



Many Investors, One Voice

Submissions to the Securities Act Review 2010

A view from the retail investors perspective

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NZSA Submissions on the Securities Act Review 2010

1. Introduction

The Ministry of Economic development (MED) released a discussion paper titled Review of Securities law in June 2010. This called for interested groups to make comments on a range of existing provisions and proposed changes to be incorporated into a new Securities law regime.

The new Act will replace the Securities Act 1978 and the Securities Markets Act 1988 and consequently will bring regulation of most financial products under the aegis of one comprehensive regime. The formation of the Financial Markets Authority (FMA) means that the new Securities Act must be written with harmonisation between the underlying law and the functioning of the new regulator in mind.

The New Zealand Shareholders Association is the only independent national group that represents the interests of retail investors in the equity markets. We also consider and comment on debt instruments and finance company debenture issues. We do not generally represent members in the derivatives area of the markets so our comments in this regard are limited to areas where consistency of approach is important.

One of our major concerns is the need to engender confidence in the regulation and operation of the New Zealand capital markets and to that extent, we take a close interest in the “public good” aspect of legislative changes, as part of our core function.

While our submission is written to present the perspective of the retail or smaller investor, it necessarily extends into peripheral areas where these have a potential to impact adversely on the whole operation of the securities markets.

In our view, much effort goes into making the law workable from the seller and regulator viewpoint, but often consideration of the buy side of the market is less well canvassed. Partly this is a result of the issuers of financial products having greater resources to review and comment on changes, and partly it arises because new law is layered over existing legislation which in our opinion has been weighted unevenly towards issuer concerns in the past. As a consequence, there is a perception of a lack of regulatory protection and/or inappropriate mechanisms for enforcing the provisions that do exist.

This has reduced retail investor confidence and our submission seeks to ensure a better balance is achieved when the new law is enacted.

2. Executive Summary

We must give credit to the MED for producing a well thought out discussion paper of rare quality. In many ways the NZSA agrees with the approach taken, but there are areas where we differ and others where a change of emphasis is required in our view.

The NZSA believes that where possible principles should be the guiding force rather than prescription. Definitions based on economic substance are good examples of this approach.

Where prescription is required it is better to use this in the form of exemptions rather than trying to second-guess every conceivable scenario. This approach also has the advantage of allowing considerable flexibility to manage unforeseen issues as they arise. However, in the area of disclosure we do think that detailed prescription will be necessary for the reasons outlined in part 4 of our submission.

A second guiding principle is the need for consistency in all matters as far as possible. A single framework structure with reporting, disclosure, exemption, licensing, liability, enforcement and penalty matters aligned across all classifications is the ideal outcome as it reduces the complexity of understanding, and limits any use of regulatory arbitrage.

We think that the suggested two tier approach to documentation is too simplistic. Disclosure should be both accessible and comprehensible. We propose a three tier approach which will better serve the needs of unskilled retail investors as well as those who are more financially literate.

The matter of liability is well canvassed in our submissions and we comment on the need for expert and celebrity endorsements to be covered under this heading due to the disproportionate influence they can have at the retail level.

In the area of exemptions we also strongly disagree with proposals that certain classes will be automatically opted out of Securities Act coverage. Our third principle is that any exemptions should be based on the requirement for an active opt-out process whether for individuals or issuers.

Collective schemes are likely to become more important with the growth of Kiwisaver and NZ Superannuation and in our view quite a number of changes are needed in this area to align issuer performance to retail investor's expectations. The guiding principle in our submission on this area is for collective issuers to have clear and enforceable duties to act in the best interests of the individual investor.

The Authority will need to have considerable powers either directly or via intermediaries to make orders, set regulations and provide guidance if it is to be effective. Our thrust here is to resolve matters expeditiously and without court intervention. Further we have definite views that any penalties should affect the culprits, whether individuals or corporates, and should not expose investors to the double jeopardy of being both defendant and victim simultaneously.

We have concerns about proposals to allow second tier exchanges to perpetuate the imbalance of information between issuers and retail customers, but support open access to securities registers subject to some safeguards. The use of binding rulings and very tight restrictions on retrospective exemption powers align with our guiding principles. We also suggest an extension to the list of director's duties in line with some overseas definitions.

Finally, we are in favour of merit based actions in the public enforcement arena as a way of setting clear parameters for participants in the securities market.

3. Recommendations

1. The Act should be designed on a set of guiding principles with an overlay of prescription and exemptions.
2. Person to person lending should remain illegal due to the difficulty of controlling such offers on the internet.
3. The new Act should have flexibility to add additional classifications at the Authorities discretion.
4. Definitions should be aligned between securities law, accounting standards and other legislation wherever possible
5. Definitions of various exempt groups are too wide ranging and should be reviewed.
6. Exemptions should be based on an active opt-out provision only. Automatic exemptions should have no part in this new legislation. Responsibility for compliance should generally rest with the issuer. In the case of an investor voluntarily opting-out or choosing self-certification, there must be a clear process and liability would then revert to the investor.
7. Both civil and criminal liability should extend to all offers of financial products with any inappropriate situations being dealt with by exemption.
8. Exemptions for partly paid products should be based on the final fully paid value when being considered.
9. The power to void incorrect allotments should lie with the investor, but for a limited time frame of 1-2 years only.
10. We oppose two tier legislation based on religion, culture race or anything similar.
11. Disclosure documents should be in a three tier system. Tier one - a short summary of key prescribed information (PDS). Tier two - a short prescribed summary of more advanced information that would be useful for most active retail investors. Tier three - additional information that the issuer sees fit and generally more suited to skilled investors making in-depth study of the issue. Tier two and three would be held on a register accessible via the internet. Provision to be made for the 15% of investors without internet access.
12. Both form and content of tier one and tier two documentation to be prescribed.
13. Self assessment to be required for risk assessment of issues except debt issues where third party assessment would be acceptable. Promoter, expert and celebrity responsibilities to be clarified and made consistent.
14. Collective investment schemes should extend to schemes that do not involve pooling of investors funds, such as private banks.
15. A licensing regime to extent to managers, supervisors and custodians of collective schemes.
16. Laying off of liability of managers to third parties to be made illegal.

17. A mechanism be developed to allow investors or the Authority to remove or replace supervisors.
18. Enshrine the duties and liabilities of managers and supervisors in legislation.
19. Require performance objectives to be clearly set out in collective's documentation.
20. Make whistle blowing mandatory for avoidance of doubt.
21. Include insurance schemes with an investment element into the collective investment regulatory system.
22. Allow a dual regulatory regime between international funds and wholly NZ funds.
23. Authority to develop guiding codes of practise based on principles.
24. Allow other exchanges to have a lower level of rules only if they can obtain approval of the Authority for the variations.
25. Align NZ law with the Convention.
26. Provide binding rulings and no action letters.
27. Strictly limit the circumstances of retrospective exemptions.
28. Consider introducing a section dealing with validity of settlements as referred to in the Members Bill proposal.
29. Make the Authority the primary coordinator of financial literacy efforts and fund accordingly.
30. Add an additional director's duty as per the Australian rules 5.1.116.
31. Allow the authority to take enforcement cases in the public good.
32. Increase the length of management bans and make disclosure of prior bankruptcies compulsory.
33. Introduce an infringement notice scheme for minor issues.
34. Extend the jurisdiction of the rulings panel.

4. Specific comments

The following comments are linked to specific items within the MED discussion paper. The numbering used is the same as that adopted in this document with the addition of the specific clause number at the end of the paragraph number. We have preferred this approach to that of asking the questions raised as this allows us to clarify specific details more accurately. To maintain clarity and brevity, in some cases we have commented on specific detail which will impact on earlier overview statements. Where this has occurred, it is our intention that both items are to be linked together.

Where we have not commented, we either agree with the Ministries approach or have no view on the subject.

Chapter One – Principles

- Item 1.2 Principles. Generally we agree with the approach taken by the MED. Our preference is that where possible principles should be the guiding force rather than prescription. Where prescription is required it is better to use this in the form of exemptions from the underlying principles rather than trying to second-guess every conceivable scenario and write regulation or law to suit. Such an approach creates too many opportunities for “word by word” interpretation and often results in the intent of the law being undermined.
- Items 3.7.31-34 We see particular difficulties with person to person lending services being legal. While the suggestion that the service itself be regulated is sensible, it fails to take into account the international nature of internet based commerce. There would be no way to control or enforce any New Zealand disclosure and governance regimes on overseas providers. The competition argument advanced is in our view outweighed by this risk. Therefore, we believe that unless a mechanism enforcing New Zealand law and enforcement on all providers is able to be developed, such services should remain prohibited.
- Item 4.1.37 We are happy with the initial 4 categories proposed. We would suggest that legislation allows flexibility for further classes to be added in the future to provide continuity of cover should a new product that does not fit be developed. This would by necessity extend to the provision of appropriate disclosure and governance requirements, which should be able to be promulgated by regulation initially, with empowering legislation (if required) to be enacted within say 12 months.

We believe that some different disclosure requirements will be necessary between the categories. For example, the cost of administering collective schemes is not an appropriate disclosure for a debt issue. However, disclosure should be common for basic information.

We believe the same governance standards should apply to all categories. Good governance is critical to minimising investment risk.

- Item 4.1.41 and Item 4.1.47 We agree that the definition of equity and debt be aligned to the appropriate accounting standard for the reasons outlined in the discussion document. In particular, many investors do not understand the situation as it applies to preference shares, capital notes and some other hybrid instruments and are dismayed to find their “debt” has become quasi equity when things go wrong. It is essential that the description of the investment matches the accounting treatment and that this is clearly spelt out to investors.
- Item 4.1.54 In our view collective investment schemes should extend to schemes that do not involve pooling of investors funds with other investors or with the promoter. A specific example is the situation with the “Private Banks” divisions run by the main trading banks. It is currently difficult to determine the total fee structure as commissions and brokerage payments received by the collective vehicle (the Private Bank) are not typically disclosed to the investor. On the other hand banks have specific prudential requirements which may create a higher bar than that faced by other unregulated non-pooled investment vehicles at present. Whether this extends to the activities of all their subsidiaries is however often not clear.

Therefore we would propose that to avoid arbitrage opportunities, where collective vehicles are subject to different regimes, the higher level should apply. That will generally mean the provisions of the new securities Act as applied to collective investment schemes. This will force comparability of disclosure, fee structures and reporting. The costs of doing so will be minimal.

Item 4.2.65 to 4.2.68 We favour largely retaining the status quo with regard to designating a financial product. However it seems reasonable that the issuer should be consulted in cases where the classification is different to that requested by the issuer. This is important in two respects.

Firstly, it is conceivable that an innovative new product may not fit one of the 4 proposed categories and consultation will establish whether an additional category is required.

Secondly, we are not in favour of products being re-classified as this creates uncertainty in the markets, particularly buyers.. (I bought an apple and they gave me a pear but insisted it was an apple – for a while. I hate pears and never buy them!) The discussion paper talks about provision for re-designation, exemptions, terms and conditions. The result of such a process is to add complexity, time and ultimately cost to the process. If a product is reclassified, this opens a whole host of issues. Some investors can only invest in certain types of financial products. Reclassification may introduce extra cost and reduce the returns (or the opposite). Either way this is unfair to those who did or did not purchase originally based on the initial classification. By stating that designation changes would not have retrospective effect, the regulator would effectively create two classes of the same investment. This is highly confusing to most investors.

As the MED paper points out, categories and definitions are deliberately broad and consequent regulation should cover most situations. In our view it is essential to

classify financial products accurately at the start and then make no change. This should be the objective.

- Item 4.4.77 we agree with this approach to insurance definitions. It allows flexibility for the future if investment component becomes a feature of some contracts.
- Item 4.5.3.91 We agree that the anti avoidance measures must be retained. We believe that an effective intervening mechanism must be in place to require the issuer to ensure that the product complies with the requirements for public issuance before this can occur. This might be best done by deeming all issues to the public covered unless they have gained an exemption. Any other option would defeat the purpose of the regulations.
- Item 4.5.3.93 We support the proposal to remove vendor liability in IPO's excepting for vendor who are directors and/or promoters for the IPO. To remove any doubt, documentation should clearly identify who the liable parties are. It should be prohibited to set up a special purpose vehicle to avoid liability if this amendment is accepted.

Where the vendor or promoter is a company or partnership removed from the IPO vehicle, liability should be extended to the partners of that partnership or directors of that company to avoid situations such as Feltex, where investors have been unable to even identify the parties responsible, much less commence proceedings.

- Items 4.7.102 to 4.7.104 We are opposed to any development of a two tier approach to regulation based on religion, race or similar. While we note the possible capture of some Islamic finance structures under the new act where this would not be the case for non-Islamic equivalents, making special provision is unworkable in the secular society we have in New Zealand. The moment special provision was made we would have every other group expecting exemptions and special treatment.

Chapter Two. Offers to Exempt Investors

- Item 3.4.18 We believe that MED thinking is flawed in its approach to exemptions for certain classes of investors. We note also that the CMDT also saw issues with current thinking. The MED proposal is to automatically opt-out some classes of investors including investment businesses, sophisticated investors, large entities, investors making investments of \$500,000 or more, relatives, personal friends and some employees. In our view this is the wrong way to do it. The new law must be written that all individual investors (including trusts) are included unless they opt-out. The exceptions could be investment businesses and large entities as they would be expected to have the necessary expertise in house and/or the income to pay for appropriate advice.

There is insignificant cost in this proposal. Offerers can still target the various “special” groups to avoid full Securities Act compliance, but the mechanism we propose would avoid the situation where someone was unknowingly taken out of the coverage of the Act simply because they invested a large sum of money, say the proceeds of an average Auckland house sale. Instead they would have to demonstrate they had taken independent legal advice and sign a prescribed form indicating they understood the implications of their actions. For regular sophisticated or habitual large investors, it may suffice to have a generic statement which would cover multiple situations until such time as it was revoked.

We are particularly concerned that without this “positive action” approach, pressure will continue to be put on family members, friends, church congregations and the like to invest in schemes that give no protection under the new Act. This is a particular problem for recent immigrants and pacific island churches. A number of high profile, high value fraud convictions reinforce the need for some people to be protected from the consequences of their own good intentions.

For some issuers, this would be an impediment as it would make it much harder to close “sales”. We would put transactions with groups such as Blue Chip, large depositors in numerous failed finance companies and a number of failed property investment “opportunities” into this category.

- Item 3.4.21 We agree that it should be the responsibility of the issuer to ensure that exempt investors have provided the appropriate documentation to demonstrate this. We are not opposed to a register of exempt people which would be more convenient for habitual large investors. However, given our proposals above, this may be unnecessary and uneconomic as the numbers involved could be small.
- Item 4.3.26 we favour the proposal to extend the civil liability regime to all offers of financial products.
- Item 4.4.27 We generally favour criminal liability applying to all offers regardless of the categories they may be aimed at. The argument that some classes of investor are able to enforce civil claims for say false and misleading statements on which they relied presupposes that the investor is able to take on such a claim. For example, the investor simply might not be able to afford it (as a result of monetary loss caused by their investment). In these circumstances, the culprits may not be subject to a civil claim due to a lack of funds. The threat of criminal liability would however reduce the likelihood of this occurring, or the false or misleading statements ever being made.
- Item 4.4.28 there is no point in including an opt-in provision making issuers criminally liable as no-one will ever take up this option. There may be an argument for an opt-out from criminal liability if agreed by the investor, but again we see little point as it is unlikely to be used.
- Items 4.7.35 and 4.7.36 In our view the proposals to exempt investment businesses are too wide ranging as currently written. A considerable number of small sole or

family businesses would be exempt. We do not believe that all such businesses have the necessary sophistication to warrant this. They may however invest or administer a considerable amount of money on behalf of smaller investors who would lose the protections of the Act by proxy as investment businesses may be tempted to chase high returns without being appraised of the consequent risks. We acknowledge that advisors have responsibilities under other legislation, but in our view the MED proposal removes a layer of investor protection for no good reason. We would prefer to see a combination of staff numbers, turnover, value of funds administered and possibly professional qualifications and/or prior experience taken into account.

- Item 4.8.42 we see the MED definition (any two of three options) to be too wide. There are many retail investors with portfolios in excess of \$1million. Although we have already expressed our objection to automatic inclusion of some categories into the exempt category (preferring the opt-in option) the proposal seems to hinge on an investor making numerous small trades over a two year period. This in no way indicates a “sophisticated” investor to our thinking, quite the opposite in fact. We would suggest that less frequent but much larger trades would be a more appropriate measure. Our figures would be 2 or more trades of \$20,000 or more per quarter for the last eight quarters.
- Item 4.8.45 We do not believe that the alternative definition of three years experience in business management, accounting, finance or commercial law is appropriate compared to experience in an actual investment company environment. Even the local dairy owner or self employed taxi driver could come within this definition. It should be discarded as an option.
- Item 4.10.49 We agree that \$500,000 is far too low to constitute a large investment. A figure of at least \$1million would be more appropriate. However our preference of having to actively opt-out of Securities Act coverage to qualify as an exempt investor would deal with this issue.
- Item 4.10.50 We disagree with the MED stance on investors who are committed to paying in the future. The key determinant should be the total quantum of investment required, whether in one payment or several when deciding if an investor could qualify for exemption. Again our opt-out preference covers the situation if this is accepted. If the MED preferred approach of automatic exemption was applied, investors may find themselves exempt from the protections of the act virtually by stealth at some point in the future. Inevitably, some products would end up structured to exploit this possibility. This would defeat the investor protections in the Act and is highly undesirable.
- Item 4.11.52 to 4.11.61 We accept the definitions as proposed. However, we are concerned that spouses, family and close friends are often subject to pressure or are persuaded to sign documents that they do not understand. As a result they may end up in an investment which is not subject to the regulations in the Securities Act. For

these groups we favour a statutory declaration accepting the “opt-out” provision as detailed earlier in this document.

- Item 4.13.79 We agree with the MED that evidence of consultation alone should not be sufficient for investors to be deemed exempt. We believe there must be a positive “opt-out” provision.
- Item 4.14.81 We are comfortable with the maximum of \$2million from up to 20 investors in 12 months. Alignment with Australia is seen as desirable to ensure equal investment opportunities are available in NZ. We also favour the logical limit of \$100,000 per investor. In common with all other exemptions, we believe investors in these small offers should have to make a positive “opt-out” decision from the provisions of the Securities Act.
- Item 4.15.88 and 4.15.93 If there is a clear process including having sought independent legal advice, we favour the suggestion that anyone can opt out of the provisions of the Act. This will allow a degree of flexibility which may suit the circumstances of some individuals, and which could not be accommodated in any other way.

We acknowledge the concerns raised that too many exempt persons reduces the cost effectiveness of making public offers. For that reason, exemptions should be primarily available only to small issues. Our proposed positive “opt-out” process which actually requires specific action by the investor will have the effect of dampening the numbers seeking exemption. Research shows that inertia is a significant driver and consequently many people will not bother to seek exemptions or will be put off when the implications are explained.

- Items 4.15.1.91 to 4.15.2.99 We agree that independent legal advice and a prescribed form are required to effect an “opt-out” provision. We agree that this should be similar to the contracting out provisions of the Property (Relationship) Act. This would effectively remove the “Chinese walls” structures within larger law firms to create independence.
- Item 4.15 3. 101 We do not favour the approach the Ministry is promoting. This could easily result in unscrupulous issuers pressuring investors into “being certified” as suitable by effectively non-independent third parties without realising the implications of what they are signing. If third parties are allowed, they must be completely independent of the issuer and a degree of screening must occur.
- 4.16.112 to 4.16.116 We disagree with self-certification by sophisticated investors. There are many people with considerable assets and/or investments who also suffer from a variety of medical complaints or early dementia that reduces their ability to make a rational judgment when it comes to self certification. A large proportion of the investing public are elderly and this issue is therefore more concerning than might initially be thought. Our suggested option is along the lines of paragraph 115

with the possible requirement for a medical certificate for people above a certain age, possibly 65 or 70.

- Item 4.16.121 If it is decided despite our reservations that self certification is allowed, we favour a register to be kept where the onus is on the investor to notify the registrar when they no longer qualify, or renew their registration every 3 years, whichever is first. Access to such a register would be limited to determining the investor was in fact exempt and no “fishing expeditions” or bulk uploading to identify potential exempt investors would be allowed.
- Item 4.18.125 In the case of void allotments, we favour the MED’s third option as outlined in paragraph 133. Allowing the subscriber to void an allotment if he/she/it has wrongly been accepted as exempt will make it simple for unwilling investors who have been “coerced” to withdraw. This element of simplicity would be a very powerful discipline on promoters who could see their subscriber base rapidly disappear if they attempted to circumvent the provisions of the Act by underhand means.
- Item 4.18.134 we consider the MED suggestion of 7 years to be unreasonable as a timeframe for being able to void allotments. This could have the effect of an incorrectly exempted person being able to benefit for some years while things are going well, only to change their mind when conditions deteriorate after say 6 years and demand their money back. This situation could be even more onerous in the case of partly paid investments where the total time could arguably stretch out even further depending on the starting point for the 7 years. Because business often goes in cycles, this is a very real possibility. Such a long time frame would be a disincentive to some types of investment and could be crippling if demanded at a vulnerable time. Instead we favour a maximum of 1-2 years from the time an investment becomes fully paid up. There is an argument to be made that if the exemption system is robustly designed, a void allotments process may not in fact be necessary.

Chapter 3

- Items 1.2.3 to 1.2.11 We agree with the purpose of disclosure as set out in the review. To achieve the goal that disclosure should be accessible and comprehensible to all types of retail investors, we think it inevitable that a reasonable degree of prescription overlaid on a framework of guiding principles will be required. While we accept that differing levels of disclosure could be appropriate for secondary audiences, the need for adequate primary disclosure is essential. This is because the knock-on effect from failures where poor disclosure has been a contributor greatly undermines the credibility of all securities markets in the eyes of many retail investors. To build a more wealthy society it is important that this perception is eliminated.

- Item 2 in total We agree with the point of sale comments, in particular the comments about the excessive length of current prospectuses. We might point out also that with the advent of IFRS accounting standards this situation is now occurring in most company reports and far from making things clearer, it is proving impossible for even relatively sophisticated retail investor to sort through the volumes of largely irrelevant information.
- Items 3.2.48 to 3.2.57 Of the options canvassed in the discussion paper, we prefer Option 3. However we suggest that information on the register should be further broken down into two sections. Our rationale is that the proposed tier one document of very limited length will be inadequate to disclose some information that others may consider essential. By utilising a register, we could easily have a relatively short prescribed tier two level that expands on some of the key tier one information and includes a number of prescribed financial figures and ratios. For example, the people running the company are important to investors. The tier one document should at the very least name the directors. The tier two documents could provide brief biographies. The tier three information would be at the issuer's discretion. The advantage of this arrangement compared with the Ministries proposal is a greater level of comparability when assessing offers. If a register is utilised it must have a comprehensive search function to make it user friendly. We develop these themes in the following points. We also suggest that regardless of the requirement for tier one documents to be available in hard copy, they should also be included in the register to form a complete record of the offer.
- Items 3.3.1.59 to 60 Standardised and heavily prescribed product disclosure statements relevant to each product classification are essential if this is to be a short and comparable document. Tier one information (PDS) appearing on the FMA website and the issuers own website must be identical in all respects.
- Item 3.3.1.63 We do not accept that the cost of producing a two page PDS is prohibitive. In our view the key information that investors commonly use should be on this document, even if it is subject to occasional change. The Ministry states that director's names need not be on the PDS. We disagree. Investment philosophy usually has as a basic requirement the need to know the people running the company (or investment). This is commonly called the Buffett approach. We are also troubled by the proposed complete absence of any financial data-see below.
- 3.3.1.65 Any PDS documents prescribed must have as its first objective, the requisite key information. The length should be secondary to this in our view. However, even for equities, we see a two to three page initial PDS as practical if our three tier approach is adopted. PDS documents should not have extra information as this would compromise comparability. Additional information would have to go on the register. In our model, this would fit at the tier three level.
- Item 3.3.2.68 In order for searching functions to be effective, it will be necessary to prescribe some mandatory search fields at the time the document is prepared.

- Item 3.3.2.71 Ongoing disclosure should be included on the register for products that are not already subject to this regime. We do not envisage that this would need to apply to listed equities as a considerable number of technical and housekeeping disclosures are made which would not be relevant to the assessment of suitability for investment.
- Item 3.4.4.1.72 This clause while covering some details does not include any reference to the need for the issuer to not be misleading. A significant risk in some instances is that the investor does not realise that the issuer is a separate special purpose company which is often far removed from the parent. It is common practise to include the parent company in the name of the issuer thereby implying a connection which may not actually exist. We believe this is a hidden risk factor and therefore believe such a practise should be specifically prohibited unless the named parent company is guaranteeing the issue in some significant way.
- Item 3.1.1.75 Generally we agree with the self assessment and summary approach. There is a need to ensure that only relevant risks are assessed. The danger is that a scattergun approach will be adopted and very low risk items will be included. This has the effect of masking the main risks. We are concerned that a risk-meter ratings system could leave the regulator open to the charge that it had somehow contributed by providing an incorrect assessment of risk if an investment was to fail. The loss of confidence that would result, whether or not the claim was reasonable, would seriously damage the credibility of the regulator. Equally, we have reservations about third party assessments. Reports of this type almost inevitably recommend whatever it is that the commissioning company is seeking approval for. This is hardly surprising given the conflicted position of the third party who relies on the commissioning company for their payment. However there are some differences between products and there is no single solution. (See below)
- Item 3.4.1.2.84 We agree with the Ministry's selection of option A-self assessment as each collective will have its own investing style which will affect the necessary disclosure.
- Item 3.4.1.2.85 The best approach for equities is probably still self-assessment. This is because of the vast range of different activities that companies undertake. They should know their industry best. For this reason, we think independent assessment is unlikely to add much.
- Item 3.4.1.2.89 This is the one area where we think independent assessment has real merit. There are a number of rating agencies and the process is well understood. We accept that this approach is not infallible, but it provides reasonable guidance. We note that in comparable offshore jurisdictions, to be successfully floated debt issues inevitably require a ratings agency assessment.
- Item 3.4.1.2.90 There is no suitable alternative to self assessment for derivatives given their complexity and diversity. We favour a sophistication warning on all derivatives.

- Item 3.4.1.3 in total In our view, the key information being requested is too basic as set out. There must be some basic financial KPIs and ratios included for equity and debt issues for example. We have highlighted other information such as the directors names and the relationship of the issuer to the parent entity earlier in our submission. This whole section needs a complete re-think in our view.
- Item 3.4.2 in total Again we think the level of information being suggested is too basic with the exception of the derivatives section and in particular the principle in clause 108. As above this whole section needs a complete re-think in our view.
- Item 3.4.3.110 We believe that signposts to educational resources should also include groups such as the NZSA which offer face to face educational seminars. However we would not favour extensive notes on these resources in order to maintain reasonably short documentation.
- Item 3.4.4.114 to 3.4.4.116 As outlined earlier, we do not generally favour the Authority making risk judgments on equities, debt or collective investments because of the loss of credibility when it inevitably gets one wrong. We would suggest that only derivative products should have such a warning imposed and it should be a blanket requirement to alert investors that these are more complex and require a higher level of financial literacy to understand. Should an issuer wish to voluntarily add a sophistication warning to another class of product we believe they should be free to do so.
- Item 3.4.5.117 to 3.4.5.118 The current short form system is adequate, but if our submissions are accepted, they will be superseded by the new process relating to offer documents.
- Item 3.4.2.131 We agree that ongoing disclosure by collective investments is generally poor or not comparable between products. If our submissions are accepted, they will be superseded and improved by the new process relating to offer documents.
- Item 6.1.195 The penalties for promoters should align across the various parts of the Act.
- Item 6.2.200 Where an expert is used, our view is that person must owe a duty of care and a fiduciary duty to the investors to whom their advice is directed. We believe it should not be allowable for the expert to have a general disclaimer which may have the effect of limiting their liability.
- Item 6.3.203 We think celebrities should have liability for their endorsement statements. In order to make this workable, it would be acceptable for celebrities to rely on expert advice provided that the provisions of 6.2.200 would also apply to that expert. There is probably a reasonable case to be made for requiring celebrities to seek such expert advice. Care would be needed in defining a "celebrity".

- Item 7.1.204 We agree with the CMDT suggestion that restrictions on pre-prospectus securities should be removed. The ability to ban and liability for untrue statements will be sufficient deterrent. Any attempts to prescribe the content will arguably disadvantage the issuer's ability to present the full story to potential investors.
- Item 7.2.2.222 We agree that advertising should be regulated in a principles-based fashion with the Authority having the power to issue compliance orders and to include advertising methods and technologies as necessary. Any advertising is still subject to the provisions of the Commerce Act and the Fair Trading Act, so we believe this extra flexibility for the authority is all that is required. We do not see a particular need for certification as a failure to comply will have onerous consequences. The Authority should however offer an approval service if issuers wish to have advertising checked for compliance. Item 7.2.3.228 While we agree with a principles based approach to advertising we do think that the Act should clarify the difference between a communication and advertising.

Chapter 4

- Item 1.1.3 As outlined in our submissions on chapter one, we are generally in favour of collective schemes without pooling being included in the general definition of collective schemes. An example we gave was in relation to Private Bank arrangements.
- Items 1.2 and 1.3 We believe the MED has summarised the question of "why" and the overriding principles very well in this section and that what follows should be guided by these. Our only reservation is that while consistency with international best practice is desirable, this may need some modification to suit the NZ situation, particularly with regard to the size of the market and the corresponding affordability.
- Item 2.3.26 We agree with the problems identified with the existing regulatory framework and would comment that the impact of many of these is felt most keenly by retail investors. The result is distrust by many potential investors and consequently a relatively poor investing/savings record compared with say property investing and as measured against participation rates in other countries. This distrust is a constant theme that we keep hearing.
- Item 3.3.46 The comments attributed to the CMDT regarding collective scheme managers are exactly correct in our opinion.
- Item 4.1.50 In our view both fund managers and custodians should be licensed. We see this as a proactive step whereas the alternative of disqualification is really only actively pursued subsequent to a failure. The usual complaint by the industry is one of cost of compliance. Given that the requirements proposed are largely about good governance and accountability, we believe the costs will be modest for well run

managers as they will already be in compliance. However it is a necessary step to prevent abuse by the minority who are not as professional.

- Item 4.1.51 It is essential that fund managers are legally responsible for investment decisions even if they have delegated the function. If not, we predict that every fund manager will insert a layer of delegation in the process specifically to lay off any liability. By including the provision, the manager's responsibility to the interests of the investor is reinforced as well as creating unambiguous accountability.
- Item 4.1.52 Certain items (which should be prescribed) must have a mandatory reporting requirement. Within the existing regulations, there have been numerous instances where "judgment calls" have resulted in matters which "should" have been reported remaining hidden. For example the disclosure of bank covenant breaches has been a problem with equities. In collective schemes, a number of instances have occurred where Trustees have not been informed of material changes and have not been able to intercede until it is too late.
- Item 4.1.54 We agree with the need for a common set of disclosure documents. Retail buyers must have offers presented in a consistent and comparable manner in order to make informed decisions.
- Item 4.3.59 We disagree with the Authority using a fixed maximum penalty. We would prefer the maximum to be a percentage of the supervisor's fees. This will focus all supervisors, large and small on the need to discharge their duties with care.
- Item 4.3.66 We agree with the MED that the various changes underway will greatly enhance the regulatory settings and we commend them for trying to bring everything into synchronisation as soon as possible.
- Item 4.4.71 We see the proposal to license fund managers as a "fence at the top of the cliff" approach and strongly support it.
- Item 4.4.73 The argument regarding potential costs of licensing and the risk of over regulation leading to a reliance on the disqualification provisions in the FSPA holds no weight with retail investors. This is classic "ambulance at the bottom of the cliff" thinking. Its downside is best illustrated by the finance company debacle where nothing could be done until failure occurred. We would rather see a smaller pool of quality managers on whom we could rely.
- Item 4.5.1.83 We agree with the duties that the Ministry proposes for supervisors. However the document is silent on the question of who appoints the supervisors. In our view the new Act should set out a mechanism where supervisors are initially appointed by the collective fund manager, but must be confirmed annually by investors. We also see a need for investors to be able to effect a change of supervisor and propose that ten percent of investors by value should be able to force

a poll of all investors. A simple way to ensure there were no vexatious applications would be to require the applicants to pay the costs of the poll unless the vote was in their favour, in which case the manager would become liable.

- Item 4.5.1.85F We believe consideration should be given to extending the Authorities power so that it might substitute a different supervisor if it considers this to be essential to the proper operation of the collective scheme or exceptionally, in the public good.
- Item 4.5.1 Q 15 In our view the answer to this question is that there are only “pros” to the functions, duties and liability, and rights of supervisors set out in the paper. We seeing these as a huge step forward in terms of building retail investor confidence.
- Item 4.5.2 in total We support the proposals to enshrine the principles governing the functions and duties of managers in legislation. Most currently would comply and we see little additional cost or complexity. It would however encourage a higher standard from those who may not be so mindful of their duties at present.
- Item 4.5.3.100 We see no need for an external administrator in regard to asset pricing. If the regulatory mechanisms are as robust as the review proposes, and an appropriate methodology of valuation is clearly disclosed, an external administrator would simply add an unnecessary additional cost.
- Item 4.5.4.105 Experience has shown that unless adequate prudential supervision is in place, things can go very wrong. Therefore on balance we favour a licensing regime covering custodians. This might be effected by simply extending the current Reserve Bank supervisory role rather than setting up a new structure. We see this applying to both banks (which is already the case) and non-bank custodians. This is a one rule for all approach.
- Items 4.6.1.115 to 4.6.1.121 We support the proposed process for valuing assets and in particular feel that timing effects on unit pricing must be transparent in any allotments.
- Items 4.6.1.122 to 4.6.1.126 In our view, the most effective way to minimise pricing errors and limit breaks is to require the manager to make good any consequent losses by the investor, but to be unable to recoup any gains paid in error. The approach set out in the review lacks teeth. Consultation on how to prevent future errors achieves no worthwhile outcome or compensation for those who have been affected.
- Item 4.6.2.131 to 4.6.2.132 We believe that where a scheme has a performance objective, this should be required to be set out clearly in the documentation for investors to benchmark against. This will enshrine the policy in the public arena and reduce the likelihood of fund managers deviating from a core risk assumption on which many investors may have committed funds. We do recognise that from time

to time, it may be advantageous for managers to change the policy and if this is deemed the case, it should require a super majority of investors by value to achieve this. We also believe that where a continuing fund has previously changed its investment policies, this should need to be disclosed to potential investors before accepting any funds. Our rationale is to alert investors that the management decisions of the fund need more careful scrutiny. It may be that the policy change was both timely and appropriate, or the opposite may be true. That is an assessment that the potential investor must make once notified.

- Item 4.6.4.153 to 4.6.4.154 We are of a view that considerable protection must be supplied to whistleblowers. The best way to do this is to make whistle blowing effectively a mandatory requirement. We do not favour monetary rewards for whistleblowers as this may increase the temptation to blackmail employers in return for silence. We recommend that any money recovered should go back to the victims and costs of investigation should be added to any penalty. Equally we think the regulator should be careful who is penalised. There must be no costs incurred by the fund itself (only by the manager or supervisor or custodian) as to do so may result in a double jeopardy for the investors.
- Item 5.4.169 We support the recommendation that insurance schemes with an investment component should be classified as collective schemes. The necessary split for regulatory purposes is straightforward and should not be costly. The benefits are that no possibility of regulatory arbitrage would exist.
- Item 6.3.201 We support the proposal for a dual regulatory regime for funds that are traded in NZ only or in NZ/overseas respectively. We see this as a New Zealand solution for New Zealand conditions.

Chapter 5

- Item 2.10 Our view is that principles based laws with the ability of the regulator to develop Codes of Practice, or if necessary promulgate regulations, is the most appropriate way to ensure flexibility when seeking to control securities markets behaviour. The key over-riding principle is that customers must be treated fairly and that obligations both ways a concise and transparent.
- Item 3.1 in total If another market wishes to set up different rules it should have to justify this via a process that allows us and others to make submissions. We prefer to not prejudge, so generally approve of the possibility of second-tier exchanges providing the regulator takes account of submissions plus imposes the onus on the new operator to explain why. In particular, we are nervous of the proposal to water down the continuous disclosure and insider trading requirements. These are important balancing factors in the information asymmetry between issuers and investors and should not be lightly waived. We do accept however that in order to encourage smaller companies to go public, it may be necessary to reduce the

administrative burden and cost. We would suggest that a size level be set (turnover, staff numbers, profitability?) at which point full tier one listing is required along with full compliance with the new Act, even if the initial listing is at a lower level of compliance.

- Item 3.2.26 We and our members would be very concerned if share registries were not readily available. In our view, the electronic form should be free of charge as the cost of preparation is negligible. We would accept a modest charge for hard copy to cover printing costs and preparation time.
- Items 3.2.32 to 3.2.35 We disagree with the Ministry that the issue of “improper use” of registry data is not a problem. Both Australian, and more recently, NZ based groups have begun to make predatory offers. This is the main improper use along with access for unsolicited advertising (although this is not yet an issue.). The solutions are simple. We propose that where offers to purchase securities are made, they must include in large bold letters at the top, the most recent publically traded price and must carry a warning that investors should check the current price (including instructions where to find this) prior to accepting the offer. We consider advertising based on the use of the register should come under the aegis of the “unsolicited mail” laws which would give the recipient rights and the advertiser obligations not to be a nuisance. Notwithstanding the above, the Authority should be given the power to block access on application by the company. We do not believe that this power to block should rest with the company. Time is of the essence in these situations and a strict limit should apply for a decision to be made. Possibly as short as 48 hours.
- Item 3.3.45 We agree with the Ministry’s intention to align NZ law with the Convention. In particular we see a simplification in compliance for dual listed entities.
- Item 4.1.58 to 4.1.62 In our view the Authority should have the power to provide market participants with binding rulings. Such an approach gives clarity to both sides of the transaction. We consider that rulings should be for individual situations rather than attempting a “blanket” approach. We do not favour any ability to withdraw a binding ruling (otherwise why bother with the process), except where there was undisclosed material information at the time the application was made. We see this as a disclosure issue and the full requirements and penalties of the Act should apply. We note the concern that the courts could interfere with binding rulings. This is an undesirable outcome as it reduces certainty. The suggestion that the Rulings Panel be given the powers is reasonable to overcome this. With regard to the potential cost of obtaining a binding ruling, we note that issuers could always seek non binding guidance in which case costs would be modest. This would be adequate for most instances excepting where an issuer is “pushing the boundaries”. In this case they would have to make a commercial decision to either pay the cost or modify the proposal to a more conventional structure.

- Item 4.1.63 to 4.1.65 We do not generally favour retrospective exemption making power, however we acknowledge that minor immaterial breaches may require action at times. We would suggest a two tier approach. The Authority should be able to grant retrospective relief for immaterial breaches, but compulsion to seek court clarification for more significant breaches.
- Item 4.1.66 We endorse the need for no action letters. This should be specifically enshrined in the legislation rather than continuing by convention. No action letters should be subject to continuous disclosure.
- Item 4.1.68 to 4.1.70 We do not believe Gazetting exemption notices adds anything except time to the process. Few if any retail investors read Gazette notices. However, exemptions should not come into force until they have appeared on both the issuer and Authority websites.
- Item 4.2.78 to 4.2.80 Unlike the Ministry we think the Members Bill regarding validity of settlements has considerable merit. Currently, investors rarely have time on their side and are railroaded into unfair settlements. Most often these are only accepted under duress or may not even be made until the last hour of the last day possible. This imbalance is unfair as the issuer has the investor's money (and resources) and has a motive to spin the process out as long as possible.
- Item 4.1.82 to 4.1.88 We believe that investigative powers in relation to breaches under the Fair Trading Act should sit with the Commerce Commission, so to at least ensure consistency in approach in relation to cases under the Fair Trading Act. In our view, rather than mirror the Fair Trading Act, the new Law should refer back to the Fair Trading Act in terms of the relevant prohibitions i.e. the prohibitions in the Fair Trading Act apply. In this regard the breaches and the penalties will match those as set out under the Fair Trading Act which is not currently the case under the Securities Markets Act (see paragraph 85).
- Item 4.2.89 to 4.2.91 It is essential that the Authority has the power to bring cases in the public interest. This should extend to having the ability to institute complaint to other authorities regarding other legislation. Any other approach creates potential regulatory arbitrage opportunities.
- Item 4.3 Subject to the comment above, we think the enforcement of the CCCFA should sit where it currently sits. To bring them under the FMA umbrella adds a huge workload and the need for much broader expertise in other areas of the law. We believe the FMA should be focussed on the securities markets.
- Item 4.4 in total The Authority should have a significant role in promoting financial literacy. It should be a coordinator rather than a direct provider.
- Item 4.5.103 We support the need for the Authority to be able to gather care needs to be taken that this does not become too onerous and costly. There is anecdotal evidence that currently policy is often made in something of an information vacuum. This is very undesirable. We see no confidentiality issues providing data is

aggregated. Having to provide data would likely prevent issuers such as Aorangi and HMF slipping under the regulatory radar.

- Item 5.1.109 Whilst we agree with the current directors duties, we would like to see an additional duty as detailed in 5.1.116 added. Specifically: “To avoid using their position or the information they obtain from holding the position, to gain an advantage for themselves or someone else, or cause detriment to the company”.
- Item 5.1.122 to 5.1.124 Public enforcement may have an important role in developing case law. Our consistent position is that any action should be based on merit. Certainly public action “should” be allowed, but not “must” be undertaken. We are also concerned that these actions target the potentially guilty parties rather than the company. To do otherwise places investors in a position of double jeopardy where they not only suffer from the actions but may have to defend the company and pay any penalties. The current action with Nuplex is an example. Both the directors and company have been charged. We fail to see how the “company” can be liable for non-disclosure when the directors had responsibility for the decision. We understand that very large sums are being expended to defend the company. This is not insurable, whereas the director’s defence is covered by insurance. This seems unfair to investors. We also think that the body of law now, and any future decisions will aid in setting appropriate boundaries. On strictly commercial grounds, actions to define these boundaries may not be viable, so the regulator has an important role to play.
- Item 5.1.137 We do not believe that public enforcement would have the dire consequences set out in this clause. For the most part, the rules remain unchanged. The penalties may be stronger, but that is of no consequence to someone undertaking their director’s duties in a sound and ethical manner. The bottom line is that those who are incompetent or who offend in a significant manner should not be directors. We favour a full range of sanctions being available. In addition, we think it important that where monetary compensation is achieved, this should flow to the victims after reasonable deduction for any costs incurred.
- Item 5.2.159 We agree with a significant increase in the maximum period for management bans.
- Item 5.3.2.169 to 5.3.2.171 We agree with the Ministry’s approach to bankruptcy. In addition we would like to see a compulsion that former bankrupts must disclose this if they are a director or a promoter of a public issue. This “track record” is very significant to a when considering a retail investment. This disclosure should be at a tier one level (on the PDs).
- Item 6.1.176 to 6.1.179 We consider the Ministry’s preliminary view on enforcement via infringement notices to have particular merit. For more minor issues, this offers a rapid and cost effective solution. We would want to be assured that more serious offending was not included in such a scheme as for some people, the cost might be worth it to achieve the particular outcome they are seeking. For example property

developers cut down protected trees as the \$20,000 penalty is much less than the potential gains after the tree is removed.

- Item 6.3 in total. We favour rapid resolution of problems as a way to maintain public confidence in the integrity of the system. The suggestions regarding extending the jurisdiction of the Rulings Panel consequently appeal to us. While some right of appeal to the courts must remain, we do not favour the establishment of a specialist financial court which we view as a very expensive alternative to the status Quo. If our submissions are accepted. The various resolution and enforcement powers in the new act should reduce the number of cases needing to be heard.