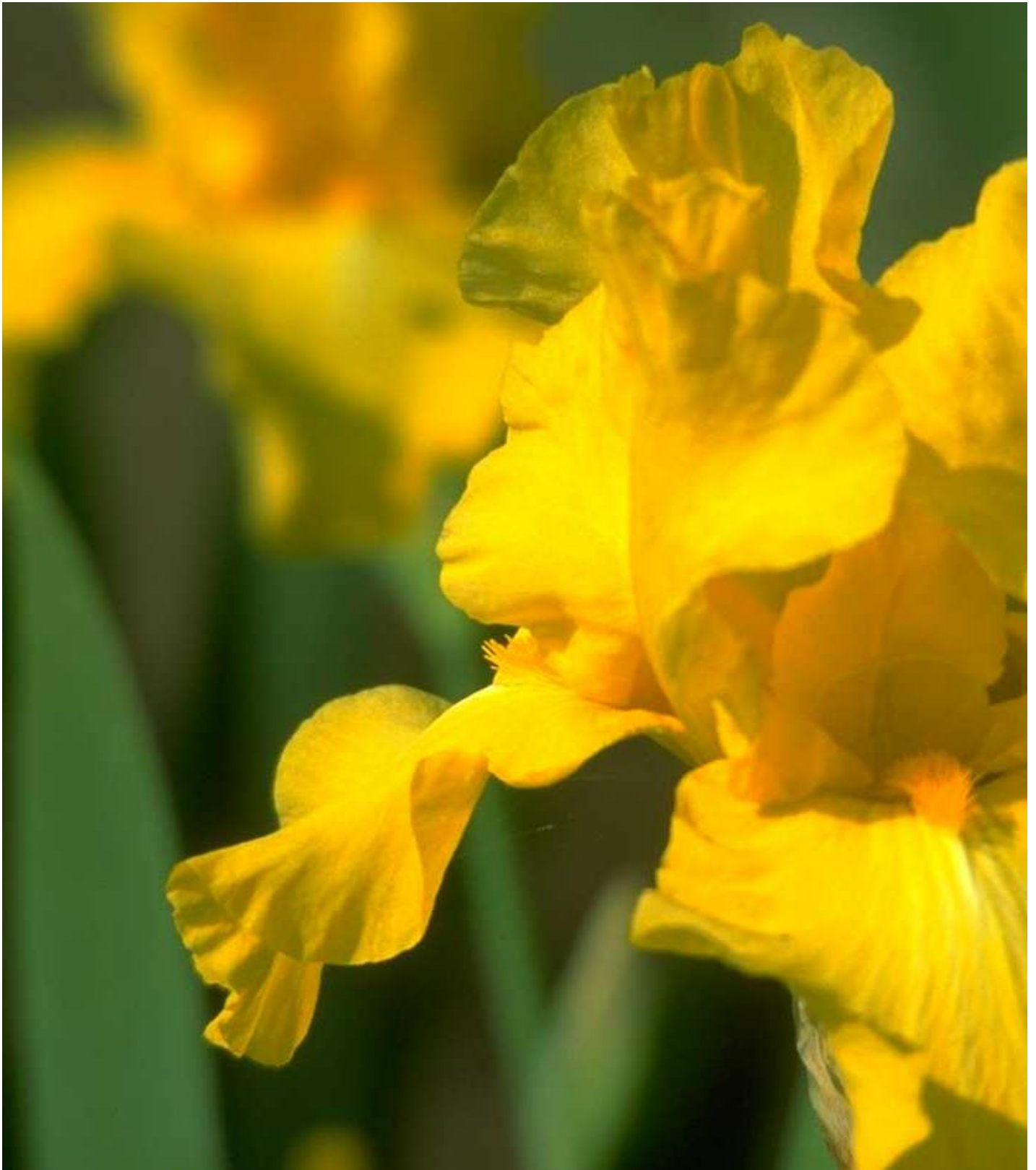


Financial Services Quarterly

SPRING 2006

Bell Gully





Welcome to the Spring 2006 issue of *Financial Services Quarterly*, a review of current legal issues in the financial sector.

Each quarter, we summarise recent issues and preview upcoming developments under these headings:

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Need more information?

For more information on any of the cases, articles and features in *Financial Services Quarterly*, please email rachel.gowing@bellgully.com or call on 64 9 916 8825.

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.

In the courts

Change demand lodged at the PPSR

A case seeking maintenance of financing statements on the PPSR when a change demand had been lodged by the debtor.

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Director's bankruptcy does not invalidate company actions and failure to disclose does not preclude enforcement

The High Court has decided that the bankruptcy of a director does not invalidate actions taken on behalf of the company and that failure by a lender to disclose under the Credit Contracts Act does not necessarily preclude enforcement.

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An unusual history of payments prevented payments from being set aside even though they were made within the specified period and when the company was unable to pay its debts.

Sale at undervalue can prejudice a lender's ability to claim under a guarantee

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Relief orders granted under Securities Act for late filing

An Australian-based fund manager failed to comply with certain requirements of the New Zealand Securities Act (Australian Registered Managed Investment Schemes) Exemption Notice 1999.

Analysis of a one page guarantee

The court had to consider whether a non-standard one page guarantee adequately identified the plaintiff, whether it was simply an agreement to guarantee, whether consideration was given and whether the guarantee was an independent obligation.

In the journals

Reform of New Zealand's financial sector law

This article discusses four separate reviews of New Zealand's financial sector law that are currently being undertaken, with nine discussion documents having been released.

S&P picks more flops in finance

This article discusses an assertion by credit ratings agency Standard and Poor's that five or more companies in the non-bank finance sector are likely to fail in the next year.

Voluntary administration

In this article, examples show that voluntary administration is already a part of New Zealand's insolvency landscape.

Anti-money laundering reforms: another compliance headache for business

In this article, the author argues that the compliance burden for businesses looks set to increase if the Government enacts proposals contained in a Ministry of Justice discussion document on Anti-Money Laundering and Countering the Financing of Terrorism.

Legislation/In Parliament

Commerce Committee reports back on the Business Law Reform Bill

The Business Law Reform Bill has been reported back to the House by the Commerce Committee. The Bill includes amendments to the Companies Act 1993 and the Financial Reporting Act 1993. It also consequentially amends the Corporations (Investigation and Management) Act 1989, the Reserve Bank of New Zealand Act and the Securities Markets Act 1988.

Securities Commission releases third review of financial reports

The Securities Commission has completed the third cycle of its financial reporting surveillance programme. The reviews aim to encourage issuers to improve the quality of their financial reports and thus contribute to the integrity of New Zealand's securities markets.

Draft regulations regarding mutual recognition of securities offerings released

Commerce Minister Lianne Dalziel has released draft regulations to implement the next step in co-ordinating business law in New Zealand and Australia.

New maximum priority amounts for preferential claims by creditors

The maximum priority amount that applies to certain preferential claims by creditors of a company in liquidation or by creditors of a bankrupt person, has been increased.

Final discussion document released on proposals to prevent money laundering and terrorist financing

Associate Justice Minister Clayton Cosgrove has released the third and final discussion document on proposals to prevent money laundering and terrorist financing.

Recent developments

CCCFA – compliance issues you should know about

The Commerce Commission has distributed an article on compliance issues under the Credit Contracts and Consumer Finance Act to industry groups.

Insolvency Law Reform Bill – Select Committee Report

This Bill has now been passed and is awaiting assent.

Finance companies improve their disclosure, but risks remain

The Securities Commission has reviewed the offer documents of 20 companies prepared since its report.

Developments in New Zealand’s securities market regulatory framework

In a speech made by a member of the New Zealand Securities Commission, the focus was on four developments in the New Zealand regulatory framework.

In the courts

Change demand lodged at the PPSR

This was a case seeking maintenance of financing statements on the PPSR following lodgement of a change demand by the debtor that they be removed.

In this case¹, a company (the purchaser) purchased two Lamborghini cars from another company (the vendor) in April this year. The changes of ownership were recorded on 18 and 23 May.

Subsequently, the purchaser became aware that a third company (the third party) had registered financing statements in respect of the two cars. Pursuant to section 162(d) of the Personal Property Securities Act (the PPSA), the purchaser lodged a change demand that the financing statements be removed on the grounds that the third party did not hold a security interest over the cars.

Section 165 of the PPSA provides that the person lodging the demand under s 162 may enter a financing change statement discharging the registration if the secured party fails, within 15 working days after the demand is given, to comply with the demand or to obtain a court order maintaining the registration.

Section 167 provides that at any time before the financing change statement is registered, the court may, on application by the secured party, and if satisfied that none of the grounds for making a demand under section 162 exist, order that the registration be maintained or be discharged or amended.

Accordingly, the lodging of the change demand by the purchaser meant that, unless the third party obtained an urgent court order that the financing statements be maintained, they would be discharged.

The third party elected to seek a court order maintaining the financing statements.

It turned out that the third party had filed the financing statements on the grounds that it had a security interest in both cars that derived from either:

- an alleged oral agreement to provide the third party with an opportunity to purchase either of the cars at a reduced price as a commission fee for brokering an arrangement between the vendor and a third party for the exchange of land for the cars; or
- an oral agreement in respect of one of the cars between the third party and the vendor. Apparently, the vendor had offered to sell the car for a price that the third party wished to pay in two instalments and the vendor had said that it would consider the instalment payment proposal.

The purchaser asserted that no security interest existed and so issued the demand in reliance on s 162(d) of the PPSA.

The court decided that the first alleged agreement failed for lack of certainty as to the essential term of price and as to the nature of the contractual right of the third party. The second alleged agreement failed on the grounds that no concluded contract had been made.

The court noted that, even if a contract could be shown to exist, it would create personal rights and obligations as between the parties to the agreement, and not a security interest in the property.

The financing statements were discharged.

¹ *Asset Traders Ltd v Favas Sportscar World Ltd*, 3 August 2006, High Court Auckland CIV 2006-404-004353

An individual who signed as a director was not personally bound

The Court of Appeal¹ has allowed an appeal by an individual who, in the High Court was found personally liable under a guarantee in a sale and purchase agreement, even though she signed that agreement as a director of the principal debtor and not as a guarantor.

The High Court decision was summarised in the Summer 2006 issue of [Financial Services Quarterly](#).

The Court of Appeal did not dispute that it is possible for a person to sign a contract once but in a dual capacity. However, there is a presumption that, if the person signing purports to sign on behalf of a company or other person, he or she is signing only in that capacity. The court decided that it would take clear words or extrinsic evidence to rebut that presumption.

In this case, the Court of Appeal found that:

- the sale and purchase agreement made no reference to the individual as a party;
- another director of the principal debtor could have signed and the vendor had no reason to expect this particular individual to do so;
- the guarantee provision could be read as a covenant by the principal debtor to procure a separate guarantee from the individual;
- the individual had added the word "director" beneath her name when she signed; and
- there was no evidence of the individual orally agreeing to provide a guarantee.

Consequently, this case was able to be distinguished from other cases where directors have been found to sign in dual capacities (and is more consistent with decisions in other cases where, on similar facts, directors have not been liable).

The Court of Appeal concluded that it was "fairly arguable " that the individual had signed only as a director of the principal debtor and that summary judgment should not have been entered against her. It was recognised, however, that other evidence may emerge at full trial.

¹ *Vuletic v Contributory Mortgage Nominees Limited* 17 May 2006, Court of Appeal, CA250/05

Director's bankruptcy does not invalidate company actions and failure to disclose does not preclude enforcement

The High Court has decided that the bankruptcy of a director does not invalidate actions taken on behalf of the company and that failure by a lender to disclose under the Credit Contracts Act does not necessarily preclude enforcement.

In this case¹, a company (the lender) lent \$100,000 to another company (the borrower) so that its director could set up a carpet retail business. In November 1999, the borrower granted a mortgage in favour of the lender. There was no separate loan agreement, just the mortgage in the name of the borrower, which contained a deed of covenant in the director's name. The mortgage was not registered, but a caveat was lodged.

In March 2000, the director was adjudicated bankrupt, and in May 2000 he resigned as a director of the borrower.

In February 2001, an amended loan agreement was signed by the director. The loan agreement capitalised the interest due, increasing the loan to \$112,000. In addition, the term of the loan was extended to May 2001. However, no interest was paid and the principal sum was not repaid on its due date.

Various steps were taken by the lender to recover the loan.

In the High Court, the lender claimed \$112,000 plus interest from the borrower on the basis of a loan agreement and mortgage. It also claimed that the director had guaranteed the loan. Both the borrower and the director denied that they owed any money to the lender and raised a number of defences.

The judge pointed out that the issues in this case were based on contract, not enforcement steps taken under a mortgage. There was no doubt that the agreement to lend money between the lender and the borrower was a credit contract. The issues were:

- whether an enforceable contract was created and who it was between;
- whether the director was liable as a guarantor;
- the effect of the variation to the contract;
- whether there had been a failure to disclose under the Credit Contracts Act 1981; and
- whether, if there was a valid contract and there had been failure to disclose, the court should grant relief.

Justice Asher decided that:

- The loan contract was enforceable.
- The borrower was liable contractually under the amended loan agreement, pursuant to which it borrowed \$112,000 for 16 months at an interest rate of 16% per annum.
- Although the amended loan agreement was signed by the director and a witness, it reads as if his signature was on behalf of the borrower and himself because the agreement referred to both the borrower as mortgagor and the director as covenantor.

"The task of interpretation of the ambit of an attestation is no different from the interpretation of any other part of a contract. It is necessary to consider all the provisions in the document and the signature in its context to ascertain as a matter of interpretation, the capacity in which it has been signed."

¹ *Mardon & Stephens Group Ltd v Zenn Holdings Ltd*, 1 August 2006 – High Court, Auckland CIV-2006-404-707

- The fact that a director has become bankrupt does not invalidate actions taken by that person on behalf of the company - section 18(1)(c) of the Companies Act 1993 must apply.
- There is no doubt that the director's bankruptcy discharged him from any obligations as covenantor under the first loan agreement. The guarantee was a debt provable in his bankruptcy under section 114 of the Insolvency Act 1967. However, he was liable as guarantor under the amended loan agreement.
- The lender had failed to disclose under the Credit Contracts Act 1981. However, the judge decided that the creditor should not be prevented from enforcing the contract because it was not a financier, the failure to disclose was inadvertent, the essential terms of the agreement were made known and the director was not prejudiced by the failure to disclose.

The judge determined that a fair penalty was the deduction of one year's interest (\$17,920) from \$112,000.

Unusual history of payments prevents them being set aside on insolvency

In this case¹, an unusual history of payments prevented payments from being set aside even though they were made within the specified period and when the company was unable to pay its debts.

The case involved an application by liquidators under section 292 of the Companies Act 1993 to set aside payments made by a company to an equipment hire business (the applicant).

It was not disputed that the payments took place during the specified period and at a time when the company was unable to pay its debts. However, the applicant claimed that it received the amounts in good faith and altered its position in the reasonably held belief that the payments were validly made.

The High Court agreed with the applicant in part. Looking at the established pattern of trade between the two businesses, it found that there was no orderly appropriation of payments to invoices and so, in accepting certain payments from the insolvent company, the applicant was merely acting in the ordinary (albeit unusual) course of business, and not in anticipation of the company's demise.

However, the applicant also accepted other payments on behalf of the insolvent company from a third party and those payments were found by the court to be voidable because there was no history of trading with, or receiving payments from, that third party.

¹ *Re Yukich Brothers Limited*, 1 June 2006, High Court, Auckland, CIV 2005-404-3056

Sale at undervalue can prejudice a lender's ability to claim under a guarantee

In this case¹, guarantors successfully claimed that the value of their guarantee should be reduced by the amount lost on sale.

An English football club borrowed a significant amount of money, security for which was given over its football stadium. The loan was guaranteed by the directors of the club up to a maximum amount of £100,000.

Administrators were subsequently appointed to the club, who sold the stadium and other assets. However, the lender still had unsatisfied indebtedness of £136,000.

Demand was made under the guarantee, but the guarantors claimed that the bank sold the property at an undervalue, which breached its equitable duty of care. Accordingly, they claimed that the value of the guarantee should be reduced by the same amount as the value wrongly lost from the sale. Since the guarantors argued that the value lost was more than £100,000, the guarantee would effectively be extinguished.

The court agreed with the principles of the claim, and held that:

- a creditor normally has no duty to realise any securities, but, if it does so, it owes a duty to the principal debtor to act prudently and with reasonable care so as to seek to obtain a proper price;
- a creditor also owes such a duty of care to guarantors – a guarantor's liability could (as with the principal debtor) be reduced or extinguished by the amount realised by the creditor; and
- that duty was not removed by the express terms of the guarantee in this case, although it stated that the guarantee:
 - was unconditional and "all liabilities";
 - was payable on demand; and
 - would not be affected by the bank enforcing its security rights or doing, or failing to do, anything else.

In New Zealand, Section 103A of the Property Law Act imposes on lenders a comparable duty to mortgagors to take reasonable care to obtain the best price reasonably obtainable at the time of sale.

¹ *Barclays Bank PLC V Kingston* [2006] EWHC 533 (QB)

Drawings or shareholder loans?

In this case¹, the court had to decide whether payments made to directors and shareholders of a company in liquidation were drawings or shareholder loans.

The defendants were both directors and shareholders of the plaintiff company in liquidation. Within the three years prior to the company's insolvency, the company advanced substantial sums to the defendants. The advances were described as "drawings" in the cash book.

The liquidator argued that the advances were in fact shareholder loans that should be repaid to the company. The defendants argued that the advances were payments made as rewards for their services and that the description in the cash book was for convenience only and needed to be finalised.

The court determined that, because the defendants did not pay tax on the payments they received, and because there was no other evidence supporting the reward for services argument, the payments were repayable shareholder loans.

¹ *Covich Contractors Ltd (in liq.) v Covich* High Court Auckland, CIV-2005-404-006821, 27 July 2006

Relief orders granted under Securities Act for late filing

An Australian-based fund manager failed to comply with certain requirements of the New Zealand Securities Act (Australian Registered Managed Investment Schemes) Exemption Notice 1999 for filing documents with the Registrar of Companies within prescribed time limits.

Under the exemption notice, a fund manager is able to offer securities in New Zealand without registering a prospectus here. In this case¹, the fund manager was applying for a relief order to validate its offer, since, without validation, the subscriptions would become immediately repayable plus 10% interest under the Securities Act 1978.

The Securities Commission did not oppose the application, and only one of the 375 investors in the relevant securities objected to a relief order being made.

Relief orders were granted for the other 374 investors. The court went on to consider the position in respect of the objecting investor, but ultimately found that late filing was a purely technical breach of the legislation that had not resulted in the investor being "materially prejudiced". The investor may have found that the investments yielded less than had been hoped for, but that was not a prejudice that was material to, or caused by, the failure to file on time.

A relief order was granted by the court using its discretionary powers under s37AH of the Securities Act.

¹ *Re Perpetual Investments Management Limited* 21 June 2006, High Court, Wellington, CIV 2005-485-1565

Analysis of a one page guarantee

In this case¹, the court had to consider whether a non-standard one page guarantee adequately identified the plaintiff, whether it was simply an agreement to guarantee, whether consideration was given and whether the guarantee was an independent obligation.

A family trust was the owner of a property on which a new home was to be constructed. The first and second defendants were a director and a shareholder of the construction company that carried out the work on the house. A contract was entered into in April 2004. The work started later than anticipated and there were various delays, which are the subject of another dispute between the parties.

In December 2005, a document titled "Guarantee" purporting to guarantee the obligations of the construction company up to \$500,000, was signed by the defendants. The guarantee was not market standard, and was only one page long.

In March 2006, the trust gave notice of cancellation of the contract and notice to the defendants of claim under the guarantee.

The court had to consider the following issues:

Was the guarantee invalid for failure to identify the plaintiffs?

The defendants argued that the guarantee was unenforceable because the trust, in whose favour it was given, was not a legal person and the identity of the recipient of the guarantee was a material term.

The court determined that even though it is not a legal entity, naming the trust as the recipient of the guarantee was sufficient identification to allow the guarantee to be enforceable for the purposes of the Contracts Enforcement Act.

Was the document only an agreement to agree?

The opening paragraph of the guarantee recorded that the defendants "are jointly and/or individually to enter into and sign in favour of [the trust] a deed of guarantee...".

The court decided that the opening paragraph was merely a preamble to the operative part of the document and that the operative provisions made it clear that it was intended to be a binding guarantee and not an agreement to enter into a guarantee in the future.

Was consideration needed and, if so, was it given?

The court decided that because the formalities required by section 4(1) of the Property Law Act were all present:

- it was signed by the party to be bound;
- it was attested to by a witness who had added his signature, place of abode and calling; and
- it was a deed and therefore consideration was not necessary.

The court also noted (quoting *O'Donovan & Phillips, The Modern Contract of Guarantee*) that it was not necessary for the parties suing under the guarantee to sign it.

Was the guarantee an independent obligation or dependent on a breach by the construction company?

The court determined that the guarantee was an independent obligation because it stated that the guarantors were "liable as principal guarantors".

¹ *Rhee Family Trust & Anor v Cho & Anor* AK CIV 2006-404-1512, 28 August 2006

In the journals

Reform of New Zealand's financial sector law

David Craig, Journal of International Banking and Financial Law

Four separate reviews of New Zealand's financial sector law are currently being undertaken, with nine discussion documents having been released.

New Zealand is currently undertaking four separate reviews of New Zealand's financial sector laws:

- Review of Financial Products and Providers;
- Review of Domestic Institutional Arrangements;
- Review of Anti-Money Laundering and Countering the Financing of Terrorism Laws; and
- Review of Financial Intermediaries.

Nine discussion documents have been released, and broadly, the following proposals have been made:

- the financial sector will become considerably more regulated than it is now - in particular, non-bank deposit takers and insurers will be subject to much more onerous regulatory regimes;
- in addition to the costs associated with the proposed new licensing regimes, financial institutions will also face costs associated with more extensive disclosure; and
- the regulators (in particular, the Securities Commission but also the Reserve Bank of New Zealand) will have significantly broader responsibilities and powers (and, presumably, will need more resources) than they do now.

The nine headings below replicate the subject matter of the nine discussion documents.

Registration of financial institutions

The Ministry of Economic Development has proposed that the Companies Office register financial institutions that are not otherwise subject to a registration regime. As part of the registration process, the Companies Office would collect base level information about the institution and undertake negative assurance checks relating to directors, senior management and significant shareholders (e.g., that a director does not have a criminal record and is not a recent bankrupt).

By contrast, positive assurance checks (e.g., that a director is a "fit and proper person") would be undertaken by the relevant regulator – most likely the Reserve Bank or the Securities Commission. This register would, like the current Companies Office register, be electronic and publicly available for searching.

In terms of what "financial institutions" will need to register, it is clear that the list will include those institutions required to be registered as part of New Zealand's international anti-money laundering/countering the financing of terrorism obligations. However, the discussion document suggests that other institutions, such as general insurance providers, will also need to register.

Securities Offerings

It is proposed that the Securities Act be amended to clarify what "the public" is in terms of offers of securities "to the public". In particular, the scope of the existing exemptions for "relatives and close business associates" and "professional and habitual investors" would be clarified.

As a related point, feedback has also been sought on whether investors under exempt offers should nonetheless have the protection of certain parts of the Securities Act. For example, while the disclosure regime in the Act would not apply to exempt offers, the misstatement liability regime would apply. It is also proposed that the offer document must contain educational material on financial concepts so that the target audience can understand what is being disclosed.

Finally, a contentious issue raised by the discussion document is whether a continuous disclosure regime should be extended beyond listed securities to all securities where there is an established secondary market. If adopted, this proposal would significantly increase the cost of capital for non-listed issuers.

Supervision of Issuers

The general conclusion seems to be that the current regime of trustee supervision for debt and collective investment scheme issuers is sound. There appears to be little appetite for a single Government regulator to replace trustees as the frontline monitor of these issuers. However, it is proposed that trustees be subject to entry approval, and general oversight, by the Securities Commission.

In the interests of consistency, it is also proposed that trust deeds disclose certain mandatory matters and contain certain minimum protections for investors in debt securities.

Collective Investment Schemes (CISs)

CIS products include unit trusts, superannuation schemes, KiwiSaver schemes, life insurance policies with an investment component and participatory securities. They are currently regulated under a number of unrelated pieces of legislation. The proposal is that there should be a uniform set of rules applying to CISs. The only exception would be for existing employer stand-alone and defined benefit superannuation schemes, which would be subject to a transitional structure to minimise scheme wind-up.

The single regulatory framework for CISs would involve, among other things:

- oversight by an independent trustee supervisor;
- entry and ongoing requirements for issuers;
- clearer and more effective powers for trustees and the Securities Commission; and
- consistent trust deed requirements.

Non-Bank Deposit Takers (NBDTs)

The discussion document for NBDTs proposes significant change. NBDTs are financial institutions, other than banks, whose core business involves borrowing money from the public to lend to others. The category includes finance companies, credit unions and building societies. The clear premise of this discussion document is that NBDTs pose additional risks to investors (over and above those of other debt issuers), which justify special treatment. The key proposal is that there be two tiers of NBDTs:

- Tier one – authorised deposit takers (ADTs). ADTs must meet licensing and supervisory requirements similar to those applied to registered banks. ADTs are likely to be regulated by the Reserve Bank, which would have the power to require a deposit taker to become an ADT where the size or nature of its business makes it systemically important.
- Tier two – other deposit takers. This group would be supervised under an enhanced trustee-based model. It would be regulated by the Securities Commission and its members would be required to disclose prominently that they are not ADTs.

It is proposed that a special case be made for credit unions and building societies that do not become ADTs. These entities would be regulated by the Reserve Bank, but under a modified model that reflects their small size and mutual nature.

Insurance

New Zealand's insurance legislation is piecemeal and often arbitrary in its application to particular providers or products. The main proposal of this discussion document is a single regulatory regime to apply to all insurance products and providers. The features of that regime would include:

- licensing and prudential requirements for all insurance providers (including "fit and proper person" vetting for directors, senior management and significant shareholders, a start-up solvency support plan and a start-up capital requirement);
- the requirement of a physical presence in New Zealand to obtain a licence to operate as an insurer in New Zealand;
- monitoring and supervision by the Insurance and Superannuation Unit, which focuses on disclosure and director attestation; and

- potentially, mandatory ratings for all insurers and a requirement for accounting separation (with segregated funds) for life, general and health insurance businesses.

Mutuals' Governance

Mutual financial institutions include friendly societies, insurance mutuals, credit unions, industrial and provident societies and building societies. Currently, each of these entity types is regulated under its own legislation. This discussion document proposes that one statute set out base-level corporate governance standards for mutuals, but recognises that there may need to be some flexibility in the application of these statutory standards given the special features of each type of mutual.

Consumer Dispute Resolution and Redress

At present, the two main mechanisms for consumer redress in the financial services sector are the Banking Ombudsman and the Insurance & Savings Ombudsman schemes. This discussion document notes that there are gaps where aggrieved consumers have no real alternative to seeking redress through the courts. Rather than proposing a single regime to deal with this issue, the discussion paper presents a series of options for reform. These options range from the "do nothing" option to compulsory membership of an industry-based dispute resolution system.

Platforms and Portfolio Management Services

Platforms and portfolio management services are computerised administration services that are designed to hold, trade and report on investments. They bundle together the functions of a financial adviser, a custodian and, in the case of a platform only, an administrator.

The services offered through these internet-based platforms, as distinct from the securities that may be traded through them, are largely unregulated in New Zealand.

This discussion document proposes to change that by:

- requiring platform providers, portfolio service providers and custodians to be registered, and to be approved and supervised by the Securities Commission;
- specifying statutory duties for platform providers (e.g., to appoint a registered custodian and ensure the platform is operated in a proper and efficient manner) and custodians (e.g., to hold assets as bare trustee on behalf of investors and to have independent audits conducted); and
- requiring service providers to send investors a disclosure statement. That statement would set out information about the service and its associated costs and risks, and the identity and responsibilities of the service provider and the custodian.

What next?

Following receipt of submissions on the discussion documents in December 2006, the Ministry of Economic Development will develop policy proposals for consideration by Cabinet by April 2007. Assuming Cabinet endorsement, the supporting legislation will then be drafted. The Government hopes to have the legislation in force by 2008.

S&P picks more flops in finance

Andrew Janes, Dominion Post, 15 August 2006

Following completion of a survey of the top 20 New Zealand finance companies, credit ratings agency Standard and Poor's (S&P) have said that five or more companies in the non-bank finance sector are likely to fail in the next year.

S&P said that, with the exception of a handful of larger, more seasoned finance companies, the general quality of the non-bank finance sector is focused towards the lower end of the credit spectrum.

Credit analyst Craig Bennett identified the following three factors that made finance companies vulnerable:

- lack of liquidity;
- high exposure to one sector (for example, the used car market); and
- low level shareholder equity.

Bennett said that *"the key thing is the covenants that are built into the debenture stock"* and noted that the three finance companies who have recently failed were all in breach of their covenants.

S&P considers that there is a lack of transparency in the finance sector and that it is difficult for investors to assess how risk relates to returns. To combat this, S&P suggests improved disclosure and the establishment of an appropriate risk benchmark.

Voluntary administration

William Black, NZ Lawyer, 22 September 2006

In this article, examples show that voluntary administration is already a part of New Zealand's insolvency landscape.

As previously covered in *Financial Services Quarterly*, voluntary administration is a feature of New Zealand's revised insolvency laws. Briefly, voluntary administration is the process whereby a company appoints its own administrators who, in collaboration with the creditors, take necessary measures to give the highest possible return to creditors. This may mean trading for a while longer or providing working capital to the company, as opposed to immediate liquidation.

In Australia, voluntary administration is already an alternative to liquidation. Two proceedings involving New Zealand companies that are subsidiaries of Australian companies are summarised by the author as follows.

First example

A New Zealand company supplied wheels to two major vehicle manufacturers. The company was profitable but it was rendered insolvent by virtue of its exposure under cross guarantees.

The administrators negotiated a "stand-still" agreement with the creditors, pursuant to which creditors agreed not to enforce their guarantees and to freeze their position as at the date of administration. In return, agreements were put in place subordinating the Australian creditors to the New Zealand trade creditors, which enabled the New Zealand company to continue trading in New Zealand.

When the main New Zealand supplier demanded cash on delivery, the administrators supplied \$10 million of working capital to maintain operations at a profitable level.

The expected outcome is that New Zealand creditors will get 100 cents in the dollar and that there will be a substantial surplus for the Australian creditors.

Second example

An Australian mining and civil engineering company put itself into voluntary administration in Australia. The New Zealand branch of the company was directly subject to the voluntary administration process by virtue of its incorporation as an overseas branch.

The administrators closed the unprofitable Australian units and continued trading in New Zealand and in the profitable Australian units while preparing the business for sale.

Under a Deed of Company Arrangement (which all New Zealand and Australian creditors voted on) each creditor should receive 75 cents in the dollar. If the company had been liquidated, it is expected that each creditor would only have received 10 cents in the dollar.

Conclusion

The author's conclusion is that there is obvious economic benefit in making the restructure of distressed companies easier and quicker.

Anti-money laundering reforms: another compliance headache for business

Anthony Davies, The Independent, 30 August 2006

The author argues that the compliance burden for businesses looks set to increase if the Government enacts proposals contained in a Ministry of Justice discussion document on Anti-Money Laundering and Countering the Financing of Terrorism.

The discussion document, which is a response to an adverse report from a 2003 IMF Financial Action Taskforce, suggests major amendments to the Financial Transactions Reporting Act 1996. While the need for reform is widely acknowledged, the Institute of Financial Advisors has mixed feelings about the proposed changes and has the following comments about some of the practical aspects of the recommendations:

- the costs and responsibility for record keeping by the advisors are onerous;
- it wants a model providing improved guidance and increased certainty as to what advisors must do;
- it wants a two year implementation period;
- there needs to be a balance between costs and obligations; and
- it cites the requirement to keep records until 5 years after the cessation of a business relationship as "crazy".

It is expected that a legislative reform package will be introduced in 2007.

Legislation/In Parliament

Commerce Committee reports back on the Business Law Reform Bill

The Business Law Reform Bill has been reported back to the House by the Commerce Committee. The Bill includes amendments to the Companies Act 1993 and the Financial Reporting Act 1993. It also consequentially amends the Corporations (Investigation and Management) Act 1989, the Reserve Bank of New Zealand Act, the Securities Markets Act 1988 and the Insurance Companies Deposits Act 1953.

The major changes include:

Companies Act

In relation to annual reports, the committee has proposed that:

- shareholders be sent annual reports or notice of their availability, in which case there will be time limits to comply with a request to receive them; and
- current directors that are subject to an overseas prohibition order will not be automatically disqualified from the directorship when the provision comes into force.

Financial Reporting Act

It is proposed that:

- to simplify the issuing of share purchase and option plans for New Zealand employees, the Securities Commission can exempt directors or classes of directors of issuers that are incorporated or constituted outside New Zealand from preparing, auditing and filing requirements, so long as there is no significant detriment to New Zealand subscribers;
- it be made explicit that a person is a recipient of money from a conduit issuer only if he or she received 10% or more of the money raised from the public, and that the aggregate amount provided to the person and related parties constituted 75% or more of the money raised from the public;
- the definition of "related person" in clause 27 be amended so that it is the same as the definition of "associated person" in section 2(2) of the Securities Markets Act; and
- amendments be made so that certain sections of the Bill apply to and from accounting periods that are in progress when the Act commences, allowing relevant entities to take advantage of the reduction in compliance costs one year earlier.

Insurance Companies Deposits Act

It is proposed that use of the word "insurance" in a company name be prohibited without the consent of the Chief Executive of the Ministry of Commerce.

Securities Commission releases third review of financial reports

The Securities Commission has completed the third cycle of its financial reporting surveillance programme. The reviews aim to encourage issuers to improve the quality of their financial reports and thus contribute to the integrity of New Zealand's securities markets.

The Commission reviewed 45 financial reports with balance dates from 31 March 2005 to 30 September 2005. Nineteen issuers had matters that needed to be addressed and three matters relating to continuous disclosure notices that have been referred to the NZX for consideration.

For the first time, the Commission looked into disclosures required for the transition to New Zealand Equivalents to International Financial Reporting Standards (NZ IFRS). More than half of the reports either did not include information about the transition to NZ IFRS, or only partially complied with the requirements.

"These disclosures are very important for issuers to signal to the market the likely impact of adopting NZ IFRS," Chief Accountant Alastair Boulton said. "A great deal of effort is going into NZ IFRS transition but the Commission is disappointed with the level of response to these disclosures in the financial statements examined in Cycle 3."

The Commission is continuing its Financial Reporting Surveillance Programme and is currently reviewing financial reports of early adopters of NZ IFRS with a 31 December 2005 balance date.

Draft regulations regarding mutual recognition of securities offerings released

Commerce Minister Lianne Dalziel has released draft regulations to implement the next step in co-ordinating business law in New Zealand and Australia.

The draft regulations, to be made under the Securities Act 1978, would enable the mutual recognition of securities offerings, allowing issuers to offer securities in both Australia and New Zealand using the offer documents of their home jurisdiction.

It is the next step towards completing one of the major achievements under the Memorandum of Understanding on Business Law Co-ordination between Australia and New Zealand signed earlier this year.

"The regime is intended to remove unnecessary regulatory barriers to trans-Tasman securities offerings and reduce the costs of raising capital in both Australia and New Zealand".

Submissions closed on 24 October.

In the near future, the Australian Government proposes to release the exposure draft of its Bill to implement the regime.

New maximum priority amounts for preferential claims by creditors

The maximum priority amount that applies to certain preferential claims by creditors of a company in liquidation or by creditors of a bankrupt person, has been increased from \$15,000 to \$16,420.

This revised figure is to take into account the overall percentage increase in average weekly earnings in the private sector.

The regulations effecting this change came into force on 30 September 2006.

Final discussion document released on proposals to prevent money laundering and terrorist financing

Associate Justice Minister Clayton Cosgrove has released the third and final discussion document on proposals to prevent money laundering and terrorist financing.

The discussion documents outline proposed regulatory changes to enable New Zealand to meet its Financial Action Task Force (FATF) obligations.

FATF's 33 members include New Zealand, the United States, Great Britain, Canada and Australia.

Mr Cosgrove stated that "*New Zealand's stable financial system makes it attractive for international criminals to deposit funds here and then move the money to other jurisdictions, so we must not be a weak target. Money laundering also occurs here, primarily by drug dealers, so these measures are important for making our communities safer.*"

The third discussion document seeks comment on the proposed framework for monitoring and enforcing businesses' compliance with the FATF compliance requirements.

Mr Cosgrove said that the Government is proposing the most cost-effective, business-friendly option, noting "*our aim is to minimise costs by using existing regulatory arrangements rather than creating a new agency to carry out this vital work. For example, it is proposed that the Reserve Bank, the Securities Commission and the Department of Internal Affairs supervise the businesses they already regulate for other purposes.*"

The Government plans to introduce the proposed framework in two stages to allow more time to consult with industry over the supervisory requirements. Mr Cosgrove said the approach is broadly consistent with the Australian reform process currently underway.

Financial institutions and casinos will be the first group of businesses covered by the new requirements. Other businesses, including lawyers, accountants, and real estate agents, will be not be covered until the second stage, although they will remain subject to their existing legal obligations to prevent money laundering and terrorist financing.

The document *Anti-Money Laundering And Countering The Financing Of Terrorism: Supervisory Framework* is available on the Ministry of Justice's website at www.justice.govt.nz.

Submissions close on 30 November 2006.

Recent developments

CCCFA – compliance issues you should know about

The Commerce Commission has distributed an article on compliance issues under the Credit Contracts and Consumer Finance Act (the CCCFA) to industry groups.

In its article, the Commission summarises enforcement actions taken against creditors who, in the Commission's view, have breached the CCCFA.

The Commission has:

- commenced criminal proceedings against two creditors;
- entered into a settlement with one creditor;
- issued formal warnings to 13 creditors; and
- issued compliance advice letters to six creditors.

The following key compliance issues have been highlighted by the Commission:

Disclosure

- Legible disclosure must be made;
- failure to properly disclose prevents enforcement;
- documents must be updated to reflect the different requirements of the CCCFA; and
- some people don't realise their activities are covered by the CCCFA.

Improving compliance with the disclosure requirements of the CCCFA is a stated priority for the Commission.

Two creditors are being prosecuted by the Commission under both the CCCFA and the Fair Trading Act for disclosure-related breaches. Specifically, one company failed to update its documents to comply with the CCCFA, and another company disclosed using a faxed photocopy, which was effectively illegible.

Unreasonable fees

Credit fees must be reasonable. The Commission expects that creditors will have undertaken a cost analysis process to set their fees and is using this to decide whether it thinks fees are unreasonable.

Establishment fees

It is the Commission's view that establishment fees must be restricted to those costs that are directly attributable to establishing the loan, such as processing the application and documenting the contract.

Provision for bad debts

The Commission has advised a creditor against including provision for the costs associated with bad and doubtful debts in its monthly administration fee. It also notes that no provision for bad or doubtful debts should be included as part of a default fee and that the averaging of the costs associated with bad and doubtful debts over all defaulting debtors is unreasonable and likely to be a breach of the CCCFA.

Third party fees

Third party fees must not exceed what the third party actually charged the creditor. A creditor has been warned about its practice of charging the cost of staff time in carrying out searches of the Personal Property Securities Register.

Commissions on credit-related insurance

In November 2005, the Commission issued guidelines on its position relating to "reasonable commission" allowed to be retained by creditors under section 45 of the CCCFA. It has concluded that commissions for

credit-related insurance should be no more than 20% of the gross premium. [Click here](#) to link to the Commission's website, where a copy of the guideline is available.

Full prepayment

- Creditors who want to include the time taken to re-lend money in its repayment formulas must be prepared to justify it; and
- charging extra interest on full prepayment can be seen as charging interest in advance, which is a breach of the CCCFA.

The Commission's position is that *"any estimate of loss should be calculated on the basis that a creditor will take reasonable steps to mitigate their loss and to re-lend money as soon as possible"*. Creditors who claim an allowance for the time taken to re-lend the money should be prepared to demonstrate, based on an analysis of its operations, that a delay in re-lending the money is unavoidable and that the extent of the delay has been accurately calculated.

Credit related insurance

The Commission has warned a creditor for requiring an unemployed debtor to obtain credit-related insurance that covered redundancy.

Another creditor was warned for charging a guarantee fee for a "guarantee" that was, in effect, an insurance contract. The Commission has stated that disguising an insurance product to avoid the requirement to provide a proportionate rebate of the insurance premium to debtors who prepay is likely to be a breach of the CCCFA.

Agents and brokers

The Commission has made clear its expectation that creditors who use agents or brokers will take reasonable steps to ensure that those agents or brokers also have adequate compliance programmes.

[Click here](#) to link to a full copy of the Commission's article.

Insolvency Law Reform Bill – Select Committee Report

The Select Committee issued its report on the Bill on 20 August.

Its recommendations included:

- amendments to ensure better consistency with the Personal Property Securities Act;
- tightening up of the proposed voluntary administration procedure for companies;
- changing the voidable preference rule in section 292 of the Companies Act 1993 to bring it into line with the equivalent Australian provisions (changing the “ordinary course of business” exception to a “continuing business relationship” exception); and
- maintaining Crown priority in insolvency.

Finance companies improve their disclosure, but risks remain

The Securities Commission has reviewed the offer documents of 20 companies prepared since its report.

This review focused on key areas identified in the Commission's earlier report such as disclosure of the risks of the investment, and the investment activities of the company. Each company's most recent investment statement, prospectus, financial statements, and advertising were reviewed for compliance with securities law.

Two finance companies had not followed the guidance set out in the report and still had poor disclosure, particularly about risk. Ten others had improved their disclosure on the basis of the report but had fallen short in other areas. The Commission required these 12 companies to rectify their disclosure deficiencies. All of them amended their offer documents and/or advertisements and one also amended its financial statements. Other companies have agreed to make improvements when they update their offer documents or prepare new advertisements.

The Commission noted that finance companies can be a high risk investment and that investors should read the investment statement and the prospectus so that they know who the finance company is lending money to, and how well the repayments are going.

Currently, investing \$5,000 in a registered bank for a year gives a return of about 6%. Investing the same money in a finance company for the same term will return about 3% above the bank rate. That difference might seem small in percentage terms, but it may not be representative of the higher risk an investor takes with a finance company.

Investments with finance companies are generally for a fixed term. Usually this means that investors can't withdraw their money until the end of the term, even if the company's financial position deteriorates. If they are allowed to cash the investment in early, they will likely have to pay a penalty.

The Commission does not have a prudential regulatory role - it cannot step in to stop a finance company failing or to take action against a finance company that fails. It also cannot help investors recover their money.

Where appropriate, the Commission refers possible breaches of securities law to the Registrar of Companies to consider prosecution. The Commission is working with the Registrar on matters raised in the review and on finance company issues more generally.

Developments in New Zealand's securities market regulatory framework

In a speech made by Professor Keitha Dunstan, a member of the New Zealand Securities Commission, the focus was on the following four developments in the New Zealand regulatory framework:

Securities Legislation Bill

Professor Dunstan stated that the New Zealand Securities Commission (the NZSC) is very supportive of the Securities Legislation Bill because it will bring New Zealand more fully into the international mainstream of regulatory law and practice.

In addition, the Bill introduces a new regime for dealing with market manipulation - for example, a prohibition on false or misleading statements with regard to listed securities will be introduced, together with general provisions for dealing with misconduct in relation to securities issues and trading.

Professor Dunstan also noted that the NZSC will have new powers to act against anyone manipulating the market and the *"courts will be able to impose hefty civil penalties and, in some circumstances, enter criminal convictions and impose prison sentences"*.

The Bill also addresses the regulation of investment advisers – an area where New Zealand has been seen to lag behind. Advisers will be subject to new disclosure requirements and the NZSC will have new enforcement powers, enabling it *"to ban misleading, confusing or deceptive advertisements and to generally enforce compliance with the disclosure requirements"*.

Professor Dunstan stated that further substantive developments in the regulation of advisers and other financial intermediaries will follow.

Securities Commission

Professor Dunstan discussed the role of the NZSC, some developments in the past few years and significant cases it has dealt with.

International Financial Reporting Standards (IFRS)

All reporting entities in New Zealand must comply with IFRS equivalents for accounting periods that start on or after 1 January 2007.

The core platform of New Zealand equivalents was approved by the Accounting Standards Review Board in 2004, and the Financial Reporting Standards Board is responsible for the ongoing development of IFRS equivalents and of New Zealand specific financial reporting standards.

Professor Dunstan stated that *"compliance with best international practices in accounting and reporting is a 'must' for the credibility of our companies and for investor confidence in New Zealand"*.

Trans-Tasman relationship

Professor Dunstan noted that New Zealand and Australia have been working on business law co-ordination for the past six years in order to pave the way for trans-Tasman co-ordination of regulatory structures.

In her concluding remarks, Professor Dunstan emphasised *"the importance to New Zealand of meeting international standards in securities regulation and cross-border co-operation on matters of enforcement"*.

Bell Gully news

Bell Gully retains top finance law rankings

Bell Gully has retained its top rankings in the latest *IFLR1000* Guide to the World's Leading Financial Law Firms. The firm is named in the top tier of recommended New Zealand firms in the practice areas of banking and financial services, capital markets, insolvency and restructuring, and mergers and acquisitions. Bell Gully maintains the top tier rankings it has been awarded by *IFLR1000* in previous years.

Bell Gully lawyers go bald to support leukaemia

A corporate Shave for a Cure® challenge in Auckland and Wellington has seen Bell Gully and PricewaterhouseCoopers raise an incredible \$63,360 to provide vital support for patients with leukaemia.

Bell Gully appoints new partner

A finance lawyer with a global track record of advising on major banking and capital markets transactions is the newest partner at law firm Bell Gully. Wellington-based Hugh Kettle has been promoted to partner, a year after returning to the firm from the UK.

For further details and more news visit: www.bellgully.com

Useful Web links

New Zealand government

- Consumer affairs [www.consumeraffairs.govt.nz]
- 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]
- New Zealand Government [www.govt.nz]
- NZ Government E-Commerce Information [www.ecommerce.govt.nz]
- NZ Treasury [www.treasury.govt.nz]
- Office of the Clerk of the House of Representatives [www.clerk.parliament.govt.nz]
- Parliamentary Counsel Office [www.pco.parliament.govt.nz]

New Zealand financial agencies and organisations

- Commerce Commission [www.comcom.govt.nz]
- The Companies Office [www.companies.govt.nz]
- Export Credit Office [www.treasury.govt.nz/exportcreditoffice]
- NZ Law Commission [www.lawcom.govt.nz]
- Office of the Banking Ombudsman [www.bankombudsman.org.nz]
- Office of Insurance and Savings Ombudsman [www.iombudsman.org.nz]
- Office of the Privacy Commissioner [www.privacy.org.nz]
- Personal Property Securities Register [www.ppsr.govt.nz]
- Reserve Bank of New Zealand [www.rbnz.govt.nz]
- Securities Commission [www.sec-com.govt.nz]
- Takeovers Panel [www.takeovers.govt.nz]

New Zealand commercial sites

- CLANZ [www.clanz.org]
- Financial Services Federation [www.fsf.org.nz]
- Institute of Chartered Accountants [www.icanz.co.nz]
- NZ Bankers' Association [www.nzba.org.nz]
- NZ Business Roundtable [www.nzbr.org.nz]
- NZ Institute of Economic Research [www.nzier.org.nz]
- NZ Exchange [www.nzx.com]

Australian government sites

- Banking Ombudsman [www.abio.org.au]
- National Office for the Information Economy [www.ogo.gov.au]

Australian commercial 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

- Bank for International Settlements [www.bis.org]
- Global Banking Law Database [www.gbld.org]
- International Monetary Fund [www.imf.org]
- International Swaps and Derivatives Association [www.isda.org]
- NASDAQ [www.nasdaq.com]
- New York Stock Exchange [www.nyse.com]
- United States Securities and Exchange Commission [www.sec.gov]
- World Bank [www.worldbank.org]