

CMD Taskforce report raises issues for Securities Act review

By Glenn Joblin, Partner 23 December 2009

Last week, the Capital Market Development (CMD) Taskforce issued its final report – intended to be a comprehensive blueprint for the future of New Zealand's capital markets.

The recommendations of the Taskforce cover a broad range of factors affecting capital markets, including product disclosure, market regulation and taxation. The Taskforce has gone to some lengths in its report to stress that its recommendations are designed to “be mutually reinforcing”, and, to be effective, the recommendations should not be viewed or developed in isolation from each other. We will have to wait until the New Year to see whether the Government is prepared to adopt the “total package” of reforms put forward in the Taskforce's final report ([click here](#) to access a summary of the Taskforce's key recommendations). The Government does intend to look closely at some of the Taskforce's recommendations as part of the current review of the Securities Act.

In this update, we detail the Taskforce's commentary and recommendations which are particularly relevant to the Securities Act review.

Securities Act review

The Government has indicated that its current review of the Securities Act will 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.

The Taskforce considers the review of the Securities Act to be critical to the development of New Zealand's capital markets and is something which 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.

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.

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.

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.

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.

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.

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.

(1) 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.

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.

(2) 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.

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.

(3) 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.

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.

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.

Comment

The Government has 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.

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.

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

Having concluded its work, the final report of the CMD Taskforce leaves the role of further investigation and implementation of its recommendations to the Government and other agencies. The Government has indicated that it will consider the report as a matter of priority over the coming weeks, and expects to be able to detail how it will be progressed early in 2010. The Prime Minister is to lead the response, as an indication of how important the changes are regarded by the Government.

Discussion documents on the Securities Act review are also due to be released early in 2010.

We will update you on any further developments.

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

In the meantime, if you would like to discuss any aspect of the CMD Taskforce final report or the nature and timing of any follow-up, please contact one of our team:

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