



**BELL GULLY**

# Commercial Quarterly

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AUTUMN 2009

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The header image features a blue rectangular box on the left containing the text 'BELL GULLY' in white, uppercase letters. To the right of this box is a photograph of a tree-lined path with sunlight filtering through the leaves. Below the photograph, the words 'commercial quarterly' are written in a white, lowercase, sans-serif font.

**BELL GULLY**

## commercial quarterly

**Welcome to the Autumn 2009 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**  
**Utilities and resources**

**In this issue, feature articles include:**

- Government takes first step to implement its overseas investment review;
- An update on corporate governance in the wake of the credit crisis;
- PPSA "wool" case revisited;
- Update on the Securities Disclosure and Financial Advisers Amendment Bill;
- Fast track for capital raising: simplified disclosure prospectus;
- Proposed securities regulation changes released;
- New listing rules in place;
- New Government Policy Statement on Electricity Governance; and
- New Zealand's Emissions Trading Scheme – still up in the air?

**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](http://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](mailto: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

### **Government takes first step to implement its overseas investment review**

On 22 April 2009, the Minister of Finance and the Minister for Land Information issued to the Overseas Investment Office a new Designation and Delegation letter that provides the first opportunity to consider how the government may implement the outcome of its review of the overseas investment regime. This letter, setting out the powers and functions delegated to the Overseas Investment Office, is intended to result in fewer applications needing a ministerial decision, so as to increase the timeliness of the application process. In this article, partner David Boswell outlines the key aspects of the government's review and considers whether the Designation and Delegation letter is a step in the right direction.

### **PPSA "wool" case revisited**

The Court of Appeal has reversed the High Court's decision in *JS Brooksbank & Co (Australasia) Limited v EXFTX Limited (in receivership and liquidation)* by finding that a supply arrangement between the parties was not a "security interest" under the PPSA and allowing the supplier to sue in conversion for its goods. In this article, senior associate Hamish Taylor analyses the decision and discusses some practical implications of the decision for suppliers.

### **Bell Gully's take on changes to the RMA**

The government's Resource Management (Simplifying and Streamlining) Amendment Bill is currently before the Local Government and Environment Select Committee. In this update to our article "[RMA reforms signal a step in the right direction](#)" (in the Summer 2009 issue of Commercial Quarterly), senior partner David McGregor, partner Andrew Beatson and senior solicitor Vivienne Holm outline Bell Gully's concerns about several aspects of the bill.

## Commercial business law

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#### Background

The current Overseas Investment Act and Regulations resulted from the Labour Government's 2003/2004 review of the 1973 overseas investment regime. One of the underlying objectives of this review was to establish relatively liberal overseas investment rules in order to develop the New Zealand economy to its full potential, while, at the same time, provide greater protection for New Zealand iconic sites of special, historical, cultural or environmental interest. This was to be achieved through a narrower focus on assets of critical interest, including those unique assets requiring protection.

The current regime has been widely criticised by those wanting to attract foreign investment to New Zealand. Most of the criticism is directed at the structure, process (particularly the uncertain, and at times lengthy timeframe for a decision) and complexity of the regime and not at the fundamental concepts enshrined in the legislation.

While there has been little disagreement over the need to have an overseas investment regime that both attracts overseas investment and, at the same time, protects New Zealand's strategic and unique assets, it has become obvious that the current legislation is too cumbersome and complex and needs reform.

#### 2009 review of the overseas investment regime

In announcing the terms of reference for the 2009 review, the National Government acknowledged there is scope to improve the design and implementation of the current overseas investment screening regime to ensure that it provides clarity, certainty and predictability for overseas investors. It also noted that it would like to ensure that investment applications are processed efficiently and in a way that minimises compliance costs for overseas investors.

The review is being led by the Minister of Land Information with the assistance of Treasury and the Overseas Investment Office. A Technical Reference Group has also been established to advise officials on the practicality of any proposed amendments and to provide suggestions on other improvements that can be made to the regime.

The 2009 review is unlikely to result in a complete new set of laws for overseas investment. The government has indicated that its focus will be on the "most problematic areas of the legislation so that unnecessary barriers to foreign investment can be quickly identified and removed".

Changes arising from the review may be implemented in three ways. First, by way of ministerial directive letters to the Overseas Investment Office to extend its delegated authority, and to provide to the Overseas Investment Office direction on government policy. Secondly, by cabinet amending the Regulations. Other changes involving wider issues currently dealt with by the Overseas Investment Act 2005 may be made by Parliament amending the Act.

The government has not set a timetable to complete the review and enact any necessary changes. It is expected to take several months to complete. It is anticipated that cabinet will consider recommendations arising from the review during the next few months, with any new regulations implemented well before the end of this year. If changes to the 2005 Act are recommended they will take longer to enact. There is likely to be some public consultation during the select committee process which may mean the Act is not amended until the end of 2009 at the earliest.

However, the government is not so constrained by process when it comes to issuing ministerial directives. It has not waited to complete the review before issuing the April Designation and Delegation letter.

### **New Designation and Delegation letter**

In December 2007, the Labour Government, through its Designation and Delegation letter to the Overseas Investment Office, substantially increased the delegated decision-making role of the Overseas Investment Office so that ministerial approval was only required for a limited number of categories of "sensitive land".

The government's April 2009 Designation and Delegation letter further reduces the number of applications requiring ministerial approval by increasing the categories of special land applications that can be considered by the Overseas Investment Office. This is consistent with the government's stated intent to reduce application times. However, it remains to be seen whether the government has gone far enough to make a material difference, as there are still a number of categories of "sensitive land" decisions requiring ministerial approval.

It is understandable why ministers want to retain the ultimate decision-making power when non-urban land exceeding five hectares adjoins certain unique assets such as the foreshore and seabed, regional parks and land administered by the Department of Conservation. However, it is more difficult to understand why ministers still require this right in other situations, such as when the sensitive land being acquired adjoins such things as a reserve or public park.

The issuing of the Ministerial Directive letter to the Overseas Investment Office gave the government the opportunity to move quickly to help address common criticisms of the present regime, namely that it takes too long to obtain an OIO consent and that too many low level applications require ministerial approval. While the latest Ministerial Directive improves the position, especially for transactions involving urban land, unfortunately, by being reluctant to change the level of delegation to make decisions on non-urban sensitive land, they have not made the most of this opportunity.

### **2009 OECD Report**

The OECD recently released its Economic Survey on New Zealand. In its report, the OECD noted that New Zealand has one of the highest amounts of inward foreign direct investment (FDI) relative to GDP among OECD countries. The report then went on to note that, despite this good performance, "OECD comparisons suggest that New Zealand could do even more to create a welcoming environment for FDI. The latest OECD FDI restrictiveness index showed that in 2006, FDI restrictions in New Zealand were still above OECD averages in 6 out of the 9 sectors examined."

The report then went on to suggest that New Zealand should do something to ease current screening requirements, noting the information showed that "screening requirements in New Zealand are some of the highest among OECD countries".

### **Way forward**

Those wanting to see reform by the removal of unnecessary red tape, delay and cost no doubt hope that the government takes notice of the comments from the OECD report and listens to the feedback from the Technical Reference Group it has appointed. They will also be looking for evidence that the government remains committed to its objectives of providing clarity, certainty and predictability and to establishing an environment that allows applications to be processed efficiently and in a way that minimises compliance costs.

The April Designation and Delegation letter provides some comfort that the government will implement the necessary changes. However, because of the somewhat tentative approach it adopted when delegating to the Overseas Investment Office decisions on certain non-urban sensitive land, there is, as yet, no clear indication that the government will go far enough to make the necessary reforms to rectify all of the major shortcomings with the current regime.

Time will tell whether the government makes the most of the current opportunity to achieve reform so that the overseas investment regime encourages desirable overseas investment while, at the same time, ensures protection of New Zealand strategic and unique assets.

We will keep you updated on any further developments.

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For further background information on the review and for related documentation and news releases visit LINZ's website at [www.linz.govt.nz/overseas-investment/about-oio/oia-review/](http://www.linz.govt.nz/overseas-investment/about-oio/oia-review/) or [click here](#). The new [Designation and Delegation letter](#) is also available on this site.

If you would like information on the current overseas investment regime, see Bell Gully's [Guide on the Overseas Investment Act 2005](#).

## Commercial business law

### PPSA “wool” case revisited

*The Court of Appeal has reversed the High Court’s decision in JS Brooksbank & Co (Australasia) Limited v EXFTX Limited (in receivership and liquidation) by finding that a supply arrangement between the parties was not a “security interest” under the PPSA and allowing the supplier to sue in conversion for its goods. In this article, senior associate Hamish Taylor analyses the decision and discusses some practical implications of the decision for suppliers.*

#### Background

Last year we commented on the High Court decisions in *Segard Masurel (NZ) Ltd v Nicol*<sup>1</sup> and *JS Brooksbank & Co (Australasia) Ltd v EXFTX Limited (In receivership and liquidation)*<sup>2</sup> (*JS Brooksbank*) regarding the Personal Property Securities Act 1999 (PPSA), including remarks on the resulting practical implications for people not wanting to find themselves with an unperfected security interest ranking behind a bank where a customer is in financial difficulties. (See our article [“Suppliers beware: take the extra step and register your interest”](#) in the Autumn 2008 issue of Commercial Quarterly for further details.)

The decision in *JS Brooksbank* was recently considered by the Court of Appeal<sup>3</sup>, bringing the application of the PPSA back into the spotlight and, in particular, whether the transaction in this case had in fact resulted in a security interest being created.

#### The facts

The case centred on a supply agreement between JS Brooksbank & Co (Australasia) Ltd (JSB) and EXFTX Limited (Feltex) which provided that Feltex would obtain neither possession nor title to the wool supplied by JSB until JSB received cleared funds. However, when Feltex went into receivership, certain wool, mistakenly delivered by JSB’s brokers to Feltex and not paid for by Feltex, was on Feltex’s premises and the receivers took control of it.

#### The High Court’s decision

The High Court held that claims in conversion and constructive trust could not succeed and that JSB had an unperfected security interest in the wool over which ANZ’s perfected security interest (in all present and after-acquired property of Feltex) took priority.

The High Court based the existence of this security interest upon the delivery of the wool by JSB through its agents and that, subsequent to the delivery, JSB’s interest in the wool amounted to a security interest for the purposes of section 17 of the PPSA because the supply agreement was a conditional sale contract including an agreement to sell subject to a retention of title. JSB’s security interest then attached to the wool when Feltex obtained possession on delivery which, in accordance with section 40(3) of the PPSA, gives a debtor rights in the collateral from possession under a conditional sale agreement. With the security interest attached, JSB had not perfected it by registering a financing statement on the PPSR which meant that JSB lost the “super-priority” it would otherwise have been accorded and ANZ’s perfected security interest over all Feltex’s assets took priority.

#### The Court of Appeal’s decision

The Court of Appeal disagreed and overturned this decision on the basis that no security interest was created in favour of JSB.

In reaching its conclusion, the Court of Appeal went back to the definition of security interest in section 17 of the PPSA itself and asked the question: whether JSB had an interest in personal property (the wool)

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<sup>1</sup> [12 February 2008] HC, Auckland, CIV 2007-404-003603

<sup>2</sup> [2008] NZBLC 102, 113

<sup>3</sup> [2009] NZCA 122

provided for by a transaction (the supply agreement) that in substance secured payment, ignoring the form of the transaction and the fact that JSB retained title.<sup>4</sup>

The key aspect the court focused on was whether the supply agreement “in substance” secured payment. It concluded that while the accidental delivery of the wool prior to JSB receiving cleared funds resulted in Feltex obtaining possession and JSB effectively retaining title, the supply agreement was not intended to secure payment by Feltex. It was specially formulated to prevent JSB from having any credit exposure to Feltex. The supply agreement contemplated no delivery until payment had been made and it did not enable JSB to have recourse to the wool if payment was not made, which is the typical retention of title situation.

As a result the Court of Appeal noted that, despite the fact that on this occasion delivery was mistakenly made prior to payment with title not transferring, an arrangement that did not in substance create a security interest (because it did not secure payment), could not turn into one that did.<sup>5</sup>

The Court of Appeal also rather helpfully looked at whether the ANZ’s security interest had attached to the wool. On this point the court looked at section 40 of the PPSA which says that a security interest attaches where the debtor has rights in the collateral. A debtor has rights in goods sold under a conditional sale agreement (including an agreement to sell subject to retention of title) no later than when the debtor obtains possession of the goods. It concluded that the goods were not “sold” under the supply agreement and Feltex had no right of possession as against JSB. ANZ’s security interest had not, therefore, attached to the wool.

As to whether JSB could sue for conversion, while the High Court had previously determined that an action for conversion was not available because JSB through its agents had voluntarily delivered the wool, the Court of Appeal made it clear that because Feltex employees were aware of the terms of agency (i.e. that the wool was not to be released prior to the receipt of cleared funds) and that JSB had not acquiesced to the wool’s release or made any representations to Feltex that the agents were authorised to deliver it; JSB was entitled to sue in conversion for return of the wool.

### **Practical implications**

The original High Court decision in this case created some controversy, as it seemed to cast the net quite wide in terms of when a security interest might arise. The Court of Appeal’s decision does not serve to limit the scope of what might constitute an “in substance” security interest, it instead reminds us that to have an “in substance” security interest the transaction involved must secure payment or performance of an obligation. Some practical matters to keep in mind are:

- When drafting or interpreting a supply contract, take care when considering whether the transactions set out in the contract will give rise to a security interest. Seek professional advice if you have a concern, as it is better to identify an issue at the outset than find out when you come to enforce your contract that you have an unperfected security interest.
- As priority between competing security interests is now determined under the PPSA regime, you should ensure that you perfect any security interest by registering a financing statement on the PPSR within the applicable timeframe. Failure to do so could result in your security interest being defeated by perfected security interests in respect of the same goods.
- When drafting a supply contract which creates a security interest, ensure that the contract contains an adequate description of the goods being supplied by item or kind such that it will enable the goods to be identified. Failure to do so may affect the enforceability of your security interest.
- Ensure that the information provided in the financing statement (including the description of the collateral) is accurate. If a registration is “seriously misleading” because of an error or omission in a financing statement, the supplier’s security interest may be rendered unenforceable.

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<sup>4</sup> See above n3, at [49]

<sup>5</sup> See above n3, at [54]

## Commercial business law

### Bell Gully's take on changes to the RMA

*The government's Resource Management (Simplifying and Streamlining) Amendment Bill is currently before the Local Government and Environment Select Committee. In this update to our article "[RMA reforms signal a step in the right direction](#)" (in the Summer 2009 issue of Commercial Quarterly), senior partner David McGregor, partner Andrew Beatson and senior solicitor Vivienne Holm outline Bell Gully's concerns about several aspects of the bill.*

#### Background

In keeping with its pre-election promise, the government announced in early February that it would be embarking on a significant series of reforms to the Resource Management Act (RMA). This announcement was followed by the introduction of the Resource Management (Simplifying and Streamlining) Amendment Bill later the same month.

The bill represents the first phase of the government's proposed reforms. It is directed at addressing some of the excessive bureaucracy, costs and delays associated with the current form of the RMA. The key provisions in the bill include:

- removing frivolous, vexatious and anti-competitive objections;
- streamlining processes for projects of national significance;
- creating an Environmental Protection Authority;
- improving plan development and plan change processes;
- improving resource consent processes;
- streamlining decision making;
- improving workability and compliance; and
- improving national instruments.

(For a more detailed overview of this bill refer to our earlier article "[RMA reforms signal a step in the right direction](#)".)

#### Bell Gully's submissions on the bill

Bell Gully supports the proposal to reform and improve the RMA but are concerned about several aspects of the bill which could have unintended results.

Set out below are some of our key concerns which we included as part of Bell Gully's submission to the Local Government and Environment Select Committee on the bill.

##### *Scope of appeals*

Bell Gully has identified the proposal to limit appeals on proposed plans and plan changes as a major area of concern. The amendment will heighten existing concerns that local authorities can often act as 'the judge in their own cause' under the RMA. If local authorities are made responsible for both promulgating and making the final decision on plan provisions without any right to appeal, there will be a perception (and at times a reality) that the process is unfair.

In our view the amendment is also likely to compromise the quality of the planning instruments prepared under the RMA. The Environment Court has provided valuable input on planning instruments in the past, due to its first hand knowledge of the approaches being taken to key issues around the country. The court also has the advantage of hearing the reliability of evidence tested by way of cross examination, unlike local authority decision makers.

### *Trade competitors*

The bill includes extensive provisions restricting the rights of trade competitors. In our view, they go too far.

The new provisions curtail landowners' rights to seek appropriate provision for their own properties in district and regional plans where this could give them a "trade advantage" over other developers.

Similarly, the provisions on resource consent applications take an overly proscriptive approach by preventing trade competitors from mounting an opposition unless they are "directly affected" (and the effects in issue don't relate to trade competition).

We agree that the issue of vexatious submissions and appeals should be addressed. However, in some cases trade competitors have assisted consent authorities by resourcing inquiries into legitimate resource management issues. A better balance can be struck by allowing trade competitors to participate in hearings provided they pursue only those issues which have already been raised by other parties.

### *Independent commissioners*

Applicants are to be allowed to elect to have their proposals dealt with by independent commissioners. This change sounds good on paper, but it needs to be understood that many consent authorities appoint commissioners from a shortlist they have prepared themselves, and that some commissioners rely on repeat work for their livelihoods. For commissioners to be truly independent they should be chosen from a national database.

### *National environmental standards*

The proposed amendments only require the Minister for the Environment to publicise the "subject matter" of new environmental standards for public comment. There is no requirement to provide a draft of the standard, or the opportunity for submissions to be made on the minister's recommendation (which is prepared following the review of public comments). We consider that it is critically important that environmental standards, which have such far-reaching impacts, be subject to more careful and thorough consideration.

### *Incentivising faster decision-making*

The bill introduces new provisions which require local authorities to adopt a policy for discounting administrative charges where a resource consent is not processed within the timeframes set out in the RMA, and the fault lies with the consent authority. Unfortunately little guidance is provided on formulating those policies.

Among other things, the bill doesn't make it clear that discounts should reflect the duration of delays (by providing for some form of sliding scale). If policies do not specify for the discount to increase with the passage of time, consent authorities will have little incentive to prioritise applications after the trigger date for a reduction has passed.

### *Public notification*

There are extensive proposed changes to the public notification regime, including a new section providing that a consent authority must publicly notify an application if it is satisfied that the adverse effects of the activity beyond the "immediate environment" will be more than minor.

The meaning and scope of the term "immediate environment" is vague and uncertain. It is unclear whether it is intended to refer only to the subject site, adjoining properties or a wider area.

Bell Gully is suggesting that the term "adjacent environment" be substituted for clarity.

### *Representation at proceedings*

The bill provides that only the Attorney-General can represent the public interest in proceedings in the Environment Court.

Other amendments to the RMA (including the changes on notification of applications for resource consent and the proposal to remove the right to make further submissions on plan provisions) may create situations where the scope or significance of a matter is not identified by affected parties until after the first-instance decision is made. In those situations the right to join proceedings may assume critical importance. In order to ensure good outcomes it is important that those who are best placed to provide useful input are able to do so.

Statutory or iwi authorities and industry representatives will often be better placed in terms of institutional knowledge, inclination and resources to represent the public interest than the Attorney-General. We have sought a change to enable them to do so.

### *Further submissions*

We have also sought further changes to the bill to enhance the effectiveness of some of the other initiatives. Please contact your usual Bell Gully adviser if you would like a copy of our submission.

### **Next steps**

The closing date for submissions to the Local Government and Environment Select Committee on the bill was 3 April. The select committee is currently hearing submissions on the bill and is due to report back on the bill on 19 June 2009. Environment Minister Nick Smith has indicated that the final form of the bill will be enacted by July 2009.

In the meantime, further details of the second phase of the RMA reforms have been announced by the minister. These reforms will be directed at improving the "economic and environmental outcomes" of the RMA and will involve ten related work streams. These include:

- greater central government direction to improve management of aquaculture, infrastructure, urban design and water;
- developing the scope, functions and structure of the proposed Environmental Protection Authority;
- alignment of the RMA with the Building, Conservation, Forests, and Historic Places Act; and
- further reforms to the RMA process which were considered too complex to be included in the current bill.

The minister has indicated that the second phase will proceed at a much more modest pace than the fast track taken for the passage of the Resource Management (Simplifying and Streamlining) Amendment Bill. The second phase of reforms will involve a number of advisory groups and opportunities for public consultation.

The second round of amendments represents an important opportunity for our clients to take the initiative and pursue changes to the RMA which would address existing problems, regardless of whether they have already been identified by the government. Bell Gully will be actively involved in the process and we encourage all our clients to let us know of any issues or amendments they would like to see considered by the minister.

We will keep you informed of any further developments.

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

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## Company law

### **An update on corporate governance in the wake of the credit crisis**

A number of recent reports have identified deficiencies in the corporate governance practices of many failed companies. These findings include deficient risk management practices, weaknesses in board composition and the failure of non-executive directors and shareholders to effectively monitor decisions of the board. In this article, partner Andrew Brown and solicitor Sophie Gladwell take a closer look at some of these reports and highlight some key findings for New Zealand companies' corporate governance practices.

### **Strict liability for directors and employees under Fair Trading Act confirmed**

In this article, senior associate Peter Jenkins and solicitor Nick Christiansen outline why individuals can expect to be held personally and strictly liable for breaches of consumer legislation following a recent Court of Appeal decision which confirmed a broad approach to liability in a leaky building case.

### **No scope for shirking directors' duties**

A recent High Court case highlights how important it is for non-executive directors to understand the extent of their statutory obligations and take an active role in ensuring that appropriate corporate governance practices are in place.

## Company law

### **An update on corporate governance in the wake of the credit crisis**

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#### **RESEARCH HIGHLIGHTS POOR CORPORATE GOVERNANCE PRACTICES**

Since the Enron scandal in 2001, there has been an increased awareness of the significance of corporate governance and the role it plays in ensuring a company's accountability, legal compliance, stakeholder relationships and performance.

It is therefore not surprising that the current credit crisis has led to a new focus by regulators, shareholders and others on poor corporate governance practices in search of answers to the recurring question: how could it all have gone so wrong?

Attention has been particularly focussed on executive remuneration practices, which are widely thought to have encouraged excessive risk taking, as one key area of corporate governance requiring reform. In February 2009, new guidelines were introduced in the United States restricting executive pay for companies receiving government financial assistance and a range of reform proposals are currently under consideration in Australia<sup>6</sup> to address executive remuneration issues. Similar concerns and developments are evident in Europe and Asia.

However, remuneration policies are not the only corporate governance issues being linked to the current economic crisis and company failures. Deficient risk management practices, weaknesses in board composition and the failure of non-executive directors and shareholders to effectively monitor and scrutinise the decisions of boards are also being highlighted as key areas requiring reform to avoid future failures.

#### **Risk management**

The global financial crisis has been a salutary reminder of the importance of risk management at all levels of an organisation. The OECD published a report in February 2009 (*The Corporate Governance Lessons from the Financial Crisis*)<sup>6</sup> which concludes that the crisis can:

*"to an important extent be attributed to failures and weaknesses in corporate governance arrangements which did not serve their purpose to safeguard against excessive risk taking in a number of financial service companies."*

The report primarily examines the banking sector and significant events involving banks such as UBS, Société Générale and Bear Stearns, and suggests that in some circumstances information concerning risk was used inadequately.

The report notes that less effective boards were unaware of strategic decisions being made by management and had not implemented an effective mechanism to enable the board to oversee the banks' risk appetite. In addition, certain boards had a limited technical understanding of products (such as mortgage-backed securities) and a lack of control over balance sheet growth and liquidity needs.

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<sup>6</sup> Australia is proposing to introduce amendments to the Corporations Act 2001 (Cth) aimed at curbing what it terms 'excessive golden handshakes' or termination payments paid to departing company executives. It has also directed the Productivity Commission to undertake an inquiry into the current Australian regulatory framework around executive remuneration.

The lack of an active risk committee was cited as another possible reason for ineffective risk management, as Lehman Brothers' risk committee was noted as meeting only twice (in 2006 and 2007) and Bear Stearns' committee was formed just before it collapsed.

The report also identifies the inferior prestige and status afforded to risk management staff as a possible contributing factor. For example, Société Générale informed its shareholders of an "imbalance...between the front office, focused on expanding its activities, and the control functions which were unable to develop the critical scrutiny necessary for their role". The US Securities and Exchange Commission (SEC) recognised that one feature of Bear Stearns' failure was that staff involved in risk worked in close proximity to traders, which suggested to the SEC that risk managers suffered a lack of independence.

The report also acknowledged that although rating agencies, disclosure and accounting standards played a role in causing the credit crisis, the best boards were able to use their own powers to overcome the weaknesses and associated risks in these areas. Effective boards had implemented systems which led to the efficient sharing of information and open dialogue across management and the board.

### **Board composition**

In New Zealand, the most glaring example of failures in corporate governance has been in the finance company sector. A recent report issued by the Registrar of Companies to the Ministry of Economic Development<sup>7</sup> highlights board composition and the competence of directors as key factors which contributed to the collapse of 29 finance companies in New Zealand over the last two years.

The report notes that the boards of these finance companies tended to lack the breadth of experience and skills required to oversee the scale, complexity and characteristics of financing operations. It also points out that several of the companies were led by a dominant chief executive who was the "principal architect of the company's modus operandi". Further, a pattern was recognised where several directors had previously been involved in finance industry failures.

The Registrar also criticised a raft of behaviour exercised by the boards of these companies. The report states that "too often directors were not adequately informed, misled or failed to take sufficient interest in the affairs of the company". It also identifies instances of excessive related party lending, the adoption of practices which masked the true performance of loan portfolios and the use of funds received for investment from new investors being used to repay the maturing loans of existing investors.

### **Non-executive directors and shareholder passivity**

The UK Treasury published a report on the banking crisis in May 2009 ("*Banking Crisis: reforming corporate governance and pay in the City*") which states that "banks have failed because those leading and managing them failed".<sup>8</sup> The UK Treasury quotes PIRC, a leading UK corporate governance consultancy, which accuses boards of being primarily responsible for the failure of banks because they "approved the business strategies and products that have caused such damage".

The UK Treasury has highlighted a failure of non-executives to fulfil their role of effectively overseeing and acting as a check on executive directors, and the UK Treasury suggested that some boards "operate as members of a 'cosy club'". In order to address the current failings of non-executives, the UK Treasury has suggested some areas for reform: to limit the number of non-executive directorships that an individual can hold; require non-executives to have a relevant professional qualification to sit on the board; to broaden the talent pool from which the banks can draw upon in appointing non-executives; and to examine ways in which the relationship between institutional shareholders and non-executives can be strengthened.

Institutional shareholders have also been accused of failing in their task of scrutinising and monitoring the decisions of boards. While the UK Treasury suggests that further consideration should be given to reform in this area, PIRC has subsequently suggested that the problem may not be the corporate governance framework or mechanism itself, "but the failure of some shareholders to use the rights they have effectively"<sup>9</sup>.

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<sup>7</sup> 2007/08 financial review of the Ministry of Economic Development, Report to the Commerce Committee (dated 19 March 2009)

<sup>8</sup> Banking Crisis: reforming corporate governance and pay in the City.

<http://www.publications.parliament.uk/pa/cm/cmtreasy.htm> HM Treasury's report examined and made recommendations for change in areas such as corporate governance, remuneration and the roles of credit agencies, auditors, the media and accounting standards.

<sup>9</sup> <http://www.pirc.co.uk/news/story336.html>

## **IMPLICATIONS FOR NEW ZEALAND**

With the global spotlight on corporate governance practices and the likelihood of increased government scrutiny of corporate conduct on the horizon, it is an opportune time for New Zealand companies to assess the effectiveness of their own corporate governance practices.

The New Zealand Securities Commission has already announced that it will review the corporate governance disclosure practices of selected listed issuers as part of its ongoing financial reporting surveillance programme. In making this announcement, the commission's chair, Jane Diplock, noted that there was a need for "greater assurance that issuers have robust corporate governance arrangements in place" in the current financial climate.

The starting point for any corporate governance review will be based on New Zealand's own approach to "best practice" in corporate governance, as envisioned by company law, the NZX's Corporate Governance Best Practice Code and the Securities Commission's set of nine principles entitled *Corporate Governance in New Zealand – Principles and Guidelines*. Together these provide a comprehensive framework for companies to develop sound corporate governance practices.

However, New Zealand companies should also be mindful of the recent corporate governance issues being highlighted in other jurisdictions. Some of the key themes on corporate governance practices arising out of the reports noted above and other overseas studies include the following:

- Boards should ensure they have access to all relevant information. This includes ensuring that there are appropriate systems of control in place in particular for risk management, financial and operational control and compliance with the law.
- Companies should consider re-emphasising the roles of the CEO and the board in the risk management process so that they can properly oversee, monitor and have a forward looking perspective of risk issues. In addition, boards should consider having separate risk and audit committees.
- Boards should ensure that when an independent director is selected, the focus is not only on independence and objectivity but also on capabilities. This may include acquiring appropriate skills upon appointment and ensuring they keep up-to-date with relevant laws, regulations and changing risks through in-house and external training.
- Participation of non-executive directors should be encouraged. For example, if directors have not had sufficient experience of the specific market in which the company operates, as their experience comes from other arenas, the relevant directors should be given market specific training enabling them to be aware of the relevant risks and apply the corporate governance principles to their company.

For further details on New Zealand's corporate governance requirements and how to improve practice and procedure, please feel free to contact your usual Bell Gully adviser or:

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## Company law

### Strict liability for directors and employees under Fair Trading Act confirmed

*In this article senior associate Peter Jenkins and solicitor Nick Christiansen outline why individuals can expect to be held personally and strictly liable for breaches of consumer legislation following a recent Court of Appeal decision which confirmed a broad approach to liability in a leaky building case.*

The judges said consumer protection was best served by a broad approach and confirmed that directors and employees can be liable as principal parties under the Fair Trading Act (FTA). They can face strict liability even though they may have been acting within the scope of their employment or in their capacity as director.

The recent case of *Body Corporate 202254 v Taylor* (2008) 12 TCLR 245 is a classic example of leaky home litigation. The owners of affected houses were from a single development. As all of the companies involved in the development's construction had been struck off, they sought to claim against the director of the main development company.

The claim was based on a marketing brochure which the owners alleged contained misrepresentations breaching section 9 of the FTA, which provides: "No person shall, in trade, engage in conduct that is misleading or deceptive or is likely to mislead or deceive."

It was assumed for the appeal that the director had personally made the representations in the brochure.

The question for the court was whether the section could apply to the defendant given that he was acting as the director of a limited liability company at the time that he allegedly made the representations.

#### **Is a director "in trade"?**

This question divided the court. The majority favoured a broad approach in interpreting the section while a strong minority dissent supported a more narrow interpretation.

Previous cases in which the courts have held that an employee or director could be principally liable under the FTA have typically involved directors who were seen as the alter ego of a company and were personally responsible for the acts complained of (*Gloken Holdings Ltd v The CDE Ltd* (1997) 6 NZBLC 102,272 and *Kinsman v Conrfields Ltd* (2001) 10 TCLR 342).

Some commentators, however, have criticised this approach and argued that the section should be read narrowly to ensure that employees did not find themselves unexpectedly liable for representations made in the course of their employment.

In an earlier decision the Court of Appeal had shown sympathy with these criticisms and suggested that the matter needed to be looked at again (*Newport v Coburn* (2006) 8 NZBLC 101,717).

#### **Majority approach**

Trade is defined in section 2 of the FTA as "any trade, business, industry, profession, occupation, activity of commerce, or undertaking relating to the supply or acquisition of goods or services or to the disposition or acquisition of any interest in land".

In the view of the majority this definition was consistent with a broad approach. In particular the judges noted that the terms "profession" and "occupation" could include a person not trading on their own account. It was therefore sufficient that the defendant's conduct took place within the context of his occupation.

The majority recognised that the existence of accessory liability provisions (s 43) could show a legislative intention to specify the circumstances under which employees and directors were liable. However, their view was that accessory liability provisions applied where the impugned conduct could not be attributed directly to a defendant but did not apply where a director had personally and directly infringed s 9 (as the

director would have committed the breach, not aided or abetted it as the section requires). The judges pointed to section 45(2) which deems that any conduct of a director or employee is also engaged in by their company; the use of the word "also" suggesting dual liability.

Finally, the majority considered that the risk of unexpected and unacceptable liabilities being imposed was overstated. Claims were likely only to be brought against senior employees who could obtain insurance to cover any risk and not all misleading or deceptive conduct which a director participated in would necessarily be conduct on the part of that director so as to fall within s 9, they said.

In the majority's view, consumer protection was best served by a broad approach to liability. They saw no reason to depart from the broad approach consistent with that of New Zealand and Australian authority on the issue.

### **The dissenting view**

For the judges in the minority, the broad approach conflated the concept of a person engaged in trade (such as a sole trader) with acting in the course of trade. If the section was interpreted in light of the rest of the Act, a narrow interpretation was appropriate. The range of terms used in the definition was designed to ensure that there was no room to argue that particular types of undertaking, such as a profession, were excluded. However, the omission of the term "employment" from the definition of trade showed that employees were not intended to be caught by the definition.

Other grounds on which the minority dissented included:

- It was compelling that the FTA already made provision for secondary liability (s 43). Therefore, there was no need to read s 9 broadly as the provisions of s 43 ensured that directors could still be sued personally if they were appropriately involved. The difference is that under s 43 it would be necessary to show intention for a director to be found liable as an accessory.
- On policy grounds, the broad approach cut across accepted concepts of limited liability and should not be adopted.
- It would also expose employees to unexpected, and strict, liability for representations they make on behalf of their employers. Direct liability for employees in such circumstances was not justified by consumer protection considerations.

### **What the decision means**

The decision firmly establishes the principle of primary liability for directors and employees who face claims under the FTA. This means that if a director or an employee is found to have made a misrepresentation, even if it is in the course of their employment, they can be personally liable. The liability that they will face will be strict, with no exception for an unintended breach.

It is important to note that the decision does not allow for a director to be found vicariously liable for the actions of his or her company. Instead, directors and employees will only face claims if their own actions are at fault. An employee who is merely a conduit for a representation made by their employer will not face liability.

The decision can be criticised for potentially giving rise to the unexpected consequences that the minority feared. It does not necessarily follow, as the majority believed, that only senior employees will face claims under the provision. On the broad approach there is nothing to prevent claims being brought against more junior employees. Nor is it realistic to expect that senior employees will simply be able to obtain insurance as a precaution. It has to be hoped that reference by the majority to the discretionary nature of the remedy is an indication that the courts will be prepared to ameliorate these potentially harsh consequences.

## Company law

### No scope for shirking directors' duties

*A recent High Court case highlights how important it is for non-executive directors to understand the extent of their statutory obligations and take an active role in ensuring that appropriate corporate governance practices are in place.*

#### The background facts

The defendant in this case<sup>10</sup> was a general medical practitioner who agreed to act as a non-executive director of FXHT Fund Managers Limited (FXHT Funds) in December 2005 as a favour to a family friend's son, Mr Hitchinson. The defendant also provided a small capital contribution and guaranteed property and equipment leases entered into by FXHT Funds.

FXHT Funds had been set up by Hitchinson, the only other director of FXHT Funds, as the business vehicle for managing private clients' investments in foreign exchange markets. Decisions as to the day-to-day management of investors' funds were made by Hitchinson, who was also employed by FXHT Funds as a funds manager. Mr du Plessis, a trader, was also engaged by FXHT Funds on an independent contractor basis.

FXHT Funds initially invested investors' funds through a European trading platform, referred to in the case as FXCH. However, the funds performed badly and in September 2006 a decision was made to withdraw the funds from FXCH and re-invest them in a South African trading platform, FX Active. The defendant, relying on the advice of Hitchinson and du Plessis, had agreed to this change in trading platforms.

In late November 2006, the defendant was notified by du Plessis that he had not been paid commission for two weeks and that some investors' funds were unaccounted for. The defendant confronted Hitchinson and, when dissatisfied with his response, required Hitchinson to resign as a director and reported the matter to the police. FXHT Funds was placed into liquidation on 14 December 2006.

The liquidators were unable to recover any investors' funds from FX Active, which was no longer operating. Hitchinson was charged with fraud for the misappropriation of investors' funds totalling US\$297,751 and NZ\$44,985.

The liquidators and FXHT Funds commenced proceedings against the defendant, contending that he was in breach of various duties owed by him to FXHT Funds. They also sought orders requiring the defendant to contribute to the liquidation to compensate those who invested with FXHT Funds (now unsecured creditors of the company).

#### The decision

The High Court confirmed that the correct approach for determining whether the defendant should be required to contribute to the company's liquidation was the two-step approach set out by the Court of Appeal in *Mason v Lewis*<sup>11</sup>. The court must:

1. first determine whether the defendant was in breach of any of the duties he owed to FXHT Funds as a director; and
2. if so, consider what, if any, relief the defendant should be given in determining the appropriate contribution under section 301 of the Companies Act 1993 (the Act).

#### **1: Did the defendant breach his duties as a director?**

The court found that there was no evidentiary basis to support the liquidator's claims that the defendant had breached section 131 (the duty to act in good faith and in the best interests of the company), section 133 (the duty to exercise power for a proper purpose) or section 136 of the Act (the duty to ensure the

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<sup>10</sup> *FXHT Fund Managers Limited (in liquidation) and Anor v Dirk Oberholster*; HC Whangarei, CIV-2007-488-000285, 9 April 2009

<sup>11</sup> [2006] 3 NZLR 225

company does not agree to incur improper obligations). However the court did find that the defendant had breached his duties under both sections 135 and 137 of the Act.

#### *Section 135 (reckless trading)*

The court confirmed the Court of Appeal's approach in *Mason v Lewis* for determining a breach of duty under section 135, noting that the test of whether a director has agreed to, caused or allowed the business of a company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors "...is objective [and as such] it can make no difference when determining liability under s135 that [the defendant] was innocent and unaware of Mr Hitchinson's fraud."

The defendant did not implement formal reporting systems or test Hitchinson's verbal assurances that FXHT Funds was doing well. The defendant also failed to ensure that the investors' money was kept separate from the company's bank account.

Assessing the defendant's actions in this case, the High Court concluded that "even accepting the reasonable constraints on a non-executive director...and allowing for a degree of informality, [the defendant's] actions in this case fall well short of what could reasonably be expected of a director." The High Court found that the defendant's failures created an environment which allowed Hitchinson's dishonesty to thrive.

The court came to a different conclusion, however, in relation to the plaintiff's submission that the defendant was in breach of section 135 in respect of the decision to transfer FXHT Funds' trading platform to FX Active. Although the subsequent collapse of FX Active was a contributing factor for the investors' losses, the High Court found that, on the facts, the decision was, "prima facie, a reasonable and legitimate business decision".

#### *Section 137 (duty of care)*

The court observed that the basis for the liquidators' claim under section 137 was "in large part a recasting of the breach of section 135 by permitting the business of the company to be carried on without adequate control." To that extent, and following the court's finding that the defendant had breached section 135 by allowing Hitchinson to run FXHT Funds without sufficient controls, the High Court held that such failure also constituted a breach by the defendant of his duty of care under section 135.

However the court did not find that the decision to transfer investors' funds to FX Active constituted a breach of the defendant's duty of care. In this instance, the court considered that as a non-executive director who was not involved with the day-to-day management of the company, the defendant was entitled to rely on the advice and experience of Hitchinson and du Plessis in this matter.

#### *The section 138 defence*

The defendant argued that even if he was found in breach of his statutory duties, he was entitled to rely on the defence available under section 138 of the Act through his reliance on the advice of others in performing his duties as a director. However, in this case, the advice being relied on came in the form of oral and informal advice from Hitchinson which the court considered was insufficient to support the statutory defence. For the protection of this section to attach, the court noted that a director should have relied on "proper written documentation". In this case there were no reports, statements and financial data in any formal sense.

### **2: What amount should the defendant contribute to the liquidation?**

Under section 301 of the Act, if a director is found to have breached a duty, the court may order the director to contribute to the assets of the company by way of compensation as the court "thinks just". The court's power under section 301 is not only discretionary but also allows the court to inquire into the overall justice of the order relative to the breaches and consequent losses.

In determining the amount the defendant was required to contribute under section 301 of the Act, the court made a distinction between the losses attributable to Hitchinson's misappropriation of clients' funds and the losses arising from the decision to change trading platforms. In the court's view, since it had found that the defendant had not been in breach of any duty in making the decision to change trading platforms, he should not be required to contribute to the losses sustained as a result of the transfer.

In terms of the defendant's liability for the other losses of FXHT Funds, the court followed the approach taken by the Court of Appeal in *Mason v Lewis*. This involves:

- establishing the financial figure attributable to the lack of corporate governance on the part of the defendant; and
- assessing the appropriate level of relief by considering three factors: causation, culpability and the duration of the trading.

The court also noted that more recent cases had made reference to the means of the director as a possible additional factor for consideration.

On the facts, the court considered that the defendant should have put in place appropriate corporate governance practices at least by March or early April 2006 (four months in to his role as director). This included establishing "a budget, a basis for a structured monthly reporting and review of profit and loss, together with some proper means of ensuring that clients' funds were treated as trust funds." Without these measures in place, it made it easier for Hitchinson to misapply client funds. The defendant would also have become aware that the company's earnings were not sufficient to meet its outgoings.

In determining the culpability factor, the court assessed the blameworthiness of the defendant. On the facts, the court acknowledged that the defendant was also a victim of Hitchinson's fraud and was not actively involved in the failure of the company.

Taking all of these factors into consideration, the court held that the defendant's liability should be capped at approximately 50 percent of the monies misapplied by Hitichinson.

### **Commentary**

This decision confirms the Court of Appeal's observation in *Mason v Lewis* that "the days of sleeping directors with merely an investment interest are long gone". The absence of direct culpability for losses to the company or its creditors will not, in itself, prevent a director from having to contribute to a company's losses if he or she is held to be in breach of his or her statutory duties.

All directors, including non-executive directors, have a responsibility to take an active interest in the corporate governance practices of a company. It is not sufficient to rely on verbal assurances given by those responsible for the day-to-day business operations.

*\*This case note was written by Neetha Alex, a solicitor in Bell Gully's corporate department.*

## Securities and capital markets

### **Update on the Securities Disclosure and Financial Advisers Amendment Bill**

On 30 April 2009, the Commerce Select Committee reported back on the Securities Disclosure and Financial Advisers Amendment Bill, introduced into Parliament on 18 February 2009, with only minor amendments. This article outlines the select committee's recommendations and discusses some of the shortcomings with their proposed amendments.

### **Fast track for capital raising: simplified disclosure prospectus**

The Ministry of Economic Development (MED) has released the draft regulations outlining the requirements for the contents of the simplified disclosure prospectus (SDP). In this update partner Andrew Brown and senior associate Stephen Layburn outline the SDP regime contemplated by the draft regulations and note some areas that may need further consideration by MED to assess whether the draft regulations achieve the new regime's objective of reducing the costs of raising capital.

### **Proposed securities regulation changes released**

Changes to make it easier for businesses to raise capital are a step closer with the release of a discussion document on proposed changes to securities regulations in April 2009. The discussion document, which highlights proposals to improve flexibility for issuers, is a response to the recommendations of the government-appointed Capital Market Development Taskforce. In this article, partner Andrew Brown and senior associate Stephen Layburn comment on the proposed changes.

### **New listing rules in place**

Recent amendments to the NZX Listing Rules should make it easier for NZX listed issuers to raise capital. In this article, partners Gavin Macdonald and Andrew Brown discuss the changes to the Listing Rules of the NZSX/NZDX and NZAX Markets which came into effect on 3 April 2009.

### **New rules on short form prospectuses**

The Securities Commission has replaced (with amendments) the Securities Act (Short Form Prospectus) Exemption Notice 2002 with a substitute exemption notice, the Securities Act (Short Form Prospectus) Exemption Notice 2009 (2009 Exemption). In this update, partner Brynn Gilbertson outlines the differences between the old and new rules.

## Securities and capital markets

### Update on the Securities Disclosure and Financial Advisers Amendment Bill

*On 30 April 2009, the Commerce Select Committee reported back on the Securities Disclosure and Financial Advisers Amendment Bill, introduced into Parliament on 18 February 2009, with only minor amendments. This article outlines the select committee's recommendations and discusses some of the shortcomings with their proposed amendments.*

#### BACKGROUND

The Securities Disclosure and Financial Advisers Amendment Bill is described as containing a number of measures aimed at streamlining the raising of capital for New Zealand businesses. Our article, in the Summer 2009 Commercial Quarterly, "[Responding to the financial crisis: the Securities Disclosure and Financial Advisers Amendment Bill](#)", discusses these aspects of the bill. In addition, the bill includes minor technical amendments to the Financial Advisers Act 2008.

The bill was referred to the Commerce Select Committee in March 2009 and a short deadline for submissions on the bill was called for by the select committee, reflecting the urgency of the select committee to report back to the House on 30 April. The bill has now passed its second reading and is currently with the Whole House Committee. It is expected to be passed in June 2009.

#### SECURITIES ACT AMENDMENTS

##### No changes for the simplified disclosure prospectus regime

One of the core provisions in the bill is the introduction of the simplified disclosure prospectus (SDP) regime to the Securities Act 1978. This will allow NZX-listed issuers who are subject to the continuous disclosure regime to issue a SDP instead of a full prospectus and investment statement for certain specified securities offerings. The SDP will also reduce the level of duplication between forms of disclosure by enabling listed issuers to refer to information previously disclosed under their continuous disclosure obligations rather than reproducing the information in full.

##### *Submissions in favour of further streamlining of the disclosure regime*

The bill only contains minor amendments to the Securities Act to enable the new SDP. Most of the details of the SDP regime, including the scope of the regime and the details of the information to be provided in the SDP, are to be set out in regulations made under the Securities Act. However, the select committee report indicated that there were a number of submissions made on the SDP regime and, in particular, the need to streamline the disclosure regime further.

As the bill stands (but subject to the final form of the regulations), listed issuers are likely to have to undertake the same due diligence process for a SDP offer as they would for any other offer. The SDP will be an advertisement for the purposes of the Securities Act and will be subject to the civil and criminal liability regimes contained in the Securities Act. A full due diligence process will need to be undertaken in order for the listed issuer and its directors to be in a position to take advantage of the defences available under the Securities Act. This would undoubtedly reduce some of the benefits that the new regime is expected to offer.

The report notes that the select committee spent some time considering the proposal that the appropriate test for the disclosure of information under the SDP regime should be in line with the "material information" test under the Securities Markets Act. This would limit the information to be disclosed under the SDP (and the corresponding due diligence required) to the material information relating to the rights and liabilities of the securities being offered and the effect of the offer on the issuer.

However, the select committee was not in favour of this proposition. In its view, the appropriate approach for the SDP is as presented in the bill. The select committee expressed concern over the potential for a gap between all information that is material to new securities being issued and that which is considered "material information" under the Securities Markets Act which regulates disclosure in the secondary market.

In the case of a new issue of securities, the select committee considers it appropriate that directors undertake a due diligence investigation to ascertain whether all adverse information has been properly referred to in the SDP irrespective of the information made available through the continuous disclosure regime. In the select committee's view this is not an onerous requirement "if there are effective processes in place for continuous disclosure."

#### *SDP regulations*

A draft of the SDP regulations was released by the Ministry of Economic Development for consultation shortly after the select committee released its report on the bill. For details on these draft regulations please refer to the article "[Fast track for capital raising: simplified disclosure prospectus](#)" in this issue of Commercial Quarterly.

#### **Committee's recommendations to the proposed exemptions from disclosure requirements**

The bill also contains amendments to the safe harbour exceptions in section 3(2) of the Securities Act and to the "eligible persons" regime of the Act. Among other minor technical amendments, the select committee has made two noteworthy changes to these aspects of the bill.

#### *Changes to the restrictions of the bill's proposed amendments to section 3(2)(a)*

The select committee has recommended that the safe harbour provided by section 3(2)(a) of the Securities Act be amended to provide that an offer of further securities, which is made only to persons who have previously paid a minimum subscription of at least \$500,000 for securities of the issuer in a single transaction, is not an offer of securities to the public to which the prospectus disclosure regime applies if made within 18 months of the first allotment.

Prior to the select committee's deliberations, this proposed exception included the restrictions that the further securities offered had to be identical to the initial securities offered and that the offer of further securities must be made within 12 months of the first allotment of the initial securities.

The select committee's amendments to this section will now allow the issuer to utilise a range of different securities to raise further capital from its investors. This is a welcome addition. However, the restriction that the initial investment is to be assessed on one particular investment with the issuer is more limiting than the corresponding safe harbour provided under Australian legislation, which provides for the investor's \$500,000 minimum subscription amount to be assessed on the collective amount invested in the same class of securities with the issuer.

As noted above, the select committee has also recommended extending the period in which an offer of further securities can be made from 12 months to 18 months. The select committee felt that it was appropriate to retain the relatively small timeframe in which the \$500,000 initial investment is to be made, but considered that the 12 month period originally proposed would not give the issuer enough time to complete a full annual reporting cycle and decide whether additional capital needed to be raised. Again this amendment is also welcomed, although it is unclear why a restriction to a single financial reporting cycle should be the basis for determining the appropriate time period for this exemption. From a practical perspective, this is still a narrow window of opportunity within which to conduct a "no document" follow-up offer to persons who can only be sophisticated investors and does not reflect the requirements of either an issuer's need to undertake such capital raisings nor recognise the ability of the target audience to make their own enquiries prior to subscribing.

#### *Changes to the bill's proposed amendments to the "eligible persons" criteria*

The bill's proposed changes to the "eligible persons" criteria were introduced to amend anomalies in the original wording of this provision. The proposed amendments will allow offers of securities to be made to eligible persons, as well as persons who fall within one or more categories of the subparagraphs of section 3(2)(a) of the Securities Act (as amended by the bill), without requiring a prospectus or investment statement.

The select committee's recommendations include the insertion of a new sub-clause to the "eligible persons" safe harbour which requires "experienced" investors, to whom an offer of securities has been made, to sign a written acknowledgment that they will not receive information usually provided by an issuer making an offer of securities to the public, particularly the investment statement and prospectus. The select committee sees this as a necessary change. Currently under the Securities Act an "experienced" investor is only required to acknowledge that an independent financial services provider will not be providing the investor with a prospectus and an investment statement, even though a financial services provider normally has no obligation to provide an investment statement and prospectus to the investor.

## **AMENDMENTS TO THE FINANCIAL ADVISERS ACT 2008**

The select committee's recommendations include further amendments to the sections of the bill dealing with the Financial Advisers Act (FAA), to remedy errors in that Act that have come to light since the Act was passed.

### *Retirement village disclosure statements*

The select committee's recommendations have introduced a new clause to the FAA which clarifies that disclosure statements made by operators of retirement villages under the Retirement Villages Act 2003 do not constitute financial advice for the purposes of the FAA.

### *Liability and disclosure obligations of employees of qualifying financial entities*

The committee's recommendations also introduce further clauses to the FAA to correct the discrepancies in the FAA between the liability and disclosure obligations that apply to an employee of a qualifying financial entity when advising on different types of financial products.

The proposed amendments:

- confirm that disclosure and conduct obligations of authorised financial advisers apply whether or not they are employed or are agents of a qualifying financial entity; and
- clarify that employees and agents of qualifying financial entities who are exempted from registering as financial advisers under the FAA, will not be committing an offence when performing a financial adviser service.

### *Alignment of the Financial Advisers Act with the Financial Service Providers (Registration and Dispute Resolution) Act 2008*

The select committee's recommendations have addressed the inconsistency between the registration requirements of financial advisers under the FAA and the Financial Service Providers (Registration and Dispute Resolution) Act. Under the proposed amendment, employees of financial service providers (when operating in their capacity as employees) would not be required to register and belong to a dispute resolution scheme (under the FAA and the Financial Service Providers (Registration and Dispute Resolution) Act) unless the individual was required to register under the FAA.

## **A MISSED OPPORTUNITY?**

The select committee has chosen to sideline some useful submissions on the bill that would have addressed a number of known issues with the Securities Act. This includes missing other "safe harbour" opportunities from the disclosure requirements of the Securities Act, particularly those which could have accommodated small-scale offerings by SMEs at a time when they need it most. It is also unlikely that the new SDP regime will live up to its promise to make a significant difference to the time and costs associated with securities offerings for listed issuers given that there will still be a need for extensive due diligence under the new regime.

The government has promised to undertake a wider review of the Securities Act later this year. We hope to see the submissions on the bill addressing some of the wider problems with the Securities Act being taken up as part of this review.

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

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## Securities and capital markets

### Fast track for capital raising: simplified disclosure prospectus

*The Ministry of Economic Development (MED) has released the draft regulations outlining the requirements for the contents of the simplified disclosure prospectus (SDP). In this update partner Andrew Brown and senior associate Stephen Layburn outline the SDP regime contemplated by the draft regulations and note some areas that may need further consideration by MED to assess whether the draft regulations achieve the new regime's objective of reducing the costs of raising capital.*

The objective of the SDP is to streamline the disclosure documents required by a listed issuer seeking to raise further capital: one of the recommendations of the Capital Market Development (CMD) Taskforce. The SDP seeks to reduce the level of duplication between forms of disclosure by enabling listed issuers to refer to (and rely on) information previously disclosed under their continuous disclosure obligations.

When the idea of a SDP (or "term sheet" offering document) was first promulgated by the CMD Taskforce, some suggested that its use should be confined to a narrow range of offers only suitable for existing investors and not able to be renounced (transferred or sold) to other members of the public. This suggestion has been dropped in favour of limits on the types of security that may be offered by means of an SDP. These limits are outlined under the heading "general provisions" below.

Judging by the limits set, an SDP could be used not only for rights issues of equity securities to existing investors, but also for a range of other offers of equity and debt securities to existing and new investors. However, one of our initial concerns is that the draft regulations are likely to require an issuer to undertake reasonably extensive due diligence. This would undermine one of the primary objectives of the CMD Taskforce: to improve businesses' access to capital and reduce the costs of raising capital.

#### Four specific issues for consultation

MED noted that it would particularly welcome submissions on four specific issues:

- a) the extent to which the regulations meet the objective of streamlining the capital raising process whilst meeting investor protection objectives;
- b) whether an issuer of debt securities using the SDP should be required to provide financial statements for the "borrowing group" or just those of the "issuing group" where the net assets of the issuing group are largely the same as those of the borrowing group;
- c) whether the use of an SDP should be restricted to "vanilla" securities or should be also available for more complex products; and
- d) whether listed unit trusts should be entitled to issue equity under an SDP.

#### General provisions

Only listed issuers that already comply with the continuous disclosure obligations of NZX will be able to use an SDP to make an offer of securities. The securities to be offered by means of an SDP must be either:

- listed; or
- unlisted equity securities which rank equally with or in priority to other listed equity securities of the issuer; or
- unlisted debt securities (not being securities that may be converted into equity) which rank equally with or in priority to one or more other listed debt securities of the issuer; or
- unlisted convertible securities which meet two requirements:
  - on a liquidation, they must rank equally with or in priority to one or more other listed debt securities of the issuer; and

- for distributions, they must rank equally with or in priority to other listed equity securities of the issuer.

An issuer seeking to make an offer of further (listed) securities by means of an SDP must also:

- make the information referred to as having been disclosed under its continuous disclosure obligations available on an internet site, as well as ensuring that it is available for inspection (and copying); and
- file with the copy of the SDP lodged with the Companies Office for registration copies of all such (reference) disclosure information identified in the SDP as being material to the securities or the offer – as though that information was a "material contract".

In Australia, the requirement to make available information previously disclosed under an issuer's continuous disclosure obligations has often been achieved by including in the disclosure document a "wrap up" disclosure statement summarising relevant material disclosures.

### **Content requirements**

The detailed disclosure obligations for an SDP (which will form additional schedules to the Securities Regulations 1983) indicate that MED (as the drafter) wants to have a foot in both camps by requiring both:

- a) some prescriptive information about the securities being offered (including the terms of the securities offered, relationship with other listed securities of the issuer, preliminary and issue expenses, details of any charges payable by the subscriber, information about returns to subscribers from the securities, and a statement whether or not the subscriber is entitled to sell their interest in the securities) in what is simply a hybrid of the existing prescriptions for prospectus and investment statement disclosure; and
- b) all information that investors and their professional advisers would reasonably require to make an informed assessment of the offer (including references to all information disclosed by the issuer under its continuous disclosure obligations, any information required to update or correct those disclosures, and a reference to the latest financial statements of the issuing group).

The first limb also introduces several new disclosure requirements for SDPs which are not currently required to be included in an investment statement or prospectus. The most significant of these is the requirement that, where securities are issued to finance capital projects, the SDP must include an indication of the expected financial benefits of the project. This is in addition to being required to disclose information about returns on a basis which has been taken directly from the prescriptive disclosure requirements for an investment statement.

The second limb uses the standard of disclosure applied for prospectus disclosure in Australia but without the corresponding qualifications that the information must be provided only:

- to the extent to which it is reasonable for investors and their professional advisers to expect to find the information in the prospectus; and
- if a person whose knowledge is relevant (i.e. the issuer and its directors) actually knows the information, or in the circumstances ought reasonably to have obtained it by making inquiries.

### **Drawbacks**

The addition of such "catch-all" provisions, without the corresponding qualifications, is likely to preclude any significant reduction in the due diligence required to ensure that the issuer's directors can still rely on the due diligence defence provided by the Securities Act 1978. As a result, the use of an SDP may not significantly streamline the process of capital raising for a listed issuer.

These provisions also impose some additional disclosure requirements that are not currently required to be included in an investment statement or prospectus - one of which is forward looking in that it requires an indication of the expected financial benefits of a project.

In addition, the directors of the issuer must state whether, after due enquiry, the issuer is in compliance with its continuous disclosure obligations.

These matters may seriously detract from the SDP achieving the objective of a more efficient capital raising.

## **Next steps**

The proposals to introduce the SDP regime are a welcome streamlining of the securities issue process. However, on first reading, the draft regulations have a number of significant shortcomings that will limit the usefulness of the SDP regime. It is hoped that dialogue with MED over the contents of the regulations will result in a sensible balance between the twin objectives of streamlining the capital raising process and ensuring that adequate standards of disclosure information are available for investors.

The circulation of the draft regulations and the speed with which a host of interested parties have worked to produce both the enabling legislation and the regulatory detail that supports it further signals the responsiveness to the pressures being imposed by the existing financial climate and the need for New Zealand businesses to raise capital efficiently.

Submissions on the draft regulations closed on 27 May. We will keep you updated with further developments.

To access a copy of the draft regulations visit the Ministry of Economic Development's website at <http://www.med.govt.nz/> or [click here](#).

## Securities and capital markets

### Proposed securities regulation changes released

*Changes to make it easier for businesses to raise capital are a step closer with the government's release of a discussion document on proposed changes to securities regulations in April 2009. The discussion document, which highlights proposals to improve flexibility for issuers, is a response to the recommendations of the government-appointed Capital Market Development Taskforce. In this article, partner Andrew Brown and senior associate Stephen Layburn outline the proposed changes.*

The discussion document addresses both the Capital Market Development (CMD) Taskforce's headline recommendations aimed at making securities disclosure more meaningful as well as the CMD Taskforce's recommendation for an urgent implementation of the Securities Commission's modernisation study and resulting recommendations dating back to 1999-2000.

#### **KEY CHANGES**

The major amendments proposed in the discussion document are outlined below.

#### **Financial statements**

The discussion document proposes that the Securities Regulations be changed to require financial statements used in prospectuses for offers of equity, debt or participatory securities to be prepared in accordance with New Zealand International Financial Reporting Standards (NZIFRS), which is the requirement under the Financial Reporting Act 1993. Currently the content requirement prescribed by the Securities Regulations for the financial statements that are to be contained in a prospectus differ from those under the Financial Reporting Act and this can lead to issuers having to prepare two different sets of financial statements. The change should be welcomed and reduce compliance costs.

#### **Definition of borrowing group**

In the context of an offer of debt securities, the Securities Regulations currently require disclosures in relation to the borrowing group - being the issuer of the debt securities and any guaranteeing subsidiaries. However, many issues of debt securities include guarantees by parent and sister entities which do not presently fall within the meaning of the "borrowing group". Consequently, a change is proposed to the Securities Regulations to include disclosure about guaranteeing parent and sister entities to ensure proper disclosure about all entities that are guaranteeing the issuer's obligations.

#### **Prospective financial information**

The Securities Regulations currently require prospectuses for initial offerings of equity securities to contain a prospective statement of cashflows for the next 12 months rather than full prospective financial statements. This requirement has been heavily criticised on a variety of levels, including that it does not provide meaningful information. A recommendation has been made to require full prospective financial statements.

#### **Disclosure of interests**

A proposed change to ensure that the disclosure of directors', promoters' and managers' interests is consistent across all types of securities offerings (including equity, debt, unit trusts, life insurance policies and superannuation schemes) has been recommended. At present differing disclosure obligations for different kinds of issuers contributes to a lack of uniformity and allegations that it hampers meaningful comparison between different investment products.

#### **Consideration for securities**

A change is recommended to provide for the Securities Regulations to enable the price/consideration payable for securities to be determined by a formula, so long as the formula is set out in full and clearly explained. The absence of such flexibility is an example of the need to bring the content requirements up

to date as the disclosure of price/consideration payable routinely leads to requests for exemptions by the Securities Commission.

### **Flexibility in advertisements**

The Securities Regulations also prescribe the content requirements for promotional material covering securities offers. Among the proposals are measures designed to provide more flexibility about the financial information that may be contained in advertisements. First, it is proposed to relax the current restriction that only allows securities advertisements to contain prospective information that is included in the relevant prospectus for the securities, including by allowing references to commentary or analysis of prospective financial information. Secondly, a proposal to allow advertisements to include information from interim or unaudited financial statements regarding the net assets and assets and liabilities of the issuer. This development is to address the difficulties encountered where the audited (annual) financial statements are not the most recently published financial information available.

### **Modernisation**

Measures to address a number of known problems with the Securities Regulations, including by closing a loophole over distribution of advertisements via the internet. Other changes are proposed by way of a limited rewrite of the Securities Regulations to rid them of outdated terminology, unclear definitions and otherwise undertake a modernisation exercise. The rewrite will not change the substantive effect of the Securities Regulations

### **SIMPLIFIED DISCLOSURE - PROSPECTUS REGULATIONS**

The draft regulations that are required to implement the simplified disclosure prospectus (SDP) which features in amendments to the Securities Act 1978 contained in the Securities Disclosure and Financial Advisers Amendment Bill now before Parliament were not included as part of this discussion document. However the discussion document did seek views on whether the use of a SDP should be restricted to "non-complex" products such as shares, preference shares, securities that convert into ordinary shares of the same issuer and debt securities.

A draft of the SDP regulations was released by MED in May 2009 for consultation. For further details on these draft regulations please refer to the article "[Fast track for capital raising: simplified disclosure prospectus](#)" in this issue of Commercial Quarterly.

### **MUCH WELCOMED CHANGE**

A number of the proposals contained in the discussion document represent a much-welcomed update to detailed content requirements which are out-of-date and/or unwieldy.

The closing date for submissions was 8 May 2009, but there is no indication yet as to when MED is likely to implement the proposals. The discussion document and the consequential changes to the Securities Regulations are very much a stop-gap measure pending a more thorough review of the Securities Act which, we understand, is scheduled for later this year.

To access a copy of the discussion document visit the Ministry of Economic Development's website at <http://www.med.govt.nz/> or [click here](#).

For a copy of Bell Gully's submissions on the discussion document [click here](#) or visit our website at <http://www.bellgully.com/resources/resource.02215.asp>

## Securities and capital markets

### New listing rules in place

*Recent amendments to the NZX Listing Rules should make it easier for NZX listed issuers to raise capital. In this article, partners Gavin Macdonald and Andrew Brown discuss the changes to the Listing Rules of the NZSX/NZDX and NZAX Markets which came into effect on 3 April 2009.*

The changes to the Listing Rules of the NZSX/NZDX and NZAX Markets (the New Rules) put in place the changes outlined in NZX's December 2008 consultation Exposure Draft with some minor amendments.

Many of the changes have been prompted by current market conditions and some of the recommendations of the Capital Markets Development Taskforce. However, a number of the New Rules are not directly related to the financial crisis.

#### **WHAT HAS CHANGED?**

A summary of the New Rules is set out below.

#### **Rights issues**

The New Rules have reduced the prescribed time period for a rights issue. The closing date for applications to be received after the mailing of entitlement letters has been reduced from a minimum of 18 business days to a minimum of 12 business days. Details of the issue must now only be announced to the market five business days before the Record Date. The minimum timeframe for completing a rights issue is therefore now reduced to just over three weeks compared with the previous timeframe of approximately six weeks.

This should make rights issues more attractive. Because a rights issue will now be able to be completed more quickly, it will be easier for issuers to accurately price a rights issue and result in less risk to underwriters. It will, of course, mean that investors will have less time to decide whether or not to take up their rights.

#### **Private placements**

The New Rules now allow an NZSX listed issuer to issue up to 20 per cent (previously 15 per cent) of the total number of shares on issue in any 12 month period without first obtaining shareholder approval under Rule 7.3.5. The New Rules also allow directors, associated persons of directors or employees to participate in such placements, subject to satisfaction of certain conditions.

A consequential amendment has also been made to the related party transaction provisions in Rule 9.2.2 to ensure that in the case of a private placement under Rule 7.3.5, only the market value of the securities being issued to related parties and employees of the issuer is taken into account in determining whether the placement is a related party transaction which requires shareholder approval.

#### **Pricing**

The previous requirement to obtain NZX approval for certain non-pro-rata share issues (which was required if the issue price was less than 90 per cent of VWAP over a 20 business day period before the issue) has been replaced. The New Rules no longer require NZX approval but instead require the directors to sign a fairness certificate if the issue price is less than 85 per cent of VWAP over a five business day period before the issue.

#### **Remuneration of directors with shares**

The New Rules allow for directors to be remunerated, in whole or in part, by the issue of securities. Previously, the Listing Rules only contemplated cash remuneration. Issuers looking to take advantage of this will initially need to obtain an authorising shareholders' resolution in the same way as they would need shareholder approval for an increase in directors' fees.

The change will assist issuers to align management and shareholder interests more closely and allow issuers more flexibility in the way they remunerate directors in periods of cash constraint.

### **Related party transaction threshold increased**

The New Rules permit issuers to enter into transactions with, or involving, related parties without the need for shareholder approval if the transaction value is no greater than 10 per cent of the issuer's average market capitalisation. The previous threshold was 5 per cent of average market capitalisation. For services transactions, the threshold in relation to the annual gross cost to the issuer has increased from 0.5 per cent to one per cent of average market capitalisation.

These changes have been made in recognition of the general fall in market capitalisations over recent months and the fact that, for smaller companies in particular, 5 per cent often represents a very small absolute amount. However, concerns expressed by some market participants and the Securities Commission that this amendment could have significant consequences for larger issuers and undermine investor confidence in the market have resulted in a new disclosure requirement being introduced. A new Rule 10.1.3 requires announcement to the market of transactions involving related parties which are for a value in excess of 5 per cent, but less than 10 per cent, of an issuer's average market capitalisation.

### **Financial assistance**

The New Rules permit issuers to provide financial assistance without shareholder approval to persons other than directors and associated persons of directors or employees for the acquisition of shares if the amount of financial assistance, together with all other financial assistance given in the preceding 12 months, is not greater than 10 per cent of the issuer's average market capitalisation. The previous threshold was 5 per cent of average market capitalisation.

The threshold in respect of financial assistance to employees without shareholder approval has been increased to 5 per cent of average market capitalisation.

The overall limit for both categories over a five year period has also been increased from 5 per cent to 10 per cent of average market capitalisation.

### **Share buybacks from employees**

The New Rules remove the restriction on the buyback of shares from employees.

## **CHANGES NZX HAS DECIDED NOT TO PROCEED WITH**

### **Appraisal reports**

In NZX's initial consultation paper on this round of rule changes released in November 2008, NZX also proposed to make Appraisal Reports (which are required in respect of share issues to directors and their associated persons, share buybacks affecting control and "related party" transactions) non-mandatory. This proposal has been abandoned, but NZX has stated that it will issue a guidance note on applications for waivers from the requirement for an Appraisal Report within the next three months.

### **Minority shareholders and independent directors**

NZX has also decided not to proceed with its controversial proposal in the November consultation paper that only minority shareholders may vote on the remuneration, appointment or reappointment of independent directors.

## **CHANGES DEFERRED**

### **Reduced offer document requirements**

As previously noted (see the article "[Update on NZX reforms to capital raising and flexibility](#)" on our website), one of NZX's key proposals directed at improving capital raising (put forward in the November consultation paper) was deferred until relevant legislative changes are put in place. This proposal would permit a NZX listed issuer which was in compliance with its continuous disclosure obligations to be able to raise equity, on a pro-rata basis, from its existing shareholders and to raise debt using a Term Sheet Offering Document rather than an investment statement and prospectus.

It is likely that this proposal will be revisited later this year following the implementation of the Securities Disclosure and Financial Advisers Amendment Bill.

#### **ADDITIONAL STYLISTIC CHANGES**

NZX has taken the opportunity as part of this round of rule changes to make a number of other minor changes to the Listing Rules. These are largely stylistic changes, but some of the changes may give rise to confusion. In particular it should be noted that references to previously revoked rules have been removed, which has resulted in a number of existing rules being renumbered. Section 1 of the Listing Rules has undergone the biggest redraft, although most of the wording replicates the wording of the old version of the Listing Rules.

#### **FURTHER REVIEW**

NZX has stated that it will review the operation of the New Rules after 12 months to ensure they are working as intended.

Full copies of the New Rules can be found at [www.nzx.com/regulations/rules](http://www.nzx.com/regulations/rules)

## Securities and capital markets

### New rules on short form prospectuses

*The Securities Commission has replaced (with amendments) the Securities Act (Short Form Prospectus) Exemption Notice 2002 with a substitute exemption notice. In this update, partner Brynn Gilbertson outlines the differences between the old and new rules.*

Effective from 23 March 2009, the Securities Act (Short Form Prospectus) Exemption Notice 2009 (2009 Exemption) retains the exemptions and conditions that had been previously provided which had exempted issuers from the requirement to include financial statements in a short form prospectus for the offer of certain securities to existing holders, provided that certain recent financial statements have been sent to shareholders.

#### **Exemption available where section 209 notice has been sent in lieu of annual report**

In June 2007, amendments to section 209 of the Companies Act 1993 took effect (relating to obligations to make an annual report containing the financial statements available to shareholders). Before these amendments, an annual report was required to be sent to shareholders not less than 20 working days before the annual meeting. The amendment made it possible to send a notice advising shareholders of their right to receive an annual report in place of the annual report.

Previously, an issuer was required to include financial statements in a short form prospectus even where that issuer had made use of the section 209 notice procedure. Under the 2009 Exemption, an issuer that has made annual reports available to shareholders under the section 209 procedure will not be required to include those accounts in its short-form prospectus.

The policy underlying the short form prospectus provisions of the Securities Regulations 1983 is that short form prospectus disclosure should be available to companies if the most recent annual report has been made available in accordance with the Companies Act 1993. The 2009 Exemption is consistent with that policy and aligns the relief in this area between the Securities Regulations 1983 and the Companies Act 1993.

#### **Condensed interim financial statements**

The 2009 Exemption also provides that compliance with NZ IAS 34 in respect of interim financial statements is sufficient compliance with the requirements of the Financial Reporting Act 1993 for the purposes of short form prospectuses. This exemption has the effect that condensed interim financial statements can now be used in short form prospectuses without the need for full notes to those statements. Condensed interim financial statements are still required to be included in the short-form prospectus, even where the issuer has previously sent those interim financial statements to shareholders.

The amended exemption recognises that a reduced level of information is appropriate for offers of securities to existing security holders and enables issuers to make offers to these existing investors on the basis of reduced disclosure and, accordingly, with lower compliance costs.

## Competition and consumer law

### **Time to change the focus**

In this article, partner Phil Taylor and senior associate David Blacktop discuss how the economic environment, a change of government and a changing of the guard at the Commerce Commission provide an opportunity for the commission to shift its balance towards a greater emphasis on resolving cases earlier and at lower cost to New Zealand Inc.

### **Decision upheld in consumer credit test case appeal**

In this article, partner Jenny Cooper and solicitor Nick Christiansen discuss a recent High Court decision which confirms the ability of lenders to set prepayment fees based on their business model and lending practices, rather than the "safe harbour" formula advocated by the Commerce Commission.

### **Overseas defendants stay in Commission's line of sight**

The Court of Appeal's ruling in the long running Koppers Arch Commerce Act litigation represents a significant victory for the Commerce Commission in confirming the territorial reach of the Act to overseas defendants. In this article, senior associate Jenny Stevens comments on the significance of the court's decision.

### **When failing = winning**

For firms facing closure in these tough economic times, the prospect of recouping some of the losses by selling to another industry player is likely to be welcomed. In this article, partner Torrin Crowther discusses the scope to achieve Commerce Commission blessing for such a sale, even when it might result in the purchaser gaining a very high market share (or even a monopoly).

## Competition and consumer law

### Time to change the focus

*In this article, partner Phil Taylor and senior associate David Blacktop discuss how the economic environment, a change of government and a changing of the guard at the Commerce Commission provide an opportunity for the commission to shift its balance towards a greater emphasis on resolving cases earlier and at lower cost to New Zealand Inc.*

#### **The commission's "deterrence" phase**

*The thermometer of success is merely the jealousy of the malcontents. (Salvador Dali)*

If Paula Rebstock's tenure as Chair of the Commerce Commission is judged by "the jealousy of the malcontents", then based on the level of comment attracted over recent months alone, her tenure has been extraordinarily successful.

The commission under Ms Rebstock has grown not only its numbers, but also its sophistication, experience and expertise and, importantly, its reputation for being a strong regulator. Indeed, increasing its enforcement impact was one of the commission's strategic priorities during Ms Rebstock's time as chair. Through several high profile "wins", the commission has established a reputation for a "bite as bad as its bark" and generated much greater awareness of the rules of competition than was previously the case.

This period in its history could be described as a "deterrence" phase. The sense from business is that the commission has focussed almost entirely on sending the signal that breaches will be prosecuted and that its desire to send a message of zero tolerance for non-compliance has led it to leave no stone unturned in pursuing enforcement successes. It also appears to have been a strong factor considered by the commission in investigating and issuing proceedings in particular cases. At times, there has been a feeling that sending a deterrent message has been achieved but at the expense of reaching an earlier, lower cost resolution.

With a change in the chair, a change in minister, and most importantly the current economic outlook, it is an appropriate time to step back and question how implementation of New Zealand's competition laws should be developed over the next five years and the role the commission should adopt. In his pioneering work on antitrust policy, E.S Mason commented that:

"What we are concerned with in the main are not questions of crime and punishment but the devising of rules relating to market structure and business practices that will prevent the unhealthy, and facilitate the healthy, growth of the economy. It is a question of hygiene rather than morals."

The new chair has the opportunity to move the commission beyond deterrence, towards a phase of greater and earlier engagement with business regarding the substance of investigations in order to better balance achieving the commission's goals and minimising the current high costs of investigations.

#### **The role of competition policy**

In one of the very earliest Commerce Act cases, the Court of Appeal held that the Commerce Act was "based on the premise that society's resources are best allocated in a competitive market where rivalry between firms ensures maximum efficiency in the use of resources".

Implicit in this statement is recognition that while facilitating competition is the primary focus of the Commerce Act, the fundamental and underlying policy objective is to promote New Zealand's economic interests and economic efficiency. After all, the Commerce Act was introduced as part of the package of economic reforms post-1984, designed to maximise New Zealand's economic efficiency.

The Ministry of Economic Development has made conceptually similar statements in its "Code of Good Regulatory Practice" where it states that regulations should only be adopted where "the costs on society are justified by the benefits to society, and that achieve objectives at lowest cost, taking into account alternative approaches to regulation".

Promoting economic efficiency via the Commerce Act depends not only on outcomes but also on approach. The commission's approach to administering the legislation, prioritising its focus and carrying out its duties all have direct impacts on the New Zealand economy. Having now established its reputation as a strong and sophisticated regulator with zero tolerance for non-compliance, the issue is what approach will most benefit New Zealand Inc and further the underlying policy objective of the legislation, i.e., greater economic efficiency?

### **A change of focus**

It goes without saying that deterrence remains an important goal, but given the work it has already done, there is limited benefit for New Zealand Inc in the commission continuing to focus principally on a deterrence reputation. That is not to say there is no room for enforcement action in some cases.

The costs of enforcement action are high – the time and costs associated with court proceedings associated with investigations as well as court are hugely burdensome for those involved. Justice Sackville's comments in *Seven Network Limited v News Limited* provide a cautionary tale. He estimated that the parties had spent in the order of A\$200m on legal costs alone and noted that this did not include possible appeals.

The costs go beyond direct legal costs and include indirect costs resulting from uncertainty and the management time and resource required. Investigations and litigation distract management time, reducing management focus on core responsibilities – creating dynamic and innovative firms that compete strongly in markets.

The commission's strong enforcement reputation means it can and should shift the balance towards seeking to engage with business to find solutions that achieve the correct policy outcome for the least cost on a case by case basis. A forthright discussion and expression of its concerns at an early stage with the aim of achieving a pragmatic and effective solution can save a lot of time, cost and effort and promote better outcomes for New Zealand Inc.

### **The best information for the minimum cost**

This change of focus should also be applied during investigations. Commission investigations involve huge costs similar to those involved in litigation.

Of course the commission needs to be able to investigate. The only question is ensuring that the commission gets the best information it can, for the minimum cost to the economy. There is a sense among business that the commission does not appreciate the costs that its investigations impose or the effects of those costs on the bottom line, which can manifest themselves in reduced profits, investment in expanding the business, and employment.

For example, business people often express frustration with the breadth of section 98 notices (which require a person to provide information to the commission), in terms of subject matter and time period. While in our experience the commission is generally open to refining the requests (so long as the refined scope still captures the information it requires), given the time and cost impact of these notices on businesses, there is considerable scope for the commission to make better and more effective use of the section 98 process through a consultative approach and by providing greater context for what it is seeking.

Methodology which encourages market participants and the commission agreeing the scope for section 98 notices would provide the commission with the information it needs and lower the cost to the economy as a whole. From the commission's perspective, more efficient section 98 notices will lessen its need to review irrelevant material. It always has the opportunity to have a second bite once it has considered the initial agreed scope of information and given the greater efficiency up-front, time should not be an issue.

### **Achieving engagement – Section 100 orders as a "barrier" to effective engagement**

There is a strong desire for the commission to work alongside business to achieve outcomes. While there is often good engagement between the commission and business sectors, some adjustments would procure a stronger relationship, ensure that all parties are fully aware of each other's position and mitigate any aspects which tend to entrench positions, rather than provide a platform for a constructive solution.

The commission's use of section 100 orders is an example of a practice that can get in the way of resolving issues.

Section 100 orders are confidentiality orders which were originally enacted to protect the disclosure of confidential information provided to the commission. More recently, the commission has used these orders to prohibit witnesses from disclosing details of any matters discussed at commission interviews, including the questions asked and the answers given.

Through these orders businesses are unable to receive information from their own employees about what is discussed at the commission interviews as the company is not usually permitted to attend (and any lawyers attending are subject to the same confidentiality orders).

These orders do provide the commission with an investigative advantage, but at the same time they can create a real barrier to resolution by preventing the business under investigation – which can only act through its employees – from having a full understanding of the matters at issue. In the same way, the commission's co-operation and leniency policy, which effectively require businesses to be prepared to admit breaches of the Commerce Act before the commission will provide any substantive indication of its concerns, can also be a barrier to resolution. If employees are not candid with their employer, and the commission will not indicate its concerns, the business is left with insufficient knowledge of the problem and an insufficient basis to resolve it proactively and constructively. Although the business will want to address any problem it has at an early stage (rather than spend money on a protracted investigation), it is left in the dark.

Now would seem ideal for the commission to reflect on altering its approach – letting down its strict guard on its enforcement powers where necessary to enable business and the commission to get to and address the substance of matters more quickly and more efficiently.

*This article was first published in Competition Matters, NZLawyer, 1 May 2009.*

## Competition and consumer law

### Decision upheld in consumer credit test case appeal

*In this article, partner Jenny Cooper and solicitor Nick Christiansen discuss a recent High Court decision which confirms the ability of lenders to set prepayment fees based on their business model and lending practices, rather than the "safe harbour" formula advocated by the Commerce Commission.*

The High Court upheld the District Court's decision in *Commerce Commission v Avanti Finance* in which the District Court dismissed charges against Avanti under the Credit Contracts and Consumer Finance Act 2003 (CCCFA). (See the article "[Consumer credit test case provides guidance on fees](#)" in the Winter 2008 issue of Commercial Quarterly to read our earlier commentary on the District Court's decision.)

#### The District Court case

The commission had alleged that the prepayment fees charged by Avanti were unreasonable under the CCCFA because the formula Avanti used did not involve a reasonable estimate of Avanti's loss on prepayment. Drawing on the "safe harbour" formula provided for in the CCCFA, the commission alleged that Avanti's alternative formula did not relate to the time taken to re-lend funds, had no regard to changes in interest rates, and did not take into account mitigation of loss by re-lending. However, the court found that the safe harbour formula did not reflect Avanti's loss, was not suited to Avanti's business structure, and that Avanti's formula was reasonable.

#### The High Court appeal

The commission appealed the District Court decision to the High Court. The focus of the appeal was whether Avanti was required to calculate its loss on the assumption that it would immediately re-lend the prepaid funds despite the fact that it had excess funds available and prepayment did not affect its ability to issue new loans.

The commission contended that the reasonableness of any alternative formula used to calculate a prepayment fee must be considered against the principles inherent in the safe harbour formula. This would require allowances for changes in prevailing interest rates, mitigation of loss through re-lending, the reduction of the outstanding balance due over time, and the time value of money. In the commission's view, although the CCCFA allows creditors to use their own formula, it was wrong for Avanti to depart from the safe harbour formula for reasons linked to its business structure rather than reasons to do with the characteristics of loans themselves.

Justice Asher in the High Court held that a prepayment fee calculation is not unreasonable if it involves an objective estimate at the time of entering into the contract of compensation to the creditor for it was further held that it is reasonable for a creditor to take into account the fact that a new loan will not replace the old one and that profit on the loan is lost through prepayment.

His Honour held that the CCCFA explicitly provides two alternatives - the safe harbour formula, or an appropriate alternative formula - and that the reasonableness of an alternative formula does not depend on its similarity to the safe harbour formula. His Honour said that it makes no logical sense for the legislature to have provided for alternative formulae if they were to be driven by the terms of the safe harbour formula, and that the only benchmark is reasonableness.

Finally, His Honour refused to accept the commission's contention that it is inappropriate to consider the creditor's business structure in setting prepayment fees, saying that an assessment of reasonableness requires consideration of the loss of the actual creditor, and more than "a barren focus on a contractual term against a market backdrop".

The High Court decision affirms the District Court's decision in this important test case and gives lenders welcome guidance on the factors they need to take into account in setting prepayment fees.

## Competition and consumer law

### Overseas defendants stay in Commission's line of sight

*The Court of Appeal's recent ruling in the long running Koppers Arch Commerce Act litigation represents a significant victory for the Commerce Commission in confirming the territorial reach of the Act to overseas defendants. In this article, senior associate Jenny Stevens discusses the court's decision.*

On 18 March 2009, the Court of Appeal (*Harris & Ors v Commerce Commission* [2009] NZCA 84) upheld the 2007 decision of Justice Hugh Williams when it found that the Commerce Act can apply to persons who are alleged to have entered into arrangements or understandings offshore that are directed at New Zealand markets even where those persons:

- a. are not resident or carrying on business in New Zealand; and
- b. have not personally engaged in any conduct in New Zealand or sent communications to New Zealand.

The appellants are three individuals who reside overseas. The commission alleges they were involved in reaching understandings in two New Zealand markets for wood preservatives and that those understandings constituted breaches of the Act. Some parties have already admitted liability and had financial penalties imposed.

The appellants lodged protests to jurisdiction in the High Court, arguing that the Act did not apply to them as overseas defendants, as well as denying involvement in the conduct alleged. The appellants pointed to section 4(1) of the Act, which provides:

"This Act extends to the engaging in conduct outside New Zealand by any person resident or carrying on business in New Zealand to the extent that such conduct affects a market in New Zealand."

The appellants argued that the coverage of the Act was "pushed out" to overseas conduct only in the circumstances specified in section 4. The court rejected this argument. As the Act does not address the situation of a person not resident or carrying on business in New Zealand, the court had to consider the position of such persons as a matter of statutory interpretation, keeping in mind the policy and purposes of the Act.

Three factors were decisive.

#### **Actual conduct in New Zealand not required**

First, the appellants argued that some conduct in New Zealand should be required for the Act to apply. As the commission had accepted the appellants had not personally engaged in any relevant dealings in New Zealand (except the alleged attendance at one meeting in New Zealand by one of the appellants) that requirement was not met. The court rejected this. While accepting that a case is likely to be stronger if an overseas person has acted personally in New Zealand (by, for example, sending relevant communications to New Zealand or attending relevant meetings in New Zealand), the court found such personal action was not a pre-requisite to liability.

"[I]t is sufficient that the communications or directions in furtherance of the anti-competitive arrangement were given to New Zealand actors while they were overseas. If the New Zealand actors then acted in New Zealand to give effect to the anti-competitive arrangement, they can properly be regarded as having acted at the direction of, or on behalf of, the overseas residents in that respect. The overseas residents will be regarded as having committed conduct in New Zealand, and s4(1) will be irrelevant."

#### **Anti-competitive behaviour and conspiracy**

Second, the commission sought to draw an analogy between the anti-competitive understandings alleged and the criminal concept of conspiracy. The court agreed this was an appropriate analogy to assist in interpreting the intended territorial scope of the Act. At common law, the principles of territoriality around conspiracy are wide so that, for example, a conspiracy formed abroad to do an illegal act in, say, England could be prosecuted in England even though no overt act had occurred in England to further the conspiracy.

The court found this analysis and reasoning useful in understanding the important policy considerations of the Commerce Act. As the concept of conspiracy is incorporated into the Act, the court considered that was an indication that Parliament intended the Act to have extraterritorial application in circumstances beyond those referred to in section 4.

### **Increased globalisation**

Third, an apparently influential factor in the court's decision is its frequent reference to the effects of increased globalisation. The court considered its approach "reflects the realities of globalisation" and that "legal analysis must reflect the reality of increased globalisation, and this is a particularly powerful factor in a case such as the present".

Taking these factors together, the court found that the Act can apply to the appellants and a full trial on the commission's allegations against them could now proceed.

In reaching this conclusion, the court has extended the territorial reach of the Act. An entity cannot insulate itself from liability in New Zealand by entering into an anti-competitive arrangement overseas directed at a New Zealand market, take care not to hold meetings in, or to even send communications to, New Zealand about the arrangements and then implement the arrangement in New Zealand through local entities.

Although the decision is positive for the commission, the court notes that while there is jurisdiction under the Act in these circumstances "[t]he Commission may face practical problems in seeking to hold such entities to account". This may be so, but the commission has already shown itself to be a litigant who is not afraid of long and difficult battles.

*This article was first published in Competition Matters, NZLawyer, 3 April 2008.*

## Competition and consumer law

### When failing = winning

*For firms facing closure in these tough economic times, the prospect of recouping some of the losses by selling to another industry player is likely to be welcomed. In this article, partner Torrin Crowther discusses the scope to achieve Commerce Commission blessing for such a sale, even when it might result in the purchaser gaining a very high market share (or even a monopoly).*

The theory behind what competition lawyers call the "failing firm" argument is that the acquisition of a business that will otherwise exit the market has no detrimental impact on competition – no matter how large the acquirer becomes as a result – because that exit would have meant it would not be a competitor in any event.

That's the theory. It's not quite as simple in reality because, in the formal clearance context, the commission needs to be "satisfied" the business will fail, there are no alternative buyers and the target's assets will not otherwise constrain the firm seeking a clearance. Indeed, there have been only a handful of successful failing firm applications since the 1990s.

However, the current economic climate suggests that we may see more in the short term. This is not because the commission is likely to relax the threshold it applies, but because: (a) for many firms the prospect of failure is now more acute than it has been for some time; and (b) the pool of potential bidders for such firms is likely to be smaller (i.e. there is a much reduced prospect that another bidder will acquire the firm and continue to compete with the applicant firm). No doubt in recognition of this, the commission has said it is gearing up for more failing firm applications and is in the process of preparing guidelines for how it will assess these applications.

The commission's clearance for Fletcher Building to acquire certain masonry assets from Stevenson Group is a very recent example of the commission accepting the "failing firm" argument.\* The commission cleared the transaction on the basis there was no real prospect of a third party acquiring the masonry division as a going concern, or acquiring the masonry assets on closure and using them to compete in the relevant markets. The commission's full written reasons, which are yet to be released, are likely to provide useful guidance for firms contemplating similar applications.

Irrespective of those full reasons, what is clear is that firms advancing the failing firm argument should be prepared to provide the commission with:

- evidence of previous attempts to restructure or otherwise turn the business around – this being relevant to the question of whether, absent the deal, there is a realistic prospect the firm will be able to trade its way out of its current predicament;
- details of the sales process undertaken, and in particular whether any firms other than the applicant made bids for the business; and
- the firm's assessment of any such bids, and why none represent a true alternative to the acquisition by the applicant (which involves measuring those alternative bids against the benefits of liquidating the assets upon closure).

The commission will also be interested in associated management reports, board papers and board minutes.

The importance of a robust assessment of closure benefits should not be underestimated. It is the closure benefits that form the threshold against which to measure alternative bids from third parties, *not the amount the firm seeking clearance is willing to pay*. If an alternative bid is more attractive than liquidation (taking into account monetary and non-monetary considerations such as transaction certainty, a "clean exit", etc.) the commission is unlikely to be satisfied the business will close absent the acquisition by the applicant firm, meaning the failing firm argument is likely to fail.

The fact third parties are willing to buy the business or its assets is not necessarily fatal to the argument – so long as their offers are less attractive than the firm's liquidation benefits (which typically accrue from selling off inventory, scrapping the assets, putting the assets to alternative use or selling the assets off-

shore). Furthermore, it is not necessary to show that the entire target company will fail, only that the particular division for which clearance is sought will fail or otherwise exit the market.

Time is invariably of the essence in the failing firm context, which can create a tension with the commission's statutory obligation that it be "satisfied" in the clearance context that a substantial lessening of competition is not likely. Firms seeking a swift outcome will do well to ensure they at least meet, and where possible beat, commission timeframes for providing information and comment on various issues. Understandably, the commission will be far less willing to divert resource from elsewhere to achieve an urgent decision if it does not believe the parties themselves are making similar sacrifices. This will largely be in the hands of the target, not the applicant, because it is the target's information that is key to the failing firm argument. Fortunately, targets that meet the "failing firm" grade tend to be incentivised to achieve a timely clearance.

*\*Bell Gully acted for Stevenson Group in successfully advancing the failing firm argument.*

*This article was first published in Competition Matters, NZLawyer, 6 March 2009*

## Utilities and resources

### **New Government Policy Statement on Electricity Governance**

On 11 May 2009, the Government released a revised Government Policy Statement on Electricity Governance to deal with the issues of security of the electricity supply and the need to streamline the process used for approving plans for small upgrades of the National Grid. In this update, senior associate Chris Hay comments on the key changes.

### **Ministerial review of the electricity sector**

On 1 April 2009, the Government announced a Ministerial Review of the electricity sector with a view to implementing any required structural reform by June 2010.

### **New Zealand's Emissions Trading Scheme – still up in the air?**

In this article, partner Simon Watt and senior associate Kate Radka discuss the likely outcome for New Zealand's Emission Trading Scheme in light of its current review and recent economic events.

## Utilities and resources

### **New Government Policy Statement on Electricity Governance**

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#### **Background**

The Government Policy Statement on Electricity Governance (GPS) sets out the objectives and outcomes the government wants the Electricity Commission to work towards in its governance of the electricity industry.

The updated and revised GPS released in May, follows a public consultation on the proposed changes to the GPS in March this year (see our article in the [Summer 2009 issue of Commercial Quarterly](#) for further details). Discussions and submissions on the GPS were received from a variety of interest groups including lines companies, retailers and generators, Transpower New Zealand Limited (Transpower), the Commerce Commission and the Electricity Commission.

The changes to the GPS marked the beginning of the National Government's proposed reforms of the electricity sector and, at this stage, have been limited to matters that the government considers warrant urgent attention. It is likely that the GPS will undergo further changes, some of which may be quite significant, as a result of the current Ministerial Review of the performance of the electricity market and the government's proposed review of the Labour government's "New Zealand Energy Strategy to 2050" (NZES) released in October 2007. (For further details on the Ministerial Review, refer to the article "Ministerial Review of the Electricity Sector" in this issue of Commercial Quarterly.)

The principal changes to the GPS relate to:

- emphasising the need to ensure the security of the electricity supply;
- streamlining the process required for the approval of investments by Transpower in smaller National Grid upgrade projects; and
- removing redundant references to the NZES and the New Zealand Energy Efficiency and Conservation Strategy (NZECS).

#### **Security of supply**

To emphasise the importance the National Government places on security of supply, the section dealing with security of supply has been shifted nearer to the beginning of the GPS. However, it is not clear how, if at all, the repositioning of the section within the GPS will result in the Electricity Commission giving greater emphasis to the issue of security of supply given that there have been no variations made to the wording of this section.

The Electricity Commission in its submission on the revised GPS stated that it shared the Government's wish to ensure security of supply, but made no direct comment on what this particular change to the GPS would mean in practice for the commission.

#### **Smaller grid upgrades**

##### *Previous approval process*

The government believed that the previous process (administered by the Electricity Commission) for the approval of investments in the National Grid (Grid) did not have sufficient flexibility to allow the smaller Grid upgrade projects to be quickly approved and implemented.

The process required all upgrades of the Grid above \$1.5 million to be approved by the Electricity Commission under Part F of the Electricity Governance Rules. Without such approval Transpower cannot recover the costs of such investments from its transmission customers. Transpower indicated that under

the old approval regime it was experiencing substantial delays in applying for and obtaining regulatory approval for what it believed were minor investments in upgrades of the grid.

Accordingly, the government has adopted policies which are intended to enable minor investments in the grid to be approved more quickly and to reduce regulatory costs.

#### *New approach*

[Paragraphs 87 and 88](#) of the GPS set out the new approach by which grid upgrade projects, where the total cost is less than \$20 million, are to be subject to a more streamlined approval process. The principal features of this new process involve:

- Transpower being required to develop and submit upgrade plans to the Electricity Commission for approval. The plans must set out the rationale for the expenditure and must meet the minimum reliability standards for the grid. In developing the plans, Transpower is to undertake a detailed planning role. This will include consulting with materially affected parties and having regard to all submissions it receives prior to lodging the plans for approval.
- The Electricity Commission being able to approve the plan without undue delay provided it is satisfied that Transpower has demonstrated the appropriate rationale for the proposed expenditure and has complied with the consultation requirements. The commission will not be required to assess and evaluate the merits (technical, economic or otherwise) of any investment plan which has an expected cost of less than \$20 million.
- Amendments to a previously approved grid upgrade plan are to be dealt with in the same manner providing the total cost under the amended plan is less than \$20 million.

#### *Potential for delays under new process*

The submissions the Ministry of Economic Development received on this aspect of the GPS were generally supportive of the approach to streamline the approval of small grid upgrade projects. However, the Commerce Commission pointed out that this change may require it to alter the approach it takes to the review and approval of Transpower's capital expenditure if the new streamlined process for small grid upgrade projects does not meet the Commerce Commission's regulatory oversight obligations of Transpower's capital expenditure under Part 4 of the Commerce Act. This may "necessitate the Commerce Commission consulting on the treatment of Transpower's capital expenditure that has been approved by the Electricity Commission" since the Commerce Commission cannot pre-determine the outcome of such a consultation.

There is a risk that if this further scrutiny by the Commerce Commission is required, the objective of achieving a more streamlined approval process for the smaller grid upgrade projects will be defeated. However in recommending this change to cabinet, the Minister of Energy and Resources, Gerry Brownlee noted that in his view this is unlikely to be a significant risk because, any additional process put in place by the Commerce Commission (for small grid upgrades) is likely to be more streamlined than the process currently required by the Electricity Commission.

#### **Removal of NZES and NZEECS references**

The deletion of references to the NZES and the NZEECS in the revised GPS is consistent with the shift in focus in relation to the electricity sector under the new government. The focus of the Labour Government was on energy efficiency and sustainability, whereas the National Government considers that these goals, whilst important, should not be at the risk of security of supply. Reviews of the NZES and the NZEECS are proposed for later this year.

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

[Garry Downs](#)  
Partner

[Chris Hay](#)  
Senior Associate

## Utilities and resources

### Ministerial review of the electricity sector

*On 1 April 2009, the government announced a Ministerial Review of the electricity sector with a view to implementing any required structural reform by June 2010.*

#### Terms of reference

The Terms of Reference state that the objective of the review is to "improve the performance of the electricity market and its institutions and governance arrangements in order to better achieve the government's objectives for the electricity sector". These are to ensure that the electricity sector contributes to economic growth by providing security of supply and efficient prices. The review is required to identify any early improvements which can be made from streamlining transmission investment decisions and the current overlap between the Electricity Commission's role and the Energy Efficiency Conservation Authority's similar role in promoting energy efficient programmes. The wider review is required to:

- assess the current performance of the electricity industry and governance arrangements;
- identify any problem areas; and
- have a particular focus on the current institutional and governance aspects with a focus on the industry's involvement in rule making and the role of the Electricity Commission.

#### Technical Advisory Group

The Energy and Resources Minister has appointed six experts to the Technical Advisory Group established for the Review, being Brent Layton as Chair, David Russell, Lewis Evans, Stephen Franks, Toby Stevenson and Miriam Dean QC.

The Technical Advisory Group is required to undertake its analysis on a cost benefit basis and to have regard to a number of important industry reports including the LECG report on the electricity sector regulatory and governance arrangements released in February 2009 and the New Zealand Commerce Commission's findings and recommendations into competition in the wholesale and retail electricity markets released in May 2009.

Importantly, the review is required to use the current market design as a starting point and to focus on improvements to the model. It is not mandated to move away from a market-based approach.

We will keep you updated on any further developments.

## Utilities and resources

### **New Zealand's Emissions Trading Scheme – still up in the air?**

*In this article, partner Simon Watt and senior associate Kate Radka discuss the likely outcome for New Zealand's Emission Trading Scheme in light of its current review and recent economic events.*

New Zealand's Emissions Trading Scheme (NZ ETS) remains under review. While the government awaits the findings of the NZ ETS Parliamentary review committee, trading of New Zealand's Kyoto-compliant units is already underway.

The government expects to amend the scheme by September 2009. We believe the framework is most likely to remain in place. However it is possible in the current economic climate, and in light of the volatile carbon market, that the government may implement measures to provide greater financial protection for business.

#### **Outline of the NZ ETS**

The NZ ETS is an economy-wide, all-gases scheme. Participants with compliance obligations must surrender emission units equivalent to all emissions calculated to arise from specified activities. Participants carrying out one of the limited removal activities specified in the Climate Change (Emissions Trading) Amendment Act (the Act) will be awarded units for emission reductions.

The primary unit of trade and compliance under the NZ ETS is a New Zealand Unit (NZU). Each NZU is backed by a Kyoto-compliant unit, primarily an Assigned Amount Unit (AAU). NZUs may be traded internationally, in which case they would be converted into AAUs. The following Kyoto-compliant units may also be traded and surrendered under the NZ ETS:

- Certified Emission Reduction Units (CERs) – except CERs from nuclear projects and ICERs from developing countries;
- Removal Units – although in reality this is unlikely to occur;
- Emission Reduction Units (ERUs); and
- AAUs – although AAUs originating outside of New Zealand may only be used for compliance purposes until 2012, and must be of a type specified in regulations (which have yet to be released but are likely to have an associated environmental integrity requirement).

Future international linking with other emissions trading schemes is foreshadowed in the Act by the inclusion of "approved overseas units" as a type of unit that may be surrendered for compliance purposes in the Act.

A relatively unique feature of the NZ ETS is that emission units allocated to forestry owners under the scheme can be exchanged and interchanged like any other non-forestry NZU and are available for trading and for compliance use on the same basis. Unlike ICERs and tCERs, awarded for emission reductions arising from forestry-related Clean Development Mechanism projects, any NZUs or AAUs allocated or awarded to forestry owners will not be temporary in nature.

#### **The government's review and trans-Tasman harmonisation**

While the NZ ETS framework is most likely to remain in place, it is possible that the government may introduce measures to provide greater financial protection for business, notably around the price of carbon, by providing for a price cap or a greater allocation of free units to specific industries.

This would also assist with aligning the NZ ETS and the proposed Australian Carbon Pollution Reduction Scheme (CPRS) in future. It is no secret that the New Zealand and Australian governments continue to discuss this as a possibility, particularly with the recently established joint working group of Australian and New Zealand officials to work through options for harmonising the NZ ETS and CPRS. If the findings of this group are adopted, they could significantly alter the NZ ETS.

Specific areas most likely to be the focus of change for harmonising the schemes are the inclusion of a price cap, aligning the types of units acceptable to trade in the schemes, the method for allocating free units to trade-exposed industry, and the timing of sector entry into the schemes. Judging by Australia's recent announcements further delaying the CPRS to mid-2011 with a proposed price cap of AU \$10 for the first year, and for New Zealand not to expect any particular "special" treatment over other countries, any alignment of the schemes is unlikely to occur prior to 2013.

### **International trading**

International trading is recognised and permitted by the NZ ETS. There is no restriction under the current form of the Act on the number of units that may be traded internationally (subject to the requirement not to breach the compliance period reserve which ensures New Zealand retains sufficient AAUs to be able to meet its own Kyoto obligations). We expect a number of units to be sold internationally as participants look to trade with international entities to obtain sufficient units for compliance purposes at the end of each annual compliance period.

To date, there has been some selling by New Zealand to international entities, including both ERU and AAU trades, and New Zealand entities have also been in discussions with Eastern European entities to acquire Green Investment Scheme AAUs.

Early ERU trades have arisen from the government's Projects to Reduce Emissions (PRE) tender rounds in 2003 and 2004. The PRE programme was designed to support initiatives that would reduce emissions and attract investment from developed countries, or companies within those countries, on projects that help them meet their greenhouse gas emission reduction commitments. There are 40 projects in the PRE scheme resulting in the following ERU trades:

- Dutch government agency SenterNovem acquired 530,000 ERUs from the Te Apiti Wind Farm.
- Swiss industry initiative Climate Cent Foundation acquired 642,469 ERUs from Project White Hill.
- Electrabel S.A. acquired 228,000 ERUs from Tararua Wind Farm Stage II.
- Kansai Electric Power Co. Inc. acquired 300,000 ERUs from Tararua Wind Farm Stage III.
- British Gas Trading Ltd acquired 200,000 ERUs from the Burwood Landfill Gas Utilisation Project.
- Kommunalkredit Public Consulting GmbH acquired 149,006 ERUs from the Awapuni LFG to Energy Project.
- Barclays Capital PLC acquired 300,000 ERUs in the Putauaki Geothermal Development.

A number of New Zealand and Japanese entities have been negotiating the acquisition of AAUs, primarily from New Zealand forestry participants in the NZ ETS or in the Permanent Forest Sink Initiative.

The first trade of post-1989 NZUs involved the forward sale of 50,000 NZUs at NZ \$20 (approximately 9 Euros) per unit. We are expecting the finalisation of other NZU and AAU trades to both domestic and international entities shortly.

### **Fiscal initiatives**

The NZ ETS contemplates a number of fiscal initiatives to assist with the transition to the NZ ETS, including the free allocation of units to the forestry and agricultural sectors, as well as to trade-exposed entities (although only for the proportion of their production which is trade exposed), with a phase-out of free allocation to the agricultural sector and trade-exposed entities expected to start in 2018.

There are also some more unique fiscal initiatives to New Zealand that have been, or may be, introduced by the government, including:

- The NZ ETS legislation created a fund to promote energy efficiency and renewable energy technologies in the home. A total of NZ \$1 billion has been allocated over the next 15 years, starting July 2009. The details of the programme have not been finalised yet, but the Act states that the fund can be used for household insulation, energy efficient appliances and lighting, and space and water heating efficiency improvements. Already we have seen the introduction of government funding for the insulation of homes and expect further initiatives to be developed throughout the year.
- New Zealand's unique emissions profile is heavily skewed towards agricultural-based emissions (agricultural greenhouse gases make up at least 49% of New Zealand's total emissions). In recognition of the difficulties in abating such emissions and the need to address abatement in this

area, an agricultural research and development fund has been established, with the aim of driving research and development of technological solutions for agricultural emission abatement.

Businesses have been lobbying government for further Projects to Reduce Emissions (PRE) tender rounds (as discussed above), which would incentivise the development of more emission reduction projects. Until now the government has been reluctant to introduce further PRE rounds, as a result of the projected deficit for 2012. However, with the recent announcement that New Zealand is estimated to have a 9.6 million tonnes surplus at the end of 2012 – worth an estimated \$241 million, there is a real possibility that the government may revisit the PRE programme, and instigate another tender round for PRE projects.

### **Pre-1990 forestry deadlines looming**

Pre-1990 foresters (including farmers and other landowners with pre-1990 forests on their land) have important decisions to make in light of the looming deadlines in June and July 2009.

With the Act continuing to be in effect, despite the review taking place, those with pre-1990 forests who wish to apply for an under 50 hectare exemption (where they are eligible to do so) must do so by 30 June 2009. For those who do not apply for an exemption from deforestation liabilities, or are not eligible to do so, an application for the one-off allocation of units for pre-1990 forests must be filed by 31 July 2009.

A failure to apply for an exemption (where eligible) could expose a pre-1990 forester to approximately \$20,000 in compliance costs per hectare (assuming a price of carbon of \$25 a unit) for deforestation of that pre-1990 forest. Similarly, for those who determine the commercial risk to be low and do not apply for the exemption, or are not eligible for an exemption, then a failure to apply for the one-off allocation for their pre-1990 forest could cost them the opportunity to receive around \$975 to \$1,500 per hectare worth of units (again, assuming a carbon price of \$25 per unit and depending on the date on which they acquired the forest).

There is a possibility that the government will push out one or both of the June or July 2009 deadlines as a result of the delayed reporting from the NZ ETS review committee. However, this is yet to have been determined by government and foresters should continue to work towards the first deadline of June 2009.

*Bell Gully's [climate change team](#) is available to advise in detail on the ETS and its implications, and on carbon trading in general.*

## Bell Gully News

### [Bell Gully collects deal team award](#)

Bell Gully's work on the country's significant deals of 2008 saw its corporate practice named the New Zealand Deal Team of the Year at Australasia's premier legal awards.

### [Inspiring lawyer and leader named CLANZ-Bell Gully Young Corporate Lawyer of the Year](#)

A lawyer described as an inspiration to all corporate counsel is the winner of the 2009 CLANZ-Bell Gully Young Corporate Lawyer of the Year Award.

### [Bell Gully climate change deal finalist for Australasian law awards](#)

The world's first ever carbon deal for avoided deforestation has been shortlisted for the Energy & Natural Resources Deal of the Year at this year's ALB Australasian Law Awards.

### [Maori land and governance](#)

A recent Maori Land Court decision indicates that the court is becoming more definitive about governance standards required in commercial dealings, suggests senior solicitor Tama Potaka.

### [Minister appoints Bell Gully partner to government overseas investment advisory group](#)

Bell Gully partner Andrew Petersen has been appointed to an expert advisory group charged with advising on the review of New Zealand's overseas investment rules.

### [Chambers global names Bell Gully New Zealand market leader](#)

Bell Gully has topped the New Zealand law firm rankings for the sixth consecutive year in leading international legal publication Chambers Global.

### [Legal launch a first for New Zealand](#)

New Zealand's legal landscape has gained a major new resource with the launch of the country's first practice manual for lawyers working in-house in the private and public sectors.

## Useful web links

### New Zealand Government

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

### New Zealand regulatory agencies and organisations

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

### New Zealand commercial sites

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

### Australian sites

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

### International sites

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