CHAPMAN TRIPP

TO: COMMERCE SELECT COMMITTEE

ON: FINANCIAL MARKETS (REGULATORS AND KIWISAVER) BILL

(FINANCIAL MARKET ASPECTS)

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INTRODUCTION

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ABOUT CHAPMAN TRIPP

3 Chapman Tripp is a leading law firm with a strong practice in corporate and securities law. The matters covered in the Financial Markets (Regulators and KiwiSaver) Bill (**the Bill**) are of direct interest to us as legal practitioners and to our clients.

Chapman Tripp is making two submissions on the Bill. This submission focuses on financial market aspects (principally Parts 1-6, and 8 of the Bill). Our second submission deals with those provisions in the Bill which will affect the governance of KiwiSaver schemes.

SUBMISSION STRUCTURE

4 This submission covers those issues on which Chapman Tripp has a strongly held view, and will discuss them in the sequence in which they appear in the Bill.

SUMMARY OF MAIN ISSUES

5 Our over-arching observation is that the Bill should avoid pre-empting the *Review of Securities Law* wherever possible and should confine itself to those changes which are necessary to allow the Financial Markets Authority (**FMA**) to be effectively established in the first quarter of 2011.

Particular matters we consider would be more appropriately addressed within the longer timetable of the Review of Securities Law enabling more consideration are:

- whether the FMA should have the power to bring civil actions on behalf of investors, and
- whether substantial reform is required to the process for registering securities offers.

FINANCIAL MARKET PARTICIPANTS

(definitions, clause 2)

6 We think the term **financial market participant** has been too narrowly defined by reference (through the definition of **financial service provider**), to a person that is, or is required to be, registered under the Financial Service Providers (Registration and Dispute Resolution) Act 2008 (**FSPA**), and their controlling owners, directors, senior managers, and related companies.

The linkage to the FSPA means that persons excluded from the requirement to register under FSPA would not be within the jurisdiction of the FMA – for example:

- overseas persons without a place of business in New Zealand that offer financial services into New Zealand (excluded by the territorial scope in s 8A of the FSPA)
- issuers or promoters that have participated in offers of securities prior to commencement of the FSPA
- persons excluded by s 7 of the FSPA or regulations or exemptions under the FSPA.

A more generic definition of **financial service provider** would be more appropriate - perhaps by simple reference to a person that is, or has at any time, provided a financial service (as defined in the FSPA)

RIGHT OF ACTION

(Part 3, subpart 3)

7 Subpart 3 of Part 3 of the Bill (empowering the FMA bring a civil action on behalf of a person, or take over proceedings initiated by that person, against a financial markets participant where it considers this to be in the public interest) is, in our view, unwarranted.

Our concerns relate to both the substance of the proposal and to the procedure by which it is being progressed.

We consider Subpart 3 to be a significant piece of legislation in its own right; granting the FMA broad powers in relation not only to the Securities Act, Securities Markets Act and Financial Advisers Act but also to a number of other important statutes, including the Companies Act and Financial Reporting Act.

Such a major change to New Zealand's regulatory landscape would be much more appropriately considered within the context of the broader Review of Securities Law.

As to substance, we note that the Government's original Cabinet Paper relating to the Bill identifies a number of costs and risks associated with the proposed right of action, these being that:

- people will become less willing to take up directorships because of the increased likelihood of civil cases being taken against them

- directors will become more risk-averse in their decision-making

- there will be significant resourcing and incentive issues if the power is seen as a simple substitute for investors taking private action, and

- the Review of Securities Law may result in changes that affect the new power, notably a specific public enforcement regime for directors' duties.

We concur with this analysis.

Specific provisions in the Bill with which we have serious concern are that:

- the FMA does not require a person's consent to take action on that person's behalf and can seek leave in the Court to over-ride any objections (in which event the person has the right to be heard in Court but will have to meet any legal costs)

- where the FMA takes over a proceeding against the wishes of a person, the Court can nonetheless order that person to continue to pay the costs of the proceeding

- there appears to be no requirement in the Bill for an investigation by the FMA to be completed, or even substantially advanced, before proceedings are initiated or taken over (indeed, the Bill as drafted offers substantial emergency powers to the FMA to obtain interim relief without carrying out the appropriate procedural steps), and

- there appears to be no protection against the FMA using the powers conferred in the Bill retrospectively against behaviour that occurred before the Bill's passage.

We accept that the Bill seeks to constrain the FMA's exercise of these powers by imposing a detailed public interest test but this does not solve the problem because there is not always perfect alignment between the public interest as interpreted by the regulator and the investor's interest.

The Cabinet Paper seeking approval for the Bill's introduction seems to recognise this tension. It states: "The primary objective of the power should be to promote the public interest rather than to obtain redress for investors, although

redress would usually follow if the FMA's action were successful."

But court proceedings take time and, even if the FMA won, the investors' interests will not have been best served if, absent the litigation, they would have been able to secure redress earlier by other means.

We note that the conferral of this sweeping new power was not part of the Government's original intention but was introduced relatively late in the policy-making process at the request of the FMA Establishment Board. We also note that the Establishment Board was divided on the question and that the recommendation had majority rather than unanimous support.

The Government's original view was that there is no need "to significantly change the powers of the regulator at this stage". We agree. To allow a publicly funded regulator to enforce private commercial rights is a big step, the need for which has not been demonstrated.

We therefore suggest that, if this matter is to be considered, it should be addressed as part of the Review of Securities Law rather than within this Bill.

NEW REGISTRATION PROCESS FOR SECURITIES OFFERS

(Part 5, clause 97)

8 The Bill transfers to the FMA (as opposed to the Registrar of Companies) responsibility for the substantive examination of prospectuses, and provides for a minimum 'pause' period of five working days (extendable to ten at the FMA's request) during which the FMA will carry out this assessment.

The Companies Office is proposed to become a simple lodgement agency, responsible only for a cursory 'tick the box' exercise, checking legibility and basic data such as the date before registering the prospectus.

This is a reversal of the present system in which the Registrar conducts the substantive review, and the Securities Commission has the ability to consider an issuer's appeal should the Registrar refuse to register a document.

We do not consider that such radical change is necessary or desirable at this time:

- the current arrangement works well, and would require only relatively minor amendment to transfer the current substantive pre-registration vetting review from the Registrar of Companies to the FMA staff being transferred from the Registrar. The appeal right could be reassigned to the Board of the FMA or the proposed Securities

- it will expose regular issuers to substantial costs and upheaval to redesign their processes. In some cases they will need to re-publish and re-register their offer documents by the time the registration part commences

- it will put increased pressure on the FMA while it is still finding its way, and

- the effect of the limited 'notice and pause' time limits on the FMA will mean that it will need to prioritise and risk-weight which types of documents get reviewed with the result that some will not be reviewed at all. Currently all prospectuses are pre-vetted to some degree, and more complicated issues can be constructively progressed over a period of weeks before publication.

The proposed structure is based on the Australian model, and does not reflect the realities of the smaller New Zealand market.

We doubt the FMA will be resourced to discharge the substantive review in a short period to a comparable degree as the Australian Securities and Investments Commission.

The requirement that issuers make a prospectus publicly available during the "pause period" after the Registrar has registered the document, but before the FMA has conducted its review, is theoretically intended to introduce a level of public exposure into the process. However New Zealand has relatively few independent analysts to conduct this function and it is likely that the only real scrutiny will come from the issuer's business competitors.

In our experience, the Australian post registration review period invariably means offer documents are not printed until after expiry of the 7 (or 14 if extended) day exposure period. This unnecessarily increases underwriting risk and cost in public offers of equity or debt securities (it is less of a constraint for continuous issuers such as managed funds, as those issuers may be able to continue to rely on previously registered documents).

For all these reasons, we recommend that the FMA simply take over the Registrar and Securities Commission's current roles in the modified version of the status quo suggested above while the new FMA structure is bedded in. The issue of whether more substantial reform is needed is more appropriately considered within the context and timetabling of the broader Review of Securities Law.

At a more minor, but practical, level:

- the renaming of memoranda of amendment as instruments of amendment does not have any stated purpose, but will unnecessarily require issuers to incur costs to change their documentation and processes for amending prospectuses. Such a change would be better addressed as part of the Review of Securities Law consideration of offer documentation, and

- if the Government does prematurely proceed with the new 'notice and pause' regime, the requirement for issuers to publish prospectuses on their website (new section 43B) should be removed – this is impractical for special purpose issuers, and would unnecessarily clutter websites for continuous issuers of many different securities products – rather a link to new prospectus registrations should be continuously published by the Registrar or the FMA.

REGISTER OF SECURITIES

(Part 5, clause 98)

9 We support the proposal to establish a Register of Securities. However, we think the register is overly focused on the prospectus, and should be broadened to cover other types of offering document; particularly investment statements (the primary offering document under the Securities Act 1978 as it stands), offer documents lodged with the Registrar under mutual recognition of securities offerings treaties, and offer documents prepared under exemption notices.

Accordingly, changes should be made to the proposed new section 43P to expand the types of offer document to be contained on the register, and section 43S to enable searches on broader categories of offer documents than prospectuses. This change would allow for better comparisons of offers and alternatives.

EXEMPTIONS

(Part 5, clause 120)

10 We broadly support the provisions relating to the exemption regime, as they are currently proposed. We acknowledge that the proposals to curtail the ability to make class exemptions, that we had strong objection to when first publicly announced in July[1], have since sensibly been reversed by the Government.

The move to allow the FMA simply post individual exemptions on its website, rather than have them published by the Parliamentary Counsel Office, is a good one. It will allow significant streamlining of the process.

[1] See http://www.chapmantripp.com/Pages/Publication.aspx?ItemID=760.

EXCHANGE REGULATION

(Part 6)

11 We have some concerns about the proposal to move away from the current registered exchange (i.e. NZX) rule disallowance regime (if the Minister determines a rule is not in the public interest), to a regime requiring all amendment rules to be approved by the FMA.

We are not aware of any market failure justifying such a significant change to NZX's governance over its own markets and rule making processes.

A more appropriate change, pending further consideration as part of the Review of Securities Law, would be to simply transfer the disallowance role from the Minister to the FMA. The proposed market integrity regulations could sit as a backstop if the Minister, on advice from the FMA, is not satisfied that current registered exchange (NZX) rules are adequate.

We also have some reservations about the overly legalistic framework proposed for the Securities Markets Rulings Panel (**Panel**) to take over the functions of the NZ Markets Disciplinary Tribunal as the entity responsible for adjudicating matters in relation to the registered exchange (NZX).

We think the prescription proposed means the Panel will not be able to act as a 'committee of the market', capable of acting quickly (at least for simpler matters) with relatively informal procedures, as originally conceived.

SELF-INCRIMINATING STATEMENTS

12 We commend the decision not to carry forward into the Bill section 69T of the Securities Act, which restricts the ordinary right under the Evidence Act for witnesses not to incriminate themselves.

We can see no reason in law or natural justice why the privilege against self-incrimination should not apply to FMA investigations.

TECHNICAL ASPECTS

13 We would be happy to discuss our submission directly with officials, if that would assist clarify any technical aspects.