CAPITAL MARKET DEVELOPMENT TASKFORCE

Progress Report

31 July 2009

Table of Contents

I Introduction

The Capital Market Development Taskforce has now completed over half of its work. We have commissioned a number of analytical reports, released an interim report of changes to reduce the costs of accessing capital markets during the financial crisis, and continue to consult widely with industry participants. We have also undertaken significant work on defining the issues, risks and opportunities in the New Zealand capital markets. We therefore think it is timely to report to the Government outlining:

- the framework the taskforce has adopted to analyse New Zealand's capital markets and assess current issues;
- our view of the major issues facing New Zealand's capital markets; and
- the shape of our final reports, scheduled to be completed in December 2009.

The appendices of this report provide practical recommendations for changes to laws and regulations to improve investor outcomes. They also complete our earlier interim report by including some initial suggestions to make capital markets more accessible to small firms. We thank INFINZ, the NZVCA, and the many others who have engaged with us on our work.

We are mindful of the context against which we are reporting. The financial crisis has highlighted a number of deficiencies and vulnerabilities in global capital markets as they have operated to date. It is therefore important that we take the time to stand back from the crisis and think about how we can use this as an opportunity to reshape our capital markets to better serve New Zealand. In doing so, it will be important that we have, and are recognised as having, a robust and certain regulatory regime. Given New Zealand's large current account deficit, it is critical that our markets are both attractive to international flows of capital, and further developed to be attractive to the higher level of domestic savings that will be required as we reduce our external deficit. A sound regulatory environment is an important contributor to that.

We are currently witnessing a process of economy-wide deleveraging and balance sheet adjustment by firms and households. Moreover, banks, which are themselves deleveraging, are tightening credit criteria and slowing their lending growth. As a result firms are turning directly to capital markets to raise debt and particularly equity. Indeed, the "new normal" for the New Zealand economy compared to the previous decade is likely to involve more conservatively geared household and firm balance sheets and a more constrained and conservative banking sector. In this environment, the role and development of public and private capital markets and the non-bank financial sector take on much greater importance. Improving our capital markets now will assist firms and households to emerge more strongly from the crisis than would otherwise be the case. More broadly, given the changes to global capital markets, now is the right time to be looking to reposition our markets in response to challenges and new opportunities.

II The framework used by the Capital Market Development Taskforce

Capital markets are the markets in which firms and governments raise capital, and where securities – that represent claims to capital – are traded. They:

- facilitate financial intermediation between savers and borrowers and capital formation;
- facilitate the management of financial risk;
- provide a range of product options for savers, borrowers and risk managers; and
- link savers, borrowers and risk managers through time and across international boundaries.

These functions are critical for New Zealand's productivity as a nation, and for the well being of individuals. If our savings are not effectively channelled to productive investments, we will be less well off as a country. And, as we illustrate later in this report, there are some clear indications that savings are not well directed in New Zealand. Our own personal standard of living will be affected by the choices available to us and the performance of our own direct and indirect investments (for example, our holdings in superannuation schemes). Similarly, many of the businesses that employ us rely on funding and risk management services that capital markets provide. The better that capital markets work, the better off we all are.

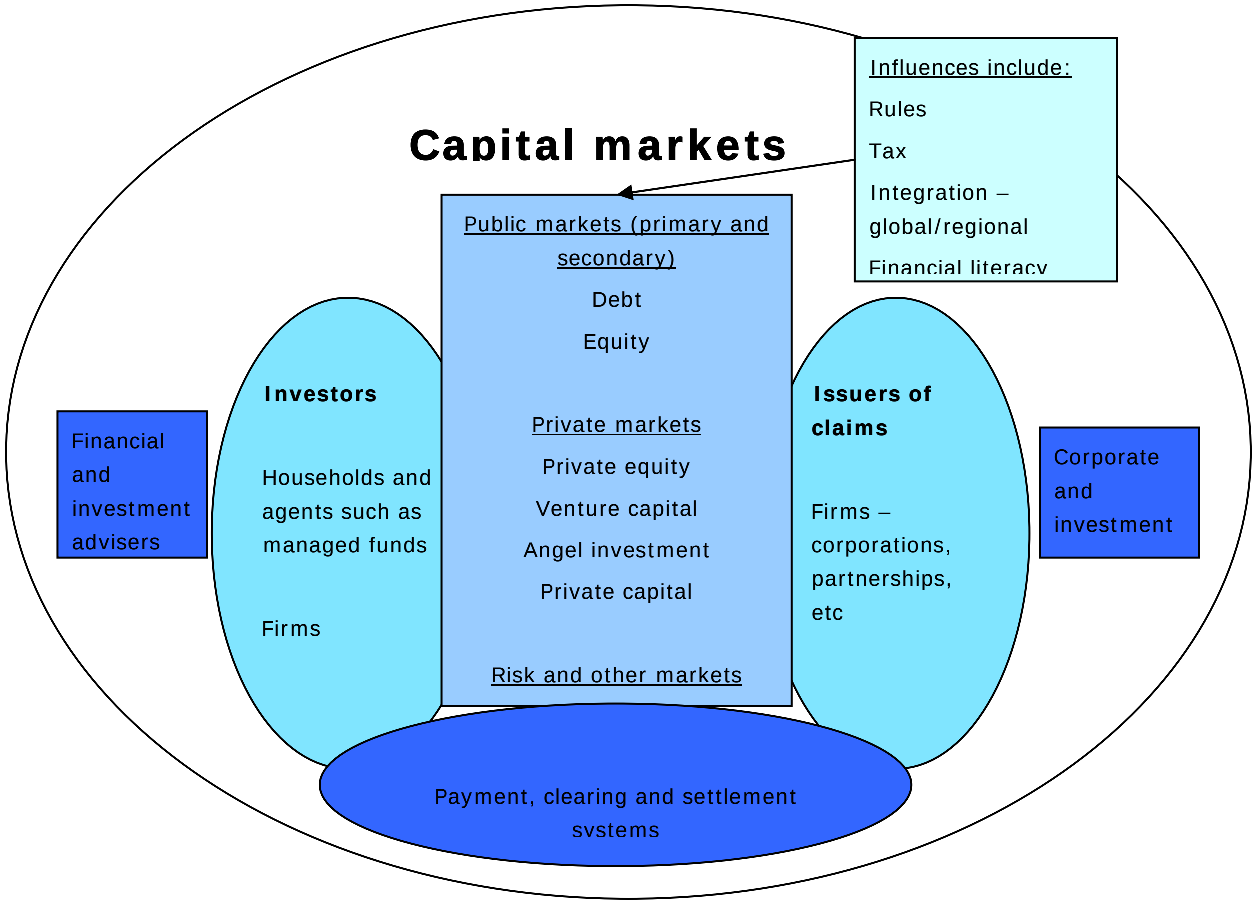
Capital markets are an important part of the economy. As recent studies illustrate, our productivity performance has been poor relative to that in other countries.[1] Ultimately, actions across a range of areas in the economy will be necessary to improve our economic growth rate. Our brief is not to tackle the overall productivity challenge, but to focus on the way in which capital markets can contribute to improving our economic performance.

The remainder of this section looks at how we would like to see the various parts of our capital markets working. Effective capital markets are characterised by efficiency, soundness, and a well-developed range of products:

- Efficiency – capital markets promote an appropriate allocation of capital and risk with relatively low transaction costs and spreads by international standards, and lower the cost of capital.
- Soundness – capital markets continue to operate efficiently in a plausible range of adverse circumstances.
- Product range – there is a full range of choice between alternative financial instruments for investors and issuers.

The taskforce uses the following diagram to represent its concept of our capital markets:

[1] See, for example, MED, Treasury and Statistics New Zealand, *Economic Development Indicators 2007*, available at: http://www.med.govt.nz/templates/ContentTopicSummary____32815.aspx.



To make recommendations that will enable our capital markets to best serve New Zealand, the taskforce has organised itself into a number of subgroups looking at the issues from the point of view of participants (investors and issuers), markets (public markets, private markets and derivatives), and cross-cutting influences which shape our markets (regulations, tax, and infrastructure). Below we outline the way we are thinking about these aspects of our capital markets.

- **Investors**

  The investor subgroup wants to see better **outcomes** for investors, and better **choices** available to them. This requires that investors have access to a range of products, information about them, competent and trustworthy advisers, and are sufficiently educated and financially literate. In some areas, investors have been poorly served by our capital markets and the taskforce considers that there are major improvements that can be made.

- **Issuers**

  The issuers subgroup is aiming to increase **access** to capital markets, and to lower **costs** for businesses. Both transaction costs and the cost of capital are important. Our interim report in November 2008 suggested changes here to allow firms to more efficiently raise capital and we will be looking for further gains in our final reports.

  Capital markets operate between investors and issuers. The taskforce is looking across all components of capital markets – from the various public and private market segments, through to the advisers that both issuers and investors rely on in making decisions.

- **Public Markets**

  Public markets include listed equity and debt markets. Listed equity markets provide a way for many companies to finance working capital and fund growth. Public debt markets provide an alternative to bank lending, and are often a cheaper and more flexible source of debt funding.

  We are aiming to significantly grow New Zealand's public capital markets so that they can provide a competitive, accessible source of funding to develop and grow New Zealand companies. This will also add to the attractiveness of New Zealand for companies considering locating here. As part of our final reports, we will provide performance indicators for well functioning capital markets. For public markets, these are likely to include factors such as capital raisings, total capitalisation, liquidity and transaction costs.

- **Private markets**

  Private sources of capital include private equity, venture capital, and angel investors, as well as the capital provided to privately-owned companies by individuals, families, other companies and capital retained by private companies themselves. Venture capital provides vital funding for high growth firms who are too small for public markets and unable to service or provide collateral for large amounts of debt. Large firms may also seek private equity funding for transactions such as leveraged buyouts (LBOs), and use private placements of both debt and equity.

  We are looking for ways to support the development of New Zealand's private capital markets and better link them to our public capital markets to enable our firms' continued access to capital as they grow. For private markets, performance measures such as capital commitments, investments, and exits are important, particularly for the institutional part of private markets (e.g. private equity and venture capital).

- **Derivatives**

  Although some derivative products have acquired an ambiguous reputation as a result of the financial crisis, derivatives play an important role in our economy by providing mechanisms to buy and sell risk. Companies use derivatives to transfer risk to others who are more able and willing to bear it. For example, companies buy foreign exchange forwards and futures to hedge against changes in foreign exchange rates. This enables them to undertake activities that they would be unwilling to if they had to accept currency risk.

  We are aiming to achieve an environment in which derivative products and exchanges are developed and are sufficiently liquid to meet the risk management needs of New Zealand companies.

  In addition to the various components of markets, we have formed subgroups looking at cross-cutting influences on capital markets. This includes the way in which regulations, international integration, and tax settings influence markets and their development.

- **Rules**

  New Zealand needs a regulatory framework that is easy to understand. It should encourage productive and creative behaviour while discouraging "gaming" activity. Regulation should allow players the freedom to innovate within clear boundaries, but be firmly and consistently enforced when those boundaries are overstepped. In this respect, research shows that "good" laws that are not enforced, or not enforced with sufficient timeliness to retain confidence, can have detrimental impacts on capital markets. This is partly because of the "adverse selection" that results as low integrity players are attracted to activities where laws are not enforced, and partly due to the uneven playing field created as high integrity players incur compliance costs that those without integrity do not.

We should aim to require our capital market regulators to behave consistently, fairly and predictably in their interventions and be perceived as such. For our regulators to be effective, they must develop the confidence and respect of participants, including foreign participants.

Our regulatory architecture should enable cost-effective implementation and enforcement of the regulatory framework and regulations we have chosen.

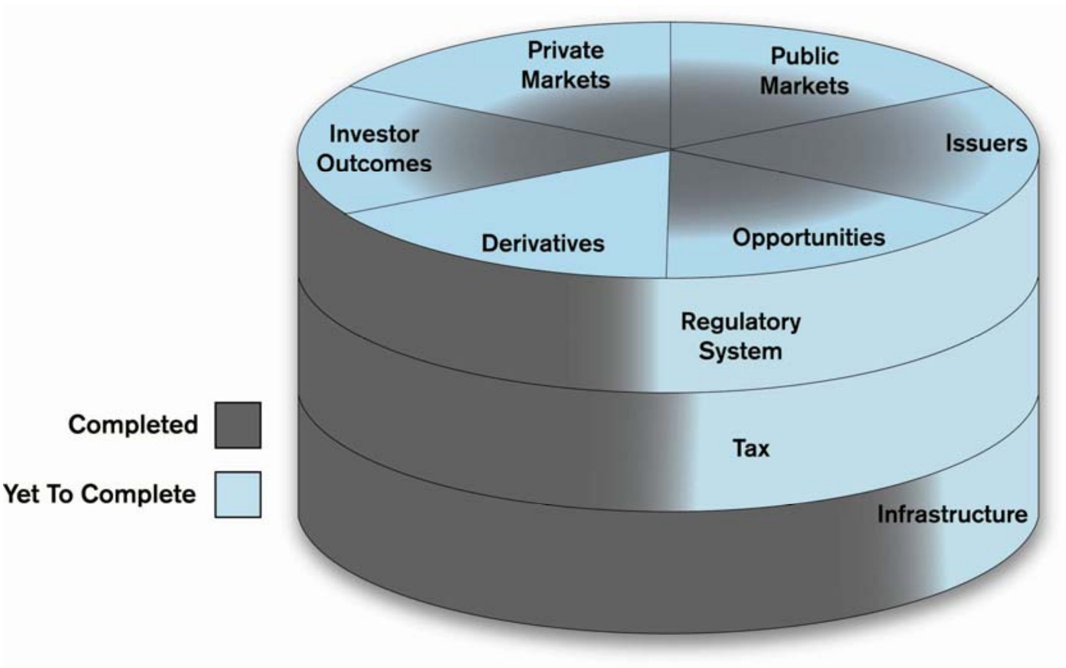
- **Tax**

  Reforms to the tax regime should be competitively neutral and encourage capital markets to grow in New Zealand rather than in other jurisdictions. The tax subgroup is assessing whether current tax settings might be constraining capital market development. It is working closely with the newly-formed tax working group, which is facilitated by the overlapping membership of the tax working group and the taskforce.

- **Infrastructure**

  New Zealand should aim to have a clearing and settlements infrastructure that is efficient, flexible, and manages risk effectively. It should be integrated across the spectrum of products and accommodate new capital market innovations. It needs to retain the confidence of domestic and foreign participants alike.

The following diagram illustrates the progress each of these subgroups has made thus far:



III Issues and Observations

The CMD taskforce has assembled ample evidence that New Zealand's capital markets are not functioning as well as they could. While many aspects of our capital markets work well, too much investment is unproductive, our public capital markets are thin, and our private capital and derivatives markets are underdeveloped. Investors have seen negative outcomes from parts of the market – most recently involving some finance companies – and the market for financial advisers does not work well. Issuers are faced with outdated regulation and unnecessary compliance costs.

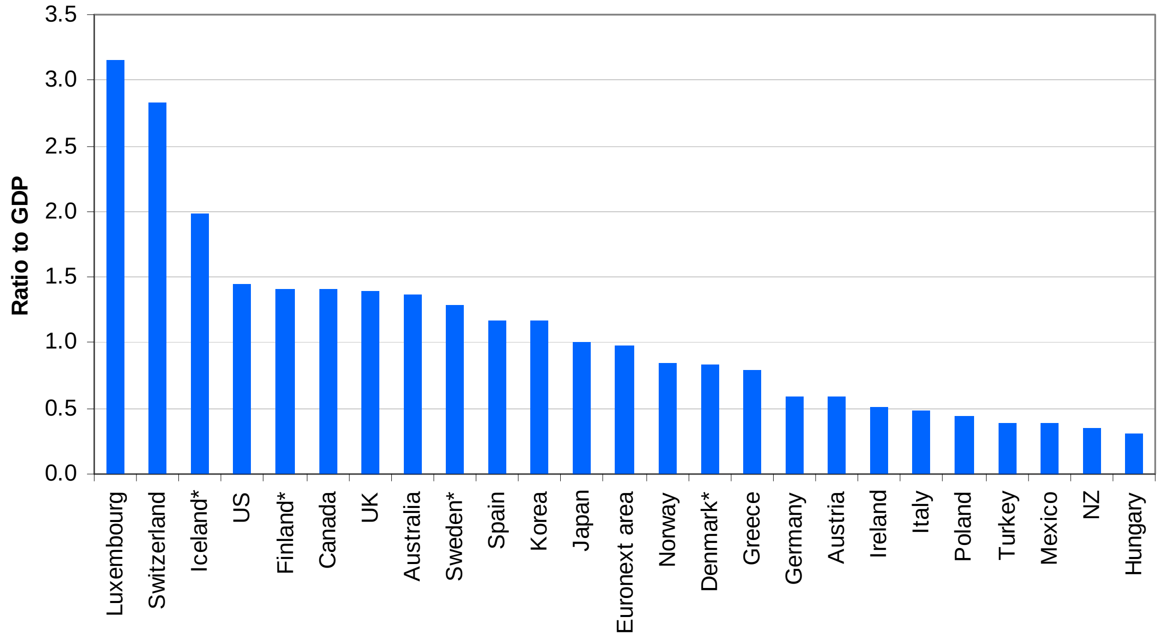
The taskforce believes that New Zealand can, and should, do much better than this. While we might be a relatively small country, many of the barriers to better performing capital markets are within our collective control. We are developing recommendations to improve our capital markets. Some of the solutions are relatively straightforward, and some recommendations are included in the appendices of this report. Others require more thorough analysis, and will be contained in our final reports.

The remainder of this section contains a range of observations about the state of our capital markets and some of the underlying features of our economy that influence our markets. Our final reports will consider the implications of these in more detail.

(a) Thin public capital markets

In "stock" terms, New Zealand's listed equity markets are relatively small and illiquid by international standards. Although they provide a full range of equity products, there is limited participation by firms in a number of industries, including agriculture, utilities and banking.

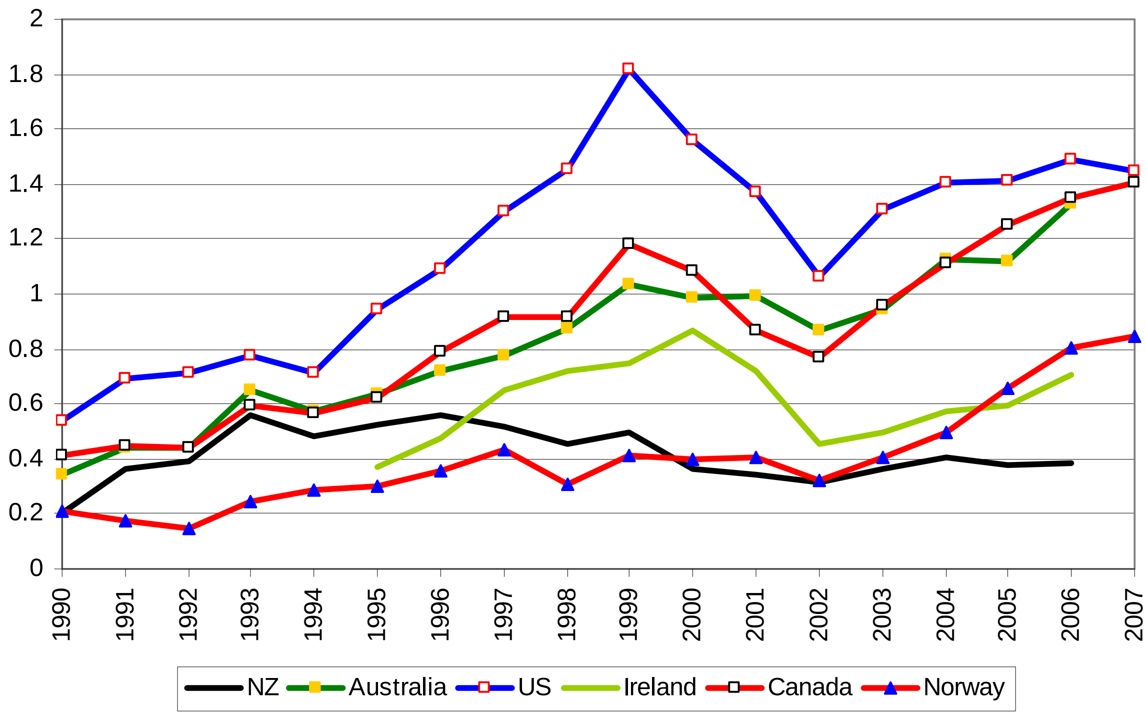
Figure 1 Domestic market capitalisation to GDP ratio for OECD countries, December 2007



Source: World Federation of Exchanges, Annual Statistics, Equity Markets; OMX, Total Equity Trading; OECD National Accounts. *Figures from OMX exchange have been obtained separately and may include listings of foreign companies.

In "flow" terms, there has been little growth in listings and relatively small amounts of capital raised in IPOs and secondary offerings. Whereas New Zealand and Australia had similar ratios of stock market capitalisations to GDP in 1992, over the past 17 years Australia and other countries have seen significant growth of their markets while New Zealand's has stagnated (figure 2). The taskforce intends to do further work to better understand the reasons for these differences. Data on NZX listings show that over the past 15 years the attrition rate from the listed market is not out of line with that in other countries, but there have been comparatively few "births".[2] From 1992-2007 there were only 138 new listings on the main board of the NZX, almost matched by the 127 de-listings. In addition, compared to companies listed in other markets New Zealand companies tend to pay relatively high dividends, rather than retaining earnings for reinvestment. In other words, our market is dominated by "yield" rather than "growth" companies.

Figure 2 Domestic market capitalisation/GDP for selected countries, 1990-2007



Source: World Federation of Exchanges, Times Series Statistics, Equity Markets; OECD National Accounts, Exchange Rates

Short-term debt markets are dominated by banks, while the small domestic corporate bond market is mostly comprised of infrastructural and SOE issuers that have very solid credit ratings. While debt securities markets are relative small in New Zealand, there have been a number of very successful retail bond issues this year.

(b) Patchy private markets that are not well linked to public markets

New Zealand's economy is dominated by SMEs. These companies have a high reliance on bank debt and little access to alternative sources of external financing. New Zealand has one of the most bank-dominated financial systems in the OECD. Some SMEs with high growth potential may be constrained by the availability of funding, and there is not a well developed pipeline to public markets.

[2] See Lawrence, et al. (2009).

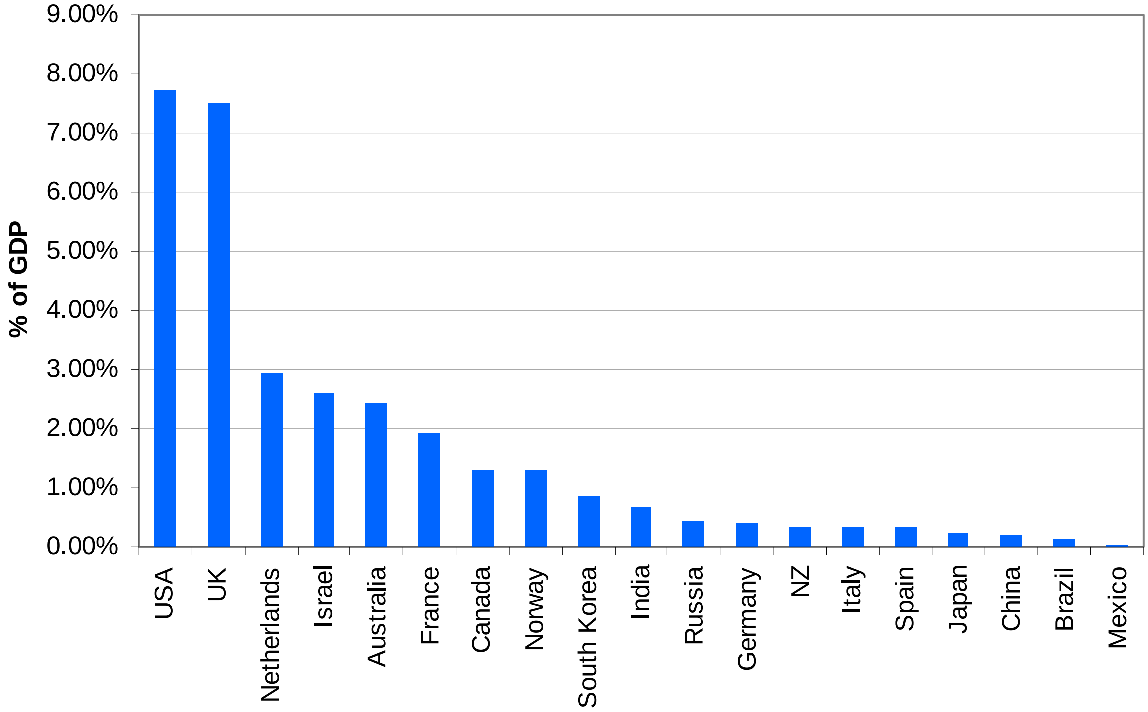
For privately held companies, most capital is provided from families and individuals, retained earnings and institutions. The firms in the market, and their capital structures, are heterogeneous and there is relatively little information about the market. However, we know from surveys[3] that few companies rely on outside capital, or on outside talent for governance or advice. From a capital market perspective there are issues on both sides of the market – owners tend to be sceptical about the benefits which capital markets can bring and often have little ambition to grow their businesses, while investors often find it difficult to access investment opportunities in this part of the market.

A subset of private companies is funded via organised private equity or venture capital firms. Private equity is well integrated across New Zealand and Australia at the buy-out end of the market. Australasian private equity funds continue to raise capital with a mandate to invest in New Zealand, which they treat as part of an Australasian market.

Private equity fundraising activity in New Zealand is low, however, with few local investors participating in this market. Private equity in New Zealand, particularly early stage investment (into firms that are growing but are not yet profitable) suffers from:

- small pools of institutional funding.
- a shortage of talent; and
- a limited track record.

Figure 3 Private equity raised 2002-2007



Source: NZVIF

Venture capital market activity over recent years is encouraging but modest. The level of venture capital investment in 2007 was substantially higher than in 2004 (0.04% versus 0.01%), and New Zealand's ranking shifted up the international ranks considerably.[4]

[3] E.g. the ANZ Privately Owned Business Barometer.
[4] Josh Lerner and Stuart Shepherd "*Venture Capital and its Development in New Zealand*", (16 June 2009).

(c) Underdeveloped derivatives market

As a small, open economy, New Zealand is vulnerable to shocks to export and import prices, exchange rates, credit conditions, and other economic risks. Derivatives provide a way to shift some of these risks to the parties best able to manage them. For example, we have a well-developed over-the-counter market for foreign exchange derivatives, which helps firms to hedge exchange rate risk.

It might be expected that, as a country with a significant primary sector, New Zealand would have a wide range of commodity derivatives. These are underdeveloped , however (although NZX will launch a dairy instrument later this year). This makes it more difficult for producers to manage risk. In addition, derivatives markets can contribute to the functioning of the underlying physical markets by improving liquidity and information assimilation.

Further, New Zealand has no derivatives exchanges of its own. A limited range of New Zealand financial derivative contracts are listed on the Sydney Futures Exchange, of which only the 90-day bill future is liquid.

(d) Low levels of investment in capital market products

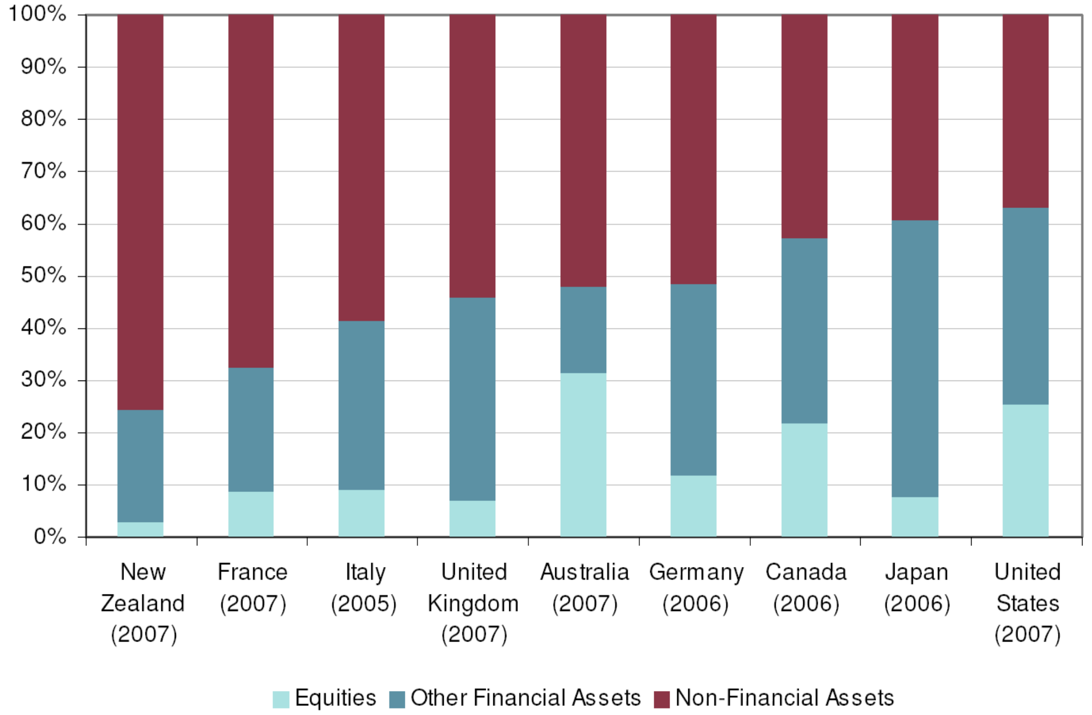
Levels of household wealth are moderate by international standards but it is the very different portfolio composition of New Zealand households compared to other countries that distinguishes us.[5] New Zealand household assets are heavily weighted towards housing, and that imbalance has increased over time. This has been at the expense of other assets, particularly financial assets. New Zealanders have the lowest holdings of financial assets of the nine countries compared in Figure 4, and New Zealand is the only country to have experienced a decline in household net financial wealth relative to income over the past twenty years. The composition of financial asset holdings is also heavily tilted towards low-risk and high-liquidity assets such as bank deposits and high-risk debt (e.g. finance companies), with little in-between (investment-grade debt). New Zealand households have the lowest share of financial assets invested in equities (12% compared to an average of 29% for the nine countries compared).

There is likely to be a wide range of reasons for our limited investment in capital market products. They include a limited range of investable assets in some sectors (see the following subsection) and the relative generosity of New Zealand Superannuation, which reduces the need for separate retirement saving for many New Zealanders. In addition, work undertaken by Janice Burns and Maire Dwyer in 2007, and much of the prior academic literature, noted the contribution of rapidly rising house prices from 2002-2007, a strong preference for larger and second homes, underdevelopment of pension funds, and a widespread perception that capital markets (equity markets in particular) and other financial assets are relatively risky with insufficient reward. Many investors do not trust capital markets with their savings, lack the ability to navigate through the complexities of financial assets, and do not seek out or receive adequate financial advice. There are also biases in tax settings and other policies in favour of housing. These are discussed further below.

---

[5] See Davis (2009), on our savings practices. This paper was commissioned for the taskforce.

Figure 4 Composition of household saving (latest available year)



Source: OECD

(e) A large number of co-operative, government owned, foreign-owned, and smaller companies have chosen not to participate in capital markets

The New Zealand economy has a number of structural features that reduce the investment opportunities available to investors and limit firm participation in capital markets:[6]

i. Significant New Zealand export industries such as agricultural production and processing are based around co-operative enterprises who have (with a few exceptions) chosen not to participate in public equity markets.

ii. Some industries such as utilities, ports, rail and air transport have significant central and local government ownership. In many countries these would be privately owned or would have some listed equity. Air New Zealand is the only New Zealand company largely owned by central government that has listed equity, and there are only a handful of listed companies that are partly or majority-owned by local government.[7]

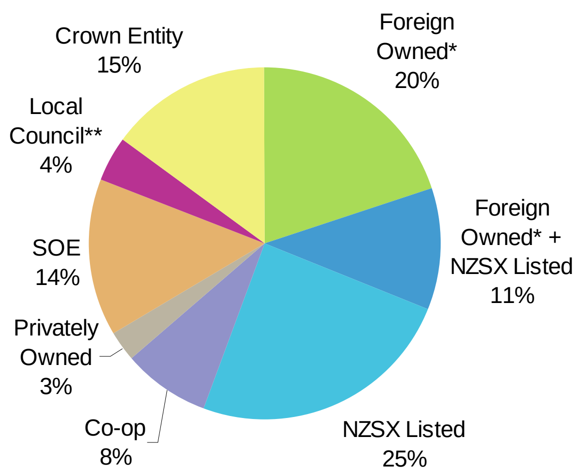
iii. Many of New Zealand's largest companies are subsidiaries of foreign companies, and few of these choose to raise equity in New Zealand. Of the companies listed in New Zealand Management Magazine's top 200, 116 are majority foreign-controlled, and of these only 14 are listed. In contrast, the top 200 includes 50 New Zealand-owned companies (excluding co-operatives and government-owned companies), and of these 40 are listed on the NZX.

iv. Relative to its size, New Zealand is the headquarters for relatively few "global sized" firms that are large contributors to the capital markets compared to other small, open economies. In the Forbes list of the 2000 largest public companies for 2009, New Zealand had only two entries – Telecom ranked at 1575 and Fletcher Building ranked at 1720

[6] See Evans (2009) and an MED (2009) note on the structure and ownership of the New Zealand economy. These pieces were commissioned for the taskforce.
[7] E.g. Auckland International Airport, Port of Tauranga, and Lyttleton Port of Christchurch

(were Fonterra listed, we would have three) – and the market capitalisation of these firms is less than 10% of GDP. In comparison, Australia has 46 Forbes 2000 companies, and all of the small Nordic countries have at least 10. In all these countries, the market capitalisation of Forbes 2000 companies exceeds 80% of GDP.

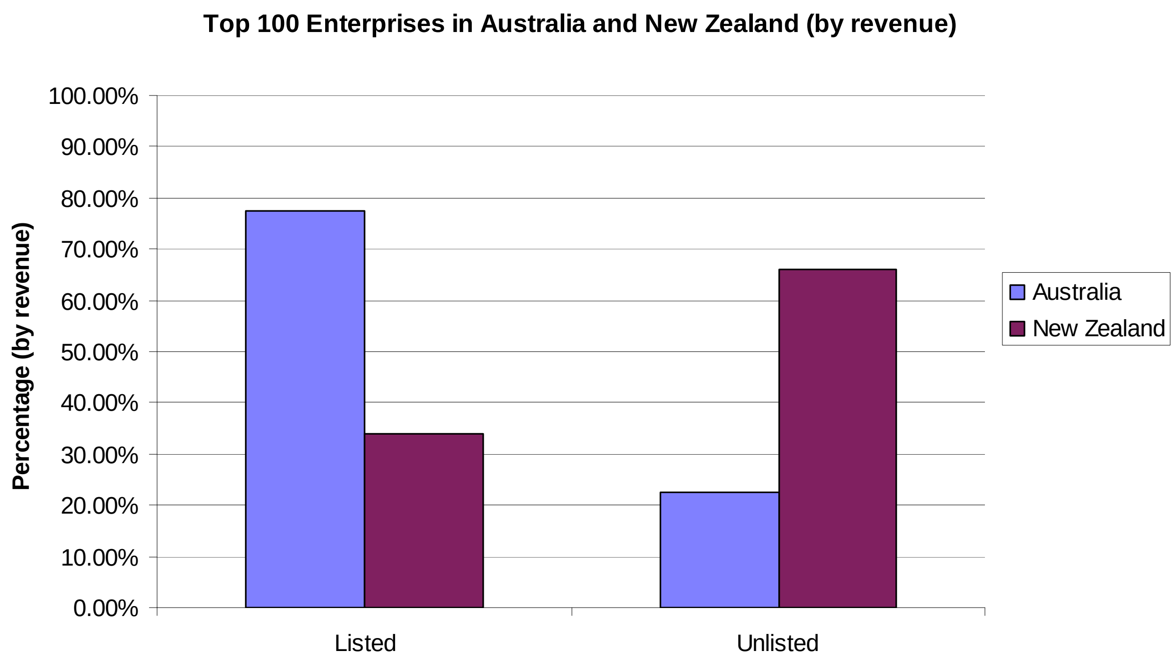
Figure 5. Ownership of New Zealand's largest 200 companies, weighted by equity



Source: New Zealand Management Magazine December 2008.

**** More than 50% overseas controlled***
***** Includes Regional Community Trusts***

Figure 6 Extent of public market listings in Australia and New Zealand



(f) Investor outcomes undermined by poorly regulated financial intermediaries and advisors and their practices

Capital markets require a well-designed regulatory environment. For the most part our capital markets are well-served, for example through continuous disclosure by listed issuers. However, weaknesses in regulation, poor issuer and adviser incentives, and low investor literacy have allowed many issuers to offer products with higher risk than justified by the returns, and to engage in practices that harm investors and the reputation of the capital markets in general. This points to problems in financial regulation, corporate governance and financial reporting.

The most prominent recent example of this has been the finance companies. In many cases, these offerings were characterised by confusing and misleading disclosure of risks, inadequate supervision by trustees and statutory regulators, and uninformed and ill-advised investors. Finance companies were thus able to offer much lower interest rates than were justified by their risks, and to engage in a variety of practices that raised risks further.

Some commentators have also noted that there are problems in the managed funds industry. It has been suggested that fees are not always transparently disclosed, investors lose ownership and control over their funds, and there is a lack of independent trustee supervision over parts of the market. Investor distrust of managed funds appears to be widespread.

(g) Significant problems in the market for financial advisers

Financial products are inherently complex. For investors to make good decisions, they require trusted and competent sources of financial advice. Many of the problems faced by investors in recent years have come from deficiencies in the market for financial advisers. These include ongoing conflicts of interest (particularly where advisers receive commissions or are effectively salespeople for particular providers), low levels of competency, and inadequate disclosure of conflicts and fees. The Financial Advisers Act will help to address many of these issues, but implementation will be critical, as discussed in the following section.

(h) Outdated regulation and unnecessary compliance costs for issuers

As well as providing better choices and outcomes for investors, regulation must also allow low cost access to capital markets for companies. An irony of the current regulatory system's emphasis on disclosure for new securities offerings is that, despite its providing little guidance for investors, much of it is highly prescriptive and costly for issuers to comply with. These costs are particularly onerous for small businesses, which make up the bulk of New Zealand's economy. There is also a lack of regulatory clarity for some products, such as derivatives, which stifles innovation.

We welcome the Government's announcement of the Securities Act review and will be working with officials to look at the overall regulatory framework. The role and scope of regulatory organisations will be part of that. Regulatory reform in capital markets has tended to be ad hoc, responding to problems. There is now opportunity to stand back and look afresh. As noted earlier, it is especially important to get the regulatory framework right, given the financial crisis.

(i) Inadequate analyst research coverage of quoted securities

There are also weaknesses in the market for information. Work commissioned for the taskforce has found that no analyst research is available on 42% of companies listed on the NZX, and a further 13% of companies have only one or two analysts covering them.[8] Research on the smaller companies is of variable quality and not readily accessible to all potential investors. Analyst coverage has been shown to improve the liquidity and depth of securities and raise prices, thus lowering companies' cost of capital. It also improves market efficiency. Similar problems have been documented in other countries, although the issue may be more acute in New Zealand as our listed companies are on average smaller than overseas. As a result, traded volumes tend to be lower, making it uneconomical for the broking industry to research those companies.

(j) A clearing and settlement infrastructure that may not best suit New Zealand's needs

Clearing and settlement infrastructure is a vital and often neglected part of a country's financial system. This infrastructure has received increasing attention in the wake of the financial crisis as it is important for risk management. The taskforce is reviewing New Zealand's clearing and settlement regime to consider what system will best suit our needs. A taskforce working group has engaged an international expert to conduct the review, which will recommend a future clearing and settlement system configuration that is efficient, integrated, internationally competitive, responsive to capital market innovations, credible in the international marketplace, and low risk. It is anticipated that the taskforce will publish the report of the consultant, and their response to that report, in September or October.

(k) Tax settings which may be constraining capital market development

It is clear that tax considerations are much broader than just capital markets, and tax policy cannot be set for just one part of the economy. But, the taskforce will be identifying areas where tax policy can impact on capital markets. There is a prima facie case that some tax settings are a barrier to capital market activity. These include the tax treatment of corporate bonds, offshore income distributed to non-resident investors, annuities, and capital gains. There are also perceived biases in tax settings and other policies in favour of housing.

(l) New opportunities for New Zealand in the international financial services market

The financial crisis is significantly changing aspects of how financial services are conducted globally, providing new opportunities for New Zealand to participate in international financial services. The taskforce is looking for ways in which New Zealand can leverage its competitive strengths to play a greater part in the market for international financial services.

Relationship to Government's existing regulatory work programme

We are aware that the Government is undertaking a number of significant initiatives that will help to address the above issues:

---

8 Esperance Capital, *The Research Market In New Zealand: Equity and Debt* (July 2009). This report was commissioned for the taskforce.

- Finalising the regulations for the Financial Advisers Act 2008 and implementing this regime. The Financial Advisers Act attempts to improve the quality of financial advice. It will be important to ensure that the detail of how it is implemented achieves the aims sought, while minimising adverse side effects.
- Implementing prudential supervision for non-bank deposit takers, under the Reserve Bank Amendment Act 2008.
- The MED report, *Changes to Securities Regulations*, proposes to implement a number of the recommendations in the taskforce's first interim report to cut unnecessary compliance costs. The taskforce welcomes these proposals, and has made a submission which includes additional amendments to the Securities Regulations 1983.
- Implementing the simplified disclosure prospectus for listed issuers, and other elements of the Securities Disclosure and Financial Advisers Bill.
- Passing the legislation currently before Parliament to allow for designated settlement systems is a priority and should happen as soon as possible.

Government has an ambitious and wide-ranging work agenda in this area, including starting a comprehensive review of the Securities Act 1978, and there is considerable overlap with the issues the taskforce is considering. Rather than duplicating work already underway, we will continue to work closely with Government and officials to ensure that we allocate our resources to where we can make the most effective contribution. We will also provide input on current initiatives as appropriate and clear signals as to our views of priorities.

The appendices to this report include some changes to laws and regulations that we think will be straightforward to implement. These include changes that will complete our November interim report to make it easier for small companies to raise capital. We think these should be introduced before the end of the year.

In our view, New Zealand has an opportunity to stand back now from ad hoc changes to our legislation and think carefully about the overall framework that would best suit New Zealand and build on its strengths. We expect our final reports will provide a good foundation for this work.

IV The taskforce's final reports

The taskforce's final reports will address the issues identified above and provide recommendations in the following areas:

(a) Regulatory changes to improve investor outcomes in financial products and advisory markets

There is a need to improve investor outcomes in capital markets if they are to be active and confident participants in those markets. Underpinning outcomes is investors' ability to trust issuer and adviser firms to treat them ethically. Ultimately, a "healthy market" reflects an appropriate range and quality of investment opportunities and investors' ability to make decisions selecting the most appropriate products for their circumstances. An important aspect of this is investors' ability to obtain and assess key information, and to have confidence in advice received by professional advisers.

Morningstar recently undertook a study[9] that measured the experiences of managed fund investors in 16 countries in North America, Europe, and Asia. The fund management industry and regulation in New Zealand scored last out of the 16 countries examined. With regard to investor protection and transparency in prospectuses and reports, New Zealand attained the worst possible grade of D-. Morningstar observed that the Securities Commission is under resourced, and fund custodians are not required to be independent. Morningstar also reported inadequate requirements for disclosure of portfolio holdings, fees, and portfolio managers. This indicates that, in at least some parts of our market, we have a long way to go to come into line with international best practice and thus cultivate preferable outcomes for investors.

There is a need for more principles-based regulation focussed on ethical standards for issuers and advisers. This is because detailed rules have struggled to keep up with innovative financial markets. It has also been commonplace for firms to employ creative strategies to arbitrage around these rules. Regulation should be aimed at achieving the following five objectives:

1. The fair treatment of customers is central to the corporate culture of firms.
2. Consumers are given effective, clear and accurate information about products and advisers.
3. If customers receive advice, it takes account of their circumstances.
4. Products perform as firms have led customers to expect, and service is of an acceptable standard.
5. Consumers do not face unreasonable barriers if they want to change product, switch provider, submit a claim or make a complaint.

Some specific areas of focus for improving investor outcomes include:

- Key information investors need should be provided up-front in offering documentation and should be easy to understand without jargon and complex legal wording. It should facilitate key decision-making: to invest, seek further advice from experts, or avoid

[9] Rekenthaler, Swartzentruber, Sin-Yi Tsai, "Global Fund Investor Experience," (May 2009), Morningstar Fund Research. The full report can be found here: http://corporate.morningstar.com/us/documents/MethodologyDocuments/ResearchPapers/MRGFI.pdf

unsuitable products. Where offering documentation could lead directly to an investment, it should be easy to make comparisons between different products and issuers, and to assess risk-return tradeoffs.

- Financial products aimed at retail investors need to be designed to use transparent structures and employ checks and balances that set appropriate incentives on issuers. For example, greater fee transparency is needed.
- Investors need trustworthy and competent financial advice to make investment decisions.
- Investors need to be better educated about the basic information needed to invest, and who to obtain advice from.
- Regulators need the powers, resources and incentives to act early and decisively against issuers and advisers violating accepted standards, rather than being the "ambulance at the bottom of the cliff".

The Financial Advisers Act 2008 will go a long way to fixing the advisers market, but implementation will be critical. If incorrectly implemented it could produce an occupational licensing regime which ultimately benefits service providers rather than retail investors. Appendix I contains more detail of the principles the taskforce considers important in this area, and some more specific recommendations for change. The taskforce will include further work in this area in its final reports, including on collective investment schemes.

(b) Improved regulation to reduce costs and uncertainty for issuers

The taskforce made a number of recommendations in its first interim report to lower compliance costs for both listed and unlisted issuers. We congratulate the Government and officials for their rapid response to implement many of those recommendations. Appendix II in this report furthers this aim with a number of suggestions for additional changes to laws and regulations. These have been drawn from discussions with many legal practitioners, along with the recent report of the New Zealand Venture Capital Association, *Regulatory and Tax Recommendations*. We thank all those who have contributed. We think that legislation implementing these amendments should be introduced before the end of the year.

The Securities Act is in need of a more fundamental review, for example around the distinction between public and private securities offers, and an overhaul of disclosure requirements. We support the Ministry of Economic Development's review of the Securities Act, and intend to work closely with the Ministry to provide input into this.

(c) Tax changes

The taskforce is undertaking significant investigative work on taxation issues. It is important that any specific changes to remove barriers to capital market activity form part of a coherent tax system. As well as the taskforce's own work on tax, a number of taskforce members are on the Government's newly established Tax Working Group, which will consider the medium-term direction of the tax system.

The taskforce will be reporting on tax issues in its final reports.

(d) Rethinking the role of government

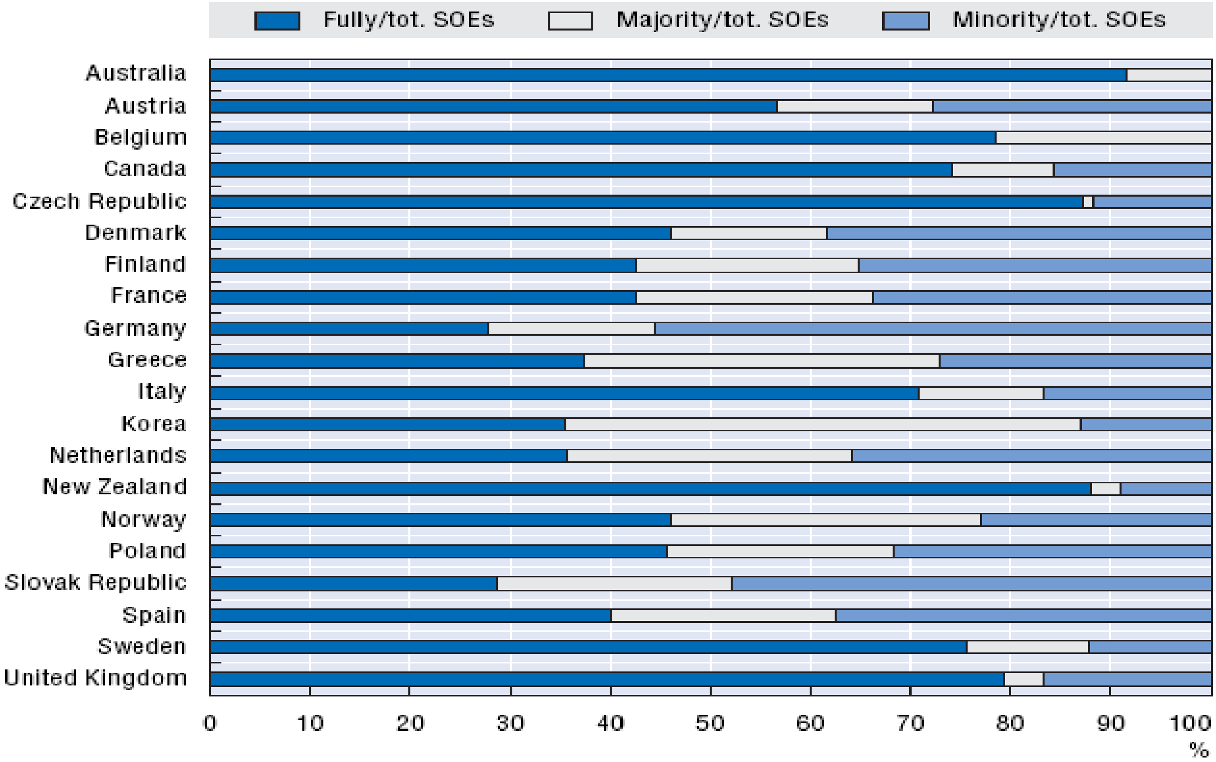
While the above changes are largely regulatory, we should also signal that we see a broader role for government being appropriate in some areas. Governments are actively involved in capital markets in a range of ways and we need to to ensure their involvement is appropriate and used to best effect. Robert Merton has argued that governments have four roles in financial markets, in addition to their role as a regulator. They act as:

- *Direct participants*. A number of public sector organisations are active in our capital markets. This includes debt issuance, government ownership of companies and other assets, and the New Zealand Superannuation Fund and the New Zealand Venture Investment Fund. Government should leverage this involvement to aid capital market development where that will benefit the economy.

  Central and local governments are issuing increasing quantities of debt. We welcome NZDMO's moves to issue government bonds with maturities of around 10-12 years. We encourage the Government to continue this trend by issuing bonds with maturities of 20-30 years, and to consider issuing retail bonds. A liquid sovereign yield curve has spillover benefits to the rest of the market; in particular it serves as a benchmark for the pricing of longer-dated corporate bonds, and supports the development of some financial products, such as annuities. The taskforce has also been working actively to help develop the local authority bond market and there may be a role for government in facilitating that.

  As owners of businesses, central and local governments are equity market participants. However, relative to many other countries, governments in New Zealand generally choose to control their businesses through 100% ownership, rather than partial stakes (see Figure 7). This both limits government's ability to benefit from the disciplines that capital markets can bring to the management of those assets and reduces the ability of the public to directly invest in those assets. Various ideas for how government can participate more in equity markets without compromising control over its assets have been discussed in recent years and we will be exploring this further.

Figure 7 Ownership of state-owned enterprises in OECD countries



Source: OECD, Questionnaire on Corporate Governance of State Owned Enterprises, 2003.

- *Industry competitors and benefactors of innovation*. In some cases there is a role for governments to take a lead in encouraging innovation. An example is the introduction of Kauri bonds. That market would not have developed to the current extent without the support of the Reserve Bank.

We welcome the fact that the Reserve Bank has explicitly included a secondary objective around supporting capital market development in its latest Statement of Intent. A similar objective may be appropriate for other public sector organisations.

Similarly, in establishing initiatives such as KiwiSaver, the Government, through the design of these programmes, exercises a considerable degree of influence on the outcomes for capital markets. In our final reports, we will consider ways in which government can leverage further from those kinds of initiatives. One possibility, raised at the Job Summit, would be to allow default KiwiSaver funds to invest a greater proportion of their assets into equities, for example, via a life-steps type fund.

We are currently investigating whether there may be a case for government to encourage research on small quoted companies in New Zealand. These companies are currently not covered or poorly covered by research analysts, and this is likely to contribute to low liquidity in securities markets.[10] Support for company research may be justified by its public-good characteristics such as non-rivalry, a significant fixed cost to produce the information and a low marginal distribution cost.

There are also likely to be areas where market failure (such as a coordination failure) means that action is required by government if New Zealand is to be able to take advantage of new opportunities. The taskforce is undertaking an extensive investigation

[10] Esperance Capital, *The Research Market In New Zealand: Equity and Debt* (July 2009). This report was commissioned for the taskforce.

into opportunities for New Zealand to attract a greater share of international financial services business. We aim to rigorously assess specific government initiatives that might support New Zealand to capture these opportunities, and their associated costs and benefits. We will provide recommendations on this in coming months.

- *Negotiators in international markets*. Governments negotiate with each other to lower international barriers to capital flows. These include harmonizing regulations, entering into mutual recognition agreements, and double tax treaties. The taskforce supports calls for updating and widening double taxation treaties, which have fallen out-of-date and tend to concentrate on traditional trading partners at the expense of emerging markets.

  With respect to the Single Economic Market (SEM) and broader international integration, we are unclear as to whether there are specific measures to prioritise here. Evidence suggests we are already very highly integrated with Australia and the Asia-Pacific region as a whole. There are many ways to approach the SEM, and the taskforce is wary of adopting inferior legislation or regulatory approaches simply because they happen to be in existence in Australia. With careful planning, we believe that we can achieve further capital market integration, but advantage New Zealand as a destination and market in certain areas.

- *Unwitting interveners*. Broader tax and regulatory settings and other interventions can either help or hinder the functions of capital markets. An example of this is the Overseas Investment Act. While aimed at ensuring benefits to New Zealand from foreign investment, it has a number of adverse consequences for our companies and capital markets. We provided advice on this in our November interim report and are keen to provide further input into the Treasury's current review of the Act.

V Next steps

Our reporting deadline has been extended until mid-December 2009 to reflect the additional work we have undertaken in response to the financial crisis.

We will shortly release the research commissioned to date to inform our work, including reports on the links between capital markets and savings practices, international integration, talent, the research market, financial literacy and the structure of the New Zealand economy.

Over coming months, we will release further reports as they are completed. These include reports on the clearing and settlement infrastructure that best suits New Zealand's market and on the opportunities for New Zealand in global financial services. Our final reports, due in mid-December, will complete our work. They will cover issues ranging from the role and structure of regulatory institutions, through to the role of government in capital markets, tax and the regulatory regime for collective investment schemes.

Appendix I Principles for Improving Investor Outcomes

1. Where do we want to get?

What would a "healthy" market look like for investors?

- Access to a full range of suitable products.
- Ability to increase their financial well-being by making informed investment decisions.
- Confidence to participate without fear of being "ripped off" or misled.

2. How do we get there?

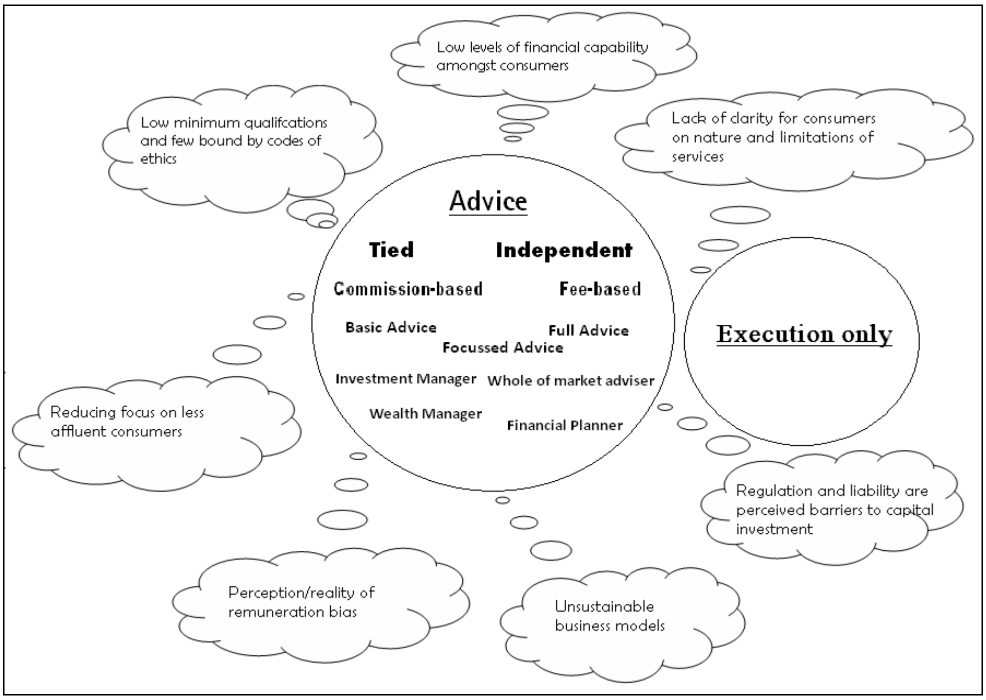
The recent Morningstar report indicates that at least in parts of our market, we have a long way to go to achieve the outcomes above.[11] Underpinning these outcomes is investors' ability to trust issuer and adviser firms to treat them ethically. Ultimately, a "healthy market" reflects an appropriate range and quality of investment opportunities and investors' ability to make decisions selecting the most appropriate products for their circumstance. An important aspect of this is investors' ability to obtain and assess key information, and to have confidence in advice received by professional advisers.

Why is intervention required to achieve a "healthy market?"

Information asymmetries arise (between issuer/investor and adviser/investor) because the benefit of disclosure is not always captured by the issuer/adviser. Hence, they have limited incentives to disclose information effectively. In addition, advisers may have direct incentives to promote particular investments which are not in their client investors' interests. This results in "agency problems" being commonplace in capital markets. Moreover, an insufficient level of financial literacy amongst investors compounds the lack of confidence to invest. The combined effect is to increase the cost of capital in New Zealand because a higher price is required to compensate for the level of risk perceived by investors and to achieve investor participation in parts of the capital markets. The diagram below illustrates the various problems in the retail investment market.

[11] Rekenthaler, Swartzentruber, Sin-Yi Tsai, "Global Fund Investor Experience," (May 2009), Morningstar Fund Research. The full report can be found here: http://corporate.morningstar.com/us/documents/MethodologyDocuments/ResearchPapers/MRGFI.pdf

Figure 8. Issues in the retail investor market



Source: FSA

What are the principles required to achieve the desired outcomes?

This section proposes principles to achieve a healthy market for investors. Firstly, principles are established for the market as a whole. The discussion then looks more specifically at how these might apply in particular parts of the market: financial advisers, product disclosure, and managed funds.

Principles-based regulation, focussing on ethical standards, is particularly important in the financial services industry as it has typically been difficult for detailed rules to keep up with the innovative and complex nature of financial markets. Moreover, it has been commonplace for firms in this industry to employ creative strategies to arbitrage around set rules.

The Market as a Whole: Treating Customers Fairly

Proposal: The taskforce proposes that the Government introduce a regime that generally requires all firms participating in the retail investment market (e.g. issuers and advisers) to treat customers fairly.

This could be modelled on the “Treating Customers Fairly” regime (TCF) currently being implemented by the UK’s Financial Services Authority (FSA). This principle-based initiative establishes a number of objectives that all firms are required to integrate into their business culture. It is the responsibility of senior management to decide what this means for their particular firm, and to take responsibility for ensuring that all staff members/firm representatives act in accordance with these principles.

For example, all finance sector firms should be required to adhere to the following objectives:

1. The fair treatment of customers is central to the corporate culture of firms.

2. Consumers are given effective, clear and accurate information about products and advisers.

3. If customers receive advice, it takes account of their circumstances.

4. Products perform as firms have led customers to expect, and service is of an acceptable standard.

5. Consumers do not face unreasonable barriers if they want to change product, switch provider, submit a claim or make a complaint.

How should standards be enforced?

In order to restore public confidence in retail investment markets, and for any new standards of conduct, competency or disclosure to be effective, the standards need to be policed effectively. Regulators need to be seen as taking a proactive and strict approach to enforcement. This could include high profile, publicly announced spot checks of advisers and issuers to ensure their compliance. When making assessments, regulators should take the point of view of the investor, and the burden of proving compliance should lie with the issuer/adviser. Where appropriate, there need to be avenues of redress for adversely affected investors.

In the UK, the FSA has signalled that it will use its full range of regulatory powers to take tough enforcement action in circumstances where a firm's systems of actions leave open the potential for significant consumer detriment, and is working to embed TCF into its regulatory and supervisory approach. In an initial assessment, firms will have to prove to the FSA that they have put practices into place to achieve the TCF outcomes, and delivery of TCF will then be tested as part of FSA's usual supervision of firms.

Financial Advisers

For the market to work well, we need to ensure that advisers have appropriate incentives to act in their clients' best interests. This requires that:

- The adviser market is ethical, competent, competitive, independent and accessible.
- Financial advisers have legal obligations and incentives to act solely in their clients' interests. The "agency problem" is reduced to the lowest level reasonably feasible.
- Financial advisers are held accountable and investors receive appropriate redress when advisers breach the codes.
- Investors are sufficiently informed and financially literate to take some responsibility for their own investment decisions and make *appropriate use of* (rather than suffer from *over-dependence on*) financial advisers. Whether investors understand the implications of any disclosed conflicts of interest is also an important consideration.

This should result in a market where:

- Investors are able to confidently engage a financial adviser who provides independent, well-grounded advice and acts in the investors' best interests.
- Investors have a good understanding of the services provided. This includes the cost and nature of products offered.

Proposal: Ultimately, this requires that a clear fiduciary duty be placed on financial advisers. The taskforce proposes that such a duty be established in New Zealand.

Has this been done elsewhere?

In the US, the anti-fraud provisions of the Investment Advisers Act of 1940 and most state laws impose a duty on investment advisers to act as fiduciaries in dealings with their clients. This means that advisers have a fundamental obligation to act in the best interests of their clients and thus hold the client's interest above their own in all matters. Conflicts of interests are to be avoided at all costs, although in some instances this will be impossible. Where this is the case, this must be disclosed to the clients as well as an explanation as to how the adviser will maintain impartiality in its recommendations. The Securities Exchange Commission (US) has said that an adviser has a duty to:

- Make reasonable investment recommendations independent of outside influences.
- Select broker-dealers based on their ability to provide the best execution of trades for accounts where the adviser has authority to select the broker-dealer.
- Make recommendations based on a reasonable inquiry into a client's investment objectives, financial situation and other factors.
- Always place client interests ahead of its own.

In the UK, institutions have a duty of care to investors which imposes similar obligations.

Product Disclosure

There are a number of principles for effective product disclosure in order to meet objective 2 above:

- Disclosure for offers of securities to the public should be timely, concise, explicit, and accessible to all investors.
- Key information should be provided up-front and be easy to understand without jargon and complex legal phraseology; this should facilitate key decision-making: to invest, seek further advice from experts, or avoid unsuitable products.
- Disclosure should be highly standardised; this is because even if comprehensive disclosure exists, each firm will put this in a form that casts their data in the most favourable light and limits the ability of investors to make comparisons across firms. This may require regulatory prescription as proposed in section 3 below.
- The financial literacy of investors needs to be considered alongside any enhanced or standardised disclosure.

Managed Funds

At present, investors in managed funds do not retain individual ownership of their funds. Rather, the legislated norm is currently for investor monies to be put into separate legal entities – super funds, unit trusts and other collective investment vehicles or group investment schemes – where they lose the direct claim on their property and have to rely on trustees or managers of that separate entity to protect their assets. Individual members are not allocated specific assets, but a unit of the whole fund.

Arguably, this approach is flawed. For open funds, it is problematic as it means individual members' asset holdings may be distorted when other members buy or sell units in the fund. For a closed fund where all members leave the fund at the same time, it is not as much of an issue.

Fund managers should have the responsibility to act as carers for investors' property. Investors' property rights are preserved and this results in managers and trustees maintaining a fiduciary duty to individual contributors.

3. Further Proposals

This section outlines a number of more detailed measures, consistent with the principles above, to achieve a healthy market for investors. These actions partly specify potential avenues for meeting the desired outcomes within the "treating customers fairly" framework.

Financial Advisers

This section first looks at the work already underway to address the issues around financial advisers, and then discusses additional proposals to further this work.

How are the issues around financial advisers currently being addressed?

In New Zealand, the Financial Advisers Act 2008 is currently being implemented. This, together with the Financial Service Providers Act 2008 establishes a registration and licensing regime.[12] The legislation also:

- Requires disclosure by financial advisers to help ensure that investors and consumers can make informed decisions about whether to use a financial adviser, and whether to follow a financial adviser's advice.
- Requires competency of financial advisers to help ensure that financial advisers have the experience, expertise, and integrity to match effectively a person to a financial product that best meets their need and risk profile.
- Ensures that financial advisers are held accountable for any financial advice that they give and that there are incentives for financial advisers to manage conflicts of interest appropriately.

In our view, this will go a long way towards achieving what is needed to improve investor outcomes, but further changes may be required. For example, the legislation itself does not establish a fiduciary duty on financial advisers, but whether one will ultimately be imposed will

[12] Note that the Taskforce recognises a number of risks associated with occupational licensing such as creating barriers to entry or those pointed out by Friedman (1962). Notwithstanding this, it is clear that the market as it currently operates is not working, and we accept the Government's move to establish a licensing regime. However, careful thought needs to be given to ensuring this regime is implemented in ways that reduce the impact of any unintended adverse effects.

depend on the Code of Professional Conduct (which is yet to be drafted). The Taskforce also proposes that the legislation should restrict the use of certain words as outlined below. We will be working with officials and the Securities Commission as they consult on how to implement the regime and our final reports will contain further recommendations in this area.

Proposal: Restrict the use of the words "independent adviser"

Why would this help?

The words "independent adviser" are likely to give consumers the perception that they are receiving objective advice on a whole range of products, and that this advice is solely in their best interests and not influenced by any other factor. This is often not the case, but investors may not realise this. Restricting the use of these words should make any lack of independence clear.

How should the use of these words be restricted?

If the adviser receives and retains any incentives from issuers or fees apart from those paid directly by clients, or any other kind of incentive from issuers are received, or the adviser is restricted to providing advice on products from anything less than the full range of providers, the use of the words "independent adviser" should be prohibited. Anyone using the label of "independent adviser" will have the obligations of a fiduciary duty as described above.

Has this been done elsewhere?

The Corporations Act in Australia restricts the use of certain words, such as 'independent,' 'impartial' and 'unbiased.' For example, adviser entities cannot call themselves 'independent' unless any commissions they receive are rebated in full to their clients.[13]

The Financial Planning Association of Australia (FPA)[14], also appears to be heading down this route. They have recently recommended that product commission payments to financial planners be phased out and that fee based remuneration becomes the standard model for financial planning advice. If adopted, the changes will apply to new clients from 2012.[15] The intention to transition away from product provider influence over financial planner remuneration and to require planners to set their own charges for their advice and services, and then negotiate these with the client. The association also questions whether the term "financial planner" should be restricted in application to those who offer fee based charging exclusively.

---

[13] Corporations Act 2001 (Australia) S923A

[14] The FPA is the leading professional body for financial planning in Australia. There are currently around 12,000 members (individuals and businesses), 9000 of whom are practising financial planners. Members are bound by a code of ethics, high professional standards and must meet continuing professional education requirements.

[15] FPA Consultation Paper, "Financial Planner Remuneration," April 2009

The idea is based on the following six principles for financial planner remuneration:

- Consumers must be able to understand the fees they are paying
- Consumers must be able to compare the fees they are paying
- Consumers must be presented with a fee structure that is true to label
- Consumers must be presented with fees that are separated from advice and product
- Consumers must agree the fee with their financial planner and should be able to request that the fee is switched off if no on-going advice is being provided
- Consumers should pay for financial planning services, not product providers

The UK's FSA has also recently announced that they are considering requiring financial advisers to explicitly classify themselves as providing "independent advice" (all products) or "restricted advice" (can only recommend the firms' own products). They also propose to ban product providers from offering commission to adviser firms and, in turn, to ban adviser firms from recommending products that automatically pay commission.

Product Disclosure

Current disclosure documents are both costly for issuers to prepare and not useful for most investors (or their advisers). A more simplified, concise and standardised approach to what is required is likely to help. The FSA has recognised this and is currently undertaking work to bring disclosure documents into line with these principles to improve their effectiveness.

The Taskforce makes three specific proposals in this area: to mandate a one- or two- page disclosure document targeted at unsophisticated investors, to standardise fees disclosure across all forms of disclosure, and to create a centralised website for disclosure documents.

Proposal: Mandate a one- or two-page disclosure document

What would be the purpose of this?

This document is intended to provide key information needed for investors to make an investment decision including whether or not to seek further advice. It could potentially replace the investment statement, which although aimed at providing information in a more accessible manner has not achieved its objective.

This document is to be targeted at less sophisticated investors, and needs to be presented in a way that induces such investors to read and understand it (e.g. via the use of a graphic designer or communications expert). It should also be standardised across providers to enable easy comparison.

Has this been done elsewhere?

The Committee of European Securities Regulators (CESR) is providing advice to the European Commission on the creation of a similar document called the Key Information Document (KID).[16] The KID is a two-page document which is intended to replace the current simplified prospectus for collective investment schemes.[17] The CESR is currently working on a number of technical

[16] The Committee of European Securities Regulators, "CESR's advice to the European Commission on the content and form of Key Information Document disclosures for UCITS," (February 2008), Ref.: CESR/08-087

[17] The document is to include the following information:

- Names of fund manager, and promoter/group
- Fund objectives and investment strategy
- Material risk/reward factors likely to affect the fund
- Indication of past performance
- Summary of charges payable directly and indirectly by the investor
- Treatment of income (paid out or capitalised)
- Where/how to find further information
- How the fund's home state taxation regime effects the investment
- Legal liability for the KID
- Identity of competent authority responsible for the fund

issues[18] as well as consumer-testing the initiative and is due to provide their final advice in October 2009.

What information should be included?

For ease of comprehension, the document should exclusively include information needed for investors to answer the following questions:

- What is the risk-return of this product (need to make clear this relationship, as this tends to be poorly understood and need to recognise that it will depend on the horizon under consideration)?
- Does this product meet my needs (i.e. stable income flow or capital growth)?
- Does this product help me diversify?
- How does this product compare to others (with regard to the above, as well as fees and charges)?

If investors seek more detailed advice, they can then refer to the prospectus. This could be aided by including signposts to the location of further information. Signposts could also point to financial education resources such as the "Sorted"[19] or Securities Commission websites.

How will the information be assessed?

There are a number of options for the assessment of the key information to be included in the document such as the nature of the investment and indications as to the risk and return of the product:

- Require independent assessment of these factors
  - While desirable from the investor perspective, someone would have to be chosen to undertake this work and it would need to be paid for. The more complex the assessment required (e.g. the level of risk), the greater the cost involved.
  - One option would be for a government agency to undertake the assessment – or to more simply confirm whether or not the product is a vanilla equity or debt issue, or a more complex product for which investors are encouraged to seek further advice.

- Issuer assessment
  - An alternative (and the current approach) is to allow issuers to assess their own products.
  - If this approach is taken, there must be severe penalties for misleading information.

- Date of preparation of the KID.

[18] Specifically, issues regarding disclosure of risk and reward (whether a narrative or synthetic risk-reward indicator should be used), past performance, and charges (consideration of a summary figure and options for presentation of overall fees).

[19] www.sorted.org.nz

Proposal: More standardised fees disclosure

What is the issue?

One significant difficulty with current disclosure documents is that fees information is not presented in a uniform way and is often vague and scattered throughout the document. This makes it very difficult to understand the fees that may be charged, let alone compare fees from different providers.

What is a potential solution?

If the one- or two- page disclosure document is adopted, this should simply include a single maximum total fee. More detailed fees disclosure should be presented elsewhere, such as the prospectus.

Has this been done elsewhere?

In Australia, the Corporations Amendment Regulations 2005 (No.1) sets out enhanced fees disclosure requirements. The regulations apply to superannuation products and managed investment products and require providers to include in their periodic and product disclosure statements (PDS) a set of prescribed disclosures in relation to fees. The regulations require the PDS to include the following components:

- A 'Consumer Advisory Warning Box' which alerts consumers to the importance of value for money and the compounding value of fees and costs and their impact over time on end benefits,
- A 'Fees and Costs' template which is a standardised fees table that simplifies the disclosure of fees and costs and allows for more effective comparison across products,
- An 'Additional Explanation of Fees and Costs' section which includes additional important information about fees and costs, and
- An 'Example of Annual Fees and Costs' which provides an illustrative worked example of fees and costs in a balanced investment option for a specified account balance and level of contributions.

Proposal: Centralised website for disclosure documents

The recent Morningstar report pointed out New Zealand's lack of a centralised website where disclosure documents of all public companies and investment funds can be easily accessible to investors with internet access. The introduction of such a website would enable investors to easily get information about investment options. The website could also allow investors to look at different investment options by type of option, risk level, minimum amount etc.

Managed Funds

Potential Solutions:

- Principles-based regulation could require trustees, directors and managers of funds to make a statutory declaration in the annual report each year that they have done nothing to further the interests of themselves or the fund, at the expense of any individual member.

- Use non-discretionary bare trusts instead of discretionary trusts as the intermediate vehicle that sits between investors and their money.

Appendix II Measures to complete our November interim report and reduce the cost of capital raising for small companies and in private markets

Since the release of the taskforce's interim report, we have consulted widely with industry participants on additional changes that would complement our first set of recommendations. These new recommendations are described in this section, and have been selected on the basis that they could be quickly implemented to reduce the cost of raising capital for small companies and private markets. Where we have received ideas that are not addressed in this report, we will be considering them for our final reports in September.

Summary of recommendations to reduce the cost of capital raising for small companies and private markets

PROPOSAL	IMPACT	EASE OF IMPLEMENTATION
Changes to the Takeovers Act 1993 and Takeovers Code		
1. Amend Takeovers Act to ensure that joint shareholders are counted as a single shareholder in determining whether the Code applies to unlisted firms, and reinstate $20 million asset minimum	High	Medium – Policy work and legislative change
2. Amend Takeovers Code to remove need for independent advisers report for small firms (if 1 not implemented)	Medium	Medium – Policy work and legislative change
Changes to the Securities Act 1978		
3. Amend requirements for Securities Commission exemptions to be gazetted to be consistent with Takeovers Panel	Low	Easy – Technical legislative change
4. Allow issuers to file section 37A(1A) certificates to extend the life of a prospectus and advise investors of a material adverse change to the company's financial position	Medium	Medium – Policy work and legislative change
5. Remove restrictions on pre-prospectus publicity	Low	Medium – Policy work and legislative change
6. Create a statutory exemption in the Securities Act for employee share schemes	Medium	Medium – Policy work and legislative change
7. Remove voiding of entire offers when they are taken up by a single member of the public	Low	Medium – Legislative change
8. Certification of a wealthy person should occur any time 12 months prior to subscription, rather than prior to the offer	Low	Easy – Technical legislative change
9. Allow $500,000 minimum subscription for non-public offers to be paid in instalments	Medium	Easy – Technical legislative change
10. Remove vendor shareholder liability in IPO exits	Medium	Medium – Legislative change
Changes to the Securities Regulations and Exemption Notices		
11. Amend the venture capital scheme exemption to increase the range of issuers that can use it, and the cap.	Low	Easy – Securities Commission Exemption notice
Changes to the Limited Partnerships Act 2008		

12. Clarify that a special partnership that re-registers as a limited partnership succeeds to the rights and liabilities of the special partnership.	Low	Easy – Technical legislative change

Additionally, a number of proposals in our first interim report are yet to be implemented:

- Consider adding a new "registered investors" exception to the non-public offers section of the Securities Act.
- Consider adding as an additional exception to the Securities Act an equivalent of the Australian "20:12 rule".
- Amend Securities Act to define investments in limited partnerships under the Limited Partnerships Act as equity investments.
- Include a new power for the Securities Commission to issue "no action" letters, which would prevent it from taking action in relation to a matter (particularly where the question of breach is arguable or on matters which are not material).
- Retrospective exemption power for the Securities Commission.
- Financial Reporting Act requirements for companies with 25% overseas shareholdings should be made consistent with requirements for domestically-owned companies.
- Raise threshold for subsequent equity issues by listed companies before prospectus disclosure and shareholder approval is required.

In our 13 May 2009 submission on the MED discussion paper *Changes to the Securities Regulations* we made three further recommendations:

- Abolish the prescriptive disclosure obligation to provide material contracts in prospectuses.
- Make financial disclosure requirements for debt issues more meaningful by removing full notes on interim financial statements, 5 year trend numbers, and separate financial statements for recently acquired businesses.
- Risk sections of prospectuses should be specific to the issuer.

We encourage the government to consider these recommendations as soon as possible.

Changes to the Takeovers Act and Takeovers Code

(a) Amend Takeovers Act to ensure that joint shareholders are counted as a single shareholder in determining whether the Code applies to unlisted firms, and reinstate $20 million asset minimum.

The Takeovers Act defines companies that are subject to the Takeovers Code (Code companies) as listed companies (and recently delisted companies), and unlisted companies with 50 or more shareholders. Prior to the Takeovers Amendment Act 2006 there was an additional requirement that unlisted companies had assets of greater than $20 million.

For unlisted companies, the Takeovers Panel has recently ruled on the basis of the current law that each trustee of a family trust counts as a separate shareholder. More generally, where there are joint shareholdings, each individual counts as a separate shareholder, despite the fact that joint shareholders must make joint decisions on the securities they hold.

This means that many small companies now fall within the scope of the Takeovers Code, and are subject to significant compliance costs. This also makes it impractical for many of these companies to carry out rights issues to raise capital from existing shareholders, or to introduce new large shareholders.

The shareholder limit is easily avoided by listing only one trustee on the share register and therefore serves no purpose apart from imposing costs on firms that haven't done so.

The $20 million requirement has also been removed, as:

- it was considered incompatible with the objective of the Takeovers Act, which aims to protect minority shareholders of widely held companies, not to protect the shareholders of "large" companies; and
- the Act did not define the valuation methodology for assets.

This has further increased the number of companies that fall within the scope of the Code. For companies with assets of less than $20 million, the costs of complying with the code are likely to exceed the benefits to minority shareholders.

The taskforce proposes that section 2 of the Takeovers Act be amended to redefine "specified company". The new definition would:

- clarify that joint shareholdings count as a single shareholder; and
- reintroduce the requirement that unlisted companies have assets of over $20 million, along with specifying an appropriate valuation method, or a similar size threshold.

(b) Amend Takeovers Code to remove need for independent advisers report for small firms

The Takeovers Code requires Code companies to provide shareholders with an independent adviser's report when seeking shareholder approval.

The taskforce recommends that this requirement be removed for small firms (defined by assets) seeking a pro-rata rights issue. This would reduce compliance costs (at least $25,000 plus GST for an independent advisers report) for small Code companies, along with associated delays.

This change would not be needed if recommendation 1 above were implemented.

Changes to the Securities Act

(a) Amend requirements for Securities Commission exemptions to be gazetted to be consistent with Takeovers Panel

Industry participants have expressed satisfaction with the responsiveness of the Securities Commission in assessing and granting exemptions to parts of the Securities Act 1978, Securities Markets Act 1988 and the Financial Reporting Act 1993. These exemptions allow issuers to overcome rigidities in the law and are frequently essential to capital raising, as well as facilitating offers of new products, and products offered by overseas issuers.

However, procedural issues outside of the Commission's control can create delays for issuers seeking exemptions. Exemptions by both the Securities Commission and Takeovers Panel are signed by members and then gazetted. Whereas Takeovers Panel exemptions come into force as soon as they are signed, the Securities Commission advises that its Exemption Notices do not come into force until the day after they are gazetted.

The Securities Commission suggests that if a notice is not ready in time to meet the midday Tuesday deadline for the *Gazette*, it is possible to arrange for a supplementary *Gazette* to be published at the cost of the issuer ($700 including GST).

The taskforce suggests amendments to section 5(5) of the Securities Act 1978, section 48(1) of the Securities Markets Act 1988, and section 4B(1) of the Financial Reporting Act 1993 to make the Securities Commission exemption powers consistent with those of the Takeovers Panel. In each case this would require removing from the clause the words “by notice in the Gazette”, and adding a new clause similar to section 45(4) of the Takeovers Act 1993:

“An exemption shall be notified in the Gazette as soon as practicable after being granted”.

(b) Allow issuers to file section 37A(1A) certificates to extend the life of a prospectus and advise investors of a material adverse change to the company’s financial position

Section 37A(1)(c) of the Securities Act allows directors to extend the life of a registered prospectus beyond 9 months if they file a certificate (under section 37A(1A)) stating that there has not been a material adverse change to the financial position of the issuer since the date of the statement of financial position.

However, if there has been a material and adverse change to the financial position of the company, the Companies Office does not allow issuers to extend the life of the prospectus by inserting new interim financial statements and by disclosing these changes. Instead, issuers need to register a new prospectus.

To allow a memorandum of amendments would be consistent with the reduced disclosure required of listed issuers the Securities Disclosure and Financial Advisers Amendment Bill, which is based on an original prospectus plus announcements made under continuous disclosure. The investor would still have access to all information material to the offer, while the costs to some issuers of having to reissue a prospectus would be avoided.

The taskforce suggests that section 37A be amended to allow issuers to extend the life of a prospectus by issuing interim financial statements, in conjunction with a statement of material and adverse changes to the issuer’s financial position.

(c) Remove restrictions on pre-prospectus publicity

The Securities Act section 5(2CA) allows issuers to advertise offers of securities without an investment statement or prospectus, so long as the advertisement makes certain statements (e.g. that no money is currently being sought) and only conveys a restricted range of information (e.g the name of the issuer and the terms of the intended offer). This publicity is exempted from Part 2 of the Act, with the exception of section 38B (the Securities Commission can prohibit false or misleading advertisements) and section 58 (criminal liability for untrue statements).

Restrictions imposed on pre-prospectus publicity prevent issuers from fully testing the demand for their securities, and tailoring their offer to suit this demand. This increases the risk that offers will be undersubscribed. It also prevents issuers from communicating with their shareholders about the development of new offers. Restrictions on pre-prospectus publicity in section 5(2CA) should be removed.

(d) Create a statutory exemption in the Securities Act for employee share schemes

Many New Zealand companies do not adopt employee share schemes due to costs and uncertainties created by the Securities Act. This reduces firm’s ability to incentivise and reward employees. It also reduces access to international venture capital funding where employee share schemes are mandatory.

There are two existing Securities Commission exemption notices:

a. Securities Act (Employee Share Purchase Schemes - Listed Companies) Exemption Notice 2006

b. Securities Act (Employee Share Purchase Schemes - Unlisted Companies) Exemption Notice 2005

These allow companies to use a reduced, evergreen prospectus for employee share schemes, along with providing an updated copy of the company's financial reports.

A statutory exemption would go further than this, and allow for complete exemption from prospectus requirements for these schemes. We recommend amendments to section 3 or section 5 of the Securities Act to put this into effect.

Caps could be introduced to ensure that these schemes are not used as a primary form of capital raising, e.g. offers to employees under this exemption might be capped at 15% of share capital, as is the case in the existing Securities Commission exemption notices, or capped at a certain percentage of employee remuneration.

(e) Remove voiding of entire offers when they are taken up by a single member of the public

Section 3(5) of the Securities Act provides that "proof of an offer of securities to one person selected as a member of the public shall be prima facie evidence of an offer of securities to the public". The effect of this section, when read in conjunction with section 3(2)(a), is that each and every person whom an offeror offers an investment opportunity must fall within one of categories referred to in section 3(2)(a) if there is to be no offer to the public. If any one person to whom an offer is made and securities are allotted is a member of the public (i.e. falls outside section 3(2)(a)) and is not otherwise an *eligible person* under section 5(2CB), then the entire offer and allotment will have been undertaken in breach of the Securities Act if there was not a registered prospectus and an investment statement. The severe consequence of such a breach is that the offer is void (see section 37(4)) unless the issuer is granted a mandatory or discretionary relief order by a court (sections 37AC to 37AL).

We recommend the Act be amended so that it is clear that the allotment of securities to persons who are genuinely not members of the public or are eligible persons in such circumstances does not void the offer. Only the allotment of securities to a member of the public (who is not an eligible person) is void.

This would reduce the uncertainty to issuers, especially given the current uncertainties around the section 3(2)(a) exemptions.

An alternative would be to allow the Securities Commission to validate the offer, rather than a court.

(f) Certification of a wealthy person should occur any time 12 months prior to subscription, rather than prior to the offer

For a person to be considered *wealthy* (and thereby an eligible person) section 5(2CD) of the Act requires the person's assets or income be certified by a chartered accountant "no more than 6 months before the offer is made". The Securities Disclosure and Financial Advisers Amendment Bill would extend this to 12 months.

The date of the "offer" can be unclear, as it is defined broadly in the Act to include "any proposal or invitation to make an offer". So even contacting a person to discuss whether they wish to invest could be a breach of the Act. Since it is unlikely that an investor would obtain certification *before* receiving such a proposal, most attempt to use this exemption breach the law.

Accordingly, we suggest that the requirement be amended to provide that a person can be certified after receiving an offer, but prior to subscription. This could be accomplished by an amendment to section 5(2CD) to omit the word "offer" and substitute the word "subscription".

An alternative would be to retain certification12 month before the offer, but to also allow certification to occur after the offer but before subscription.

(g) Allow $500,000 minimum subscription for non-public offers to be paid in instalments

A further issue with section 3(2)(a)(iia) of the Act is that there is no allowance for the issuer to call for the $500,000 to be paid in instalments, following allotment. This is a common way of structuring private equity fund offerings, and offers to these investors may be caught by the Securities Act unless they are subject to other exemptions.

There is no policy reason for making this distinction. A commitment to pay $500,000 is not materially different to paying $500,000 up front, and such investors are likely to be sophisticated.

The taskforce suggests that section 3(2) of the Act be amended to include persons who have, prior to allotment, committed to paying at least $500,000 in subscriptions as called by the issuer.

(h) Remove vendor shareholder liability in IPO exits

When a firm performs an initial public offering, vendor shareholders are regarded as “issuers” under section 6(7) of the Securities Act and therefore face liability if statements in the prospectus are misleading . In a private equity fund, these vendor shareholders include management shareholders who may have advised or encouraged the IPO, but will often have little, if any, control or influence over the formation of the offer or the preparation of the offer documentation. General market practice is to avoid this liability through special structures, which can cost over $50,000 to establish, as well as being time consuming to set up. The offer also becomes more complex and difficult for investors to understand.

We recommend the Securities Act be amended to remove issuer liability for vendor shareholders. Vendor shareholders should remain liable where they are directors, or have acted as promoters for the IPO. This could be achieved by adding a new subsection to section 6 to the effect that nothing in subsections (2) or (3) will apply where the original allotter has registered a prospectus and the holder of the security is not a director of the original allotter or a promoter.

Changes to Securities Act Exemption Notices

(a) Amend the venture capital scheme exemption to increase the range of issuers that can use it, and the cap.

The Securities Act (Venture Capital Schemes) Exemption Notice 2008 allows specified scheme administrators to match investors to issuers that offer securities to the public without appointing a statutory supervisor or registering a prospectus. This exemption works well for the exempted schemes, however:

a. The specific scheme administrators are largely restricted to Economic Development Agencies. Angel investment networks have a greater interface with potential investors.

b. Offers are capped at $5 million. Further benefits could be obtained from raising it.

We recommend the Securities Commission replace the Securities Act (Venture Capital Schemes) Exemption Notice 2008 with a new version that:

- Allows angel investment networks to run schemes under the exemption.
- Raises the maximum issue size, perhaps to $10 million.

This would allow a greater amount of funding to be channelled through these venture capital schemes to small firms with minimal Securities Act compliance costs.

Changes to the Limited Partnerships Act 2008

(a) Clarify that a special partnership that re-registers as a limited partnership succeeds to the rights and liabilities of the special partnership.

The Limited Partnership Act 2008 repealed the sections of the Partnership Act 1908 that allow for "special partnerships". Existing special partnerships have a seven-year life and will need to re-register as limited partnerships before they expire.

The NZVCA has suggested that the Limited Partnership Act 2008 be amended to contain provisions that new limited partnerships succeed to the rights and liabilities of the special partnerships that they replace. This will reduce the costs of moving to the new legal form. We endorse this recommendation.

Appendix III Proposals to reduce costs for collective investment schemes and lower fund management fees

The taskforce has also received feedback that securities law imposes unnecessary costs on superannuation schemes and managed funds. We therefore include two additional proposals to lower costs for these funds. Reducing costs is likely to flow on to reduced fees, and increased competition.

(a) Remove the need for a hard copy of managed funds' annual reports to be sent to all investors

The Superannuation Schemes Act 1989 requires that investors be sent a copy of the annual report of the trustees within 6 months of the close of each financial year (Section 17(1)(a)). This requirement imposes considerable costs on superannuation schemes while few are read.

For comparison, the Companies Act provides for the electronic distribution of annual reports, although it still requires companies to post a notice to shareholders saying how they can obtain an annual report by electronic means (see Companies Act 1993, sections 209-209B).

We recommend that section 17(1)(a) of the Superannuation Schemes Act 1989 be amended to state that schemes only need to notify members of the release of the annual report and, if the issuer of the scheme has a website, to provide an electronic copy. Require (in Section 17(1)(b)) schemes to provide a hard copy of the annual report on request.

This would reduce the costs to scheme managers (one scheme manager estimates $250,000 per year in printing and distribution), and pressure on superannuation scheme fees.

(b) Fund managers rather than trustees should issue most Regulation 17 certificates.

Clause 17 of the Securities Regulations requires that whenever a communication falls within the definition of "Advertisement" in Section 2 of the Securities Act, a director of the issuer must certify that he or she has read the advertisement, the advertisement is consistent with the prospectus, and it is not misleading.

For KiwiSaver and other superannuation schemes, the "issuer" is the superannuation trustee, rather than the fund manager. However, the fund manager is in the best position to verify that the advertisement meets the requirements of the certification. The practical effect of having the current regime in place is such that a full sign off procedure must occur internally at the manager and then the documents and assurances from the manager must be delivered to the Trustee and the Trustee must go through its own procedures and finally decide whether or not to execute the Regulation 17 certificate. In reality, the trustee is totally relying on the manager's assurances that the contents of the Regulation 17 certificate are correct.

Some examples of what needs to go through this process are set out below:

- All presentations to employers or individuals (either existing or prospective members) even though the content of the presentation may be virtually identical to a previous presentation, but there is a minor change (such as the name of the employer or the presenter/agent).
- Any direct mail letters to customers would have to each be signed off individually.
- Any website changes that are needed (this is a high risk area given the need for the website to be up to date at all times).
- Annual review presentation to existing members and employers.

- Transfer documentation between superannuation and KiwiSaver schemes and KiwiSaver to KiwiSaver schemes.

The Securities Act (Externally Managed KiwiSaver Schemes and Superannuation Schemes) Exemption Notice 2008 provides some relief from the traditional Regulation 17 requirements where schemes have trustee corporations. It allows executive officers of the trustee corporation to execute the certificates, provided the officers are authorised by the directors of the trustee corporation. This could be extended to allow fund managers to issue certificates also.

We propose amendments to the Securities Act (Externally Managed KiwiSaver Schemes and Superannuation Schemes) Exemption Notice 2008 to enable to manager to attest to the veracity of the advertisements and to allow the trustee to delegate to the manager the sign off for those advertisements that are more of a routine nature. Some advertisements, such as investment statements, would still need to be certified by the trustee.