SECURITIES LEGISLATION BILL REGULATIONS

Discussion Document

March 2006

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Regulatory and Competition Policy Branch
Ministry of Economic Development
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I FOREWORD

I am excited to be working in the Commerce Portfolio once more. It is an area with which I have experience, and enjoy.

The Securities Legislation Bill is a long-awaited modernisation of New Zealand's securities trading law and I am pleased to be able to see the Bill through its final stages. I believe that having clear and robust laws for our securities markets is vital to give both domestic and international investors the confidence they need to invest in New Zealand.

The government greatly values the assistance of stakeholders – in particular, the benefit of their working knowledge of our markets – in designing new legislation. I therefore encourage you to make a submission, so that we might have the best possible securities markets legislation for New Zealand.

Hon Lianne Dalziel

Minister of Commerce

March 2006

II INFORMATION FOR SUBMITTERS

The Ministry of Economic Development has prepared this discussion document following consultation with other government officials and agencies. Written submissions on the issues raised in this document are invited from all interested parties.

HOW TO MAKE A SUBMISSION

Submissions should be sent to **Asha Stewart** at the contact details provided below. The Ministry asks that submissions sent in hard copy **also be provided in electronic form** (Adobe Acrobat, Microsoft Word 2000 or compatible format).

Please note that the questions in the discussion document are only intended to provide a suggested focus of the issues. Some of the questions have elements that overlap with other questions. Submitters should also feel free to provide broader comments where desired if issues are not subject to specific questions. **However, submitters should provide reasons for their answers or in support of their position.** There is no need to address all the issues or questions, and submitters should feel free to provide submissions only on the issues of direct concern if so desired.

The closing date for submissions is**: 21 April 2006**

After receiving submissions, the Ministry will evaluate them and seek further comments where necessary before developing recommendations for the Minister and then Cabinet to consider.

COPIES OF THE DISCUSSION DOCUMENT

Hard copies of the discussion document are available on request from Asha Stewart at the contact details provided below. The document is also available electronically on the Ministry of Economic Development Website (www.med.govt.nz).

CONTACT FOR QUERIES AND SUBMISSIONS

Please direct all submissions and any queries to:

Asha Stewart

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Postal: Securities Legislation Bill Regulations
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Attention: Asha Stewart
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THE OFFICIAL INFORMATION ACT 1982 AND THE PRIVACY ACT 1993

Submissions are subject to the Official Information Act 1982 and the Privacy Act 1993. If the Ministry receives a request for information contained in a submission, it would be required to consider release of the submission, in whole or in part, in terms of the criteria set out in these Acts.

In providing your submission, please advise if you have any objections to the release of any information contained in your submission, and, if you do object, the parts of your submission you would wish withheld, and the grounds for withholding (for example, commercial confidentiality).

If no objections are made, the Ministry will assume that you have agreed to the public release of the information contained in your submission.

DISCLAIMER

Any statements made or views expressed in this discussion document are the views of the Ministry of Economic Development and do not reflect government policy.

Readers are advised to seek specific advice from a professional qualified in the relevant subject area before undertaking any action in reliance on the contents of this discussion document. While every effort has been taken to ensure that the information contained in this document is accurate, the Crown does not accept any responsibility whether in contract, tort, equity or otherwise for any action taken, or reliance placed on, any part, or all, of the information in this document, or for any error or omission from this document.

In particular, many of the issues discussed in this document are also the subject of review in various international jurisdictions. Again, every effort has been made to ensure statements relating to the legal or institutional arrangements of these jurisdictions are accurate. However, some information may have dated since the time of writing, and readers are advised to seek specific advice from professional advisers with current knowledge of the relevant jurisdiction.

PROCESS

This discussion document reflects preliminary views only on the matters raised. The submission period runs from Tuesday 21 March 2006 to Friday 21 April 2006. Following this, the process will run as follows:

- Officials will then analyse the submissions made and finalise proposals for the content and substance of the regulations to submit to the Minister of Commerce by May 2006. A Cabinet paper will then be prepared and submitted to Cabinet by the Minister of Commerce, seeking final policy approvals for the regulations and authority to provide drafting instructions to Parliamentary Counsel Office.

- Once Cabinet policy approval is obtained, drafting instructions will be forwarded to Parliamentary Counsel Office. It is expected that drafting will take around three months to complete.

- Targeted consultation will then be undertaken on the draft regulations with those who submitted on the discussion document and any other interested parties.

- Once the consultation has been completed and drafting finalised, the regulations will be submitted to the Cabinet Legislation Committee by the Minister of Commerce. This paper will seek authorisation for the submission of the regulations to Executive Council.

- An Order in Council will be prepared by PCO and the regulations will be submitted to Executive Council. The Governor-General authorises the regulations by Order in Council.

- Once confirmed, the regulations will be sent by PCO to the *New Zealand Gazette* for publication on the Thursday following the Executive Council meeting. In accordance with Cabinets' '28 day rule', the regulations will come into force 28 days following publication in the Gazette (or at some later date, should this be appropriate). The enactment of the regulations will also be communicated via the Ministry's newsletter, and to interested parties such as the Takeovers Panel, the Securities Commission, and those on the "Review of Financial Products and Providers" and "Financial Intermediaries Taskforce" databases.

Please note that the parts of the Securities Legislation Bill that require regulations will not come into force until the regulations are ready for enactment.

ACCESS TO CURRENT STATUTES, REGULATIONS AND BILLS

Current statutes and regulations may be accessed through the government's interim Public Access to Legislation website at www.legislation.govt.nz. The Securities Legislation Bill and other current Bills may be accessed through the Office of the Clerk website at www.clerk.parliament.govt.nz and selecting "Select Committees" then "Select Committee Reports".

ACKNOWLEDGMENT

The Ministry would like to thank everyone who has assisted with drafting this discussion document.

III BACKGROUND – THE SECURITIES LEGISLATION BILL

The government's securities law reform programme and the Securities Legislation Bill

1 One of the key objectives of Government over the past five years has been to make participation in New Zealand's securities markets more attractive to domestic and overseas investors and cost-effective for local and international firms. To this end the Government has been undertaking a four-step law reform programme for securities law that seeks to promote confidence in the New Zealand share market.

2 The key components of the Government's reform programme are:

- Introduction of the Takeovers Code (2000);
- Passage of the Securities Markets and Institutions Bill (2002);
- The Securities Legislation Bill (awaiting its second reading in the House of Representatives); and
- Review of the Securities Act 1978, now encompassed in the Review of Financial Products and Providers (policy proposals due with Cabinet at the end of 2006 - see www.med.govt.nz/buslt/bus_pol/financial-products/ for further information)

3 The Securities Legislation Bill is designed to encourage investment in New Zealand's capital markets by strengthening the regulatory framework embodied in securities, securities trading, and takeovers laws. The Bill also aims to modernise securities trading law in line with international practice. The Bill will amend parts of the Securities Markets Act 1988, the Takeovers Act 1993, and the Securities Act 1978.

4 The Securities Legislation Bill was introduced to the House of Representatives on November 30th of 2004 and has generally been widely supported. It was reported back to the House of Representatives by the Commerce Select Committee in June 2005 and at the time of writing is awaiting the Committee of the Whole Stage of the Bill. It is intended that this Bill be divided into the following three separate Bills at the Committee of the Whole House stage: a Securities Amendment Bill, a Securities Markets Amendment Bill, and a Takeovers Legislation Amendment Bill.

Content of the Bill

5 The Bill:

- Amends the Securities Markets Act 1988 by:
  - Introducing a new insider trading regime based on a new rationale for regulation – that insider trading is a harm to the market;

- Introducing new prohibitions on market manipulation (in particular, prohibitions on the dissemination of false or misleading information and the creation of a false or misleading appearance of trading or demand for a security);

- Simplifying the regime for the disclosure of substantial holdings in public issuers of securities;

- Inserting more effective investment advisers' and brokers' disclosure obligations formerly found in the Investment Advisers (Disclosure) Act 1996;

- Creating a new Part Five to the Act, which overhauls and improves the enforcement powers and remedies available for breaches of securities trading law, collecting them into a single part; and, consequently,

- Creating a new Part Six that picks up and expands the regulation making powers and the Securities Commission's exemption-making powers.

- Aligns and improves the range of penalties and remedies under the Securities Act 1978 and the Takeovers Act 1993 with those contained in the new Part Five of the Securities Markets Act 1988;

- Expands the regulation-making power in the Securities Act to allow the making of regulations that incorporate, by reference, financial reporting standards and generally accepted accounting practice to allow the Securities Regulations to more effectively refer to and utilise International Financial Reporting Standards and other standards.

- Expands the jurisdiction of the Takeovers Panel to inquire beyond the formal documents of a takeover and examine other conduct that may be misleading or deceptive in relation to a takeover; and

- Allows for information-sharing between the Commerce Commission, Securities Commission, and Takeovers Panel in their respective roles in policing false, misleading, or deceptive conduct.

A copy of the Bill, as reported back from Select Committee, can be attained at:

www.clerk.parliament.govt.nz/Content/SelectCommitteeReports/234bar2.pdf

Regulations under the Securities Legislation Bill

6 There are four areas in the Securities Legislation Bill that require regulations to be passed to bring into effect substantial obligations under the Bill. These four areas are:

(i) Investment Advisers' and Brokers' disclosure;

(ii) Substantial security holders' disclosure;;

(iii) Insider trading exemptions; and

(iv) Market manipulation exemptions.

The relevant regulation-making powers in the Bill are found in sections 49A, 49C and 49D of the Bill.

IV EXECUTIVE SUMMARY

7 The Securities Legislation Bill requires secondary legislation in addition to the primary legislation for several reasons. Regulations are flexible and able to be easily updated to address new developments within the securities markets. They are also the appropriate place to set out the technical form and detail of disclosure required under the disclosure provisions of the Bill. Additionally, the new market manipulation and insider trading regimes have a broad application, and regulations are the appropriate place for technical exemptions to these regimes as well as clarifying that certain market efficient behaviours are not caught by the provisions in the Bill.

8 Thus, as above, there are four areas of the Bill requiring regulations:

- Investment advisers' and brokers' disclosure;
- Substantial security holders' disclosure
- Insider trading exemptions; and
- Market manipulation exemptions.

Investment Adviser and Broker Disclosure

9 The most substantial area requiring regulations to be drafted is Investment Adviser and Broker Disclosure. The Securities Legislation Bill places additional disclosure obligations on investment advisers and brokers as a new Part Four to the Securities Markets Act. The Bill requires investment advisers and investment brokers to disclose more information prior to giving investment advice, or receiving investment money or investment property. This is a change to the current regime, where much of the important disclosure is only made available on request by the consumer – and many consumers do not know to ask for this information.

10 Section 49 of the Securities Legislation Bill contains the regulation empowering provisions for investment advisers and brokers. From the these provisions, and from submissions made to the Select Committee, and the Taskforce on Financial Intermediaries,[1] officials have identified the following areas for inclusion in this discussion document:

- Whether any further information should be required to be disclosed by investment advisers or by investment brokers (for example, whether an investment adviser should disclose to a client the cost of switching products);

[1] The Task Force on the Regulation of Financial Intermediaries was an independent Task Force appointed by the Minister of Commerce in 2004 to review the regulation of financial intermediaries. The Task Force reported back in 2005. Refer www.med.govt.nz/templates/ContentTopicSummary____12430.aspx

- Whether any regulations are required on the further contents of the disclosure statement and the method and form of disclosure under Part Four (for example, whether or not there should be a prescribed form for disclosure).

- Whether an investment adviser should be required to have a minimum level of professional indemnity insurance and prescribe the minimum level amount; or whether an investment adviser should be required to give an undertaking that the adviser has adequate professional indemnity insurance to protect the person receiving investment advice; and

- Whether there should be any exemptions (on terms and conditions, if any) for any person or class of persons, any class of transactions, or class of investment advice (e.g. telephone), or investment brokers services from compliance with any investment advisers' or investment brokers' disclosure obligation or obligations (for example, whether advice on products similar to bank terms deposits should be exempted).

11 In addition, this discussion document addresses s20 of the Securities Legislation Bill, which allows for regulations to define or to provide further detail to the existing definitions of "bank term deposit" (under the definition of "security") "investment advisers' disclosure obligations"; "investment advisers' obligations"; "investment brokers' disclosure obligations"; and "investment brokers' obligations".

12 The discussion document asks questions around how these exemptions should be drafted, provides examples of how other jurisdictions have treated these areas, and queries whether any other exemptions are needed.

Substantial Security Holder Disclosure

13 The substantial security holder regime was implemented with the enactment of the Securities Markets Act 1988, primarily in response to the 1987 securities markets crash. The purpose of the regime is to promote an informed market by ensuring that participants in New Zealand's securities markets have access to information concerning the identity and trading activities of persons who are or may be entitled to control or influence the exercise of significant voting rights in a public issuer.

14 The Government believes that the current substantial security holder disclosure regime is fundamentally sound. However, some minor problems have been identified. The Securities Legislation Bill simplifies the current disclosure regime by requiring disclosure of relevant interests by class. A person will have a "relevant interest" if they are the holder of that security, have the power to control voting, or disposal of the security, or have an ability to control the security in this manner via trusts, nominee companies, family members and so on. Disclosure will only be required in respect of listed, voting securities. This excludes listed non-voting securities (such as debt) and voting but non-listed securities (such as interests in the manager of a collective investment scheme). The new regime also includes classes of listed securities that are convertible into voting securities.

15 The Securities Legislation Bill also gives the Securities Commission the power, after having regard to the purpose of the substantial security holder regime, to require that a person disclose to the market the nature and extent

of all relevant interests that person maintains in any securities of a public issuer (whether listed or not, voting or non-voting, existing now or in the future).

16 The intent of these amendments is to clarify the situations in which disclosure is required, and make those disclosures more straightforward.

17 Clause 28 of the Securities Legislation Bill will insert a new section 49A to the Securities Markets Act 1988. This section empowers the making of regulations for the purpose of substantial security holder disclosure. This discussion document will consider whether the current substantial security holder regulations are sufficient and asks whether any changes should be made. In particular, the document covers:

- Details as to the substantial security holding that are or may be relevant for disclosure (such as the name of the public issuer, or the number and percentage of securities of that class in which a relevant interest is held);

- The documents, certificates, and statements that must accompany disclosure. The 1997 Regulations require certain documentation to be attached to the disclosure notice when there is a change in the number of securities held, or change in the nature of the relevant interest. The documentation includes such things as written contracts, agreements, deeds, or instruments affecting the securities or relevant interests;

- When disclosure is required to be made (including disclosure only on request);

- Prescribing the form and method of disclosure, or providing for the relevant registered exchange to determine that form or method of disclosure; and

- Exempting (on terms and conditions, if any) classes of persons, transactions, relevant interests, or substantial holdings, from compliance with any substantial holding disclosure obligations.

Insider Trading

18 The Bill introduces a new insider trading regime, based on the ideas of market efficiency and market fairness, not on the fiduciary duties owed by officers or agents of a company to that company. One becomes an insider by virtue of a connection to the inside information itself, rather than by a connection to the particular company that this inside information pertains to. Thus, the new regime has a significantly broader ambit than the current regime, and the Bill contains exemptions to ensure market-efficient conduct is not inadvertently captured. In addition, section 49D(b) of the Securities Legislation Bill allows for the making of regulations to exempt certain conduct from the insider trading provisions. The regulations are for more technical exemptions than would appropriately be included in the primary legislation, and address those areas where flexibility and adaptability are required.

19 Officials have as yet identified only one area that may require regulations to exempt it from the regime. This is the matter of passive investment instruments – index funds, which are weighted the same as a stock exchange index in order to mirror the stock exchange's performance, and exchange-

traded funds, which track an index and represent a basket of shares like an index fund, but trade like a stock on an exchange and therefore experiences price changes throughout the day. This discussion document briefly canvases this issue and considers whether an exemption is necessary, even if just for "avoidance of doubt". The document seeks feedback on how such an exemption should be drafted, and whether any further exemptions are needed.

Market Manipulation

20 The Securities Legislation Bill introduces a market manipulation regime to New Zealand which will apply to securities traded on a registered exchange. Sections 11 – 11D in the Bill contain new prohibitions against making false or misleading statements or creating a false or misleading appearance of trading. Also included in the Bill, as section 13, is a general dealing misconduct provision. This prohibits misleading or deceptive conduct generally and applies more widely to dealings in both listed and non-listed securities.

21 As with the insider trading regime, the scope of the new regime is relatively wide, therefore regulations will be needed to remove any risk that market-efficient conduct would be caught by the prohibitions of the Bill.

22 From submissions made during Select Committee, officials have identified three areas for inclusion in this discussion document. They are:

- Market stabilisation arrangements: after an initial public offering of securities, the underwriter purchases securities (or an offer to purchase securities is made) for a limited period, in order to prevent or slow any fall in the market price for those securities;

- Short selling, where borrowed securities are sold with the expectation that the asset will fall in value. When the investor needs to return the borrowed securities, they must buy them back off the open market. The investor will profit if the price has fallen from when they sold the securities; and

- Crossing of trades, where securities are traded between clients of a single exchange participant or a single client and the exchange participant itself without the orders having first been matched in the order screen.

31 The discussion document asks questions around how these exemptions should be drafted, provides examples of how other jurisdictions have treated these areas, and queries whether any other exemptions are needed.

V DISCLOSURE OBLIGATIONS UNDER THE SECURITIES LEGISLATION BILL

INTRODUCTION

23 The Securities Legislation Bill places additional disclosure obligations on investment advisers and brokers as a new Part Four of the Securities Markets Act. These disclosure obligations enhance those formerly found in the Investment Advisers (Disclosure) Act 1996 ("IADA").

24 Previously, under the IADA, investment advisers and investment brokers had to disclose certain convictions, bankruptcies, and prohibitions prior to giving investment advice or receiving investment money or investment property (s3(1)). In addition, investment brokers had to provide a brief description of their procedures relating to the receipt and disbursement of money or property (s3(2). Investment advisers had to disclose certain information relating to qualifications, experience and remuneration if requested to do so by the client (within five working days of that request) (s4). These obligations on the adviser only arose on the request of a client.

25 The Securities Legislation Bill now requires investment advisers and investment brokers to disclose more information prior to giving investment advice, or receiving investment money or investment property, without requiring a prior request from a potential or actual client.

26 In the new Part Four:

- Sections 41B to 41G set out the disclosure requirements for investment advisers
- Sections 41H to 41J set out the disclosure requirements for investment brokers
- Sections 41K to 41P set out disclosure requirements applying to both advisers and brokers
- Sections 41Q to 41U deal with offences
- Section 41V deals with territoriality
- Sections 41W and 41X restrict contracting out and deal with various liabilities.

Reason for changes to the IADA

27 The changes in the Securities Legislation Bill were introduced to address a number of problems with the IADA's disclosure regime:

- some people seeking investment advice did not know of their right to ask for important disclosure such as the adviser's experience and information that indicates the adviser has conflicts of interests;

- the disclosure statement did not contain other information that investors may have found useful in making decisions about whether to ask for, or rely on advice (e.g. dispute resolution facilities and whether the investment adviser is a member of a professional body);

- the absence of offence provisions for recommending illegal investment products was thought to heighten the risks for people investing in the market;

- there were a lack of incentives for investment advisers to comply with the IADA because private enforcement of the law was often difficult due to the prohibitively high litigation costs and difficulties in obtaining evidence;

- the definition of "investment adviser" in the IADA may not have covered all persons who provide investment advice; and

- the IADA was inconsistent in places with other securities legislation. For example, the IADA referred to "investors", while other securities legislation referred to "members of the public". This, along with a lack of definitions for advice, broker and product advertisements, led to confusion and a lack of clarity as to the coverage of the IADA.

28 To combat these concerns, the Securities Legislation Bill now:

- makes the previous requested disclosure obligations mandatory, and requires them to be given prior to advice or services being provided;[2]

- requires investment advisers to disclose whether or not dispute resolution facilities are available, and other information which was considered useful for consumers;[3]

- includes offence provisions for failure to disclose, and penalties for such offences including fines of up to $300,000;[4]

- gives the Securities Commission enforcement powers to encourage compliance;[5]

- extends the circumstances in which advisers and brokers may be banned by expressly noting that prohibitions in overseas jurisdictions may be considered;[6]

- updates definitions[7] and addresses inconsistencies with other securities legislation.[8]

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[2] Refer ss41B and 41H Securities Legislation Bill

[3] Refer s41C(e) Securities Legislation Bill. The Financial Intermediaries Taskforce recommended setting up a dispute resolution system for financial intermediaries to which clients of investment advisers and brokers would have access. Refer to "Confidence, Change And Opportunity – Final Report Of The Taskforce on Financial Intermediaries" available at www.med.govt.nz/templates/MultipageDocumentTOC____13788.aspx and the ongoing work of officials at www.med.govt.nz/templates/ContentTopicSummary____15293.aspx

[4] Refer ss41Q – 41T and ss43K-43O Securities Legislation Bill.

[5] Refer ss42B-42L Securities Legislation Bill

[6] S43K Securities Legislation Bill

Reason for disclosure

29 The reason for the disclosure requirements in the IADA, and now the enhanced disclosure requirements in the Securities Legislation Bill, is to ensure that members of the public have sufficient information to compare the types of investment services on offer and those offering the services, so that the public can make informed choices on the basis of that information disclosed.

30 Specifically, increasing the quality of consumer information through enhanced disclosure obligations on financial intermediaries (such as investment advisers and brokers) will, according to the Task Force on Financial Intermediaries:

- enable an individual consumer to make better decisions about an intermediary or a financial product (for example, whether to deal with that intermediary, whether the intermediary's fees are negotiable etc);
- enable a consumer to make comparisons across intermediaries and financial products;
- encourage greater competition between intermediaries and between product generators (for example, competition on fee structures and fee amounts);
- contribute to poor performing intermediaries and/or product generators exiting the market, and good quality intermediaries and/or product generators increasing their business, with the overall effect of increasing levels of performance; and
- address the problem of information asymmetry (e.g., where investors don't have sufficient expertise, time or information to make investment choices unaided). [9]

31 Enhanced disclosure should also help reduce conflicts of interest by requiring advisers and brokers to provide information on any benefits that they may receive for recommending a certain product, or any relationships they have that may be seen as influencing their advice/services. While it is not clear whether risks of conflicts of interest are actually prevalent in the New Zealand market,[10] it appears that there is at least a perceived risk of conflict of interest through anecdotal evidence noted in the recent Financial Intermediaries' Taskforce report,[11] and where a "majority" of respondents agreed that

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[7] For example, refer definition of "investment adviser" at s20 Securities Legislation Bill

[8] The Commerce Select Committee Report accompanying the Securities Legislation Bill is available at www.clerk.parliament.govt.nz/Content/SelectCommitteeReports/234bar2.pdf

[9] Taskforce report at page 38 in relation to financial intermediaries.

[10] The Taskforce referred to anecdotal evidence noting the presence of conflicts of interest– Taskforce report at page 23.

[11] Since the Taskforce report, Cabinet has provided "in-principle" approval to the introduction of a co-regulatory model of regulation for financial intermediaries in New Zealand, with the Securities Commission (as the government regulator) working together with industry-based "approved professional bodies" to create and approve standards for individuals and businesses who provide financial advice or who market financial products to members of the public. As at the date of this discussion document, Ministry officials are carrying out detailed design work on the co-regulatory model and will take into account the disclosure obligations on investment advisers and investment brokers under the Securities

enhanced financial intermediary disclosure is required, particularly around fees and charges.[12]

32 The specific form and content of this investment adviser and broker disclosure is to be set by regulation.

REGULATION MAKING POWERS IN RELATION TO INVESTMENT ADVISERS AND BROKERS

33 Section 49 of the Securities Legislation Bill contains the regulation empowering provisions for investment advisers and brokers.[13] Particularly, section 49C of the Securities Legislation Bill allows for regulations to:

- Prescribe any further information to be disclosed under s41B (i.e. by investment advisers) or 41H (i.e. by investment brokers);[14]
- Prescribe any further contents of the disclosure statement and the method of disclosure under Part Four;[15]
- Require an investment adviser to have a minimum level of professional indemnity insurance and prescribe the minimum level amount;[16]
- Require an investment adviser to give an undertaking that the adviser has adequate professional indemnity insurance to protect the person receiving investment advice;[17]
- Exempt any person or class of persons, any class of transactions, or class of investment advice (e.g. telephone), or investment brokers' services from compliance with any investment advisers' or investment brokers' disclosure obligation or obligations;[18]
- Prescribe how information disclosed in a disclosure statement must be set out;[19] and
- Prescribe a form for use as a disclosure statement.[20]

34 In addition, s20 of the Securities Legislation Bill also allows for regulations to define or to provide further detail to the existing definitions of "bank term deposit" (under the definition of "security"); "investment advisers' disclosure obligations"; "investment advisers' obligations"; "investment brokers' disclosure obligations"; and "investment brokers' obligations".

Legislation Bill and proposed regulations. Refer www.med.govt.nz/templates/ContentTopicSummary____15293.aspx

[12] Taskforce report at page 42

[13] No regulations were made under IADA, even through there was power to do so under s12 of the IADA.

[14] s49C(1)(a) Securities Legislation Bill

[15] s49C(1)(b) Securities Legislation Bill

[16] s49C(1)(c)(i) Securities Legislation Bill

[17] s49C(1)(c)(ii) Securities Legislation Bill

[18] s49C(1)(d) Securities Legislation Bill

[19] s49C(1)(e) Securities Legislation Bill

[20] s49C(1)(f) Securities Legislation Bill

REGULATIONS PRESCRIBING ANY FURTHER INFORMATION TO BE DISCLOSED

35 Section 49 allows for the Governor General to prescribe any further information that must be disclosed under s41B (which requires investment advisers not to give investment advice to a member of the public unless they have first made disclosure in accordance with s41C to 41G and any requirements specified by regulation under 49C) or under s41H (which requires investment brokers not to receive investment money or investment property to a member of the public unless they have made disclosure in accordance with s41I and 41J and any requirements specified by regulation under 49C).

36 Sections 41C to 41G of the Securities Legislation Bill generally require an investment adviser to disclose information on their qualifications and experience; whether they are a member of a professional body; whether they have professional indemnity insurance; whether there are dispute resolution facilities available; any past criminal convictions; the nature and level of the fee, as well as any relevant remuneration (including the amount or rate, and the name of the person from whom remuneration will be received, whether the adviser is an associated person or has a relationship with anyone connected with the investment, or someone who may influence the provision/content of investment advice)[21] and finally, details of securities about which advice is given.

37 Sections 41I to 41J of the Securities Legislation Bill generally require an investment broker to disclose criminal convictions, and procedures for dealing with money.[22]

38 In addition to these disclosure obligations in the Securities Legislation Bill, the recent report by the Taskforce on Financial Intermediaries suggested that the following additional disclosure obligations should apply to financial intermediaries (on the basis that this will increase intermediary performance):[23]

- if there is a variable product sale component to a fee or charge (for example, a commission);
- in dollar terms on a periodic basis, the difference between the aggregate gross returns on all investments organised though the financial intermediary and the actual net return received by the consumer, with an explanation of the difference (in categories of costs, for example, the amount attributable to financial intermediary deductions, to ancillary service deductions, such as wrap providers, and any product generator fees or costs that are deducted after establishing gross return);

[21] See discussion on “relevant remuneration” below
[22] Refer ss41B-41J Securities Legislation Bill
[23] Taskforce report at page 38

- to the extent practicable, the total benefits to the financial intermediary of the consumer's business where those benefits are not already disclosed as part of the actual gross and net gross return disclosure above (for example, if an financial intermediary obtains an interest rate margin on funds deposited by the consumer with the financial intermediary);[24] and

- where advice or marketing is directed to switching products, disclosure of remuneration to the financial intermediary, the cost to the client (for example, exit fees, entry fees and implementation fees), and the benefits of the alternative as against the existing product.[25]

39 The Ministry is aware that some of the information that the Taskforce suggested should be disclosed is information that investment advisers and brokers would have to rely on third parties to produce (e.g. information about product structure and the way that fees are charged). The Ministry is raising these additional obligations to ask for your views on whether or not these matters are sufficiently covered under existing requirements in the Securities Legislation Bill or whether further prescription is required by way of regulation.

Questions:

Q1 Should investment advisers or brokers be required to disclose any information in addition to the requirements under the Securities Legislation Bill?

Q2 Ministry officials are working to review the Taskforce recommendations in relation to extended disclosure obligations. Do you agree with the disclosure obligations suggested by the Taskforce (at paragraph 38 above) should apply to investment advisers and brokers? In your view, what costs or obstacles would apply to investment advisers and brokers in providing the additional information as described at paragraph 38 above? And, would the additional information produced by these disclosure obligations assist consumers sufficiently to outweigh the cost to investment advisers and brokers?

[24] Taskforce report pages 40-41

[25] Taskforce report page 41. By comparison, in Australia, where an adviser recommends that a client dispose of, or reduce the client's interest in, all or part of a particular financial product and instead acquire all or part of, or increase the client's interest in, another financial product, s947D(2) of the Corporations Act 2001 (Aust) requires advisers to provide additional information to the investor, including any charges the client will or may incur in respect of the disposal or reduction and the acquisition or increase; any pecuniary or other benefits that the client will or may lose (temporarily or otherwise) as a result of taking the recommended action; and information about any other significant consequences for the client of taking the recommended action that the adviser knows, or ought reasonably to know, are likely. This information also has to be expressed in dollar terms (see s947D(2)(d)).

METHOD AND FORM OF DISCLOSURE

40 The method and form of information to be disclosed can be prescribed by regulation.[26] The current requirements for the method for disclosure are set at s41K of the Securities Legislation Bill[27] – generally, that disclosure is to be made in writing,[28] state the date when it was prepared, and:

- state the name, address, and business telephone number of the investment adviser or investment broker concerned;
- in the case of an investment adviser or investment broker who is an employee of an investment adviser or investment broker, state the name of that employee; and
- be either received by the investor or delivered or sent to the investor at the investor's last known address or an address (including an electronic address) specified by the investor for this purpose.[29]

41 In Australia and the United Kingdom, the Australian Securities and Investment Commission (ASIC) and the Financial Services Authority (FSA) provide guidance on the form of disclosure by publishing suggested set forms (depending on the particular product being offered) and by continuing to consult on and review the current form and content of such disclosure. [30]

42 In Australia, disclosure is required to be made in a form which is "clear, concise, and effective"[31] on the basis that consumers will more easily use information that is easily read and understood.[32] As well, the level of detail required for disclosure is the level of detail that is generally what a member of the public (as opposed to a wholesale investor) would require for the purpose of deciding whether or not to act on the advice.[33]

43 "Clear, concise, and effective" (in relation to product disclosure statements) has been explained by ASIC:

- using a range of communication tools
- avoiding industry and legal jargon
- providing more information if a complex product

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[26] s49C(1)(b) and (f) Securities Legislation Bill

[27] There is no set prescribed form for disclosure in the Securities Legislation Bill

[28] Previously, the IADA required disclosure to be in writing unless made by way of broadcast, within the meaning of the Broadcast Act 1989 – s5(a) IADA

[29] See discussion on timing of disclosure below.

[30] For example, refer to the "Good Disclosure Principles at "[PS 168] Disclosure: Product Disclosure Statements (and other disclosure obligations)" at www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/PS168.pdf/$file/PS168.pdf, media reports (e.g.) The Age "Move to streamline financial advice" 11 October 2005 and the ongoing consumer research work carried out by the FSA (e.g. "Consultation paper 05.12 Investment product disclosure: Proposals for a quick guide at the Point of sale" at www.fsa.gov.uk/pubs/cp/cp_05.12.pdf)

[31] For example, refer s947B(6) Corporations Act (Aust) referring to Statements of Advice

[32] Corporations Regulations (Aust) 7.7.04 – in relation to Financial Services Guides provided by a financial services licensee

[33] s947B(3) Corporations Act (Aust) – in relation to the level of detail required in a Statement of Advice to be received by a retail client (generally speaking, this can mean a member of the public)

- extraneous information being provided only if the overriding effect is still clear and concise. [34]

44 The Taskforce suggested, as an alternative definition of "concise", requiring disclosure in a form that could be read by a consumer within 10-15 minutes.[35]

45 If regulations under the Securities Legislation Bill were to prescribe additional methods or a set form for investment adviser or investment broker disclosure, they could require information to be disclosed:

- within a certain restricted number of pages
- under set headings or questions
- in text/font of a certain size; or
- in a certain format (e.g. electronically).

46 The Ministry is keen to hear your views on whether or not it is appropriate for regulation to prescribe the set method or form of disclosure in addition to the requirements listed at s41K of the Securities Legislation Bill, and, if so, what method or form such disclosure should take.

Q3 In addition to the requirements at s41K of the Securities Legislation Bill, should regulations prescribe additional requirements for the set method or form of investment adviser and investment broker disclosure?

Q4 If regulations should prescribe additional requirements for the method and form of investment adviser and investment broker disclosure, what should these requirements be (for example, should there be a set page limit, set headings, set format or set size)?

Q5 In your view, would the benefit of prescribing set methods or a form of investment adviser and investment broker disclosure through regulation outweigh the cost of the additional disclosure requirements?

Timing

47 Under the Securities Legislation Bill, investment advisers and brokers must make all disclosure in writing prior to providing the investment advice or service.[36]

48 The Ministry is aware of concerns that advisers/brokers may find it difficult to disclose all required information prior to actually giving the advice or providing the service. It may be that for some forms of information, for example, relevant remuneration (see discussion below), it may be more appropriate for

[34] Disclosure: Product Disclosure Statements (and other disclosure obligations) at ASIC PS168.49, pg 14
[35] Taskforce Report page 42
[36] S41C Securities Legislation Bill

information to be disclosed by a different method, for example, by information being made available as soon as possible after the service is to be provided, before the customer agrees to accept the service, or by way of a cooling off period.

49 The Ministry is keen to hear your views on any obstacles on investment advisers and brokers disclosing any particular type of information prior to giving investment advice or receiving investment money or property.

Q6 In your view, are there any obstacles which would make it difficult for investment advisers and investment brokers to disclose all required information prior to providing investment advice, or receiving investment money or property?

Q7 If any obstacles have been identified in relation to timing, which disclosure obligations do they affect? What would be the cost of requiring disclosure prior to the investment advice being provided, or investment money or investment property being received? Is there an appropriate time within which the required information could be disclosed so that it would still benefit the recipient of the advice or service?

Relevant remuneration

50 Under section 41F of the Securities Legislation Bill, investment advisers have an obligation to disclose whether or not they have an interest or a relationship that a reasonable person would find reasonably likely to influence the adviser in giving the investment advice. This includes an obligation to disclose, prior to giving that investment advice,[37] any relevant remuneration, any relationships with anyone connected with the investment, or with anyone who may reasonably be expected to influence the content or provision of the investment advice, and any other indirect pecuniary or other interest in giving the investment advice.[38] Specifically, s41F(3) requires an investment adviser to disclose (again prior to the investment advice begin given), in the case of remuneration, to the extent practicable, the amount or rate of the remuneration, and the name of the person from whom the remuneration has been or will or may be received.

51 It is a common express requirement in other jurisdictions that, in expressing the amount or rate of remuneration, dollar amounts are used, so consumers understand the exact cost. For example, in the United Kingdom, investment advisers have to disclose commission (or its equivalent) in cash terms.[39] In Australia, information about remuneration is required to be disclosed in dollar amounts, on the basis that consumers understand information better when

[37] See discussion on timing of disclosure above
[38] s41F(1) and (2) Securities Legislation Bill
[39] Refer www.fsa.gov.uk/pages/library/communication/pr/2004/018.shtml : "The existing system for the disclosure of the cost of advice, introduced in 1994, requires disclosure in cash terms of commission received by IFA firms and remunerations (which the FSA proposes to rename "commission equivalent") by non IFA firms.

presented in dollar figures.[40] For example, in Australia, investment advisers must describe any remuneration (including commission) or other benefits that the investment adviser will receive that might reasonably be expected to be or have been capable of influencing the investment adviser in providing the advice, as well as any such benefits received by people associated with the investment adviser (e.g. director, employee, related body corporate) in dollar amounts.[41]

52 The Ministry is keen to hear your views on whether there are any obstacles to providing disclosure on the amount or rate of relevant remuneration prior to the services being provided. These obstacles may arise either because it is difficult to express or to calculate the remuneration as an amount or rate; or because it is difficult to calculate the amount or rate at that time prior to the advice/service being provided (that is, an issue of timing). The Ministry is interested in whether regulations should prescribe any set method or form of disclosure to address such obstacles, for example, by set wording to describe trail commissions, or remuneration which is dependent upon a range of factors.

53 These obstacles have been recognised in Australia, where ASIC provides guidance on how to comply with the general requirements (described at paragraph 51 above) in situations where it is not possible to ascertain an amount of remuneration, commission or other benefit payable to a particular person that is attributable to the financial services provided by the providing entity. In such situations, AISC notes that it is generally sufficient to set out:

- the circumstances in which the benefit is expected to be received;
- in the case of a monetary benefit — the factors (if any) that will influence the amount of the benefit (e.g. the hourly fee rate, where the client is to be charged a fee); and
- in the case of a non-monetary benefit — a clear description of the benefit.[42]

54 In addition, in relation to dollar disclosure, while the information must still be represented in a way that is easy for the client to understand,[43] ASIC suggests that it may be better for investment advisers to use a formula rather than a dollar amount to disclose the information to consumers, for example, where there are:

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[40] ASIC Policy Statement 182 Dollar Disclosure– pg 17 at www.asic.gov.au/asic/asic.nsf/lkuppdf/ASIC+PDFW?opendocument&key=ps182_pdf. Also refer the example in ASIC PS175.52 of the type of information that may be included in a Financial Services Guide (FSG): "I will receive an upfront commission from the product issuer where you decide to buy a product I recommend to you. Usually this upfront commission is 5% of the amount you invest, although the exact amount may vary from 3% to 10% depending on the product. For example, for an investment of $10,000 in a product whose manager pays me 5%, I will receive an upfront commission of $500. In addition to the upfront commission payment, I will also receive ongoing commissions. The amount I will receive varies depending on the circumstances, although typically I receive an ongoing commission of 1% per annum of the value of your holding in a product (as at 30 June each year) for as long as you hold the product."

[41] s947B(2) (d) Corporations Act (Aust)

[42] ASIC Policy Statement 175 Licensing: Financial product advisers – conduct and disclosure PS 175.38

[43] ASIC PS 175 Licensing Financial Product Advisers at page 41 at www.asic.gov.au/asic/asic.nsf/lkuppdf/ASIC+PDFW?opendocument&key=PS175_pdf

- unknown facts or circumstance, e.g. trailing commissions[44] or volume bonuses where the amount is dependent on unknown future matters.

- non-monetary benefits

- costs of derivatives, foreign exchange contracts, general insurance products and life insurance risk products (advisers may have to summarise the factors that may affect costs, as there are too many variables to be certain).

- interest payable on deposit products; and

- foreign currency amounts.[45]

55 The Ministry is also keen to hear your views on whether there are situations where it may be difficult to provide disclosure of relevant remuneration, either because it is difficult to calculate the amount or rate of remuneration, or because it is of timing issues, and whether or not regulations could provide guidance on a method or form of disclosure to assist with such situations. Particularly, the Ministry is interested in your views on:

- the type of "soft" commissions which will be captured by the reference to "indirect benefit or advantage" in the definition of "remuneration" at s41F(4) and whether regulations are required to provide additional guidance on how, and the extent to which, such benefits /advantages should be described; and

- whether there are any difficulties for intermediaries in disclosing such information in the event that the benefit or advantage is received by their employer or firm.

Q8 In your view, are there any obstacles which would make it difficult for investment advisers and investment brokers to disclose the amount or rate of all relevant remuneration, prior to the investment adviser or broker providing a service (this may because it is difficult to calculate the amount or the remuneration, or because it is difficult to describe the remuneration prior to providing the service). Particularly, are there obstacles which may make it difficult to describe the full range of "soft" benefits or advantages which may be covered by the definition of "remuneration" at s41F(4), or if that benefit or advantage is received indirectly?

Q9 If any obstacles have been identified, can you please describe them, and also the types of remuneration that the obstacles would affect?

Q10 Can you suggest any set method or form of disclosure which would allow investment advisers and brokers to describe any such remuneration in a more general form (e.g. through prescribed wording rather than referring to

[44] Trailing commissions are where advisers receive money from managed fund accounts to cover the cost of monitoring these investments. A Securities Commission Discussion paper "Law Reform: Investment Advisers, A Discussion Paper" (27 Aug 2001) at p30 suggested that these are common in New Zealand.

[45] ASIC Policy Statement 182 – Dollar disclosure at 182-32

"amount" or "rates") or at a later time (e.g. through prescribed time limits which set the date by which the amount or rate has to be disclosed after the service has been provided)? What would be the costs and benefits applying to investment adviser, brokers and members of the public of such regulations?

Q11 Should regulations require any types of relevant remuneration to be disclosed in dollar figures to make it easier for consumers to understand?

PROFESSIONAL INDEMNITY INSURANCE

56 The Securities Legislation Bill requires investment advisers to disclose whether or not they hold professional indemnity insurance. Section 49C allows for regulation to require investment advisers to have a prescribed minimum level of professional indemnity insurance, or to give an undertaking that the adviser has sufficient professional indemnity insurance.

57 Professional indemnity insurance generally indemnifies the insured person in respect of the liabilities arising out of, or in the course of, that person's professional activities or business.[46] This requirement is placed on financial advisers in a number of jurisdictions, including the United Kingdom and the European Union. In the United Kingdom, the rationale for requiring personal investment firms to hold professional indemnity insurance is the relatively low base capital requirements for such firms.[47] Professional indemnity insurance is also seen to indirectly address consumer protection and market confidence objectives by providing a source other than a firm's capital from which justified claims can be met.[48] The FSA has set rules in relation to professional indemnity insurance, including rules that specify the wording of professional indemnity insurance policies, to ensure "a higher degree of clarity for firms and for underwriter about what constitutes complaint cover, and greater consistency in the scope and quality of cover being sought".[49]

58 The FSA also suggests that having set rules on professional indemnity insurance will ensure that personal investment firms can more easily comply with the General Insurance Mediation Directive adopted by the European Union which requires insurance and reinsurance intermediaries to hold professional indemnity insurance.[50]

59 The Ministry is keen to hear your views on professional indemnity insurance, and the extent to which regulations should require minimum levels or undertakings.

[46] See for example, definition of professional indemnity insurance for financial advisers at s9(2)(b) *Financial Advisers Act* (Singapore): "a contract of insurance with an insurer under which a person is indemnified in respect of the liabilities arising out of or in the course of this business as a financial adviser."
[47] Consultation Paper 193, paragraph 2.7, page 7 – FSA July 2003. See also accompanying press release at www.fsa.gov.uk/pages/Library/Communication/PR/2003/065.shtml
[48] Consultation Paper 193, paragraph 2.7, page 8 – FSA July 2003
[49] Consultation Paper 193, paragraph 3.7, page 14 – FSA July 2003
[50] Consultation Paper 193, paragraph 3.4-3.5, pages 11-12 – FSA July 2003

Q12 The Ministry is interested whether or not regulations should require investment advisers to have a minimum level of professional indemnity insurance, and prescribe the amount of that minimum level, or to give an undertaking that the adviser has adequate professional indemnity insurance for the protection of the persons to whom the adviser gives investment advice? If you believe that a minimum level should be set in regulation, how do you think this minimum level should be determined?

Q13 What would be the costs and benefits applying to investment adviser, brokers and members of the public if such regulations were implemented?

SHOULD THERE BE ANY EXEMPTIONS?

60 Under section 49C(1)(d) of the Securities Legislation Bill, any person or class of persons, any class of transactions, or class of investment advice (e.g. telephone), or investment brokers services can be exempted from compliance with any investment advisers' or investment brokers' disclosure obligation or obligations (on terms and conditions, if any).[51]

61 The investment adviser disclosure obligations and the investment broker disclosure obligations are set out at ss41B to 41G (for investment advisers); ss41H to 41J (for investment brokers) and ss41K to 41P (disclosure requirements applying to both advisers and brokers).

Investment adviser and investment broker definition

62 Unless exempted, all people who fall under the definition of "investment adviser" have to comply with the investment adviser obligations, and similarly, all people falling under the definition of "investment broker" have to comply with the investment broker obligations.[52]

63 As defined, an "investment adviser" is a person who gives investment advice in the course of their business or employment. This includes both a person and his or her employer where that person is giving investment advice in the course of his or her employment.[53] The definition of investment adviser now expressly excludes:

[51] s49C(1)(d) Securities Legislation Bill

[52] "Investment advisers' disclosure obligations" are defined to mean sections 41B to 41G and 41K to 41O and any regulations with which those sections require compliance. "Investment advisers obligations" are those sections as well as section 41P ("*Advertisement must not be deceptive, misleading or confusing*") and 41T ("*Recommending or receiving money for, acquisition of securities prohibited if offer for subscription illegal*"). "Investment brokers' obligations" are defined to mean sections 41H to 41O and any regulations with which those sections require compliance. "Investment brokers' obligations" are those sections as well as section 41P and 41T.

[53] s20 Securities Legislation Bill

- an issuer or a promoter or a trustee (within the meaning of the Securities Act 1978 or the Unit Trusts Act 1960) or statutory supervisor (within the meaning of the Securities Act 1978), of the particular securities to which the advice relates (however, if an employee, agent or person otherwise associated with such an issuer, promoter, trustee or statutory supervisor gives investment advice in the course of their business, that employee (etc) is an investment adviser);

- a person who only transmits investment advice relating to particular securities given by the issuer or a promoter or a trustee or statutory supervisor, of those securities;

- the offeror or target company in a takeover offer made under the Takeovers code, or an independent adviser in the exercise of that person's functions under the Takeovers Code.[54]

64 The class of people who fall under the definition of "investment broker" is unchanged from the IADA.[55]

65 The Ministry is interested in hearing your views on whether or not there are any class of investment adviser of investment broker which should be exempted from any or all of the disclosure obligations the Securities Bill.

Q14 In your view, is there any class of persons which should be exempted from compliance with the investment adviser disclosure obligations or the investment broker disclosure obligations? If so, which class of person should be exempted, and why?

Definition of investment advice

66 Investment advice is a recommendation, opinion or guidance given to a member of the public in relation to acquiring or disposing (or not acquiring or not disposing of) securities.[56]

67 The definition of "investment advice" excludes recommendations, opinions or guidance given by journalists, or guidance as to procedures, prospectuses, investment statements, authorised advertisements and bank disclosure statements to a document issued in lieu of a prospectus or investment statement with an exemption under the Securities Act 1978.[57]

68 In Australia, advice from a lawyer given in his or her professional capacity, about matters of law, legal interpretation or the application of the law to any facts, as well as advice from a tax agent given in the ordinary course of activities as such an agent and that is reasonably regarded as a necessary part of those activities is expressly excluded from the definition of "financial

[54] s20 Securities Legislation Bill
[55] s20 Securities Legislation Bill and s2 IADA
[56] s20 Securities Legislation Bill
[57] s20 Securities Legislation Bill

product advice."[58] ASIC provides further guidance on what counts as "financial product advice" by noting that communications which are factual are expressly excluded from the definition (and hence the accompanying responsibilities attaching to the provision of financial product advice[59]) unless such a communication can be seen to imply a recommendation.[60]

69 Further, ASIC has recommended that if information does not constitute financial product advice, then the adviser should consider giving a disclaimer to the effect that the adviser is not providing financial product advice, and that the consumer should consider obtaining independent advice.[61]

70 This builds on the existing requirement in Australia on investment advisers to warn the client that the advice is, or may be, based on incomplete or inaccurate information relating to the client's relevant personal circumstances; and that, the client should, before acting on the advice, consider the appropriateness of the advice, having regard to the client's relevant personal circumstances.[62]

71 The Ministry is keen to hear your views on whether there are any classes of investment advice which should be exempted from the disclosure obligations under the Securities Legislation Bill. There is no corresponding obligation in the Securities Legislation Bill on investment advisers to disclose to consumers that certain types of information that they may provide may fall outside under the definition of "investment advice".

Q15 In your view, is there any definition of investment advice which should be excluded from all or some of the disclosure obligations in the Securities Legislation Bill? If so, which class of advice, and why?

Q16 Would the benefit of excluding certain classes of investment advice outweigh the costs?

Excluded products – definition of "security"

72 The Securities Legislation Bill relies on regulations to define "bank term deposit" (refer definition of "security" under (e) in section 20).

73 As noted, the definition of "investment advice" is restricted to recommendations (etc) about acquiring or disposing of securities. The Securities Legislation Bill excludes "bank term deposits" (together with other excluded securities and call debt securities) from the definition of "security". A person providing advice on bank term deposits is not providing investment

[58] S766B Corporations Act (Aust)
[59] Refer Part 7.7) of the Corporations Act (Aust) ("Financial Services Disclosure") for the obligations attaching to the provision of financial product advice, either as general advice or personal advice.
[60] ASIC guide, May 2005 "Licensing: The scope of the licensing regime: Financial product advice and dealing" at pg 8 (refer www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/advicedealguide.pdf/$file/advicedealguide.pdf)
[61] ASIC guide, May 2005 "Licensing: The scope of the licensing regime: Financial product advice and dealing" at pg 9
[62] Refer Corporations Act (Aust) ss 945B, 947B(2)(f), 947C(2)(g) (in relation to personal advice) and s949A (in relation to general advice). ASIC is currently looking at refining the requirements of s949A - refer "Refinements to the Financial Services Regulation – Proposals Paper, May 2005" at page 13

advice, hence that person is not an investment adviser, and is not subject to the disclosure requirements under the Securities Legislation Bill. The Commerce Select Committee agreed to exclude bank terms deposits in this way on the basis that bank term deposits are relatively straightforward, have a low market and default risk, and are generally well understood by the public.[63]

74 The Ministry notes that under the current Review of Financial Products and Providers, the government is considering an appropriate definition of "deposits" and the nature of supervisory arrangements for a range of (as yet unspecified) deposit takers. The Review's key objective is to develop an effective and consistent framework for the regulation of the non-bank financial sector that promotes confidence and participation by investors and institutions, and results in a sound and efficient financial sector - in summary, a better framework for both investors and industry.[64] The first phase of the Review resulted in a report on the current framework, identification of (any) problems and general directions for reform.[65]

75 In phase two of the Review (the current phase at the date of this discussion document) Ministry officials will be responsible for developing proposed options for reform through further research, consultation, and design, taking into account the feedback and work already contributed. In phase three of the Review, the Ministry will release for consultation a discussion paper on the proposed reforms. This is scheduled for the first half of 2006. A series of consultation meetings on the paper will also be held in the first half of 2006. Finally, in phase four of the Review, the Ministry will develop policy proposals, again, in conjunction with the advisory groups. It is intended that policy proposals will be sent to Cabinet in late 2006, with legislation planned to be passed in 2008.

76 In light of the Review, it may be appropriate if the definition of "bank term deposit" required for the Securities Legislation Bill used specific terms, for example, referring to a "bank term deposit" as a "term deposit with a registered bank" so it cannot be said to in any way be pre-determining the outcome of the broader Review.

77 definition is still required to be inserted into regulations at this stage so that the exemption for advice on a "bank term deposit" can take effect. We would consider reviewing this definition in light of any changes resulting from the work under the review of Financial Products and Providers.

78 he Ministry seeks your views on the clearest definition of "bank term deposit" in the New Zealand context and invites comments on the definition listed above, as well as any other possible definitions that may describe a bank term deposit by reference to (e.g.) the entity offering the institution or the nature of the security (e.g. any set restrictions on its callability).

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[63] Commerce Select Committee commentary on the Securities Legislation Bill at page 5

[64] The Review of Financial Products and Providers is being led by the Ministry of Economic Development, in conjunction with an inter-departmental working group comprising officials from Treasury, Reserve Bank, Securities Commission and the Ministry of Consumer Affairs. For more information, please refer to www.med.govt.nz/templates/ContentTopicSummary____479.aspx

[65] A copy of the report is available at www.med.govt.nz/templates/StandardSummary____14104.aspx

79 he Ministry is also interested in canvassing your views on whether or not there are any other products in addition to bank term deposits about which advice can be provided which are also "relatively straightforward, have a low market and default risk, and are generally well understood by the public."[66] There is the power under section 49 for regulations to be made for the purpose of exempting any class of transactions or any class of investment advice from compliance with any investment advisers' or investment brokers' obligations.

80 The Ministry notes that, as drafted, under the Securities Legislation Bill, New Zealand investment advisers providing advice on bank term deposits (however defined) will be subject to none of the disclosure obligations in the Bill. This can be contrasted with Australia where, although the Corporations Act 2001 (Aust) places lesser obligations on those who deal with or provide financial product advice about basic deposit products,[67] (for example, advisers do not have to provide a Financial Services Guide,[68] or a Statement of Advice),[69] advisers do still have to provide the following information:

- the name and contact details of the adviser
- information about the dispute resolution system that covers complaints by persons to whom the adviser provides financial services, and about how that system may be accessed;[70]
- details of remuneration, commission, or other benefits people associated with the adviser will receive that might reasonably be expected to influence the adviser in giving advice; and
- any other interests, associations or relationships between the adviser and its associates on the one hand, and the issuers of financial products on the other, that might reasonably be expected to have influenced the adviser in giving advice (in lieu of a Statement of Advice).[71]

81 The Ministry asks submitters to note that all securities under the definition of "bank term deposit" will fall outside the investment adviser disclosure regime. It is, of course, possible to exempt classes of investment advice (subject to any terms and conditions) which are similar to bank term deposits by way of regulation under section 49C(1)(d) of the Securities Legislation Bill so that, depending on the terms and conditions, investment advisers are exempt from some but not all disclosure obligations.

Q17 In your view, what definition best describes a "bank term deposit"?

Q18 Are there any other products similar to bank term deposits about which advice is provided? What are these products, and why are they similar to bank term deposits?

[66] Refer paragraph V73 above
[67] s941C Corporations Act (Aust)
[68] s941C(6) Corporations Act (Aust)
[69] s946B(5) Corporations Act (Aust)
[70] s941C(7) Corporations Act (Aust)
[71] s946B(6) Corporations Act (Aust)

Q19 What would be the costs and benefits to exempting other products in addition to "bank term deposits" from the definition of "security" under the Securities Legislation Bill?

Q20 In your view, should advice/transactions on any bank term deposit or any other products still be subject to compliance with any investment adviser and broker disclosure obligations under the Securities Legislation Bill? If so, which disclosure obligations, and why?

Exemption for advice given under time restraint or over the telephone

82 The Ministry acknowledges that it may be difficult to comply with the obligation to disclose information about remuneration or fees prior to giving advice where investment advice, or information about advisers, is given under time restraint and/or in non-traditional fora, e.g. over the telephone or through web broadcasts. Exempting certain classes of investment advice under s49C of the Securities Legislation Bill (e.g. advice given by telephone) may counter the risk that investment advisers and brokers could be less likely to provide advice orally or other than in face to face meetings with clients, due to the amount of information to be provided before advice can be given.

83 In some jurisdictions, transactions involving financial product recommendations can be made over the telephone without the normal written disclosures about the product being provided beforehand, provided that certain oral disclosures are made, and that a written product disclosure statement is provided subsequently.[72]

84 In Australia, if a client expressly instructs that they require the financial service to be provided immediately, or by a specified time and it is not reasonably practicable for the adviser to give the client the required disclosure information before the service is provided as so instructed, then the investment adviser can instead give the client a statement containing the following information, and then provide full disclosure within five working days:[73]

- information about the remuneration (including commission) or other benefits that the adviser (and other associated persons, etc) is to receive related to the advice; and

- information about any associations or relationships between the adviser, or any related body corporate, and the issuers of any financial products, (being associations or relationships that might reasonably be expected to

[72] For example, in the United Kingdom, refer the Financial Services Authority Handbook, Conduct of Business at paragraph 6.4.27 (which refers to telephone sales of financial products) and paragraph 5.7.3 (which refers to disclosure of charges in relation to products). The Australian Securities and Investments Commission (ASIC) is looking at streamlining the oral disclosure requirements in light of concerns that the oral disclosures are being made by way of a formal script, which has caused some consumers to hang-up, refer "Refinements to the Financial Services Regulation – Proposals Paper" May 2005, page 12.

[73] s941D(4) Corporations Act (Aust)

be capable of influencing the entity providing any of the authorised services).[74]

85 This "five working day extension" applies despite the general rule in Australia that an investment adviser must disclose certain information[75] to the client as soon as practicable after it becomes apparent to the investment adviser that the financial service will be, or is likely to be, provided to the client. [76]

86 The Ministry is interested in your views on the provision of advice in certain situations where it may be difficult to comply with the obligation to disclose information about remuneration or fees prior to giving that advice.

Q21 In your view, is there any class of investment advice which, when provided in certain situations, such as over the telephone, should be exempted from compliance with any or all investment adviser or investment broker disclosure obligations? If any, can you please describe the class?

Q22 Should such advice be exempted from all or just some disclosure obligations?

Q23 Would the benefit of excluding such a class of investment advice outweigh the cost of requiring full disclosure?

Exemptions for advice given in a public forum?

87 Australia has reduced disclosure obligations where an adviser provides general advice in a public forum.[77] "Public forum" is defined in the Corporations Regulations to mean:

a. an event (if any person is permitted to attend the event; and the event is attended either by more than 10 clients; or the number of clients could not reasonably be ascertained before the event commenced); or

b. a broadcast, if any person may view or hear the broadcast; or

c. a flyer or other promotional material that is displayed or otherwise available in a place that is accessible to the public.

88 This includes television broadcasts, promotional material contained in newspapers and magazines, radio broadcasts, internet websites and web casts and public lectures or seminars.[78]

[74] s941C(5). If the entity providing advice acts under a contractual arrangement with an insurer in providing any of the authorised services) then the entity also has to provide a statement that identifies the services provided under the arrangement; states that they are provided under the arrangement; and explains the significance of the services being provided under those arrangements. This type of arrangement is called a "binder", which means an authorisation given to a person by a financial services licensee who is an insurer to enter into contracts that are risk insurance products on behalf of the insurer as insurer; or deal with and settle, on behalf of the insurer, claims relating to risk insurance products against the insurer as insurer – s761A Corporations Act (Aust)

[75] The information to be provided is described as a "Financial Services Guide"

[76] s941D (1) Corporations Act (Aust)

[77] s941C(4) Corporations Act (Aust)

89 In such situations the adviser does not need to provide the client with the usual full disclosure (as would be required in a standard Financial Services Guide prior to providing the advice). Instead the adviser is only required to give the client:

- the name and contact details of the adviser;
- information about the remuneration (including commission) or other benefits that the adviser (and other associated persons, etc) is to receive related to the advice;
- information about any associations or relationships between the adviser, or any related body corporate, and the issuers of any financial products, if they are associations or relationships that might reasonably be expected to be capable of influencing the adviser in providing any of the services; and[79]
- if the client is a member of the public, a warning that the advice has been prepared without taking account of the client's objectives, financial situation or needs; and that the client should consider the appropriateness of the advice with other information.[80]

90 The Ministry is keen to hear views on how much investment advice is currently provided in a public forum in New Zealand. This information will help inform any policy decisions on exemptions for such advice.

91 The Ministry also notes that this section is not intended to address an individual or firm advertising its services in a public forum as a provider of investment advice. This is the case in the United Kingdom, where the case of an investment adviser merely publicly advertising services through the use of logos, or a general statement about the business, is generally exempt from disclosure obligations.[81]

[78] 7.702(2) *Corporations Regulations 2001 (Aust)*
[79] s941C(5)
[80] s949A(2)
[81] FSA Handbook, COB 3.2.5

Q24 In your view, should investment advice given in a public forum be exempted from compliance with any or all investment adviser or investment broker disclosure obligations?

Q25 How do you define advice available in a public forum? In your view, how much investment advice in New Zealand is provided in a public forum?

Q26 If so, should such advice be exempted from all or just some disclosure obligations?

Q27 Would the benefit of excluding such a class of investment advice outweigh the cost of requiring full disclosure?

VI SUBSTANTIAL SECURITY HOLDER DISCLOSURE

BACKGROUND

92 The Securities Markets Act 1988 was enacted primarily in response to the 1987 Stock Market crash. The purpose of the substantial security holder regime is to:[82]

> promote an informed market, and to deter insider conduct, market manipulation, and secret dealings in potential takeover bids, by ensuring that participants in New Zealand's securities markets have access to information concerning the identity and trading activities of persons who are, or may at any time be, entitled to control or influence the exercise of significant voting rights in a public issuer.

93 Similarly, Sinclair J has described the regime as being designed to:[83]

> ensure that a public issuer, its members, the Stock Exchange and the investing public at large are kept informed as to the ownership of voting securities in a public issuer and as to the identity of those who are, or may be, in a position to control the company. In particular it is aimed at restricting secret dealing in shares for a takeover advantage.

94 Disclosure ensures that the market has information concerning the identity and trading activities of persons who are, or may at some point be, entitled to control or influence the exercise of significant voting rights in a public issuer and thus its direction or strategy. This disclosure regime, combined with the continuous disclosure regime and the directors' and officers' disclosure obligations contained in Part 2 of the Act, ensure that investors have sufficient information to make accurate judgements about where to invest. This allows the market to work more efficiently as resources are more effectively channelled into appropriate investments.

95 The Review of Securities Trading Law, which resulted in the Securities Legislation Bill, identified that the current substantial security holder disclosure regime was fundamentally sound; however, some minor problems had been identified.[84] The Securities Legislation Bill simplifies the current disclosure regime by requiring disclosure of relevant interests by class, and in respect of listed, voting securities only. The Securities Legislation Bill also gives the Securities Commission the power, after having regard to the purpose of the substantial security holder regime, to require that a person disclose to the market the nature and extent of all relevant interests that person maintains in any securities of a public issuer (whether listed or not, voting or non-voting, existing now or in the future). The intent of these amendments is to clarify the situations in which disclosure is required, and make those disclosures more straightforward.

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[82] Securities Legislation Bill clause 26, new section 20

[83] *Brook Investments Ltd (in vol liq) v Paladin Ltd* 490 NZPD 5282-5283 (21 July 1988)

[84] *Review of Securities Trading Law: Substantial Security Holder Disclosure* (24 July 2003); available at www.med.govt.nz/templates/MultipageDocumentTOC____14448.aspx

OBLIGATION TO DISCLOSE

Relevant interests

96 The Securities Legislation Bill will insert a new Subpart Three of Part Two of the Securities Markets Act, relating to substantial security holder disclosure. One of the key concepts is a "relevant interest". The basic rule is that a person will have a relevant interest in a security if they are the holder of that security, have the power to control the voting or disposal of the security, or have an ability to control the security (now or in the future) in this manner via trusts, nominee companies, family members and so on.[85]

"Event" disclosure

97 Substantial security holdings (and substantial security holders) are the basis for the mandatory "event" disclosure obligations under the regime. A substantial security holding is defined as a relevant interest in five per cent or more of a class of listed voting securities of a public issuer.[86]

98 This differs from the current regime in that the obligation in keyed to five per cent of *a class* of securities (the current regime uses the total) and is limited to *listed voting* securities. This excludes listed non-voting securities (such as debt) and voting but non-listed securities (such as interests in the manager of a collective investment scheme). The new regime also includes classes of listed securities that are convertible into voting securities.

99 The new subpart sets out mandatory disclosure obligations in four circumstances:[87]

- Where a person begins to have a substantial security holding (i.e. acquires a relevant interest in five per cent or more of a class of listed voting securities of a public issuer);[88]
- Where a substantial security holder has a change of one per cent or more in that person's substantial security holding;[89]
- Where the nature of the relevant interest of the substantial security holding changes;[90] and
- Where a person ceases to have a substantial security holding (i.e. the holding drops under five per cent of a class of listed voting securities of a public issuer).[91]

[85] Securities Legislation Bill clause 20, new sections 5-5B
[86] Securities Legislation Bill clause 26, new section 21
[87] Refer to the listed exemptions at Securities Legislation Bill clause 26, new sections 30-33
[88] Securities Legislation Bill clause 26, new section 22
[89] Securities Legislation Bill clause 26, new section 23
[90] Securities Legislation Bill clause 26, new section 24
[91] Securities Legislation Bill clause 26, new section 25

"Required" disclosure

100 In drafting the Securities Legislation Bill, it became apparent that two types of security did not fit comfortably with the numerical thresholds that "trigger" disclosure obligations under the mandatory "event" disclosure obligations:

- Future-arising securities (for example, contractual or equitable rights to not-yet issued voting securities); and

- Unlisted convertible securities (unlisted securities that presently exist but do not attract voting rights until "conversion" in accordance with their terms).

101 Because these securities are not listed, the extent of any single class may not be known to all persons holding securities in that class. This sometimes makes determining whether or not one holds five per cent of that class a difficult exercise. While it may be possible to require disclosure by class of interests in securities that may arise in the future, the potential number of disclosures, the indeterminacy of when the disclosure obligation arises, and the compliance costs attendant on these difficulties appears in combination to exceed the value of requiring their mandatory disclosure.

102 Accordingly, Cabinet agreed to introduce a new power for the Securities Commission. In addition to the four mandatory "event" disclosure obligations, the Securities Commission may require any person to disclose to the market the nature and extent of all relevant interests that person maintains in any securities of a public issuer (whether listed or not, voting or non-voting, existing now or in the future). Such an order would be exercised by the Commission upon being satisfied that the person is, or may at some time in the future be, entitled to control or influence significant voting rights in the public issuer. This is consistent with the purpose of the substantial security holder regime to promote an informed market.[92]

SUBSTANTIAL SECURITY HOLDER REGULATIONS

103 The Securities Markets Act sets out the obligations to disclose. This amounts to *who* must disclose and *when*. The Securities (Substantial Security Holders) Regulations 1997 set out the detailed requirements and forms for disclosure of substantial security holdings (*what* must be disclosed). Some changes will need to be made to the Regulations to reflect the Securities Legislation Bill amendments, but the Ministry considers that the thrust of the Regulations will remain unchanged. Moreover, the Regulations were updated in 1997, and the Ministry believes that they are well-understood in their current form. The current Regulations form the basis for the following consideration of disclosure requirements.

104 Similar provisions are also found in the Securities Markets (Disclosure of Relevant Interests by Directors and Officers) Regulations 2003. These Regulations provide for the disclosure of interests and trades of securities of a public issuer by the directors and officers of that public issuer. When these Regulations were being considered, submitters were of the view that

[92] Securities Legislation Bill clause 26, new section 34

substantial security holder and director and officer disclosure were similar, and it would be helpful to co-ordinate the disclosure requirements so far as possible. These Regulations are also considered in the following consideration of disclosure requirements.

Regulation making power

105 Clause 28 of the Securities Legislation Bill will insert a new section 49A to the Securities Markets Act 1988. This section empowers the making of regulations for the purpose of substantial security holder disclosure. Section 49A authorises making regulations that include information as to:

- details as to the substantial security holding;
- the documents, certificates, and statements that must accompany a disclosure;
- when disclosure is required to be made (including disclosure only on request);
- prescribing the form and method of disclosure, or providing for the relevant registered exchange to determine that form or method of disclosure; and
- exempting (on terms and conditions, if any) classes of persons, transactions, relevant interests, or substantial holdings, from compliance with any substantial holding disclosure obligations.

Details as to the substantial security holding

Permitted requirements

106 Section 49A itself identifies a number of details that may be relevant for the purposes of substantial security holder disclosure, although these are expressly without limitation and others may be included in regulation. These include:

- the nature of the relevant interests;
- the number, nominal value (if any), and class of securities;
- the date of the transaction
- the terms and conditions (including consideration) of the transaction;
- details as to the circumstances of the transaction;
- the date of the last disclosure by the substantial security holder; and
- information relating to other persons that may have disclosed in relation to the transaction or holding.

Existing requirements

107 Similarly, the 1997 Regulation identifies the following details as relevant for substantial security holder disclosure:

- The name of the registered holder or intended registered holder;[93]
- The provision of the Securities Markets Act under which the relevant interest arises;[94]
- The date of the transaction affecting the relevant interest;[95]
- The number of securities affected by the transaction;[96]
- The consideration (expressed in New Zealand dollars) for the transaction;[97]
- A description of the nature of the transaction;[98]
- The name of the other party to the transaction;[99]
- The name of the public issuer;[100]
- The name of the class of securities;[101]
- The number of votes attached to each security in that class;[102]
- The number and percentage of securities of that class in which a relevant interest is held;[103] and
- The number and percentage of securities of that class in which a relevant interest that were held the last time the person disclosed.[104]

108 The directors' and officers' disclosure provisions contain similar requirements.

Q28	The Ministry believes that the current details described above are appropriate and should be retained. All the above information is important to ensure the purposes of the regime are met. Do you agree? Are there any details you consider should/should not be disclosed?

Multiple relevant interests

[93] Securities (Substantial Security Holders) Regulations 1997, Regulation 10(1)(a) and Schedule, Form 1, Note 5
[94] Securities (Substantial Security Holders) Regulations 1997, Regulation 10(1)(b). Guidance as to the relevant interest(s) that need to be disclosed is found in the Schedule, Form 1, Note 4
[95] Securities (Substantial Security Holders) Regulations 1997, Regulation 10(1)(c)
[96] Securities (Substantial Security Holders) Regulations 1997, Regulation 10(1)(d)
[97] Securities (Substantial Security Holders) Regulations 1997, Regulation 10(1)(e)
[98] Securities (Substantial Security Holders) Regulations 1997, Regulation 10(1)(f) and Schedule, Form 1, Note 7
[99] Securities (Substantial Security Holders) Regulations 1997, Regulation 10(1)(g)
[100] Securities (Substantial Security Holders) Regulations 1997, Schedule, Form 1, Note 1
[101] Securities (Substantial Security Holders) Regulations 1997, Regulation 7(a)
[102] Securities (Substantial Security Holders) Regulations 1997, Regulation 7(b)
[103] Securities (Substantial Security Holders) Regulations 1997, Regulations 7(c), 7(d), 7(e) and 7(g)
[104] Securities (Substantial Security Holders) Regulations 1997, Regulations 7(f) and 7(h)

109 Two or more relevant interests are required to be disclosed separately.[105] However, the Securities Markets Act and the 1997 Regulations also distinguish between "beneficial" and "non-beneficial" relevant interests.[106] The Regulations currently separate disclosure of beneficial and non-beneficial relevant interests, providing separate columns for beneficial and non-beneficial relevant interests.[107] The significant factor in this regard is that certain additional documentation is required for non-beneficial relevant interests (the documentation point is discussed below).

110 The directors' and officers' disclosure provisions do not contain separate columns in the disclosure form for beneficial and non-beneficial relevant interests. They instead rely on the general requirement that separate relevant interests be disclosed separately.

Q29	The Ministry believes that there is no need to maintain the differentiation in the disclosure form between beneficial and non-beneficial relevant interests. To improve the clarity of the form and disclosures, separate forms should be completed for beneficial and non-beneficial relevant interests. Do you agree?
Q30	If there were separate disclosures for beneficial and non-beneficial, would this create additional compliance costs? If so, would the benefits gained by improving the clarity of disclosure outweigh these compliance costs?

Different disclosure requirements

111 The directors' and officers' disclosure requirements expressly differentiate between "initial" (as a result of the listing of the public issuer or appointment as director or officer)[108] and "ongoing" disclosure (as a result of a change in holding).[109] Initial disclosures only require details as to the interests held as of the date of disclosure and do not require details as to the underlying transactions that gave rise to the interest. Ongoing disclosures require details as to the transaction too.

Q31	Do you think that different disclosure requirements should be introduced depending on which of the four disclosure obligations described above at paragraph 99 is triggered? In particular, should there be reduced disclosure requirements for initial disclosures?

Accompanying documentation

112 The 1997 Regulations require certain documentation to be attached to the disclosure notice where there is a change in the number of securities held, a change in the nature of the relevant interest, or any relevant interest other than a beneficial relevant interest.[110] The documentation includes copies of the following:

[105] Securities (Substantial Security Holders) Regulations 1997, Regulation 11
[106] Securities Markets Act 1988 section 5(1)(a), Securities Legislation Bill clause 20, new section 5(1)(b) and Securities (Substantial Security Holders) Regulations 1997 Regulation 3 and Schedule, Form 1, Note 3
[107] Securities (Substantial Security Holders) Regulations 1997, Regulation 7 and Schedule, Form 1
[108] Securities Markets Act 1988 section 19T(1)
[109] Securities Markets Act 1988 section 19T(2)
[110] Securities (Substantial Security Holders) Regulations 1997, Regulation 12

- Written contracts, agreements, deeds or instruments affecting the securities or relevant interest;[111]

- Any written document that records material terms of any agreement affecting the securities or relevant interest;[112] and

- If no written documents exist, a memorandum in writing specifying the material terms of any trust, agreement, arrangement or understanding from which the relevant interest arises.[113]

Q32	The Ministry believes that the current documentation requirements described above are appropriate and should be retained. All the above documentation is important to ensure the purposes of the regime are met. Do you agree? Are there any pieces of documentation you consider should/should not be disclosed?

113 Excluded from the documentation to be provided are documents that have previously been disclosed in another substantial security holder notice[114] and documents in respect of an on-market transaction.[115] Also excluded are documents where the substantial security holder has a beneficial relevant interest.

Q33	The Ministry considers that the current exclusions described above seem appropriate and should be retained. They are necessary to ensure that the compliance costs of the regime do not outweigh the benefits. Do you agree? Are there any other circumstances where you consider exclusions should/should not be introduced? Note the class exemption for investment management contracts[116] – is it appropriate that this standing exemption be moved into law?
Q34	Do you think that different documentation requirements should be introduced depending on which of the four disclosure obligations described above at paragraph 99 is triggered? In particular, should there be reduced disclosure requirements for initial disclosures? This may be particularly relevant where, for example, a five per cent stake has been built up over a long period of time and some historical documentation is not available. Note however that regulations do already deal with situations where no documents exist.

Request/mandatory disclosure

114 The regulation making power contemplates that in some circumstances it may be appropriate to require substantial security holders to disclose all information on a mandatory basis, and some information to be disclosed on request. This on request disclosure would be in addition to the statutory Securities Commission "request" disclosure described above. Under the current substantial security holder and directors' and officers' disclosure requirements, mandatory disclosure of all information is required.

[111] Securities (Substantial Security Holders) Regulations 1997, Regulation 13(a)
[112] Securities (Substantial Security Holders) Regulations 1997, Regulation 13(b)
[113] Securities (Substantial Security Holders) Regulations 1997, Regulation 13(c)
[114] Securities (Substantial Security Holders) Regulations 1997, Regulation 14(a)
[115] Securities (Substantial Security Holders) Regulations 1997, Regulation 14(b)
[116] Securities Act (Investment Management Contracts) Exemption Notice 2002.

Q35	The Ministry considers there should be mandatory disclosure of all information. The information is normally easy to provide and it is necessary to achieve the objectives of the regime. Request-based disclosure may also increase compliance costs as people could end up having to make a number of disclosures to individual market participants instead of to the market as a whole. Do you agree? Is there any information that should be disclosed only on an on-request basis?

Form and method of disclosure

115 The regulation making power allow for the form and method of disclosure to be prescribed, either through setting out a form that must be completed or providing that the relevant registered exchange may prescribe the form and method.

116 The current substantial security holder and directors' and officers' disclosure requirements prescribe forms. Both provide for a "complete the boxes" style of form setting out the required information as described above.

Q36	Should the government prescribe a form or should the government allow the relevant registered exchange to prescribe the form to be completed? If the government does prescribe a form, do you prefer the general approach of the current substantial security holder form or the directors' and officers' form?

117 The 1997 Regulations also prescribe acceptable methods of filing. These must be delivered, faxed or filed by agreed electronic means.[117] No other "method" requirements are set out.

Q37	The requirements for electronic filing have been superseded by the Electronic Transactions Act 2002 and do not need to be reproduced. However, are there any "method" requirements that should be prescribed? For example, should notices be *required* to be sent electronically? Or should the government allow the relevant registered exchange to prescribe the method by which the form must be completed?

Exemptions

118 Exemptions from the disclosure requirements are set out in the Securities Markets Act 1988. Under the proposed new legislation, a person has an exemption from the disclosure requirements where:

- The person's ordinary business is money lending or financial services, and the relevant interest arises due to a security given for the purposes of an ordinary business transaction;[118]

- The person is authorised to undertake trading activities on a registered exchange's market, and the relevant interest arises due to trading securities on behalf of another;[119]

[117] Securities (Substantial Security Holders) Regulations 1997, Regulation 16
[118] Securities Legislation Bill clause 20, new section 6(1)(a)
[119] Securities Legislation Bill clause 20, new section 6(1)(b)

- The person has been authorised by resolution of the directors of the public issuer to act as its representative at a particular meeting of members of the public issuer, and a copy of the resolution is deposited with the public issuer before the meeting;[120]

- The person is appointed as a proxy to vote at a particular meeting of members of the public issuer and the instrument of appointment is deposited with the public issuer before the meeting;[121]

- The person is a bare trustee of a trust;[122]

- The person is a director of the public issuer and the public issuer has a relevant interest in the security;[123]

- The person is a member of a body corporate and the body corporate's constitution or section 45 of the Companies Act 1993 gives the member pre-emptive rights on the transfer of the security, if all members have pre-emptive rights on the same terms;[124]

- The person has a relevant interest only because it is related to another person (for example, a related body corporate) that has an relevant interest, and that other person complies;[125]

- The person is a bare trustee or nominee (subject to certain threshold conditions);[126] or

- The person is a trustee, executor, or administrator of a deceased person's estate (partial exemption from time period only).[127]

119 The regulation making power allows for additional exemptions to be made. There are no additional exemptions in the 1997 Regulations.

Q38	The Ministry considers that the current exemptions described above seem appropriate and should be retained. They are necessary to ensure that the compliance costs of the regime do not outweigh the benefits. Do you agree? Are there any other circumstances where you consider exemptions should/should not be introduced?

Other changes

120 Consequential changes will need to be made to the regulations to reflect changes to the Securities Markets Act. This will include changes such as cross references and terminology. Most significantly, with the focus on disclosure with reference to class totals, it will include removing references to disclosure of total numbers of securities.

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[120] Securities Legislation Bill clause 20, new section 6(1)(c)
[121] Securities Legislation Bill clause 20, new section 6(1)(d)
[122] Securities Legislation Bill clause 20, new section 6(1)(e)
[123] Securities Legislation Bill clause 20, new section 6(1)(f)
[124] Securities Legislation Bill clause 20, new section 6(1)(g)
[125] Securities Legislation Bill clause 26, new section 30
[126] Securities Legislation Bill clause 26, new section 31
[127] Securities Legislation Bill clause 26, new section 33

Q39	Other than consequential changes, the Ministry considers that the other provisions of the 1997 Regulations (relating to for example acknowledgement of notices and forms requiring disclosure) can be carried through to the new regulations. Do you agree? Are there any other changes that need to be made?

VII INSIDER TRADING

BACKGROUND

Insider trading under the Securities Legislation Bill

121 The Securities Legislation Bill takes a new approach to insider trading based on considerations of market efficiency and market fairness, rather than a fiduciary relationship. By widening the scope of the regime to include all those who have an information connection rather than a fiduciary connection, the Bill aims to capture all trading on the basis of unequal information.

122 Section 8A of the Securities Legislation Bill contains a new definition of 'insider', referring to them as an 'information insider' to emphasise the information connection. A person is an information insider of a public issuer if that person:

- Has material information relating to the public issuer that is not generally available to the market; and
- Knows or ought reasonably to know that the information is material information; and
- Knows or ought reasonably to know that the information is not generally available to the market.[128]

123 The information insider must not trade; disclose the information to another person where the insider knows that person is likely to act on the information; or advise or encourage another person to trade or hold securities (or advise or encourage that person to advise or encourage a third individual to trade or hold securities).[129]

124 Because the new approach is quite broad, there is a wide range of potential defendants. A range of exceptions where the prohibition on insider conduct does not apply have been included to ensure that certain market efficient behaviours can continue without hindrance. The exceptions relate to:

- trading required by enactment;
- disclosure required by enactment;
- underwriting agreements;
- knowledge of person's own intentions or activities;
- agents executing trading instructions only;
- takeovers;

[128] Securities Legislation Bill 2005, s8A.
[129] Ibid., ss8C, 8D and 8E.

- redemption of units in a trust; and
- trading by the Reserve Bank.[130]

125 A range of affirmative defences have also been developed:

- Absence of knowledge of trading;
- Inside information obtained by independent research and analysis;
- If both parties in the transaction had equal information;
- Options and trading plans; and
- A Chinese wall defence.

The need for regulations to create exemptions from the regime

126 In addition, section 49D(b) of the Securities Legislation Bill allows the making of regulations for the purposes of exempting conduct from being insider conduct – that is, conduct that would otherwise fall within sections 8C, 8D or 8E. The government wishes to ensure that market efficient conduct will not be caught under the new regime. The government also aims to provide certainty for market participants where there may be a risk that a particular behaviour will be caught by the legislation. There has been only one type of conduct identified in consultation so far – passive investment instruments.

INDEX FUNDS AND EXCHANGE-TRADED FUNDS

127 In submissions to Select Committee, several submitters raised the issue of exchange-traded and passive index funds and expressed a concern that these instruments would contravene the new insider trading provisions.

128 An index fund is a portfolio of investments that are weighted the same as a stock-exchange index in order to mirror its performance. This type of investment is also referred to as indexing. The most widely known index fund is probably is the Standard and Poors (S&P) 500, which invests in 500 companies from a diverse range of industries and in New Zealand, the NZSX10 index, which invests in the 10 largest companies on the NZSX market.

129 An exchange-traded fund (ETF) is a security that tracks an index and represents a basket of shares like an index fund, but trades like a stock on an exchange, thus experiencing price changes throughout the day as it is bought and sold. Two of the most well known ETFs are SPDR (Spider), which tracks the S&P 500 index and QQQQ, which tracks the Nasdaq-100. In New Zealand, NZX offers the TENZ, the MIDZ; the FONZ and the MOZY.[131]

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[130] Ibid., s9A-99G.

[131] TENZ invests in the 10 largest companies listed on the NZSX Market, the NZSX10 Index; MIDZ invests in the NZSX MidCap Index, all the companies in the NZSX50 Index, excluding those in the NZSX10 Index; FONZ invests in the 50 largest listed companies on the NZSX, the NZSX 50 Portfolio

130 Index funds and ETFs are also known as “passive” funds because no active management of the fund is undertaken and it simply tracks the index. Shares are only bought and sold if the composition of the index changes, e.g. in the TENZ fund, if a company left the top ten of the NZSX. Because there is no active management of the fund, it has been proposed that index funds and ETFs be expressly excluded from the insider trading regime by way of regulation. The Ministry believes that Bill will not capture these passive investment instruments, but will consider whether a full exemption clause is necessary or should be included as an “avoidance of doubt” provision.

Q40 Do you agree that index funds and ETFs should be specifically excluded from the insider trading regime? Why/why not?

Q41 Do you consider this unnecessary for the reason that index funds and ETFs will not be captured by the current provisions of the Bill? Or, would you prefer to see the exemption included in the regulations “for the avoidance of doubt”?

Q42 Is there any other conduct that you believe should also be expressly excluded from the insider trading provisions? Why should this particular behaviour be excluded?

Index Fund; and MOZY invests in the ASX MidCap 50 Index, 50 companies ranked from 51 to 100 on the Australian market.

VIII MARKET MANIPULATION

BACKGROUND

Market Manipulation under the Securities Legislation Bill

Market manipulation provisions in the primary legislation

131 Market manipulation is a deliberate attempt to interfere with the free and fair operation of the market. It includes practices known in the market as: price manipulation; marking the close or ramping; pumping and dumping; wash trades; false or misleading information; capping and pegging and warehousing. Manipulation can impede securities markets from operating as independent pricing mechanisms, and undermines the integrity and fairness of those markets.

132 Current New Zealand legislation does not directly address market manipulation but does contain a number of provisions in the Crimes Act 1961; the Fair Trading Act 1986 the Securities Act 1978 and the Securities Regulations 1983 which may apply to some forms of market manipulation. The NZX Market Participants Rules contain a general prohibition on market participants placing an order that is likely to create a false or misleading appearance of trading in any securities or the price of any securities – or create the effect thereof.[132]

133 The Securities Legislation Bill introduces a market manipulation regime to New Zealand, which applies to securities traded on a registered exchange. Sections 11 – 11D in the Bill contain new prohibitions against making false or misleading statements or creating a false or misleading appearance of trading. Also included in the Bill, as section 13, is a general dealing misconduct provision. This prohibits misleading or deceptive conduct generally and applies more widely to dealings in both listed and non-listed securities.

The need for regulations to create exemptions from the regime

134 As the ambit of the new regime is relatively broad, regulations will be needed to allow certain market efficient conduct to continue outside of the prohibitions of the Bill. The government also aims to provide certainty for market participants where there may be a risk that a particular behaviour will be caught by the legislation.

135 Section 49D(b)(ii) of the Securities Legislation Bill empowers the Governor-General, by Order in Council to make regulations for the purpose of exempting conduct from being market manipulation (conduct that would otherwise fall within section 11 or 11B).

136 Regulations may only exempt conduct from sections 11 or 11B. No exemptions can be made from the general dealing misconduct provision,

[132] NZX Market Participant Rules, A10.2

section 13 of the Securities Markets Act, as this section is intended to be a catch-all 'in-trade' securities comparable to section 9 of the Fair Trading Act.

137 In addition to any possible regulations exempting conduct from section 11B, the Bill does allow defences to some conduct which would otherwise be presumed to contravene section 11B (refer section 11C).

138 There are also general prohibitions against market manipulation in the NZX Participant Rules. Market participants are prohibited from placing orders that might create a false or misleading appearance of trading in or the price of securities.

139 There were three types of market activity raised by submitters as appropriate for exemption:

- Market stabilisation arrangements;
- Short selling; and
- Crossing of trades.

MARKET STABILISATION

140 It is possible that regulations are needed to address the perceived need to enable market stabilisations following an initial public offering (IPO) of securities.

141 Market stabilisation involves the purchase of, or the offer to purchase, securities in order to prevent or slow any fall in the market price of those securities following an offer of securities. This is done to achieve a more orderly secondary market for securities following an initial issue or sale. An offer of securities may lead to a fall in the price of those securities because of the sudden increase in supply or imperfections in the pricing and allocation process. To counteract the effect of this artificially low price, the underwriter of an offer may attempt to stabilise the price of the securities by purchasing, or offering to purchase, the securities for a limited period following the issue or sale of the securities.

142 The US Securities and Exchange Commission notes that 'although stabilisation is price-influencing activity intended to induce others to purchase the offered security, when appropriately regulated it is an effective mechanism for fostering an orderly distribution of securities and promotes the interests of shareholders, underwriters and issuers.'[133]

143 These arrangements are generally designed to insulate the open market price of new listings for a period of up to 30 days. These arrangements help to increase investor confidence in the market for the new issues or sales of securities and the general view is that this increased confidence benefits the market more widely. Market stabilisation arrangements also assist corporate fundraising. Companies are more inclined to raise funds in this manner if

[133] Securities and Exchange Commission, 'Anti-Manipulation Rules Concerning Securities Offerings."

they know that there will be some kind of initial support for the price of the securities.

144 A market stabilisation arrangement will typically involve the following steps:

- The underwriter to an offer is provided with an option to buy additional shares from the issuer equivalent to no more that 15% of the total number of shares being made available under the offer.

- Following the close of the offer, the underwriter can allocate more shares to investors than were made available under the original offer. The size of this short position is limited by the size of the option held by the underwriter.

- If during the first 30 days following the listing of the shares, the market falls below the final price as determined under the book build process, the underwriter or stabilisation broker acting for the underwriter may buy shares on the market under certain terms.

- If the underwriter does not buy a sufficient number of shares on market to cover its short position – this will be the case in the event of a price increase following listing – it may exercise the option to the extent necessary to do so.[134]

145 There was a concern that the new market manipulation provisions might deem the above activity to be creating a false or misleading appearance of trading, thus curbing a market efficient activity. There are concerns that because s11B does not require an intention to induce others to buy, sell or subscribe to securities, there is a risk that stabilisation conduct may breach this provision.

146 NZX Market Participants in their submission to the Select Committee on the Securities Legislation Bill argued that in the particular circumstances of an IPO, stabilisation may be necessary to avoid the securities trading at a price that does not reflect their actual value. They also assert that if market stabilising conduct is not allowed, this may be an impediment to simultaneous international issues of securities.

147 NZX allows market stabilisation arrangements under its listing rules and the rules also contain a general prohibition against misleading or deceptive acts or representations. MED understands that it is relatively common internationally for IPOs seeking to list on a securities exchange to have market stabilisation facilities built into their structures, although from anecdotal evidence received it is less common in New Zealand at the present time.

International comparison of stabilisation regimes

148 Market stabilisation in respect of new issues is allowed under Australian, Canadian, UK and US law, in certain prescribed circumstances. Market stabilisation may be used only to prevent or slow a fall in the price of securities, rather than to lift the price.

[134] ASIC Interim Guide on Market Stabilisation, ASIC Information Release 00/031

149 Commonalities across these jurisdictions included:

- Any stabilisation must occur for the purposes of preventing or limiting a decline in the market price of securities;
- The fact that a bid is a stabilising bid must be disclosed;
- Priority must be given to non-stabilising bids; and
- The price range in which stabilising bids can be placed is limited (generally no higher than the last independent market price).

Q43	Do you believe that market stabilisation arrangements should be exempted from the Securities Legislation Bill? Why/why not?

(a) Australia

150 In Australia, the Corporations Law prevents a person from engaging in misleading or deceptive conduct, false trading and market rigging, and insider trading. As market stabilisation arrangements are intended to have an effect on the price of securities that might not otherwise occur there is a possibility that these arrangements may contravene Corporations Law provisions.[135]

151 The Australian Securities and Investments Commission (ASIC) allows market stabilisation arrangements in limited circumstances and under defined conditions. ASIC does so by issuing 'no-action' letters, in which ASIC states to a particular person that it does not intend to take regulatory action over particular conduct.[136] Generally speaking, ASIC does not consider that a person involved in market stabilisation is in breach of the Corporations Act so long as all that person does is undertake market stabilisation arrangements in line with ASIC's stated conditions.[137] The stabilisation must facilitate the offer of securities and must not lead to – or be likely to lead to – a false, misled or uninformed market in the shares. Market stabilisation other than in the context of an initial public offering of shares is prohibited.

152 ASIC is in the process of formalising its policy on Market Stabilisation.[138] ASIC is proposing to permit market stabilisation for IPOs, secondary offerings

[135] In particular, persons who undertake market stabilisation may contravene sections 1041A (market manipulation), 1041B-1041C (false trading and market rigging), 1041H (misleading and deceptive conduct) and 1043A (insider trading).

[136] ASIC Policy Statement 108: No-action letters

[137] Current conditions include that:

- the issuer must disclose the nature and effect of the arrangement to prospective investors;
- the underwriter must notify the ASX prior to engaging in market stabilisation and must maintain records of each stabilising purchase;
- the issuer must obtain a stabilisation agreement letter from the ASX;
- it must be disclosed that the bid is a stabilisation bid;
- bids must not be higher that the highest independent price;
- non-stabilisation bids take priority; and
- arrangements may be operated for a maximum of 30 days following the first day of trading in the shares.[137]

[138] Refer www.asic.gov.au/asic/asic_pub.nsf/byid/DAB9A12E4736E242CA256FC00082EBB9?opendocument for the most recent ASIC media release on market stabilisation

and secondary sales. ASIC intends to provide a standard no-action letter to persons involved in market stabilisation of offers that satisfy the proposed criteria on: (a) the nature of the offer; (b) the type of security; (c) the size threshold; (d) over-allotment of securities; and (e) the appointment of a stabilisation manager.

153 The proposed new criteria include requirements that:

- The offer of securities must be by way of an IPO, secondary offering or secondary sale; accompanied by a disclosure document and for cash;
- The offer must relate to shares (or equivalent securities) and these shares must be quoted by the Australian Stock Exchange Limited;
- The total value of the securities offered must be greater than AUD$50 million;
- The issue must meet certain criteria for over-allotment:
  - The stabilisation manager must have an over-allotment option (an option granted by the issuer enabling them to acquire additional securities at the issue or sale price under the prospectus);
  - The over-allotment option must be no greater than 15% of the total number of securities being made available under the offer;
  - The stabilisation manager may over-allot the issue, with the size of the over-allotment limited by the size of the over-allotment option; and
  - The stabilisation manager may only acquire securities under the market stabilisation up to the size of the over-allotment;
  - There must be a stabilisation manager, who has responsibility for ensuring compliance with the conditions of the market stabilisation.

154 The standard no-action letter will contain conditions relating to: the issuers; the stabilisation manager and the stabilisation broker. The proposed conditions cover (a) disclosure of stabilisation; (b) the maximum price of bids; (c) how bids must be made; (d) preventing insider trading; (e) reporting and record keeping; (f) period of stabilisation; and (g) limitations on refreshing the over-allotment option.

155 Conditions of the no-action letter include:

- The issuer must disclose the nature and intended effect of the market stabilisation in the disclosure document;
- All stabilisation bids must be identifiable as such in ASX's automated trading system;
- The stabilisation manger or broker must notify the issuer and ASX daily of the number of securities purchased by them on the previous day; and the total number of all securities purchased under the market stabilisation;
- Stabilisation bids must be the lower of the highest independent bid and the final price (the lowest price payable by institutions under the offer);

- The stabilisation manager must not effect any stabilising purchase at a price that the person knows or suspects is a result of activity that is fraudulent, deceptive or manipulative;

- A stabilisation agreement letter must be sought from ASX;

- Stabilisation bids must only be made for the security being stabilised (not derivatives or convertible into those securities). The stabilisation broker must identify the price and quantity of stabilisation bids and no undisclosed bids may be made;

- The stabilisation broker must notify ASX in advance of its intention to engage in market stabilisation;

- The stabilisation manager must maintain records of the name of the company whose securities were stabilised and the details of each stabilising purchase (date, time, price, size etc);

- ASIC may ask the issuer to appoint an independent market analyst to prepare of report on the stabilisation at the issuer's cost;

- Market stabilisation may only take place for a maximum of 30 calendar days;

- The stabilisation broker may refresh the over-allotment option.

Q44	Under what circumstances/conditions should market stabilisation be permitted?
Q45	Do you think that having a restriction around the size of the over-allotment (such as the 15% suggested by the ASIC proposal) is appropriate?
Q46	Should we consider imposing a size threshold on the offer of securities? If so, what would be an appropriate threshold? Note the ASIC suggestion of $50 million, which it is suggested would probably not be appropriate in a New Zealand context.
Q47	Should there be a requirement to appoint a stabilisation manager?
Q48	Should the stabilisation manager or issuer be required to disclose information to the market around the stabilisation purchases? What effect do you think might this disclosure have on the attempt to stabilise the price of the securities? Should there be a requirement that any stabilisation arrangement dealer must not have inside information?

(b) Canada – Ontario

156 In Ontario, there is a general prohibition restricting trading by issuers, dealers and parties related to each, in securities during the course of a distribution, take-over bid, issuer bid or similar transaction. However, Rule 48-501 allows exemptions from trading restrictions and includes an exemption for market stabilisation and market balancing activities.

157 Market balancing activities should be undertaken to maintain a fair and orderly market in the security offered by attempting to reduce price volatility or managing inconsistencies between buying and selling interest.

158 Conditions include:

- Stabilisation bids must be at the lower of the issue price or the last independent sale price;

- A dealer may not engage in such activities if the dealer is aware that the market price is not fairly determined by supply and demand – i.e. where the dealer knows that there is undisclosed material information regarding the issuer;

- The covering of short positions is allowed.

Q49	Do you agree that the stabilisation bids should not be higher than the last independent market sale price?

(c) The United States

159 In the US, Congress has granted the broad rulemaking authority to the Securities and Exchange Commission to combat manipulative abuses in whatever form they might take. The SEC adopted 'Regulation M' in 1996 which is intended to preclude manipulative conduct by persons with an interest in the outcome of an offering. Regulation M governs the activities of underwriters, issuers, selling security holders, and others in connection with offerings of securities.

160 Generally speaking, Rule 104 of Regulation M prohibits stabilising activities except those transactions specifically allowed by the rule's provisions. Rule 104 allows underwriters to conduct stabilising arrangements for the purpose of preventing or retarding a decline in the market price of a security to facilitate an offering.

161 Rule 104 includes the following conditions:

- Any bids or purchases not necessary to prevent or retard a decline in the price of a security are prohibited – as is stabilising for manipulative purposes;

- Priority must be given to independent bids, regardless of the size of that bid;

- The placing of more than one stabilising bid in more than one market at the same price at the same time is prohibited;

- Offerings of securities eligible for re-sale are excluded;
- Persons stabilising the price of a security can initiate a stabilising bid in many market with reference to the last independent transaction price in the principal market for that security – persons stabilising may then maintain, reduce or raise that bid to follow the independent market;

- No stabilising bid may be made at a price higher than the stabilising bid in the principal market or the security's offering price;

- A stabilising bid may be increased to the level of the highest independent bid in the principal market, or if the principal market is closed, the highest independent bid in the market at the previous close;

- Where an independent market for an offered security does not exist, the maximum stabilising level is limited only by the offering price.

- Stabilising permitted outside the US under certain conditions;

- Any person entering a bid for the purpose of stabilising must notify the market on which the bid is being placed, and to disclose the purpose of the bid to the person to whom the bid is entered (e.g. broker);

- Prospective stabilising activity and the likely effects on the market price must be described briefly in offering and disclosure documents to potential investors;

- A person subject to Rule 104 who sells any security where the price may or has been stabilised must send the purchaser the prospectus or other offering document before or at the completion of the transaction;

- Underwriters must keep records of transactions, including the name of the securities, the price, date and time of each transaction etc.

Q50	Should the issue be required to include the fact that market stabilisation may occur and what effect that might have on the price of the securities in offer documents?
Q51	Should market stabilisation be allowed in on-market transactions only?
Q52	Should multiple bids be allowed?

United Kingdom

162 In the United Kingdom, The Financial Services and Markets Act 2000 contains penalties for market abuse. Section 118 describes market abuse as:

> behaviour which is likely to be regarded by a regular user of that market who is aware of the behaviour as a failure on the part of the person or persons concerned to observe the standard of behaviour reasonably expected of a person in his or their position in relation to the market.[139]

163 Market abuse must also meet certain conditions, amongst them behaviour that is likely to give a false or misleading impression as to the supply, demand or price of a security – or would be likely to distort the market in investments of the type in question.

[139] Financial Services and Markets Act 2000

164 Under section 120, the Financial Services Authority is empowered to include in its Code, provisions around what does not amount to market abuse; is not market abuse under certain specified circumstances; or is not market abuse if undertaken by a certain specified category of person.

165 The Financial Services Authority Handbook contains specific price stabilising rules.[140] The rules allow market stabilisation transactions that have the effect of providing support for the offering of securities during a limited time period, if they come under selling pressure. This is permitted in order to alleviate the pressure generated by short-term investors and maintains an orderly market in the securities as well as contributing to greater confidence of investors and of issuers in the financial markets.

166 The rules apply in the following way:

- The securities must be 'relevant' securities, which include:
- Stabilisation is only to be undertaken for 30 calendar days;
- Before the opening of the offer period for the relevant securities, the issuer or entities undertaking the stabilisation must disclose:
  - The fact that stabilisation may be undertaken;
  - The fact that stabilisation transactions are designed to support the market price of the securities;
  - The beginning and end of the period in which stabilisation may occur;
  - The identity of the stabilisation manager; and
  - The existence and maximum size of any over-allotment facility (or greenshoe option), the exercise period and any conditions of use.
- The details of all stabilisation transactions must be notified by issuers to the market authority no later than seven (market) days following such transactions;
- Within one week of the end of the stabilisation period, the following information must be disclosed by the issuer:
  - Whether or not stabilisation was undertaken;
  - The date at which stabilisation started;
  - The date at which stabilisation last occurred; and
  - The price range within which stabilisation was carried out, for each of the dates stabilisation transactions were carried out.
- In the case of an offer of securities, stabilisation shall not be executed above the offering price.

[140] MAR 2, Financial Services Authority Handbook, fsahandbook.info/FSA/handbook

Q53	What length of time is sufficient for a market stabilisation arrangement to have its intended effect? Note Australia's proposed 30 days, which mirrors the UK requirement.
Q54	Should market stabilisation arrangements be permitted for IPOs only or also for secondary offerings and secondary sales?

SHORT SELLING

167 Short selling is the selling of a borrowed security, commodity or currency, with the expectation that the asset will fall in value. For example, an investor who borrows shares of stock from a broker and sells them on the open market is said to have a short position in the stock. The investor must eventually return the borrowed stock by buying it back from the open market. If the stock falls in price, the investor buys it for less than he or she sold it, and hence makes a profit. This is the mirror image of a person who buys a security expecting that it will rise in value. For this reason, short selling is more popular in "bear" as opposed to "bull" markets.

168 Short selling is predominantly an activity undertaken by professionals. It is used by market makers and intermediaries to hedge customer business and by hedge fund managers to establish principal positions are part of their investment strategies. It is also undertaken by investment banks, funds or even individual market participants who have a view on how a particular security or market will perform in the future. Short selling is invariably a risky transaction because of the substantial risk to the seller if the security or the market increases in value.

169 The Ministry understands that at the present time there is not a great deal of short selling activity taking place in New Zealand. This is mostly attributed to the manner in which short selling is taxed, as currently these lending transactions are taxed as a sale of shares rather than as a loan. The government has recently introduced a Bill containing specific securities lending rules to allow the taxation of "qualifying" securities lending transactions on the basis of economic substance rather than legal form, i.e. qualifying transactions will be taxed as a loan rather than a sale of shares. However, tax treatment aside, it must be acknowledged that the New Zealand market is small and relatively illiquid, bar a few of the larger stocks. Another reason for the low occurrence of short selling could also be the general upwards trend of the New Zealand stock market in recent years.

170 There are varying views as to whether or not short selling has a positive or negative impact on markets. Critics have linked short selling to market manipulation and perceive it as a cause of market instability. One example of a manipulative use of short selling is a "bear raid" where a security is sold short in order to drive down the price by creating an imbalance of sell-side interest. Another is the "short and distort" where a trader takes a short position and then employs a smear campaign to drive down the price of the stock. This is the exact opposition of the traditional "pump and dump" scheme, where traders buy up large volumes of stock, issue false information as to its value and then sell out while the price is artificially inflated. Short selling can also result in disorderly trading and settlement disruption.

171 Supporters of the practice of short selling, on the other hand, argue that it is a normal part of market operation and that it increases liquidity in the markets and levels out fluctuations in market prices. They contend that short sale activities add to the supply of securities available to buyers and moderate the risk that the price is artificially high owing to a temporary reduction of supply.

172 Although most jurisdictions allow the practice of short selling, there are restrictions placed around it at the government and individual securities exchange level. Although short selling is seen as serving a useful market purpose, it is also acknowledged that it may be used as a means for manipulation. The Financial Services Authority in the United Kingdom recently reviewed the practice of short selling and concluded that it remained 'a legitimate investment activity, which plays an important role in supporting efficient markets.'

173 There is no legislation dealing with short selling in New Zealand, however as mentioned above, the New Zealand Exchange has provisions in its Market Participant Regulations against misleading or deceptive acts or representations. NZX specifically allows short selling on its markets, however NZX reserves the right to restrict short selling in any (or all) securities at its discretion. NZX also requires that brokers making short sales on behalf of clients to first ensure that the client has margin cover of at least 15% of the contract price of the short sale.[141] Other than this, there are no restrictions around the practice.[142]

174 There were concerns raised in submissions to Select Committee that short selling would be captured by new section 11B(a)(ii) of the Securities Markets Act. While this is probably debatable, it is suggested that regulations could set out a basic exception for short selling to clarify what sort of activity is considered not to be appropriate market efficient activity.

International Comparison of short selling regulation

(a) United Kingdom

175 Apart from the general prohibition against market abuse contained in the Financial Services and Markets Act as described above, the United Kingdom does not specifically regulate the practice of short selling. Short selling is not a legally defined term in either primary or delegated legislation. It is up to the particular securities exchange to prescribe rules for its market participants around short selling, if it is so desired.

Q55 Do you think short selling should be exempted from the Securities Legislation Bill if it is done in accordance with the rules of a registered securities exchange? Note that these rules would still have Government review and approval as all securities exchange rules need to be approved by the Minister on recommendation of the Securities Commission.

Q56 Or do you think the regulations should contain clear guidelines on what

[141] Market Participant Rule, 11.7.1
[142] Prior the its demutualization, the New Zealand Stock Exchange had considerably more detailed rules around short selling.

constitutes non-manipulative short selling?

(b) Australia

176 Short selling is prohibited in Australia in primary legislation under section 1020B of the Corporations Act 2001, but the Act contains a number of exceptions that enable short selling to take place under certain restrictive conditions:

- Where the sale is made for the purpose of buying or selling an odd lot of securities;
- Where the sale is part of an arbitrage transaction;
- Where the seller has entered into a contract to buy the securities which is conditional only on payment, an instrument of transfer or documentation;
- Where arrangements have been made for the delivery of the securities to the buyer within three business days. If the sale is made on a stock exchange, the price must not be lower than the last reported sale and the stock exchange must be informed that it is a short sale; or
- Where the securities being sold are the subject of a declaration by a stock exchange that they are approved for short selling.

177 The Australian Securities and Investments Commission has the power under s1020C to prohibit short selling in certain cases in order to protect persons who might suffer financial loss if they were to buy or sell securities in that manner; or to protect the public interest.

Q57 Do you agree that short selling as part of an arbitrage transaction should be exempted as a general rule?

Q58 Should there be a limit on the period of time that a person may hold a short position? Note ASIC's requirement of 3 business days.

Q59 Do you agree with the ASIC requirement on selling the stock, the price must be not lower than the last reported sale?

Q60 Should a person who is selling a security short be required to inform the securities exchange that it is a short sale?

Q61 Do you see a need to create a general power for the Securities Commission to protect persons who may suffer financial loss, such as the one ASIC has been given under s1020C of the Corporations Act?

(c) Canada – Ontario

178 As described above, in the market stabilisation section, the Ontario Securities Commission Rules restrict trading by issuers, dealers and their respective related parties in unlisted, as well as listed, securities during the course of a distribution, take-over bid, issuer bid or similar transaction. Sub-clause 3.1(1)(h) of Rule 48-501 provides an exemption from the Rule for a dealer-restricted person in connection with a bid or purchase to cover a short position, provided it was entered into before the commencement of a dealer-

restricted period (periods such as immediately prior to an IPO or prior to the circulation of a takeover bid). Short positions entered into during a dealer-restricted period may be covered by purchases for the purposes of market stabilisation under the exemption in 3.1(1)(a).

(d) United States

179 The SEC essentially regulates short selling in the United States through three rules contained in the Securities Exchange Act:

- Rule 3b-3, which defines the term 'short sale';
- Rule 10a-1 which prohibits short selling in a falling market; and
- Rule 10a-2 which prohibits broker-dealers from engaging in certain activities that could facilitate an illegal short sale.

180 Rule 10a-1 of the Act prohibits investors from selling a security short unless that stock's last trade was at the same price or higher than the preceding trade. This aims to limit short-selling in a declining market as continuous short selling on a falling stock will keep forcing it down, damaging the market further. This rule is also known as the 'up-tick' rule and the NYSE and NASD also have similar rules preventing short selling unless the last trade of the stock is at the same or higher price.[143]

181 Rule 10a-2 of the Act requires brokerage firms who allow their customers to sell short to first ensure that the shares can be borrowed or that delivery of the securities can be made to the purchaser by the settlement date.

182 The SEC this year adopted Rule 105 of Regulation M to replace rule 10b-21 under the Exchange Act. Rule 105 is also designed to prevent short sales from being covered with securities obtained from an underwriter, broker, or dealer who is participating in a public offering. This aims to stop manipulative short selling prior to a public offering by short sellers who cover their short positions by purchasing securities in the offering, thus largely avoiding exposure to market risk. This type of short sale could result in a lower offering price and reduce the issuing company's proceeds. Rule 105 prohibits covering a short sale with offering securities obtained from an underwriter or dealer if the short sale occurred during the period 5 days prior to pricing until pricing or the period from filing the registration until pricing, whichever is shorter. This differs slightly from the period under 10b-21 began with the filing of a registration statement, which was a potentially longer period.

Q62	Should we be concerned about short selling prior to a public offering?

CROSSINGS OF TRADES

[143] The NYSE has a set of restrictions it can implement when experiencing significant daily moves, either up or down. Rule 80A under the NYSE contains an index arbitrage test (or 'downtick-uptick' test), which is used to reduce the volume of trades, given that large volume trades magnify fluctuations and are potentially harmful to the exchange. Regardless of whether the market is up or down, this restriction is applied whenever there is a daily move of 170 points or more in the Dow Jones Industrial Average.

183 Crossings of trades occur where securities are traded between clients of a single exchange participant or a single client and the exchange participant itself without the orders having first been matched in the order screen (hence the old name, “marriage”). The practice is permitted by the NZX Participant Rules,[144] on the condition that crossings (other than large or international crossings) executed during market hours be within the on-market bid and offer quotations for the security at the time it was carried out. All crossings must be reported through the FASTER trading system.

184 It is possible that regulations are needed to ensure that not all crossings are captured by the prohibition on giving a false or misleading appearance of trading. This is on the assumption that there are legitimate crossing of trades, as described in the NZX Participant Rules (see above). However, it is also possible that some crossings of trade are manipulative and should remain under the market manipulation prohibitions.

Q63	Are there legitimate crossings of trades? If so, in what situations do they occur? What conditions / exemptions are required so that such crossings can occur?
Q64	What is your view of such an exception in light of the likely costs and benefits?

[144] See NZX Participant Rules, D10.1

APPENDIX 1: SUMMARY OF QUESTIONS FOR SUBMISSION

Q1 Should investment advisers or brokers be required to disclose any information in addition to the requirements under the Securities Legislation Bill?

Q2 Ministry officials are working to review the Taskforce recommendations in relation to extended disclosure obligations. Do you agree with the disclosure obligations suggested by the Taskforce (at paragraph 38 above) should apply to investment advisers and brokers? In your view, what costs or obstacles would apply to investment advisers and brokers in providing the additional information as described at paragraph 38 above? And, would the additional information produced by these disclosure obligations assist consumers sufficiently to outweigh the cost to investment advisers and brokers?

Q3 In addition to the requirements at s41K of the Securities Legislation Bill, should regulations prescribe additional requirements for the set method or form of investment adviser and investment broker disclosure?

Q4 If regulations should prescribe additional requirements for the method and form of investment adviser and investment broker disclosure, what should these requirements be (for example, should there be a set page limit, set headings, set format or set size)?

Q5 In your view, would the benefit of prescribing set methods or a form of investment adviser and investment broker disclosure through regulation outweigh the cost of the additional disclosure requirements?

Q6 In your view, are there any obstacles which would make it difficult for investment advisers and investment brokers to disclose all required information prior to providing investment advice, or receiving investment money or property?

Q7 If any obstacles have been identified in relation to timing, which disclosure obligations do they affect? What would be the cost of requiring disclosure prior to the investment advice being provided, or investment money or investment property being received? Is there an appropriate time within which the required information could be disclosed so that it would still benefit the recipient of the advice or service?

Q8 In your view, are there any obstacles which would make it difficult for investment advisers and investment brokers to disclose the amount or rate of all relevant remuneration, prior to the investment adviser or broker providing a service (this may because it is difficult to calculate the amount or the remuneration, or because it is difficult to describe the remuneration prior to providing the service). Particularly, are there obstacles which may make it difficult to describe the full range of "soft" benefits or advantages which may be covered by the definition of "remuneration" at s41F(4), or if that benefit or advantage is received indirectly?

Q9 If any obstacles have been identified, can you please describe them, and also the types of remuneration that the obstacles would affect?

Q10 Can you suggest any set method or form of disclosure which would allow

investment advisers and brokers to describe any such remuneration in a more general form (e.g. through prescribed wording rather than referring to "amount" or "rates") or at a later time (e.g. through prescribed time limits which set the date by which the amount or rate has to be disclosed after the service has been provided)? What would be the costs and benefits applying to investment adviser, brokers and members of the public of such regulations?

Q11 Should regulations require any types of relevant remuneration to be disclosed in dollar figures to make it easier for consumers to understand?

Q12 The Ministry is interested whether or not regulations should require investment advisers to have a minimum level of professional indemnity insurance, and prescribe the amount of that minimum level, or to give an undertaking that the adviser has adequate professional indemnity insurance for the protection of the persons to whom the adviser gives investment advice? If you believe that a minimum level should be set in regulation, how do you think this minimum level should be determined?

Q13 What would be the costs and benefits applying to investment adviser, brokers and members of the public if such regulations were implemented?

Q14 In your view, is there any class of persons which should be exempted from compliance with the investment adviser disclosure obligations or the investment broker disclosure obligations? If so, which class of person should be exempted, and why?

Q15 In your view, is there any definition of investment advice which should be excluded from all or some of the disclosure obligations in the Securities Legislation Bill? If so, which class of advice, and why?

Q16 Would the benefit of excluding certain classes of investment advice outweigh the costs?

Q17 In your view, what definition best describes a "bank term deposit"?

Q18 Are there any other products similar to bank term deposits about which advice is provided? What are these products, and why are they similar to bank term deposits?

Q19 What would be the costs and benefits to exempting other products in addition to "bank term deposits" from the definition of "security" under the Securities Legislation Bill?

Q20 In your view, should advice/transactions on any bank term deposit or any other products still be subject to compliance with any investment adviser and broker disclosure obligations under the Securities Legislation Bill? If so, which disclosure obligations, and why?

Q21 In your view, is there any class of investment advice which, when provided in certain situations, such as over the telephone, should be exempted from compliance with any or all investment adviser or investment broker disclosure obligations? If any, can you please describe the class?

Q22 Should such advice be exempted from all or just some disclosure obligations?

Q23 Would the benefit of excluding such a class of investment advice outweigh the cost of requiring full disclosure?

Q24 In your view, should investment advice given in a public forum be exempted from compliance with any or all investment adviser or investment broker disclosure obligations?

Q25 How do you define advice available in a public forum? In your view, how much investment advice in New Zealand is provided in a public forum?

Q26 If so, should such advice be exempted from all or just some disclosure obligations?

Q27 Would the benefit of excluding such a class of investment advice outweigh the cost of requiring full disclosure?

Q28 The Ministry believes that the current details described above are appropriate and should be retained. All the above information is important to ensure the purposes of the regime are met. Do you agree? Are there any details you consider should/should not be disclosed?

Q29 The Ministry believes that there is no need to maintain the differentiation in the disclosure form between beneficial and non-beneficial relevant interests. To improve the clarity of the form and disclosures, separate forms should be completed for beneficial and non-beneficial relevant interests. Do you agree?

Q30 If there were separate disclosure, would this create additional compliance costs? If so, is there a way to address separate disclosure obligations in the same form?

Q31 Do you think that different disclosure requirements should be introduced depending on which of the four disclosure obligations described above at paragraph 99 is triggered? In particular, should there be reduced disclosure requirements for initial disclosures?

Q32 The Ministry believes that the current documentation requirements described above are appropriate and should be retained. All the above documentation is important to ensure the purposes of the regime are met. Do you agree? Are there any pieces of documentation you consider should/should not be disclosed?

Q33 The Ministry considers that the current exclusions described above seem appropriate and should be retained. They are necessary to ensure that the compliance costs of the regime do not outweigh the benefits. Do you agree? Are there any other circumstances where you consider exclusions should/should not be introduced? Note the class exemption for investment management contracts[145] – is it appropriate that this standing exemption be moved into law?

Q34 Do you think that different documentation requirements should be introduced

[145] Securities Act (Investment Management Contracts) Exemption Notice 2002.

depending on which of the four disclosure obligations described above at paragraph 99 is triggered? In particular, should there be reduced disclosure requirements for initial disclosures? This may be particularly relevant where, for example, a five per cent stake has been built up over a long period of time and some historical documentation is not available. Note however that regulations do already deal with situations where no documents exist.

Q35 The Ministry considers there should be mandatory disclosure of all information. The information is normally easy to provide and it is necessary to achieve the objectives of the regime. Request-based disclosure may also increase compliance costs as people could end up having to make a number of disclosures to individual market participants instead of to the market as a whole. Do you agree? Is there any information that should be disclosed only on an on-request basis?

Q36 Should the government prescribe a form or should the government allow the relevant registered exchange to prescribe the form to be completed? If the government does prescribe a form, do you prefer the general approach of the current substantial security holder form or the directors' and officers' form?

Q37 Should we be concerned about short selling prior to a public offering?

Q38 The Ministry considers that the current exemptions described above seem appropriate and should be retained. They are necessary to ensure that the compliance costs of the regime do not outweigh the benefits. Do you agree? Are there any other circumstances where you consider exemptions should/should not be introduced?

Q39 Other than consequential changes, the Ministry considers that the other provisions of the 1997 Regulations (relating to for example acknowledgement of notices and forms requiring disclosure) can be carried through to the new regulations. Do you agree? Are there any other changes that need to be made?

Q40 Do you agree that index funds and ETFs should be specifically excluded from the insider trading regime? Why/why not?

Q41 Do you consider this unnecessary for the reason that index funds and ETFs will not be captured by the current provisions of the Bill? Or, would you prefer to see the exemption included in the regulations "for the avoidance of doubt"?

Q42 Is there any other conduct that you believe should also be expressly excluded from the insider trading provisions? Why should this particular behaviour be excluded?

Q43 Do you believe that market stabilisation arrangements should be exempted from the Securities Legislation Bill? Why/why not?

Q44 Under what circumstances/conditions should market stabilisation be permitted?

Q45 Do you think that having a restriction around the size of the over-allotment (such as the 15% suggested by the ASIC proposal) is appropriate?

Q46 Should we consider imposing a size threshold on the offer of securities? If

so, what would be an appropriate threshold? Note the ASIC suggestion of $50 million, which it is suggested would probably not be appropriate in a New Zealand context?

Q47 Should there be a requirement to appoint a stabilisation manager?

Q48 Should the stabilisation manager or issuer be required to disclose information to the market around the stabilisation purchases? What effect do you think might this disclosure have on the attempt to stabilise the price of the securities? Should there be a requirement that any stabilisation arrangement dealer must not have inside information?

Q49 Do you agree that the stabilisation bids should not be higher than the last independent market sale price?

Q50 Should the issue be required to include the fact that market stabilisation may occur and what effect that might have on the price of the securities in offer documents?

Q51 Should market stabilisation be allowed in on-market transactions only?

Q52 Should multiple bids be allowed?

Q53 What length of time is sufficient for a market stabilisation arrangement to have its intended effect? Note Australia's proposed 30 days, which mirrors the UK requirement.

Q54 Should market stabilisation arrangements be permitted for IPOs only or also for secondary offerings and secondary sales?

Q55 Do you think short selling should be exempted from the Securities Legislation Bill if it is done in accordance with the rules of a registered securities exchange? Note that these rules would still have Government review and approval as all securities exchange rules need to be approved by the Minister on recommendation of the Securities Commission?

Q56 Or do you think the regulations should contain clear guidelines on what constitutes non-manipulative short selling?

Q57 Do you agree that short selling as part of an arbitrage transaction should be exempted as a general rule?

Q58 Should there be a limit on the period of time that a person may hold a short position? Note ASIC's requirement of 3 business days.

Q59 Do you agree with the ASIC requirement on selling the stock, the price must be not lower than the last reported sale?

Q60 Should a person who is selling a security short be required to inform the securities exchange that it is a short sale?

Q61 Do you see a need to create a general power for the Securities Commission to protect persons who may suffer financial loss, such as the one ASIC has been given under s1020C of the Corporations Act?

Q62	Should we be concerned about short selling prior to a public offering?
Q63	Are there legitimate crossings of trades? If so, in what situations do they occur? What conditions / exemptions are required so that such crossings can occur?
Q64	What is your view of such an exception in light of the likely costs and benefits?