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Mega reform of financial sector law a step closer

In previous newsletters, we have expressed dismay at the convoluted process for financial sector law reform that is currently under way. Our dismay continues with the recent release by the Ministry of Economic Development (**MED**) of discussion documents as part of the Review of Financial Products and Providers (**RFPP**).

Let's put this into context. The RFPP, which began in March 2005, is one of at least four separate reviews of financial sector law currently being undertaken. The other three are:

- the Review of Domestic Institutional Arrangements being led by Treasury (this is considering who should regulate domestic financial institutions);
- the AML/CFT Review being led by the Ministry of Justice (this is considering the adequacy of New Zealand's anti-money laundering and countering the financing of terrorism laws); and
- the Review of Financial Intermediaries being led by the MED in conjunction with the Financial Intermediaries Task Force (this is considering the regulation of those who market financial products or provide financial advice to members of the public).

Adding to the confusion, the release of these MED discussion documents is the third of four stages in the RFPP. And did we mention that there are nine discussion documents totalling just over 640 pages? An interesting step along the road to achieving the objectives of promoting confidence and participation in financial markets and reducing unnecessary compliance costs.

For those who prefer not to wade through these 640 pages, here is an overview of what is proposed. While it is difficult to draw many common threads from the discussion documents, a few points are clear:

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

The nine headings we use below coincide with the subject matter of the nine discussion documents.

1. Registration of financial institutions

The MED proposes that the Companies Office register financial institutions that are not otherwise subject to a registration regime. As part of the registration process, the Companies Office would:

- collect base level information about the institution; and
- undertake *negative* assurance checks relating to directors, senior management and significant shareholders (e.g., that a director does not have a criminal record and is not a recent bankrupt).

By contrast, *positive* assurance checks (e.g., that a director is a “fit and proper person”) would be undertaken by the relevant regulator – most likely the Reserve Bank or the Securities Commission.

This register would, like the current Companies Office register, be electronic and publicly available for searching.

The key question in determining the scope of this proposal is, of course, what “financial institutions” will need to register? It is clear that the list will include those institutions required to be registered as part of New Zealand’s international AML/CFT obligations. However, the discussion document suggests that other institutions, such as general insurance providers, will also need to register.

2. Securities offerings

The Securities Act regulates offers of securities “to the public” in New Zealand. If an offer is not made “to the public”, the disclosure provisions in that Act do not apply. In practice, it is not always clear whether an offer is made to the public. The proposal is that the Securities Act be amended to clarify

this issue. In particular, the scope of the existing exemptions for “relatives and close business associates” and “professional and habitual investors” would be clarified.

As a related point, the discussion document also seeks feedback on whether investors under these exempt offers should nonetheless have the protection of certain parts of the Securities Act. For example, it might be that, while the *disclosure* regime in the Act would *not* apply to exempt offers, the *misstatement liability* regime *would* apply.

Currently, the disclosure regime in the Act is based upon a dual offering document approach – that is, a prospectus and an investment statement. The discussion document proposes to revert to a single offer document, having a Part A and a Part B. Part A will, like the investment statement, be targeted at retail investors. It will be in a prescribed form for the relevant security type and will, in theory at least, be concise (the proposal is to limit it to five pages). Part B will, like the prospectus, be targeted at professional investors. It is not clear at all how this approach would differ from the not uncommon practice now of combining the prospectus and investment statement.

The financial literacy of the average New Zealand retail investor has long been of concern to the Government. There is little point in requiring comprehensive disclosure by issuers if the target audience cannot understand the information provided. In an attempt to improve financial literacy, it is proposed that the single offer document must contain educational material on financial concepts.

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

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non-listed issuers.

3. Supervision of Issuers

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

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

Overall, despite this discussion document running to 76 pages, it is a sound endorsement of the status quo.

4. Collective Investment Schemes (CISs)

CIS products include unit trusts, superannuation schemes, KiwiSaver schemes, life insurance policies with an investment component and participatory securities. They are currently regulated under a number of unrelated pieces of legislation. Not surprisingly, the proposal is that there should be a uniform set of rules applying to CISs. The only exception would be for existing employer stand-alone and defined benefit superannuation schemes, which would be subject to a transitional structure to minimise scheme wind-up.

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

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

and

- consistent trust deed requirements.

5. Non-Bank Deposit Takers (NBDTs)

In contrast to the preceding two discussion documents, this one *does* propose significant change. NBDTs are financial institutions, other than banks, whose core business involves borrowing money from the public to lend to others. The category includes finance companies, credit unions and building societies. The clear premise of this discussion document is that NBDTs pose additional risks to investors (over and above those of other debt issuers), which justify special treatment. We can only speculate how much this premise has been influenced by the recent run of finance company collapses.

The key proposal is that there be two tiers of NBDTs:

- Tier one – authorised deposit takers (**ADTs**). ADTs must meet licensing and supervisory requirements similar to those applied to registered banks. These requirements include a minimum credit rating (not lower than BB), a minimum level of capital (“possibly \$5 million”), a minimum capital adequacy ratio (10-15%) and minimum prudential standards. ADTs are likely to be regulated by the Reserve Bank. The Reserve Bank would have the power to require a deposit taker to become an ADT where the size or nature of its business makes it systemically important.
- Tier two – other deposit takers. This group would be supervised under an enhanced trustee-based model. It would be regulated by the Securities Commission and its members would be required to disclose prominently that they are not ADTs.

It is proposed that a special case be made for credit unions and building societies that do not become ADTs. These entities would

be regulated by the Reserve Bank, but under a modified model that reflects their small size and mutual nature.

6. Insurance

There has been little logic surrounding the development of New Zealand's insurance legislation in the last century or so. The legislation is piecemeal and often arbitrary in its application to particular providers or products. Given this background, it is not surprising that the main proposal of this discussion document is a single regulatory regime to apply to *all* insurance products and providers. The features of that regime would include the following:

- licensing and prudential requirements for all insurance providers (including “fit and proper person” vetting for directors, senior management and significant shareholders, a start-up solvency support plan and a start-up capital requirement);
- in order to obtain a licence to operate as an insurer in New Zealand, an entity must have a physical presence in New Zealand;
- monitoring and supervision by the Insurance and Superannuation Unit, which focuses on disclosure and director attestation; and
- potentially, mandatory ratings for all insurers and a requirement for accounting separation (with segregated funds) for life, general and health insurance businesses.

Ironically, despite the breadth of these reforms, this discussion document notes repeatedly the success of self-regulation in the insurance industry.

7. Mutuals' governance

Mutual financial institutions include friendly societies, insurance mutuals, credit unions, industrial and provident societies and building societies. Currently, each of these entity types is regulated under its own legislation. A common criticism of the legislation governing mutuals is that it does not require sufficiently robust corporate

governance standards (by comparison to those required under the Companies Act in the case of, say, a finance company). This is seen as a potential risk for investors.

This discussion document proposes that one statute set out base-level corporate governance standards for mutuals. It recognises that there may need to be some flexibility in the application of these statutory standards given the special features of each type of mutual.

8. Consumer dispute resolution and redress

At present, the two main mechanisms for consumer redress in the financial services sector are the Banking Ombudsman and the Insurance & Savings Ombudsman schemes. However, as this discussion document notes, there are gaps where aggrieved consumers have no real alternative to seeking redress through the courts (which includes the Disputes Tribunal).

Rather than proposing a single regime to deal with this issue, the discussion paper presents a series of options for reform. These options range from, at one extreme, the “do nothing” option to, at the other extreme, compulsory membership of an industry-based dispute resolution system. Given the flavour of the other RFPP reforms, it seems reasonable to suppose that the latter option is more likely to be implemented than the former.

9. Platforms and portfolio management services

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

This discussion document is welcomed as it contemplates filling a current legislative void.

“Submissions on the discussion documents are due by 1 December.”

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We are increasingly called upon (particularly, by overseas clients) to advise on the regulatory framework in New Zealand for internet-based platforms. Our response is typically that the services themselves (as distinct from the securities that may be traded through them) are largely unregulated in New Zealand.

This discussion document proposes to change that by:

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

What next?

Submissions on the discussion documents are due by 1 December. The MED will then develop policy proposals for consideration by Cabinet by April 2007. Assuming Cabinet endorsement, the supporting legislation will then be drafted. The Government hopes to have the legislation in force by 2008.

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