The Financial Markets Conduct Bill – what came out in the wash?

The Financial Markets Conduct Bill[1] has emerged from the Commerce Select Committee more finely honed and fit for purpose.

This Brief Counsel highlights some of the key changes, particularly in relation to the liability settings as they were the Committee's focus. We will be publishing further commentaries on other aspects of the Bill over the coming weeks.

The Bill is expected to be passed early next year for progressive commencement during 2014, with a two year transition period.

Select committee process

The Committee received 62 submissions, and heard 37, including from Chapman Tripp.[2] The main officials' report from the Ministry of Business, Innovation and Employment *(MBIE)* provides some of the rationale for the Committee's decisions and is available online.[3]

Liability

The report acknowledges that by far the most significant matter remaining under debate in the Bill was the liability regime. This is also one of the toughest parts of the Bill to get right because it underpins the Bill's accountability and investor protection objectives, will have a major influence on its market development objectives and is the pressure point for tension between these objectives.

Fortunately, the key overarching change in the Bill – moving the default setting for enforcement and remedies from criminal to civil – has been further reinforced in the revised Bill.

A number of submitters, including Chapman Tripp, raised concerns about the introduction of criminal sanctions for directors and issuers who know that, or are *reckless as to whether,* the disclosure requirements relating to offer documents have been met. We argued that the threshold was too low and that there should be proof of deliberate dishonesty.

The Committee has, however, retained knowledge and recklessness as the mental elements for serious offences. But it has narrowed the application to the "primary person in the contravention" – usually the issuers or the offeror – with accessory liability limited to people who act for the purpose of aiding or abetting the offence.

A director will be criminally liable if an offer document is issued (or is allowed to continue in the market) with the director's authority, permission or consent and the director knows that it contains a misstatement or omission which is reckless, false, misleading or likely to mislead.

The Securities Act currently criminalises material misstatements, regardless of whether there is a deliberate intention to deceive, and makes directors and promoters liable for a five year jail term unless they can establish that they had reasonable grounds to believe and did believe that the statement was true.

The Bill reduces the scope of criminal exposure by requiring the Crown to prove beyond reasonable doubt not only that the information was misleading but that it was issued with "a guilty mind". However, although the tests to establish guilt are higher, so are the maximum penalties – up to 10 years in prison or a $1 million fine for an individual, $5 million for a company.

The Committee has responded to our submission raising concerns that the defences available to directors, and others involved in a contravention, were insufficient. Defences to civil liability have been significantly expanded, and now more closely mirror the Australian law. They are:

(in relation to due diligence) if person A can prove that the contravention was due to:

- reasonable reliance on information supplied by another person, or
- an act or default by another person beyond A's control and which A took reasonable precautions to avoid

and (in relation to disclosure) that:

- all reasonable inquiries were made and that, on the basis of these, there were reasonable grounds for believing that the statement was accurate.

The commentary on the Bill also seeks to provide comfort to the diligent director by stating that the liability regime:

> *should not discourage capable prudent people from becoming directors with overly punitive sanctions and companies should be able to attract directors with diverse skills and backgrounds.*
>
> *Although directors should supervise capital raising and exercise due diligence regarding offer documents, they should be able to focus mainly on business strategy and supervising management, rather than on compliance and liability.*
>
> *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.*

Chapman Tripp comments

The wide-ranging secondary liability provisions of the previous draft have been restricted now to civil liability orders, with criminal aiding and abetting dealt with under the Crimes Act. This, and the use of the more coherent *"involved in a contravention"* concept, is good news for investors and market development alike and also better aligns our regimes with international norms (notably in the US, UK and Australia).

The "price" for resetting in favour of civil remedies is that the new statutory presumption that non-disclosure caused a securities loss, although controversial, has been retained. But this is a price worth paying. The civil format is superior from the perspective of recoveries, costs, and justice. Although civil remedies exist in the Securities Act, in practice they have been negated by the requirements to prove individualised causation and reliance. The Committee has also clarified that it remains for the Court to measure how much damage has been suffered by an investor, even if the presumption on causation of loss is in favour of the investor.

The breadth and flexibility of the civil remedies – including some (management bans) which are highly punitive – raises the question why legislators have continued to obscure the boundaries through criminal fault elements that stray from grounds of dishonesty – which justify criminal sanctions – into the realm of negligence – which do not.

Indemnities and insurance

The Committee has helpfully aligned the restrictions on indemnities and insurance to closely follow the approach taken in the Companies Act, in recognition that insurance and indemnities play an important part in making the financial markets workable for participants – and can enhance the prospect of investor recovery if something goes wrong.

Derivatives

The officials' report noted that some submitters continue to be concerned that the Bill does not adequately fit the 'square peg' of derivatives into the 'round whole' of a regime primarily designed for securities. We strongly support the project of bringing derivatives into the general framework for financial products. As with other parts of the Bill, the real test will come with the regulations which will provide the detail of the regime.

The officials' report helpfully clarifies the matrix of possibilities for who will have to be licensed or make disclosure, given that derivatives typically will have two "issuers". In summary, only those in the business of entering into derivatives must comply and then only where there is a retail counterparty.

A further exclusion from the requirement to provide a Product Disclosure Statement *(PDS)* has been added to cater for wholesale investors for derivatives with a minimum notional value of $5 million (a bit like the $500,000 threshold for subscriptions). The Bill also clarifies the intent that an umbrella PDS can be lodged for a derivative product type and would not need to be modified for individual derivative contracts that have been customised.

Fair dealing

The Committee has recommended further amendment to centralise the prohibition on misleading conduct in Part 2 of the Bill, now termed 'fair dealing'.

Misleading and deceptive conduct in relation to financial services and products will be now be removed from the Fair Trading Act and regulated entirely by the Bill.

The Committee foreshadows that, if the Consumer Law Reform Bill is reported back to the House in early October with enhanced unsubstantiated representations, unfair contract terms, or oppressive conduct' prohibitions, equivalent rules should be included in Part 2 of the Bill.

The Committee has also recommended relocating the 'unsolicited meetings' regime, within Part 2 but with additional exceptions for offers made through authorised financial advisers or QFE advisers acting in their ordinary course of business.

Product disclosure

The framework for product disclosure is largely left intact.

The detail required in PDS focused on retail investors, and the *online register of offers of financial products* for more detailed information, will be finalised after MBIE has consulted on the regulations – expected within the next few months.

Exclusions

The Committee has recommended a range of refined exclusions for Schedule 1, when the product offering disclosure rules will not apply, or will apply with limited scope:

- exclusions for wholesale derivatives are now more workable, with the focus on transactions with a notional amount, discussed above
- a 'large' investment business will now be defined as one with at least $5 million net assets or $5 million revenue (previously $10 million gross assets; $20 million turnover)
- the 'investment activity' exception will be simplified to a person that has met only one of the following criteria:
  - has had an investment portfolio of $1 million, in the last two years
  - has carried out transactions in the last two years to acquire/dispose of financial products at a price of more than $1 million
  - has been employed or engaged in an investment business in the last 10 years, and for at least two years in that period has been involved to a material extent in investment decision making
- a new exclusion will apply to offers of listed financial products of the same class as an existing class. This potentially goes even further than the Australian 'low doc' rights issue exception, and could make further capital raising by listed issuers very efficient – relying primarily on continuous disclosure through the market rather than detailed offer documents.

Governance/Managed Investment Schemes

An exemption to the requirement that superannuation schemes register as a standard managed investment scheme is proposed for:

- existing schemes which are closed to new members, and
- workplace schemes which allow withdrawal on leaving employment with the relevant workplace or industry.

CHAPMAN TRIPP

Licensing/DIMS changes

Existing licences under other licensing regimes will be recognised. The Financial Markets Authority, in making its licensing decisions, will have to have regard to whether the applicant is already licensed under the Financial Service Providers (Registration and Dispute Resolution) Act and whether the proposed market service is merely incidental to other licensed services.

Transition

The Bill provides for a one year transition for issuers to elect to comply with the 'old' securities offering rules, as long as all allotments are completed within two years. Most transitional arrangements will last two years.

Chapman Tripp commentaries

Because much of the Bill is unchanged, our earlier commentaries are still relevant. You can access them online.[4]

Where to next?

Chapman Tripp has been following the Bill's evolution closely and will continue to do so. Much of the detail of the reforms will be implemented through regulations which MBIE plans to put out in draft for consultation.

Footnotes

1. http://www.legislation.govt.nz/bill/government/2011/0342/latest/096be8ed80928540.pdf
2. http://www.chapmantripp.com/publications/Pages/Chapman-Tripp-submission-on-Financial-Markets-Conduct-Bill.aspx
3. http://www.parliament.nz/NR/rdonlyres/B6B07829-8929-4649-8808-60F8A6565428/242083/50SCCO_ADV_00DBHOH_BILL11150_1_A260792_Departmenta.pdf
4. http://www.chapmantripp.com/search/results.aspx?k=(scope:"ALL")&r="owstaxIdChapmanTrippTopics"%3D%23e890873c-5626-4c90-b335-1efc5a3c91d9:"Securities law review"&v1=date

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