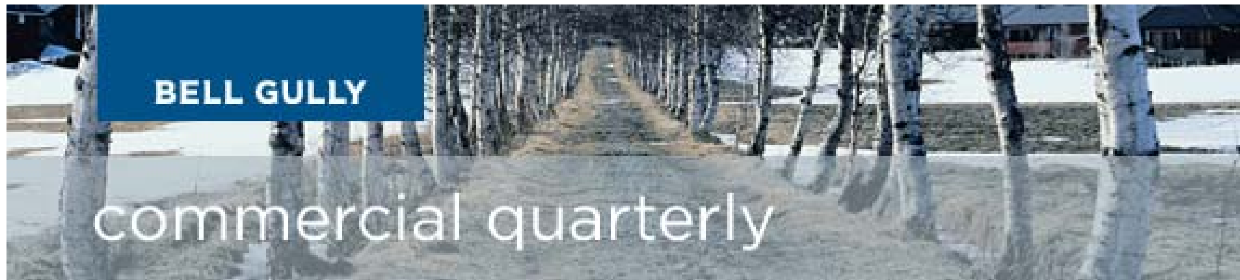
Commercial Quarterly

WINTER 2008



Welcome to the Winter 2008 issue of *Commercial Quarterly*, Bell Gully's digest of current corporate and commercial law issues.

Each quarter we preview upcoming developments and summarise recent cases and legislation of interest under the following headings:

Commercial business law
Company law
Securities and capital markets
Competition and consumer law
Intellectual property and information technology
Utilities and resources

In this issue, feature articles include:

- Takeovers Panel continues to advocate for regulatory changes for schemes of arrangements and amalgamations
- More regulatory policy initiatives in the electricity market
- Emissions Trading Scheme looks set to be a reality
- Key aspects of the Financial Advisers Bill still under consideration
- The trans-Tasman Mutual Recognition of Securities Offerings scheme
- Directors' duties: factors to weigh up before making business decisions
- Further refinements for the minority buy-out regime
- Vision and pragmatism aim for new capital markets taskforce
- Directors' and Officers' disclosure – simplification at last
- Commerce Commission looks to formalise the merger clearance process
- Price control amendments update
- Beware of domain name scare tactics

Previous issues of Commercial Quarterly are available on our website.

A companion publication, *Regulator Report*, covers developments in the corporate and regulatory sector (New Zealand and Australian exchanges, securities markets regulators, and takeovers and competition regulators) and is published approximately every three weeks. *Regulator Report* is available online at www.bellgully.com.

Need more information? For more information on any of the cases, articles and features in *Commercial Quarterly*, please email Diane Graham at diane.graham@bellgully.com or call on 64 9 916 8849.

Disclaimer: This publication is necessarily brief and general in nature. You should seek professional advice before taking any action in relation to the matters dealt with in this publication.

Commercial business law

Does New Zealand need franchise-specific legislation?
Following a series of alleged franchising scams earlier this year, the government is seeking feedback on whether there is a sufficient level of concern in the market to warrant introducing franchise-specific legislation.

Chinese checkmate: why Sydney stopovers could be fatal for free trade
In this article, Bell Gully solicitor Campbell Pentney highlights a potential issue for New Zealand businesses that import Chinese-made goods via another country, especially Australia, to be aware of if they are to take full advantage of the New Zealand-China Free Trade Agreement.

Flexible working rights a reality
In June, legislation came into force which gives many employees the right to request flexible working arrangements - a small step towards achieving what has become the Holy Grail of the modern workplace: work-life balance.

eDealing update

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Does New Zealand need franchise-specific legislation?

Following a series of alleged franchising scams earlier this year, the government is seeking feedback on whether there is a sufficient level of concern in the market to warrant introducing franchise-specific legislation.

On 15 August, the Minister of Commerce Lianne Dalziel released a discussion document *Review of Franchising Regulation in New Zealand* inviting interested parties to comment on whether franchisees are sufficiently protected by current laws and structures, or whether there is something more that the government should be doing in the form of education initiatives or through the introduction of a franchise regulatory framework.

Types of franchising arrangements under review

Franchising is essentially a way of doing business. It has no fixed legal meaning, but the term is often used loosely to refer to a form of licensing distribution arrangement. The discussion document is primarily focused on business format franchising, which is based on a long term contract and licence where the franchisor grants a franchisee the right to operate a copy of its business system for a specified period.

Typically under this arrangement, the franchisees are the owners of their own business but will obtain the right to use the intellectual property, the business system and the know-how of the franchisor. Franchisees may also benefit from national advertising campaigns and established support systems. The franchisors usually gain their income from initial and on-going fees paid by the franchisees, or through supply and distribution agreements.

This arrangement can also be multi-tiered whereby a franchisor grants a master franchisee the right to grant sub-franchises.

In most, if not all cases, this type of arrangement will be subject to a written franchise agreement accompanied by an operations manual, and usually allows the franchisor to retain a high degree of control over the franchisee.

Status quo

In New Zealand there is no specific law relating to franchising, but franchise agreements are subject to a range of generic laws, including contract law, consumer law, intellectual property law and competition law. There is also voluntary self-regulation of business format franchising through the Franchise Association of New Zealand Inc (FANZ).

The discussion paper notes that, with a few exceptions, the status quo appears to be working well and that there is no evidence of widespread problems with the current framework.

Problem areas

Areas which have been identified as potential problems which need to be addressed include:

- the lack of relevant information available to franchisees to enable them to make informed decisions on whether to enter into the franchise arrangement;
- unsuitable options for resolving disputes;
- contractual power imbalance, particularly in relation to the ability of a franchisor to cancel a contract without just cause, or unreasonably prevent the transfer of an agreement; and
- in the absence of franchise specific legislation, the potential for adverse public perception of the franchising sector to inhibit the growth of the sector.

The discussion document, however, states that this consultation is not to be used for responses to the recent reports of scams in the franchising sector, which the government believes is sufficiently addressed by current laws dealing with fraud. Similarly the government does not want to receive comments on

unconscionability (an issue often raised in franchising arrangements) since this is currently being reviewed in a wider context by the Ministry of Consumer Affairs as part of its review of the Fair Trading Act.

Future regulation

The discussion paper offers a number of options which could be pursued if it was considered necessary to introduce franchise specific legislation. This includes requirements for:

- mandatory information disclosure by franchisors to enable franchisees to do their due diligence;
- mandatory professional advice for the franchisee before entering into a franchise agreement;
- a cooling off period to allow a franchisee to withdraw from a contract if they decided the arrangement was not suitable for them;
- an alternative dispute resolution process;
- rules for franchising contracts to limit contractual power imbalance;
- an obligation of good faith on franchisors in relation to their post-contractual conduct; and
- institutional oversight.

Submissions

To access a copy of the discussion paper visit the Ministry of Economic Development's website at www.med.govt.nz. Submissions close on 21 November 2008.

Chinese checkmate: why Sydney stopovers could be fatal for free trade

In this article, Bell Gully Solicitor Campbell Pentney highlights a potential issue for New Zealand businesses that import Chinese-made goods via another country, especially Australia to be aware of if they are to take full advantage of the New Zealand-China Free Trade Agreement.

As noted in the Autumn 2008 issue of Commercial Quarterly, in April China and New Zealand signed a free trade agreement (the FTA) in Beijing and it is expected to be in force by 1 October 2008.

One of the key objectives of the FTA is to "eliminate barriers to trade in, and facilitate the cross-border movement of, goods and services between the parties" and this will be accomplished by lowering or eliminating tariff rates for most types of goods that pass between New Zealand and China.

On reviewing the details of the FTA we have become aware of an apparent limitation in that the preferential tariff treatment only seems to apply to goods that are consigned directly between China and New Zealand.

Where goods pass through a third country, the preferential tariff treatment will only be allowed where:

- the goods do not enter into the trade or commerce of that country; and
- the goods do not undergo any operation in the third country other than unloading and reloading, repacking, or any operation required to keep the goods in good condition.

In addition, where goods transit through a third country, the duration of that transit or any storage in that third country cannot exceed six months.

Whether either of these requirements are met will be a question of law. We understand Customs to have taken the initial view that clearing goods through the customs processes of a country may well result in those goods entering "the trade or commerce" of the country.

Chinese-made products may often be brought into New Zealand via Australia. This could be because the product has been bought by an Australian reseller (perhaps an Australian parent company) or an Australian buying agent. If under such an arrangement the product has passed through Australia in the sense of having been entered into the trade or commerce of Australia then the limitations outlined above may exclude the benefits of the China-New Zealand FTA.

Further, the benefits of the Australia-New Zealand FTA only apply to goods of Australian origin – so the Australia-New Zealand FTA would also not provide relief.

If you may be affected by this and would like to discuss this further, please contact any member of Bell Gully's tax team.

Flexible working rights a reality

In June, legislation came into force which gives many employees the right to request flexible working arrangements - a small step towards achieving what has become the Holy Grail of the modern workplace: work-life balance.

The Employment Relations (Flexible Working Arrangements) Act (which will amend the Employment Relations Act 2000) gives an employee responsible for the care of another person the right to request a variation in their "working arrangements". This piece of legislation was originally part of a Green Party MP Members' Bill and was picked up by the Government as part of the Department of Labour's Work Life Balance Project.

Understanding the scope and application of the legislation and putting in place the right processes to deal with requests for flexible working arrangements will be key to its success.

Who is entitled to what?

The "working arrangements" that an employee may request to vary include an employee's hours of work, days of work or place of work.

An employee who is "responsible for the care of any person", and has been employed by their employer for the immediately preceding six months, can request a variation in their working arrangements.

The level of responsibility required, or the care that an employee must provide, is not defined in the legislation. However, sample request documents produced by the Department of Labour include a section where an employee must specify how the request would, if granted, "enable the employee to provide better care for the person concerned."

The legislation appears to apply to those with a pre-existing ongoing responsibility to ensure the care, welfare and/or safety of another. It is not limited to parents of school-aged children, as the care of disabled and elderly will fall within the definition.

The legislation does not extend the right to request a variation in working arrangements to all employees – care of a person is required. For employees who want alternative working arrangements for another purpose, this must be the subject of a separate discussion and agreement between employee and employer outside the bounds of this new legislation.

Steps for employees

An employee's request to vary their working arrangements must be in the correct form: it must be in writing, specify the nature of the variation and the period of time for which the variation is proposed, any changes required by the employer to accommodate the request and, in particular, how the variation will enable the employee to better care for the particular person.

Steps for employers

To achieve administrative convenience, and what will become best practice, employers should develop a request form incorporating these elements. The Department of Labour has a basic template request form, which an employer can adapt appropriately.

An employer, upon receiving a request, must deal with it as soon as possible, and no later than three months after receiving it. The employer must then inform the employee whether their request has been approved or refused.

Dealing with the request will require the employer to investigate whether the employee is entitled to make a request, and decide whether the request could be accommodated (including by making any changes to the workplace that the employee may have suggested).

Yay or nay?

There are eight particular grounds for refusing a request. These are: the inability to reorganise work among existing staff, the inability to recruit additional staff, a detrimental impact on quality, a detrimental impact on performance, insufficiency of work during the periods the employee proposes to work, planned structural changes, the burden of additional costs and a detrimental effect on ability to meet customer demand.

An employee may only make one request in any 12 month period. In addition, a request to vary working arrangements which have previously been negotiated under a collective agreement must be refused by an employer. This may have particular significance in workplaces where collectives govern the work of a large number of employees, and separate advice should be sought in any particular situation in which the working arrangements under a collective may be varied.

An employer must deal with a request in a reasonable manner, and only refuse a request if it cannot be accommodated on the basis of the grounds mentioned above. There is no specific requirement for a refusal to be in writing – but best practice would require an employer to do so (especially if the employee is dissatisfied with the decision, and seeks to raise an employment problem). Again, the Department of Labour has a basic template refusal form.

An employee has the right to refer a refusal to a Labour Inspector in the first instance and, if dissatisfied, to the Mediation Service. A final right of appeal can be made to the Employment Relations Authority, which has the power to impose a penalty up to a maximum of $2,000 where an employer does not follow the appropriate processes described above when dealing with a request.

Regardless, the Authority has no power to require an employer to implement the employee's proposed working arrangements. In other words, employees are unable to challenge the substantive grounds relied on by an employer to decline a request.

This part of the Act will be reviewed after two years and employers will have the opportunity to provide feedback on this new legislation.

This article is by Matt McGoldrick, a solicitor in Bell Gully's employment law team and was originally published on our website on Thursday 3 July 2008.

eDealing update

Bell Gully has been using Land Information New Zealand's (LINZ) Landonline online electronic system for registering land title documents since the beginning of 2007. Since that time, there have been a number of developments that have improved Landonline's functionality and increased the number of land title instruments that can be registered electronically using the system. LINZ introduces these developments as periodic "Releases" from time to time.

Overview of development of eDealing

The mandatory date by which all discharges of mortgage had to be completed electronically was 1 May 2007. Release 2.9 was introduced on 11 June 2007. However, most of the changes related to the appearance of the database rather than the functionality of Landonline.

From 1 August 2007, it has been compulsory for all standard transfers and mortgages (ie. no annexure schedules) to be completed electronically. Release 2.10, introduced on 8 October 2007, made more substantial changes to Landonline's capabilities, increasing the number of instruments capable of being registered electronically. This update also streamlined the sign & certify procedures, making the database more user-friendly.

Release 3.0 on 24 April 2008 has meant that all discharges of mortgage, transfers and mortgages are e-capable. Multiple transfers and mortgages are able to be completed within the same dealing. There is also greater flexibility, with conveyancers now able to use eDealing to complete more complex transfers and mortgages.

In addition, there is now the option to "Add Text" or "Add Image" to certain instruments. This means that additional clauses or conditions can be included as an annexure schedule to the instrument being registered. Where these functions are used, the dealing is not automatically registrable and requires LINZ staff to check the information before the eDealing transaction is registered. Therefore, the dealing is "lodged" immediately, but it may take up to 15 days for it to appear on the title.

With Release 3.1, LINZ aims for all land transactions to become e-capable, including variations of mortgages, caveats, changes of names and easements.

LINZ plans to make electronic lodgement compulsory for all instruments from 31 October 2008.

Commercial issues in relation to eDealing

As eDealing has become market practice, it is evident that the electronic environment, as with the paper environment, has some limitations. Outlined below are some commercial issues that we have identified.

Opening hours of the Land Register

The Land Transfer Regulations prescribe opening hours for the Land Register of 9am to 4pm. While it is possible to create, pre-validate, sign & certify and release instruments at any time, an eDealing cannot be submitted to alter the Register before 9am or after 4pm.

As such, if settlement is due to occur in the afternoon of any day, including funds being drawn down, it is important to remember that the eDealing (containing all instruments - for example, discharge of old mortgage, transfer and new mortgage) may not be able to be submitted until the following morning.

From our experience, the reason for the delay is that confirmation of receipt of funds may not be able to be provided by the borrower's solicitor until the following morning, or that the borrower's solicitor is awaiting confirmation of receipt of funds from the vendor's solicitor. This means that the vendor's solicitor and the borrower's solicitor will not release the instruments that they are responsible for until they have received adequate funds.

Furthermore, while the Register can be altered from 9am onwards, it can take several hours until all instruments have been released and the eDealing is submitted.

In order to protect our clients' interests during this period, our practice is to hold a guaranteed search of each certificate of title in addition to undertakings from all other parties involved in the eDealing. However, it is worth noting that, during this intervening period, it is possible for other instruments, such as caveats or mortgages, to be registered.

Lodged eDealings can be requisitioned

As outlined above, it is now possible to register instruments that contain additional text or images, such as annexure schedules. An instrument that contains additional information is considered to be "non-standard". The additional text/image can be included simply by typing text into the box provided or by attaching a document. As there is a greater possibility for human error with "non-standard" instruments, these must be checked by a LINZ officer to ensure that they comply with the provisions of the Land Transfer Act. As such, while a "standard instrument" is automatically registered, a "non-standard" instrument must be lodged, which can take up to 15 business days. If an eDealing contains a combination of standard and non-standard instruments, the whole dealing will be lodged for registration. During the 15 day period, the eDealing will appear as a "pending dealing" to those who search the title and any instruments registered will be added to the title behind the lodged dealing. As such, the lodgement process does not alter the priority of the eDealing, but it can take up to 15 days to receive confirmation that the titles have been updated.

If the LINZ officer determines that there is an error in a lodged instrument, they will "requisition" the eDealing to the submitting firm to correct the error. The requisitioning process does not prejudice the priority of the eDealing as a whole. However, if a dealing has a significant error or omission, then the eDealing can be rejected, which means it is not acceptable for registration. A rejected dealing will be given a new dealing number and will need to be amended and resubmitted. The priority of a rejected dealing will be lost.

A re-submission fee applies for rejected and requisitioned eDealings.

Company law

Further refinements for the minority buy-out regime

In May 2008 the Commerce Select Committee reported back on the Companies (Minority Buy-out Rights) Amendment Bill 2007, which sets out to improve the efficiency and effectiveness of the Companies Act's minority buy-out regime. As expected, the Committee has recommended further modifications to the Bill, although some may see its recommendations as falling short on certain aspects of the buy-out regime. In this article, solicitor Jennifer Coote outlines the Committee's key proposed amendments to the Bill.

Directors' duties: factors to weigh up before making business decisions

It is inevitable that a director's business decisions and practices will be scrutinised closely by a company's shareholders, liquidators and aggrieved creditors in the event of a company's insolvency. In this article, senior associate Graeme Switzer and solicitor Sukhdeep Johal analyse two recent High Court cases to illustrate the standards applied to, and types of actions required from, directors wanting to avoid the possibility of being ordered to dig into their own pockets to repay an insolvent company's debts.

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BACKGROUND

The current minority buy-out regime allows a dissenting shareholder to require the company to buy its shares for a "fair and reasonable" price when the shareholder has unsuccessfully voted against a fundamental change in the structure or direction of the company.

The rationale underlying the regime is that a minority shareholder should not be forced to continue to own an interest in a company which is materially different from when the shareholder invested in the company. It is also of little benefit to the company if a disgruntled minority is forced to remain as shareholder. Instead the minority should be able to exit the company at a price which is fair and reasonable.

Although the minority buy-out regime is generally viewed as desirable, in practice its operation has proved difficult for both shareholders and companies largely as a result of the uncertainty surrounding the mechanisms for establishing a "fair and reasonable" price. In an early case brought under the current regime (sections 110 to 115 of the Companies Act 1993), *Natural Gas Corporation Holdings Ltd v Infratil*[1] (Natural Gas), Justice Doogue went so far as to describe the current procedures as "defective" and "substantially flawed".

This judgment culminated in a Law Commission Report (Report 74: Minority Buy-Outs) in 2001, and it is this report which, six years later, formed the basis for the Companies (Minority Buy-out Rights) Amendment Bill introduced in November 2007. For commentary on the Bill see the article *"New bill to improve "practical operations" of the minority buy-out regime"* in the Spring 2007 issue of Commercial Quarterly.

In general there has been widespread support for the reform of the minority buy-back regime and general support for the detailed reform contained in the Bill. There has been some concern however over certain aspects of the Bill, particularly with regard to some of the Law Commission's recommendations adopted in the Bill which are considered to be too far in favour of the dissenting shareholder.

PROPOSED AMENDMENTS TO THE BILL

The Commerce Select Committee, which released its report on the Bill in May, has recommended that the Bill be passed subject to some further amendments.

Share valuation methodology

The main focus of the Bill is to provide a statutory framework for calculating a fair price for the dissenting shareholder's shares. Following the Law Commission's recommendations, the Bill provides for the price to be an "honest estimate" calculated in accordance with certain prescribed guidelines on the valuation date, the treatment of the effect of the triggering event and the valuation base. The Commerce Committee has recommended that changes be made to each of these aspects of the Bill.

Fair and reasonable price

The Commerce Committee has rejected the Bill's use of a new "honest estimate" approach to the valuation of shares in favour of a return to a "fair and reasonable" valuation method. The Committee preferred the current "fair and reasonable" valuation method, noting that it is "well established and requires an objective assessment of value".

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[1] [2000] 3 NZLR 727

This is a sensible amendment as it is difficult to see how a reference to an "honest estimate" of value would give a board any greater guidance in determining the correct valuation. Submissions on this aspect of the Bill pointed out that "honest estimate" is not used in financial reporting practice nor has it been the subject of judicial consideration.

Valuation base

One of the more controversial sections in the Bill is the requirement to, in determining a "fair and reasonable price":

- base the valuation on the entire class of shares split pro-rata among the shareholders; and
- exclude any effects of the event proposed or authorised by the resolution to which the shareholder dissented (the triggering event).

As drafted, the Bill only permits a departure from this methodology where the shareholders are being bought out in the event of an amalgamation under section 221 of the Companies Act. In these circumstances, the valuer is entitled to take the benefits of the amalgamation into account when assessing fair value, on the basis that to do otherwise would be preventing shareholders who were being "squeezed out" of participating in the amalgamation from sharing in any benefit of the amalgamation to the company.

Submissions on this aspect of the Bill pointed out that there were other circumstances where it would not be appropriate to use this valuation technique, both for exiting shareholders as well as for the company.

Submissions identified that shareholders may also be squeezed out in other situations and, given it is not practicable to list all these situations, recommended that the existing exception be replaced with a broad catch-all exception.

It was also pointed out that this methodology effectively excluded the application of a minority discount to the dissenting shareholder's shares, which may provide an opportunity for the potential misuse of, or gaming by use of, the buy-back provisions, especially in the case of listed companies.

In response to these submissions the Committee has recommended replacing the amalgamation exception with a broader exception to allow the use of a different valuation method whenever the prescribed methodology would be "clearly unfair" to the shareholder or the company (see new section 112(3) of the Bill).

Date of valuation

Another key criticism of the existing minority buy-out regime is the absence of a specified valuation date. As drafted, the Bill provides for the valuation date to be fixed as the date on which the company gives the notice agreeing to buy the shares, this being the date on which the contract to buy-back the shares comes into existence. The Commerce Committee, however, has recommended that the valuation takes place "as at the close of business on the day before the date on which the resolution was passed".

The Commerce Committee considers that the advantages of the original scheme for the date of valuation were outweighed by the fact that it required the shareholder and the company to "anticipate events, and that it could result in different shareholders having different valuation dates."

Under the Commerce Committee's recommendations it will also be possible to choose an alternative valuation date under the new broad exception in section 112(3), noted above, should the board or the arbitrator determine that the "fair and reasonable" methodology is "clearly unfair" to the shareholder or the company.

Procedural changes

The Commerce Committee has also recommended certain changes be made to the new procedural provisions.

Arbitration determinations in cases of objection

The Bill is to retain the provision for the price to be determined by arbitration in the event the shareholder and the company can not agree on the purchase price. This will be seen by many as a missed opportunity to make a substantial improvement to the buy-out regime. Submissions received on this aspect of the Bill called for the arbitration provisions to be replaced with an analogous regime to rules 57 and 58 of the

Takeovers Code which would require the price to be determined by an independent expert who is experienced in company valuations. This regime has been successfully used to determine values for the purposes of the compulsory acquisition provisions in the Takeovers Code, and is noted as being a relatively quick and inexpensive process in comparison with the experiences of those who have dealt with similar matters through arbitration.

The Commerce Committee, however, has recommended some further clarification of the arbitration process. It recommends that the Bill be amended to specify that the provisions of the Arbitration Act 1996 will apply when a matter is referred to arbitration. Further, it has also clarified the wording of the Bill to confirm that either party will be entitled to initiate arbitration proceedings if there is a dispute as to value and not just the company.

Damages and interest

Another aspect of the Bill which has been the subject of some criticism is the addition of the provision to allow the arbitrator to award a shareholder damages for any shortfall in the initial payment. This is seen by some as inappropriate, as any delay in a price determination should be adequately covered by the interest provisions (especially under the Committee's suggested amendments to the interest provisions noted below). However, the Committee has decided to retain this provision subject to the removal of the ability of an arbitrator to award such damages where the shortfall was not foreseeable. The Committee considers that the ability of an arbitrator to award damages in itself should provide adequate incentive for a company to avoid delays in offering an adequate price for the shares.

The Commerce Committee has also recommended that the arbitrator is given discretion to award an interest rate for outstanding balances "on the basis and at the rate that the arbitral tribunal thinks fit having regard to all the circumstances", as opposed to an award being restricted to being within the Judicature Act 1908 interest limits.

Passing of legal and beneficial title

The Commerce Committee received a number of submissions on the inappropriateness for the legal and beneficial title to remain with the dissenting shareholder pending final resolution of the arbitrated price. In response, the Committee has recommended that the legal title to the shares passes to the company on notification of the company's decision to purchase the shares as effectively this is the date on which the contract for sale is formed. From this date, the shareholder will not be entitled to vote in relation to its shares, receive distributions, or exercise any other rights attaching to those shares.

Although legal title to shares normally transfers when the transfer is entered on the company's share register, it is appropriate that a dissenting shareholder, who has signalled its intention to exit the company, should no longer be able to participate in the benefits of being a shareholder, during the period in which the company determines the price of those shares and while any objection to this valuation is being resolved (during which time the shareholder receives the benefit of payment of the provisional price).

NEXT STEP

The Bill is now awaiting its second reading and is included amongst the Government's raft of legislation that it would like to see passed before the House rises for the General Election.

We will update you with any further developments on its passage.

To access a copy of the Commerce Committee's report on the Companies (Minority Buy-out Rights) Amendment Bill visit Parliament's website at www.parliament.nz.

Directors' duties: factors to weigh up before making business decisions

It is inevitable that a director's business decisions and practices will be scrutinised closely by a company's shareholders, liquidators and aggrieved creditors in the event of a company's insolvency. In this article, senior associate Graeme Switzer and solicitor Sukhdeep Johal analyse two recent High Court cases to illustrate the standards applied to, and types of actions required from, directors wanting to avoid the possibility of being ordered to dig into their own pockets to repay an insolvent company's debts.

It is important for all directors to be aware of their duties under sections 131 to 137 of the Companies Act 1993, and in particular, the requirement for directors to act in good faith and in the best interests of the company.

The High Court recently examined two cases to assess whether the directors had failed to meet their statutory duties in situations where the company was, or was near to being, insolvent. The focus for both cases was on the reckless trading provision in section 135 of the Act which provides that a director must not:

- agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors; or
- cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors.

Both cases involved plaintiffs making applications under section 301 of the Act, which empowers the court to make orders where directors (and other persons referred to in section 301) have been guilty of negligence, default or breach of duty or breach of trust (or other matters referred to in section 301) in relation to the company, including that the director(s):

- repay or restore the money or property or any part of it with interest at a rate the court thinks just; or
- contribute such sum to the assets of the company by way of compensation as the court thinks just.

Where the application is made by a creditor under section 301, the court can order the director to pay or transfer the money or property or any part of it with interest at a rate the court thinks just to the creditor.

Boutique Tanneries Limited (in liquidation) and Anor v Handley[2]

The claim

In this case, the company and its liquidators sued the sole director of the company for contributing to the deficiency on the company's liquidation on the basis that the director had breached his duties:

- to act in good faith and in the best interests of the company;
- not to agree to, cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors;
- not to agree to the company incurring an obligation unless the director believes on reasonable grounds that the company will be able to perform the obligation; and

[2] HC AK CIV 2006 404 2713 (July 2008)

- to exercise the care, diligence and skill that a reasonable director would exercise in the same circumstances.

They also sued the director for breaching the obligation to keep proper accounting records under section 194 of the Act.

The decision

The court found the director had breached duties owed to the company under section 135 (reckless trading) and section 137 (duty of care) of the Act and the director was ordered to contribute $100,000 to the losses caused. The director was also found to have breached the duty to maintain proper accounting records.

These findings were made, notwithstanding that the sole director had suffered poor health as a result of strokes and a heart condition. The director had also kept the company trading and honoured all commitments except to the IRD.

The judge acknowledged the director's ill health was a mitigating factor to the extent of his culpability. However, the judge also pointed out that the liquidators were entitled to argue that the director could have contracted other appropriate expertise to manage the company in his incapacity or to cease trading earlier. Therefore, the level of the director's culpability was treated as relatively high, but not to the extent to attribute financial responsibility for 100 percent of the loss.

On the liquidators' second cause of action alleging the director owed a duty to the company to keep proper accounting records, the judge considered it was clear the director was responsible for the absence of records. However, the judge was not satisfied that in this case the level of recoveries available to meet the costs of the liquidation and pay creditors had been substantially frustrated by the absence of records. This was reflected in the relatively low amount of $20,000 ordered to be contributed in relation to breach of this duty.

Basis for decision

In assessing the nature of the duty not to trade recklessly (under section 135) the court referred to the following summary of the law in the Court of Appeal's decision in *Mason and ors v Lewis* (discussed in the Autumn 2006 issue of Commercial Quarterly), which stated the "essential pillars" of section 135 as:

- the duty which is imposed is one owed by directors to the company (rather than to any particular creditors);

- the test is an objective one (that is, the director is to be assessed against a reasonable director in the same position as the director under scrutiny);

- a focus not on a director's belief but rather on the manner in which a company's business is carried on, and whether that modus operandi creates a substantial risk of serious loss;

- what is required when the company enters troubled financial waters is a "sober assessment by the directors, … of an ongoing character, as to the company's likely future income and prospects".

The decision in *Mason* also made the point that the court must draw a distinction between the taking of legitimate and illegitimate risks and that where a company has little or no equity, directors will need to carefully consider whether continuing to trade has realistic prospects of generating cash that will service pre-existing debt and meet the commitments that such trading incurs.

On the facts of this case, the court noted that it was reckless of the director to default on his obligations to the IRD as, within one year of starting to default, he was ignoring a liability that would rapidly threaten the solvency of the company. Had the IRD enforced payments earlier than it did, the company would have been under-resourced to make the payments and further, the IRD's preferential claim would have led to losses for the remaining creditors who, at the time, were only being paid as a result of IRD payments being ignored.

In assessing a director's duty under section 137, the court noted the duty imports obligations of exercising the care, diligence and skill that a reasonable director would exercise, taking into account:

- the nature of the company;

- the nature of the decision; and
- the position of the director and the nature of the responsibilities undertaken by him or her.

The section 137 assessment required an objective assessment, which meant that the sole director was to be assessed against a reasonable director in the same position, namely a sole director of a relatively small trading business without guidance from a board. No credit was to be given for a particular director's lack of any requisite experience or knowledge. Further, while the director's personal circumstances may be taken into account in considering the quantum of the penalty to be imposed, they could not be any excuse for imposing a different objective standard of care when considering the breach of section 137.

Of more general note is the court's reference to the effect of external market conditions on the director's decisions. In this case the industry in which the company operated had suffered a down-turn. The court noted that the director had not mismanaged into insolvency a business that was trading in an industry enjoying positive conditions. The judge stated that the prospect of an up-turn in industry conditions might possibly warrant a decision to continue trading for somewhat longer than would otherwise be justified. However, the judge went on to note that whilst an industry down-turn makes it more difficult to operate any company successfully, ultimately that cannot lessen the obligation to cease trading when the continuation of business is likely to create a substantial risk of serious loss to the company's creditors.

Jordon and Vance v O'Sullivan and Ors[3]

The facts

The plaintiffs in this case were the liquidators of Condrens Parking Limited. Four of the defendants were at various times the directors of Condrens (together the directors). The fifth defendant was a company (Parking New Zealand Limited) of which Mr O'Sullivan (one of the directors) was at all material times the sole director and shareholder. The basic legal proposition that the plaintiffs relied upon in this case is where a company is, or is near to being, insolvent, the duties that the directors owe to that company require them to consider the interests of the company's creditors.

The claim

The liquidators claimed that the directors breached duties they owed to consider the interests of Condrens' creditors in relation to two aspects of Condrens' business:

- First, the directors O'Sullivan, McKinley and Condren were all (directly or indirectly) shareholders in a related company called Car Parks International Ltd (CPI) and advances were made by Condrens to CPI (the CPI Advances). The liquidators claimed that the CPI Advances, which were shown in Condrens accounts as assets at face value, were in fact irrecoverable and without those assets Condrens was balance sheet insolvent (it had negative shareholders funds).

- Second, the directors caused or allowed Condrens to enter into, or assume liability under, long-term leases of three car parking buildings (the Specified Leases). They did this when, considering Condrens' financial position, they were required to act with heightened caution and particular regard to the interests of creditors. The directors were in breach of these requirements because they failed to assess properly or provide for the risks associated with entering into the Specified Leases. Those risks essentially related to Condrens obtaining sufficient car parking revenue to meet lease outgoings and associated overheads.

With respect to the CPI Advances, the plaintiffs alleged the directors breached sections 131, 135 and 137 and with respect to the Specified Leases, sections 135, 136 and 137.

Justice Clifford stated:

"The basic legal principal articulated by the plaintiffs, that is, where a company is, or is near to being, insolvent, the duties that directors owe to the company require them to consider the interests of the company's creditors, has a well known pedigree."

In relation to this, Justice Clifford cited the cases *Nicholson v Permakraft (NZ) Ltd*[4] and more recently the Court of Appeal case of *Robb v Sojourner*[5].

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[3] HC WN CIV 2004-485-002611 (May 2008)

The court's decision

In assessing whether the directors had been reckless, several cases were cited, including reference to the summary of the "essential pillars" of section 135 as stated in the Court of Appeal's decision in *Mason and ors v Lewis* (noted above in the *Boutique Tanneries* case). In assessing the alleged liability under sections 135 and 136, Justice Clifford considered the common question of whether, regarding the CPI Advances and the Specified Leases, the directors engaged in illegitimate trading - in other words, whether the directors took illegitimate risks.

The court found the directors did not take illegitimate risks in making the CPI Advances. In the court's view, the directors had a fairly accurate understanding of those risks and covered the risks where necessary by the provision of additional capital.

Regarding the Specified Leases, the plaintiffs' challenge to the directors' business conduct was their failure to explicitly consider and provide for (in terms of additional capital resources) risks that were inevitably associated with their expansion strategy. The directors were required to approach the decisions with particular caution.

The court acknowledged the directors may not have met best practice corporate governance standards but Justice Cliiford concluded that the conduct of the directors, in committing Condrens to the Specified Leases, did not constitute reckless trading, or the taking of illegitimate business risks.

The reasons given by the court for reaching this conclusion included:

- the directors' conduct did not depart so markedly from orthodox business practice and involve such extensive and unusual risk to the creditors that it could be fairly stigmatised as reckless;
- the directors did undertake a sober assessment of the business decisions involved in entering into each of the Specified Leases;
- the directors investigated each of the car parking sites involved, reached a view as to the revenue the sites could generate – based admittedly on their own assessment of likely supply and demand factors – and they negotiated the terms of the leases in each case over some period of time; and
- their under-estimation of the risks involved in the start-up phase of each of the lease operations was not sufficient, in this case, to conclude that the directors breached the duties they owed to Condrens.

It should also be noted that in reaching that conclusion, the court considered it important that the directors had, very recently and in their capacity as shareholders, demonstrated a willingness to support the company's trading by the provision of further capital.

Practical implications

These cases provide good examples of the difficulties directors may find themselves in when dealing with a business that is insolvent or near insolvent. Some key points to note from these cases are outlined below.

- The court will apply an objective test rather than simply considering the director's particular individual circumstances when assessing whether a director has carried out his or her duties to the company and its creditors under the Companies Act.
- When considering a potential breach of the duty not to trade recklessly (under section 135 of the Act) the courts will make an assessment of whether directors have taken legitimate or illegitimate risks. Where a company has little or no equity, directors should consider very carefully whether continuing to trade has realistic prospects of generating cash that will service both pre-existing debt (including any debts owed to the IRD) and meet the commitments that such trading inevitably attracts.

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[4] [1985] 1 NZLR 242

[5] [2008] 1 NZLR 751

- Personal circumstances such as old age and ill health may mitigate some of the potential culpability associated with insolvency, but where there are other options available to a director to prevent insolvency such as ceasing trading earlier or contracting expertise to manage the business the charged director will likely face the bulk of the potential penalties if he or she is held to have breached his or her duties. Such personal circumstances will not result in a different test being applied to the director's circumstances than is otherwise applied to section 137 of the Act.

- The prospect of an up-turn in the potentially insolvent company's industry conditions might possibly warrant a decision to continue trading for somewhat longer than would otherwise be justified, but that does not lessen the obligation to cease trading when the continuation of business is likely to create a substantial risk of serious loss to the company's creditors.

- Although failure to keep well maintained accounting records, in accordance with the Act, may not always directly contribute to the insolvency of a company, it should be remembered that it will constitute a separate cause of action under section 194.

Securities and capital markets

Takeovers Panel continues to advocate for regulatory changes for schemes of arrangements and amalgamations
Last week the Takeovers Panel released details of its latest recommendations for regulatory change for schemes of arrangements and amalgamations.

The trans-Tasman Mutual Recognition of Securities Offerings scheme
In June 2008, the Australian and New Zealand Governments introduced a mutual recognition scheme which should make it easier for issuers to extend their securities offerings outside their home jurisdictions to members of the public in their trans-Tasman counterpart country. In this article Bell Gully partners, Anna Buchly and James Gibson discuss how the scheme is to operate in both jurisdictions.

Key aspects of the Financial Advisers Bill still under consideration
The Finance and Expenditure Committee has recently released its second interim report on the Financial Advisers Bill and has called for a further round of public submissions on its latest proposals. In this article, Bell Gully partner Haydn Wong re-looks at the main aims and expectations of the bill as introduced last year and outlines the current changes under consideration.

Directors' & Officers' disclosure - simplification at last
In July 2008, Cabinet agreed to amend the Securities Markets (Disclosure of Relevant Interests by Directors and Officers) Regulations 2003 (D & O Regulations) to reduce compliance costs. Key to those amendments are the problems associated with the very wide definition of "officer". A number of operational improvements are also to be made to the D & O Regulations.

Vision and pragmatism aim for new capital markets taskforce
In this article, senior associate Stephen Layburn looks at the new taskforce charged with developing plans for strengthening New Zealand's capital markets, a move which is in step with similar approaches being taken in key international economies.

Legislation to transform capital markets, boost investor confidence
In this article, senior associate Stephen Layburn provides a useful reminder of pending legislative developments arising from the Review of Financial Products and Providers against the backdrop of the public war of words that has broken out between Minister of Commerce Lianne Dalziel and media commentator Brian Gaynor about the Capital Market Development Taskforce.

Report on cycle seven of the Securities Commission's review of financial reports
The Securities Commission has completed the seventh cycle of its financial reporting surveillance programme. Although generally pleased with the level of compliance, the Commission has highlighted a number of areas with room for improvement. These include the disclosure of related party transactions, substantial security holders, directors' interests and directors' share dealings. The Commission also highlighted issues surrounding the disclosure of key management in its latest review.

Takeovers Panel continues to advocate for regulatory changes for schemes of arrangements and amalgamations

Last week the Takeovers Panel released details of its latest recommendations for regulatory change for schemes of arrangements and amalgamations.

Background

Over the last two years, the Takeovers Panel has expressed its concern about the perceived increase in the use of amalgamations and schemes of arrangements under the Companies Act as an alternative to a takeover offer made under the Takeovers Code, and it has been pressing for legislative reform to address these concerns.

The Panel has been particularly concerned about what it considers to be a lower level of shareholder approval required to give effect to an amalgamation or scheme of arrangement under the Companies Act than would be required if the transaction were undertaken as an offer under the Takeovers Code. In addition, the Panel considers that the same shareholder protections contained in the Takeovers Code, such as those relating to the provision of information and independent advice, are not available to shareholders when the transaction is carried out as an amalgamation or scheme of arrangement.

The Takeovers Panel initially sought reforms to address these issues as part of a Business Law Reform Bill at the end of 2006. However, the Government was not willing to include what was a substantive law reform proposal in a bill without the benefit of a fuller process and analysis and the Panel was asked by the Government to lead a second round of public consultation in 2007.

The Panel's latest recommendations to the Minister of Commerce continue to seek amendment of the reconstruction options in the Companies Act in a slightly modified form from its 2006 proposals.

The Takeovers Panel's recommendations

In its latest recommendations to the Government, the Panel has called for substantive amendments to both Parts 13 and 15 of the Companies Act where code companies are involved.

No amalgamations for code companies

The Panel is recommending prohibiting the use of long form amalgamations under Part 13 of the Companies Act where an amalgamating company is a code company. Bell Gully does not share the Panel's view that this change is necessary and we consider that the amalgamation structure should continue to be available in appropriate cases (see our submissions on the Panel's 2007 consultation paper).

The removal of this amalgamation mechanism would mean that the choice of transaction structure for changes of control of code companies would be limited to the mechanisms under the Takeovers Code or the scheme of arrangement mechanism under Part 15 of the Companies Act.

Part 15 schemes of arrangements or amalgamations

The Panel continues to advocate for some Takeovers Code equivalent principles to be considered where code companies look to effect a scheme of arrangement or amalgamation under Part 15 of the Companies Act.

The Panel proposes that Part 15 be amended to provide that the court would be prevented from approving a scheme that would have any effect on the voting rights of a code company unless:

- the court is satisfied that the shareholders of any such code company would not be adversely affected by the transaction not being undertaken under the Takeovers Code; or

- the Panel has issued a "no objection statement" to the amalgamation or arrangement.

This is said to bring New Zealand legislation more closely in line with that in Australia in that it is similar to section 411(17) of the Australian Corporations Act.

It is not clear what a "no objection statement" would involve. In its press release, the Panel indicates that should its proposed amendments to the Companies Act be enacted, the Panel would develop and publish information about:

- the criteria the Panel would apply for the giving of a "no-objection statement" (which, it notes, is likely to be similar to those that apply in Australia);
- the timing of the giving of "no-objection statements" for the Court processes for schemes;
- how to obtain a "no-objection statement"; and
- any fees for making an application for a "no-objection statement".

This will be essential for the new process if the Panel's recommendations are followed and we think that the criteria under which "no-objection statements" will be considered should be published now by the Panel given that, in practice, that criteria will play a material part in the operation of the regime.

Voting thresholds

Another key area where the Panel has been keen to change the rules for schemes of arrangement is in relation to the voting thresholds applied by the court for the approval of a scheme. Currently the courts require approval by 75 percent of the shareholder votes cast. This, the Panel argues, can potentially result in schemes being approved by a very small number of shareholders. The Panel is of the view that this can be overcome by providing an additional requirement that those voting in favour must represent a majority of the shares eligible to be voted (that is, more than 50 percent of the total voting rights of the company).

However, as pointed out by Bell Gully and other respondents to the Panel's December 2007 consultation paper, a concern with this proposal is that a large proportion of shareholders often fail to participate in the voting process and in the case of some funds, the managers are unable to vote. Practice suggests that the Panel's additional threshold requirements are likely to be difficult to achieve (particularly for companies with widely held share registers) and could mean that a scheme could be approved by an overwhelming majority of those who vote but not be passed because of a failure to meet the majority of voting rights threshold requirement. In such cases, this would mean that transactions that were opposed by only a small number of shareholders may not be able to proceed even though they were supported by the vast majority of shareholders who exercised their rights to vote. More fundamentally, the proposed change is not consistent with the voting approval mechanisms in the Takeovers Code itself which enable change of control transactions to proceed with approval by only 50 percent of votes cast.

It is also unclear why the voting threshold applying to amalgamations or arrangements should be different from that which applies to other major events requiring approval from a company's shareholders. A company (including a code company) can sell its entire business undertaking, or be placed into liquidation, by a 75 percent majority of votes cast with board support. There is no apparent justification for requiring a different (and higher) voting threshold merely because the transaction in question is one which could also have been conducted under the Takeovers Code.

The proposed changes may also not achieve the alignment with Australia referred to by the Panel. Australia does currently have a 50 percent test - but it is only a requirement that more than 50 percent by number who actually vote at the meeting support the resolution. The Australian requirement is not more than 50 percent of all voting rights - as is proposed by the Panel. In addition, Bell Gully understands that consideration is being given to dropping this requirement in Australia, which is what the New Zealand Companies Act did in relation to schemes of arrangement in 1993 when the new Act was introduced.

Interest classes

Under the Panel's latest proposal, the 75 percent voting threshold must be obtained at meetings of each "interest class" of shareholders. To ensure that there is more clarity and certainty on this part of the voting process, the Panel is recommending that further statutory guidance be given to the court in Part 15 of the Companies Act on how to determine "interest classes". The Panel believes that New Zealand should codify (to some extent) the issue of voting in classes of shareholders as the law has been developed in Australia.

Additional amendments

If the proposed amendments to the Companies Act are enacted, the Panel recommends providing a statutory exemption from the application of the Takeovers Code where the Panel has provided a "no objection statement" for a code company involved in a Part 15 scheme of arrangement.

The Panel also recommends additional amendments be made to the Companies Act to ensure that the Panel has all the necessary statutory functions and powers to undertake its new role. This will include the right for the Panel to be heard in court where it opposed a transaction being undertaken as a scheme under the Companies Act.

Next Steps

In Bell Gully's view, the current reconstruction provisions of Parts 13 and 15 of the Companies Act are important and appropriate mechanisms to achieve the objectives contemplated by the legislature when passing that Act. We continue to believe that the proposed changes are unnecessary. The existence of schemes and amalgamations provide market participants with an array of options which enable them to match their individual situations with the most appropriate mechanism.

It is now, however, up to the Government to take the next step. Given that the proposed changes involve potentially significant amendments to the Companies Act, and would substantially increase the role and powers of the Panel, it is to be hoped that there will be an opportunity for an independent review of the proposals (possibly by the Law Commission) and a full opportunity for interested parties to make submissions.

If the proposed reforms are to be introduced, we believe it is important that the criteria to be applied by the Panel in issuing "no-objection statements" are clearly identified and, preferably, that they be incorporated into the Takeovers Code.

To view a copy of the following documents:

- the Takeovers Panel's press release on its latest recommendations;
- the Takeovers Panel's Explanatory Memorandum;
- the Regulatory Impact Statement; and
- the Recommendations to the Minister of Commerce,

visit the Takeovers Panel's website at www.takeovers.govt.nz.

For further information please contact your usual Bell Gully corporate adviser.

Securities and capital markets

The trans-Tasman Mutual Recognition of Securities Offerings scheme

In June 2008, the Australian and New Zealand Governments introduced a mutual recognition scheme which should make it easier for issuers to extend their securities offerings outside their home jurisdictions to members of the public in their trans-Tasman counterpart country. In this article Bell Gully partners, Anna Buchly and James Gibson discuss how the scheme is to operate in both jurisdictions.

On 13 June 2008, Australia and New Zealand exchanged diplomatic notes to bring into effect the trans-Tasman Mutual Recognition of Securities Offerings scheme (mutual recognition scheme).

The mutual recognition scheme permits an Australian issuer to extend an offer regulated under Australian law into New Zealand using the disclosure document required under Australian law, subject to meeting certain conditions. This means that the Australian issuer will no longer need to prepare an investment statement to wrap around the Australian disclosure document.

On the other side of the Tasman, the mutual recognition scheme permits a New Zealand issuer to extend an offer regulated under New Zealand securities laws into Australia using only the offer document required under New Zealand law, subject to meeting certain conditions. No separate Australian offer document is required.

While the current economic climate may not be conducive to securities offerings, it seems inevitable that Australian issuers will start to take advantage of the Regulations once market conditions improve. Given the relatively minimal compliance cost involved, extending an Australian offer to New Zealand investors may become routine for many Australian issuers.

Easing the path for Australian issuers to extend offerings into New Zealand

The laws implementing the mutual recognition scheme in New Zealand are set out in Part 5 of the New Zealand Securities Act and the Securities (Mutual Recognition of Securities Offerings – Australia) Regulations 2008 (New Zealand Regulations). To make an offer in New Zealand in reliance on the mutual recognition scheme, the offer and the issuer must satisfy the following requirements.

The offer must be a regulated offer in Australia

The offer of securities in Australia must require a disclosure document or Product Disclosure Statement under the Australian Corporations Act. That document must have been lodged with the ASIC and any exposure period must have expired before the offer can commence in New Zealand.

Nature of the issuer and certain prohibitions

The issuer must be incorporated under the laws of Australia or be a natural person resident in Australia. Further, the issuer or any person concerned in the management of the issuer must not be prohibited from being involved in management of the issuer under Australian or New Zealand law or previously banned by the New Zealand Securities Commission from making a regulated offer.

Type of securities

The mutual recognition scheme applies to offers in New Zealand of equity securities, debt securities, interests in collective investment schemes and any interest in, or option to acquire, such securities.

Filing of documents with NZ Registrar of Companies

Before making the offer in New Zealand, an Australian issuer must provide the New Zealand Registrar of Companies with written notice of its intention to make an offer under the New Zealand Regulations. The notice must contain certain information including:

- a statement that the Australian issuer intends to make an offer in accordance with the mutual recognition scheme;
- a description of the securities to be offered;
- the proposed offer period in New Zealand and Australia;
- details of the person authorised to accept service in New Zealand; and
- a statement that the Australian issuer submits to the New Zealand jurisdiction.

The notice must be accompanied by the Australian disclosure document or PDS, a copy of any exemptions or declarations granted by an Australian regulator which are being relied on by the issuer, and the constituent documents of the Australian issuer.

Disclosure document

The Australian disclosure document must include the relevant warning statements contained in the New Zealand Regulations. These include statements that:

- the offer is being made pursuant to the New Zealand Regulations; and
- the offer is principally regulated under Australian, rather than New Zealand law.

The disclosure document must also highlight potential currency risks and any different tax treatment for New Zealand investors.

Ongoing requirements

While the offer remains open in New Zealand, the Australian issuer must comply with certain conditions. These conditions include ensuring that the offer remains open in Australia, the offer complies with Australian securities laws, and that New Zealand investors can obtain certain documents relating to the offer and the issuer free of charge.

Notification requirements

The Australian issuer must notify the New Zealand Registrar of Companies if certain circumstances arise during the offer period. Those circumstances include:

- when a change is made to the disclosure document or PDS;
- when a supplementary or replacement disclosure document or PDS is required to be issued under Australian law;
- there is a change or revocation of a general exemption relevant to the offer or an offer specific exemption; or
- ASIC begins an enforcement action or exercises a power it has under law in relation to the offer.

Failure to comply and its consequences

If an Australian issuer breaches a term or condition of the New Zealand Regulations then the Australian issuer, the principal officers of the Australian issuer, every promoter of the securities and every director of the issuer may each be liable on summary conviction to a fine not exceeding NZ$300,000. If the offence is a continuing one, a further fine may be imposed not exceeding NZ$10,000 for every day or part of a day during which the offence continues.

In these circumstances the New Zealand Securities Commission may also make an order prohibiting the distribution of the Australian disclosure document or banning the Australian issuer from making an offer under the New Zealand Regulations.

Liability for misstatements – which law applies

The mutual recognition scheme exempts a qualifying offer of securities from civil liability for "untrue statements" (i.e., misleading statements or omissions of material particulars) under the New Zealand Securities Act.

However, the New Zealand Securities Act continues to apply to impose criminal liability on an Australian issuer and its directors for distributing an offer document in New Zealand that contains an untrue statement. That criminal liability is subject to a "reasonable grounds to believe" defence.

Although it seems contrary to the intent of the mutual recognition scheme, there remains the possibility that an Australian issuer and its directors could be sued by a New Zealand investor under the New Zealand Fair Trading Act (the New Zealand equivalent of the Australian Trade Practices Act) for losses caused by misleading or deceptive conduct or statements in relation to an offer of securities. If that liability exists, the "reasonable grounds to believe" defence will again be available.

Easing the path for New Zealand issuers to extend offerings into Australia

The laws implementing the mutual recognition scheme in Australia are set out in Chapter 8 of the Australian Corporations Act and the Corporations Amendment Regulations 2008 (no.2) (*Australian Regulations*). To extend an offer into Australia in reliance on the mutual recognition scheme, the following requirements, must be satisfied.

The offer must be a public offer made in New Zealand

The offer must be made to members of the public in New Zealand in accordance with the New Zealand Securities Act (which generally means that the offer will be made via a registered prospectus and investment statement). The New Zealand public offer must be open for acceptance in New Zealand at the same time as the offer made in Australia.

Nature of the issuer and certain prohibitions

- The issuer must be incorporated under the laws of New Zealand.
- The issuer or any person concerned in the management of the issuer must not be prohibited from being involved in management of the issuer under New Zealand or Australian law and must not have been previously banned by the Australian Securities and Investment Commission (*ASIC*) from making a regulated offer.

Type of securities

The mutual recognition scheme applies to offers made in Australia of shares, debentures and interests in managed investment schemes, and certain rights, interests and options in these financial products.

Filing of documents with ASIC

Before a New Zealand issuer makes an offer in Australia in reliance on the mutual recognition scheme it must provide ASIC with written notice of its intention to make an offer. The notice must be accompanied by:

- any offer document required by the New Zealand Securities Act (i.e., typically, a prospectus and an investment statement);
- the constituent documents of the New Zealand issuer or the scheme constitution;
- details of any exemption from the New Zealand Securities Act that applies to the offer; and
- an address for service on the issuer in Australia.

Offer document

The New Zealand offer document must include the relevant warning statements contained in the Australian Regulations. These include statements that:

- the offer is regulated under New Zealand Securities law; and
- Australian law does not apply to the offer.

The offer document must also highlight potential currency risks and any different tax treatment for Australian investors.

Ongoing requirements

While the offer remains open in Australia, the New Zealand issuer must comply with certain conditions. These conditions include ensuring that the offer remains open in New Zealand, that the offer complies with New Zealand securities laws and that Australian investors can obtain certain documents relating to the offer and the issuer free of charge.

Notification requirements

The New Zealand issuer must notify ASIC if certain circumstances arise during the offer period. Those circumstances include when:

- a change is made to the offer document;
- a replacement offer document is required to be issued under New Zealand law;
- there is a change or revocation of a general exemption relevant to the offer or to an offer specific exemption; or
- the New Zealand Securities Commission or the New Zealand Companies Office begins an enforcement action or exercises a power it has under law in relation to the offer.

Failure to comply and its consequences

If a New Zealand issuer breaches a condition of the Australian Regulations then the New Zealand offeror commits an offence and may be liable to a fine of up to A$20,000 or to imprisonment for up to five years, or both. Under Australian law, New Zealand issuers with at least 100 shareholders must also comply with the continuous disclosure rules contained in the Australian Corporations Act.

Pre-offer advertising

The New Zealand issuer must ensure that any pre-offer advertising in Australia complies with the general content rules for pre-offer advertising contained in the Australian Corporations Act.

Australian law liability for misleading or deceptive statements

Notwithstanding the Australian Regulations, under the Australian Corporations Act the New Zealand issuer (and persons involved in the relevant contravention, directors of the New Zealand issuer) remain subject to civil and criminal liability for making statements or disseminating information in respect of the offer which is likely to mislead or deceive.

For further information, please contact your usual Bell Gully adviser or:

Anna Buchly
Partner

James Gibson
Partner

Official Guide

The New Zealand Securities Commission and the Australian Securities and Investments Commission have published a joint guide for the trans-Tasman mutual recognition scheme for offers of securities. To access the guide visit the Securities Commission's website at www.seccom.govt.nz.

Key aspects of the Financial Advisers Bill still under consideration

The Finance and Expenditure Committee has recently released its second interim report on the Financial Advisers Bill and has called for a further round of public submissions on its latest proposals. In this article, Bell Gully partner Haydn Wong re-looks at the main aims and expectations of the bill as introduced last year and outlines the current changes under consideration.

BACKGROUND

The Financial Advisers Bill was introduced into Parliament in December last year and received its first reading in February this year. Concerns about certain aspects of the bill prompted Commerce Minister Lianne Dalziel to take the relatively unusual step of proposing changes to the bill to be considered as part of the Finance and Expenditure Committee's review of it.

To date, there have been two rounds of public consultation on the bill during the select committee process which have been followed by two interim reports on the bill. The committee invited further submissions on its most recent report, indicating that it is considering further changes in the direction of the bill. Submissions closed on 22 August.

However, it is still only concepts which are being debated. Again, the committee's latest proposed changes have not been supported by drafted amendments to the bill, which leaves considerable scope for uncertainty in terms of practical outcomes since the devil will be very much in the detail to come.

In a recent speech to the Institute of Financial Advisers, Lianne Dalziel indicated that the decision on whether an updated draft bill will be released for comment before it is reported back to Parliament is a decision for the select committee, but went on to note that she would be concerned at a delay which would not allow sufficient time for the bill to pass before the General Election. Given that the final select committee report is due in Parliament by 1 September, it seems likely that any further amendments to the bill will be in the Committee of the Whole House by way of a Supplementary Order Paper. Although the Minister has indicated that her officials will continue to work with industry during this phase of the bill, the process will be necessarily pressurised given the tight timeframes that will apply at that stage and the scope for amendment limited as a consequence.

AIMS AND EXPECTATIONS

The Financial Advisers Bill forms part of the wider financial services law reform aimed at tightening the regulation of financial advisers and financial service providers and increasing protections for members of the public when seeking financial advice. However since the Bill was first introduced the Commerce Minister has indicated that the Bill has undergone a change in focus. The recent collapse of finance companies, together with industry feedback and investor responses, has meant that instead of the Bill being primarily about reviewing the regulations around the financial sector and encouraging industry participation, the focus "is now on rebuilding investor confidence as quickly as possible".

As drafted, the Bill has three aims:

- *To ensure that members of the public can make informed decisions in deciding whether to use a financial adviser and in assessing a financial adviser's financial advice.*

  Financial advisers will be required to disclose their experience and qualifications, certain criminal convictions, fees and potential conflicts of interest (which will replace the investment adviser disclosure obligations).

- *To ensure that people acting as financial advisers have sufficient experience and expertise to provide advice in their particular area.*

The Bill requires that all financial advisers are registered and meet the criteria for receiving and maintaining registration.

- *To hold financial advisers accountable for the advice that they give.*

  The Bill imposes certain conduct obligations on financial advisers, including the obligation to act with integrity, to exercise reasonable care, diligence and skill, and a prohibition on engaging in misleading or deceptive conduct.

  The Bill's conduct and disclosure obligations are enforceable through a range of civil remedies, including compensation orders for compensating investors' losses and banning orders for advisers, and specific offences.

WHO IS A FINANCIAL ADVISER?

The Bill regulates the giving of financial advice and the activities of financial advisers. Put broadly, only a registered financial adviser may give financial advice in the course of business to a member of the public.

The Bill then goes on to impose a number of requirements on financial advisers giving financial advice, including disclosure requirements and conduct requirements.

The key definitions that determined the scope of the Bill's application were originally cast in very broad terms, presumably to attempt to address the range of possible circumstances in which financial advice is given. Lianne Dalziel has since commented that it "was never the intent of the Bill to capture every person who discusses financial matters but it was necessary to start this way so [the Government] would have a clear picture of who should and who should not be covered" by way of receiving critical feedback in relation to those who should not be caught.

Financial advice is defined as providing a recommendation, opinion or guidance in the course of business on the financial implications of a financial decision. A financial decision, as the Bill was originally drafted, was defined to include saving, holding, investing or realising or borrowing money or property, giving a security (including a guarantee or indemnity) and making financial provision for the future.

As the Bill was originally drafted, it cast a wide net and relied on exemption-making powers to exclude any persons or classes of persons who were inadvertently captured. The cumulative effect of these definitions created considerable potential for capturing activities that most would not normally consider to be financial advice. For example, advice in relation to the sale of any asset is included, which could extend to sales of motor vehicles. A reliance on exemptions seems an inefficient way to prescribe the scope of the Bill, especially given the penalties associated with a failure to comply with its provisions.

Following feedback after the first reading of the Bill (and at the request of the Government) the select committee issued an interim report proposing that the scope of the Bill be narrowed in two ways:

- the Bill will only capture advice given in relation to specified "financial products"; and
- only persons who are, broadly, in the occupation of giving financial advice will be financial advisers for the purposes of the Bill.

Narrower definition of financial products

It was proposed that advice in relation to a financial decision must relate to the buying, selling or holding of financial products. Financial products are defined as:

- securities (as defined in the Securities Act 1978); or
- any contract of life insurance, disaster insurance, general insurance and medical insurance; or
- any consumer credit contract (as defined in the Credit Contracts and Consumer Finance Act 2003).

Occupational focus

It was also proposed that the Bill be amended so that a financial adviser would only refer to a person:

- whose primary occupation is to provide advice in relation to any savings or investment planning; or
- who regularly provides such advice in the course of their business.

This change was seen as more controversial. One could argue consumers should be protected from those who actually provide financial advice, regardless of whether they purport to have that as their primary occupation or regularly do so. In some respects, those who provide financial advice on an ad hoc basis may present an even greater risk in terms of competency.

Latest approaches under consideration

In its latest interim report, the select committee has indicated that there has been qualified support to the proposal to narrow the application of the Bill and it will proceed with this approach by ensuring the focus is on financial products, rather than financial decisions or occupations.

Definition changes

The committee is now considering recommending that the reference to "implications of a financial decision" in the Bill as introduced be removed, and that "financial advice" be defined with reference to "financial products". The Committee is also considering amending the Bill to clarify that the definition of "financial product" could include debt, equity, credit, and risk products, as well as investment in real estate.

A tiered approach for financial advisers

In a third attempt to get the balance right for financial advisers covered by the Bill, the select committee is now considering taking a more middle-of-the-road approach.

The latest proposal would involve amending the Bill to establish two levels of financial advisory services, each with a different level of obligation imposed on the adviser. This is seen as having the advantage of allowing for more flexibility in dealing with the different occupations and as providing a more tailored regulatory response for different types of financial advice.

Under this proposal, "Category 1 Advisory Service" would include advice on complex securities or investment and savings planning. Any individual providing Category 1 Advisory Service would have to be authorised by the Securities Commission to provide such advice.

"Category 2 Advisory Services" would include advice on credit, general insurance or simple securities, such as bank term deposits or call accounts. Individuals falling under this category would not need to be authorised to provide these services, but would be subject to the basic disclosure and conduct requirements of the Bill and their own individual obligations under the Financial Service Providers (Registration and Dispute Resolution) Bill. It is also likely that most individuals falling under this category, namely those working for registered banks, insurance companies, credit unions and building societies would be covered by their institution's certification (see the discussion below).

However, early responses from the industry indicate that this two-tiered approach is not favoured by some. In particular, there is concern that in adopting a two tier approach there is a potential for some to exploit loopholes in the classification of products between the two categories and in the complexity of deciding which category an advisor is in.

Authorisation requirements for Category 1 Advisers

The select committee is also considering making some recommendations about how financial advisers will be required to seek authorisation from the Securities Commission. This is likely to involve the financial adviser being required to meet relevant competency levels, meet fit and proper person requirements and be registered under the Financial Service Providers (Registration and Dispute Resolution) Bill. Authorised financial advisers would be required to comply with any ongoing disclosure and conduct requirements specified in regulations, and the terms and conditions of their authorisation.

NEW DISCLOSURE OBLIGATIONS

The latest interim report notes that the committee is considering introducing tiered disclosure obligations for the different categories of financial advisers through the provision of a new regulation making power

that would allow for regulations that specify disclosure obligations applying to different categories of advisers.

The Bill would be amended to ensure that there is a general obligation to make disclosure in addition to the existing obligations relating to the form and accuracy of disclosure, and the regulation making power would replace the specific disclosure obligations currently in the Bill.

SUPERVISION OF FINANCIAL ADVISERS – CO-REGULATORY VS. SECURITIES COMMISSION

Co-regulatory model

The Bill previously provided for a co-regulatory model with "approved professional bodies" responsible for the registration and monitoring of financial advisers and the Securities Commission responsible for registering and overseeing the approved professional bodies, and for ensuring the overall health of the financial advice industry. It was the approved professional bodies that were to set standards for financial advisers to join the body, monitor their members, carry out discipline, participate in dispute resolution and report to the Securities Commission.

The intention of the co-regulatory model was for each sector within the financial advice industry to establish its own approved professional body, to allow each sector to set rules relevant to the sector.

Concerns with the co-regulatory model

There were two main concerns with the co-regulatory model. First, the many high-profile collapses of finance companies and associated allegations of sub-standard financial advice have made it less palatable for the financial advice industry to be seen as largely self-regulated. While the Securities Commission would have had an overall supervisory role, when it comes to monitoring individual financial advisers the responsibility would lie with the approved professional bodies.

The second concern was that it would take too long to set up the approved professional bodies. Although some sectors already have a self-regulating body that could be adapted into an approved professional body, such as NZX for listed securities advisers, a number of sectors do not. By moving to the Securities Commission as the sole regulator, the Commerce Minister indicated that the time required to introduce the new rules could be shortened from four years to two.

Securities Commission as the sole regulator

These concerns around industry self-regulation and timing have led to the proposal that the entire responsibility for regulation be placed on the Securities Commission. The Commission will undertake all of the functions previously assigned to approved professional bodies.

It is proposed that the Securities Commission would consult with the financial adviser industry and that the commission would include at least one person from the industry.

While the co-regulatory model is no longer considered a viable option, concerns are still being voiced over the proposal to provide regulatory oversight by the Securities Commission rather than through industry-led approved professional bodies. Some of the issues which are raised with this centralised approach include:

- how the Securities Commission will organise itself to ensure the efficient processing of registration and accreditation of investment advisers;
- how the Securities Commission will develop the registration and accreditation requirements for different sectors of the financial adviser industry and the degree of, and effectiveness of, consultation with industry in this regard; and
- the complications caused by the Securities Commission acting as rule setter, exemption provider, investigator, prosecutor and, to an extent, enforcer of the requirements of the Bill and the requirements for registration and accreditation.

New Commissioner of Financial Advisers

Further discussion on how some of these issues are to be addressed is provided in the latest select committee report. The committee notes that it is considering the establishment of a Commissioner of

Financial Advisers as part of the Securities Commission. This, it notes, would help ensure that the Securities Commission can act as both a statutory enforcer as well as the regulator.

Under this proposal, all functions of the Securities Commission would be exercised by the new commissioner, except for investigations and the enforcement of breaches of statutory obligations (criminal breaches). The commissioner's role would include responsibility for establishing a code of conduct and undertaking disciplinary proceedings for breaches of that code of conduct. To assist the commissioner's decision making, the committee further proposes that a Rule-Making Committee and a Disciplinary Committee be established to ensure that the commissioner receives advice from the industry when exercising his or her judgement.

INSTITUTIONAL ACCREDITATION SYSTEM

The other aspect of change to the regulatory regime is the newly-introduced concept of an institutional accreditation system. Certain institutions, particularly banks, have pointed out that it would be unduly costly and onerous for all their employees to be individually registered and that it should be sufficient for the institution alone to be accredited. Under the proposed institutional accreditation system, an employee of an accredited institution would not need to be individually accredited, so long as the only financial advice that the employee gives is in relation to products offered or sold by his or her employer.

The certification of an institution would enable an institution to meet the obligations of all financial advisers affiliated with that institution, and would allow an institution to standardise compliance for advisers affiliated with that institution.

The criteria for an industry to be accredited have not yet been established so it is difficult to assess the merits and risks of this system. The Minister of Commerce and the latest select committee report have indicated that the institution would have to show that it has processes in place to ensure that any employees or agents covered by its certification have appropriate product and client knowledge and that the institution is accountable for advice it gives (for example, through a customer complaints resolution mechanism). Such institution would also need to be registered under the Financial Service Providers (Registration and Dispute Resolution) Bill.

In a recent speech the Minister of Commerce has also indicated that certified institutions would be responsible for identifying those employees or agents who need to be individually authorised by the Securities Commission where the type of advice given by them falls outside that covered by the institution's certification.

It is unknown what would qualify as an institution. If the definition is broad, this could lead to a quasi-approved professional bodies model for those that satisfy being, to an extent, self-regulated. In its latest report the select committee has indicated that this accreditation model would be available for use by a range of financial institutions, including banks, insurance companies and credit unions.

In any event, this outcome represents something of a compromise that simplifies the situation for those advisers that come within its ambit. The committee is however now considering requiring individual financial advisers covered by an institution accreditation to still meet their individual disclosure obligations under the Bill.

As with many of the proposed changes, the robustness and effectiveness of the system will depend on yet-to-be announced details.

To access a copy of the Second Interim Report on the Financial Advisers Bill and a copy of the Bill visit parliament's website at www.parliament.nz.

For more information please contact:

Haydn Wong
Partner

Directors' & Officers' disclosure - simplification at last

In July 2008, Cabinet agreed to amend the Securities Markets (Disclosure of Relevant Interests by Directors and Officers) Regulations 2003 (D & O Regulations) to reduce compliance costs. Key to those amendments are the problems associated with the very wide definition of "officer". A number of operational improvements are also to be made to the D & O Regulations.

The D & O Regulations were made under Part 2 of the Securities Markets Act 1988, and require directors and officers of public issuers to disclose relevant interests and dealings in securities of the public issuer (and any related body corporate). Disclosures made under the D & O Regulations are designed to help with the monitoring of possible insider trading activities and market manipulation. Those disclosures are also designed to encourage transparency and good corporate governance in securities dealings.

The D & O Regulations have been in force since 2004 and have brought a significant number of employees, who are caught by wording that requires disclosure of officers who "take part" in the management of a listed company's business, within the disclosure regime. By casting the net so widely, the D & O Regulations have imposed a significant additional compliance cost on listed companies for arguably little incremental improvement in the quality of disclosures about significant changes in the trading patterns in the securities of listed issuers. By contrast, similar disclosures in Australia are only required to be made by directors.

Simplification

The amendment approved by Cabinet will reduce the number of people included in the definition of "officer" to those people who are within two tiers of direct reporting to the board of directors. That is, D & O disclosure will now only be required to be made by:

- directors;
- persons who report directly to the board (typically the CEO and perhaps the CFO); and
- persons who report directly to the CEO.

The Ministry of Economic Development suggests that this amendment will target the area where insider trading risk is perceived to be the most acute. The Ministry further suggests that the need for the D & O disclosure regime to retain its current form has been reduced by the changes to the insider trading regime which came into force earlier this year.

A number of additional changes are also proposed to:

- separate out the D & O Disclosure forms into two separate forms (one for initial disclosure and one for ongoing disclosure);
- remove the current prohibition on disclosing multiple acquisitions or disposals on the same form – as long as the transactions took place within five trading days; and
- allow authorised persons to lodge D & O Disclosure forms on behalf of the relevant director or officer (noting that the director or officer remains liable for the D & O Disclosure obligation, including that disclosure is made correctly).

Timeline
Submissions on the draft of the proposed amendments to the D & O Regulations circulated by the Ministry of Economic Development closed on 15 August. It is expected that the amendments to the D & O Disclosure Regulations will come into effect at the end of September.

We will provide a further update when the new regulations are enacted. In the meantime, to view the proposed amendments to the regulations click here.

For further information contact:

Stephen Layburn
Senior Associate

Vision and pragmatism aim for new capital markets taskforce

In this article, senior associate Stephen Layburn looks at the new taskforce charged with developing plans for strengthening New Zealand's capital markets, a move which is in step with similar approaches being taken in key international economies.

In July, the Government announced the establishment of an industry-led taskforce to produce a blueprint and action plan to develop New Zealand's capital markets. The Capital Market Development Taskforce will look at the current state of our capital markets, the international context, future risks and opportunities and changes needed to deliver the best possible financial system for New Zealand.

Within a timeframe of about a year, it is expected to come up with a plan that combines vision with practical solutions.

In the last months a similar approach has been announced in both the UK and Australia, at its heart the belief in the importance of robust capital markets to a country's economic performance. The new Mayor of London, Boris Johnson, has announced that he has asked senior city executives to work with the City of London Corporation to examine how London can sustain its position as the world's leading financial centre.

In New Zealand, the taskforce will be chaired by investment banker Rob Cameron and will comprise a group of private sector members - Adrian Orr, Cathy Quinn, Franceska Banga, Gareth Morgan, Jonathan Ling, Mark Weldon, Nigel Williams, Rob McLeod and Scott St John - who will be supported by key officials from the Ministry of Economic Development, Treasury, the Reserve Bank and the Inland Revenue Department. The taskforce will have about a year to develop and prepare its blueprint and action plan and will report to a group of senior Ministers including the Ministers of Finance and Economic Development.

A key operating feature will be to foster open dialogue and well-informed robust debate based on high quality analysis and to this end the taskforce is charged with regularly seeking input from experts in other sectors in order to develop an action plan that will have initiatives of relevance to both the private and public sectors.

Taskforce objectives

The taskforce's main objectives are to develop and launch a blueprint and action plan to improve New Zealand's financial system for the benefit of the New Zealand economy and its business. This means the taskforce will review the country's financial system to:

- identify key constraints and key opportunities for development;
- identify and debate options to improve performance; and
- develop a blueprint and action plan for future development.

In announcing the taskforce, the Government noted that thriving capital markets are increasingly recognised as essential for New Zealand's economic growth. This is because greater depth and breadth in New Zealand's financial system will help firms raise funds in New Zealand and allow the country to capture more of the gains for business growth. In turn, better developed local capital markets will also deliver other benefits, including encouraging firms to locate to this country.

The Government also noted that it was important to build consensus around the importance of capital markets to New Zealand's future growth and that expert advice was needed to provide well-informed and robust views. As a result, the Government expectation is for a blueprint and action plan that is both visionary and pragmatic.

Taskforce scope

The terms of reference allow the taskforce to identify the areas it considers key to improving New Zealand's capital markets. Participants from the Ministry of Economic Development, the Treasury, the

Reserve Bank and the IRD will ensure that relevant data and information held by government agencies is made available.

The taskforce will identify specific areas of research and then seek to produce possible visions for New Zealand's capital markets from which it will look to choose the one that is most favourable.

While the taskforce is likely to explore a wide range of policy areas, including in areas of the economy such as tax and immigration, it will be kept informed about relevant issues being undertaken by government agencies or advisory bodies. Taskforce recommendations for policy changes will need to go through the appropriate processes.

Why the taskforce?

A taskforce was first proposed at the November 2007 Investment Forum which saw a group drawn from the business and finance sectors, academics and senior staff from public sector bodies, debate how best to improve the investment environment for New Zealand firms. The one-day November 2007 forum considered, as a central discussion paper, a report entitled 'Improving the Investment Environment for New Zealand Firms'. A key recurring theme from the forum was the willingness of the private sector to engage with government to advance the interests of "NZ Inc".

While many forum participants agreed that, although New Zealand's capital markets had improved over recent years, noting the impact on savings through the introduction of KiwiSaver and the PIE regime, more work was required to strengthen and deepen our capital markets. Also stressed was the importance of developing an agreed vision of New Zealand's financial system.

Next steps

By setting the taskforce the objective of developing a blueprint and action plan to develop New Zealand's capital markets and, in doing so, to work closely with public sector agencies, the Government's stated objective is to allow it to respond quickly to the taskforce's recommendations.

When the blueprint is finalised, the Government expects to be in a position to outline some actions it will take in response to the recommendations. Recommendations which cross into some policy areas elsewhere in the economy will require further work through the usual policy processes.

The Government also noted that it is also expected that the action plan will include initiatives that the private sector will commit to implementing.

More information about the taskforce is available at www.med.govt.nz/cmdtaskforce

Legislation to transform capital markets, boost investor confidence

In this article, senior associate Stephen Layburn provides a useful reminder of pending legislative developments arising from the Review of Financial Products and Providers against the backdrop of the public war of words that has broken out between Minister of Commerce Lianne Dalziel and media commentator Brian Gaynor about the Capital Market Development Taskforce.

In an open letter to the Minister of Commerce[6], Brian Gaynor is scathing of the newly established taskforce designed to look at the current state of our capital markets, the international context, future risks and opportunities, and changes needed to deliver the best possible financial system for New Zealand.

Gaynor's argument

In his letter to the Minister, Gaynor gives his view of many of the problems affecting capital markets activity in the period since 1987.

He argues the new taskforce is stacked with representatives of the "sell-side" of the market and should have contained a reasonable number of representatives of small investors from the market's "buy-side". He says successful markets depend on having sellers and buyers who have "total confidence in the integrity and reliability of the process", and investors currently have little confidence in our capital markets because of past indiscretions and a lack of regulatory protection.

Gaynor's view of the problems include well-known statistics on New Zealand investment which provide a sad reflection of the level of depth and spread of capital markets activity in this country. Over the years, Gaynor's views have remained consistent and he provides a valuable contribution to the national dialogue on the state and development of our capital markets, largely from a "buy-side" perspective.

Russell Committee

One bone of contention in Gaynor's argument is his escalation of the significance of the output from the Ministerial Committee of Inquiry into the Sharemarket chaired by former Reserve Bank Governor Sir Spencer Russell (Russell Committee) and the reasons why the Russell Committee's recommendations were not implemented. Assembled in 1988, after the events of 1987, the Russell Committee reported its findings in early 1989. Gaynor reports that none of its recommendations were implemented because of what he describes as "capture" by a combined force of Treasury "dries" and interests associated with the Business Roundtable.

The Russell Committee's recommendations were described at the time as falling into three loose groupings: the first two relating to improving the efficiency of trading and the flow of market information and the third relating to market supervision and enforcement. Arguably, the first two areas had already been addressed or were in the process of being addressed by the time the Committee released its report. In addition, there have been a number of incremental changes to the NZX Listing Rules and the Securities Markets Act 1988 which have bolstered support in this area. It is also possible to point to the changes to the Securities Markets Act which came fully into force on 29 February 2008, particularly those relating to insider trading and market manipulation, as providing additional legislative teeth.

The third area was that of market supervision where the Russell Committee's recommendations were described as prescribing a self-regulatory structure within a statutory framework. Again, it is arguable that this model had already been established and, in the case of the co-regulatory model now being pursued with success by NZX and the Securities Commission, can be seen to have worked well.

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[6] For a copy of the letter see Brian Gaynor: An open letter to Lianne Dalziel - 26 July 2008 - NZ Herald: New Zealand Business, Markets, Currency and Personal Finance News

Gaynor does make a observation about the knock-on impact of regulatory activity. In referring to recent events he notes that capital has simply moved to the less well-regulated parts of the economy such as the finance company sector and a seriously over-heated property sector. The blame for this he lays at the feet of the financial advisory profession.

Minister's response

In part, the Commerce Minister's response seeks to defend her and her government's record in relation to the finance sector. As such it provides a catalogue of recent legislative measures, such as the recent changes to the Securities Markets Act, as well as changes to tax policy and (of course) the introduction of Kiwisaver.

Turning to the establishment and make up of the taskforce, the Minister notes that one reason for establishing the taskforce is so that the private sector can partner with government to seek solutions that will enable our capital markets to grow. The Minister follows the lead of the All Blacks' selectors by not discussing individual selections, or indeed some of Gaynor's preferred candidates, and instead notes that the selection policy was based on a desire to get a diverse input of skills and expert opinion, noting that the taskforce had the opportunity to seek additional participants if they felt that would add strength.

The taskforce is understood to have already begun meeting and there is some suggestion that it may seek to report earlier than its September 2009 deadline. Having said that, there is a lot of work for it to do.

To paraphrase the Minister, the taskforce is not going to be able to cure many of the problems which beset capital markets activity in this country. As well as the legacy issues identified by Gaynor, the wash-up from more recent events is likely to have an impact on the "buy-side" for some time.

The Review of Financial Products and Providers (RFPP)

The Minister's response to Gaynor's open letter provides a timely reminder of the progress of the RFPP and three bills currently before Parliament that go some way towards addressing some of Gaynor's concerns around regulatory protection. These are:

- **Reserve Bank of New Zealand Amendment Bill (No 3):** This Bill amends the Reserve Bank of New Zealand Act 1989 in order to implement elements of the new regulatory framework for non-bank deposit takers and enhance the Reserve Bank of New Zealand's accountability and transparency arrangements in relation to its financial sector functions.

  It will require non-bank deposit takers (including finance companies) to be licensed by the Reserve Bank, as well requiring directors and senior managers to be subject to a "fit and proper persons" requirement, and comply with minimum prudential requirements which will be set by the Reserve Bank. Enforcement of the new prudential supervision regime will be undertaken and enforced by trustees and the Reserve Bank. In addition, those non-bank deposit takers will continue to be subject to disclosure requirements under the Securities Act 1978 – which are (themselves) expected to get something of a work out as a result of the recent series of failures by a number of high-profile finance companies.

- **Financial Service Providers (Registration and Dispute Resolution) Bill**: This Bill will require providers of defined financial services and financial services products to be registered as well as providing for supervisory and enforcement functions and will establish a comprehensive, industry-based dispute resolution service with the aim of improving consumer access to redress in the financial services sector.

- **Financial Advisers Bill:** This Bill aims to:
  - ensure that members of the public can make informed decisions in deciding whether to use a financial adviser and in assessing a financial adviser's financial advice (by requiring financial advisers to disclose their experience and qualifications, certain criminal convictions, fees and potential conflicts of interest);
  - ensure that people acting as financial advisers have sufficient experience and expertise to provide advice in their particular area – by requiring all financial advisers to be registered and meet certain criteria for receiving and maintaining registration; and
  - hold financial advisers accountable for the advice that they give by imposing certain conduct obligations on financial advisers, including obligations to act with integrity,

exercise reasonable care, diligence and skill (and prohibit engaging in misleading or deceptive conduct).

There continues to be a broad spectrum of views about the constituent parts of the RFPP, including the timing and content of the proposed new regulatory regime affecting the financial advisory sector. The key message that can be taken from the Minister's reply is that the legislative landscape is about to undergo a fundamental change as a result of the implementation of the next phase of the RFPP.

While it is unlikely that any single development, including the recommendations of the taskforce when they emerge in 2009, will provide a silver bullet, each new development will be regarded by many as an important element in the task of restoring confidence to our capital markets. Without a restoration of that confidence, there remains the risk that savings and investment will continue to "leak" into non-productive activities, such as much of the recent speculative investment in real estate to the detriment of the economy, which will continue to rely on the savings of overseas-based investors to expand.

This article was first published on the Bell Gully website on 6 August 2008.

Report on cycle seven of the Securities Commission's review of financial reports

The Securities Commission has completed the seventh cycle of its financial reporting surveillance programme. Although the Commission was generally pleased with the level of compliance by the issuers it reviewed, the Commission has highlighted a number of areas with room for improvement. These include the disclosure of related party transactions, substantial security holders, directors' interests and directors' share dealings. The Commission also highlighted issues surrounding the disclosure of key management in its latest review.

In Cycle 7, the Commission reviewed financial reports of 44 issuers with balance dates from 31 December 2006 to 30 September 2007. This represents the conclusion of the Commission's first round of its financial reporting surveillance programme which began in 2005, with all NZX listed issuers having now been reviewed (except for some dual or overseas listed entities). The next cycle will begin the second round of reviews where listed issuers will be selected again for review.

The level of compliance in Cycle 7 was generally good, but the Commission found that 17 issuers had matters that needed to be addressed. In respect of those 17 issuers, satisfactory agreement was reached on 83 percent of the matters raised following the initial letter from the Commission.

Related Party matters

In its report, the Securities Commission drew attention to inadequate or possible non-disclosure of related party information by issuers. This, they noted, was particularly unsatisfactory given the current climate and the effect related party relationships can have on an entity's financial performance and financial position.

The Commission identified the following disclosure items as instances where inadequate disclosure or possible non-disclosure of related party information occurred:

- the identity of the ultimate holding company of the issuer;
- the nature of the relationship between related companies;
- key management personnel information;
- the identity of related entities;
- the types of transactions between related parties;
- related party transactions; and
- the terms of settlement of outstanding balances.

Key management personnel

In relation to issuers that have no staff or key management personnel, the Commission drew attention to the fact that the term "key management personnel" is not limited to a person directly employed by the reporting entity. This means that reporting entities are also required to disclose key management personnel information:

- where a related party compensates key management personnel on behalf of the reporting entity;
- where the reporting entity contracts out its key management functions or has those functions performed on its behalf by another entity; and
- where the reporting entity's key management personnel compensation is paid, in substance, on its behalf (whether or not the reporting entity pays management fees to the other entity). For example, where these services are rendered on the reporting entity's behalf by the directors and officers of another entity.

Substantial security holder disclosure

In its report, the Commission again reminds issuers to take their obligations under the Securities Markets Act regarding substantial security holders disclosure seriously, notwithstanding that the primary obligation for such disclosures is on the substantial security holders.

Issuers should ensure their annual disclosures are accurate and comply with the Securities Markets Act. Following the amendments to the Securities Markets Act, which came into force on 29 February 2008, the failure to comply with substantial security holder obligations is now a criminal offence, subject to a fine of up to $30,000. Civil penalties of up to $1 million can be imposed by the court, which can also make a range of orders relating to any holding of securities, including orders to forfeit or dispose of securities. The Commission notes that it intends to review substantial security holder disclosures more closely in future and take action where appropriate.

In Cycle 7 some of the areas of concern identified by the Commission related to:

- the number of substantial security holdings disclosed in the annual report being inconsistent with those in the notice filed with NZX;
- no substantial security holder information being disclosed in the annual report in respect of some substantial security holders;
- no substantial security holder notice being filed with NZX; and
- non-disclosure in the annual report of the date of the substantial security information and the total number of voting securities in the issuer.

Directors' interests and share dealings

In this cycle the Commission identified five issuers in relation to the non-disclosure or inadequate disclosure of directors' interests and share dealings in their annual reports as required by the Companies Act, the Securities Markets Act and NZX Listing Rule 10.5.3(c).

The matters highlighted by the Commission in its report includes:

- the non-disclosure of directors' share dealings in the annual report;
- the inconsistent disclosure of total share holdings between the current and previous annual reports without any disclosure of share transactions having taken place during the year;
- the non-disclosure of shares issued and date of issue to directors in lieu of directors' fees in the annual report;
- the non-disclosure of consideration paid or received for directors' share dealings;
- the inconsistent disclosure of the total number of shares held by a director between the annual report and the notice filed with the NZX; and
- the non-filing of NZX notices for changes in the holdings of persons associated with the directors.

The review also identified issues relating to non-disclosure of waivers in annual reports.

To a view a copy of the report visit the Securities Commission website at www.seccom.govt.nz

Competition and consumer law

Commerce Commission looks to formalise the merger clearance process
In July 2008 the Commerce Commission released its Draft Merger and Acquisitions Process Guidelines. While useful in terms of providing transparency of process, senior associate David Blacktop outlines why the guidelines are unlikely to speed up the clearance process and will not fundamentally change the current regime from a merger participant's point of view.

Price control amendments update
The Commerce Select Committee has reported back on the Commerce Amendment Bill which rewrites New Zealand's price control laws. In this update, senior associate David Blacktop highlights two important changes the Committee has recommended be made to the Bill: the provision of additional appeal rights; and improvements to the transitional arrangements for electricity lines businesses.

Court of Appeal finds vendors in NZ Bus not liable
In this article, senior associate Jenny Cooper comments on the recent Court of Appeal decision which overturned the High Court's landmark finding of accessory liability for breach of the Commerce Act against the vendors of Mana Coach Services to New Zealand Bus Limited. The High Court decision was the first time that vendors had been found liable under the Act in relation to an anti-competitive business acquisition.

Consumer credit test case provides guidance on fees
In this article, senior associate Jenny Cooper and solicitor Nick Christiansen outline how the dismissal of charges against a finance company in a test case over loan fees should bring greater clarity for an industry that is increasingly under the watch of New Zealand regulators.

Commerce Commission looks to formalise the merger clearance process

In July 2008 the Commerce Commission released its Draft Merger and Acquisitions Process Guidelines. While useful in terms of providing transparency of process, senior associate David Blacktop outlines why the guidelines are unlikely to speed up the clearance process and will not fundamentally change the current regime from a merger participant's point of view.

Criticisms of current regime

During the last half of 2007, the Commerce Commission commissioned an external review of the way in which it goes about the merger clearance process. The clearance process allows parties seeking to make an acquisition to apply to the Commission for a clearance which provides an immunisation for the acquisition from later challenge by the Commission or another party.

The clearance regime has been criticised in some quarters as being too slow (with frequent extensions asked for), uncertain and, because the Act requires the Commission to be satisfied that no anti-competitive effect would occur, biased against acquisitions. Our experience is that clients are also concerned about a lack of access to Commissioners directly.

What can the review achieve

The Commerce Commission must work within the framework provided by the Commerce Act. MED is currently reviewing the legislation governing the clearance regime. The Commission's review can therefore only address the processes it adopts in terms of setting timeframes and expectations for merger participants.

Pre-merger notification

The guidelines have an extensive discussion of pre-merger notifications. There are two parts to this. First, the Commission suggests parties that are intending to file a clearance application notify the Commission at an early stage so that it can expect a clearance. This enables the Commission to plan its resourcing appropriately and this suggestion simply formalises current best practice.

The second part of the process covers the current practice of senior management meeting with senior Commission staff, and in many cases the Chair, to inform them directly of the matter. While these "fireside" chats have in our experience little bearing on the overall outcome, they are valued by clients who feel that these meetings are their only chance to meet with Commission members directly.

The draft guidelines suggest these meetings would only occur with Commission staff in the future and would not involve Commissioners.

The Commission has also suggested that, prior to any pre-meeting with Commission staff, parties must file a:

"…substantially developed draft application form at least two working days before the prenotification discussion meeting. However, a longer timeframe may be appropriate for more complex mergers. This allows the Commission sufficient time to review the draft application form in preparation for the meeting."

In practice, the request for a draft clearance application may be problematic because there may well be changes to the application put forward prior to the filing of a clearance. The Commission would rightly question why changes have been made and this might mean that parties will be reluctant to engage in this process.

Proposed timeframes: 8 – 12 weeks for a clearance

The proposed timeline adopted by the Commission anticipates a clearance will take 8-12 weeks to achieve. This reflects the current timeframes. The timeframes anticipate at after eight weeks the Commission will be in a position to either clear a transaction or, alternatively, say "we have some concerns and need more time". In that case the Commission will send a "letter of concern" to the parties and ask for a four week extension.

Letter of concern process

The Commission already adopts a letter of concern process and this is helpful for parties. The practical reality of a letter of concern is that it is incumbent on the parties to produce compelling evidence as to why there is no competitive concern – if that is not possible clearance will almost certainly be declined.

With this in mind, we note that the guidelines propose a meeting between the Commission and the merger parties five working days from receipt of a letter of concern. While we think such a meeting is a good idea, five working days does not allow parties much time to respond fully to any detailed concerns raised.

Submissions on the draft set of process guidelines and revised application form for businesses seeking clearance closed on 1 August. To access a copy of these documents visit the Commerce Commission's website at **www.comcom.govt.nz.**

Price control amendments update

The Commerce Select Committee has reported back on the Commerce Amendment Bill which rewrites New Zealand's price control laws. In this update, senior associate David Blacktop highlights two important changes the Committee has recommended be made to the Bill: the provision of additional appeal rights; and improvements to the transitional arrangements for electricity lines businesses.

Forms of control unchanged

As noted in the Autumn 2008 issue of Commercial Quarterly, New Zealand's current price control regime provides for bright line regulation. This means there is either full price control or there is none - there is no middle ground. The Bill provides the Commerce Commission with a greater armoury to exert "control". It will be able to recommend companies be placed under a range of forms of regulation namely:

- An information disclosure regime under which companies must disclose certain information, such as prices, to the Commission which in turn performs a monitoring role. The rationale being that businesses will temper any supra-competitive pricing for fear of further regulation. The Bill immediately imposes this regime on Auckland, Christchurch and Wellington international airports.
- A negotiate/arbitrate regime under which a company will be required to reach agreement, through negotiation, on the supplier's prices and quality standards during a specified regulatory period, and to provide for binding arbitration if negotiation is unsuccessful. This regime is similar in concept to the Telecommunications Act 2001.
- A default/customised price-quality regime, similar to the existing Electricity Lines Business (ELB) price path threshold regime but with major improvements (outlined below).

None of these options are fundamentally changed.

When control may be imposed

The Committee made two important changes to the test for when control *may* be imposed by the Commission:

- First, the Bill now requires that a person must have "scope" to exercise "substantial market power" before control may be imposed. Previously, this requirement would be satisfied where a person has "substantial scope" to exercise "market power", which is a much lower test.
- Second, the benefits of regulation must now "materially" exceed the costs of regulation. Under the previous drafting the word "clearly" was used. "Materially" appears to impose a more certain and higher standard than "clearly". For example, the benefits may "clearly" outweigh the detriments in the sense of leaving little doubt but the gap between benefits and costs may nonetheless be immaterial.

Given the purpose of regulatory intervention, we think these are sensible changes. We also agree with the Committee's decision not to set out the situations where control *should* be imposed as suggested by some submitters. We agree with the Committee that this is very much a second step (once the *may* threshold is reached) for which the Minister should exercise his or her discretion.

Appeals

For every regulated good or service, the Commission must publish input methodologies which are designed to promote certainty for business subject to regulation. Input methodologies set out the Commission's method for determining the cost of capital, valuing assets, allocating common costs, etc.

Under the Bill as introduced parties could appeal the "input methodologies" set by the Commission to the High Court. However, the Bill did not provide for customised price path decisions which applied the

methodologies to particular companies to be appealed. That is, firms could appeal the method up front but not the application of that method to its particular circumstances in the context of, for example, the Commission setting a customised price path.

The Select Committee has recommended two changes:

- While the Bill retains an ability to appeal to the High Court against input methodologies, these can only be overturned where a different methodology would be "materially" better in achieving the purpose of the Bill. Only in exceptional circumstances would the court reach this view where an appeal arises from a specialist tribunal. It appears to us it is effectively an unreasonableness test akin to the judicial review standard.

- Introducing appeals against the Commission's final determinations – ie. appeals against decisions applying input methodologies to a particular business in relation to customised price/quality thresholds. There is no similar "materially better" threshold for these appeals and presumably the conventional High Court approach to appeals from Commission decisions will apply. However, parties appealing against a final decision cannot appeal "against all or any or part of an input methodology". While the rationale for this exception is apparent, it is unclear exactly how this division will play out, particularly in the light of the high thresholds that would apply for overturning a price path threshold. This might provide an incentive for the Commission to put a lot of detail in the initial methodologies which would be difficult to overturn but which would also be immune from later challenge at the final decision stage.

Improved transitional arrangements for Electricity Lines Businesses

The revised Bill includes improved transitional arrangements for Electricity Lines Businesses moving from the current price path thresholds regime to the new information disclosure regime and the default/customised price quality regime (for non "trust-owned" ELBs).

The current price path thresholds regime is a screening mechanism designed to identify ELBs that *might* warrant control. The new regime potentially imposes direct pecuniary penalties on firms that breach default/customised price quality thresholds. This raised the potential that an ELB would breach the current screening thresholds but be immediately exposed to pecuniary penalties. In effect, this would impose retrospective liability for decisions taken prior to the Bill coming into force. The Bill has been revised to remove this problem.

> To read the select committee's full report on the Commerce Amendment Bill visit the New Zealand Parliament website at www.parliament.nz.

Competition and consumer law

Court of Appeal finds vendors in NZ Bus not liable

In this article, senior associate Jenny Cooper comments on the recent Court of Appeal decision which overturned the High Court's landmark finding of accessory liability for breach of the Commerce Act against the vendors of Mana Coach Services to New Zealand Bus Limited. The High Court decision was the first time that vendors had been found liable under the Act in relation to an anti-competitive business acquisition.

The Court of Appeal confirmed that vendor liability could arise but considered that the vendors should not be liable in this case because they were not involved in the clearance process and were not aware of the Commission's concerns about the acquisition. Justice Hammond set out a new test for accessory liability under the Act based on "dishonest participation". He held that it was unacceptable to "take a punt" by proceeding with a business acquisition without a clearance or authorisation where the participant has knowledge that it is a borderline case. Such behaviour may give rise to penalties under the Act for any parties, including vendors, who "dishonestly" aid and abet the transaction or are knowingly concerned in it.

The facts

In 2005, NZ Bus, the largest bus company in the Wellington region and in NZ, entered into an agreement with Blairgowrie Investments Limited and others (the Vendors) to acquire Mana, the second largest bus company in the Wellington region. The agreement was conditional on NZ Bus obtaining Commerce Commission clearance or authorisation.

During the clearance process the Commission expressed concerns to NZ Bus and its parent company, Infratil, that the acquisition would reduce competition. A meeting was held at which NZ Bus claimed Commission staff encouraged them to proceed without a clearance. This was denied by the Commission. NZ Bus then took legal advice and concluded that the least-risk highest-benefit strategy was to withdraw the clearance and complete the acquisition. It approached the Vendors to seek a waiver of the clearance condition, telling them that its advice was that clearance was not needed.

The Vendors waived the condition and NZ Bus withdrew its application for clearance. Before the transaction was settled, the Commission began proceedings against NZ Bus, Infratil, and the Vendors, alleging that the acquisition breached s47 of the Act as likely to have the effect of substantially lessening competition in a market.

High Court decision – vendors found liable

In the High Court Justice Miller found that the acquisition did breach the Act and that NZ Bus was accordingly liable. He also held that the Vendors were liable as accessories to the breach. Whereas the acquirer in a business acquisition in breach of the Act is automatically liable without any requirement to prove knowledge or intention, Justice Miller applied the same test for accessory liability found in the criminal law. He held that an accessory is liable under the Act only if:

- it has knowledge of the essential facts that establish a contravention of the Act (i.e. the facts which led the court to conclude that the transaction was likely to substantially lessen competition); and
- its participation was intentionally aimed at the acts that form the contravention (i.e. the acquisition).

The Vendors were liable "by participating in the waiver with knowledge of essential facts sufficient to establish contravention of s47". This finding was based on their market knowledge, rather than any understanding on their part as to whether a competition law analysis would reveal a breach of the Act. In fact, Justice Miller held that the Vendors were unaware of the Commission's concerns and had reasonably relied on advice that a clearance was not necessary.

In contrast, despite knowing of the Commission's concerns, Infratil was not liable as it did not know all the facts about the market that led the court to conclude that the acquisition was likely to substantially lessen competition.

Court of Appeal decision – new test proposed

The Court of Appeal upheld Justice Miller's finding that the acquisition breached s47 but overturned the liability finding against the Vendors. The court expressed misgivings about applying the criminal law test for accessory liability in the competition law context. Their main concern was that determining whether an acquisition is likely to have the effect of substantially lessening competition relies on an evaluative assessment of a wide range of facts and circumstances and is often very difficult to know in advance.

In view of this, Justice Hammond concluded that the criminal law approach was not suitable and, instead, adopted a test of "dishonest participation" under which liability depends on an objective assessment of whether the alleged accessory was guilty of "commercially unacceptable conduct".

Applying this test Justice Hammond found that the Vendors were not liable – their involvement was limited and they had not been told there was a real risk the Commission would decline clearance. In contrast, he would have held Infratil liable on the grounds that its decision to take a "punt" in a borderline case was "commercially unacceptable conduct". However, a finding by the High Court that the Commission had hinted to Infratil that NZ Bus might consider withdrawing the application meant it was difficult to say that there had been "objective dishonesty" by Infratil. Infratil therefore escaped liability.

In his separate judgment, Justice Arnold agreed with Justice Hammond that there were difficulties in applying the criminal law approach to accessory liability. However, he considered that Justice Hammond's "dishonest participation" approach did not provide any greater certainty as it relied on the court's intuitive judgment as to what was commercially appropriate on the facts of each case. Applying the traditional approach, Justice Arnold came to the same result as Justice Hammond, with neither the Vendors nor Infratil found liable.

Left with the deciding vote between the traditional approach and Justice Hammond's alternative, Justice Wilson opted not to cast it, stating that he agreed with both his fellow judges.

Liability lessons

The Court of Appeal clearly felt that the High Court's findings on liability were at odds with where culpability lay in this case. Their decision suggests that a vendor will not be held liable for a business acquisition unless they are on notice that the Commission has concerns or they have some other reason to be concerned that the transaction may breach the Act (unlike an acquirer who is automatically liable if an acquisition is found to have breached the Act). Where there are such concerns, vendors (and other parties) should obtain independent expert competition law advice and should not agree to the transaction proceeding without a clearance or authorisation only after a careful analysis of all the facts and circumstances indicates that it is safe to do so.

This article was first published in Competition Matters, NZLawyer magazine, 27 June 2008.

Consumer credit test case provides guidance on fees

In this article, senior associate Jenny Cooper and solicitor Nick Christiansen outline how the dismissal of charges against a finance company in a test case over loan fees should bring greater clarity for an industry that is increasingly under the watch of New Zealand regulators.

The Commerce Commission's prosecution of Avanti Finance Limited, a large New Zealand lender to low-income borrowers, was the first case of its type under the Credit Contracts and Consumer Finance Act 2003 – and as such had many eyes on the outcome.

In June, the Auckland District Court dismissed charges that Avanti breached the Act by charging excessive fees to borrowers who repaid loans early.

While the Commission has yet to announce whether it will appeal[7], the decision provides helpful guidance that lenders are not obliged to use the regulatory formula to calculate their early repayment fees and may use an alternative approach if that is more appropriate to the structure of their business. However, the decision also reinforces the need for lenders to justify that their fees are calculated on actual estimated costs and losses, and are not simply arbitrary.

Avanti and the CCCFA

The Commerce Commission's prosecution of Avanti related to its prepayment fees.

Avanti was charged with offences over the fees it charged on 50 fixed-rate fixed-term loans that were fully repaid before their contractual end date.

CCCFA's provisions

The CCCFA specifies that a fee charged by creditors on early repayment of a consumer loan must not exceed a reasonable estimate of creditor's loss from early payment. The loss may be calculated using either the "safe harbour" formula set out in the regulations, or "an appropriate procedure set out in the consumer credit contract for calculating that loss". Prepayment fees calculated using the "safe harbour" formula are deemed to be reasonable.

The safe harbour formula calculates the loss as the present value of the difference between the interest payments the creditor was expecting under the original contract and those which they can obtain by re-lending the repaid funds at prevailing interest rates. The formula assumes that the creditor can mitigate its loss by re-lending the repaid funds. If interest rates have not fallen since the original loan was made, then the creditor is considered to have suffered no loss.

Many lenders have chosen not to use the safe harbour formula because it does not capture their actual losses on a prepayment, such as marketing and broker commission costs. Nor does it reflect the fact that in many cases re-lending is unrelated to prepayment. Until now the Commission has taken the narrow view that any formula that results in a higher calculation of loss than the safe harbour formula is likely to be "unreasonable" and breach the Act.

The Commission's case

Avanti's prepayment fee was calculated on the basis of the difference between the rate charged on the loan and the 90 day bill rate, plus a margin of 1.9%, for a 90 day period. The Commission alleged that this resulted in an unreasonable estimate of its loss because:

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[7] Since writing this article, the Commerce Commission announced on 3 July 2008 that it was appealing this decision as it considered the case raised important issues in relation to consumer credit law and that the appeal will seek clarity on principles of law.

- The formula imposed an arbitrary 90 day interest period which did not relate to the time taken to re-lend funds;
- The formula had no regard to changes in prevailing interest rates and therefore no regard to a variation in the rate at which funds would be re-lent; and
- The formula did not take into account mitigation of loss by re-lending prepaid funds.

The Commission argued that the formula captured three months of future profit in a situation where the creditor had use of the prepaid funds, no risk associated with those funds, and offered no service to the prepaying debtor. The safe harbour formula would not have allowed Avanti to claim a prepayment fee as interest rates had increased over the relevant period.

Avanti's defence

Avanti argued that its loss was the unearned interest on the loan over the remainder of the loan term less the amount saved by repaying the prepaid funds into its bank, plus the administrative costs incurred on early termination (which Avanti did not charge a separate fee for). Avanti's formula was intended to estimate that loss of margin. In fact, according to Avanti's expert witness, the company's actual loss was greater than the amount of its prepayment fee on all but one of the 50 loans.

Avanti said that the safe harbour formula was inappropriate for its business because subsequent lending would occur regardless of any prepayment. Avanti had maintained a significant unused bank facility during the relevant period, meaning that it had excess lending capacity. This capacity, meant prepayment created no further opportunity to re-lend the prepaid funds.

What the judge said

The judge found that a creditor's loss is the gain the creditor would have made if the contract was not prepaid and had run its course, subject to the creditor's obligation to mitigate its loss. In Avanti's case, the judge said that prepayment did not create new lending opportunities for the company, but merely reduced its borrowings. The court agreed with Avanti that the safe harbour formula did not reflect its actual loss because there was no link in Avanti's business between prepayment and subsequent re-lending. The judge commented that the legislation does not stipulate how Avanti should run its company or source its funds. The court was satisfied that Avanti's formula was a reasonable estimate of its loss, and dismissed the charges.

This decision is welcome recognition that the safe harbour formula is not always the right way for creditors to calculate loss from prepayments and that they have the freedom to adopt a formula that reflects their business model.

This article was first published on Bell Gully's website on Friday 20 June 2008.

Intellectual property and information technology

Beware of domain name scare tactics

Has your business been on the receiving end of a communication from a purported domain registrar advising you that someone else is attempting to register domain names or internet key words which incorporate the name of your company or your trade mark? In this article senior associate Colleen Cavanagh outlines the appropriate response to such notices.

Beware of domain name scare tactics

Has your business been on the receiving end of a communication from a purported domain registrar advising you that someone else is attempting to register domain names or internet key words which incorporate the name of your company or your trade mark? In this article senior associate Colleen Cavanagh outlines the appropriate response to such notices.

These types of notices, particularly out of China, are becoming increasingly common. They are usually an attempt by an organisation or person pretending to be a legitimate domain name registrar to drum up business.

Usually the notice will state that a third party has applied to register certain domain names or internet key words incorporating your trade mark or company name. It will invite you to contact the registrar to register your domain name promptly to prevent the other party from obtaining registration.

By way of background all .cn domain names and internet key words in China are administered by a quasi-governmental body called China Internet Network Information Centre and can only be registered via a registrar accredited by this organisation. Chinese law states that a domain name or internet key word registrar is supposed to register domain names and internet key words on a first come, first served basis.

So what should you do if you receive one of these notices? The answer is "probably nothing". Certainly no response to the bogus registrar is required. However, you should take the opportunity to review whether you need to protect your name or trade mark by registering appropriate domain names and/or internet key words through reputable accredited registrars. You may elect to do this for marketing purposes or even for defensive purposes. Clearly registration will be very important if you plan to do business in China where the bulk of these notices appear to originate from. The registration of your desired domain name by someone else will be frustrating and disruptive of your marketing plans. It will cost much less to take proactive steps to register your domain names now, than it will to sort out the aftermath if someone acquires registration first.

The question is how far do you go with registration? There is a proliferation of ways in which you can register domain names with different country codes and extensions, and clearly a cost benefit analysis is required to determine how far to go. The registration of an internet key word, which enables internet browsers to be directed to your website, may be an attractive option but requirements will vary from business to business.

Further advice and information

Bell Gully's Intellectual Property team can advise you on all types of IP issues, including the registration and maintenance of trade marks. Contact Colleen Cavanagh for more information.

Utilities and resources

Emissions Trading Scheme looks set to be a reality
In this article, senior associate Kate Radka provides a brief update on changes to the Climate Change (Emissions Trading and Renewable Preference) Bill following the release of the amended Bill and an update on the likelihood of the Bill being passed before elections.

More regulatory policy initiatives in the electricity market
The Government has recently introduced or proposed a further series of policy initiatives, all aimed at promoting renewable generation as the best means of addressing New Zealand's response to climate change. This includes: the proposed National Policy Statement for Renewable Electricity Generation; the establishment of a Senior Energy Officials Group to oversee the implementation of energy efficiency measures; an enhanced role for the Electricity Commission in relation to energy efficiency, renewable generation activities and the purchase of reserve power; and a proposed further relaxing of the current restrictions on lines companies investing and operating renewable generation projects and selling the output to customers within their local area network. In this article, partner Garry Downs, senior associate Louise Hill and solicitor Sukhdeep Johal set out the key aspects of these new policy initiatives and consider how they "fit" with the regulation of the electricity industry.

Amendments to the Electricity Industry Reform Act 1998
A decade ago, the electricity industry went through fundamental reform as restrictions were placed on the ownership or operation of both a line network business and a generation retail business. The proposed amendments to the Electricity Industry Reform Act further water down the strict rules on separation. A lines company can now own and operate new renewable generation and sell the output to consumers connected to its network. In addition, certain other combinations of line businesses and generation retail businesses are now permitted. In this article, partner Garry Downs, senior associate Louise Hill and solicitor Sukhdeep Johal outline the latest proposed amendments and describe the impact of the Bill should it be passed in its current form.

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Emissions Trading Scheme looks set to be a reality

In this article, senior associate Kate Radka provides a brief update on changes to the Climate Change (Emissions Trading and Renewable Preference) Bill following the release of the amended Bill and an update on the likelihood of the Bill being passed before elections.

The Finance and Expenditure Select Committee reported back on the Climate Change (Emissions Trading and Renewable Preference) Bill in the middle of June 2008, recommending a number of amendments including:

- the deferral of the introduction of liquid fossil fuels into the scheme from 1 January 2009 to 1 January 2011;
- the deferral of the start of the phasing-out of free allocations from 2013 to 2018, with the free allocation of units to agricultural participants and trade-exposed industries to be phased out gradually over the period 2018 to 2030;
- the deferral of the introduction of activities relating to sulphurhexaflouride, perflourocarbons and hydrofluorocarbons from 1 January 2010 to 1 January 2013;
- the inclusion of coastal fishing and shipping into the scheme, provided an Order in Council is passed;
- the inclusion of a number of new removals activities, which would be eligible to receive units for carbon removals, including (if an Order in Council is passed) carbon capture and storage activities;
- the ability (if it is accepted into Kyoto Protocol and an Order in Council is passed) to include forestry offsets, whereby the forest/land owner would be able to deforest an area of land without incurring deforestation liabilities provided they planted the same amount of forest elsewhere;
- the provision for settlement of Crown Forest Land to receive a one-off allocation of units similar to other pre-1990 forest land (albeit not on an equitable basis as other pre-1990 land);
- amendments to the provisions relating to trade-exposed entities to provide greater flexibility to enable small to medium sized enterprises to have the opportunity to receive an allocation of units for trade-exposure.

The Select Committee Report included two strongly worded minority reports from the National Party and the Green Party. National's report stated its support for an emissions trading scheme in principle, but specified that it would not support the Bill in its current state and voiced its concerns at the speed at which the Bill was being "rushed through".

The Green Party also voiced concerns about the Bill in its minority report, but unlike National it was concerned that the emissions trading scheme as set out in the Bill fails to truly achieve the level of emission reductions the Green Party considers necessary. Although the Green Party continues to voice concerns, it announced on 26 August 2008 that it would support the Bill in exchange for a number of substantial amendments. The Green Party has highlighted some of the agreed amendments and associated policy trade-offs as:

- the use of dividends from state-owned power companies towards a billion dollar fund to make New Zealand homes warm, dry and cost-effective to heat;
- a contestable pool of credits for firms with new technologies that help set our economy on a low carbon path;
- the tightening of rules around the allocation of free credits so that not all firms will get 90 percent if they don't need them; and
- allocation plans will be scrutinised by Parliament, which will have the opportunity to overturn them if they are not fair and effective.

The support of the Green Party alone is not enough for Labour to get the Bill passed. It also requires the support of New Zealand First, which was announced on 27 August 2008 following closely guarded negotiations that have been carried out over the last couple of months.

As anticipated, support from New Zealand First does not come lightly for Labour, with the announcement of further proposed amendments to the Bill in addition to those announced by the Green Party on 26 August. This includes a one-off allocation of funding to each household in New Zealand, with greater funding expected for low income households and Super Gold Card holders, for Labour to address. New Zealand First has also indicated that it brought about considerable changes to forestry and agriculture in the proposed emissions trading scheme and the Government has accepted these changes. What is not clear is whether this is a reference to amendments arising from the Select Committee process following the influence of New Zealand First, or whether further considerable amendments can be expected to be introduced in the Second Reading of the Bill.

The Government has only ten sitting days left in Parliament in which to get the Bill safely through its Second and Third Readings before the elections later this year. With necessary support from the minority parties now secure, it looks like the legislation for an emissions trading scheme may be passed in the next month.

For further guidance on the Finance and Expenditure Committee's main changes to the NZ ETS and the main changes to participant obligations in the Climate Change (Emissions Trading and Renewable Preference) Bill visit the Ministry for the Environment's climate change website at www.climatechange.govt.nz.

To access the Finance and Expenditure Committee's report on the Bill visit parliament's website at www.parliament.nz/en-NZ/SC/Reports/.

For more information, please contact Kate Radka or Bell Gully's Climate Practice Group leader, Simon Watt

Utilities and resources

More regulatory policy initiatives in the electricity market

The Government has recently introduced or proposed a further series of policy initiatives, all aimed at promoting renewable generation as the best means of addressing New Zealand's response to climate change. This includes:

- *the proposed National Policy Statement for Renewable Electricity Generation;*
- *the establishment of a Senior Energy Officials Group to oversee the implementation of energy efficiency measures;*
- *an enhanced role for the Electricity Commission in relation to energy efficiency, renewable generation activities and the purchase of reserve power; and*
- *a proposed further relaxing of the current restrictions on lines companies investing and operating renewable generation projects and selling the output to customers within their local area network.*

In this article, partner Garry Downs, senior associate Louise Hill and solicitor Sukhdeep Johal set out the key aspects of these new policy initiatives and consider how they "fit" with the regulation of the electricity industry.

Introduction

With the introduction of the New Zealand Energy Strategy the Government signalled its intention to overhaul the policies surrounding the electricity industry with the intention of "advancing sustainability and economic transformation and helping New Zealand respond to climate change". The recent introduction of the new Government Policy Statement on Electricity Governance in May 2008 and the proposed National Policy Statement for Renewable Electricity Generation are part of that package.

Linked with these developments are the amendments to the Electricity Industry Reform Act 1998 (EIRA). The Commerce Committee examined the proposed EIRA Amendment Bill and recommended that it be passed with a number of suggested amendments. Overall the amendments are welcome and are intended to simplify the amendments being made to the EIRA. (For further commentary on the EIRA see the article "Amendments to the Electricity Industry Reform Act 1998" in this issue of Commercial Quarterly.)

Efficiency?

Given the Government's promotion of renewable energy, the recent developments in the policy and regulatory areas of the electricity industry are targeted at that objective. We have the New Zealand Energy Strategy (Energy Strategy), the New Zealand Energy Efficiency and Conservation Strategy (E & C Strategy), proposals for treatment of the electricity industry in the Government's emissions trading scheme, the Government Policy Statement on Electricity Governance, the proposed National Policy Statement for Renewable Electricity Generation, and the amendments to the EIRA. To implement these policies and to ensure appropriate regulation of the electricity industry we have the Electricity Commission and the Energy Efficiency and Conservation Authority (EECA). Also having input on electricity matters are the Commerce Commission, the Ministry of Economic Development, the Ministry for the Environment (through the Resource Management Act) and the Ministry of Consumer Affairs.

The Government established the Electricity Commission in 2003 with the principal objectives of ensuring that electricity is produced and delivered to all classes of consumers in an efficient, fair, reliable and environmentally sustainable manner and promoting and facilitating the efficient use of electricity. The Government Policy Statement on Electricity Governance states that maximising the contribution of cost-effective energy efficiency and conservation is a key means to achieving the vision set out in the Energy Strategy for a reliable, resilient system delivering New Zealand sustainable, low emissions energy services.

The Government has established a Senior Energy Officials Group to oversee the implementation of the Energy Strategy and the E & C Strategy and to coordinate the development of priority energy efficiency programmes. This group is led by the Ministry for Economic Development and includes the Electricity Commission as well as other relevant agencies such as Ministry for the Environment, the Ministry of Transport, the EECA and the Department of Building and Housing. According to the Government Policy Statement on Electricity Governance, the group has responsibility for ensuring a coordinated and cohesive

programme, and for providing a forum in which to address matters relating to consistency of programmes with energy policy and the government's broader climate change and sustainability objectives, and for coordinating stakeholder engagement. It is unclear, however, to what extent this group will have any authority in relation to the various agencies and commissions.

Government Policy Statement on Electricity Governance

In May 2008 the Government introduced a new Government Policy Statement on Electricity Governance (Governance Policy) which replaces the earlier versions of this document. The reason for the 2008 review is to address the Energy Strategy. As stated in the foreword to the Governance Policy, "the [Electricity] Commission has a critical role to play in taking the [Energy Strategy] from strategy to vision". The amendments to the Governance Policy reflect developments over the past four years, and in particular the Energy Strategy. The Governance Policy sets out the objectives and outcomes the Government wants the Electricity Commission (the Commission) to give effect to.

The key amendments to the Energy Strategy include:

- *Contribution to programme design, delivery and monitoring*

  A new section relating to the Energy Strategy and the E & C Strategy. The Government expects the Commission to contribute to programme design, delivery and monitoring. The Commission will need to make provision for delivering these actions in its planning processes and accountability documents, such as the Output Agreement and Statement of Intent.

- *Monitoring compliance for low income and vulnerable consumers*

  In the area of consumer protection, the Commission is tasked with monitoring compliance with the guideline on arrangements to assist low income and vulnerable consumers to ensure that, amongst other things, any consumer who is dependent on electricity for critical medical support will not be disconnected for reasons of non-payment. This is clearly in response to the death of Folole Muliaga in May 2007.

- *Liaising with the Gas Industry Company*

  The Government requires the Commission to work closely with the Gas Industry Company to establish a single independent complaints resolution scheme that includes both electricity and gas, because the size of the gas market does not justify a separate scheme, many of the same companies are involved in both sectors, and many customers buy electricity and gas from the same retailer. The Commission is required to work with the Gas Industry Company to "coordinate approaches to approval and governance of an electricity and gas consumer complaints scheme".

- *Energy efficiency*

  The electricity efficiency section of the Governance Policy has been revised and "beefed up". The Governance Policy states that "maximising the contribution of cost-effective energy efficiency and conservation is a key means to achieving the vision set out in the Energy Strategy for a reliable, resilient system delivering New Zealand sustainable, low emissions energy services". A principle of the Energy Strategy is that investment in energy efficiency measures should occur where this is cheaper than the long-term costs of building extra generation and network capacity, including environmental costs. It is the Government's intention that EECA be the primary service delivery agency for energy efficiency programmes in this section. The Commission is required to work closely with the EECA, to ensure that the Commission's activities complement the work of the EECA and that duplication of effort is avoided. The Commission is required to draw on the expertise of the EECA in the management of energy efficiency programmes in designing, administering and delivering its programmes. The Government requests that the Memorandum of Understanding between the EECA and the Commission be reviewed to clarify the respective roles of each agency and to reflect the Government's intentions described in this section of the Governance Policy.

- *Facilitating the development of renewable energy resources*

  The Government also sets out in the Governance Policy its policy and objectives in relation to renewable energy, which the Commission is required to give effect to. The Governance Policy states that "encouraging the development of renewable energy resources is a key part of the Government's Energy Strategy for managing climate change and long-term energy security". The

Government's objectives in relation to renewable electricity energy now include the objective that the specification of the grid planning processes and approval criteria should allow grid upgrade plans to facilitate the efficient and timely development of renewable generation resources, taking into account any difference in lead times for transmission and generation investment.

- *Integrating wind generation with other generation sources*

  The Commission is required to investigate the extent to which hydro and other generation sources can be integrated fully with intermittent wind generation in order to ensure that the maximum economic potential of wind generation can be achieved. This work should also include consideration of the changing role of older thermal generation plants.

- *New "winter energy margin" to meet security of supply*

  Significant changes have been made in the area of security of supply. In particular the "1 in 60" dry year standard has been replaced by a standard expressed in terms of "winter energy margin", which is the margin between forecast capacity to supply in a mean hydro year and forecast demand. In order to meet the security of supply objective, the Commission is required to use reasonable endeavours to ensure that the generation and transmission system is capable of maintaining a mean winter energy margin of 17 percent for New Zealand overall and 30 percent for the South Island. The Governance Policy states that this new standard will provide a level of security similar to the 1 in 60 standard, but provides a measure that is clearer, and easier to calculate and understand.

- *Security standards for peak demand*

  The Commission is also required to develop and set security standards for adequacy of capacity to meet peak demand.

- *Monitor resources to ensure market delivers consistently*

  The Commission is expected to be active in monitoring resource available to meet demand, and, in particular determining whether the market is consistently failing to deliver new capacity sufficient for an adequate energy margin and to meet peak demand. If the Commission determines that the market is consistently failing to deliver sufficient capacity, it should use the powers available to it to make recommendations to the Minister on any arrangements or policies that it considers necessary to provide better outcomes.

- *Contracting for reserve energy to maintain the desired energy margin*

  The Commission still has an obligation to contract for, but not own, reserve energy to maintain the desired energy margin if it considers that the New Zealand or South Island mean year energy margin is unlikely to be met by market participants. The previous limit placed on reserve energy of 1200GWh has been removed. The Government has continued to emphasise, however, that in contracting for reserve energy the Commission should seek to:

  - minimise the risk that reserve energy affects the incentives for market participants to respond to higher prices, construct new capacity, enter into hedge and other contracts, and investment in demand side manage; and

  - maximise static and dynamic efficiency.

- *Determination of a storage guideline level*

  The Commission should determine, for each contracted form of reserve energy, a storage guideline level at which it would expect reserve energy to be operating. If storage falls below a particular storage guideline level, and the relevant reserve energy is not being dispatched, the Commission may choose to offer that reserve energy for dispatch at a lower price in order to preserve hydro storage and to reduce shortage risks.

- *Emergency response plan*

  In addition to the Commission's task of managing the electricity sector to minimise the risk of supply shortages, the Government recognises that there will be infrequent circumstances where

there is a material risk of shortage. To manage such circumstances, the Commission is required to establish an emergency response plan that identifies and includes a range of measures to cover contingencies more severe than those allowed for within the mean winter energy margin. Such measures are to include conservation campaigns.

- *Other "tweaks" to the Governance Policy*

  The Government has also reviewed and made some "tweaks" to areas of the Governance Policy relating to system operation and wholesale and related markets, transmission, distribution, interrelationship with the Commerce Commission, distributed generation, and retail.

Proposed National Policy Statement for Renewable Electricity Generation

In August 2008 the Government introduced a proposed National Policy Statement for Renewable Electricity Generation. This policy statement sets out an objective and policies to enable the sustainable management of renewable electricity generation under the Resource Management Act 1991. The preamble to the proposed policy statement states that the contribution of renewable electricity generation, regardless of scale, towards addressing the effects of climate change plays a vital role in the wellbeing of New Zealand, its people and the environment. The Government recognises, however, that development that increases renewable electricity generation capacity can have environmental effects that span local, regional and national scales, often with adverse effects manifesting locally and positive effects manifesting nationally. Adopting a nationally consistent approach to balancing the competing values associated with the development of New Zealand's renewable energy resources will provide greater certainty to decision-makers, applicants and the wider community.

In essence, the proposed policy statement recognises that the current regime for decision-making under the Resource Management Act in relation to proposed new renewable generation projects requires a focus on local impacts (often negative when considering the building of a power station), and little regard for the national benefit of such projects. The proposed policy statement attempts to ensure a consistent approach to assessment of these projects and ensure national benefits be taken into account.

The policies set out in the proposed policy statement include:

- decision-makers must have particular regard to the national, regional and local benefits relevant to renewable electricity generation activities. These benefits may include maintaining or increasing electricity generation capacity while avoiding, reducing or displacing greenhouse gas emissions, and maintaining or increasing security of electricity supply at local, regional and national levels by diversifying the type and/or location of electricity generation;

- when considering measures to avoid, remedy or mitigate the adverse environmental effects of renewable electricity generation activities, consent authorities must have particular regard to the constraints imposed on achieving those measures by (amongst others) the nature and location of the renewable energy source, the local of existing structures and infrastructure, and logistical or technical practicalities associated with development, operating or maintaining the proposed renewable electricity generation activity;

- when considering proposals to develop new renewable electricity generation activities, decision-makers must have particular regard to the relative degree of reversibility of the adverse environmental effects associated with proposed generation technologies;

- by 13 March 2012, local authorities are to notify a plan change, proposed plan or variation to introduce objectives, policies and (where appropriate) methods, into policy statements and plans to enable activities associated with:

  - the identification and assessment by generators of potential sites and energy sources for renewable electricity generation;

  - research-scale investigation into emerging renewable electricity generation technologies and methods; and

  - the development and operation of small and community-scale distributed renewable electricity generation.

Comment

The proposed policy is welcomed. We consider it takes the right factors into account. The question is whether those factors have the appropriate weightings attributed to them. For example, should reversibility be given more consideration over security of supply or vice-versa? We think this is a legitimate debate for the industry to have.

To access a copy of the proposed National Policy Statement for Renewable Electricity Generation and a copy of the Evaluation Report on the NPS visit the Ministry for the Environment's website at www.mfe.govt.nz.

The Minster for the Environment has appointed a Board of Inquiry to hear public submissions and provide recommendations to the Minister. It is expected that the Board of Inquiry will publicly notify the proposed national policy statement and call for public submissions shortly.

For further information, please contact:

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Amendments to the Electricity Industry Reform Act 1998

A decade ago, the electricity industry went through fundamental reform as restrictions were placed on the ownership or operation of both a line network business and a generation retail business. The proposed amendments to the Electricity Industry Reform Act further water down the strict rules on separation. A lines company can now own and operate new renewable generation and sell the output to consumers connected to its network. In addition, certain other combinations of line businesses and generation retail businesses are now permitted. In this article, partner Garry Downs, senior associate Louise Hill and solicitor Sukhdeep Johal outline the latest amendments and describe the impact of the Bill should it be passed in its current form.

Introduction

In June 2008 the Commerce Committee reported back on the Electricity Industry Reform Amendment Bill. The recommendation of the Commerce Committee was that the Bill be passed with the amendments set out in the Commerce Committee's report.

As previously reported in the Summer 2008 issue of Commercial Quarterly, the proposed amendments to the Electricity Industry Reform Act are intended to further relax the ownership separation rules and restrictions for lines companies and generation/supply companies. The Bill seeks to encourage lines companies to invest in permitted generation, particularly renewable generation. It proposes to achieve this by:

- relaxing some of the corporate separation and arm's length rules relating to generation and retailing;
- allowing electricity lines businesses to sell more electricity;
- allowing electricity lines businesses to hedge the output of their generation; and
- allowing electricity lines businesses to invest in generation and retail without limit outside their own lines areas.

In its report the Commerce Committee indicated that submissions fell mainly into two opposite schools of thought: one of them that nothing short of repeal of the entire Electricity Industry Reform Act would suffice, and the other that the amendments in the Bill are more than is needed. The Commerce Committee appears to have disagreed with both; it considers that the Bill should be passed with the recommendations set out in its report.

The Commerce Committee's recommendations largely clarify the Bill, and are welcome. The key changes made by the Commerce Committee are:

- making it clear that only the proportion of generation that is owned by the lines business is counted towards its connected generation (for example if a lines company owns 10 percent of a 200MW generator, then it is attributed with 20MW of generation to count towards its connected generation cap). The selling cap does not change in proportion to the extent of the lines company's interest in the business selling the electricity;
- making it clear that generation disregarded for the purpose of calculating the connected generation cap rule (such as renewable electricity generation) would nevertheless be counted towards the threshold for corporate separation and arm's length rules. The effect of this is that although a lines company may invest in renewable generation without such generation counting towards the lines company's connected generation cap, the lines company must still comply with the arm's length rules and corporate separation rules;
- inserting a new provision providing that a lines business that is involved in 5MW of connected generation and selling more than 5GWh per annum of electricity to connected customers must have a comprehensive, written use of systems agreement with its retail arm. This agreement should not discriminate in favour of the generation business and must be published on the generator's internet site; and

- inserting a new Schedule 1 in replace of the existing Schedule 1 of the Act. Schedule 1 sets out the arm's length rules. The effect of the new schedule is that businesses must not discriminate in favour of their sister business or the customers, suppliers or members of their sister business, and must not enter into a transaction in which its sister business is interested if the terms of the transaction are such that unrelated parties in the position of the parties to the transaction, each acting independently and in its own best interests, would not have agreed to. Each business must have at least one independent director that is not a director or manager of the other business and must not share any executive directors. If the generation business is involved in more than 30MW of connected generation, including any renewable generation or other generation which is not counted towards the connected generation cap, then the managers of the lines company must be separate from the managers of the generation company (this applies only to managers and not to directors).

What can a lines company do?

What exactly can a lines company do in relation to ownership or operation of generation activities? We set out below a quick guide to the main activities that a lines company can be involved in.

- A lines company may invest in thermal or renewable generation and sell the results of that generation in any region outside of its lines area, without restriction. It need not comply with the arm's length separation rules provided that the generation is not connected to its lines.

- A lines company may invest in "new" (ie. generation commissioned after 8 August 2001) renewable generation which is connected to its lines, of any size. This renewable generation does not count towards the lines company's connected generation cap. This also applies to generators that are partly renewable and partly fossil fuel based, provided that fossil fuels provide no more than 20 percent of the fuel for the generator in any 12 month period. The lines company may sell this electricity to the customers within its lines area.

  If the renewable generation is over 5MW the lines company must have a comprehensive, written use of systems agreement that provides for the supply of lines services to the business that is involved in selling electricity. The use of systems agreement must not discriminate in favour of one business and must contain arrangements that include elements that the business usually omits or omit electricity that the business usually includes in use of systems agreements with independent parties. The use of systems agreement must be published on the internet. In addition, the directors of the electricity business must publish on an internet site a certificate signed by the directors stating whether or not, in the preceding calendar year, the terms of the use of system agreement are a true and fair view of the terms on which line services were supplied during that year.

  The lines company must also comply with the arm's length rules if the lines company is involved in more than 10MW of connected generation. In that case, the business involving the relevant line must be carried on in a different company from the company that carries on the business involving the qualifying generation or the selling to connected customers. The businesses must then comply with the requirements of Schedule 1, which are outlined in general terms above.

- A lines company may invest in thermal generation up to 50MW (or 20 percent of the average of the maximum demand, in the immediately preceding three financial years, on the local network area). Again, if over 5MW the lines company must comply with the requirements in relation to the use of systems agreement described above, and if over 10MW, the lines company must comply with the arm's length rules described above. The lines company may sell this generation to its customers within its lines business area.

- A lines company may be involved in the generation of reserve energy that is in accordance with the terms and conditions for that reserve energy set by the Commission, and this is not included in the connected generation cap of the lines company.

- A generator can own lines which are not connected directly or indirectly, to the national grid.

- A generator can own lines which convey electricity only from a generator to the national grid or from the national grid to a generator.

- A generator can own lines which convey electricity mostly in competition with another line or lines operated by another electricity business that is not an associate of the generator, provided that the competition is actual competition and not potential competition.

Bell Gully comment

We think the proposed changes are sensible as far as they go. Among other things they allow a line company to invest in a new wind farm or other renewable project and obtain a natural hedge to the project economics by selling the output to consumers on their network should they wish to.

However, if you stand back from these proposed changes they are really saying that the market issues that originally drove the 1998 reforms are, for a variety of reasons not so relevant in 2008. If you accept this, then there is a strong case to be made for repealing the Electricity Industry Reform Act in its entirety and retaining only the now – sensible arm's length operational separation rules. This could drive further simplicity and efficiency in the electricity industry while retaining appropriate protections for consumers via the other regulatory mechanisms which currently exist.

For further information, please contact:

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Partner

Louise Hill
Senior Associate

To access the Commerce Select Committee's report on the Electricity Industry Reform Amendment Bill visit parliament's website at www.parliament.nz/en-NZ/SC/Reports/.

Bell Gully News

Partnering for success at Morgo 2008

New Zealand's premier event for entrepreneurs and high growth companies takes place at Waitangi this week and Bell Gully is partnering with Morgo again this year as a conference sponsor.

Investing in funds management practice

The rapid growth in New Zealand's funds management and investment sector has prompted Bell Gully to expand its specialist practice.

Effective risk allocation in infrastructure projects

Bell Gully partners Garry Downs and Hugh Kettle have examined how identifying and allocating risk is an important part of delivering successful infrastructure projects at the New Zealand Council for Infrastructure Development's major Auckland symposium.

Bell Gully supports PPP for vital infrastructure project

Bell Gully has made a submission to the Government backing the use of public private partnerships (PPP) for important New Zealand infrastructure development such as the Waterview Connection.

Resource management expert joins Bell Gully partnership

Andrew Beatson, one of New Zealand's leading resource management and infrastructure law specialists, is the newest partner at law firm Bell Gully.

Bell Gully named New Zealand's Who's Who Legal Firm of the Year for third year running

Bell Gully has just been named New Zealand Law Firm of the Year in the Who's Who Legal 2008 awards. The firm has now received the award every year since its inception three years ago.

Bell Gully partner appointed to the Accounting Standards Review Board

Commerce Minister Lianne Dalziel has announced the appointment of Bell Gully partner Ralph Simpson as a new member of the Accounting Standards Review Board (ASRB) for a five-year term.

Bell Gully advises on electronics industry acquisition

Bell Gully has advised international power and automation technology group ABB on its acquisition of the business assets of New Zealand company Vectek Electronics.

Useful web links

New Zealand Government

- Inland Revenue Department [www.ird.govt.nz]
- Ministry of Economic Development [www.med.govt.nz]
- Ministry of Foreign Affairs and Trade [www.mfat.govt.nz]
- Ministry of Labour [www.dol.govt.nz]
- New Zealand Government [www.govt.nz]
- NZ Government E-Commerce Information [www.ecommerce.govt.nz]
- NZ Treasury [www.treasury.govt.nz]
- New Zealand Trade and Enterprise [www.nzte.govt.nz]
- Office of the Clerk of the House of Representatives [www.clerk.parliament.govt.nz]
- Parliamentary Counsel Office [www.pco.parliament.govt.nz]
- Statistics New Zealand [www.stats.govt.nz]

New Zealand regulatory agencies and organisations

- Commerce Commission [www.comcom.govt.nz]
- The Companies Office [www.companies.govt.nz]
- NZ Law Commission [www.lawcom.govt.nz]
- Office of the Ombudsmen [www.ombudsmen.govt.nz]
- Securities Commission [www.sec-com.govt.nz]
- Takeovers Panel [www.takeovers.govt.nz]
- NZ Stock Exchange [www.nzx.com]

New Zealand commercial sites

- CLANZ [www.clanz.org]
- Institute of Chartered Accountants [www.icanz.co.nz]
- Institute of Directors in New Zealand [www.iod.govt.nz]
- NZ Bankers' Association [www.nzba.org.nz]
- NZ Business Roundtable [www.nzbr.org.nz]
- NZ Institute of Economic Research [www.nzier.org.nz]

Australian sites

- Australian Financial Markets Association [www.afma.com.au]
- Australian Securities and Investment Commission [www.asic.gov.au]
- Australian Stock Exchange [www.asx.com.au]

International sites

- NASDAQ [www.nasdaq.com]
- New York Stock Exchange [www.nyse.com]
- United States Securities and Exchange Commission [www.sec.gov]