CHAPMAN TRIPP

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Dear Panel Members,

FINANCIAL SYSTEM INQUIRY SUBMISSION

1 We refer to the Terms of Reference for the Financial System Inquiry (FSI). Although we are aware that submissions recently closed, we believe it would be helpful to share some New Zealand perspectives, particularly in the light of the fundamental overhaul of securities laws that has recently been undertaking here, culminating in the Financial Markets Conduct Act 2013 (FMCA).

2 There are a number of similarities in the New Zealand experience to the key challenges the Panel is confronting. Enhancing productivity and interconnectedness with global markets;[1] funding growth; improving allocative and dynamic efficiency – including by increasing the birth rate of new enterprises and fostering their development; finding an optimal balance between the goals of stability and accountability on the one hand and competition, innovation and dynamic efficiency on the other; new opportunities and risks associated with the emergence of Asian economies; and the increasing influence of international or long-arm offshore regulation (including AML-CFT, OTC derivatives reform and FATCA).

3 There is also a high degree of integration and commonality in our financial markets – for example, New Zealand's major banks and insurance companies are Australian-owned and subject to dual 'home-host' prudential supervision.

4 As a result, the progress of the FSI will be of great interest in New Zealand. It also, given the timing of New Zealand's own reform programme, represents an unparalleled opportunity to breathe further life into the Single Economic Market project and the work programme of the Trans-Tasman Outcomes Implementation Group.[2] This integration is only one component of wider initiatives toward an Asian capital market to support the emerging trading market, so it is particularly pleasing to see this focus recognised in the appointment of an international advisory panel to the FSI.

[1] Refer http://www.productivity.govt.nz/news/low-innovation-and-weak-international-connections-limit-productivity

[2] Refer http://www.med.govt.nz/business/business-law/current-business-law-work/sem

NEW ZEALAND'S REFORM PROCESS AND RESULTING NEW LEGISLATION

5 New Zealand began its comprehensive financial law review and reform process in 2006 with the release of nine discussion documents, covering:

5.1 **Registration** of financial service providers and **consumer dispute resolution** and redress. These two papers resulted in the Financial Service Providers (Registration and Dispute Resolution) Act 2008.

5.2 Prudential supervision of **insurance** companies. This resulted in the Insurance (Prudential Supervision) Act 2010, providing for supervision of insurance providers by the Reserve Bank of New Zealand.

5.3 **Supervision** of debt issuers by trustees and of managed funds and similar investment schemes by statutory supervisors. This resulted in the Securities Trustees and Statutory Supervisors Act 2011, which is soon to be renamed the Financial Markets Supervisors Act.

5.4 **Non-bank deposit-takers** (friendly societies, credit unions, building societies, industrial and provident societies, and finance companies). This resulted in the enactment of a prudential supervision regime, overseen by the Reserve Bank and by statutory trustees, under Part 5D of the Reserve Bank of New Zealand Act 1989. This has been recently re-enacted as the Non-Bank Deposit Takers Act 2013, including a new licensing regime.

5.5 **Collective investment schemes** (including superannuation).

5.6 **Mutuals' governance**.

5.7 **Securities offerings**.

5.8 **Platforms** and portfolio management (or 'wrap') services.

6 The last four of these got picked up in the Review of Securities Law discussion paper in June 2010, which ultimately culminated in the FMCA.

7 History, in the form of the Global Financial Crisis, intervened in the orderly carrying out of the proposed review and reform programme. The GFC altered priorities and led to a series of enactments addressing matters of more perceived urgency as a result of those events.

8 In a New Zealand context, the most damaging domestic consequence of the GFC was the failure of dozens of largely unregulated finance companies who derived their funding largely from 'Mum and Dad' investors. This exposed a number of financial industry and regulatory deficiencies. In particular:

8.1 **Financial advisers**: In some cases investment in finance companies was under the recommendation of financial planners and advisers. Concerns about the qualifications of those advisers, the quality of advice provided and conflicts of interest led to the enactment of the Financial Advisers Act 2008.

This Act contains a licensing regime, ongoing compliance requirements and duties of care.

8.2 **Financial regulator**: Concerns about the powers, resourcing and performance of the Securities Commission led to that organisation being dis-established and replaced with a new Financial Markets Authority (FMA), which – like ASIC – became the primary regulator of financial markets and services, with extensive powers, increased resources and a focus on being closer to the market it regulates (in particular, by building of a significant presence in Auckland). The FMA's governing legislation is the Financial Markets Authority Act 2011.

8.3 **Auditors**: Audit quality was addressed in the Auditor Regulation Act 2011.

9 Having completed this legislative programme, attention returned to New Zealand's core securities laws, contained in the Securities Act 1978 (primary offerings) and the Securities Markets Act 1988 (trading rules and derivatives). After receiving extensive submissions on the Review of Securities Laws Discussion Document, the Government produced a series of exposure drafts of an ambitious Financial Markets Conduct Bill, which were each themselves subject to extensive consultation with market participants. The resulting FMCA has been described as a 'once in a generation' reform, which has replaced existing laws with a fundamentally new regime – aspects of which are discussed in the submissions below.

10 Another key influence during this period was the work of the Capital Markets Development Taskforce. This was an industry-led body established in July 2008 to develop a blueprint and action plan for the development of New Zealand's financial system. The Taskforce's recommendations, among other things, led to the partial privatisations of State-owned enterprises under the 'Mixed Ownership Model' and were also influential in the shape that the FMCA eventually took.[3]

11 A key insight emerging from this review and reform process is that too much financial law-making in New Zealand had been reactive to crises and that a more forward-looking and systematic approach was required. Part of this was the recognition that positive outcomes both for investors and the economy would come not from simply multiplying regulation but by developing a strong capital market and encouraging informed and confident participation in that market. This, together with a focus on the underlying drivers (such as information asymmetry and the role of gatekeepers) has resulted in some bold reforms, including:

11.1 'Low doc' offers of same class listed debt and equity products; and

11.2 Enabling of equity offerings through crowd-funding platforms and of disintermediated lending through peer-to-peer services.

[3] The Taskforce's final report is published at http://www.med.govt.nz/business/economic-development/pdf-docs-library/cmd-capital-markets-matter-full-report.pdf and the Government's resultant action plan is published at http://www.med.govt.nz/business/economic-development/pdf-docs-library/cmd-action-plan-summary.pdf

12 The New Zealand's reform process has also highlighted the importance of deep and sustained engagement among Government Ministers, policy agencies (in New Zealand led by the Ministry of Business, Innovation and Employment), financial regulators and market participants. In the case of the FSI, the benefits of this approach are amply demonstrated by the breadth and quality of the submissions made to the Panel.

13 Despite the significant changes made in New Zealand, it is recognised by the Government and by market participants that much remains to be done, particularly in the areas of improving productivity and interconnectedness, addressing tax distortions and strengthening financial market infrastructures (including research coverage and intermediation). These have ongoing focus through the Government's Business Growth Agenda, a key component of which is 'Building Capital Markets'.[4]

OTHER COMMENTS

Focus and purpose of financial markets and products laws

14 One significant change in the FMCA from previous New Zealand financial markets legislation was that the Act begins with explicit and coherent statement of its purpose and objectives. Whereas case law in the wake of the financial company collapses had focused almost solely on consumer protection, the objectives of the FMCA relate to promoting the development of financial markets and confident participation in them.[5] This resulted from the insight that both the wider economic goals and protection of investors depend on creating a strong capital market, and are unlikely to come simply from multiplying regulation and increasing controls.

Innovative capital raising, funding start-ups, commercialisation and growth

15 A major focus of the FMCA reform was on the outdated and confusing way in which the wholesale and retail markets are distinguished. The FMCA by contrast features a set of wholesale market exclusions that are clear and objective in nature. At the same time, a new set of exclusions has been developed with the intention of fostering innovation in financial product offerings and facilitating capital-raising at the venture capital and small and medium enterprise (SME) levels.[6] These include provisions for licensed intermediaries providing crowd-funding and peer-to-peer lending platforms, 'same class' offers of financial products, small personalised offers, and relief for employee share schemes and dividend reinvestment plans.

Development of a strong corporate bond market

16 In part reflecting investor preferences, New Zealand's capital markets differ from Australia's in the part played by the corporate bond market. New Zealand has sought to further facilitate growth of the retail part of this market through disclosure and compliance exemptions for 'same class' listed offers of debt securities, including new series and tranches that have different redemption dates and interest rates.

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[4] Refer http://www.mbie.govt.nz/pdf-library/what-we-do/business-growth-agenda/bga-reports/Capital-Markets-report.pdf

[5] Sections 3 and 4 FMCA.

[6] Schedule 1 FMCA.

17 We view this as a very important development that will encourage in particular the more frequent participation of investment grade issuers in the listed market and will increase the competitiveness of that format against international wholesale funding options, such as US private placements.

18 We note that a number of FSI submitters have recommended that similar initiatives are undertaken in Australia. If this were done, there could be further benefits in ensuring that same class offers can be undertaken on a trans-Tasman basis under mutual recognition offers.

Stepping stone markets

19 The FMCA makes provision for registered markets focused on new growth companies and subject to differential requirements as to, for example, continuous and periodic disclosure. NZX has responded with proposals for a New Growth Market and is currently consulting about the structure of, and rules for, that market. An interesting challenge that has yet to be fully explored will be whether it is possible to bring 'low doc' same class offerings into this sort of market without compromising investor protection or the 'gatekeeping' standards of listed markets.

20 Another debate in this context is whether the problem is a lack of capital or a lack of viable assets in which to invest (whether through private equity funds or listed markets). There is a divergence of views on this in part because of the lack of visibility into the SME sector, which forms a disproportionate part of the New Zealand economy by comparison to other OECD countries.

Liability settings

21 Perceived inadequacies and distortions in the enforcement and liability provisions of existing laws were a key focus of both policy makers and submitters. This was considered to be significant not only in considerations of justice and accountability, but because of the impact of potential criminal liability (in particular, 'deemed' and strict criminal liability of directors) on incentives and ultimately on the nature and quality of disclosure. The re-thinking in this area resulted in some of the most significant changes in the FMCA.

22 The centrepiece of the FMCA in terms of issuer and participant obligations is Part 2 (*Fair Dealing*), which applies to conduct in virtually all other parts of the Act (with the exception of formal regulated disclosure documents). Part 2 contains a broadly expressed 10b-5 type of prohibition on misleading conduct and disclosure.

23 There is no criminalisation of this prohibition (by contrast to the Corporations Act). These broad requirements, policed by the FMA, are paired with an equally broad range of proactive or pre-emptive interventions that may be undertaken by the FMA, including stop orders and direction orders (Part 8 FMCA). The intent is to enable the regulator to engage at the 'top of cliff', rather than after harm has already been done to investors and to market confidence.

24 The Securities Act featured deemed director criminal and civil liability for all communications in relation to regulated securities offerings as well as to formal offering documents, on a strict liability basis (subject to relatively narrow due

diligence defences).[7] By contrast, deemed liability in the FMCA is limited to formal initial and ongoing regulated disclosure and the crimes incorporate fault elements (knowledge or recklessness).[8]

25 The Securities Act's liability provisions only applied to directors, promoters and experts. In the FMCA, civil liability can be extended to anyone 'involved in a contravention'.[9] The notion of a 'promoter' has been abandoned. Policy makers considered, but did not proceed with, a proposal to extend liability automatically to 'underwriters'.

26 The defences have also been expanded. The issuer has a defence of reasonable reliance on third parties (and in this respect differs from the Corporations Act).[10] Those 'involved in contravention' have reasonable reliance and reasonable steps defences.[11] In relation to regulated disclosures, direct and accessory contraveners also have a due diligence defence.[12]

Disclosure challenges

27 In recent years, the efficacy of mandatory disclosure as a basis for securities laws and investor protection has come under challenge from behavioural economics and from empirical studies indicating that many investors do not read, or understand, disclosure documents.[13] A related question is whether disclosure should be targeted at retail investors, professional investors, or both.[14]

28 The debate in New Zealand focused particularly on these issues, and particularly the length and complexity of disclosure documents – with suggestions initially from the Capital Markets Development Taskforce and submitters that disclosures should be radically simplified and standardised.

29 This debate is by no means a new one – for example the issues of the efficacy and appropriate targets of disclosure was thoroughly canvassed by the United States Securities and Exchange Commission "Wheat Report" in the 1960s.[15] Policy makers here ultimately resisted the calls to either move away from disclosure or to radically

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7 Sections 56 to 59 of the Securities Act 1978.

8 Refer sections 510 and 534 FMCA.

9 Section 533 FMCA.

10 Section 499 FMCA.

11 Section 503 FMCA.

12 Section 500 FMCA.

13 See for example Troy A. Paredes "Blinded by the Light: Information Overload and its Consequences for Securities Regulation" (2003) 81 Wash U LQ 417 at 436-437; Robert Prentice "Whither Securities Regulation? Some Behavioural Observations regarding Proposals for its Future" (2002) 51 Duke LJ 1397.

14 See for example Kenneth B. Firtel "Plain English: A Reappraisal of the Intended Audience of Disclosure under the Securities Act of 1933" (1999) 72 S Cal L Rev 851; Easterbrook & Fischel "Mandatory Disclosure and the Protection of Investors" (1984) 70 Va L Rev 669.

15 Securities and Exchange Commission report Disclosure to Investors: A Reappraisal of Federal Administrative Policies under the '33 and '34 Acts (1969). Ultimately, the Wheat Report maintained that disclosure should be geared toward the needs of all types of investors, from the average investor to the professional financial analyst: "A balance must be struck which reflects, to the extent possible, the needs of all who have a stake in the securities markets". See also *Feit v Leasco Data Processing Equipment Corp* (1971) 332 F Supp 544.

simplify or reduce all disclosures, recognising that the basis for mandatory disclosure remains information asymmetry and is a key ingredient in enhancing allocative efficiency and market credibility, in addition to the consumer protection aims.[16]

30 The approach ultimately taken in the FMCA contains a number of significant changes to disclosure requirements designed to meet these challenges. New Zealand policy makers have sought to craft disclosure requirements carefully among different product classes according to their characteristics and predominant investor base and also the nature of the offer (for example, whether it is an IPO or follow-on offer). Policy makers have also taken advantage of technological changes in order to address the conflict between meeting the needs of intermediaries and professional investors without creating disclosure that is unwieldy for retail investors.

31 The key features of the new regime include:[17]

31.1 A retail-focused product disclosure statement (PDS), with prescribed format and disclosures tailored to the characteristics of the relevant product type. For example, it is anticipated that a PDS for an equity IPO will contain a full description of the issuer and its business plan and may be a longer document. By contrast, the PDS for a managed investment product would be very brief and focused on comparability among products.

31.2 The PDS will be supplemented by entries on an on-line, searchable Offer Register, including all "material information" not contained in the PDS (or contained only in a summary form, with a reference to the further information on the Offer Register). This is targeted primarily to the needs of securities analysts, financial intermediaries and professional investors.

31.3 A far greater emphasis on ongoing disclosure – for example, standardised quarterly reporting for superannuation and managed investment products.

31.4 Substantial exemptions which permit 'low doc' ongoing or secondary offers where made against a backdrop of periodic and ongoing disclosure – most notably in the exclusions for same class listed offers debt and equity, but also in employee share plans, dividend reinvestment plans etc.

31.5 Subject to tailoring of prescribed requirements for particular products, the same disclosure standards apply across all products.

31.6 There has been a move away from utilising accounting standards as a basis for disclosure requirements, which was seen as leading in some cases to

[16] In our opinion this is correct and is consistent with the weight of academic literature and empirical studies – see for example Goshan & Parchomovsky "The Essential Role of Securities Regulation" (2006) 55 Duke LR 711, Bernard Black "The Legal and Institutional Preconditions for Strong Capital Markets" (2001) 48 UCLA Law Rev 781, David Schulte "The Debatable Case for Securities Disclosure Regulation" (1988) 13 JCorpL 535 and John C. Coffee "Market Failure and the Case for a Mandatory Disclosure System" (1984) 70 Va L Rev 717.

[17] This discussion is based on the FMCA and the exposure drafts of disclosure templates. The draft regulations providing for the specific disclosure requirements are expected to be published for submission in the coming weeks.

excessively lengthy and technical disclosures. It is likely that the mandated disclosures will include non-GAAP metrics, where these are standard in the relevant industry.

32 While the FMCA seeks to raise standards by enhanced governance requirements (Part 4 FMCA) and licensing of some market participants (Part 6 FMCA), it remains fundamentally a mandatory disclosure law, and the concept of "material information" remains pervasive to that law. In this regard, another innovation of the FMCA compared to the existing law has been to provide a definition of "material information", which incorporates principles of economic rationality (information that would influence "persons who commonly invest in financial products") and explicitly limits the scope to issuer-specific information.[18] Similarly, material information for ongoing disclosures does not include generally available information.

33 This formulation is particularly relevant as the FMA has struck the balance between principle and prescription by requiring only specified information to be provided in the retail-focused PDS, while requiring all "material information" to be posted on the professionally-focused Offer Register.[19]

Integration of Australasian and Asian capital markets

34 We support the focus of the FSI on expanded integration of the Asian capital markets, including through mutual recognition and fund passporting initiatives. In this regard, one area that appears to have received inadequate attention and leadership from Australasian policy makers is the nascent Asian debt capital markets initiative.

35 Another area that is of increasing significance in the light of the G20 Pittsburgh Accord (in particular, OTC derivatives reform) and international or long arm regulation, such as AML-CFT and FATCA, is financial market infrastructures (including clearing and payment systems, trade repositories and platforms) and regulation of custody and asset management. In this regard, we submit that consideration should be given to the implications of central counterparty clearing requirements and related emerging regulatory models, such as the United States LSOC regulations.

Tax neutrality and barriers

36 Following the significant reforms in New Zealand leading up to and including the passing of the FMCA, it has been recognised that some of the most important barriers to market integration and initiatives relating to the exporting of financial services lie in taxes which cost more in market distortions and lost opportunities than they make in revenue. We encourage the focus of the FSI on these areas, including on tax settings that impede development of an integrated trans-Tasman capital market.

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[18] Section 59 FMCA: Material information means information that: (a) a reasonable person would expect to, or to be likely to, influence persons who commonly invest in financial products in deciding whether to acquire the financial products on offer; and (b) relates to the particular financial products on offer or the particular issuer, rather than to financial products generally or issuers generally.

[19] Section 57 FMCA.

37 Unfortunately in New Zealand tax settings were not a substantial part of the core FMCA project and remain a significant item on the "to do" list. For example, New Zealand has a withholding tax/approved issuer levy regime that impedes development of New Zealand's wholesale debt capital markets. Similarly, the 'tax haircut' is an impediment to development of a market in Basel III-compliant hybrid capital instruments on both sides of the Tasman.

Funding the infrastructure deficit

38 One issue that Australia and New Zealand share in common is an infrastructure deficit that will need to be addressed in order to achieve sustainable growth.

39 To date in New Zealand, while there have been some tentative moves toward PPPs, little consideration has been given to potential capital markets or superannuation fund solutions – in spite of the widespread use of infrastructure bonds in other jurisdictions and the appeal of capital markets in relation to the ability to provide tenor in relation to appropriate assets. As a result, this aspect of the FSI will be watched with considerable interest in New Zealand.

Quality research coverage and intermediation

40 New Zealand has previously had a 'do it yourself' investing culture. To some extent this is still reflected in the FMCA, the core disclosure focus of which remains the 'prudent but no expert person'. Arguably, this DIY culture has contributed to some of the recent problems in the New Zealand capital markets. In particular, the direct debenture investing undertaken in finance companies led to significant losses among particularly middle-aged and elderly savers who were looking for a regular income stream but gave insufficient attention to risk and capital preservation.

41 The Financial Advisers Act 2008, enacted in part in response to anecdotal evidence that poorly qualified financial advisers had widely recommended finance company investments for their increased yield, has had a positive effect to the extent of taking some of the unqualified financial planners out of the industry, but it is has also loaded up significant compliance burdens on brokers and the remaining financial advisory industry and – at the margins – has discouraged the giving of financial advice and recommendations to clients other than the very wealthy. This arguably has exacerbated the DIY phenomenon and, to the extent it constrains advice being provided to middle class savers, could be viewed as having adverse unintended consequences. To put it another way, in our view the balance has not been properly struck between compliance/accountability and encouraging informed participation.

42 A related issue is research, which is a requirement under the Financial Advisers Code (revised but not eliminated by the revised Code to have effect from 1 May 2014).[20] A large number of issuers even on the NZX Main Board do not have adequate research coverage, and independent research at the SME / private equity level is very limited. This is one of the issues being considered in relation to initiatives to expand and develop New Zealand's listed markets, including the inevitable calls for government subsidy. This suggestion may have some justification because the free

[20] Refer *Code of Professional Conduct for Authorised Financial Advisers*, published by FMA at http://www.fma.govt.nz/help-me-comply/financial-advisers/your-obligations/authorised-financial-advisers-obligations/code-of-professional-conduct-for-afas/

rider problem means there is a market failure in providing the socially optimal level of research and securities analysis, which in the New Zealand case is exacerbated by the small size of its domestic capital markets both in absolute and relative terms.[21]

43 A further issue that has been identified but not yet adequately addressed is how the Code rules for Authorised Financial Advisers should work with the newly liberalised rules for capital-raisings. As things stand, it would be difficult for brokers or other financial intermediaries to advise clients in relation to start-up funding or unlisted investments. This is an instance of how financial regulation needs to be considered on an integrated basis and also needs to be kept continually under review.

Technology

44 The digital revolution, and in particular the move to mobile devices as a key basis for accessing information and undertaking transactions, is now a key factor in regulatory design. Policy makers have sought to achieve technological neutrality in the FMCA and related laws in terms of delivery of offering documents and other regulated disclosures, in making offers, and in reporting to investors (eg enabling use of platforms as an alternative to sending reports).

45 Policy makers have also sought to exploit the potential of new technology by moving away from the paper prospectus to creating an online Offer Register for information access, particularly focused on advisers and analysts.

Competition, stability and innovation

46 In our view one of the key insights in the Terms of Reference is the focus on future growth and the acknowledgement of the trade-off between stability and dynamism. Considerations of stability have been at the regulatory forefront since the GFC, but issues of innovation, competition and efficiency are likely to hold the key to the structural changes that will be required for ongoing growth.

47 In New Zealand, it has been recognised that this will not be achieved without creating strong capital markets that meet the needs of savers and enable capital to be allocated efficiently. In our opinion, that goal in turn will not likely be achieved without a significant focus on strengthening the financial intermediaries sector.

48 A full-scale review of the nature of the FSI also has considerable value in creating a regulatory framework that is forward-looking, recognises the integrated nature of financial markets, and is designed to work through economic cycles. This is an antidote to the tendency to create regulation in reaction to crises, which ultimately exacerbates procyclicality and likely creates as many problems as it solves.

[21] John C. Coffee "Market Failure and the Case for a Mandatory Disclosure System" (1984) 70 Va L Rev 717 at 723-724.

CHAPMAN TRIPP

Engagement

49 We would welcome the opportunity to discuss with you any aspects of the New Zealand reform process.

Yours faithfully

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