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WEEKLY COMMENT: FRIDAY 12 APRIL 2013

1. Three important Bills currently before Parliament that will affect company organisation and reporting are:

   (a) The *Companies and Limited Partnerships Amendment Bill* (the "CLP Bill"), as reported from the Commerce Committee on 1 December 2012;

   (b) The *Financial Reporting Bill* (the "FR Bill"), on which the report from the Commerce Committee is due on 28 May 2013; and

   (c) The *Financial Markets Conduct Bill* (the "FMC Bill"), as reported from the Commerce Committee on 7 September 2012.

2. In addition, *Supplementary Order Paper No. 93* to the Financial Reporting Bill (the "FR SOP") was released on 31 July 2012. The FR SOP contained the amendments to the FMC Bill relating to reporting requirements for issuers and other financial markets participants (which are now incorporated into the FMC Bill reported from the Commerce Committee, as Part 6A).

3. This week I look at the FMC Bill and the corresponding reporting requirements in the FR SOP. Next week I will look at the FR Bill and the CLP Bill.

The Financial Markets Conduct Bill

4. The FMC Bill, which was reported from the Commerce Committee on 7 September 2012, covers four types of financial products: debt securities, equity securities, managed investment products, and derivatives. The Bill is concerned with:

   (a) Providing investors with understandable and accurate information in a form that readily allows comparison of different product offerings;

   (b) More robust safeguards in the form of better governance arrangements when others invest money on behalf of the public (e.g. managed investment schemes and discretionary investment management services);

   (c) Reduced compliance costs of raising capital through the removal of unnecessary processes such as director certification of advertisements;

   (d) Promoting innovation and effective competition by providing more opportunities for securities exchanges to develop markets suitable for smaller companies.

Commencement date

5. The Commerce Committee recommended that the default commencement date be moved back from 1 April 2015 to 1 April 2017. However, the Committee expected that most of the provisions of the Bill would come into force well before that date. Various parts of the Bill may have different start dates as appointed by the Governor-General by Order in Council.

6. The following provisions will come into force on the day after the FMC Act receives the Royal assent:

   (a) Certain rules relating to dealing with financial products on markets, including certain disclosures of substantial interests in listed issuers and the regulation of unsolicited offers to purchase products;

   (b) Regulations that apply to a derivatives issuer, including prescribed requirements for the safe custody of investors' money and property;

   (c) All of the regulations and exemptions, and the transitional and miscellaneous matters, provided for in Part 8 of the Bill.

Misleading or deceptive conduct

7. Prohibitions against misleading or deceptive conduct in relation to matters covered by the FMC Bill will no longer be dealt with by the Commerce Commission under the Fair Trading Act 1986 (the "FT Act"). Instead, the Financial Markets Authority (the "FMA") will deal with conduct regulated by the FMC. Conduct that is covered includes both conduct in New Zealand and certain conduct outside New Zealand that relates to dealings in financial products or the provision of financial services in New Zealand.

General disclosure requirements and exclusions

8. An offer of financial products in New Zealand, (regardless of where any resulting issue or transfer occurs), to which the disclosure requirements in the FMC Bill apply, is called a *regulated offer*. A *product disclosure statement* (PDS) for regulated offers must be prepared and lodged with the Registrar of Financial Service Providers (the "Registrar"). A PDS is not meant to be a long document – it will contain only key information. The remainder of the information will be contained in a *register entry* on the register of offers of financial products that will be maintained on the Internet. This is meant to allow such additional information in the register entry to be readily updated. There are ongoing disclosure requirements relating to the updating of registers.

9. A PDS must be worded and presented in a clear, concise and effective manner, otherwise the FMA may make a stop order preventing offers under the PDS or preventing the PDS from being distributed. The Commerce Committee expanded the territorial scope of the Bill, so that such stop orders can apply to restricted communications distributed to persons outside of New Zealand. Issuers are required to supply additional information and documents to the Registrar when the PDS is lodged. The FMA and the Registrar are given an initial opportunity to consider a PDS for compliance with the FMC Bill. The issuer must publish on its Internet site a statement relating to the lodgement of a PDS.

10. The penalty for knowingly or recklessly contravening the requirement to prepare and lodge a PDS or for contravening the requirement to give a PDS is, for an individual, imprisonment for a term of up to 5 years or a fine of up to $500,000, and for a non-individual, a fine of up to $2.5 million. The penalty for continuing to offer financial products under a PDS that does not comply is, for an individual, imprisonment for a term of up to 10 years or a fine of up to $1 million, and for a non-individual, a fine of up to $5 million.

11. There are a number of disclosure exclusions. The disclosure exclusions will not apply if at least one of the investors is not within the disclosure exclusions. The disclosure exclusions can, however, separately apply to any excluded investors.

12. Offers to wholesale investors, (i.e. persons who meet the specified criteria in Schedule 1, including persons who will invest at least $500,000), are excluded. Such persons are expected to perform sufficient due diligence to allow them to independently assess the merits of the offer. Also excluded are small "specified" offers that involve a maximum of 20 investors and $2 million being raised in any 12-month period, that may be accepted only by an interested person or a person with annual gross income of at least $200,000. Other exclusions are for:

    (a) Close business associates of the offeror: this includes directors and senior managers who hold 5% of the issuer's voting products or 20% of a related body corporate's voting products, relatives of close business associates, and persons who have a close professional or business relationship with the offeror;

    (b) Relatives of the offeror or of a director of the offeror;

    (c) Offers through intermediaries that hold a market services license or by a provider of discretionary investment management services that holds such a license;

    (d) Offers under employee share purchase schemes or dividend reinvestment plans;

    (e) Certain offers of derivatives;

    (f) Offers of interest in retirement villages;

    (g) Offers of interest in contributory mortgages offered by solicitors;

    (h) Generally offers by registered banks, and all offers by the Crown and local authorities;

    (i) Offers of renewals or variations; and

    (j) Offers of financial products of the same class as quoted financial products.

Disclosure requirements for derivatives

13. The Commerce Committee recognised that derivatives differ from other financial products and recommended several amendments. A PDS can be lodged for a derivative product type rather than for each individual derivative contract. Customised terms for specific investors need not be disclosed. In addition, the general disclosure exemption where the minimum amount payable by the investor is at least $500,000 would not apply to many derivatives, as they seldom require large up-front payments. The Commerce Committee recommended an exclusion for derivatives with a minimum notional value of $5 million.

14. Other disclosure requirements for derivatives are as follows:

(a) For a derivative between a licensed derivatives issuer and a retail investor (e.g. a bank and a customer) the issuer must make disclosure, but the retail investor need not.

(b) For a derivative between a person who is in the business of entering into derivatives and an investor who is not (e.g. an energy company and a retail investor) the first person needs to be licensed and must make disclosure, but the investor does not.

(c) For a derivative between two licensed derivatives issuers (e.g. two banks) disclosure is not required.

(d) For a derivative between two wholesale investors (e.g. two large energy companies) disclosure is not required.

(e) For a derivative between two investors who are not in the business of issuing derivatives, disclosure is not required.

Governance of financial products and services

15. Strict governance rules apply to financial products offered under a regulated offer, and to managed investment products in a registered scheme (whether or not there has been a regulated offer).

16. There must be a trust deed, which complies with contents requirements, for regulated offers of debt securities, and a licensed supervisor who is the trustee. The supervisor/trustee is responsible for acting on behalf of the holders of the debt security, and must act honestly, and comply with a professional standard of care.

17. There are special additional registration requirements for specific types of managed investment schemes, including Kiwisaver and superannuation schemes. Kiwisaver scheme requirements largely carry over existing requirements.

18. Superannuation schemes must be for the purpose of retirement, with any benefits paid or early withdrawal provisions being ancillary to that purpose. If a scheme has purposes that are not merely ancillary to providing retirement benefits, the Commerce Committee considered it should be registered as a standard managed investment scheme. However, some existing superannuation schemes will be treated as having a "principal retirement purpose" and some workplace schemes can provide benefits and withdrawals on leaving employment with the relevant workplace or industry.

19. Superannuation schemes will need to limit new members to those with a specified link to New Zealand (e.g. employed by a New Zealand employer or a New Zealand resident) or meet prescribed requirements that include lock-in and transfer requirements.

20. Managers of managed investment schemes will have to licensed by the FMA and comply with duties that include acting in the best interests of scheme participants. The FMA will be responsible for the issue of licenses and the monitoring and enforcement of licenses. The FMA must adhere to the licensing criteria in the FMC Bill and licensees must adhere to the disclosure obligations.

21. Related party transactions will be regulated. The related party transactions of managed investment schemes must be in the best interests of investors and be made on arm's length terms. Restricted schemes, which include employer superannuation schemes, will have a 5% limit on related party transactions (except for investments in registered schemes or some

bank products). The Commerce Committee relaxed this requirement slightly so that investments in related parties are not cumulative if those related parties are not themselves related to each other.

Financial reporting

22. The FR SOP introduced a new Part 6A into the FMC Bill relating to financial reporting. The reporting rules apply to an *FMC reporting entity* which includes all issuers of regulated products, licensees, supervisors, listed issuers, banks, licensed insurers and building societies. There is a specific exclusion for a company with fewer than 50 shareholders.

23. The External Reporting Board must have regard to which FMC reporting entities are considered to have a higher level of public accountability when preparing a proposal to vary or replace the strategy for establishing different tiers of financial reporting.

24. Every FMC reporting entity must ensure that, within 3 months after the balance date of the entity, financial statements (or, if appropriate, group financial statements) that comply with generally accepted accounting practice are completed, dated and signed. This requirement also applies to every manager of a registered scheme.

25. An FMC reporting entity that is an overseas company must prepare financial statements that include financial statements for its New Zealand business prepared as if that business were conducted by a company formed and registered in New Zealand.

26. The financial statements (or group financial statements) of every FMC reporting entity must be audited by a qualified auditor.

27. Within 20 working days after the financial statements (or group financial statements) are required to be signed, copies of the statements together with a copy of the auditor's report must be filed with the Registrar.

28. A contravention of any of the above requirements may give rise to a civil penalty of up to the greatest of the consideration for the relevant transaction, 3 times the amount of the gain made or the loss avoided, and $1 million in the case of an individual or $5 million in any other case.

Enforcement, liability and transitional provisions

29. The FMA can make stop orders that prohibit offers, issues, sales, or transfers of financial products, prohibit the supply of market services, prohibit the acceptance of contributions or deposits, or prohibit the distributions of PDSs or advertisements.

30. Offences of knowingly or recklessly contravening disclosure provisions carry a prison term of up to 10 years or a fine of up to $1 million in the case of an individual, and a fine of up to $5 million in any other case. The Commerce Committee recommended amendments to establish a separate criminal liability for a director where there is a disclosure defect that is materially adverse, and the Crown could prove a "guilty mind". The Committee's opinion was that directors should be liable for civil pecuniary penalties and to compensate investors that lose money if they fail to perform their duties, but should not be liable to imprisonment where there is no fault element.

31. In relation to civil liabilities, the Commerce Committee recommended a new term "involvement in a contravention" which would require proof that a person was an

intentional participant in the primary contravention with knowledge of all the essential facts. This should mean that professional advisers would not risk being involved in a contravention in the course of their normal activities.

32. The Commerce Committee stated there awareness of the concern that directors might be unable to pay penalties or compensate investors, since most directors' assets can be transferred to trusts. The Committee stated that the use of trusts in commercial and asset-protection contexts has implications beyond the scope of the FMC Bill.

33. The FMC Bill contains a number of transitional provisions and, in particular, provides for the Securities Act 1978, the Securities regulations 2009, and associated exemptions to continue to apply to securities offered under a prospectus registered in accordance with those former enactments up to 12 months after the commencement of the FMC Act. However, no offer or allotment of securities may be made under the former enactments after the date that is 2 years after the commencement of the new Act.

Arun David, Director

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