establishes whether the insurance company has enough assets to meet its liabilities
- Must **provide 6 & 12 monthly financial statements** to the Reserve Bank
- **Statutory fund required** for life insurers
- **No local incorporation requirement** (but must disclose any home preference to policy holders).
  - This is relevant for Australian insurers – Australian creditors get preference in an insolvency
- **No private sector trustee** (like finance companies). The Reserve Bank is the only supervisor
- The Reserve Bank has **distress management powers**:
  - Can require a recovery plan, can put the insurer into liquidation or statutory management
- Transfers of business must be approved

When the regime applies

- The regime applies if insurer **"carrying on insurance business in NZ"**
  - See ss 8 and 15 of the Insurance (Prudential Supervision) Act
  - If the insurer is labile to a NZ policy holder and has some level of activity here, they will be caught by the regime
- The test incorporates s 332 Companies Act (carrying on business in NZ test)
- To be caught by the regime there must be more than just having one NZ policy holder, but the exact level of activity is not clear

Overseas Insurance Companies

- If an overseas companies needs to be registered under the CA, then will be caught under the regime

        - An overseas company must be registered on the Companies Office's Overseas Register if it's **carrying on business here** (s 334**).** This includes business activities such as:
            - Establishing or using a share transfer office, or share registration office in New Zealand
            - Administering, managing or dealing with property in New Zealand as an agent, personal representative or trustee — even if this is through your employees or an agent.
- An overseas company will also come under the regime if they are **incorporated** in NZ

Issues with overseas insurers
Area of uncertainty – when does an overseas insurer have to get a licence under the Act?
- **It is not clear what level of activity is required** before a person is providing insurance products into NZ has to get a licence

Another issue is: how to prevent an offshore business holding out that they are regulated by New Zealand's prudential regulation regime when they are not?
- Overseas business can give a misleading impression that they are prudentially regulated in NZ when in fact they are not
    - To stop this, see s 218 (no insurance company can hold out that they are regulated unless they do in fact carry out insurance business in NZ) and s 219 (can't use a name that suggests they are carrying out insurance business in NZ if they are not)

Exemptions for overseas insurers
- There are a number of exemptions for overseas insurers
- Certain jurisdictions have been identified as having good regulatory regimes for insurance prudential supervision purposes (still need a licence but it is easier to get a licence)
- See the Insurance (Prudential Supervision) Regulations 2010
- Australian insurers in particular (don't need NZ solvency standard etc).

Insurance Prudential Supervision [TEST]

1. **Start with s 15 of the Insurance (Prudential Supervision) Act 2010**
    a. If the company is carrying on business in NZ, then it must have a licence

2. **Is the company carrying on business in NZ?**
    a. See s 8 of the Act (if incorporated, a resident, required to be registered under the CA)

3. **Is the company required to be registered under the CA?**
    a. A company that is carry on business in NZ must be registered under the CA (s 334)
    b. Carrying on business in NZ is defined in s 332 of the CA
    c. Not carrying on business in NZ merely because it enters into a contract of insurance as an insurer with a New Zealand policyholder
        i. Need to have more than one policy holder, but unclear how many

        ii. Having any physical presence (in person or through an agent) will amount to carrying on business in NZ
    d. Reserve Bank is looking into this area

4. **What about the advertising? (s 218 and s 219)**
    a. The company cannot falsely hold out that there is a NZ connection to the business, if no business in NZ is being carried out (s 218)
    b. Can't use insurance in the name of the company (s 219)

5. **FMCA advertising restrictions**
    a. Unsubstantiated representation provision etc may apply
    b. However it would be difficult to enforce the FMCA if the busines is not carried out in NZ
    c. The RB could communicate with the regulator in the country of origin, get them to look into it and see if there was anything that could be done through that

Prudential Supervision (Superannuation Schemes)

- Super schemes are intended to facilitate saving for retirement, used to be offered by employers often (some still are)

Types of schemes:

- <u>Defined benefit scheme</u> – pays out a pension when you retire, guaranteed a pension on retirement as long as you contribute [X] amount on your salary per year
- <u>Defined contribution scheme</u> (more common now) – benefit is your contributions and employers' contributions and the earnings on those contributions (no guaranteed amount on those earning). All KiwiSaver schemes are like this.

Superannuation schemes

- These are a financial product, used to be supervised in practice by the Government Actuary under the Superannuation Schemes Act (now covered by the FMCA)
- Now these are just another type of managed investment scheme with some special rules around them
- Superannuation scheme = might not be linked to an employer
- Work place schemes = require an employment relationship, scheme set up for employees of the employer, still relevant for big employers (like ACC).

KiwiSaver Schemes

- KiwiSaver schemes are governed by KiwiSaver Act and registered on the KiwiSaver register
- There are special requirements, members funds need to be locked in, fees managers charge must not be unreasonable, contributions must be made at a certain rate, members can go on contribution holiday
- Being a member gives you access to some free money from the government, provides an enforced savings mechanism, access to professional management
- Duties are imposed on the scheme managers (need to report the FMA on various matters)

- **Default** KiwiSaver schemes have extra obligations, under a contract with Crown:
    - Default schemes have a special position as they have access to automatic enrolments
    - Contract with the Crown imposes additional obligations on them, need to report on financial position to the Crown

How are they regulated?

- All the pt 3 disclosure requirements in the FMCA apply, as well as the additional disclosures that must be made
    - Since July 2013 quarterly disclosure statements have been required
- **There is no government regulation of KiwiSaver schemes or formal prudential regulation (the Reserve Bank does not supervise the schemes)**
    - There is some supervision aspect with the trustee and manager requirements
- In Australian there is a formal system of prudential regulation of super schemes
- No Crown guarantee of any KiwiSaver schemes
- **All 3 types of schemes must comply with pt 3 disclosure and s 127 of the FMCA** (need a licenced manager and trustee, need a trust deed).
- All schemes purpose needs to be providing retirement benefits.
- **Existing schemes** (schemes before the Act came into force) are subject to lesser regulation, but must be closed to new members. Can continue to operate, registered under 4th schedule of the FMCA and comply with s 131 and need 1 independent licenced regime.

The FMA's role

- The FMA is a market conduct regulator, looks at marketing practices, but is not a prudential supervisor.
    - FMA gets financial information, but no formal system of prudential regulation.
- **Regulations** require reports to the FMA
- Serious financial problems must be reported to FMA (see s 198 onwards)
- There is an onus on the supervisor (the trustee) to monitor the financial condition of the scheme
- The FMA has range of powers if it is concerned

Advice in relation to the financial markets law regime for superannuation?

- Ask if the advice is for a **new scheme** or an **existing scheme**
    - What type of scheme is it? (A KiwiSaver scheme or Superannuation scheme or another type of scheme?)
- If it is a new scheme = full FMCA applies
- If it is an existing scheme = restricted scheme with less onerous requirements
- Remember also the law in Part 2 of the FMCA about marketing a scheme

Prudential Supervision Overview

Banks

Prudential regulation? Yes

Reserve Bank is prudential regulator

See: Reserve Bank Act

See also: Statement of Principles for Bank Registration and Supervision

Must get licence, meet criteria and are monitored

Conduct regulation? Yes

FMA is conduct regulator

Bank products have some exemptions from Parts 3 and 4 of the FMCA

Subject to disclosure obligations under Reserve Bank Act

Subject to Part 2 FMCA

Finance Companies

Prudential regulation? Yes

Reserve Bank is prudential regulator

See: Non-Bank Deposit Takers Act

Must get licence, meet criteria and are monitored

Conduct regulation? Yes

FMA is conduct regulator

The financial products they issue are subject to Parts 3 and 4 of the FMCA (disclosure and governance)

Also Part 2 (fair dealing)

Superannuation Schemes

Prudential regulation?

No formal system of prudential regulation

Conduct regulation? Yes

FMA is conduct regulator

The financial products are subject to Parts 3 and 4 of the FMCA

Also Part 2

Some limited prudential type oversight through the trustee supervision

Default KiwiSaver schemes have more oversight

Insurance Companies

Prudential regulation? Yes

Reserve Bank is prudential regulator

See: Insurance (Prudential Supervision) Act

All insurers must get licence, meet criteria and are monitored

If 'carrying on insurance business in NZ'

Conduct regulation? For some type of insurance

FMA is the conduct regulator

Parts 3 and 4 of the FMCA only apply to investment life policies

See definition of "financial product" – only certain types of insurance are covered

But note definition of "financial advice product" for financial advisor regulation (broader definition)

Listed Companies

Prudential regulation?

No

Conduct regulation? Yes

FMA is conduct regulator

Disclosure obligations under Part 3 for equity securities (and Parts 3 and 4 for debt securities)

Part 2 obligations apply to these products

Trading in shares is regulated under Part 5 (insider trading and market manipulation)

NZX itself is regulated and supervised by the FMA

Credit Ratings

Background

- Credit rating are used by investors, who rely on them when deciding what investment to choose
- The government relies on them (as they form part of a prudential supervision regime)

Who needs one?

- The government has to get a credit rating themselves (NZ's is AA)
- Banks, insurers and finance companies must have a rating, which must be obtained before the entity acquires a licence
- No particular rating is required, but must be disclosed.
- It is generally accepted that there is a difference between an investment grade rating (BBB- or better) and a speculative rating (under BBB)

What does a credit rating tell us?

- It is an indication of how the rating agency views whether the entity will meet its financial obligations when they fall due
- It gives investors information in a concise and comparable way
- The rating is based on a quantitative analysis and opinion of the expert analysts

Issues with the system

- Credit rating agencies are subject to **conflict of interests**, as they are paid by the entities they rate (and clients want a good rating)
  - This means the credit rating agencies can never be truly objective
- There is also a **lack of competition** (top 3 agencies and not much else)
- **Lack of transparency**. It is difficult to know what goes on in the rating process
- There is a **lack of ongoing monitoring** of the rating, there tends to be a delay between financial deterioration and credit downgrade (see Hanover Finance and AMI for examples)
- The agencies don't keep up with innovative products, rate new products highly without knowledge of the products
- Rating companies are also **largely self-regulated**, and it is difficult to hold them accountable
- Governments get credit ratings, they want a good rating and use ratings as a regulatory tool, they are both the regulator and the regulated (regulatory capture)

Changes

- IOSCO Code of Conduct for credit rating agencies (adopted by the big 3)
- NRSRO designation (credit rating agencies can voluntary apply for this, the big 3 have)

Bringing an action against the rating agency

- This is difficult, what if you relied on the rating and it was incorrect?
- Rating agencies say their ratings are only opinions, which makes it difficult for the statement to be considered a negligent misstatement
  - It must be established that a duty of care was owed and proven that the credit agency foresaw that investors would rely on the rating and it was reasonable for them to do so
- Rating agencies are **exempt** under the Financial Advisors Act

ABN AMRO Bank NV v Bathurst Regional Council (AUS) (2014)

<u>Facts</u>

The bank marketed a complex derivative, engaged S&P to rate the notes, S&P gave it a AAA rating which was very important for marketing the notes. In communicating the rating S&P knew the rating would be marketed. The notes were sold to councils, who suffered losses.

<u>Held</u>

- The court found a duty of care was owed by the rating agency (S & P) when it gave the rating and was negligent.
- FCA found S&P liable under the misleading conduct provisions (similar to what we have in ss 19-22 in the FMCA), AMRO (the bank) was an accessory to the contraventions as well

Crowd Funding

Background

- Crowd funding is relatively new in NZ
- Crowd funding is a way for an entity with a new idea to raise funds from the public, by getting small amounts from individual people
- Often used because initial capital is difficult to raise for start-up companies

How does it work?

- Used through an intermediary (a crowd funding platform) that manages the process
- People invest in small amounts and get shares in the company that is running the business
  - These businesses are high risk, no guarantee the shares will be worth anything in the future
- Snowball effect and PledgeMe are the big intermediaries, and they screen what business can raise money through them

History

- There are 4 types of crowd funding (donation, reward (these 2 not regulated), equity and debt)
- **Equity** (people get shares) and **debt** (get bonds/ debentures) crowd funding come under the FMCA (they are considered investments)

Under the FMCA

- Disclosure requirements under pt 3 are too expensive for small start-up businesses, but also the FMCA is about investor protection – so a balance needs to be struck

Restrictions

- **The maximum that can be raised through crowd funding in any 12-month period is <u>$2 million</u>** (key limit)
- The offer must be done through a licensed crowd funding platform
  - There is no cap on what any investor can put into the venture (this is controversial and differs from other jurisdictions)
- **Only equity and debt types of crowd funding come under the FMCA**
- If the exception didn't apply, then would have to try fit within a schedule 1 exemption to disclosure, otherwise the FMCA requirements are too expensive

The exemption rationale

- The government has made a decision to encourage crowd funding by granting an exemption from the full disclosure obligations in the FMCA
  - Wanted to support high growth business raise funds
- Government noted the US granted an exemption from its securities act
- The NZ regime was flexible, the focus was on **the regulation of the platform**
  - It was seen as critical that the role of the platform was in effect the supervisor of the issuer (focus on the platform doing background checks and putting its own disclosure obligations).
  - The regulation of the platform and the way platforms operate in practice allows an exemption without too much of a risk to investors

How has the crowd funding regime worked in practice?

- There are 6 crowdfunding platforms in NZ
- Some statistics about the successfulness of campaigns (where the self-imposed minimum funds are raised)
  - Statistics show that crowd funding campaigns have been pretty successful in NZ
- NZ is regarded by some as a leader in the area of crowd funding regulation
  - One of the first jurisdictions to have a legal regime for crowd funding
  - Efficient system compared to other jurisdictions
- Haven't had fraudulent companies trying to CF crowd funding

The key to the success of the regime has been the role played by the <u>crowd funding platforms</u>

- Platforms take their role seriously and are quite exclusive (hard to get them to include your campaign on their platform)
- There are market based incentives; the platform wants to maintain its reputation as a reliable place for investors to put their money
  - Start-ups have to convince the platform they have a good business
- It is also possible for one or a few investors to act as **lead investors** (who invest lots of money). They will only invest if they think it's a good business.

- This gives the crowd funding campaign momentum and gives other investor's confidence (crowd funding campaign's with lead investors usually more likely to get on the platform).

Issues with crowd funding

The $2 million limit

- Should companies be able to raise more? That would allow good business to raise more, but would also mean a higher risk of potential loss to investors (more people invest more money = more risk)
- For SMEs it is very expensive to list on the NZX, doing IPOs are really expensive and there are ongoing costs for listing on the NZX – this means more companies have to raise from private wholesale investors

Issues with illiquidity

- If you invest in a CF campaign it is really hard to get your money back
- Generally, there is no sharemarket for the share of the companies. Could get a takeover but that's out of your control
- It is possible that the company operates an internal share trading scheme or lists on a small share market
    - CF Platforms can operate a secondary market (Snowball has done this). But this secondary market is not regulated like the NZX (no insider trading rules etc).

Conduct and Culture Review

Background

- In a Bill at the moment
- In November 2018 the FMA and the Reserve Bank reported on findings on doing a conduct & culture review on banks in NZ
- In 2019 reported on a review on life insurers
- Both reviews found serious issues with respect to the conduct & culture of banks and life insurers

The Royal Commission in Australia into Misconduct in the Banking, Superannuation and the Financial Services Industry

- AUS government set up the inquiry after complaints of how these institutions were treating people
- Looking at "poor conduct" – not just illegal, but conduct that fell short of community standards/ expectations
- Lots of poor conduct was revealed, generally the main cause was providers putting profit ahead of customers
- Those breaking the rules were not held to account, governance issues with the banks

4 big banks in NZ are all Australian owned, so similar questions were asked

- There were a few scandals, but the conduct & culture was not too bad in NZ

- 3 of our largest banks were selling interest rates swap charges and didn't explain the risks involved

The Government's response

- MBIE put out an options paper in April 2019, the government wanted to ensure the conduct & culture in the financial sector was delivering good outcomes for customers
- Options paper recommended high-level, principle-based duties enforced by a regulatory
- MBIE proposed the FMA be the regulatory responsible for enforcing these new rules
- Then the Financial Markets (Conduct of Institutions) Amendment Bill was introduced in December 2019
    - Purpose is to improve the conduct of certain financial institutions (mostly banks and insurers

The Financial Markets (Conduct of Institutions) Amendment Bill

- All entities that the new regime applies to will have to get a licence from the FMA (in addition to any other licence that is required)
- All such entities will have to comply with the **fair conduct principle**
    - This principle will require the entity to treat customers fairly, maintain a fair conduct programme to ensure they have fair systems in place, and comply with regulations on target-based incentives
- **The regime will apply to all 'financial institutions'** as defined (banks, insurers and (later) non-bank deposit takers)
- The Bill has undergone significant amendment in the process:
    - It has reduced the duties on the intermediaries, there is no longer a duty on intermediaries to comply with the fair conduct programme
    - There was a lot of industry feedback on the Bill, which has led to changes as to what will be required (in particular for intermediaries)
- The Bill recognises that there are "**financial consumers**" as a class of consumers – all types of products and services provided by the regulated entity is going to be within the scope of regulation where the products and services are provided to consumers
    - Not just investors, this is a big extension to the FMA's role

Victoria's thoughts

- Victoria thinks the regime should apply to all finance companies, and low-cost and high-cost lenders, this extension is contemplated by the Cabinet Paper
    - VS thinks the same rationale applies to these entities, as it does for banks and insurers
    - These products are complex and high risk, applies to the whole consumer credit market + there is evidence of poor conduct by these providers
    - Product-design and debt collection not regulated

"Fair conduct" principle

- Contained in section 446B of the FMCA, the institution and intermediaries must treat consumers fairly, including having due regard to their interests
- It applies when products are designed, promoted or offered and when there are dealings with a consumer

- A consumer is carefully defined in s 446S (depends on what the service is, carves out retail customers)
- Every financial institution who this applies must establish and maintain a fair conduct programme and comply with it

Compliance/ enforcement

- No penalties attach to breaches of the principle itself, however **there is a legal obligation to comply with the fair conduct programme**, and this programme's purpose is to comply with the fair conduct principle (s 446I).
- If the institution is seen to have not complied with the fair conduct programme, then there is the potential for liability (because it is a pt 6 service provision under the FMCA) – civil liability provision under s 485
- This is a roundabout way of making the fair conduct principle enforceable

Ponzi Schemes

David Ross and Ross Asset Management

- Ross Asset Management was believed to be a successful investment business. People would engage Ross Asset Management as an agent to manage their investment portfolio, had a reputation for providing good returns.
- Investors just had a management contract with Ross Asset Management, no form of security or form of interest
- This was a **discretionary investment management service (DIMS)**
  - Where someone decides what to buy on your behalf, you give them authority to do that

Hamish Macintosh

- Paid $500,000 to RAM in 2007, under the contract Ross Asset Management was to hold the money in a separate account
- The money was taken out of the account and became part of a pool of cash and securities that was used to pay out investors who wanted to cash out. In effect, Ross stole the money and used it for his own purposes.
- Ross Asset Management reported to clients that Ross Asset Management was doing what it had agreed to do, issued quarterly reports to clients etc
- In 2012, the assets available to pay investors was $15M, they had paid $115M
- Macintosh took his money out, the liquidators tried to force him to give the money back on the grounds it could be clawed back under insolvency law. They succeeded in getting $454K, he got to get what he initially contributed back
- Other clients who didn't take their money out lost everything (around $115M of clients funds was lost)

How could financial markets law be improved to prevent this happening again?

- **Disclosure** (but would this have helped? – no, nothing wrong with his character at the time)
- **Licencing** (need a market services licence, Ross Asset Management would have got this at the time)

- **Checks and balances**
  - Independent custodian that holds the assets (**this is now the law**) came about in s 455 in the FMCA.
  - **Reporting obligations to the FMA (now the law**) Ross Asset Management would have had reporting obligations under s 438 of the FMCA
  - **External audit of DIMS** (now, certain info needs to be provided in reports and custodians need to have their own records independently audited). This is prescribed in the regulations
- Overall it is unlikely that this situation could arise again

NZX

Background

- There is one main share exchange – **NZSX**

Other exchanges

- There are some smaller exchanges such as **Unlisted** and **ShareMart**
  - These operate as alternatives to NZSX, and were not regulated at all before the FMCA
  - You had to sign a disclaimer as an investor acknowledging that the protections don't apply
  - The FMCA requires these exchanges to be registered, the obligations to comply with the usual rules depends on the size of the exchange. Generally they would have reduced licencing obligations compared to NZSX (less ongoing disclosure obligations for example)

History

- The New Zealand Stock Exchange was self-regulated for many years
  - Prior to 2002, there was only industry self-regulation
- Exchanges developed in the 1860s with goldmining, but no central stock exchange until 1983, when we got the NZX, that had its own rules for membership and discipline etc
- The sharemarket crash in 1987 led to new rules to ensure brokers were responsible for their performance (participants rules)
- In the 1990s all transactions became automated (used to be done from the floor of the exchange)
- In 2000 the New Zealand Stock Exchange **demutualised** and became a company
  - This followed an international trend, our exchange converted from an associating owned by its members, to a company with its own shares listed on the exchange
  - NZSX and NZDX (debt market). Used to have NZAX (alternative exchange for smaller companies, but this closed due to lack of use)

The NZX

- The NZX provides a **primary** and a **secondary market** for trading in shares
  - Provides a market place where companies wanting to raise funds can be matched with investors (primary market)

    - Also can sell existing shares on there (secondary market)
- The Securities Commission was given a supervisory role of NZX in 2000
- Continuous disclosure rules were given legislative backing in 2002
- We now have a co-regulatory regime. This gives the FMA the role of overseeing the operations of NZX, required to be a licensed exchange and the rules need to be approved by the responsible minister
    - See FMCA part 5 subpart 7 (all financial product markets must be licenced and s 310).
    - Very small markets are exempt under s 312, and for prescribed (in the regulations) wholesale market.

- **It is very expensive to list on the NZSX**
    - Lots of ongoing fees
    - Need to arrange brokers and lawyers
    - Lots of documents to prepare
    - Regulations can exempt some small exchanges

Legal obligations for licenced market operators

[See s 314 of the FMCA]

A licensed market operator must,—

(a) to the extent that is reasonably practicable, do all things necessary to ensure that each of its licensed markets is a **fair, orderly, and transparent market**; and

(b) have **adequate arrangements for operating its licensed markets**, including arrangements—

(i) for notifying disclosures made to it under a disclosure obligation and for continuing to make those disclosures available; and

(ii) for handling conflicts between the commercial interests of the licensed market operator and the need for the licensed market operator to ensure that the markets operate in the way referred to in paragraph (a); and

(iii) for monitoring the conduct of participants on or in relation to the markets; and;

(iv) for enforcing compliance with the relevant market rules (for example, by having a sufficiently independent adjudicative body to adjudicate on contraventions of market rules that are referred to it); and

(c) **have sufficient resources** (including financial, technological, and human resources) to operate its licensed markets properly; and

(d) have adequate arrangements for ensuring that the criteria specified in section 316(c) or 317(1)(d), as the case may be, continue to be met

Listing Rules

- These rules form part of the contract between the company that is listing its shares (issuer) and the exchange
- The listing rules (all listed companies must agree to be bound by the Listing Rules) are available on the NZX website
- **The rules include (for example):**
    - Requirements for independent directors and having an audit committee of the BO

    - Minimum market value requirement of $5million (has to be a relatively large company)
    - Additional disclosure requirements in addition to the FMCA
    - Requirements to liquidity of the shares (need to be 500 public shareholders)
- The Listing Rules must be approved by the FMA
    - Formalised supervision role over share exchanges
- How does an entity get a licence as an exchange?
    - See ss 314 – 321
    - If an exchange is bigger than very small threshold, needs a licence
- Exchange needs to report any disciplinary action it takes against a company

How to get listed on NZSX

- The process of going out to the public for the first time for listing on the NZX is called an IPO (**Initial Public Offering**) and the disclosure would include the PDS required under Part 3 FMCA.
- This is an expensive and time consuming process, doesn't happen very often.
- **Mighty River Power** floated with an IPO in 2013, buying shares in the IPO was $2.50 per share, went up to $2.70, now trading around $6.59. Around 113,000 retail investors bought shares, cost $40M to do the IPO, raised 1.7BN for the government, costs were 2.4% of the costs raised (not unusual percentage)
- Need to prepare an offer document, with the PDS.
- Not many new companies are entering the NZX in recent years

Advising on whether to float an IPO

If you had to give advice to a client on the legal requirements for an IPO, then:

- Consider if the NZSX is the right place for this company's shares, or might one of the smaller exchanges be more suitable
    - NZSX is the most popular, but is very expensive
- If the NZSX is the right marketplace then tell the client about the requirements of the Listing Rules:
    - There would probably need to be some changes in how the company operates (the company's constitution would need to be changed/ created)
    - The market value needs to be $5M and securities need to held by 500 members of the public
    - Needs an audit committee and at least 3 directors
- Also would need to note the requirements of Part 3 of the FMCA (full pt 3 **disclosure** required)
- Also the **financial reporting requirements** (Part 7) and the fair trading rules in Part 5
- Also mention the **Takeovers Code**
- Note the **costs** of doing an IPO
    - Need to appoint a 'lead broker' who handles the offer, engages lawyers, accountants, an underwriter, printing costs
    - Ballpark figure would be 3-4% of the amount raised ($10M raised = $300,000 on the IPO)

Alternatives

- Smaller exchanges
- Wholesale investors
- Crowdfunding or small offer

The Role of Financial Markets Regulation

Why do we regulate the financial markets so heavily?

- NZ securities law was based on investors being told full info about what they were investing in (**all about disclosure**)
- The best protection for the public was considered to be full disclosure, as investors can then make informed decisions

Goals of FM regulation (per Richardson J in *Re AIC Merchant Finance*)

- Facilitate capital fundraising (enabling business to access money to grow their business) by requiring the timely disclosure of all relevant information to prospective investors.
- Goal of disclosure
- Goal of investor protection

In *R v Moses*, per Heath J said Securities Act purpose was investor protection, disclosure is a means to facilitate this

Investor Protection

What role does investor protection play?

The FMCA purposes in s 3 or 4 do not specifically mention investor protection

- Doesn't really fit in s 3 (maybe "fair markets" but probably not)
  - Elevating investor protection to the main purpose of the Act means investors may rely on this too much, which may be why it doesn't form part of the purpose
- Disclosure strikes a balance (imposes discipline on issuers, facilitates informed capital raising, but also requires investors to do some work themselves to understand)
  - Needs to be balanced against the other objectives, investors shouldn't be too complacent, but issuers also should not be able to mislead investors.
- Confident and informed participation is important for a successful market, people need to think the market is safe and transparent and fair

Is Financial Markets Regulation all about investor protection?

Aspects of FM regulation

- The purpose of investor protection has to be balanced against the other purposes
- Confident participation is key to a successful public fundraising market
- There is also the underlying theme of having a healthy financial services sector
- Financial consumer protection and investor protection are incidental to the broader goals of fostering an environment in which financial services businesses (in particular

banks) can operate efficiently and profitably and more generally facilitating public fundraising for New Zealand businesses
    - VS thinks investor protection is a result or subsidiary goal of the other goals. The other goals being having a market that is a safe place for investors.

Disclosure
- Disclosure is still at the centre of our regime
- The new PDS regime is to assist the prudent but non-expert person

Governance requirements
- The governance requirements in pt 4 are about investor protection, having a trustee and a manager.
- These are aspects of the regulation can be seen as facilitating investor protection even though it is not included in the stated purposes

KiwiSaver protection
- This is also about investor protection

Prudential supervision
- Especially of insurance companies, this is about investor protection

Anti-money laundering
- This not about investor protection (maybe about public confidence to an extent)

Regulation of secondary markets
- We have regulation to encourage investors to invest in secondary markets, investors won't invest if there is insider trading or market manipulation or poor disclosure

Financial advisor regulation
- About raising the standard of the sector, making sure the advisers are trained and comply with the rules
- Partly about disclosure (so people know what they are getting)
- Also about having enforcement measures in place
- There are competing incentives (acting in client's interests vs putting their own financial interests first)
- The new code of conduct, imposes an obligation to act with integrity, which touchers on conflicts, suggests the goal is to foster use of advisers
- VS thinks regulation of FAs is about encouraging investors

The Conduct of Institutions Bill
- This introduces the broader concept of financial consumer protection
- At its centre is about treating customers fairly (s 446B)
- Is this about investor protection or the flow of capital in the market? (VS thinks not really)
- It's about how they treat their customers (all consumers of financial product, not just investors)
- Focus on conduct suggests a mix of <u>underlying rationale</u>, more financial consumer protection (broader range of people, not just investors) and this broader group should have some protection

- "Consumer" = Debtors, people taking out insurance (any user of financial product)
- Rationale maybe to protect interests of Financial consumers, shift in focus not just for investors

The Australian Royal Commission Report

- The Bill was also a response to pressure from this report cites misconduct by banks as leading to the report. Consumer lending was a key focus.
- The Royal Commission said consumers of these services should be treated fairly and honestly (why?):
    - Because treating customers well has economic consequences, promotes confident participation (encourage consumers to use banking services) and competition in the market.
    - Competition is good for consumers, as lowers the price. Fair treatment foster competition as consumers can leave to another bank that treats them better (but this is not a great argument)
- Risks with this, will consumers be more complacent? More costs for compliance.

Why is consumer protection important?

- FMA/ Reserve Bank report → Consumer trust important to the financial services sector
    - We want a healthy financial services sector. To be healthy there needs to be customers that are entitled to fair treatment
- **But financial consumer protection NOT the goal of the reform**
    - The overarching goal is to protect banks and insurers. This backed up by there being no enforceable obligation to comply with the fair conduct obligations

Summary

Financial consumer protection and investor protection are incidental, but not at the forefront of the regulation of financial markets. It is all about having healthy financial markets

- Banks and insurers assist the economy
- The FMCA's purpose makes sense under this reasoning. Financial consumer protection and investor protection are not goals but bi-products of the regime.
- This is different to what the judiciary have said.