

BELL GULLY



commercial quarterly

SUMMER EDITION

FEBRUARY 2010



Welcome to the Summer 2010 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:

- CMD Taskforce's final recommendations to feature in Securities Act review;
- Early announcement on financial reporting changes;
- Corporate governance: lessons from the James Hardie decision;
- Directors with inside information must buy and sell shares for 'fair value';
- A timely reminder of the importance of careful drafting;
- Entire agreement clause means what it says;
- Law on employment protection in restructuring under review – chance for feedback;
- Hollywood takes on Australia's third largest ISP - and loses;
- Handling confidential information – proposed ASIC best practice guidelines;
- Trans-border data flow legislation is back on the agenda;
- Supreme Court confirms Commerce Commission subject to limitation period;
- Cartel criminalisation on the cards for New Zealand;
- Ins and outs of input methodologies; and
- NZ Emissions Trading Scheme - what we are seeing.

Previous issues of Commercial Quarterly are available on our website.

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

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

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

Commercial business law

A timely reminder of the importance of careful drafting

A recent Supreme Court decision raised issues concerning the proper approach to contract interpretation and the admissibility of extrinsic evidence. The court's approach serves as a timely reminder about the importance of careful and accurate drafting of commercial contracts. Solicitor Lisa Tat summarises the court's findings.

Entire agreement clause means what it says

Arguments based on the Contractual Remedies Act and the Fair Trading Act to exclude the effect of an entire agreement clause proved unsuccessful in a recent Court of Appeal case.

Law on employment protection in restructuring under review – chance for feedback

A review is underway of the law surrounding protection for employees in the event of a business restructuring. Partner Rob Towner and senior associate Tim Clarke outline the details of the review.

Commercial business law

A timely reminder of the importance of careful drafting

A recent Supreme Court decision¹ raised issues concerning the proper approach to contract interpretation and the admissibility of extrinsic evidence. The court's approach serves as a timely reminder about the importance of careful and accurate drafting of commercial contracts. Solicitor Lisa Tat summarises the court's findings.

In 1995, the Natural Gas Corporation of New Zealand and Bay of Plenty Energy entered into an agreement under which NGC agreed to supply gas to BoPE (the Agreement). NGC gave notice of termination of the Agreement in 2004, which BoPE disputed and filed proceedings in the High Court challenging its validity.

In the interim, the parties reached an agreement whereby, pending the outcome of the proceedings, NGC would continue to supply gas to BoPE (the Interim Agreement). The main terms of the Interim Agreement were that:

- NGC would continue to supply gas based on the terms of the Agreement; and
- if BoPE was unsuccessful in, or withdrew, the proceedings, it would pay NGC "for each GJ supplied, the difference between the price set out in the Agreement and \$6.50 per GJ", plus interest.

BoPE was ultimately unsuccessful in the proceedings and had to pay to NGC the amount specified in the Interim Agreement.

The court had to consider whether the "\$6.50 per GJ" recorded in the Interim Agreement was inclusive of transmission costs or whether it referred to the cost of gas energy only. NGC (now Vector Gas) appealed to the Supreme Court after the Court of Appeal held that "\$6.50 per GJ" included transmission costs.

Supreme Court's findings

General principles of contract interpretation

The ultimate objective in contract interpretation is to determine the intention of the parties as reflected in the words of the contract. The starting point is that the words of a contract should be given their ordinary meaning in the context of the contract in which they appear.

The court recognised that the ordinary or plain meaning of contractual text is always a principal, and usually the primary, consideration, but also emphasised that context and certain extrinsic material will often throw important light on the true meaning of a contract.

Pre-contract negotiations

The court accepted that pre-contractual negotiations are admissible in questions of interpretation to the extent that they establish the circumstances in which the contract was entered into, but not where they go towards showing individual intentions. Justice Wilson, however, appeared to be willing to go a step further and allow evidence of the parties' subjective intentions in some situations.

Commercial context

The court recognised the importance of considering the commercial context in which a contract was made. In particular, it placed emphasis on the importance of ensuring that a contract is interpreted in accordance with commercial or business commonsense.

Application to the facts of the case

The court considered that, in isolation, the phrase "\$6.50 per GJ" could be interpreted as meaning either inclusive or exclusive of transmission costs. The Interim Agreement, however, imported the terms of the Agreement, under which the cost of gas was inclusive of transmission costs. On this basis, the court concluded that, on the ordinary and unambiguous meaning of the words of the contract, "\$6.50 per GJ" was inclusive of transmission costs.

¹ *Vector Gas Limited v Bay of Plenty Energy Limited* [2010] NZSC 5

Despite there being no ambiguity based on the words of the Interim Agreement, the court went on to consider the context in which the agreement was made. It found that both parties knew:

- if the Interim Agreement was not reached, BoPE would have applied for an order for NGC to continue supply on the terms of the Agreement pending resolution of the proceedings. The parties also would have known that a court would have given such an order only if BoPE undertook to meet the loss to NGC (based on market rates) if BoPE were unsuccessful; and
- based on current market rates, NGC was managing to obtain, at that time, \$6.68 per GJ plus transmission costs.

The court considered that for NGC to have agreed to the price of \$6.50 per GJ inclusive of transmission costs would "flout business commonsense". Accordingly, to achieve a "commercially sensible" outcome, the court, by unanimous agreement, reached the decision that "\$6.50 per GJ" in the Interim Agreement was exclusive of transmission costs.

Practical implications

The Supreme Court's decision may seem quite radical in what appears to be a disregard for the unambiguous written text of a contract. Courts have, however, generally been shifting towards the view that extrinsic material should be used in interpretation where it establishes the context in which a contract was made and it is not necessary for there to be ambiguity in the written text before a court can use extrinsic material to assist it in ascertaining the meaning intended by both parties to a contract. The Supreme Court has now confirmed and applied that approach to contract interpretation in New Zealand.

On that basis, the underlying principles applied in the case are not as drastic a departure from established principles as the case might initially appear to suggest. The case does still raise some questions about the extent to which such an approach to interpretation may erode certainty of contract.

Some might consider that the Supreme Court approached interpretation in the way that it did to achieve a fair outcome on the facts of the case before it. But, it does not follow, and it should not be assumed, that the courts are now more likely to help a party get out of a bad deal. The reminder and lesson to take from the case is simple: always ensure commercial contracts are drafted with utmost care and attention to detail.

Commercial business law

Entire agreement clause means what it says

Arguments based on the Contractual Remedies Act and the Fair Trading Act to exclude the effect of an entire agreement clause proved unsuccessful in a recent Court of Appeal case.

It is common for parties to include an entire agreement clause as part of a sale and purchase agreement to restrict the rights and obligations of the parties to those set out in the agreement itself. This provides commercial certainty for the parties, as it means that the entire agreement between the parties is recorded in one document and precludes liability for any earlier provisional agreements or representations made by the parties during the negotiation stage of a transaction.

Recent case

The facts

In a recent Court of Appeal case², the parties to a sale and purchase agreement for shares in a maintenance company (CPS) included the following entire agreement clause in the agreement: "This agreement ... constitutes the entire agreement between the parties and supersedes all prior agreements, understandings, negotiations, representations, and discussions, whether oral or written, of the parties. The vendors make the representations and warranties set forth in clause 7 and no others..."

After completion, the purchaser discovered it had bought CPS for a significant overvalue as a result of some materially incorrect financial statements provided by the vendors during the negotiation period. However, none of the vendors' representations and warranties set out in clause 7 of the agreement covered the particular errors contained in the financial information provided by the vendors. Therefore, in order to recover the full extent of losses the purchaser had suffered, the purchaser brought a claim for damages based on the earlier misrepresentations made by the vendors under the Contractual Remedies Act 1979 and the Fair Trading Act 1986.

The High Court concluded that the purchaser had relied on the financial statements generally in deciding to proceed with the purchase of CPS and on the price, but dismissed the purchaser's misrepresentation cause of action (under section 6 of the Contractual Remedies Act) on the basis of the entire agreement clause. The High Court also dismissed the action under the Fair Trading Act. (For details of the High Court decision see the article [Entire agreement clause limits available remedies](#) in the Spring 2008 issue of Commercial Quarterly.)

The claim under the Contractual Remedies Act

Basis of claim

Where parties to a contract have excluded prior representations by them through a provision in the contract (such as in this case through the wording of the entire agreement clause), the Contractual Remedies Act allows a court to inquire into whether there has been an actionable misrepresentation if the court considers that the contractual provision is not "fair and reasonable", having regard to all the circumstances of the case. The circumstances include the subject matter and the value of the transaction, the respective bargaining strengths of the parties, and the question of whether any party was represented or advised by a solicitor at the time of negotiations or at any other relevant time.

In the Court of Appeal the purchaser claimed that the High Court was wrong to find it was fair and reasonable that the entire agreement clause should be conclusive between the parties because, although the parties were relatively sophisticated and had access to legal advice:

- the purchaser had made its reliance on the vendors' representations clear during the negotiation process;
- the errors in the accounts were significant and (although there was no finding of fraud by the High Court) resulted from the vendors' (who were also the directors of CPS) negligence and/or recklessness;

² *PAE (New Zealand) Ltd v Brosnahan* [2009] NZCA 611

- the vendors deliberately tried to conceal accounting errors after the agreement was signed; and
- there was no evidence that the entire agreement clause was specifically drawn to the attention of either party or even discussed.

Court of Appeal's decision

The Court of Appeal rejected this argument noting that there was nothing inherently unfair in such an exclusionary clause and that:

- on the facts it was irrelevant whether the clause was discussed by the parties especially given the agreement was drafted by the party trying to negate its effect;
- there was nothing inconsistent between the inclusion of the entire agreement clause and the parties' conduct during the negotiation period;
- the fact that the errors in the accounts may have been significant and the result of negligence (or recklessness) on the part of the vendors was irrelevant when considered against the plain words of the entire agreement clause;
- to deny the entire agreement clause its natural meaning would in effect reinstate a representation that the parties had agreed was of historical importance or inoperative and would convert the alleged representations about the profitability of the business into an implied warranty when they were expressly excluded; and
- it would not be fair and reasonable to allow the purchaser to invoke the statutory protection to circumvent the effect of provisions which it had deliberately structured for its own benefit.

The claim under the Fair Trading Act

The Fair Trading Act (the FTA) creates an independent statutory liability for misrepresentations made in trade. Section 9 of the FTA provides that no person "shall, in trade, engage in conduct that is misleading or deceptive or is likely to mislead or deceive." To establish liability under section 9 a plaintiff must show that:

- the parties were in trade;
- the conduct was capable of being misleading;
- the plaintiff was in fact misled by the conduct;
- it was reasonable that the plaintiffs were misled; and
- the plaintiff's reliance on the misleading or deceptive conduct caused it to suffer loss.

The question of whether the parties were "in trade" when negotiating the sale for the purposes of section 9 was not at issue as this point was conceded in the High Court and not raised on appeal.

In the High Court the judge held the cause of action under the FTA failed in two ways. First, the vendors' conduct as a whole was not misleading and deceptive because, although they made misrepresentations, the parties agreed that the only relevant representations were those specified in the agreement (through the inclusion of the entire agreement clause). Secondly, even if it was misleading and deceptive conduct, it did not cause the purchaser's loss. The vendors supplied accounts and financial information that misrepresented the financial position of CPS, but the purchaser had the opportunity to make further inquiry and did not do so. Moreover, the purchaser agreed that there would only be liability in respect of representations that were included as warranties in clause 7 of the agreement. As a result, in the High Court's view the cause of action under the FTA failed on either basis.

The purchaser argued that the High Court had been wrong to dismiss its FTA cause of action on the basis that the court had applied the entire agreement clause to defeat the claim. The Court of Appeal, however, found that the High Court had dismissed this cause of action, not on the basis of the clause, but on a finding that the purchaser had acted unreasonably in protecting its position by failing to make proper inquiry into the accuracy of the accounts, and that as a result the directors' conduct did not cause the purchaser's loss.

As an aside, the Court of Appeal also addressed the purchaser's argument that the High Court was wrong to hold that the vendors' conduct as a whole was not misleading and deceptive by the presence of the entire agreement clause.

The Court of Appeal disagreed with the purchaser's argument. It is settled that a party cannot contract out of the section 9 FTA prohibition. However, the phrase "contract out" is seen by the courts as a starting point rather than an absolute, particularly in the context of commercial transactions involving substantially independently advised parties negotiating from positions of equality. Accordingly, while mechanisms such as an entire agreement clause are not determinative, it has been accepted that they are relevant to a section 9 analysis.

In this case the combined effect of the entire agreement clause and the express warranties given by the vendors in clause 7 was not to affect or alter the legal character of the directors' pre-contractual conduct. The parties had agreed there should be no general or implied warranties and that only the express warranties were of operative force. In effect, the parties agreed that what the vendors had said or done before the agreement no longer mattered, breaking the chain of causation necessary to uphold a claim under section 9.

Practical implications

An entire agreement clause should not be treated as a non-negotiable boilerplate clause buried in the final pages of an agreement. This case highlights the importance of parties spending time to consider whether an entire agreement clause is relevant to the contract and, if included, whether it is worded to reflect the intention of the parties. In particular, it is important to ensure that where an entire agreement clause is included in an agreement consideration is given to the following:

- Confirm that, if and where appropriate, all relevant terms from any preliminary documents provided and representations made during the pre-contract negotiations have been incorporated into, or covered by the provisions of the contract.
- Confirm that there are no other documents which form part of the agreement between the parties. For example, there may be a confidentiality agreement and ancillary transaction documents such as service or supply agreements in place which form a part of the overall agreement between the parties. If there are, then reference to such agreements should be included in the wording of the entire agreement clause to clarify that they form part of the "entire agreement" between the parties. It may also be appropriate to include details of specific agreements which are to be superseded by the agreement to avoid any ambiguity.

Commercial business law

Law on employment protection in restructuring under review – chance for feedback

A review is underway of the law surrounding protection for employees in the event of a business restructuring. Partner Rob Towner and senior associate Tim Clarke outline the details of the review.

Part 6A of the Employment Relations Act provides two-tier protection for affected employees should a business restructuring result in their work being performed by a new employer. Restructuring includes first time contracting out and subsequent contracting, contracting in, and business transfers and sales.

Under the law, specified categories of "vulnerable" employees have the statutory right to transfer to the new employer, as well as certain bargaining rights. These vulnerable workers include employees who provide cleaning, food catering, laundry, orderly or caretaking services in specified work places.

For all other employees, employment agreements - collective and individual - must contain an "employee protection provision" (EPP) which provides protection relating to negotiations between the current employer and potential new employer about the transfer of affected employees.

The policy for Part 6A was to provide special protection for certain employees reported to be disadvantaged by restructuring, while retaining viability and efficiency of the market.

Amendments to Part 6A in 2006 included a requirement to review the legislation after three years. That time has arrived.

Is it working and relevant?

Public consultation has now started on a discussion document which looks at the operation and policy of Part 6A.

The first part of the review assesses whether the legislation has achieved its stated objectives and, if not, any necessary or desirable amendments. Part two considers whether the policy of providing special protection for a defined group of workers is still relevant and desirable.

Issues for comment

The discussion document seeks the views of employers, employees, their representatives and other interested organisations on a list of questions. The questions focus feedback on the particular areas under review. Issues regarding the operation of Part 6A include:

- Current levels of awareness of Part 6A provisions;
- Problems associated with the transfer of accrued entitlements (holiday pay, annual holidays and sick leave) following a restructure, and whether there should be a choice between accrued entitlements either transferring or being paid out, and whether there should be an obligation on the outgoing employer to transfer funds for accrued entitlements;
- Partial transfer of employees, for example where an employee's role is split between two employers following a restructuring;
- Transfers involving poorly performing service providers and the impact of Part 6A on tendering processes;
- Definition of specified categories of employees known as "vulnerable workers";
- EPPs, particularly the extent to which they protect employees and how compliance should be achieved.

Importantly, the Employment Court considered what constitutes an EPP in two recent cases concerning whether an employer could be restrained from restructuring in the absence of such a provision (*Norske Skog Tasman Limited v Manufacturing & Construction Workers Union Inc* and *Eastern Bay Independent Industrial Workers Union Inc v Carter Holt Harvey Limited*). To be compliant, an EPP must set out a process for the employer to negotiate with a new employer, the matters to be negotiated and a process to

be followed at the time of a restructuring. The Court found in both cases that there were no compliant EPPs. A bare obligation "to meet with the new employer" did not constitute a process for negotiating with the new employer. Rather, a process should include details of the timing of meeting(s); advice to the union and employees of such meeting(s) and intended agenda; the method of meeting; identities of attendees; and a process of reporting back the outcomes of such meeting(s). The Court went on to hold that a clause setting out the consequences of an employee rejecting an offer of employment from the new employer (disentitling the employee to redundancy compensation) did not amount to a process to be followed at the time of the restructuring but was in essence an employer protection provision.

Part two of the review seeks views on:

- Whether the policy for Part 6A is still valid and effective;
- What categories of employees, if any, should have greater protection; and
- Other possible ways to address any disadvantage that would better meet the policy objectives.

Deadline for feedback

Submissions close at 5pm on 15 March 2010. Further information about making submissions is available at the Department of Labour website: www.dol.govt.nz/consultation/

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

[Rob Towner](#)
Partner

[Michelle Banfield](#)
Senior Associate

[Tim Clarke](#)
Senior Associate

Company law

Corporate governance: lessons from the James Hardie decision

The decision of the New South Wales Supreme Court in *Australian Securities and Investments Commission v Macdonald* in April last year has generated substantial interest across the Tasman. The decision is also noteworthy here, particularly for the guidance it provides on the responsibilities of directors and senior executives, the conduct of board meetings and the release of market sensitive information. In this article, partner Glenn Joblin discusses the key aspects of ASIC's claims and the court's decision with commentary on the relevance of the decision under New Zealand's statutory regime. For a summary of corporate governance recommendations arising from the decision, see the **corporate governance tips** section at the end of the article.

Directors with inside information must buy and sell shares for 'fair value'

Insider trading is not usually associated with share dealings by directors of small private companies. However, a recent High Court case provides a useful reminder that section 149 of the Companies Act 1993 requires share transactions involving directors with material non-public information to be for 'fair value'. If they are not, the director is liable to the seller (or buyer) for the difference between the 'fair value' and the price at which the shares were sold, regardless of whether the parties have reached a prior express agreement on the sale price.

Company law

Corporate governance: lessons from the James Hardie decision

The decision of the New South Wales Supreme Court in Australian Securities and Investments Commission v Macdonald³ (the James Hardie decision) in April last year has generated substantial interest across the Tasman. The decision is also noteworthy here, particularly for the guidance it provides on the responsibilities of directors and senior executives, the conduct of board meetings and the release of market sensitive information.

In this article, partner Glenn Joblin discusses the key aspects of ASIC's claims and the court's decision with commentary on the relevance of the decision under New Zealand's statutory regime.

*For a summary of corporate governance recommendations arising from the decision, see the **corporate governance tips** section at the end of the article.*

In brief

The James Hardie decision of the New South Wales Supreme Court relates to civil proceedings brought by the Australian Securities and Investments Commission (ASIC) against former directors and certain senior executives of the former parent company of the James Hardie group. The court found that these individuals breached their statutory duty of care as a result of false or misleading stock exchange announcements, press releases and public statements made about the adequacy of the funding of a foundation established to meet asbestos-related claims against companies in the James Hardie group.

ASIC also succeeded in claims against companies in the James Hardie group for breaches of Australia's market manipulation provisions and ASX's continuous disclosure obligations.

In a subsequent penalty hearing, the court issued various penalty orders against all of the directors and the three executive officers, and banned them from acting as directors or being involved in the management of a corporation for periods ranging from five to fifteen years.

The facts of the case highlight the importance of following best practice corporate governance procedures in relation to:

- the formal conduct of board meetings;
- the responsibility of senior management and in-house legal counsel to be proactive on the information they put before a board; and
- the appropriate procedures and authorisations surrounding the drafting and release of public announcements.

Background to the James Hardie decision

The case arose out of the restructuring of the James Hardie group of companies initiated in 2001. The restructuring's principal objective was to separate the group's operating assets from the legacy of asbestos liabilities associated with James Hardie Industries Limited (JHIL), the listed parent company of two group companies which manufactured asbestos products in Australia (the subsidiaries). As part of the restructuring, a trust company was established as the new parent company of the subsidiaries and as trustee to a foundation which was intended to assume the responsibility for the group's asbestos-related compensation claims.

³ [\(No.11\) \[2009\] NSWSC 287](#)

As Justice Gzell noted in his decision, the proposal to restructure the James Hardie group and establish the foundation represented "a most significant event in the life of the James Hardie group" and was an event that the board of JHIL "were at pains to ensure was well received by the market".

When JHIL announced the establishment of the foundation in February 2001, it stated that the foundation would have "sufficient funds to satisfy all future legitimate claims", was "fully funded", and "provided certainty for both claimants and shareholders" (the ASX Announcement). The ASX Announcement also stated that expert advice from a number of firms had been sought and this "formed the basis of determining the level of funding required to meet all future claims". These statements were repeated in subsequent ASX announcements, press statements, investor "road-show" presentations and various accompanying documents.

None of the ASX announcements referred to a deed of covenant and indemnity which JHIL had entered into with the subsidiaries (the DOCI) as part of the separation arrangements. Under the DOCI, JHIL was afforded additional protection from various asbestos-related claims which could have been made by the subsidiaries (and other potential third parties) against JHIL. The DOCI also contained a put option which required one of the subsidiaries to purchase all of JHIL's shares if certain conditions arose.

Later the same year, the next stage of the restructuring of the James Hardie group was implemented by means of a scheme of arrangement. The information memorandum sent to JHIL's shareholders included a statement that partly paid shares issued by JHIL to James Hardie Industries NV (the new Dutch holding company for the group under the proposed restructuring) would enable JHIL to call on James Hardie Industries NV if it required funds to meet any further liabilities JHIL had for asbestos related claims. JHIL was entitled to cancel the partly paid shares at any time and in 2003, JHIL was transferred out of the James Hardie group and the partly paid shares were cancelled. However, James Hardie Industries NV did not announce to the market the board's decision to proceed with the 2003 changes relating to JHIL and the cancellation of the partly paid shares.

Shortly after the completion of the restructuring of the James Hardie group it became apparent that the foundation was significantly underfunded. In 2004, the New South Wales government established a special commission of inquiry to review the foundation's ability to meet future asbestos-related liabilities and to determine the effect the restructuring of the James Hardie group had on the foundation's insufficiency of assets to meet its liabilities.

The inquiry concluded that although there was likely to be a shortfall of AU\$1.5 billion in the funding of the foundation, there was nothing improper with the transactions leading to the establishment and separation of the foundation from the James Hardie group and, further, JHIL was under no legal obligation to provide greater funding to the foundation. Its findings however were very critical of JHIL's board and its management, particularly with regard to misleading statements made on behalf of JHIL at the time of the establishment of the foundation and during the restructuring of the group (noted above). It concluded that there was no satisfactory basis for the assertions made in the ASX Announcement and in other subsequent statements to the effect that the foundation would have sufficient funds to meet all future claims.

In 2008, after investigating matters arising from the inquiry, ASIC commenced civil proceedings against JHIL, James Hardie Industries NV and certain former directors and officers of those companies.

ASIC's claims and their relevance to New Zealand's securities and corporate legislative regimes

Statutory duty of care

The majority of ASIC's claims were based on establishing that the seven surviving JHIL directors and the CEO, the company secretary and general counsel, and the CFO had failed to discharge their duties with due care and diligence to ensure that JHIL did not contravene its obligations under the Corporations Act with respect to the disclosures made concerning:

- the adequacy of funding to be made available in 2001 for the foundation (with particular reference to a draft of the ASX Announcement approved by the board of JHIL in February 2001); and
- future plans relating to JHIL and the partly paid shares issued by JHIL.

In Australia this case is seen as significant partly because it is one of the few cases where ASIC has brought proceedings against both executives and directors of a company for breaches of the same obligations. The case highlights significant differences between New Zealand and Australian legislation in

this area. Under New Zealand legislation, the duty of care obligation (section 137 of the Companies Act 1993) only applies to directors and not to a company's executive officers (unless they are deemed directors). In addition, ASIC has power under the Corporations Act to bring a civil action against directors and officers of a company for breach of their duty of care. There is no equivalent statutory power under New Zealand law.

Nevertheless, the difference between the statutory regime in each country does not lessen the importance of the case for New Zealand directors and from a best practice standpoint the court's findings on the responsibilities of senior executives in this case remain noteworthy.

Market manipulation and continuous disclosure obligations

ASIC also brought civil proceedings against JHIL for engaging in misleading or deceptive conduct, providing false or misleading statements to the market and breaching its continuous disclosure obligations (through failing to disclose the DOCI and certain further information in relation to the subsequent restructuring of the James Hardie group). The findings of the court on these aspects of the case are relevant to New Zealand listed companies, their directors and senior executives because the underlying obligations of New Zealand's market manipulation and continuous disclosure rules are the same as under Australian law.

New Zealand's market manipulation rules were introduced in 2008 in the Securities Markets Act 1988. The New Zealand equivalent provisions of those which ASIC claimed had been breached by JHIL prohibit a person from:

- engaging in conduct in relation to any dealing in securities that is misleading or deceptive or that is likely to mislead or deceive;
- making a statement or disseminating information which is materially false or misleading which is likely to induce a person to trade in securities or have the effect of increasing, reducing, maintaining or stabilising the price for trading in those securities.

New Zealand's continuous disclosure obligations arise under Part 2 of the Securities Markets Act and the NZX Listing Rules. A breach of the continuous disclosure obligations can result in a fine or other penalty imposed by NZX Discipline on an issuer under the NZX Listing Rules. In addition, since an amendment to the Securities Markets Act in early 2008, liability for such a breach can extend to any person who aids, abets, counsels or procures any other person (including the issuer) to contravene a listed issuer's continuous disclosure obligations or any person who is in any way, directly or indirectly, knowingly concerned in or a party to the contravention by any other person. This allows the Securities Commission to bring proceedings against directors and key senior executives in the event of a breach by a listed company of its continuous disclosure obligations. (For further details of this change see the article ["Expanded liability under the continuous disclosure regime"](#) in the Winter 2007 issue of Commercial Quarterly.)

The decision

February 2001 board meeting

One of the key issues in the case was whether the JHIL board as part of their deliberations on the foundation proposal at a board meeting on 15 February 2001, had considered and approved a draft of the ASX Announcement prior to its release the following day.

Minutes of the meeting, which had been drafted by JHIL's solicitors prior to the meeting and signed-off as correct at the next board meeting (without objection), indicated that these events had taken place. However, each of the directors claimed that they had no recollection of the draft ASX Announcement being tabled at the February meeting, nor of its terms being discussed, nor could they recall giving their approval for it to be released.

Evidence given in support of the directors' positions included the following:

- the draft ASX Announcement was not included in the board papers for the meeting and there was no mention of the ASX Announcement in the agenda of the meeting;
- it was JHIL's standard practice in relation to ASX announcements, other than those of a financial nature, for the announcement to be approved by the CEO, the CFO, general counsel and JHIL's external legal advisers prior to an announcement being put to the board in its final form, whereas

in this instance none of these individuals recalled seeing a copy of the ASX Announcement prior to the board meeting and there was no evidence given confirming they had been sent copies of the announcement;

- two of the directors had participated in the meeting by teleconference from the United States and there was no evidence to show that those directors had been sent a copy of the draft ASX Announcement;
- each of the directors indicated that if they had seen the draft ASX Announcement they would either not have approved it or would have made comments seeking to modify its terms;
- none of the directors recalled reading the entry in the minutes relating to the approval of the ASX Announcement, (with some acknowledging that they had not read the minutes in full); and
- there were a number of inaccuracies recorded in the minutes (in addition to the alleged inaccurate entry referring to the ASX Announcement).

On the facts, the minutes were not given any special evidentiary value by the court. Under the Corporations Act there is a statutory presumption that the minutes are a correct record of a meeting, but the court held that the presumption did not apply in this case given that the minutes were not recorded in JHIL's minute book within the one-month time period stipulated in the Act. Nevertheless, the court found as a matter of fact that the entry in the minutes relating to the ASX Announcement was accurate. The court found that the directors were mistaken in their recollections of the proceedings at the meeting, and inferred from copies of the draft ASX Announcement retained by a JHIL officer (who attended the meeting), a corporate shareholder of JHIL (who had directors on the board) and JHIL's lawyers that a draft of the ASX Announcement had been circulated to the directors present at the 15 February board meeting. The court also relied on oral evidence given by one director who had acknowledged that someone might have outlined what was to be in the ASX Announcement, including the wording relating to the foundation being sufficiently funded.

The court concluded that it followed from this finding that the draft ASX Announcement had been approved by the board, even though the directors did not recall a formal vote being taken. The court noted that the practice of the JHIL board was not to formally put a matter to a meeting as a resolution. The practice was for the chair to summarise the position and directors indicated their approval or remained silent.

The ASX Announcement

Breach of duty of care by the directors

Having found that the draft ASX Announcement was circulated and approved by the board for release to the market at the 15 February meeting, the court went on to find that each of the seven directors had breached their statutory duties to exercise due care under section 180(1) of the Corporations Act.

By giving their approval to the draft ASX Announcement with its overstatement of the situation as to the level of funding of the foundation, the court found that the directors had failed in their duty to JHIL to protect it from the harm it potentially faced upon publication of the ASX Announcement, including legal action for publishing false or misleading or deceptive statements, damage to its reputation and market reaction.

The court reached this decision despite a finding that JHIL's executive officers had failed to advise the board appropriately on key aspects of the content of the ASX Announcement (see the discussion below). Based on the material provided to the board which, in addition to the independent expert reviews referred to in the ASX Announcement, included a number of earlier presentations to the board on the uncertainty of prediction of asbestos claims, the court concluded that the directors, if they had exercised their duty with the appropriate level of care and skill, could not have been satisfied that JHIL had a proper basis for making the assertions of sufficient funding, or approved the ASX Announcement or authorised the release of the ASX Announcement.

The court also rejected the argument that the approval of the ASX Announcement was a matter that the board could delegate to directors with particular expertise or to JHIL's management. In the court's view the nature of the announcement made it appropriate for management to ask the board to approve the content of the draft ASX announcement. Justice Gzell noted that it was a "key statement in relation to a highly significant restructure of the James Hardie group" and given that management brought the matter to the board, the directors were not entitled "to abdicate responsibility by delegating his or her duty to a fellow director." In Justice Gzell's opinion, the emphatic nature of the draft ASX Announcement was not something that was a matter for reliance upon management or outside experts. It was part of the function

of the directors in monitoring the management of the company to settle the terms of the draft ASX Announcement.

In the case of the two US directors, the court found both directors to be in breach of their duty of care in failing to request that they be provided with a copy of the draft ASX Announcement, in failing to familiarise themselves with its terms, or in failing to abstain from voting in favour of the announcement "as a reasonable person in their shoes with their responsibilities would have done".

Breach of duty of care by the executive officers

Although the court found that the directors were not entitled to rely on management in relation to the approval of the ASX Announcement, the court still found that the three executives had duties to bring certain matters to the attention of the directors. In particular the court found that the CEO (who was also a director of JHIL), the general counsel (who was also the company secretary) and the CFO had failed in their duty to act with due care and skill (in breach of section 180(1)) by not bringing to the board's attention that there were important limitations to the reviews of the foundation undertaken by two independent experts.

The CEO and the general counsel were also found to be in breach of the same duty for not advising the board that the language used in the ASX Announcement was expressed in too emphatic terms concerning the adequacy of funding to meet all legitimate present and future asbestos claims and in that respect the ASX Announcement was false or misleading. Justice Gzell noted that the general counsel had a "high degree of responsibility to protect JHIL from legal risks associated with the proposed publication" of the ASX Announcement and he had failed to warn the board of those risks.

In reaching these findings, the court noted that all three executives had played a significant role in the implementation of the restructuring proposal. The CEO was the leader of the restructuring proposal. The general counsel and the CFO regularly participated in decision-making that affected the whole or a substantial part of the business of JHIL, including the decision taken by the board on the foundation at the February 2001 meeting. Given their respective roles in JHIL, they were party to all relevant information which would have led to a reasonable person holding similar positions to theirs to realise that the statements were false and misleading and that they would be harmful, or potentially harmful, to JHIL.

However, the court did not agree that the CEO's duty of care extended to a duty to monitor the individual bases upon which his co-directors voted on the issue. To quote Justice Gzell: "A director is not obliged to analyse the basis upon which fellow directors intend to vote before determining his or her own course. Bearing in mind the calibre of the JHIL board members, it would be insulting for the [CEO] to ask each board member whether he or she really meant what they were about to do."

Additional allegations of breach against the CEO

The CEO was also found to be in breach of his statutory duty of care for:

- approving for release the ASX Announcement, or in failing to advise that the ASX Announcement not be released, or that it be amended before being released, to remove the matters that were false or misleading; and
- failing to ensure statements he made at subsequent press conferences and road-shows, in his role as CEO of JHIL and later as CEO of James Hardie Industries NV, relating to the funding of the foundation were not false or misleading.

However, the court found that ASIC had not established that the CEO through his actions had failed to exercise his statutory duty to act in good faith, in the best interests of JHIL and for a proper purpose. The court noted that the CEO may have been misguided in the extent to which he sought to sell the restructuring proposal, but in doing so there was no conflict between his personal interest and that of JHIL. The court pointed out that he did not take advantage of his position to make a secret profit, nor did he misappropriate the company's assets for himself. He was "overzealous, but he was overzealous in the interests of JHIL".

Market manipulation contraventions by JHIL

In addition to the breaches by the directors and the executives, the court also found that JHIL had, in releasing the ASX Announcement and certain other announcements and as a result of statements made in press conferences:

- engaged in conduct that was misleading or deceptive, or was likely to mislead or deceive; and
- released information that was likely to induce other persons to sell or purchase the shares of JHIL, or likely to have the effect of increasing, reducing, maintaining or stabilising the market price of shares of JHIL,

in contravention of the market manipulation provisions in the Corporations Act. The court concluded that the CEO used over-emphatic terms of certainty in his endeavour to sell the restructuring announcement (which he knew or ought to have known were false or misleading in a material particular). The natural effect of those statements was likely to induce listeners to purchase JHIL shares and was likely to increase the market price of those shares.

Executives' personal liability for breach of continuous disclosure obligations

The court found that JHIL breached its continuous disclosure obligations for failing to disclose the DOCI in February 2001 on the basis that a reasonable person would have expected the publication of the DOCI to have a positive material effect on the price of JHIL's shares. JHIL had acted negligently in that it did not obtain any legal advice as to whether it should disclose the DOCI and in that neither the board nor management of JHIL considered whether disclosure of the DOCI was required. The court also found that James Hardie Industries NV was in breach of its continuous disclosure obligations for failing to disclose, among other things, that the partly paid shares were cancelled as part of the transfer of JHIL from the James Hardie group.

Two of the executive officers were also found to be in breach of their duty of care in respect of the non-disclosure of the DOCI. The CEO was found to be in breach of his duty to exercise due care for:

- failing to advise the chairman of the board of JHIL whether or not the DOCI was required to be disclosed to the ASX;
- failing to seek and consider advice to satisfy himself in relation to that question;
- failing to determine that JHIL would disclose the DOCI to the ASX; and
- failing to raise with the chairman or the board of JHIL that the issue needed to be considered and determined.

Similarly, the general counsel was found not to have exercised due care through:

- failing to advise either the CEO or the board that it needed to consider whether JHIL was required to disclose the DOCI under the continuous disclosure obligations;
- failing to obtain advice for the CEO or the board or provide his own advice as to whether disclosure was required; and
- failing to advise the CEO or the board to determine that JHIL would disclose the DOCI.

As general counsel he should have noted that the disclosure issue was not an item on the agenda for the board's consideration at the February 2001 meeting and taken appropriate steps to ensure that the CEO and the board were aware that non-disclosure could result in JHIL being in breach of its continuous disclosure obligations. The general counsel was aware that if any failure to disclose material information was exposed, JHIL would suffer harm to its reputation with the prospect of adverse market reaction. The court reiterated its earlier comment made in relation to the terms of the ASX Announcement that "the core of [the general counsel's] responsibility was to protect JHIL from legal risk".

In New Zealand, the Securities Commission (like ASIC) now has the power to bring civil proceedings against directors, executives, and other individuals who are involved in a contravention by a listed issuer of its continuous disclosure obligations. This power, however, is based not on a breach of duty of care as under the Corporations Act but under recent changes to the Securities Markets Act (discussed further above). A due diligence defence is available if a person can establish on the balance of probabilities that:

- they took all steps (if any) that were reasonable in the circumstance to ensure that the issuer complied with its continuous disclosure obligations; and
- after doing so, they believed on reasonable grounds that the issuer was complying with its obligations.

Although there has been no case law on this new provision, the defence is likely to apply where directors and senior executives of an issuer have sought and relied on advice from a qualified expert who was provided with all relevant information.

Penalties

The court issued penalty orders in August 2009⁴. The CEO was banned from managing a corporation (including acting as a director) for 15 years and fined AU\$350,000. The general counsel was banned for seven years and fined AU\$75,000. Smaller fines were imposed on the CFO and the other seven directors, who were each banned from managing a corporation for five years. Six of the directors and the general counsel have since appealed the court's first instance decision. The appeal is scheduled to be heard in April 2010. Of the remaining three, two have filed notices of intention to appeal with only the CEO deciding not to appeal.

In New Zealand, the Securities Markets Act provides a number of statutory consequences for non-compliance with the market manipulation provisions and continuous disclosure obligations (depending on the nature of the breach or the offence). These include:

- a prohibition order or a corrective order issued by the Securities Commission;
- a pecuniary penalty order of up to \$1 million per person;
- a compensatory order for loss or damage suffered by any person; and
- other civil remedy orders (for example, restraining the exercise of voting rights or the acquisition or disposal of securities).

Additional consequences for non-compliance with the market manipulation provisions include:

- a management banning order for a term of up to 10 years; and
- criminal penalties (imprisonment of individuals for up to five years and/or a fine of up to \$300,000 and a fine for a body corporate of up to \$1 million).

Concluding comments

The James Hardie decision illustrates the high level of scrutiny that is required from directors when considering strategic matters and the limitations on their ability to delegate to or rely on others. In particular, directors should:

- obtain all information they need from management and ensure they read all relevant board papers before making a decision;
- ensure that they sign-off on the company's public communications on strategic decisions and that those communications are accurate and not misleading; and
- review all draft board meeting minutes before they are adopted to ensure they are an accurate record of the meeting.

In the case of senior executives, the decision reinforces the importance of fully briefing the board about significant public announcements and ensuring that the board is provided with all relevant information.

⁴ *ASIC v Macdonald* (No 12) [2009] NSWSC 714

Corporate governance practice tips

1. Board meetings

- Directors should take responsibility for obtaining all information they need from management and ensure that they are familiar with the content of any material provided to the board prior to voting on a board resolution.
- The practice of the JHIL board not to put matters requiring a decision of the board in the form of a formal resolution may have been a contributing factor to the board not giving the requisite attention to the ASX Announcement. Adopting a formal resolution procedure, especially for matters of significance, is more likely to ensure that directors apply the appropriate degree of consideration to all matters.
- Directors attending a meeting by teleconference or other electronic means must exercise the same standard of care as those directors physically present at a meeting. In particular, they should ensure that they are able to hear what is being said at the meeting and are in possession of the same information and documentation provided to other directors at the meeting.
- If a director does not wish to vote on a matter, he or she should abstain from the vote rather than simply expressing no opinion either way on a matter. A director's abstention (and the reasons for the abstention) should be noted in the minutes of the meeting.
- A complete set of all documents provided at or prior to a meeting should be kept by the company so there is clear evidence of what has, and has not, been seen by the board. Directors should also keep copies of documents provided to them.
- Although New Zealand is not subject to the same statutory minute requirements as under the Corporations Act, it is good practice for a draft of the minutes of a board meeting to be circulated and reviewed by all directors in a timely manner with directors raising any objection to the content of those minutes before they are approved. Ideally the final version of the minutes should be put before a meeting of the directors as part of the formal sign-off process.

2. Delegation and reliance

- An important limitation on a director's statutory duty of care is the ability of a director to rely on information or advice prepared by certain persons (see section 138 of the Companies Act), including officers, professional advisers and fellow directors. However, as under the equivalent Corporations Act provision, the New Zealand limitation is subject to the director acting in good faith, making "proper enquiry" and having no knowledge that such reliance is unwarranted.
- The James Hardie decision provides an example of a situation where the court considered it inappropriate for a director to rely on the particular skills of his co-directors, management or expert advisers. In the court's opinion the content of the draft ASX Announcement "involved no more than an understanding of the English language used in the document."

3. Role of senior executives

- The James Hardie decision illustrates the importance of executives taking particular care when briefing the board about significant public announcements. The information they are required to provide will reflect their level of expertise, their position and their knowledge of the matter being discussed.

4. Making public announcements

- In circumstances where a company is implementing a major transaction or becomes aware of a matter of strategic importance to the company, and the company is to make public statements on the matter, directors should not abdicate responsibility for approving and releasing public statements by delegating responsibility to other directors, to management or to advisers even if they have greater expertise in relation

to the substance of the matter.

- Establish and follow internal protocols around the release of public statements. In the James Hardie decision, evidence was given suggesting that JHIL's standard practices were not followed leading up to the presentation of the ASX Announcement to the board.
- Company announcements should be balanced and objective.
- The same standard should be applied to statements and presentations made for investor and press briefings.

5. Continuous disclosure obligations

- Review the company's communication policies to ensure clear responsibilities for continuous disclosure and identification of price sensitive information have been established.
- Ensure senior management is aware of and understand the company's continuous disclosure obligations and their potential personal liability under the Securities Markets Act.
- Maintain records in order to establish a due diligence defence if the company's internal policies fail, resulting in a breach of the continuous disclosure provisions.

Company law

Directors with inside information must buy and sell shares for 'fair value'

Insider trading is not usually associated with share dealings by directors of small private companies. However, a recent High Court case provides a useful reminder that section 149 of the Companies Act 1993 requires share transactions involving directors with material non-public information to be for 'fair value'. If they are not, the director is liable to the seller (or buyer) for the difference between the 'fair value' and the price at which the shares were sold, regardless of whether the parties have reached a prior express agreement on the sale price.

The facts

In *Wong v Fong*⁵, a family business was set up through a holding company (Pave Capital) in 2005. Mr Fong provided most of the finance for the business and through a trust (the Hobson Trust) was the majority shareholder in Pave Capital. His daughter and son-in-law (Mr Wong), who had initiated the business venture and managed the business, were minority shareholders in the company (through their interests in the Cobblestone Trust).

In 2007, the family business arrangements became unsustainable when the minority shareholders wished to pursue a business venture which Mr Fong refused to entertain. As a result, Mr Wong pressed Mr Fong to sell Hobson Trust's shareholding in Pave Capital to Cobblestone Trust. Mr Fong refused and eventually Cobblestone Trust, under the terms of Pave Capital's constitution, issued a share transfer notice to Hobson Trust nominating a price for its shares. Mr Fong disagreed with the nominated price and elected to have the shares valued at arbitration as provided by Pave Capital's constitution. A dispute then arose between the parties as to the basis Pave Capital's shares should be valued. The constitution provided for a 'fair value' to be fixed independently. Cobblestone Trust's position was that this meant the shares should be valued on the basis of a "price at which 100% of the shares would change hands between a willing buyer and a willing seller on the open market" and was insistent that it should not involve a minority discount. However, before this issue was resolved, Cobblestone Trust, which was in debt to Hobson Trust, was pressured into entering into a Deed of Dissolution for the sale of its shares to Hobson Trust with an agreement that the 'fair market value' of the shares was to be determined by an independent accounting firm (PwC).

PwC's determination of the 'fair market value' incorporated a 30% minority discount, although they did note that their assessment may have been different had they been asked to determine a 'fair value' rather than a 'fair market value'. When Cobblestone Trust refused to settle the Deed, Hobson Trust brought a summary judgment application against Cobblestone Trust. The High Court refused to grant summary judgment on the basis that there was an argument that section 149 of the Companies Act required the sale to be at a 'fair value'.

Following the summary judgment application, Cobblestone Trust, under further pressure from Hobson Trust, chose to complete the sale of shares at the PwC 'fair market value' price under the Deed of Dissolution and then brought a claim based under section 149 against Hobson Trust for the difference in the sale price and the 'fair value'.

The High Court had to determine whether section 149 applied despite the fact that Cobblestone Trust had accepted the 'fair market value' price under the express provisions of the Deed of Dissolution. Further, if section 149 did apply, the court also had to determine whether there was a difference between the statutory 'fair value' and the 'fair market value' determined by PwC.

⁵ *Wong and Fong v. Fong & Chong*, High Court Auckland, CIV 2009-404-002469 , 16 December 2009

High Court's decision

Application of section 149

Under s149 of the Companies Act a director of a company who has material non-public information about the value of the company's shares as a result of his or her capacity as a director or employee and who purchases (or sells) shares in the company is liable to the seller (or purchaser) for the difference between the 'fair value' and the price at which the shares were traded.

The High Court agreed with Cobblestone Trust, relying on a 2001 Court of Appeal decision⁶, that the transfer of the shares was subject to section 149, even in light of the parties' express agreement set out in the Deed of Dissolution. The transfer was between the trustees of the respective Trusts, but the trustees (Mr Fong and Mr Wong) were also directors of Pave Capital. As such, the court held that they could only have known of the value of Pave Capital (and its related companies) because they were directors.

Statutory fair value

Section 149 provides no guidance on how 'fair value' is to be calculated. Justice Asher in the summary judgment hearing noted that the "application of [section] 149 does not automatically result in a certain valuation formula being applied to ascertain fairness. Rather, 'fair value' has to be assessed objectively, on a case by case basis, after an examination of all the relevant circumstances".

In this case, the court acknowledged that it was not uncommon for the 'fair market value' of a minority shareholder's shares to be discounted to reflect the shareholder's lack of control over the affairs of the company which makes the shares less valuable to an arm's length purchaser on the open market. However, this it noted was not invariable. There are exceptions where a minority shareholder can be unfairly exploited if a discount is imposed. English and Australian authorities recognise that this may occur:

- where a company is a quasi-partnership which has been formed on the basis of a personal relationship involving mutual confidence with an agreement or understanding that all or some of the shareholders will participate in the conduct of the business and restrictions on share transfers; and
- where the minority interest has a special strategic value to the majority shareholder.

On the facts, the High Court concluded that both of these exceptions were applicable. Pave Capital was an example of a quasi-partnership of the type noted above. It was founded on the basis of a personal relationship involving mutual confidence. It rested on an understanding that the two shareholders would participate together in business and it also restricted share transfers. Further, under Pave Capital's constitution which required a 75% majority for ordinary as well as special resolutions, Cobblestone Trust's shareholding had a special strategic value to Hobson Trust. As such, the court held that PwC was wrong to discount the value of Cobblestone Trust's holding in Pave Capital to the extent of 30%. In its opinion, 10% of the PwC valuation represented a more appropriate discount in the context of the transaction as a whole.

Judgment

The High Court held that Hobson Trust had paid less than 'fair value' in breach of section 149 and gave judgment to Cobblestone Trust for the difference in the amount it received from Hobson Trust and the full PwC valuation less a 10% discount (being the 'fair value' set by the court).

Conclusion

This case illustrates the extent to which section 149 of the Companies Act can affect share dealings by directors. The fact that the directors held their shares through trusts did not take them out of the reach of section 149. It also did not matter that both directors were likely to be privy to the same inside information. Under section 149 inside information does not cease to be no longer "material to an assessment of the value of shares or other securities issued by the company" merely because the information is already known or is disclosed to the person with whom the director trades. Information only ceases to be held by a director "in his or her capacity as a director or employee of the company, being information that would not otherwise be available to him or her" if that information is made available to the public.

⁶ *Thexton vThexton* [2002] 1 NZLR 780

Further, section 149 applies to share dealings by directors regardless of whether there has been a prior agreement on how they are to be valued under the company's constitution, under the terms of a shareholders' agreement or in a subsequent contract of sale.

Share dealings by directors of listed companies have been specifically excluded from the application of section 149. Instead, they are subject to the insider trading regime provided under the Securities Markets Act 1988. For further information on this regime refer to the article [The new insider trading laws](#) on our website.

Securities and capital markets

CMD Taskforce's final recommendations to feature in Securities Act review

Further light has been shed on the likely direction of the Government's Securities Act review after the release of the Capital Market Development Taskforce's final recommendations and the Government's initial responses to those recommendations. In this article, partner Glenn Joblin provides details and commentary on some of the key aspects of the Taskforce's recommendations which have been signalled for inclusion in the review.

Early announcement on financial reporting changes

In an early announcement aimed at putting business concerns to rest, Commerce Minister Simon Power announced on 24 February that the Government has decided that large non-issuer companies will not be required to file their financial statements with the Registrar of Companies. Partner Gavin Macdonald outlines the details.

Handling confidential information – proposed ASIC best practice guidelines

Senior associate Stephen Layburn comments on the Australian Securities & Investment Commission's proposed best practice guidelines for handling confidential information in corporate transactions which, once finalised, New Zealand regulators may also seek to adopt.

Securities and capital markets

CMD Taskforce's final recommendations to feature in Securities Act review

Further light has been shed on the likely direction of the Government's Securities Act review after the release of the Capital Market Development Taskforce's final recommendations and the Government's initial responses to those recommendations. In this article, partner Glenn Joblin provides details and commentary on some of the key aspects of the Taskforce's recommendations which have been signalled for inclusion in the review.

BACKGROUND

At the end of 2009, the Capital Market Development (CMD) Taskforce issued its final report ([Capital Markets Matter](#)) – intended to be a comprehensive blueprint for the future of New Zealand's capital markets.

The Taskforce recommendations cover a broad range of factors affecting capital markets, including product disclosure, market regulation and taxation. (For a summary of its key recommendations [click here](#).)

The Government has now released its initial response to the Taskforce's report in the form of an action plan which sets out how it will progress each recommendation and includes a timetable for implementation. The Government has responded positively to a majority of the 60 recommendations made by the Taskforce.

Among the recommendations the Government says it will implement are:

- introducing plain English into investment statements and prospectuses, with warnings on high risk or complex products;
- ensuring the duties of fund managers and supervisors are clear and enforced;
- considering consolidating parts of the Companies Office, Securities Commission, and the NZX Disciplinary Tribunal into a new market conduct regulator; and
- making it easier and cheaper for companies to raise capital privately by clarifying and broadening the exemptions of the Securities Act and the Takeovers Act.

The action plan also confirms that changes to the Overseas Investment Act are imminent, with Cabinet decisions on proposed changes to the Act to be made by the end of February.

One additional area that the Government seems particularly keen to pursue is the Taskforce's conclusion that there is an opportunity for New Zealand to become a hub for financial services in the Asia Pacific region, specialising in providing high-value middle and back office functions for the funds management industry. In the Prime Minister's 2010 opening address to Parliament, John Key noted that the Government is keen to see if this or similar new industries could be developed in New Zealand and he has asked officials to determine what steps would need to be taken to make that a reality.

However, the Government has ruled out following the Taskforce's recommendation to improve the product range for investors through the partial listing of state-owned companies in its current term in government. It leaves open the possibility of local governments making the decision to list local government owned companies.

The next step will be release of the Government's discussion document for the Securities Act review in April 2010.

ISSUES FOR SECURITIES ACT REVIEW

Focus of review

Prior to the release of its action plan, the Government had indicated that its review of the Securities Act would focus on four key areas:

- **The scope and objectives of securities law:** to clarify what securities law is trying to achieve and to determine how to make it effective;
- **Investor information:** to determine how to ensure investors get all relevant information, but no more than they need;
- **Managed funds:** to produce clear, consistent requirements for offering all types of managed funds; and
- **Institutional arrangements:** to make sure regulatory bodies are appropriate to needs.

These are all areas which have been addressed in the Taskforce's final recommendations. The Taskforce considers the review of the Securities Act to be critical to the development of New Zealand's capital markets and should be given high priority.

In keeping with its general philosophy on capital market development, the Taskforce has emphasised that, in making changes to the Securities Act, it will be important for officials and the Government to ensure that the body of law that applies across capital markets fits together as a coherent whole.

The Government proposes to implement a number of the Taskforce's recommendations as part of its review of the Securities Act. Summaries of the Taskforce's recommendations which are central to the Securities Act review (and the Government's responses to those recommendations) are detailed below.

1. Clarify objectives of legislation

CMD Taskforce recommendation

Securities legislation should have a clear and explicit objective. The Taskforce recommends that the overriding objective of securities legislation be to facilitate capital market activity – which means that it needs to work well for both issuers and investors.

Government's response

The Government supports this recommendation and intends to progress it as part of the Securities Act review.

Comment

It is hoped that the Securities Act review will deliver on this objective. Recent changes to New Zealand's securities laws have tended to be "patch-work" and hampered by underlying legislation (the Securities Act) which is out-of-date. The current review of the Securities Act represents an opportunity for significant change and to make real improvements to the existing legislative framework.

2. Clarify the boundaries with the public market

The Taskforce has stressed that it must be made easier for sophisticated investors to access the private markets in New Zealand. These markets are not suitable for retail investors, and clear boundaries are required.

The Taskforce notes that the legislation put in place to facilitate investment by retail investors into public markets – such as the Securities Act, Financial Advisers Act and Takeovers Act – also imposes requirements on private markets and can be a barrier to the flow of capital between investors and private companies. In particular, the Taskforce points out that the exclusions from the disclosure requirements of the Securities Act are not underpinned by a coherent framework, are relatively narrow and, in some cases, are ambiguous. This, the Taskforce notes, has the result of imposing costly prospectus requirements on

securities offerings where arguably they should not be imposed, and gives rise to uncertainty about when a prospectus is required.

CMD Taskforce recommendations

Review the current Securities Act exemptions to provide a set of clearer, broader exemptions from the Act. For offers generally, consideration should be given to replacing ambiguous exceptions with a procedure for investors to agree – with appropriate safeguards – that they are able to obtain information about the offer and evaluate it without mandated disclosure.

There should be exemptions from the Securities Act disclosure regime for:

- 'registered investors' - who understand the nature of the protections under Part II of the Securities Act that will not apply, and have signed a form to confirm this (though this will require robust safeguards);
- 'those who invest money as a principal business activity' in line with the existing exemptions;
- other professional investors with clear, quantified, set criteria;
- investors who have obtained a recommendation from a conflict-free authorised financial adviser - the adviser would need to be an authorised financial adviser under the Financial Advisers Act, meeting the associated requirements for disclosure, competency, conduct and dispute resolution. The adviser should not be recommended by the issuer or anyone affiliated with the issuer, needs to be accountable to the investor, and subject to a fiduciary duty of care;
- a more clearly defined exemption for relatives and close business associates;
- wealthy investors; and
- small offers – the make-up of the New Zealand economy is such that, if the offer is made to a small number of investors, the investors are much more likely to have been chosen for their relationship with the issuer, knowledge of the offer or history of making similar investments, rather than as members of the public. They are also more likely to be in a position to negotiate with the issuer, or to reject the offer in the knowledge that there are plenty of other investment opportunities on better terms.

The main risk from this exception is that flawed contracts in small offers result in negative outcomes for investors, and this causes them and others to (irrationally) reject other securities offerings where the Securities Act does apply. This may be mitigated through clear labelling of the offers as 'small offers' without the usual mandated requirements of the Securities Act, or potentially through restrictions on their promotion to the general public.

Exemptions for professional investors should be made on the basis of explicit quantitative requirements so that there is clarity about who is included and who is not. Where quantitative information is required, investors should be allowed to provide certification of this themselves (and the issuer should be legally able to rely on it), avoiding the need for certification by a third party, such as a chartered accountant.

Government's response

The Government agrees with the Taskforce that there is a need to clarify the public/private distinctions set out in the Securities Act. Consideration will be given to the detail of these distinctions as part of the Securities Act review.

Comment

Minor changes in this area were made through the recent amendments to the Securities Act, but they were mostly to remedy existing anomalies. In addition, the change to permit follow-up offers of securities to investors who have already invested at least \$500,000 is so narrow as to be of little practical benefit.

Issuers will certainly welcome more flexibility to raise capital without costly compliance requirements. Introducing more certainty about the scope of these exemptions (such as the close business associates exemption) is also a positive step. There will need to be appropriate safeguards, as the Taskforce has noted, but a balanced set of exemptions should be achievable.

The recommendation to provide an exemption for small offers is long overdue and finally recognises the needs of SMEs, which make up a large proportion of New Zealand's economic activity and are severely constrained by the rationing of bank credit. This is a model which has been adopted in a number of other jurisdictions, including Australia.

3. Product disclosure

The Taskforce's report reiterates recent commentary from regulators, industry participants and investors on New Zealand's current disclosure regime, concluding that it is costly for issuers and yet is largely ineffective for investors.

The Taskforce notes that investment statements tend to be difficult to understand without some expertise. It considers that much of the information in investment statements is poorly presented, lost within marketing material and/or written in legalese. Also, even where key information is disclosed in a concise and simple manner, the Taskforce makes the point that each firm puts this in a form that casts their data in the most favourable light, making it difficult to compare products.

The Taskforce's report acknowledges that any reform around product disclosure will only be effective if it is combined with improved financial advisory services and improved investment literacy among New Zealanders.

CMD Taskforce recommendation

The Taskforce considers that the current regime, which requires tiered disclosure, is good in principle. It is important that both retail investors and other participants get the information they need to ensure the market works well. The Taskforce concluded that it is evident that these needs cannot be met in a single document.

Government's response

The Government supports this recommendation and intends to introduce new disclosure documents, with work already underway under the Securities Act review.

Comment

There is no doubt that the Taskforce is right that good disclosure should facilitate the actual decisions investors need to make – not just provide information. Equally, we believe that market participants would agree with the Taskforce that disclosure should be:

- timely, concise, explicit and accessible to all investors;
- provided in plain language that takes into account the investment literacy of investors; and
- highly standardised.

Achieving these objectives is the hard part. However a single document is not the best model, as we have seen from combined investment statement and prospectus documents.

The three key changes recommended by the Taskforce are described below. The Taskforce has also made a number of other recommendations that are specific to disclosure by managed funds.

(a) Mandate a two-part disclosure document

CMD Taskforce recommendation

Replace the investment statement with a new two-part disclosure document targeted at less sophisticated investors, which is standardised across providers to enable easy comparison. The document would comprise of a one- or two-page cover section that provides key information at a glance (Part A), and a slightly longer section with further, more detailed information (Part B).

Part A: a simple template that includes only the information investors need to answer the following questions:

- What are the risk–return characteristics of this product (recognising that this relationship will need to be explained and will depend on the investor's time horizon)?
- Does this product meet my needs (for example, for stable income flow or capital growth)?
- Given my portfolio, does this product help me diversify?

- How does this product compare with others (with regard to the above, as well as fees and charges)?

Part B: should further explain the information presented in Part A (for example, a breakdown of the types of fees charged and the specific risks involved), and give additional information likely to be of interest to retail investors (for example, a brief introduction about the issuer or guidance on how to make a complaint). It should be made clear to investors that Part B does not include the most essential information.

The content of Part B should also be mandated and prohibit additional material, which would remain in the prospectus.

Government's response

The Government supports this recommendation and intends to introduce new disclosure documents, with work already underway under the Securities Act review.

Comment

There is general acceptance amongst market participants that the investment statement model has not worked well. It has not delivered on the objective of providing key information to the "prudent, but non-expert investor". The Government has stated that one of the key objectives of the Securities Act review is to ensure that investors get all relevant information, but no more than they need. The Taskforce believes this can be achieved through a new two part disclosure document.

Ultimately, whether the proposed approach will work will depend on what information is required to be included in each disclosure document. The Taskforce has provided very little guidance as to what information should be included. If the Taskforce's proposal is adopted, the challenge for legislators will be ensuring that the failures of the investment statement regime are not repeated.

The registered prospectus regime would be retained if the Taskforce's recommendations are adopted.

The Taskforce's report makes little reference to the new simplified disclosure prospectus regime, other than to note that companies are beginning to make use of it and that they consider it important for any remaining roadblocks to its use to be identified and resolved. We will have to wait to see how the review of the Securities Act will impact the simplified disclosure prospectus regime. The concept of removing the need for listed issuers to duplicate information in a prospectus that they have already released to the market under their continuous disclosure obligations remains a good one.

(b) Introduce a 'sophistication warning'

CMD Taskforce recommendation

Introduce a 'sophistication warning' label for inherently risky or complex products. This would indicate that unless the investor has investment expertise, they should either avoid this product or seek professional advice about it. The need for a sophistication warning can be assessed by the issuer and enforced by the regulator.

Government's response

The Government supports this recommendation and is considering the detail of disclosure documents as part of the Securities Act review.

Comment

Some specific guidance will be needed if this recommendation is adopted. Any uncertainty about how to apply the requirement (given that it may be enforced by the regulator) will be of concern to issuers.

(c) Centralised website for disclosure documents

CMD Taskforce recommendation

Create a centralised website that enables investors to easily get information about, and compare, investment options. The website could allow investors to search for different investment options by type, risk level, minimum amount, fees and so on, and also provide, or signpost to impartial educational material. It is important that the financial information website be independently funded and maintained to avoid any perceptions or fact of conflict. One option is to impose a levy on products so that, ultimately, investors are funding it.

Government's response

The Government supports this recommendation and is considering the detail of how this should be done as part of the Securities Act review.

Comment

We believe that a centralised database is long overdue. At present, there is no central resource providing easy access to offer documents. Registered prospectuses are publicly available through the Companies Office website, but not investment statements. A functional centralised website would be useful and facilitate meaningful comparisons between competing investment products.

4. Regulatory structure and institutions

The current landscape

The Taskforce notes that New Zealand's multiple-regulator framework (known as a 'twin-peaks' framework) brings many benefits, including reducing the risk that industry or consumers assume that all financial institutions are subject to the same level of regulation, or covered by a 'lender of last resort'. The Taskforce considers that it would be sensible for New Zealand to continue to have multiple regulators and to continue with a mix of product and institutional regulation, but notes that considerable improvements should be made within these parameters.

Clarity of roles

The Taskforce points out that under the current regulatory regime, several of the main regulators have a role in policy formation, monitoring and enforcement. They also regulate both product and institutional behaviours, and there is overlap in regulatory enforcement. Problems created by such an overlap noted by the Taskforce include, in particular:

- lack of coordination between regulators leading to gaps and the potential for regulatory arbitrage; and
- added costs and uncertainty for issuers and investors leading to unanticipated risks and lack of redress.

In the Taskforce's view, there is room for improvement in defining the role of each institution (setting issuers' and investors' expectations) and reducing overlaps in activities, especially enforcement, while building critical mass in expertise. The Taskforce has highlighted the unlisted public market as a particular area of concern.

CMD Taskforce recommendation

The regulatory structures governing market conduct should be reviewed.

New Zealand should move to a refined version of the 'twin-peaks' model, with a market conduct regulator and a prudential regulator. In doing so, it will be important to ensure that the boundaries between the new market conduct regulator and the NZX and any separate Registrar of Companies' functions are clearly delineated.

Consideration should be given to consolidating the current Securities Commission with some NZX

regulatory and enforcement functions (including the NZX Disciplinary Tribunal), the Government Actuary and at least some of the functions of the Registrar of Companies. The primary objective of the new regulator (perhaps being called the Investment and Securities Commission) would be to facilitate participation in capital markets. This would require both a greater connectivity with markets and an increased focus on enforcement.

For companies and businesses that issue securities to the public, the Taskforce sees merit in consolidating all monitoring and enforcement activity associated with their corporate reporting and securities-issuing obligations. This is likely to mean some front-line market monitoring activity remains with the NZX, with protocols for referrals to the regulator, rights of appeal and the ability of the regulator to initiate investigations.

Consolidating regulation around a prudential regulator (the Reserve Bank) and a market conduct regulator would also limit the development of markets that are not squarely within the ambit of one of those regulators and thereby manage the risk of regulatory arbitrage.

Government's response

The Government supports this recommendation and is considering the regulatory landscape as part of the Securities Act review.

Comment

Prior to the release of the Government's response to the Taskforce's report, the Government had already made it clear that the review of the Securities Act will consider:

- the current roles and functions of the Securities Commission; and
- the regulatory framework and supervision around fund managers and corporate trustees.

Again, this is an opportunity to make fundamental change and to correct the duplication and overlap and fill the gaps which have been created by previous "patch-work" changes concerning the responsibilities and powers of regulatory bodies such as the Securities Commission, NZX, the Companies Office, and corporate trustees.

Conflicts of interest

The Taskforce notes that under the current regime there are potential conflicts of interest given that, currently, most regulatory agencies play some role in policy, monitoring and enforcing rules. Also, in some areas there are potential conflicts of interest within regulatory agencies, since they are both participants and regulators, for example, NZX, the Reserve Bank and corporate trustees. The Taskforce acknowledges that, in each of these cases, there are mechanisms to manage the conflicts but notes that it is important to review these issues and ensure they are being appropriately managed.

CMD Taskforce recommendation

Review and clarify roles and scope of regulatory agencies to reduce duplication and conflicts of interest, build capability and scale around centres of excellence, and ensure that the focus of regulatory agencies is on facilitating capital market activity.

Potential conflicts of interest should be eliminated, or rigorous and transparent approaches introduced to manage them. Conflicts should be explicitly identified and appropriately managed if it is not possible or appropriate to eliminate them.

Government's response

The Government supports this recommendation and is considering the regulatory landscape as part of the Securities Act review.

Comment

The perception of potential conflicts of interest has drawn criticism from a number of market commentators. It is important that the Government reviews the basis for those concerns as part of the review of the Securities Act.

Extend powers and enforcement capability of regulators

The Taskforce considers it important for enforcement to be prioritised. In its view, visible and credible enforcement needs to be seen as an integral part of the regulatory regime if it is to be effective. Rapid enforcement against market participants who breach ethical principles is critical to building confidence and participation in New Zealand's capital markets.

CMD Taskforce recommendations

Greater emphasis must be placed on monitoring and enforcement capability and activity.

As noted in its November 2008 Interim Report, the Taskforce recommends that the regulator be given the power to issue 'no action' or comment letters to provide issuers with a greater degree of certainty. The regulator should be able to deliver binding rulings and issue a 'rule book' setting out its approach to applying legislation and regulations.

The Taskforce also recommends that, in order to improve investors' access to redress, the regulator be given the power to seek civil remedies on behalf of investors in the event that duties owed to them are breached (including by fund managers and financial advisers) and where other forms of redress (such as the forthcoming Approved Dispute Resolution Schemes) are inadequate. This includes the ability to initiate and coordinate class actions.

Finally, it will be important for the market conduct regulator to have the remit to monitor and enforce behaviour across securities markets, to minimise the opportunity for poor-quality issuers to gather in parts of the market that have received less attention to date. For example, the regulator should also have the ability to define products as securities (and declare them to be particular types of securities) so that issuers cannot arbitrage regulatory boundaries.

Government's response

The Government supports these recommendations. It is considering how to shift the balance of Securities Commission activities towards a greater emphasis on monitoring and enforcement and implement the Taskforce's other recommendations on this area as part of the Securities Act review.

Comment

Lifting investor confidence in New Zealand's capital markets is important following the recent finance companies' collapses. A review of the penalties and enforcement framework for the Securities Commission is a central part of the Securities Act review. It will be interesting to see if the Securities Act review significantly changes the pecuniary penalty and compensation order regime, which was only introduced in 2006. Market commentators have welcomed the statement in the Taskforce's final report that regulators must be seen to be effective – to present a visible deterrent.

Proposals to allow the regulator to give greater certainty through a "rule book", "no action" or comment letters or binding rulings would be very useful for market participants. Regulators will need to administer those processes in a way which meets the needs of issuers, particularly when there is a requirement for urgency.

NEXT STEPS

The Government has indicated that it will give high priority to implementing its proposed changes to the Securities Act. A discussion document is expected to be released by April 2010, with the likely implementation of any changes by October 2011.

We will provide you with further updates on developments as they occur. In the meantime, if you would like to discuss any aspect of the Government's proposals for the Securities Act review or the nature and timing of any follow-up on other aspects of its action plan, please contact your usual Bell Gully adviser.

To view the Government's action plan [click here](#) or visit the Ministry of Economic Development's website at www.med.govt.nz/cmdtaskforce.

[Click here](#) to access a copy of the final report. Further information can be found at www.med.govt.nz/cmdtaskforce.

Securities and capital markets

Early announcement on financial reporting changes

In an early announcement aimed at putting business concerns to rest, Commerce Minister Simon Power announced on 24 February that the Government has decided that large non-issuer companies will not be required to file their financial statements with the Registrar of Companies. Partner Gavin Macdonald outlines the details.

The proposal that stakeholder interest warranted greater public disclosure of the financial performance of large non-issuers was contained in the discussion document released in September 2009 by the Ministry of Economic Development (MED) entitled ['The Statutory Framework for Financial Reporting'](#) (Discussion Document).

Bell Gully made one of the 147 submissions received by MED on the Discussion Document. A substantial focus of the Bell Gully submission was on MED's proposal that large, or economically significant non-issuer entities be required to file public annual financial statements. The Discussion Document indicated that the primary basis for this proposal was the view that the economic or social impact that a large entity is likely to have on the national or regional economy if it fails generated broader stakeholder interest in the financial position and performance of such entities, even if they do not have public accountability.

Bell Gully submitted that there was no evidence or analysis of any benefit from such increased disclosure and that legitimate interests were already protected (or capable of being protected). We submitted that there would be a significant increase in the compliance burden as a result of a requirement to provide access to otherwise private information well beyond those stakeholders who have a legitimate interest in and need for that information.

The Bell Gully submission commented that a similar proposal by MED in 2005 to require large non-issuers to file financial statements met widespread opposition and was not implemented. We submitted that little had changed since 2005 to indicate that the unproven views of the benefits claimed in the Discussion Document outweighed the considerable disadvantages including a possible disincentive to overseas investment in New Zealand.

In his 24 February press release, the Minister stated that he was familiar with the main arguments for and against filing requirements for large non-issuer companies. He added that some of the arguments against, such as respect for privacy and commercially sensitive information, are underpinned by the core values of the Government.

As a result, the Government concluded that the arguments against filing outweigh the arguments for filing, and the status quo should remain. The Minister suggested that this will allow the focus of the debate to move to other reform proposals that are being considered as a part of the review of the financial reporting framework. These include:

- whether to remove the requirements for SMEs to prepare financial statements in accordance with generally accepted accounting practice (GAAP); and
- the need to rationalise the financial reporting system for not-for-profit entities – particularly by removing the inconsistencies between the rules applying to different types of not-for-profit entity.

The Bell Gully submission also indicated strong support for the removal of a requirement for overseas companies that are not issuers (and which are not "large") to publish financial statements. We commented that this requirement is presently seen as inconvenient and a disincentive to foreign investment in New Zealand by requiring the publication of segmental financial information that is seen to be of little use to anyone other than competitors.

The Minister's press release indicated that announcements on the balance of the proposals in the Discussion Document were expected in the second half of 2010.

To view copies of the submissions MED received on its [Statutory Framework for Financial Reporting discussion document](#) visit MED's website or [click here](#). To read [Bell Gully's submission click here](#). The discussion document should be read together with a companion discussion document released simultaneously by the [Accounting Standards Review Board \(ASRB\)](#) entitled [Proposed Application of](#)

[Accounting and Assurance Standards under the Proposed New Statutory Framework for Financial Reporting.](#)

Securities and capital markets

Handling confidential information – proposed ASIC best practice guidelines

Senior associate Stephen Layburn comments on the Australian Securities & Investment Commission's proposed best practice guidelines for handling confidential information in corporate transactions which, once finalised, New Zealand regulators may also seek to adopt.

In December 2009, the Australian Securities & Investment Commission (ASIC) released a consultation paper on proposed best practice guidelines for the handling of confidential information in corporate transactions. The guidelines are aimed at the listed company sector and are particularly relevant to price-sensitive information about capital raisings and M&A transactions.

Objectives

The proposed guidelines are aimed at helping (primarily) listed companies and their advisers, including investment banks to raise the bar, particularly in relation to internal policies and procedures for the handling of (price-sensitive) confidential information, with the objectives of protecting price-sensitive confidential information and avoiding any unintentional or deliberate misuse of that information. However, it is important to note that the guidelines are also intended to ensure an evidential trail is created to allow investigation of leaks (and insider trading) when required.

The publication of the proposed guidelines has been driven off a project undertaken by ASIC which identified a number of abnormal stock trading patterns (and a correlation to media leaks) immediately prior to the announcement of transactions. In particular, ASIC is concerned to ensure non-public, price-sensitive (confidential) information is not misused.

ASIC acknowledges that current market practice around the protection of confidential information varies considerably in Australia, and in many respects falls short of practice in other jurisdictions such as the United States, United Kingdom and Hong Kong. ASIC claims that the guidelines, if adopted, will bring Australia into line with international best practice and enable companies and advisers to benchmark their policies and practices. New Zealand listed companies (not just those listed on ASX) will wish to monitor this development not only because of the harmonisation of the law on insider trading with that in Australia but also because of the increasingly practical reality of the existence of one trans-Tasman market for securities trading. There is also the prospect that, with the current review of our securities laws, New Zealand regulators may become more proactive in seeking to guide the market on best practice including by proposing similar guidelines.

Key proposals

The proposed guidelines, which should be seen as part of a composite set of checks and balances that also incorporate the existing fiduciary and legal obligations of affected parties, include:

- **Internal corporate policies and procedures:** Companies should have clear, documented policies which establish the standards of behaviour and procedures for handling confidential information that all employees are expected to comply with. To assist with implementation, there should be a clear allocation of responsibility for overseeing these policies and procedures and the effectiveness of the policies should be reviewed regularly.
- **The need-to-know principle:** Only people who strictly require confidential information to undertake their business role should be given access to the information. Companies should take steps to minimise the risk of outsiders finding out about or speculating on an impending transaction. The guidelines identify a number of steps, such as physical separation of employees and procedures for information barriers, physical document management and information technology controls.
- **Classification of documents:** In the case of major transactions, information created by or given to a company should be classified according to the level of protection it requires. Such a system could prescribe the specific requirements for creating, distributing and storing each class of confidential information.

ASIC states that even basic security measures can greatly reduce the mismanagement of confidential information.

- **Insider lists:** Companies should maintain a register of all people (both internal and external) who are “insiders” on sensitive transactions. Third party advisers should be required to provide the company with up-to-date lists of all people within their firm who have access to the confidential information.

ASIC believes insider lists will help to limit the number of staff privy to confidential information by promoting the “need-to-know” principle.

- **Leak investigations:** Companies should have written policies and procedures on how a suspected leak is to be investigated and employees are to be made aware that such a process may be undertaken. Best practice requires that, when a leak is confirmed, each party with access to the information (including advisers and other third parties) should consider whether to conduct a formal (but proportionate) leak investigation to identify the source of the leak and take appropriate action. Whilst it is not clear what is meant by “proportionate”, it is clear that such investigations are intended to be an internal matter only.

ASIC sees such a practice would act as a deterrent to employees who may otherwise be tempted to misuse a company’s confidential information. The discussion paper also notes that, without being seen to have conducted an investigation, an organisation may have difficulty in asserting that there is insufficient evidence to suggest that a leak came from within their organisation.

- **Umbrella agreements:** It is proposed that companies that are active participants in M&A activities or capital raisings and who use the services of investment bankers and other external advisers on a regular basis should consider setting up umbrella agreements. These agreements would set out in advance the general practices and principles to be adhered to by the adviser, including the handling of confidential information.

ASIC sees such umbrella agreements acting as a sort of ‘longstop’ in the event that a specific confidentiality undertaking is overlooked in respect of a specific transaction or where an engagement letter is not signed immediately.

- **Confidentiality agreements:** Notwithstanding the presence of an umbrella agreement, all advisers should be required to enter into transaction-specific confidentiality agreements.

ASIC notes that companies should not rely on past dealings and expectations about the professionalism of advisers and that confidentiality agreements should cover related issues such as conflicts of interest and dealings with the press.

- **Individual obligations:** The discussion paper notes that highly sensitive transactions require more stringent policies and procedures and may trigger a requirement for employees to sign individual confidentiality agreements.

ASIC sees such an approach as being aimed at focussing the employee’s mind on their responsibilities rather than relying on implicit or undocumented policies.

- **Personal account dealing:** The discussion paper proposes restrictions on employees with confidential information trading on the companies financial products (securities) with provision for pre-approval of trades, confirmation that that the trade has been completed and staff in sensitive roles being required to disclose their holdings on a regular basis (which extend to persons or entities over whom they have control).

ASIC sees such measures as part of a package of checks and balances to enable employees to satisfy themselves that they have done all they can to ensure that employees are not acting improperly. In large measure, such requirements are aimed at protecting reputation damage to the employer. In a New Zealand context, some of the disclosure issues are already dealt with by the comprehensive director and officer disclosures required by Part 2 of the Securities Markets Act 1988.

Advisers who regularly deal with price-sensitive confidential information relating to transactions from a range of parties should have controls over trading in financial products, and these should apply to all employees.

- **Beauty parades:** Conducting a “beauty parade” to select advisers for a specific confidential transaction is viewed by ASIC as involving a high risk of leaks. Potential advisers should sign confidentiality agreements before any confidential information is released to prospective advisers. Where possible, companies should keep the number of parties invited into beauty parades to a minimum (albeit recognising the importance of maintaining competitive tension in selecting advisers).
- **Market soundings:** The discussion paper notes that market soundings increase the risk of price-sensitive confidential information being misused. As a result, soundings should be a formal process that is well understood by the company and other participants. It is recommended that companies should require investment banks to seek their consent to sound the market. The discussion paper proposes a number of specific practices governing such soundings, including that soundings only take place when the market is closed or the particular security is in a trading halt, and the use of a formal script to govern soundings.

ASIC also proposes that, when a party is “brought over the wall” by means of a sounding, the investment bank should obtain written confirmation (e.g. by email) from the institution on various matters, including undertakings to comply with confidentiality and insider trading restrictions.

Perhaps most controversially, ASIC also proposes that details of soundings (including the parties who have been sounded out) should be notified to ASIC within 48 hours.

Legal risks

The risk areas identified by ASIC in relation to the handling of confidential information include:

- a confidential transaction (or an important aspect such as pricing) will be jeopardised or the company will have its business or reputation damaged;
- a director or employee engaging in insider trading; and
- the company being in breach of continuous disclosure obligations under stock exchange listing rules.

Whilst a failure to comply with the guidelines will not necessarily crystallise those risks, one of the key impacts of the guidelines is that (from an enforcement perspective) the records required by the guidelines would allow easier investigation of potential contraventions of the law.

Impact statement

The discussion paper notes that many companies (and their advisers) already have policies and procedures in place governing the handling of confidential information. As a result, it is stated that the guidelines are not expected to increase the compliance burden. However, the guidelines exceed most current understanding of best practice in Australia (and New Zealand).

Next steps

Submissions on the discussion paper closed on 21 February and a final regulatory guide is expected to be released in April.

As noted above, if the proposed guidelines are adopted, listed companies in New Zealand (and advisers) should consider following their Australian counterparts by reviewing their current policies and practices.

We will update you with any further developments.

For a copy of ASIC’s consultation paper [Handling confidential information](#) and the attached draft regulatory guide visit ASIC’s website at www.asic.gov.au

Competition and consumer law

Supreme Court confirms Commerce Commission subject to limitation period

The Supreme Court has confirmed that the Commerce Commission is subject to the three year limitation period in s 43 of the Fair Trading Act 1986 when it brings proceedings for compensation on behalf of consumers. Partner Jenny Cooper and solicitor Nick Christiansen discuss the significance of this decision.

Ins and outs of input methodologies

The Commerce Commission has released papers detailing its emerging views on input methodologies for electricity distribution services, gas pipeline services and specified airport services supplied by Auckland, Wellington and Christchurch International Airports. Senior associate David Blacktop discusses the relevance of these input methodologies and their likely impact for the regulated industries, their consumers and *New Zealand Inc.*

Cartel criminalisation is on the cards for New Zealand

At the end of January, Minister of Commerce Simon Power released a discussion document proposing criminalisation of cartel conduct in New Zealand. It would bring New Zealand into line with countries such as Australia, which has recently criminalised cartel conduct, and the United States, which has seen enforcement agencies routinely seeking imprisonment since the 1970s.

Competition and consumer law

Supreme Court confirms Commerce Commission subject to limitation period

The Supreme Court has confirmed that the Commerce Commission is subject to the three year limitation period in s 43 of the Fair Trading Act 1986 when it brings proceedings for compensation on behalf of consumers. Partner Jenny Cooper and solicitor Nick Christiansen discuss the significance of this decision.

In its recently released decision, *Commerce Commission v Carter Holt Harvey Limited* [2009] NZSC 120, the Supreme Court also provides guidance on what level of knowledge is required for a discovery based limitation period to start to run. This aspect of the decision is significant as it will affect not only the application of the Fair Trading Act 1986 (FTA), but also the application of the limitation period in the Commerce Act and potentially the future application of the Limitation Bill, currently before the Justice and Electoral Committee.

Background

The Supreme Court's decision is the latest development in long-running litigation by the Commission against Carter Holt relating to misgrading of timber prior to November 2003. The Commission started investigating Carter Holt in October 2002 and brought proceedings under the FTA in the District Court in August 2005. Carter Holt pleaded guilty and was fined \$900,000. Following the conclusion of the District Court proceedings, the Commission brought civil proceedings under the FTA in the High Court in October 2006, seeking compensation for end-users of the timber and Carter Holt's competitors.

Carter Holt applied to have the High Court proceeding struck out on the grounds that it was statute barred under s 43(5) of the FTA, having been brought more than three years after the date on which the loss or damage, or the likelihood of loss or damage, was discovered or ought reasonably to have been discovered by the Commission. The strike out application was unsuccessful in the High Court (*Commerce Commission v Carter Holt Harvey Limited* [2008] 1 NZLR 387), but succeeded in the Court of Appeal (*Carter Holt Harvey Limited v Commerce Commission* [2009] 3 NZLR 573). The Supreme Court held it was not sufficiently clear that the proceeding was time barred to justify it being struck out. Accordingly, the decision of the Court of Appeal was reversed.

The key issues for determination by the Supreme Court were, first, whose knowledge is relevant to when time begins to run under s 43(5) – the person making the application (in this case the Commission), or the person who is alleged to have suffered loss – and, secondly, what level of knowledge is required before discovery has occurred and time starts to run.

Whose knowledge is relevant?

Carter Holt argued that the High Court proceeding was time barred because the Commission had discovered the loss or damage more than three years before it brought the proceeding. The Commission argued that its knowledge was irrelevant and that the limitation period ran from the date on which loss was discovered by each person on whose behalf the claim was made (i.e. the end-users and competitors). The Commission's approach was accepted by Justice Asher in the High Court.

The judges in the Court of Appeal took two slightly different approaches. Justice Hammond considered that the relevant knowledge was the applicant's, whether that party was also the loss sufferer or not, whereas Justices Chambers and Baragwanath considered that discovery by either the applicant or the loss sufferer triggered the limitation period in respect of the application.

The majority in the Supreme Court agreed with Justice Hammond. In his judgment for the majority, Justice Tipping said that the relevant person who must discover loss or damage is the applicant for the order under s 43(1), and that the language of the subsection does not suggest any difference between an applicant who is the loss sufferer and an applicant who brings an application on behalf of a loss sufferer. The Court could see no basis for declining to apply the limitation provision equally to the Commission where it is an applicant.

A potential problem with this approach is that a person who is already out of time could simply nominate another person who is not to make the application on their behalf, thereby circumventing the limitation

period. However the majority in the Supreme Court considered that a defendant would never be ordered to pay compensation in those circumstances.

In a separate judgment the Chief Justice endorsed the approach of Justices Chambers and Baragwanath in the Court of Appeal that discovery by either the applicant or the loss sufferer on whose behalf the application is brought will trigger the limitation period.

Degree of knowledge required for discovery

The Supreme Court also considered the degree of knowledge necessary to constitute "discovery", and how likely the loss or damage must be before it will be considered to have been discovered.

In his judgment for the majority, Justice Tipping noted four options: mere possibility of loss; likelihood of loss in the sense that loss may well have occurred; likelihood of loss in the sense that loss is more probable than not; and near certainty of loss. His Honour considered that, as the statutory language provided for likelihood as the standard for the discovery of future loss, there was merit in adopting the same standard for past loss. In that context, "likelihood" meant more probable than not (in contrast to the established meaning of likelihood in the context of the Commerce Act 1986 as a real and substantial risk, a standard above mere possibility but not so high as more likely than not⁷). His Honour considered that the concept of probability is "an appropriate standard against which the occurrence of past loss should be measured". Accordingly, time will not start to run until an applicant knows or ought to know that it is more probable than not that loss has occurred.

In reaching this conclusion the Supreme Court chose not to follow the House of Lords' approach in *Haward v Fawcetts (a firm)* [2006] 1 WLR 682. In that case the House of Lords found that time started running under a knowledge-based statutory limitation when it was reasonable for the plaintiff to begin to investigate their potential claim further (this approach is also consistent with the building defect cases, such as *Invercargill City Council v Hamlin* [1996] 1 NZLR 513 (CA)). The majority in the Supreme Court considered that threshold too low to reflect the consumer protection purposes of the FTA. The Chief Justice did not reach a conclusion on the correct test, as she considered it was unnecessary to do so in this case.

The Supreme Court was unanimous in finding that it was not sufficiently clear on the evidence that the Commission had the requisite knowledge more than three years before the proceedings were filed. Accordingly, they dismissed the application to strike-out.

Conclusion

The majority of the Supreme Court's finding that loss must be known to be more probable than not before it is taken to be discovered effectively requires the civil standard of proof to be met before time begins to run and sets a very high threshold for a defendant to meet in a limitation defence.

Whereas the House of Lords' approach would give an applicant three years from the point at which they first became aware of their potential claim to make inquiries and issue proceedings, the Supreme Court has allowed applicants a potentially much longer period as discovery may not occur until an investigation has been completed. The practical effect of delaying the start of the limitation period in this way is that defendants may face lengthy investigations and the prospect of proceedings being commenced against them much later than three years after the conduct in question was committed or first came to light.

This issue is equally relevant to the Limitation Bill. Among the changes the Bill proposes is the introduction of a "late knowledge period" akin to reasonable discoverability. As drafted the Bill does not define "knowledge", nor does it specify the degree of knowledge required before a claimant is taken to know or ought reasonably to know the specified facts. It is therefore likely that, in the absence of amendments to the Bill, the Supreme Court's decision in the *Carter Holt Harvey* case will influence the application of the Limitation Bill, once enacted.

This article was first published NZLawyer, 11 December 2009.

* Bell Gully is representing Carter Holt in these proceedings and appeared on its behalf in the Supreme Court.

⁷ See *Port Nelson Ltd v Commerce Commission* [1996] 3 NZLR 554

Competition and consumer law

Ins and outs of input methodologies

The Commerce Commission has released papers detailing its emerging views on input methodologies for electricity distribution services, gas pipeline services and specified airport services supplied by Auckland, Wellington and Christchurch International Airports. Senior associate David Blacktop discusses the relevance of these input methodologies and their likely impact for the regulated industries, their consumers and New Zealand Inc.

Immediately before Christmas, the Commerce Commission released a series of documents setting out its "emerging views" on the input methodologies it will use in regulating goods and services which are controlled under Part IV of the Commerce Act – which are natural monopoly services such as electricity lines companies, owners of gas distribution and transmission pipelines and specified airports. The Commission's "emerging views" follow a lengthy submission and industry consultation process in 2009.

Why do the input methodologies matter?

Input methodologies are an important innovation introduced as part of the new regulatory regime; they form the building blocks on which the Commission will make decisions about price path thresholds (i.e., the rate at which firms can increase prices from year to year) and information disclosure obligations for regulated industries. The input methodologies cover:

- methodologies for evaluating or determining:
 - cost of capital;
 - valuation of assets, including depreciation, and treatment of revaluations;
 - allocation of common costs, including between activities, businesses, consumer classes, and geographic areas;
 - treatment of taxation;
- pricing methodologies;
- regulatory processes and rules; and
- matters relating to customised price-quality path proposals.

The object of input methodology is to deliver greater upfront certainty so as to create more predictable regulatory outcomes. It is thought this greater certainty will assist regulated suppliers to manage their businesses and foster and encourage efficient investment.

While separate methodologies must be set for each regulated industry, because the underlying rationale for regulation is similar across the industries, they will likely share many common features.

Impact of the input methodologies

Once set, the input methodologies will apply to the regulated industries for up to seven years before being reviewed. Any industry which later becomes subject to regulation will have new input methodologies set for that industry; however, in practice the methodologies set now will form a "base case" in any future analysis.

From a consumer's perspective, the methodologies will influence the amount they pay for regulated services. To illustrate, regulated prices for electricity lines businesses and gas distribution pipelines are heavily dependent on the value of the firm's asset base because, in a competitive market, a firm would earn a normal return on its assets. Therefore, the bigger the asset base, the greater the revenue the regulated firm will be able to earn without falling foul of the control regime. The input methodologies will provide the framework for firms to determine their regulated asset bases and therefore will have an impact on all of us.

Relevance of "New Zealand Inc"?

Under the old Part IV (and also under the Telecommunications Act) a key question had been whether economic regulation should be focused on improving New Zealand's overall efficiency or whether there should also be specific focus on protecting consumers from excessive prices.

The purpose statement in Part IV explicitly provides that the purpose of the regulatory regime is to "promote the long-term benefit of consumers in markets [where there is little or no competition and little or no likelihood of a substantial increase in competition]". This is achieved by:

... promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services:

- a. have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and
- b. have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
- c. share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
- d. are limited in their ability to extract excessive profits.

The Commission has said that its approach in making decisions on input methodologies is to ask (i) whether the decision would promote outcomes consistent with those that would be expected in a competitive market and then (ii) to check that, in aggregate, the outcomes are ones which promote:

- innovation and investment (s 52A(1)(a));
- maintenance of quality standards demanded by consumers (s 52A(1)(b));
- prices which promote rational choice by consumers (s 52A(1)(c));
- profits which are sufficient to reward investment, innovation and efficiency but are not excessive (s 52A(1)(d)); and
- allocative, productive and dynamic efficiency (s 52A(1)(b)).

The Commission's view is that the "central purpose" of Part IV is to promote the long term interests of consumers in regulated markets. Rather than a *New Zealand Inc* focus, the purpose statement may be said to imply that the Commission should focus on the regulated market only and ignore effects on other non-regulated markets. Does this matter? Well, while it is difficult to predict the circumstances in which this may make a practical difference, decisions in the electricity lines markets might, for example, impact on lines companies' decisions regarding the roll out of telecommunications fibre.

Where to from here?

Originally, the Commission was required to publish the methodologies by 31 June 2010, although – sensibly given their importance – this timeframe has been extended by the Minister of Commerce to 31 December 2010 (and 1 January 2011 for airports).

The next 12 months will see further rounds of industry consultation and submissions, commencing very shortly with a number of workshops in February and March, with the Commission releasing draft determinations for submissions in the second quarter and input methodologies (at this stage) set to be finally determined around October and November.

By the end of 2010, the input methodologies will be set. Once set, the Commission will be in a position to move to establishing the information disclosure (for airports, electricity lines and gas distribution businesses) and price path thresholds (for non-consumer owned electricity lines businesses and gas distribution businesses) regimes, which will come into effect in 2011.

This article was first published in NZLawyer, 5 February 2010.

Competition and consumer law

Cartel criminalisation is on the cards for New Zealand

At the end of January, Minister of Commerce Simon Power released a discussion document proposing criminalisation of cartel conduct in New Zealand. It would bring New Zealand into line with countries such as Australia, which has recently criminalised cartel conduct, and the United States, which has seen enforcement agencies routinely seeking imprisonment since the 1970s.

The [discussion document](#) is lengthy and is accompanied by an [occasional paper](#) (which reviews the theory of cartel behaviour and its treatment, and examines the evidence on the performance of different treatments for responding to cartel behaviour).

What is cartel conduct?

Cartel conduct includes provisions that:

- Fix prices;
- Restrict outputs in the production or supply chain;
- Allocate customers, suppliers or territories;
- Rig bids.

Criminalisation of serious cartel conduct has been considered previously in New Zealand. In a January 1998 discussion document, "*Penalties, remedies and court processes under the Commerce Act 1986*", the Ministry of Commerce concluded that "hard core cartelisation is a far more serious offence than the civil law offence of insider trading ... and the consequences of price fixing to New Zealand society seem to be more akin to tax and customs duty evasion".

Discussion document

The key features of the proposal put forward in the latest discussion document include the following:

- The Ministry of Economic Development (MED) is concerned that New Zealand's existing civil penalty regime does not effectively deter cartel behaviour. MED considers that the "single intervention most likely to have a significant impact on deterrence and detection is the possibility of imprisonment" and it notes the introduction of criminal penalties in Australia, where the ACCC has reported a subsequent increase in leniency applications.
- Harmonisation of business laws with Australia is also an important factor in MED's thinking. The Single Economic Market Outcomes Framework has a medium-term goal that firms operating in Australian and New Zealand markets face the same consequences for the same anti-competitive conduct.
- MED's preferred option appears to be based on the Australian legislation, which came into effect in July 2009. The Australian legislation criminalises "hard-core" cartels – price fixing, bid rigging, market allocation, and output restrictions – which it refers to as "cartel provisions".
- The necessary mental element of the proposed offence is likely to be intention together with knowledge or belief that the agreement contains a cartel provision.
- Subject to proof of that mental element, it would be an offence to make or to give effect to a contract, arrangement or understanding that contains a cartel provision.
- Criminal liability would apply to both individuals (executives and managers involved in the cartel) and the corporation.

- The jurisdiction of the offence may extend to cartels formed outside New Zealand, as for conspiracy offences under section 310 of the Crimes Act.
- The Commerce Commission would carry out the investigation of a suspected offence and make the decision whether to prosecute.
- Prosecutions would be carried out by a panel of senior barristers in private practice, as for the Serious Fraud Office.
- Trials would likely be by judge alone, rather than jury trials (applying section 361D of the Crimes Act 1961).
- A maximum sentence of between five and seven years is proposed.
- Extradition of suspects may be possible under the Extradition Act and/or Convention Against Transnational Organised Crime and Extradition Act.

The discussion document raises a number of other issues, including whether rewards for whistleblowers should be adopted.

Arguments for and against

Whether to criminalise cartel conduct is a complex issue. The arguments in favour of criminalisation can be clearly articulated, but these need to be considered alongside questions about:

- the appropriateness of criminalising cartel conduct in New Zealand;
- whether the gains from doing so would outweigh the costs (which are substantial, as anyone involved in Commerce Commission investigations and proceedings under the current civil regime will appreciate); and
- if a criminal regime is to be introduced, how it should be designed to provide certainty to businesses and individuals, avoid stifling competition, and ensure that suspects are treated fairly and in accordance with the New Zealand Bill of Rights Act.

Submissions

MED is calling for submissions on the paper and Bell Gully will be canvassing its clients and the wider business community in the course of compiling its response. Submissions are due by 31 March.

We will keep you updated with further developments. In the meantime, if you have any questions or would like assistance with making a submission of your own, please contact your usual Bell Gully adviser or:

[Phil Taylor](#)
Partner

[Torrin Crowther](#)
Partner

[Simon Ladd](#)
Partner

[Jenny Stevens](#)
Partner

[David Blacktop](#)
Senior Associate

To obtain copies of the cartel criminalisation discussion document and the occasional paper visit MED's website at: http://www.med.govt.nz/templates/MultipageDocumentTOC_42186.aspx

For Bell Gully commentary on Australia's new cartel criminalisation regime see the article [Advance Australia fear – jail for cartel conduct](#) on our website.

Intellectual property and information technology

Hollywood takes on Australia's third largest ISP - and loses

A recent decision of the Australian Federal Court has reignited debate around the liability of Internet Service Providers (ISPs) for copyright infringement. Solicitor Jessie Parker and summer clerk Grace Boos discuss what implications this landmark decision may have on New Zealand's rewrite of section 92A of the Copyright Act 1994.

Trans-border data flow legislation is back on the agenda

After languishing in Parliament for almost two years, the Privacy (Cross-border Information) Amendment Bill has reappeared on the Government Order Paper for its second reading. Solicitor Nick Laing looks at the key features of the bill.

Intellectual property and information technology

Hollywood takes on Australia's third largest ISP - and loses

A recent decision of the Australian Federal Court has reignited debate around the liability of Internet Service Providers (ISPs) for copyright infringement.⁸ Solicitor Jessie Parker and summer clerk Grace Boos discuss what implications this landmark decision may have on New Zealand's rewrite of section 92A of the Copyright Act 1994.

Roadshow Films v iiNet

More than 30 major motion picture studios, including big names such as Universal Pictures, Warner Bros and 20th Century Fox, collectively brought proceedings against iiNet, Australia's third largest ISP, claiming copyright infringement.

The facts can be summarised as follows:

- The studios had advised iiNet that certain internet users with iiNet accounts were using a peer to peer (P2P) file sharing system to illegally download films and television shows.
- The studios demanded that iiNet take steps to stop the copyright infringement e.g., sending a warning to the infringers and, if that was not sufficient to stop the infringement, suspending or terminating their internet accounts. iiNet refused.

Under Australian copyright law, a person who authorises the infringement of copyright is treated as if they themselves infringed copyright directly. The issue for the Federal Court was whether iiNet, by failing to take any steps to stop infringing conduct, authorised the copyright infringement of its users.

The Federal Court held that iiNet did not authorise the copyright infringements because:

- the infringements were a direct result of the use of a P2P file sharing system that iiNet did not create or control;
- the steps available to iiNet to prevent the infringements (i.e., issuing warnings and terminating users' accounts) were not reasonable in the absence of judicial consideration as to the extent of the infringement on each account, therefore iiNet did not have the power to prevent the infringements occurring as required under the Australian Copyright Act; and
- iiNet did not sanction, approve or countenance the infringements.

The Federal Court noted that:

- iiNet provides a legitimate business which is not intended or designed to infringe copyright;
- there is a difference between providing the means to infringe copyright (e.g., the P2P file sharing system) and providing a precondition to infringement occurring (e.g., iiNet's internet services);
- Australian law does not place a positive obligation on any person to protect the copyright of another; and
- termination of an account would prevent the affected user from using the internet legitimately even though that user had contracted and paid for this service.

Impact on the section 92A debate

For those following the section 92A debate, the Federal Court's reasoning may sound familiar. The Telecommunications Carriers' Forum raised similar arguments on behalf of New Zealand ISPs. It is clear

⁸ *Roadshow Films Pty Ltd v iiNet Limited* (No. 3) [2010] FCA 24.

from the [Copyright \(Infringing File Sharing\) Amendment Bill](#) introduced into Parliament this week that the Government has found those arguments somewhat persuasive.

The bill repeals section 92A of the Copyright Act, which would have required ISPs to adopt a policy providing for the termination of a repeat infringer's internet account. It introduces a new three stage approach for P2P copyright infringement. Under the new provisions an ISP does not infringe copyright, despite possible knowledge of a P2P copyright infringement, as long as it complies with its obligations under the Act.

1. Notice regime for P2P copyright infringement

A right holder must send "reasonable evidence" of alleged P2P copyright infringement to the appropriate ISP⁹. The reasonable evidence required will be prescribed by regulation. The ISP will then identify the relevant account holder and pass on a "detection notice" from the right holder that informs the account holder that infringing has occurred and is illegal. An ISP will issue a "warning notice" if a further infringement occurs in relation to the same right holder at least three weeks after the date of the detection notice (provided the detection notice has not expired). If, at least three weeks after a warning notice, a further infringement occurs an "enforcement notice" may be issued.

The account holder may dispute these infringement notices by sending a challenge, in the prescribed form, to the ISP that issued the notice. An ISP that receives a valid challenge to an infringement notice must immediately forward it to the relevant right holder if the challenge raises an issue that should be addressed by the right holder rather than by the ISP.

After an enforcement notice is issued the right holder has four weeks in which to take enforcement action against the account holder.

2. Copyright Tribunal for claims up to \$15,000

For claims under \$15,000, a right holder will be able to take the matter to the Copyright Tribunal. The Copyright Tribunal may award a penalty for P2P copyright infringement, the amount of which will be prescribed by regulation. Claims will generally be heard on the papers, however account holders may request a hearing or the Tribunal may order one.

Decisions of the Copyright Tribunal may be appealed to the High Court, but only on points of law.

3. Sanctions for serious infringers

Claims over \$15,000 must be pursued in the District Court or High Court, as appropriate.

Right holders will also be able to seek a court order suspending a repeat infringer's internet account for up to six months. The court will determine whether this remedy is appropriate in the circumstances, taking into account matters such as:

- multiple users of shared accounts;
- the effects on businesses that may face having their accounts suspended due to the actions of employees; and
- vulnerable users.

Comment

Although the revised approach does not address all ISP concerns, it goes some way to address an issue that was recognised by the Australian Federal Court - that it is unreasonable to expect an ISP to suspend or terminate its users' accounts in the absence of judicial consideration. However, it is clear that the

⁹ The bill addresses concerns about the broad definition of "internet service provider" by adding a new definition that is specific to P2P copyright infringement. The intent is that the new P2P copyright infringement provisions will only apply to ISPs who have the technical capability to identify IP addresses with account holders. This will exclude universities, libraries, and businesses that provide internet access to their members or employees but are not in the nature of a traditional ISP.

Minister of Commerce favours the involvement of ISPs in the process, and does not quite draw the same distinction as the Federal Court between the means to infringe copyright (e.g., a P2P file sharing system) and the precondition to infringement occurring (e.g., internet services).

The bill provides for the new P2P copyright infringement regime to come into force on 1 October 2010. We will keep you updated on further developments.

Trans-border data flow legislation is back on the agenda

After languishing in Parliament for almost two years, the Privacy (Cross-border Information) Amendment Bill has reappeared on the Government Order Paper for its second reading. Solicitor Nick Laing looks at the key features of the bill.

The bill was first introduced in July 2008 but did not receive its first reading until April 2009. The Justice and Electoral Select Committee issued its report on the bill in September 2009, recommending that it be passed with some additional amendments.

The bill amends the Privacy Act 1993 to:

- ensure that individuals located overseas can access and correct their personal information;
- allow the Privacy Commissioner (the Commissioner) to more effectively co-operate with overseas privacy enforcement authorities when dealing with complaints; and
- enable the Commissioner to prohibit the transfer of personal information to another jurisdiction in cases where that information has been routed through New Zealand in an attempt to circumvent the originating country's privacy laws.

Why does New Zealand need the bill?

One of the driving forces behind the bill is to enable New Zealand to obtain a formal finding from the European Union (the EU) that New Zealand's privacy laws adequately protect personal information being transferred from the EU to New Zealand. Currently, New Zealand businesses receiving personal information from the EU must undertake somewhat cumbersome and expensive processes to legitimise the transfer, such as entering into a contract that provides the necessary safeguards to give effect to EU privacy law.

As the EU is recognised as having some of the strictest data export controls in the world, if New Zealand meets these standards through provisions in its own privacy legislation, it will place New Zealand at a competitive advantage with major trading partners by allowing for the more free exchange of data to and from New Zealand.

Access by overseas individuals

The bill will allow any individual, including foreign nationals, to make an "information privacy request" (i.e., a request to access and correct their personal information held by an agency) under the Privacy Act. Currently, only New Zealand citizens, permanent residents and individuals located in New Zealand may make such a request. In addition to this, a public sector agency may levy a charge responding to an information privacy request where the requester is an individual residing outside New Zealand or is not a New Zealand citizen or permanent resident.

Co-operation with overseas enforcement authorities

Under the bill, the Commissioner may refer any complaint relating to a matter within the jurisdiction of an overseas privacy enforcement authority to that authority, and consult with that authority in order to determine the appropriate means of dealing with the complaint. Under the Privacy Act, there is no formal process set out. The bill also allows the Commissioner to share and transfer information to the overseas enforcement authority in relation to any investigation that the Commissioner commences themselves.

Transfer of information outside New Zealand

The bill authorises the Commissioner to issue notices that prohibit the transfer of personal information to another state. This is where the Commissioner is satisfied on reasonable grounds that:

- the information has been, or will be, received in New Zealand from another state and is likely to be transferred to another state where the privacy protection is not comparable to that established by the Privacy Act;
- the transfer would circumvent the laws of the state where the information originated; and

- the transfer would be likely to contravene the basic principles of national application set out in Part 2 of the 1980 OECD Guidelines on the Protection of Privacy and Transborder Flows of Personal Data (which set out general principles concerning an individual's right to information privacy, and their access to the information held by an agency).

The bill sets out a right of appeal against the issue of a transfer prohibition notice to the Human Rights Review Tribunal, and also provides for a criminal penalty (upon summary conviction) of up to \$10,000 for failing or refusing to comply with the notice.

Next steps

The Government has yet to give any indication on when the bill is likely to be passed, but its position on the Government Order Paper suggests that it may be during the first half of this year. Once enacted, it will send a signal that New Zealand can no longer be used as a "staging post" for cross-border data transfers that flout the originating country's privacy laws. Its operation in practice is eagerly awaited.

Utilities and resources

NZ Emissions Trading Scheme - what we are seeing

It has been a busy few months in the climate change sector, with a number of consultation documents released, submission and registration deadlines passing, and trading activity increasing. Senior associate Kate Radka details the developments.

Utilities and resources

NZ Emissions Trading Scheme - what we are seeing

It has been a busy few months in the climate change sector, with a number of consultation documents released, submission and registration deadlines passing, and trading activity increasing. Senior associate Kate Radka details the developments.

Participant registrations

We saw a significant number of participants registering on the Emissions Unit Register in January 2010 for activities within the stationary energy, industrial processes and liquid fossil fuel sectors in preparation for the introduction of these sectors to the Emissions Trading Scheme (ETS) from 1 July 2010.

Emissions intensive trade exposed (EITE) allocations

Many businesses within these sectors are following closely the Government's development of the Industrial Allocation Regulations. In December, the Government released a consultation document ([Development of Industrial Allocation Regulations under the New Zealand Emissions Trading Scheme](#)) which outlined its intended approach to implementing industrial allocation under the NZ ETS. In summary, it:

- set out the process for awarding allocation under the moderated NZ ETS;
- sought feedback on a number of technical matters;
- listed industrial activities that might be eligible for an allocation and invited firms that conduct these activities to identify themselves; and
- invited firms that perform other activities that may be eligible to receive an allocation to come forward and provide preliminary data to demonstrate this.

There is a level of angst for some businesses as to whether their activities will be considered to be "eligible activities" under the ETS, given the uncertainty arising from the interplay between the EITE aspects of the proposed (but stalled) Australian scheme and the ETS, and the manner in which officials will interpret certain sections of the Climate Change Response Act 2002 which apply to EITE. Businesses have been seeking legal advice on the areas of uncertainty, and the likelihood that their activities will meet the criteria set out in the Act. A number of submissions were received by the Government, and officials continue to be in discussions with various industries.

We expect to see increased lobbying of officials as they continue to work through the process of finalising definitions for eligible activities. Ideally the definitions would be finalised by 1 July 2010, but such a tight deadline is unlikely to be achieved. Delays in providing allocation during the first year have been catered for. The consultation document notes that allocations will be provided back-dated to 1 July 2010 for those found eligible.

Carbon trading

We have seen a significant rise in carbon trading since the start of the year, with many deals parked in 2009 awaiting the outcome of the Moderated Emissions Trading Bill process being, or close to being, finalised.

Forestry

There has been an explosion of registrations on the Emissions Unit Register of both post-1989 and pre-1990 forestry participants.

This includes forest landowners who have an obligation to register as a result of having deforested more than 2 hectares of pre-1990 forest land since 1 January 2008. Such foresters are required to file an emissions return by 31 March 2010 quantifying their deforestation liability using the form on MAF's website: www.maf.govt.nz/sustainable-forestry/ets/form_pre-1990-deforestation.htm. Although the

reporting deadline is in March 2010, emissions units to meet such deforestation liabilities do not need to be surrendered until 31 May 2011 (at the latest).

Post-1989 forests emissions return deadline

The emissions return deadline is quickly approaching for those post-1989 foresters who choose to file their return by 31 March and claim New Zealand Units (NZUs) for the net increase in carbon sequestered in their forests since 1 January 2008.

However, if foresters have not submitted their post-1989 registration application already, it is unlikely to be processed prior to the close date for emissions returns. Only registered participants may file an emissions return claiming NZUs. For those who have not yet registered, an emissions return can be filed between January and March next year (2011) for the change in carbon stocks in that forest over the period 2008 to 2010.

Pre-1990 forests allocation plan

Pre-1990 foresters awaiting the release of the Pre-1990 Forest Land Allocation Plan following the end of the consultation period on the draft plan in November 2009, will be waiting a while yet, with a further draft allocation plan to be released for consultation in March 2010.

The draft that will be released for consultation will propose regulations covering detailed aspects of the allocation of New Zealand Units to the forestry sector for pre-1990 forest land, including further rules to determine eligibility for different rates of allocation, and information requirements.

Foresters and landowners who have been seeking advice before determining whether to transfer forest land or forestry rights will be looking for greater certainty in the consultation document to ensure they will not trigger the thresholds resulting in a significant loss in value arising from the allocation arising in respect of the forest.

Pre-1990 tree weed deforestation exemptions

The Government will also be releasing proposed regulations for exemption from deforestation liabilities in relation to tree weeds on pre-1990 forest land. The consultation document is expect to specify the list of tree species that may be considered tree weeds, and the criteria and priorities for assessing tree weed exemption applications.

Transfers from Permanent Forest Sink Initiative to NZ ETS

The deadline of 1 April 2010 is looming for those parties with Permanent Forest Sink Initiative (PFSI) covenants who wish to transfer all of their forest sink area to the NZ ETS. They must have completed registration in the NZ ETS by 1 April 2010.

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

Bell Gully partner Simon Watt, an expert in climate change issues, including emissions trading, has been advising New Zealand and international organisations for a decade as they become involved in trading or prepare for new climate change laws.

Bell Gully News

Bell Gully assists in delivery of major New Zealand transport technology project

The signing of a contract to deliver an integrated super transport ticket for Auckland marks a significant milestone for many involved in the project, including Bell Gully as legal advisers. The Auckland Regional Transport Authority, in conjunction with its partner Thales and its funders the New Zealand Transport Agency and the Auckland Regional Council, has signed the contract introducing Auckland and New Zealand's first, true multi-modal transport ticket. The system will mean passengers will be able to use one smartcard ticket seamlessly between public transport trains, buses and ferries.

Partner-led pro bono programme supports those in need

Bell Gully's commitment to helping those in need has seen it develop a formal, partner-led, pro bono programme that has it targeting a \$1 million spend within three years. In addition to formalising its relationship with a number of worthy charities, the firm has also forged valuable relationships with three community law centres, at a time when the centres were facing what could have been one of the most destabilising years of their existence.

For further details and more news visit www.bellgully.com/news/index.asp

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]