REVIEW OF FINANCIAL PRODUCTS AND PROVIDERS:
SUPERVISION OF ISSUERS

Discussion Document

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2. **EXECUTIVE SUMMARY**

1. The overall objective for the review is to develop an effective and consistent framework for the regulation of non-bank financial institutions, financial intermediaries and financial products that promotes confidence and participation in financial markets by investors and institutions, and results in a sound and efficient non-bank financial sector.

2. Ensuring that there is adequate supervision of, and enforcement of the laws relating to, the primary market in the securities sector is an essential part of achieving this objective. Consumers need to be able to rely on the adequacy and accuracy of information provided to them by issuers so that they may make informed decisions about investing. Consumers are at risk of unfair and fraudulent conduct by issuers, and therefore need a degree of reassurance that issuers are being supervised, and having their compliance with the law enforced.

3. Supervision needs to be as transparent as possible. Those being supervised need supervision that is as understandable and accessible as practicable, so that there are no barriers to their compliance with the regime. Transparent supervision is also beneficial for consumers, as it may provide a degree of confidence that laws are being complied with, and that promises will be carried out.

4. Adequate supervision and enforcement needs to hold people accountable, be backed up by effective penalties and otherwise provide incentives for appropriate behaviour. It also needs to provide effective remedies when harm is suffered as a result of misconduct.

5. Supervision should be cost-effective. However, it should not necessarily be "one-size-fits-all". It is desirable to have a degree of flexibility in a supervision regime, so that the level of supervision may be tailored to the degree of risk.

6. It is recognised that supervision will never lead to a zero-risk market. However, a financial sector that is supervised effectively can encourage increased participation by consumers and businesses. This can in turn contribute to increased economic growth.

7. This document recognises that the current objectives behind the regime for the supervision of issuers is fundamentally sound. For this reason, we are not proposing the imposition of new regimes. Instead, we are making improvements to the existing regulatory frameworks in order to ensure that supervision is adequate and effective.

8. This document is split into three main parts: Supervision of Disclosure; the Trustee Supervisory Model; and Trustee Supervision of Debt Issuers.[1] In addition, a section detailing the current regulatory regime for trustee supervision is included, so the proposals may be seen in context. A brief summary of each substantive section is provided below.

[1] Trustee Supervision of Collective Investment Schemes is covered in the *Collective Investment Schemes* discussion document.

2.1 SUPERVISION OF DISCLOSURE

9. The Securities Act, together with the Securities Legislation Bill, provides sufficient prohibitions, liabilities and penalties to hold parties accountable under the disclosure regime; and sufficient remedies for those who suffer from a breach of the disclosure regime.

10. In addition, regulators are generally provided with sufficient and appropriate powers to enforce the disclosure regime. This is perhaps a reflection of the fact that the Government has undertaken two reviews in the past five years on the role and powers of the Securities Commission and the Registrar of Companies. However, there are a few minor improvements that could be made to the powers of the Securities Commission. For example:

    a. We note that under the Securities Legislation Bill, the Securities Commission will have the power to make corrective orders if a person contravenes the general dealing misconduct prohibition. We seek feedback on whether this power should be extended to a breach of the disclosure regime under the Securities Act.

    b. We have received feedback criticising the avoidance and repayment provisions regarding breaches of exemption notices. To address this concern, we are proposing to give the Securities Commission the power to specify in the exemption notice the consequences for the issuer of breaching that exemption notice and how the issuer may remedy that breach so that the exemption notice continues to apply.

    c. We have also received feedback that some issuers, who find it difficult determining what product definition their product falls into, would benefit if the Securities Commission had a power to give declarations on product definitions. To address this concern, we are proposing to give the Securities Commission the power to declare a product to be a particular type of security and the power to declare a product to be a security or derivative.

11. We also ask some questions on whether the liabilities, defences to those liabilities and penalties are adequate.

2.2 TRUSTEE SUPERVISORY MODEL

12. The current regime of trustee supervision for debt and collective investment scheme issuers is fundamentally sound. There are many benefits to the current model, such as the flexibility of trustee-based supervision, which means that supervision may be tailored to the risk of a particular issue or issuer. Trustees are close to the market, have a good knowledge of the areas they supervise, have good working relationships with issuers and regulators, have demonstrated capacity and a long and favourable track record – none of which can easily be replicated in a regulator.

13. However, some problems have been identified with the trustee model. When the Financial Sector Assessment Programme (undertaken by the International Monetary Fund and World Bank) assessed New Zealand in 2004, one of the key issues identified was the heavy reliance on trustees without proper checks and balances or accountability in the performance of their role. It is also recognised that trustees do

not face sufficient entry requirements. In addition, as the monitoring is spread between a number of trustees (as opposed to a single entity), it is difficult for government to get whole-of-sector data in order to monitor the sector.

14. In relation to superannuation, the fact that trustees are also the issuers of superannuation schemes raises concerns – particularly where the trustee is a subsidiary of the provider of the scheme (i.e. some retail master trusts and employer master trusts). In these cases, the trustee can have competing incentives, and there is the potential for conflicts of interest, making it difficult for the trustee to be an independent supervisor.

15. This document proposes the adoption of a trustee supervisory model in which the trustees' role as frontline supervisor of issuers will be maintained, but the trustees will be subject to approval and oversight by the Securities Commission. As outlined above, the existing model works well, is flexible, and has tied up in it a wealth of knowledge and capability. To move to a single government regulator would not retain these benefits, and would impose significant costs of transition. We want to use the existing regime as the basis for the proposed regime. There will be improvements made, however, to address the problems identified above to do with transparency, accountability, and independence, and otherwise ensure that there are sufficient checks and balances on trustees.

16. The issuer and trustee will be separate, in order to address the governance issues with superannuation. Note however that there will be transitional arrangements in place for current employer stand-alone superannuation schemes.

17. The Securities Commission will approve trustees according to a set of entry requirements. The entry requirements will be designed to ensure that trustees have the competence, financial capacity, character, independence, and accountability to carry out their role effectively. The requirements will be flexible enough to allow the approval of various different trustees to act with various different issues or classes of issue, commensurate with the characteristics of those issues.

18. The Securities Commission will also monitor trustees on an ongoing basis to ensure they are continuing to meet their entry requirements, carrying out their systems and procedures, and otherwise complying with any terms and conditions of appointment. The Securities Commission will receive its information largely from periodic and event-based reports from trustees. The periodic reports will also contain a degree of "statistical" information to allow the government to build a comprehensive picture of the sector overall.

19. The Securities Commission will have a variety of powers to deal with a trustee's breach of its entry requirements or failure to carry out its agreed systems and procedures. Please see the table on page 9 for details of the Securities Commission's powers.

20. Trustees will continue to undertake the "frontline" supervision of issuers, using their judgement and experience. Though there are some proposed changes to the way in which trustees supervise issuers (outlined below in the Trustee Supervision of Debt Issuers section), issuers will continue to have access to tailored, risk-based supervision.

21. We recognise that, without clear definition of the roles of the Securities Commission and trustees, tensions may arise. We seek your feedback on how to address any tensions between the two roles.

2.3 TRUSTEE SUPERVISION OF DEBT ISSUERS

22. Trustees are effective frontline supervisors of debt issuers. However, we consider that trustee supervision of debt issuers may suffer from a lack of transparency. Trustee supervision of debt issuers is largely governed by the trust deed and the terms of the trust deed are, in the main, negotiated between the trustee and issuer. While this does provide the trustee with the flexibility to take a risk-based approach to its supervision of debt issuers, there is no assurance for the government that trustees have adequate and sufficient duties and powers to carry out their role effectively; and that investors are receiving consistent minimum protections. It also makes it difficult to compare investor protections across trust deeds.

23. We are aiming to address these concerns by proposing enhanced powers and accountabilities for trustees and by proposing some consistent minimum protections for investors in debt trust deeds.

24. *Trustee powers.* Trustees will continue to have the powers set out in the Securities Act and Securities Regulations. For example, the power to seek court orders under section 49 of the Act and the powers of inspection and obtaining information under the Fifth Schedule to the Regulations. Further, trustees will continue to have the powers and duties under the Corporations (Investigations and Management) Act 1989. So trustees can carry out their role of supervising debt issuers more effectively, we propose that trustees have additional powers relating to:

    a. Obtaining information from issuers on a periodic basis;

    b. Obtaining information from auditors on matters likely to be relevant to the exercise of the powers or duties of the trustee;

    c. Amending the trust deed in circumstances where the issuer does not agree to the amendment;

    d. Engaging, at the issuer's expense, a third party expert to review specified aspects of the issuer's systems, controls and governance; and

    e. Giving directions to the issuer where it is in breach of regulatory requirements or in distress, including directions as to removing and replacing directors or senior management.

25. *Trustee accountability.* We want to ensure that trustees are held accountable in their role and that where an investor suffers loss from a breach of trustee duties, that the investor has adequate recourse against the trustee. Trustees will continue to be subject to existing accountabilities provided in statute; provisions deemed by regulation into the trust deed; and in common law. We propose that, in addition, the Securities Commission have the power to make compliance orders; and seek compensatory and civil pecuniary orders from court. These powers are set out in the table below.

26. *Trust deeds*. We propose to prescribe high level headings that must be addressed and disclosed in every trust deed. These headings include:

    a. Corporate governance;

    b. Terms of the securities;

    c. Financial covenants;

    d. Minimum capital;

    e. Exposure (to both related parties and concentration);

    f. Reporting;

    g. Trustee duties and powers;

    h. Meetings; and

    i. Appointment and removal of trustees.

27. Generally, we propose that trustees be required to address and disclose these matters in all debt trust deeds, rather than prescribe how these matters must be addressed, so that trustees continue to have the flexibility of risk-based supervision. However, in certain circumstances greater specification may be desirable. For example, we seek feedback on whether the trust deed must specify a maximum limit for credit exposures to related parties. Further, we highlight those areas where further prescription is desirable for non-bank deposit-taking institutions and refer the reader to the *Non-Bank Deposit-Takers discussion* document.

2.4 SUMMARY OF POWERS

28. This table provides a summary of the supervisory powers of the Securities Commission and Registrar of Companies under the current and proposed regimes.

POWERS (CURRENT & PROPOSED)		
	Securities Commission	**Registrar of Companies**
Disclosure	- Inspect documents - Power to request or approve Registrar or authorised persons to inspect documents - Powers to receive evidence - Power to summon witnesses - Suspend or cancel investment statement or registration of registered prospectus - Prohibit distribution of advertisements for securities - Accept enforceable undertakings from any person and seek court orders to enforce such undertakings - Apply to court for a civil pecuniary penalty order, and a compensatory order - Apply to court for management banning orders - Make corrective orders for breach of the disclosure regime - Power to specify in exemption notice consequences of breach of exemption notice - Power to declare a product to be a particular type of security or a product to be either a security or derivative - Hear appeals from decisions by Registrar (including refusal to register offer document, deed, or instrument amending offer document or deed)	- Register prospectus – or refuse to do so - Undertake inspections at request of the Securities Commission - Prosecuting offences of offering, distribution, or allotting securities in contravention of Securities Act - Prosecuting offences of misleading statements in advertisements or registered prospectuses - Prosecuting other offences under the Securities Act and Regulations - Prosecuting offences under the Financial Reporting Act 1993
Supervision of Trustees under the Trustee Supervisory Model	Approval of Trustees according to entry requirements Ongoing monitoring: - Satisfaction of entry requirements/systems agreed to upon entry - Collection of statistical data for monitoring the sector Powers in case of breach of entry and ongoing requirements: - Gather further information - Give direction to trustee - Suspension from taking on new appointments - Remove/replace/add to directors/management (court order) - Removal from specific or general appointment of trustees (court order)	
Compliance with Trust Deeds and trustee duties	Powers to enforce trustee compliance with duties and terms of trust deed: - Request information and make inspections - Direct trustee to comply with trust deed and trustee duties (possibly, in addition, orders akin to s 49 of the Securities Act) - Take action to court for compensatory orders and/or civil pecuniary penalties	- Register trust deed (and amendments) - or refuse to do so - Corporations (Investigation and Management) Act 1989 powers to request information (and trustees obliged to give such information to Registrar if they believe the issuer has breached or is likely to breach the terms of the Trust Deed) - Power to declare issuer to be “at risk”, give advice and assistance, with consent of Securities Commission, give directions relating to property

2.5 FEEDBACK SOUGHT

We welcome your feedback on the proposals. For information on how to make a submission, please refer to the discussion document *Review of Financial Products and Providers: Overview of the Review and Registration of Financial Institutions*.

3. INTRODUCTION

3.1 OUTCOMES

29. The outcome we are seeking from this review of the supervision of issuers is a sound and efficient securities market, which promotes:

    a. Confidence in the securities sector to encourage participation by consumers, firms and providers; and

    b. Productive resource allocation, economic growth and household wealth accumulation.

30. Adequate supervision of securities issuers and issues is crucial to building and maintaining confidence in the non-bank financial sector.

31. The general premise underlying the Securities Act is that the best protection of investors lies in full and accurate disclosure of information that is material to investors' decisions. This protection is supported by regulatory supervision of the disclosure regime and by providing regulators with sufficient powers to monitor and enforce compliance with the disclosure regime.

32. However, it is recognised that issues of collective investment schemes ("CIS") and debt securities require more than disclosure. The Securities Act provides additional protection for debt investors by imposing trustee supervision on debt issuers. This is because when an issuer makes an offer of debt securities, it is making a promise to the investor that it will repay that debt.[2] The purpose of imposing trustee supervision on debt issuers is to provide investors with confidence that there is an independent party to assess whether the issuer is meeting its obligations under the trust deed and offer document and to take appropriate action where either the trust deed or offer document has been or is likely to be breached.

33. Trustee supervision for CIS issuers is required because of the nature of CIS products and the type of consumers of those products. In a CIS, an investor is deferring investment decisions to a manager and placing significant reliance on and trust in the competence and integrity of the issuer. Investors may defer their investment decisions to the CIS at least in part because they do not feel they have the necessary knowledge or experience to undertake these investments. This lack of knowledge and experience also means that investors rely on effective supervision to assure a scheme's compliance with its obligations as they are unlikely to be in a position to be able to assess compliance.

34. Trustee supervision is not intended to insulate the investor from loss. While trustee supervision will provide a greater level of protection for debt and CIS issues, the investor must still make their own assessment of the risk posed by the securities offered.

[2] This can be contrasted with the nature of an equity security: an equity security provides the equity investor with part-ownership of the business, and the expectation of equity investors is that their return is dependent on the performance of the business.

3.2 REASONS FOR REGULATORY INTERVENTION

35. The reasons for regulatory intervention in the securities sector are:

    a. *Information asymmetries.* There is an imbalance of information between issuers of securities and investors. Investors have much less information about the risk profile of a product or issuer than does the issuer. This is because investors do not have sufficient expertise, time or information to gather this information. Regulatory intervention is needed to address this information asymmetry and to ensure that all investors have access to the information they need so they can choose which products or providers best suit their needs and risk levels.

    b. *Unfair and fraudulent conduct.* Apart from relying on adequate and accurate information on which to make informed decisions, investors are to a certain degree reliant on providers acting with integrity. Information asymmetries leave investors open to opportunistic behaviour. While disclosure about an issuer may go some way to address this risk, disclosure does not deal comprehensively with the misconduct of those who have a power advantage.

3.3 OBJECTIVES

36. The objectives of the supervision regime for CIS and debt securities are outlined below.

    a. To deter, detect, and minimise the risk of unfair or fraudulent conduct, including money laundering and other financial crimes. Supervision may help achieve this by monitoring the entry of people and entities into the financial sector, as well as through the ongoing monitoring of those people and entities, to survey the sector for any “red flags” that may be raised.

    b. Supervision should be flexible so as not to impede contestability, competitiveness, and innovation in the financial sector. In particular, it should be risk-based, not “one-size-fits-all”, and recognise that the regulated sector exhibits different behaviours and poses different risks to agreed policy outcomes. It should not create undue barriers to entry.

    c. In the event that a financial entity is running into difficulties, a supervisor should be able to work alone or with others to efficiently and effectively manage the resolution of those difficulties or, in the appropriate circumstances, manage the exit of a distressed entity with minimal damage to investors and the market.

    d. It should hold those being supervised accountable for things they undertake to do, or what they are required to do under the law.

    e. To ensure that the supervisor is fit and proper (including elements of capability, capacity, and independence) to carry out its supervisory function.

    f. Supervisors should have the necessary functions and powers to effectively monitor and enforce compliance with standards.

g. A supervisor should be accountable in the event that their supervision is not carried out to a high standard. There should be appropriate checks and balances and public accountability mechanisms to ensure regulatory objectives are being met.

h. Penalties and remedies should be sufficient and appropriately targeted.

37. In addition, the discussion document *Review of Financial Products and Providers: Overview of the Review and Registration of Financial Institutions* sets out general principles of regulatory design that should be followed. We believe that for the supervisory regime, the following points are particularly apt.

a. Regulation should incorporate or comply with international principles and standards unless to do so would be inappropriate for New Zealand's circumstances.

b. Regulatory processes and requirements (including supervision) should be as understandable and accessible as practical.

c. It should be cost-effective. Regulation should go no further than necessary to meet the defined objectives. A supervision regime should aim to minimise compliance and transaction costs, and should be developed with a mind to who will bear the burden of any costs.

d. Regulation should be fair and treat those affected equitably. For this reason, there should be some consistency of regulatory protections.

4. PART A: SUPERVISION AND ENFORCEMENT OF DISCLOSURE REGIME

4.1 INTRODUCTION

38. The disclosure regime is supervised and enforced by the Securities Commission and the Registrar of Companies. This part of the discussion document addresses:

    a. Whether regulators have sufficient and appropriate monitoring and enforcement powers in respect of the disclosure regime; and

    b. Whether the liabilities, penalties and remedies for breach of the disclosure regime are sufficient and appropriately targeted.

4.2 SECURITIES COMMISSION

4.2.1 Current Regulation

39. The Securities Commission has wide-ranging powers to monitor and enforce the disclosure regime. These include the power to: inspect and obtain information;[3] suspend or cancel an investment statement or the registration of a registered prospectus;[4] prohibit the distribution of advertisements for securities;[5] accept enforceable undertakings from any person and seek court orders to enforce these;[6] to prohibit a person from acting as a contributory mortgage broker;[7] and hear appeals against decisions made by the Registrar of Companies, including the Registrar's decision not to register a prospectus.[8]

40. The Securities Legislation Bill, when implemented, will enable the Securities Commission to apply to the court for a pecuniary penalty order and compensatory order where a civil liability event occurs.[9] The Securities Legislation Bill will also enable the Securities Commission to apply to the court for management banning orders,[10] and the ability to make prohibition and corrective orders if a person contravenes the general dealing misconduct prohibition.[11]

41. Any allotment of a security made where there was no registered prospectus at the time of subscription will be void under section 37 of the Securities Act. Any subscriptions received must be repaid to subscribers.

42. Any allotment of a security made where the subscriber did not receive an investment statement before subscription will be voidable at the option of the subscriber under section 37A of the Securities Act. If the subscriber chooses to void

[3] Securities Act 1978, Part 3.
[4] Securities Act 1978, ss 38F, 44.
[5] Securities Act 1978, s 38B.
[6] Securities Act 1978, s 69J.
[7] Securities Act 1978, s 44B.
[8] Securities Act 1978, s 69(1).
[9] Securities Legislation Bill, cl 4, inserting new sections 55A-55G, Securities Act 1978.
[10] Securities Legislation Bill, cl 11, inserting new sections 60A-60EA, Securities Act 1978.
[11] Securities Legislation Bill, cl 27, inserting new section 42B(a), Securities Markets Act 1988.

the allotment, the issuer must repay the subscription to the subscriber within the specified period.

43. For both void and voidable allotments, if the issuer fails to repay the subscriptions within the specified period, the issuer and directors are jointly and severally liable for their repayment together with interest (unless a director proves the default in repayment was not due to any misconduct or negligence on his or her part).

4.2.2 Problems Identified

44. The feedback we have received is that with the implementation of the Securities Legislation Bill, the supervision and enforcement powers of the Securities Commission are generally adequate. This is perhaps a reflection of the fact that the Government has undertaken two reviews in the past five years on the role and powers of the Securities Commission.

45. However, we have received feedback criticising the avoidance and repayment provisions regarding breaches of exemption notices. We have also received feedback that some issuers find it difficult determining what product definition their product falls into and who would benefit if the Securities Commission had a power to give declarations on product definitions.

4.2.3 Consequence of Breaching an Exemption Notice

46. If there is no registered prospectus at the time of subscription, any allotment of securities is void under section 37 of the Securities Act and the issuer is obliged to repay the subscription monies to the investor. Likewise, if the subscriber does not receive an investment statement before subscription, any allotment of securities is voidable at the option of the subscriber under section 37A, and if that option is exercised, the issuer is obliged to repay the subscription money to the investor.

47. If an allotment is void or voidable, the issuer is able to apply to the High Court for a relief order from sections 37 or 37A.[12] The provisions for relief orders were introduced in reaction to the discovery that a number of overseas issuers had committed minor breaches of certain technical conditions attaching to exemption notices and the inability of overseas issuers to seek relief under the Illegal Contracts Act 1970. Many of the breaches involved a failure to file certain documents with the Registrar of Companies on time, as required by the relevant exemption notice. The result of a failure to comply with a condition of an exemption is that the exemption notice no longer applies. Therefore, any securities allotted during the period of non-compliance may be void or voidable.

48. Sections 37 and 37A are important for investor protection. However, we have received feedback that, in circumstances where an issuer has breached an exemption notice, the time and cost involved in applying for a relief order can be complex and costly.

49. We propose to address this issue by giving the Securities Commission the power to specify in the exemption notice the consequences for the issuer of breaching that exemption notice and how the issuer may remedy that breach, so that the exemption

[12] Securities Act 1978, ss 37AA – 37AL, and sections 37B – 37G.

notice continues to apply and the consequence of breach can be more proportionate to the breach.

Question for Submission

1. Should the Securities Commission have the power to specify in the exemption notice the consequences for the issuer of breaching that exemption notice and how the issuer may remedy that breach? If no, why?

4.2.4 Product Declaration Power

50. We have received feedback that it would be of value to both market participants and to investors if the Securities Commission had the power to declare a product to be a particular type of security.

51. While the Securities Commission has the power to grant exemptions from compliance with any of the provisions of Part II of the Securities Act and any of the regulations made under the Securities Act, it does not have a power of declaration. If an issuer is uncertain as to what definition of security its product falls under and therefore uncertain as to how it should comply with Part II of the Securities Act, it can either proceed in uncertainty or seek an exemption from the Securities Commission.

52. While exemptions can provide certainty, they are not always the most appropriate method for resolving ambiguity or other difficulties of interpretation. Exemptions have the effect of adapting the law that would otherwise apply to, for example, an issuer or class of issuers, while a power of declaration would provide a binding interpretation on how or whether the law applied to a situation.[13]

53. We propose that the Securities Commission have the power to declare a product to be a particular type of security. This would enable the Securities Commission to consider the nature of the product and to determine which disclosure regime would provide the most appropriate protection and information for investors. It would also provide certainty for issuers as to which disclosure regime applies.

54. We also propose that the Securities Commission have the power to declare whether a product is a security or a derivative. As discussed in section 3.1.10.2 of the discussion document *Securities Offerings*, it can be unclear to an issuer whether the regulatory framework for securities or futures contracts applies. This will enable the Securities Commission to consider the nature of the product and to determine which regulatory framework should apply to the product. It would also provide certainty for issuers as to which regulatory framework applies.

Questions for Submission

2. Should the Securities Commission have the power to declare a product to be a particular type of security? If no, why?

3. Should the Securities Commission have the power to declare a product to be a

[13] Securities Commission, *Binding Rulings on Securities Law: A Discussion Paper*, Wellington, 2000.

security or a derivative? If no, why?

4.3 REGISTRAR OF COMPANIES

4.3.1 Current Regulation

4.3.1.1 Securities Act 1978

55. The Registrar of Companies is responsible for registering prospectuses.[14] The Registrar may refuse to registrar the prospectus if: it does not comply with the Securities Act; it contains any misdescription or error or any matter that is not clearly legible or is contrary to law; or the prescribed amount payable on registration is not paid.[15] The Registrar must refuse to register a prospectus if the date of registration would be earlier than the date of the prospectus; or if he or she is of the opinion that the prospectus contains a statement that is false or misleading on a material particular, or omits a material particular.[16]

56. Section 69(1) allows any person to appeal against the Registrar's decision not to register a prospectus. The appeal must be made to the Securities Commission within 15 working days of the notification of the refusal to register.[17]

57. The Securities Commission may confirm the Registrar's decision not to register or give any directions or other determination it thinks fit and, subject to a right to appeal to the High Court on points of law, the Securities Commission's decision is final and binding on the parties.[18]

58. Once the prospectus is registered, the Securities Commission may, if it is of the opinion that the prospectus is false or misleading as to a material particular (or omits any material particular), or otherwise does not comply with the law, suspend the prospectus, or cancel its registration.[19]

59. The Registrar is also responsible for registering trust deeds, and may refuse to do so if the deed does not comply with the Securities Act, or if the deed contains any misdescription or error or any matter that is not clearly legible.[20]

60. The Registrar undertakes inspections at the Securities Commission's request.[21] The Registrar also has a number of enforcement powers under the Securities Act. These include: prosecuting offences of offering, distribution or allotting securities in contravention of the Securities Act; prosecuting offences of misleading statements in advertisements or registered prospectuses; prosecuting other offences under the Act and Regulations relating to issuers and issues of securities; and prosecuting offences under the Financial Reporting Act 1993.

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[14] Securities Act 1978, s 42.
[15] Securities Act 1978, s 42(2).
[16] Securities Act 1978, s 42(3).
[17] Securities Act 1978, s 69(1).
[18] Securities Act 1978, s 69(2).
[19] Securities Act 1978, s 44(1).
[20] Securities Act 1978, s 46.
[21] Securities Act 1978, s 67A (see also ss 67 and 68).

4.3.1.2 Corporations (Investigation and Management) Act 1989

61. The Registrar of Companies has significant powers under the Corporations (Investigation and Management) Act 1989. There is no express obligation on the Registrar to supervise the affairs of any corporation.[22] However, the Registrar may, by notice in writing to a corporation, require that corporation or associated person to supply to the Registrar such information relating to the business, operation, or management of that corporation for such periods and in such form as may be specified in the notice.[23] The trustees of debt security issues are obliged to disclose information relating to the affairs of a corporation if, in their opinion, the corporation is insolvent or is likely to become insolvent or is in serious financial difficulties; or if the corporation has breached (or is likely to breach) the terms of the trust deed or the terms of the offer of the securities in a significant respect; or otherwise where such disclosure of information is likely to assist or be relevant to the exercise of powers under the Act.[24]

62. If the Registrar has reasonable grounds to believe that a corporation is one to which the Corporations (Investigation and Management) Act applies (that is, any corporation that is or may be operating fraudulently or recklessly, or it is otherwise desirable that the Act should apply for the purpose of preserving the interests of the corporation's members or creditors, or any beneficiary of any trust administered by the corporation, or for any other reason in the public interest[25]), he or she may declare that corporation to be "at risk".[26]

63. An "at risk" corporation must consult with the Registrar as to the circumstances of that corporation, and as to the methods of resolving the difficulties that it is in.[27] The Registrar has the power to give advice and assistance to the corporation.[28] With the consent of the Securities Commission, the Registrar may give directions to an "at risk" corporation requiring it not to remove from New Zealand, transfer, charge, or otherwise deal with any of its property or funds without the consent of the Registrar. Similarly, it may direct the Corporation to place in a trust account any money received for investment, or to take other such action to preserve the interests of the corporation's members and creditors.[29]

4.3.2 Problems Identified

64. The feedback we have received is that generally the Registrar of Companies has sufficient supervision and enforcement powers.

65. However, we have received some feedback questioning the role of the Registrar in registering the prospectus. Feedback shows there is some confusion as to whether registration also means that the content of the prospectus is merit-checked by the Registrar. Concern has been raised that a prospectus may be registered without an issue being raised by the Registrar, yet the Securities Commission can suspend or

[22] Corporations (Investigation and Management) Act 1989, s 7.
[23] Corporations (Investigation and Management) Act 1989, s 9.
[24] Corporations (Investigation and Management) Act 1989, s 11.
[25] Corporations (Investigation and Management) Act 1989, s 4.
[26] Corporations (Investigation and Management) Act 1989, s 30.
[27] Corporations (Investigation and Management) Act 1989, s 31.
[28] Corporations (Investigation and Management) Act 1989, s 32.
[29] Corporations (Investigation and Management) Act 1989, s 33.

prohibit the prospectus after it has been registered. Some have questioned whether the Securities Commission should play a greater role in the registration of the offer documents. We have also received other feedback that market participants see the current split roles as important.

66. The Registrar and the Securities Commission have different roles in relation to the registration of offer documents. The role of the Registrar is to check the prospectus to ensure it addresses the matters specified in the Securities Regulations, and then to register or decline to register the prospectus accordingly. It is the role of the Securities Commission to act as an appeal authority if an issuer wants to appeal the Registrar's decision not to register a prospectus.

67. Acceptance of a prospectus by the Registrar for registration does not guarantee that the prospectus complies with the Securities Act and Securities Regulations. Although the Registrar may pre-check a prospectus before registration, this does not mean the Registrar has approved its contents. The Registrar will check only to see whether, on the face of it, the prospectus meets the requirements for registration, i.e., that it includes all the information that is required by the Regulations. The feedback we have received is that the role of the Registrar in registering the prospectus improves the quality of the offer document for investors.

68. The Registrar cannot take the further step of ensuring that the contents of the prospectus are accurate. Responsibility for the accuracy of the contents rests with the promoters, directors and issuers in accordance with the Securities Act. It would be difficult for a regulator to assess the accuracy of the contents unless matters came to light, which suggested that they were not. If these matters do come to light, the Securities Commission has the ability to take steps to suspend or cancel the registration of the prospectus.

69. We did raise for discussion with advisory groups, whether the offer documents should be "lodged" rather than "registered" with a regulator, as is currently the case for offer documents in Australia. In Australia, issuers lodge a prospectus (or product disclosure statement) with the Australian Securities and Investment Commission, and there is a 14-day (or 7, for product disclosure statements) delay before the issuer is able to fundraise under the prospectus. During this two-week period, the market has the opportunity to consider the prospectus before commencement of subscriptions for the securities on offer. Where the prospectus was defective, the market could draw matters to the attention of the regulator and aggrieved parties could, if appropriate, seek injunctions preventing the fundraising. At any stage the regulator can issue a stop order preventing fundraising under a defective prospectus.

70. However, lodging rather than registering the offer document received little support from the advisory groups because of the uncertainty it can create for the issuer. It was recognised that lodgment is more appropriate in Australia, given that the disclosure requirements are more principle-based rather than prescriptive-based. We note that we have proposed in the discussion document *Securities Offerings*, that Part B of the proposed offer document for debt and equity securities be governed by a principle-based disclosure requirement, which will be supported by prescriptive disclosure requirements. This proposal is slightly more "principles-based" than the current requirements; however, it is less "principles-based" than the Australian disclosure regime.

Questions for Submission

4. Does the Registrar of Companies have a sufficient and adequate role in supervising the disclosure regime? If not, why?

5. Can the respective roles of the Registrar of Companies and the Securities Commission in registering the prospectus be better clarified in legislation?

4.4 LIABILITIES, PENALTIES & REMEDIES

4.4.1 Civil Liability

71. Section 56 of the Securities Act imposes liability on certain individuals if persons have subscribed for securities on the faith of an advertisement or registered prospectus containing an untrue statement. A statement is deemed untrue if it misleads in the form or context in which it is included or by material omission.[30] The liability is limited to compensating investors for loss or damage sustained because of the untrue statement.

72. A person will not be liable in respect of an untrue statement in a prospectus if he or she proves that his or her consent to be a director of the issuer was withdrawn before the distribution of the registered prospectus, that notice (and reason for the withdrawal) was given to the Securities Commission, and that the registered prospectus was distributed without his or her authority or consent.[31] No person will be liable in respect of an untrue statement in a registered prospectus or advertisement if he or she proves that:

    a. The advertisement was distributed, or the prospectus registered, without his or her knowledge or consent, and on becoming aware of its distribution he or she gave notice to the trustee, the Registrar, and the Securities Commission to that effect, and also gave reasonable public notice to that effect;[32] or

    b. After the distribution of the advertisement or registration of the prospectus, and before the securities were subscribed for, he or she became aware of an untrue statement, withdrew his or her consent, and gave such notice as outlined above in (a);[33]

    c. As regards every untrue statement not purporting to be made on the authority of an expert or of a public official document or statement, he or she had reasonable grounds to believe and did, up to the time of the subscription for the securities, believe that the statement was true;[34] or

[30] Securities Act 1978, s 55(a)(i).
[31] Securities Act 1978, s 56(2).
[32] Securities Act 1978, s 56(3)(a).
[33] Securities Act 1978, s 56(3)(b).
[34] Securities Act 1978, s 56(3)(c).

d. As regards every untrue statement purporting to be a statement by an expert or contained in what purports to be a copy of or extract from a report or valuation of an expert:[35]

i. it fairly represented the statement, or was a correct and fair copy of or extract from the report or valuation; and

ii. he or she had reasonable grounds to believe and did, up to the time of distribution or registration, believe that the person making the statement was competent to make it; and

iii. that person had given consent as required by the Securities Act to the distribution or registration, and had not withdrawn that consent before the distribution or registration or before the securities were subscribed for;

e. As regards every untrue statement purporting to be a statement made by an official person or contained in what purports to be a copy of or extract from a public official document, it was a correct and fair representation of the statement, copy of, or extract from, the document.[36]

73. There is also civil liability for the statements made by an expert in an advertisement or registered prospectus.[37] That expert will not be liable if he or she can prove that: he or she withdrew consent (in writing) before distribution or registration of the advertisement or registered prospectus;[38] consent was withdrawn before any subscriptions were made (and notice was given to the trustee, the Registrar, and the Securities Commission, as well as giving reasonable public notice);[39] or that he or she was competent to make the statement and believed on reasonable grounds until the time of subscription that the statement was true.[40]

4.4.1.1 Securities Legislation Bill Changes

74. The Securities Legislation Bill amends the civil liability regime. Distribution of an advertisement or registered prospectus containing an untrue statement will be known as a "civil liability event". If a civil liability event occurs, the Securities Commission may apply to the court for a pecuniary penalty order. The court will then need to determine whether there has been a civil liability event and whether the person is liable for a pecuniary penalty order. The court must then make a declaration that there has been a civil liability event, and may order the person to pay a pecuniary penalty that the court considers appropriate if the event materially prejudices the interests of subscribers for the securities involved; is likely to materially damage the integrity or reputation of any of New Zealand's securities markets; or is otherwise serious. The maximum pecuniary penalty is $500,000 for an individual, and $5,000,000 for a body corporate, for each civil liability event.[41]

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[35] Securities Act 1978, s 56(3)(d)
[36] Securities Act 1978, s 56(3(e).
[37] Securities Act 1978, s 57.
[38] Securities Act 1978, s 57(2)(a).
[39] Securities Act 1978, s 57(2)(b).
[40] Securities Act 1978, s 57(2)(c).
[41] Securities Legislation Bill cl 4, inserting new sections 55A-55F, Securities Act 1978.

75. The court may, on application of the Securities Commission, or a subscriber, order a liable person to pay compensation to all or any of the persons who subscribed for any securities on the faith of an advertisement or registered prospectus that includes an untrue statement, for the loss or damage that the persons have sustained by reason of the untrue statement.[42]

4.4.2 Criminal Liability

76. Section 58 of the Securities Act creates criminal liability for misstatements in an advertisement or registered prospectus.[43] Conviction on indictment for the offence may result in imprisonment for a term not exceeding five years (or, on summary conviction, to imprisonment for a term not exceeding 3 months) and/or a fine not exceeding $300,000, and to a further fine not exceeding $10,000 for every day or part day during which the offence is continued.[44] No person will be convicted of an offence under this section if he or she proves either that the statement was not material, or that he or she had reasonable grounds to believe (and did so believe up to the time of the distribution of the prospectus) that the statement was true.[45]

77. If an offer of a security is made to the public, a registered prospectus relating to a security is distributed, or a security is allotted in contravention of the Securities Act, then an offence is committed.[46] Such an offence is punishable on summary conviction by a fine of up to $300,000 and, if the offence is a continuing one, to a further fine not exceeding $10,000 for every day or part of a day during which the offence is continued.[47] The persons who will be liable are the issuer, every person who was a principal officer of the issuer at the time of the offence, every promoter, and every person who has authorised him or herself to be named in any advertisement or registered prospectus as a director of the issuer.[48]

78. A person shall not be convicted if the contravention was in respect of matters which, in the opinion of the court, were immaterial, or otherwise (in all the circumstances) ought reasonably to be excused.[49] A person other than the issuer will not be convicted if, in the opinion of the court, the Securities Act was not contravened with his or her knowledge and consent.[50]

79. There is also criminal liability for obstructing the exercise of powers under the Securities Act.[51] Again, a person committing such an offence is liable on summary conviction to a fine not exceeding $300,000 and, if the offence is a continuing one, to a further fine of up to $10,000 for each day or part of a day during which the offence is continued.[52]

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[42] Securities Legislation Bill, cl 4, inserting new sections 55G, Securities Act 1978.
[43] Securities Act 1978, s 58.
[44] Securities Act 1978, s 58(5).
[45] Securities Act 1978, ss 58(2) and 58(4).
[46] Securities Act 1978, s 59(1).
[47] Securities Act 1978, s 59(1).
[48] Securities Act 1978, s 59(1).
[49] Securities Act 1978, s 59(2)(a).
[50] Securities Act 1978, s 59(2)(b).
[51] Securities Act 1978, s 59A.
[52] Securities Act 1978, s 59A(2).

4.4.2.1 Securities Legislation Bill Changes

80. The Securities Legislation Bill will give the court (upon the application of certain entitled persons, including the Securities Commission and the Registrar of Companies) the ability to impose management banning orders against a person convicted under one of the criminal liability provisions, or if a pecuniary penalty order has been made against that person under the Act. They may also impose a management banning order against a person who has, while the director of an incorporated or unincorporated body, persistently contravened the Securities Act; the Companies Act 1993; the Securities Markets Act 1988; the Takeovers Act 1993; or the Takeovers Code in force under that Act, or if the body has so contravened or persistently failed to take all reasonable steps to obtain compliance with those Acts or the Code. A management banning order may, for a period of 10 years or less, prohibit or restrict the person from (without the leave of the court) being a director or promoter of, or in any way being concerned or taking part in the management of, an incorporated or unincorporated body.[53]

81. Under the Bill, a person who has been convicted of an offence under sections 58 or 59A of the Securities Act, or who has had a pecuniary penalty order made against him or her under the Act, will automatically be banned from management on the terms above for five years.[54]

4.4.3 Problems Identified

82. The feedback we have received is that generally, the Securities Act, together with the Securities Legislation Bill, provides sufficient prohibitions, liabilities and penalties to hold parties accountable under the disclosure regime and to deter negligent and intentional misleading of investors; and that there are sufficient defences for persons exercising reasonable care.

83. However, we note there has not been a successful case taken under section 56 of the Securities Act. The scope of section 56 is quite narrow because the elements of reliance and causation must be satisfied – the investor must show that it subscribed for securities in the issuer on the faith of an advertisement or registered prospectus, and that it suffered loss or damage as a result of the misstatement. We seek feedback on whether the scope of section 56 is appropriate.

84. We also note that under the Securities Legislation Bill, the Securities Commission will have the ability to make corrective orders if a person contravenes the general dealing misconduct prohibition. We seek feedback on whether the ability to make corrective orders should be extended to a breach of the disclosure regime, in respect of breaches of either the advertising or offer document provisions.

Questions for submission

6. Are the liabilities in the Securities Act sufficient and adequate? If no, why?

7. Is the scope of section 56 too narrow?

[53] Securities Legislation Bill, cl 11, inserting new sections 60A-60EA, Securities Act 1978.
[54] Securities Legislation Bill, cl 11, inserting new sections 60E, Securities Act 1978.

8. Are the defences to these liabilities sufficient and adequate? If no, why?

9. Are the penalties in the Securities Act sufficient and adequate? If no, why?

10. Should the Securities Commission have the power to make corrective orders if a person contravenes the disclosure regime?

5. PART B: TRUSTEE SUPERVISION OF ISSUERS: CURRENT REGULATION

5.1 INTRODUCTION

85. This section outlines the current supervisory regime for securities. It addresses who is able to be a trustee or statutory supervisor; the role of a trustee or statutory supervisor in terms of debt securities, CIS and superannuation schemes; it also looks at the current regulation of trustees and statutory supervisors.

5.2 THE CURRENT SITUATION

86. The current law requires that issuers of debt securities and CIS must appoint a trustee or statutory supervisor[55] to monitor the issue and act in the best interests of investors.[56] Issuers that currently require trustees or statutory supervisors include building societies, finance companies, credit unions, unit trusts, superannuation schemes, participatory securities, and retirement villages.[57]

5.2.1 Who May be a Trustee or Statutory Supervisor

87. Currently, there are two categories of entities or individuals able to act as a trustee or statutory supervisor for debt securities, participatory securities, unit trusts and group investment funds. These are:

    a. Trustee corporations, which are established by their own Acts of Parliament. The Securities Act 1978 gives trustee corporations automatic authority to act as trustees or statutory supervisors. They do not require any additional authorisation. There are currently six trustee corporations.[58]

    b. Those individuals or entities holding Securities Commission approval to act as trustees or statutory supervisors. At present, the Securities Commission has approved four companies to act as statutory supervisors or trustees in respect of participatory and debt securities; one company to retain its appointment as trustee in respect of a particular issue of debt securities; and two individuals approved as statutory supervisors in respect of specific nominated issues of securities.

88. For superannuation schemes, any person may act as trustee.

89. Collectively, the statutorily-authorised trustee corporations and Securities Commission-approved trustees and statutory supervisors are sometimes referred to as corporate trustees.

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[55] Securities Act 1978, ss 33(2); 33(3); Superannuation Schemes Act 1989, s 2 definition of "trustees"; Trustee Companies Act 1967, s 29; Unit Trusts Act 1960, s 3.
[56] The duty to act in the best interest of investors comes from common law.
[57] Note that when the Retirement Villages Act 2003 comes into force, Retirement Villages will no longer be governed by the Securities Act, and supervisors will be appointed by the Retirement Villages Commissioner.
[58] The six current trustee corporations are the Maori Trustee; New Zealand Permanent Trustees Limited; Perpetual Trust Limited; the Public Trust; The New Zealand Guardian Trust Company Limited; and Trustees Executors Limited.

90. The powers and duties of trustees and statutory supervisors are set out in the trust deeds (or deeds of participation) and common law as well as the Trustees Act 1956, Securities Act 1978, Trustee Companies Act 1967, Unit Trusts Act 1960, and Superannuation Schemes Act 1989.

5.3 DEBT SECURITY TRUSTEES

5.3.1 Debt Security Trustees' Current Role

5.3.1.1 Trustee Duties

91. The duties of a debt trustee are a combination of statutory duties, common law duties and duties implied into the trust deed.

    a. *Corporations (Investigation and Management) Act 1989*. If in the trustee's opinion the issuer has breached, or is likely to breach, in an important manner, the terms of the trust deed or the offer of securities; or if the issuer is, or is likely to become, insolvent, then the trustee must report to the Registrar of Companies.[59] This allows the Registrar to intervene before the issuer fails, so that if possible, the issuer can be managed back to financial soundness, or if not possible, the issuer can be wound up so investors can recover what assets are available.

       Before any disclosure is made to the Registrar of Companies, the trustee must take reasonable steps to inform the corporation of the intention to disclose the information, and the nature of that information.[60] The disclosure of information by a trustee in good faith in accordance with the Act is protected from civil, criminal, and disciplinary proceedings.[61]

    b. *Trustee Act 1956 and Trustee Companies Act 1967*. Trustees must also comply with all duties placed upon them by other legislation, such as the Trustee Act 1956 (which contains various provisions relating to their duties around investing funds; their general powers and indemnities; appointment and discharge; and the powers of the court) and the Trustee Companies Act 1967 (which contains various provisions relating to the administration of trustee companies, their group investment funds and their liabilities and protection).

    c. *Common law.* Trustees of debt securities are bound by common law trustee obligations, such as the obligation to act in the best interests of the beneficiaries, i.e., the investors.

    d. *Fifth Schedule to the Securities Regulations 1983*. The Schedule implies two duties into all debt trust deeds. First, that the trustee shall exercise reasonable diligence to ascertain whether or not any breach of the terms of the deed, or of the terms of the offer of the debt securities, has occurred and, except where it is satisfied that the breach will not materially prejudice the security (if any) of the debt securities or the interests of the holders

[59] Corporations (Investigation and Management) Act 1989, s 11.
[60] Corporations (Investigation and Management) Act 1989, s 12.
[61] Corporations (Investigation and Management) Act 1989, s 15.

thereof, shall do all such things as it is empowered to do to cause any breach of those terms to be remedied.[62] Second, that the trustee shall exercise reasonable diligence to ascertain whether or not the assets of the borrowing group that are or may be available, whether by way of security or otherwise, are sufficient or likely to be sufficient to discharge the amounts of the debt securities as they become due.[63]

92. In addition, under the proposed registration regime for non-bank deposit-taking financial institutions that issue debt securities to the public, the trustee may have a duty to provide a recommendation to the Securities Commission that the issuer has met the entry criteria for registration. This proposal is discussed further in the discussion document *Non-Bank Deposit-Takers*.

5.3.1.2 Trustee Functions

93. Trustees carry out several functions in order to satisfy their duties. These include:

a. Negotiating the terms of the offer;

b. Negotiating the contents of the trust deed;

c. Checking each prospectus, and stating in each prospectus that the offer complies with the trust deed (as well as stating that the trustee does not guarantee the repayment of securities or payment of interest thereon);[64]

d. Seeking reports and monitoring reports supplied by the issuer's directors and auditors;

e. Undertaking a range of remedial actions on behalf of investors in times of breach, significant change or "crisis";

f. Approving variations in the trust deed;

g. Working with the Registrar of Companies and the Securities Commission in relation to enforcement of the law.

5.3.1.3 Trustee Powers

94. The powers of a debt trustee are a combination of statutory powers, powers deemed into the trust deed, and powers negotiated between the trustee and issuer.

95. Under the Securities Act, the trustee has the power to apply to the court for an order or orders when, after due inquiry, the trustee is of the opinion that the issuer and any guarantor of the securities are unlikely to be able to pay all money owing in respect of securities when it becomes due, or the provisions of any deed relating to the securities are no longer adequate to give proper protection to the securities.[65] The court may then give such directions as it considers necessary to protect the interests of the security holders, other holders of securities of the issuer, any guarantor of the

[62] Securities Regulations 1983, reg 24, Fifth Schedule, cl 1(1).
[63] Securities Regulations 1983, reg 24, Fifth Schedule, cl 1(2).
[64] Securities Regulations 1983, Second Schedule, cl 13(3).
[65] Securities Act 1978, s 49(1).

securities, or the public.[66] This may include, for example, amending the trust deed or another deed relating to the securities, imposing restrictions on the activities of the issuer, or restraining the payment of money by the issuer to the security holders.

96. The Fifth Schedule to the Securities Regulations deems the following trustee powers into all debt trust deeds.

    a. The trustee is entitled to receive all notices of and other communications relating to any general meeting of the issuer which any member of the issuer is entitled to receive.[67]

    b. The trustee is entitled to have a representative attend any general meeting of the issuer, and to be heard at any such meeting which he or she attends on any part of the business of the meeting which concerns the trustee or the holders of debt securities for whom it is trustee.[68]

    c. From time to time, the trustee can request the issuer to make available for inspection the whole of the accounting and other records of the issuer. The issuer must give the trustee such information as it requires with respect to all matters relating to such records.[69]

    d. The trustee may request (in writing) that the issuer summon a meeting of the security holders for the purpose of considering the financial statements of the issuer for its last preceding financial year, or of giving directions to the trustee in relation to the exercise of its powers.[70]

97. Any remaining trustee powers are negotiated between the trustee and issuer and are set out in the trust deed. We are told that the trust deed will normally give the trustee power to:

    a. Represent debt security holders generally;

    b. Waive any breach or anticipated breach of the trust deed;

    c. Delegate its powers;

    d. Engage, at the issuer's expense, an expert to report on the true financial situation of the issuer;

    e. Obtain information on the value of assets shown in the issuer's statement of financial position relating to related parties, and to (if necessary) take steps including enforcement action in the light of information obtained on that basis;

    f. Act on the advice or opinion provided by an expert (e.g. a lawyer, valuer, or accountant);

    g. Appoint receivers (where security is held);

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[66] Securities Act 1978, s 49(3).
[67] Securities Regulations 1983, reg 24, Fifth Schedule, cl 2(1).
[68] Securities Regulations 1983, reg 24, Fifth Schedule, cl 2(2).
[69] Securities Regulations 1983, reg 24, Fifth Schedule, cl 2(3).
[70] Securities Regulations 1983, reg 24, Fifth Schedule, cl 3(1).

h. Appoint liquidators;

i. Apply to the court for a direction on any matter;

j. Agree to a variation or addition to the trust deed – this is normally only permitted if:

   i. in the opinion of the trustee, it is made to correct a manifest error, or is of a formal or technical nature, or is convenient for obtaining or maintaining a quotation of the debt securities on the stock exchange and is not prejudicial to the debt security holders; or

   ii. it is authorised by an extraordinary resolution; or

   iii. the trustee is of the opinion that it is not, or is not likely to become, prejudicial to the general interests of the debt security holders;

k. Call a meeting of debt security holders.

5.3.1.4 Trustee Accountability

98. The ways in which a debt trustee may be held accountable are found in statute (by implication), in the provisions deemed into the trust deed, in the common law, and in trust deeds.

99. The Trustee Act 1956 gives the court the power to appoint a trustee in substitution for an existing trustee whenever it is expedient to do so, and is inexpedient, difficult or impracticable to do so without the assistance of the court.[71] In particular, the court may appoint a new trustee in substitution for a trustee who has been held to have misconducted themselves in the administration of the trust; or is convicted of a crime involving dishonesty as defined in section 2 of the Crimes Act 1961; is bankrupt; or is a corporation that has ceased to carry on business, is in liquidation, or has been dissolved.[72]

100. The meeting provisions deemed to be contained in trust deeds allow the holders of 10 percent of the debt securities to require the issuer to summon a meeting for the purpose of giving directions to the trustee in relation to the exercise of its powers.[73]

101. The main way in which trustees are accountable is the capacity for investors to litigate against them. In addition, general trust law applies to trustees; any remedies available to beneficiaries under general trust law and the Trustee Act 1956 are available to investors when a trustee breaches its duties. The issuer may be able to remove the trustee on the terms contained in the trust deed; however, no trustee may be discharged or retire until all functions and duties of that position have been fulfilled and performed, or the issuer of the securities has appointed a replacement trustee.[74]

102. If the issuer fails and investors lose money, they are able to pursue the issuer, but of course this is unlikely to provide much comfort. Investors instead often pursue the

[71] Trustee Act 1956, s 51(1).
[72] Trustee Act 1956, s 51(2).
[73] Securities Regulations 1983, Fifth Schedule, cl 3(1).
[74] Securities Act 1978, s 48(2).

trustee through the court. This puts a strong incentive on the trustee to act in the best interests of investors at all times, so they will not, in the event of failure, be found liable to investors and have to face the financial consequences.

103. Trust deeds would normally contain provisions around retirement and removal of the trustee (subject to section 48(2) of the Securities Act which holds that no trustee shall vacate a position unless another trustee has been appointed). A trust deed would likely contain provision for retirement of the trustee; removal of the trustee by the issuer; and removal by investors by, for example, extraordinary resolution.

5.4 COLLECTIVE INVESTMENT AND SUPERANNUATION SCHEMES

104. Currently, CIS are categorised as participatory securities, unit trusts, and superannuation schemes. This review will change this structure (as outlined below in section 5.4.4).

5.4.1 Current Participatory Security Statutory Supervisors' Role

5.4.1.1 Duties

Deeds of Participation

105. The Seventh Schedule to the Securities Regulations 1983 contains the basic obligation of a statutory supervisor in respect of participatory securities, again by deeming it to be contained in a deed of participation.

106. The obligation is to exercise reasonable diligence to ascertain whether any breach of the terms of the deed of participation or of the offer of the participatory securities has occurred and, except where satisfied that the breach will not materially prejudice the interests of the holders of the participatory securities, it must do all things it is empowered to do to remedy any such breach.[75]

Corporations (Investigation and Management) Act 1989

107. The obligations on a statutory supervisor under the Corporations (Investigation and Management) Act 1989 are identical to those on a trustee (see above at paragraph 91a).

Common Law and Other Legislation

108. The Trustee Act 1956 does not apply to statutory supervisors, and the Trustee Companies Act 1967 will apply only to a statutory supervisor who is also a trustee company. However, there is a possibility that, given the right circumstances, general principles of trust law, or the obligations of a fiduciary more generally, will also be applied to a statutory supervisor.

[75] Securities Regulations 1983, Seventh Schedule, cl 1.

5.4.1.2 Functions

109. The way in which a participatory security statutory supervisor fulfils its obligations will be generally similar to a debt security trustee, though usually more "hands-off". A statutory supervisor does not need to make a statement in the prospectus. A deed of participation for a participatory security will probably not require reports from the manager as frequently as would be required from a debt security issuer.

5.4.1.3 Powers

110. A participatory security statutory supervisor has the same rights as a debt security trustee to receive information from the manager, and attend any meeting of the holders of the participatory securities (they may also call such a meeting).[76] The statutory supervisor is entitled to be heard at any such meeting on any part of the business of the meeting that concerns the supervisor or the holders of the participatory securities.[77] The statutory supervisor may also require the manager of the scheme to make available for inspection all of the accounting and other records relating to the scheme, along with all the other information the statutory supervisor requires in regard to such records.[78]

111. Statutory supervisors have the same abilities as a trustee to apply to the court when they think the issuer or any guarantor is unlikely to be able to repay all money owing in respect of the securities when it becomes due, or that the provisions of the deed of participation are no longer adequate to give proper protection to the security holders.[79]

112. The statutory supervisor will have the power to remove the manager in certain (and extreme) circumstances, such as the bankruptcy or breach of the manager, or a material breach of the deed of participation by the manager.

5.4.1.4 Accountability

Legislative

113. There are no specific legislative accountabilities upon a participatory security supervisor.

Implied

114. As with debt security trust deeds, the meeting provisions deemed to be contained in deeds of participation allow the holders of 10 percent of the securities to require the manager to summon a meeting for the purpose of giving directions to the trustee in relation to the exercise of its powers.[80] This provision could be used by investors to remove the trustee.

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[76] Securities Regulations 1983, Seventh Schedule, cl 2(1).
[77] Securities Regulations 1983, Seventh Schedule, cl 2(2).
[78] Securities Regulations 1983, Seventh Schedule, cl 2(3).
[79] Securities Act 1978, s 49.
[80] Securities Regulations 1983, Fifth Schedule, cl 3(1).

Common Law

115. The common law accountabilities on trustees may apply to statutory supervisors to the extent that principles of trust law can be extended to statutory supervisors. The main accountability mechanism for statutory supervisors is the capacity for investors to litigate against them.

Deeds of Participation

116. Deeds of participation would normally contain provisions around retirement and removal of the trustee (subject to section 48(2) of the Securities Act which holds that no trustee shall vacate a position unless another trustee has been appointed). A trust deed would likely contain provision for retirement of the trustee; removal of the trustee by the issuer; and removal by investors by, for example, extraordinary resolution.

5.4.2 Current Unit Trust Trustees' Role

5.4.2.1 Duties

Trust Deeds

117. Unit trusts are governed by the Unit Trusts Act 1960. The Securities Act applies to the offering to the public for subscription of interests in unit trusts.[81] Every unit trust must have:

a. A manager who issues interests in the unit trust and who is responsible for managing the investments and other property of the unit trust,[82] and

b. A trustee, independent from the manager, who holds the assets of the trust.[83]

118. The Unit Trusts Act specifies that the trustee must be either one of the statutorily-authorised trustee corporations, or a company or bank approved for that purpose by the Minister.[84] The Securities Commission does not have the power to approve a unit trustee.

119. The trustee of a unit trust (and the manager of that unit trust) have the same duty to observe care and diligence in the performance of their duties as any other trustee, and are each entitled to the same indemnities and relief as any other trustee.[85] The Act requires that the trustee shall not acquire or dispose of any property if it is manifestly not in the interests of the unit holders.[86] The Trustee Corporation Association's guidelines provide some direction to trustees on how to fulfil this obligation.[87]

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[81] Unit Trusts Act 1960, s 7.
[82] Unit Trusts Act 1960, s 3(2).
[83] Unit Trusts Act 1960, ss 3(3) and 3(4).
[84] Unit Trusts Act 1960, s 5.
[85] Unit Trusts Act 1960, s 24(1).
[86] Unit Trusts Act 1960, s 12(1)(c).
[87] Trustee Corporations Association of New Zealand *Practice Guidelines – 4: Unit Trusts*, TCA 2003/13, Approved December 2003. Available at www.tca.org.nz.

120. The trustee of a unit trust is required to give a statement in the registered prospectus as to whether or not, in its opinion, the manager has managed the unit trust during the accounting period referred to in the prospectus in accordance with the provisions of the trust deed and of the offer of units.[88]

Corporations (Investigation and Management) Act 1989

121. The duties of a unit trust trustee under the Corporations (Investigation and Management) Act 1989 are the same as those of a debt security trustee (see above at paragraph 91).

Common Law and Other Legislation

122. A unit trust trustee has the same duty to comply with common law and other legislation as does a debt security trustee (see above at paragraph 91).

5.4.2.2 Functions

123. The functions of a unit trust trustee are again much the same as those of a debt security trustee (see above at paragraph 93).

5.4.2.3 Powers

124. The Unit Trusts Act contains implied provisions for every trust deed. Many of these relate to the manager's role, but also included are trustee powers that are similar to those of debt security trustees – the ability to inspect the manager's books and papers, as well as other relevant information; the ability (through the manager) to call a meeting of the security holders, and chair such a meeting.[89]

125. The trustee of a unit trust may remove the manager by application to the court. However, they also have the power to remove the manager simply by certifying that such removal is in the interest of the unit holders.[90]

126. According to the Trustee Corporations Association, the trustee of a unit trust also usually has powers (by inclusion in the trust deed) to:[91]

a. Authorise any borrowing requested by the manager;

b. Appoint a temporary manager upon the resignation or removal of the manager;

c. Approve the appointment of a new auditor or remove the existing auditor;

d. Agree to modifications of the terms of the trust deed where those changes are not considered to be prejudicial to the interests of the unit holders;

e. Wind up the trust and dispose of the assets;

f. Appoint representatives to attend or chair meetings of unit holders;

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[88] Securities Regulations 1983, Schedule 3A, cl 20.
[89] Unit Trusts Act 1960, ss 12 and 18.
[90] Unit Trusts Act 1960, ss 19(1) and (2).
[91] Trustee Corporation Association of New Zealand, www.tca.org.nz.

g. Act on the directions of the unit holders; and

h. Veto any investment or sale proposal that the trustee believes is manifestly not in the interest of unit holders.

5.4.2.4 Accountability

Legislative and Implied

127. The Unit Trusts Act contains specific provision for the removal of the trustee. The manager may apply to the court for an order removing the trustee. The Minister may also apply to the court for such an order, or, if the Minister approved the trustee (under the Act) then the Minister has the power to remove that trustee without going to the court.[92] As with other securities, the trustee's office is not to be vacant – another trustee must have been appointed and assumed office before the original trustee is removed.[93]

128. If certain quorums are met at a meeting of unit holders, then those unit holders may by resolution give direction to the trustee as they think proper concerning the unit trust, as long as those directions are consistent with the trust deed and the Unit Trusts Act.[94] A trustee acting under such a direction will not be liable for anything they do or omit to do by reason of its following that advice or direction.[95] If the trust deed provides for the removal of the trustee by the unit holders, then those unit holders would be able to do so at such a meeting.

Common Law

129. The court would also have the power to remove the trustee, for example on application of a unit holder.

Trust Deeds

130. As outlined above, the unit trust deed would likely include provision for the removal of the trustee.

5.4.3 Current Superannuation Scheme Trustees' Role

131. The law currently requires that superannuation schemes have a trustee; however, there is no requirement that the trustee is a corporate trustee (i.e. a statutorily approved Trustee Corporation or a Securities Commission-approved trustee).

132. The "trustee" position in superannuation schemes is different to that in the other securities issues discussed above, as the actual trustee is the issuer under the Securities Act.[96]

133. Generally, the trustee of a superannuation scheme has the following responsibilities and obligations.

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[92] Unit Trusts Act 1960, ss 10(1) and (2).
[93] Unit Trusts Act 1960, s 10(3).
[94] Unit Trusts Act 1960, s 18(2).
[95] Unit Trusts Act 1960, s 18(3).
[96] Superannuation Schemes Act 1989, s 2 definition of "issuer".

a. Invest money in accordance with Trustee Act provisions.[97]

b. Meet all disclosure requirements and members' rights to information.[98]

c. Notification of members and the regulator of proposed transfers of members to a new superannuation scheme.[99]

d. Certify that any changes made to a trust deed are not contrary to implied trust deed provisions or the Act and lodge that certificate with a copy of the amendment with the Regulator.[100]

e. Ensure proper books of account are kept in respect of the scheme and that annual accounts of the scheme are prepared in accordance with Generally Accepted Accounting Principles and are audited (there are some exceptions from the audit requirement).[101]

f. Prepare an annual report within five months of the end of the financial year and send it to the regulator within 28 days of its completion.[102]

g. Notify the regulator as soon as possible if the scheme ceases to have a trustee who is a New Zealand resident.[103]

h. For defined benefit schemes: ensure that an actuary examines the financial position of the scheme every three years; ensure that the actuary's report is received no later than seven months after the date the financial position of the scheme was examined; and send a copy of the actuary's report to the regulator within 28 days of its receipt.[104]

i. In relation to winding up, the trustee must lodge a copy of the resolution with the regulator, ensure final accounts are prepared and audited (unless there is no need according to Act), send a copy of final accounts to regulator and everyone who was a member of the scheme before it was wound up, advise the regulator and members how assets of the scheme will be distributed and inform the regulator of the date on which the final distribution of assets is completed.[105]

j. Comply with the disclosure requirements of the Securities Act as prescribed by Schedules 3C (prospectus) and 3D (investment statement) of the Securities Regulations (with the exception of employer-sponsored superannuation schemes which are exempted by section 5A of the Securities Act from the requirement to produce a prospectus).

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[97] Superannuation Schemes Act 1989, s 8; Trustee Act 1956, ss 13B and 13C.
[98] Superannuation Schemes Act 1989, ss 15A, 16 and 17.
[99] Superannuation Schemes Act 1989, ss 9B and 9BA.
[100] Superannuation Schemes Act 1989, s 12.
[101] Superannuation Schemes Act 1989, s 13.
[102] Superannuation Schemes Act 1989, s 14.
[103] Superannuation Schemes Act 1989, s 18.
[104] Superannuation Schemes Act 1989, s 15.
[105] Superannuation Schemes Act 1989, s 21.

k. Maintain a register of members and other records as required under the Securities Act,[106] and otherwise fulfil all the obligations of an issuer under securities law.

134. The trustee also has the power to:

a. Apply to the Government Actuary for scheme registration;[107]

b. Contract some or all of the investment management and administration of the scheme to an investment manager or administration manager;[108] and

c. Amend the trust deed – within the limitations of the Act that requires that any amendments are not contrary to implied trust deed provisions nor contrary to the provisions of the Act.

5.4.4 Proposed Regulation of Collective Investment Schemes

135. It is proposed that the definition of CIS will include unit trusts, superannuation schemes, participatory schemes and life insurance policies with an investment component.

136. The proposed regulatory framework for CIS will require the CIS trustee to be independent from the issuer of the scheme. Under the proposed model:

a. The CIS trustee will have responsibility for supervising the issuer and the scheme (that is, by ensuring that the terms of the trust deed and the offer are adhered to, and the issuer continues to satisfy ongoing requirements), and acting in the best interests of investors; and

b. The issuer will have responsibility for the offer and issue of securities and investment management.

137. The functions, duties and powers of the CIS trustee and the issuer of the CIS are discussed in further detail in the discussion document *Collective Investment Schemes*.

5.4.4.1 Employer Stand-Alone Schemes (including Defined Benefit Schemes)

138. There is a case for regulating existing employer stand-alone schemes, including defined benefit schemes, in a different way to other CIS. For these schemes, it will be particularly important to ensure that any additional costs to schemes are minimised to prevent unnecessary scheme wind-up.

139. To achieve this, we have developed a transitional regulatory structure for these schemes. The proposed structure would require (at a high level) the retention of the current basic regulatory structure for these schemes, with some changes. The roles and functions of the trustee under this model would generally encapsulate functions of both the CIS trustee and the issuer within the proposed CIS regulation.

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[106] Securities Act 1978, s 51.

[107] Superannuation Schemes Act 1989, s 3.

[108] See “administration manager” and “investment manager”, s 2, Superannuation Schemes Act 1989.

140. Under this proposed model, as under the CIS model, the trustee has primary responsibility for ensuring that the terms of the trust deed and the offer are adhered to. However, because the trustee is also the manager in this case, they are not able to undertake the independent monitoring function that is attributed to the CIS trustee in the proposed framework for regulating CIS. Because of this, the regulator will need to take on some of the monitoring powers that a trustee has within the CIS model. The current requirements for actuarial assessments for defined benefit schemes would also need to continue to apply.

141. This is further discussed in the "Employer Stand-Alone Schemes" part of the *Collective Investment Schemes* discussion document.

5.5 CURRENT MONITORING AND ACCOUNTABILITY OF TRUSTEES AND STATUTORY SUPERVISORS

5.5.1 The Securities Commission

142. The Securities Commission has a degree of oversight over those trustees and statutory supervisors that it has approved. The Securities Commission does not appoint trustees or statutory supervisors indefinitely – at most, it will make an appointment for a five-year term, after which the trustee or statutory supervisor may be re-approved and re-appointed.

143. The Securities Commission also requires that approved persons report to it:[109]

a. On any occurrence or change in matters material to the Securities Commission's approval of that person; and

b. In any event, on an annual basis.

144. The Securities Commission also makes it a condition of approval that (where the applicant is a company) the approval applies only so long as the company is substantially directed and owned by people who were originally approved by the Securities Commission. The company's approval will be considered void in the event that 50 percent of the company's board or shareholders have changed since the time of approval (this is also regarded as a change in a material matter which must be reported on).[110]

145. The statutorily-authorised trustees do not face any such fetters on their trustee status, and the Securities Commission does not have the ability to assess their suitability to perform the role.

5.5.2 Government Actuary (Superannuation Schemes)

146. The primary role of the Government Actuary in relation to registered superannuation schemes is the registration and supervision of schemes.

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[109] Securities Commission, *Commission Policy for Approval of Trustees and Statutory Supervisors*, available at www.sec-com.govt.nz.
[110] Securities Commission, *Commission Policy for Approval of Trustees and Statutory Supervisors*, available at www.sec-com.govt.nz.

147. Registered superannuation schemes are required to report annually to the Government Actuary.[111] The Government Actuary can also require further information from the trustee or the administration manager.[112]

148. The Government Actuary also has enforcement powers, in particular; if the regulator has reasonable cause to believe:

a. The scheme is not operating in accordance with Act or regulations; or

b. The financial position of the scheme or security of benefits or management of scheme is inadequate;

It may:

i. Direct trustees to supply information to the scheme that the regulator directs.

ii. Cancel the registration of the scheme with 28 days' notice.

iii. Direct the trustees, administration manager or investment manager to operate the scheme in a specified manner with 28 days' notice.

iv. Order the scheme be wound up with 28 days' notice.[113]

5.5.3 Other Incentives for Compliance and Performance

149. The trustee corporations have stressed their reputational incentives to act strictly in the best interests of investors – they are also acutely aware that, when money is lost, the trustee may be the first party to be sued. Individual trustees or statutory supervisors may also face monetary liability. However, if he or she is the only trustee or statutory supervisor for a specific issue, and has no intention of applying for further appointments, the reputational incentives are not so high.

150. A trustee or statutory supervisor with professional indemnity insurance faces additional incentives to disclose promptly, as failure to do so may prejudice any insurance claim.

[111] Superannuation Schemes Act 1989, s 14.
[112] Superannuation Schemes Act 1989, s 24.
[113] Superannuation Schemes Act 1989, s 20.

6. PART C: PROPOSED TRUSTEE SUPERVISORY MODEL

6.1 INTRODUCTION

151. This part of the paper outlines the proposed model for the approval and supervision of trustees for CIS, superannuation and debt security issues.

6.2 BACKGROUND

152. The current regulation relating to trustees is laid out in part B of this discussion document, at pages 25 to 39.

6.3 ASSESSMENT OF CURRENT SUPERVISORY SITUATION AGAINST OBJECTIVES

6.3.1 Benefits of Status Quo

153. We believe that the trustee model is fundamentally sound. Trustees play an important role in ensuring an efficient securities market in several ways.

6.3.1.1 General

154. Trustees possess a store of regulatory know-how about the industry they regulate (including existing risk-management processes and systems). Such know-how, processes and systems are not easily transferable to a regulatory body, and there are transitional costs of change.

155. Trustees have also built up a specialised knowledge of the business and risks faced by the issuers they monitor. This knowledge allows them to be flexible in their supervision by tailoring constraints on the issuer's business appropriate to the level of risk that the issuer is exposed to.

156. Trustees have developed good working relationships with issuers. Issuers trust that the trustees will assist in resolving issues they confront in a confidential and discreet manner. One consequence of this is that issuers are more willing to surface issues early before they escalate into a crisis.

157. Trustees have also developed good working relationships with the Companies Office and the Securities Commission so that potential problems are brought to the attention of these regulators, remedial action is discussed, and regulators are kept informed. Trustees also actively consult with these regulators when issues may be difficult to resolve.

158. While funded entirely by issuers, trustees have both reputational and legislative incentives/obligations to act in investors' best interests and protect their investments. This inherent tension may work to deliver better market outcomes because trustee corporations are focused on working with an issuer to get the best result for investors.

159. Trustees that are commercial entities are close to the market and are able to detect and (if necessary) act on market "noise" sooner than a regulator may be able to.

160. Trustees have a demonstrated capacity to resolve difficulties quietly behind the scenes, protecting investors' funds and avoiding large disruptions to the market – which in turn contributes to the maintenance of market confidence.

161. Trustees work with issuers to ensure that issuers' products meet minimum standards before they are offered to the public, which may improve the quality of the offers coming to the market, whereas a regulator is more limited in its ability to do this because of its formal enforcement role, and is therefore more likely to be limited simply to telling the issuer that it does not comply.

162. Trustees can act as a collective voice for investors.

163. Trustees have a long and favourable track record. There have been few notable cases of institutional failure in the last 15 years attributable to alleged inadequacies with trustee performance.

6.3.1.2 Superannuation Schemes

164. Because the trustee in a superannuation scheme does not currently have the same independent monitoring role as other trustees (e.g. debt trustees and trustees of unit trusts), a number of the benefits identified above in relation to current trustee arrangements do not necessarily apply to superannuation schemes. In particular:

a. The schemes do not benefit from having a supervisor that is close to the market and able to deal flexibly with different schemes;

b. Because the issuer is the trustee there is a close relationship, but the nature of this relationship means that the trustee is unable to act as an independent supervisor; and

c. The lack of independence also means that there are limits to the degree to which trustees are able to ensure that products meet minimum standards before they are offered to the public.

165. However, other benefits do apply in relation to superannuation scheme trustees, including that:

a. Most trustees have a good working relationship with the regulator (i.e. the Government Actuary);

b. Trustees have some of the same reputational and legislative incentives and obligations to act in investors' best interests and protect their investments;

c. Trustees are legally able to act as a collective voice for investors; and

d. Superannuation trustees also have a good track record – there have been very few noted cases of scheme failure.

6.3.2 Problems with the Status Quo

166. Several problems have been identified with the current trustee model that mean that it is not meeting the objectives identified in section 3 of this discussion document. These issues were also reflected in the Financial Sector Assessment Program's evaluation of New Zealand's financial sector.[114] The main problems are outlined below; however, please note that any issues with trust deeds, or otherwise concerning the relationship between trustee and issuer or manager, are dealt with in Part D of this discussion document regarding debt securities and in the *Collective Investment Schemes* discussion document.

6.3.2.1 General

167. While trustees may individually have knowledge of the entities they supervise, there is an absence of good industry data and whole-sector perspective. It is hard for government to evaluate implementation of government objectives for the sector, and identify particular problems with the sector and address them.

168. There is a lack of official oversight and monitoring of trust deeds (or deeds of participation) and trustees' (or statutory supervisors') performance. There are limited checks and balances to ensure that the objectives of regulation are being met; for example, there is no obligation on trustees to report regularly on their performance. This means there is insufficient transparency for investors, the market, and government.

169. There is no level playing field for authorisation of trustees – the trustee corporations established by their own Acts of Parliament have trustee status conferred upon them automatically. There is no assessment of their capacity to carry out the role.

170. New Zealand is a signatory to the Financial Action Task Force ("FATF") 40 Recommendations on combating money laundering and the financing of terrorism. Trustees are subject to these recommendations. We need to consider what "fit and proper" criteria we require for trustees.

171. There is no adequate mechanism for discipline or taking remedial actions against the statutorily-authorised trustee corporations in situations of inadequate performance of their role (for example, de-authorisation, or imposition of conditions) other than the capacity for investors to litigate against them. This is because of their statutory authorisation – removal from their general ability to act would require revocation of the statute.

172. There are also issues around accountability of Securities Commission-approved trustees and statutory supervisors – again, the main threat they face is investor litigation, although in certain circumstances unit trustees may be removed by the manager or the Minister. The Securities Commission may also revoke an approval, but this does not affect appointments before the date of revocation (or powers, duties, or obligations by virtue of such an appointment).[115] In effect, a revocation

[114] International Monetary Fund: *New Zealand: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes*, May 5, 2004; *New Zealand: Financial Sector Assessment Program – Detailed Assessments of Observance of Standards and Codes*, December 22, 2004.
[115] Securities Act 1978, s 48(4).

merely prevents the trustee taking on more business. These avenues of accountability may not be sufficient – indeed, this concern was specifically raised in the FSAP Assessment.[116]

173. For CIS, protections are not consistent across similar products. The legislation for each type of CIS prescribes varied powers, duties, and obligations for trustees and statutory supervisors, with differing levels of investor protection according to the category of product.

6.3.2.2 Superannuation Schemes

174. In a superannuation scheme, investors may not be aware that in law their primary relationship is with the trustee rather than the provider of a scheme or their employer. This may mean that consumers are not aware of whom to approach in the first instance if they have any problems with the scheme. It may also mean that when assessing whether to enter into the scheme they are relying more on the reputation of the provider or employer than on the reputation of the trustee. This does not meet the objective that regulatory processes and requirements should be as understandable and accessible as practical.

175. The risk of unfair and fraudulent conduct also arises with superannuation schemes because of the nature of the roles/incentives of the parties, the relationships between the various parties and a lack of monitoring or a deterrent factor. These risks differ depending on the nature of the superannuation scheme.

a. The trustee in a retail superannuation scheme is ultimately responsible for the investment management, the administration and making the offer of the scheme products, as well as for monitoring the scheme in terms of ensuring that it complies with the terms of the trust deed and the terms of the offer. At the same time, the trustee can be appointed by the provider (and may be a subsidiary owned by the provider). While reputational effects impact on how the trustee operates these are potentially limited because of the complexity of the product, involvement of numerous parties in providing the product and a lack of investor understanding about the product. The trustee must comply with their obligations to the investor, but overall may be subject to competing incentives. There is also the issue of potential conflicts of interest where the trustee appoints a manager (administration or investment) who, along with the trustee, may be a subsidiary company of the provider. This raises questions of the trustee's ability and position to sack one or other of the managers for non-performance.

b. In the case of stand-alone employer schemes, the interests of the trustee are likely to be more aligned with the interests of the employer. The employer, along with the employee, has an interest in helping ensure that the scheme operates effectively in the interests of the employee. The reputational incentives on the employer in this case are likely to be stronger than those on retail providers, because of the closer relationship and potential for monitoring between the employer and investor.

[116] *New Zealand: Financial Sector Assessment Program – Detailed Assessments of Observance of Standards and Codes*, December 22, 2004, 26.

c. The roles and incentives within employer master trust arrangements appear to be more aligned with retail schemes than with stand-alone employer schemes. The employer's interest in the scheme is maintained through contractual relationships with the trustee (by way of a participating agreement) and investor. However, the employer in this case does not have the same level of direct control over the ongoing monitoring or running of the scheme as they do in an employer master trust scheme. An employer may be able to require the provider or trustee to report to the employer on its participating scheme, and could ultimately withdraw from the scheme, although this would require the employee's interest in the scheme to be allowed to be cashed-up or transferred to another scheme. Because there will be a number of participating employers on any particular master trust, it would also be difficult for a single employer to exercise significant control over the trustee unless their business constituted a significant part of the master trust's business. Similarly, the employer and employee will not have the same representation on the board of trustees as they may have in a stand-alone employer scheme.

d. There are also additional potential risks of fraudulent or unfair conduct that arise for investors in defined benefit schemes. Generally, the incentives of the employer and the investor are aligned, in the same way as they are with other stand-alone employer schemes. However, because the employer is required to provide a benefit for the employee in the future, they have an additional incentive to minimise the extent of that liability. This could increase the potential for unfairness or fraud to occur. In addition, the trustee for defined benefit schemes will have a duty to monitor the employer to ensure that benefits will be able to be paid. This creates a potential for conflicts of interest if there is limited independence between the trustee and the employer.

176. The regulation of superannuation schemes does not currently comply with FATF and IOSCO principles.

Questions for Submission

11. Are there any other benefits of the current regimes that need to be considered in the development of a new regime?

12. Do you agree with the problems identified with the status quo? What do you consider to be the size of these problems?

13. Are there any other costs of the current regimes that need to be considered in the development of a new regime?

6.4 GENERAL DIRECTION FOR REFORM: TRUSTEE SUPERVISORY MODEL

177. In designing a new model for the supervision of CIS and debt security issues, the objective is to retain the benefits of the current trustee model, while addressing the problems identified with that arrangement. Please note that the discussion document *Non-Bank Deposit-Takers* is proposing to create two tiers of non-bank deposit-takers

("NBDTs") that issue debt securities to the public: Authorised NBDTs, Tier 1, which would be supervised by a single supervisory authority; and Tier 2 NBDTs, which would continue to be supervised by trustees.

178. The recently announced Review of Regulatory Frameworks seeks to ensure that the nature and level of regulatory intervention meets the tests of proportionality, clarity, consistency, transparency, effectiveness and equity. It also emphasises the possibility of the use of self- and co-regulation, where appropriate, instead of the more traditional direct government intervention.

179. Several possible options for reform were identified and dismissed. These are outlined briefly below.

    a. *Maintain the status quo.* This option would not address the problems identified with the current regime.

    b. *Enhanced status quo*. This option (which essentially entails placing increased powers in the hands of the trustee companies and statutory supervisors) would address some of the issues relating to the trustee corporations' lack of "teeth". However, it would still fail to address the problems that were identified with the current regime, for example the lack of appropriate checks and balances, and transparency of the financial sector. It would also not address issues for superannuation schemes, which are currently subject to a different supervisory structure.

    c. *Direct supervision by regulator*. While this option would overcome the problems that have been identified, it would not retain the valuable benefits of the current regime, such as the relationship of trust and confidence that has been established between the trustee corporations and the people they supervise. Direct supervision by the regulator would likely lose the flexibility that is a key benefit of the trustee model. A move to a direct supervision model may also impose significant transition costs. For superannuation schemes, transitional issues would not be as significant because schemes are already subject to some direct supervision by the regulator. However, to meet the objectives identified for the review, it is likely that the level of direct supervision by the regulator would need to be more extensive. With this type of close supervision, it is particularly important that flexibility is maintained, so that supervision can reflect the level of risk associated with a particular scheme. This both minimises costs for the scheme and enables them to operate efficiently, while maintaining an acceptable level of protection for consumers. This flexibility is unlikely to be achieved through direct supervision by the regulator.

180. The other option considered was the trustee supervisory model outlined below, and an in-principle decision has been made to adopt this regulatory framework for the supervision of debt security issues and CIS and superannuation.[117] Trustees will be retained; however, they will be subject to monitoring and oversight by the Securities Commission. We believe that such a model will achieve the objective of

[117] Review of Non-Bank Financial Products and Providers, *Stage One Report to Minister*, 29 July 2005.

retaining the benefits of, and addressing the problems with, the current trustee regime.

181. Flexibility of regulation is one of the key issues addressed in the Review of Regulatory Frameworks, which emphasises that a differentiated approach to regulation may offer greater benefits than traditional "one size fits all" regulation when there are differences across the regulated entities such as different levels of risk or consequences of failure. The trustee supervisory model means that issuers will still have access to a wider range of supervision tailored to the characteristics and risks of their particular issue, rather than having to fit within a more limited range of options as would likely be the case were the Securities Commission to directly monitor issuers. There will potentially be a range of more flexible avenues to address any issues, and the intensity of supervision may vary commensurate with the level of risk faced. In addition, the actual trustees will face regulation tailored to the work that they actually carry out, rather than to a set of requirements that may not fit at all with their business.

6.4.1 Objective of the Trustee Supervisory Model

182. The suggested objective of the trustee supervisory model is:

a. To give investors confidence that their investment is subject to supervision that effectively protects their interests, and for this purpose:

i. Trustees have the capacity, industry knowledge, and experience to undertake effective and risk-based frontline monitoring of issuers; and

ii. The Securities Commission has appropriate supervision and enforcement functions and powers to provide effective accountability for the effective discharge by trustees of the legislative objectives.

6.4.2 Principles of the Trustee Supervisory Model

183. Ideally, the relationship between the Securities Commission and the trustees will be based on trust and confidence. However, in any supervisory relationship there will be the capacity for tensions between the parties to arise, particularly where interests and roles overlap, or are perceived to do so. These tensions should best be addressed by making very clear in the legislation what each party's role is, ensuring there are appropriate thresholds for the use of any powers, and clearly defining the objectives under which they are working. This will both prevent tensions from arising and provide a clear path for their resolution when they inevitably occur. This is discussed further below in section 6.5.2, as well as in Part D of this discussion document (regarding debt securities), and in the discussion document *Collective Investment Schemes*.

Questions for Submission

14. Can you see any other tensions that may arise?

15. What do you see as the objectives of the trustee supervisory relationship? Should these be included in legislation?

6.5 THE TRUSTEE SUPERVISORY MODEL

6.5.1 General

6.5.1.1 Removal of Trustee Corporations' Automatic Approval

184. In order to create a level playing field for entry, trustee corporations will no longer have an automatic right to act as trustees for debt and CIS issues. Instead, anyone wishing to be approved as a trustee will have to satisfy entry requirements, as discussed below. We will consider any appropriate transitional arrangements.

6.5.1.2 Nomenclature

185. There are difficulties with the current nomenclature – with trustee corporations; approved trustees; and statutory supervisors (a name that has caused some confusion with "statutory managers").

186. The withdrawal of the statutory automatic approval of trustee corporations will reduce some of this confusion, as there will now only be one "type" of trustee for the purposes of the supervisory regime (though of course trustee corporations may still call themselves such, and are free to distinguish themselves on this basis).

187. Under the proposed regulatory framework for CIS, "statutory supervisors" will also become CIS trustees. However, where a requirement is not appropriate for a particular type of security, the Securities Commission will (at the approval stage, as discussed below) have the power to exempt a CIS trustee from that requirement (such as, for example, the duty to hold scheme property on trust). A CIS trustee will however still be liable for its acts and omissions in the performance of its functions and duties and the exercise of its powers as if it were a trustee. For more details, see the discussion under the heading "Proposed Option For Regulating Participatory Securities" in the *Collective Investment Schemes* discussion document.

188. For the purposes of this document, the term "trustee" encompasses all kinds of trustee. The roles these different supervisory bodies will play may differ as regards individual issuers or managers, and this will be discussed in the relevant discussion documents. However, the flexibility of the approval regime outlined below means it will generally be applicable to the approval of all corporate trustees.

6.5.1.3 Independence of Trustee

189. The proposed regime will require the trustee to be independent of the issuer. This will be assessed as part of the entry and ongoing requirements for trustees. Independence enables a clear separation of roles and functions, i.e. the trustee performs a supervision role and is not connected to the issuer offering the securities.

190. The requirement for independence is important for meeting the objectives identified for the trustee supervisory model. In particular, it is important that supervisors should be free from conflicts of interest with the people or entities they regulate. In practice, independence effectively enables the trustee to negotiate terms and conditions of the trust deed that are in the best interests of the investor. It also effectively avoids the

conflict of incentives that would otherwise arise when a trustee is required to act in the interests of investors but is also financially or otherwise linked to the issuer.

191. For superannuation schemes, the requirement for a trustee to be independent of the issuer is new. The current lack of independence reflects the regulatory arrangements for superannuation schemes. Superannuation schemes are trusts where the trustee (who is also the issuer) has trustee obligations to act in the best interests of the investor. These trusts are subject to the oversight of a regulator (the Government Actuary). However, the role of the trustee (as the primary supervisor), issuer and regulator within the trustee supervisory model require that an independent trustee be appointed for these schemes, with a role and functions separate from those of the trustee who is the issuer of the scheme.

6.5.2 Role of the Regulator

192. The role of the regulator is to oversee the trustees' performance. The regulator's role will be crafted to achieve the objectives of the regime, and its exercise of power will be constrained to the principles of the supervisory model (as outlined in legislation). The regulator's key role is to ensure that trustees have the capacity and capability to perform their role; that they are in fact carrying out their role satisfactorily; and to address any circumstances where a trustee's performance is not adequate. It is stressed again that the frontline monitoring of issuers is the role of the trustee, not the regulator.

193. Under the proposed regime, there are essentially three components to the regulator's role:

a. Approval of trustees by assessing applicants against entry requirements;

b. Ongoing monitoring of a trustee's fulfilment of the entry requirements; and

c. Dealing with a breach of the trustee's supervisory obligations.

These components are discussed in more detail below.

194. The regulator will be the Securities Commission, as it already has a key role in monitoring the market and will ensure appropriate checks and balances for trustees. Its current involvement in the approval of trustees means that the increased supervision and monitoring requirements will essentially be an extension of its existing role. Further, this is consistent with the Securities Commission's role as a market conduct regulator.

6.5.2.1 Approvals

195. Under the trustee supervisory model, trustees will be approved by the Securities Commission.

196. The Securities Commission currently has a policy in place for the approval of trustees and statutory supervisors. The proposed regulatory regime reflects the Commission's existing policy to a large extent.

197. The Securities Commission will be able to approve trustees for a specific issue, for a general class of securities (i.e. debt or CIS), or on an all-securities basis.

Question for Submission

16. Is it appropriate that the Securities Commission may approve trustees on an all-securities basis? Would there be any benefit in requiring a trustee to hold separate approvals for different classes of issue (i.e. debt or CIS)? If so, would this be outweighed by the cost of having to make two separate applications?

Entry Requirements

198. Entry criteria will need to be flexible so they can be tailored to suit the trustees of various single issues or classes of issue. There are a wide variety of issues that are going to be supervised under this model, so a variety of trustees with different characteristics will be suitable as supervisors in different cases. The Securities Commission will need the ability to consider a particular issue, and to consider the necessary qualities required of the trustee in relation to that issue. For example, the required experience for a CIS trustee may differ from that required for a debt trustee. A trustee wanting approval to supervise all issues may have different experience and infrastructure requirements from an individual debt issue.

199. The Securities Commission currently considers four main elements in its approval of trustees. These are: competence and financial capacity; character; independence; and accountability. These four elements provide a solid basis for assessment of individuals or entities to perform the role and it is proposed they are retained and placed in legislation with some additional, more specific, guidance.

200. A question exists around exactly what should be placed in primary legislation, what (if any) should be in regulation, and what (if any) should be left purely to the Securities Commission's discretion. In order to fulfil FATF obligations, a certain level of detail around "fit and proper" requirements will need to be in legislation. There needs to be a balance between certainty and flexibility – to have all requirements in primary legislation would provide the greatest level of certainty, but would be inflexible and harder to change. To have the Securities Commission exercising total discretion in its approvals would be flexible and adaptable, but would lack transparency for issuers. It may also mean that the bar would be set too high, as the Commission may be too risk-averse, at the expense of a competitive market.

201. The Securities Commission's *Policy for Approval of Trustees and Statutory Supervisors* goes into some detail about its requirements for approval. These have been outlined where appropriate alongside the proposed new criteria, as we believe most are beneficial and propose that they should be retained.[118] We seek your feedback on the appropriateness of the Securities Commission's current requirements and the desirability of retaining them.

202. More specific criteria being considered for inclusion, wherever they may be placed, are outlined below.

a. *Appropriate Experience.* The trustee must have the appropriate skills, qualifications, and experience to supervise the particular issue or class of

[118] Securities Commission, *Commission Policy for Approval of Trustees and Statutory Supervisors*, available at www.sec-com.govt.nz.

issue. This requirement should be assessed at both an individual and board level. Currently, the Securities Commission requires the applicant to prepare and present a report to it, where it expects to see the curriculum vitae of the applicant (or each of its directors and any key management staff) setting out the relevant skills, qualifications and experience of those people.[119] For FATF purposes, there must be some "negative assurance" that directors and senior management have not committed breaches of the law and have not been involved in a failed offer to the public. These requirements also apply to a trustee's owners or other persons with beneficial control. Where the applicant is a company, it should also supply core information about itself, including details of incorporation, directors, shareholders, and financial statements if available.[120] Where the board of trustees is for an employer stand-alone superannuation scheme, there may be particular issues about whether all individuals on the board require experience. The fit and proper entry requirements for the board of trustees of an employer stand-alone superannuation scheme are discussed further in section 4.3.3.1 of the *Collective Investment Schemes* discussion document.

b. *Capital adequacy*. Minimum capital/financial strength to carry out its role as trustee for that particular issue or class of issue. It is recognised that trustees need a certain level of capital/financial strength in order to manage their charges through crises. They may need to incur costs, and in some cases this expenditure will not be recoverable. Therefore, it is important that trustees are able to shoulder this burden and work in the best interests of investors without financial constraints playing a significant role in decision-making.

c. *Monitoring Systems and Procedures*. Currently an applicant is expected to provide details of the procedures it will follow in carrying out its functions, such as reporting and communication channels with the issuer and security holders, the frequency and methodology with which it will carry out its risk assessments, and the level of supervision that will apply to particular issues or classes of issue. Under the supervisory model, the Securities Commission will make a similar assessment of the systems and procedures that a trustee has in place in order to supervise issues. The Commission will keep in mind the particular risks of the products supervised and give its approval only when satisfied that a trustee's procedures are adequate for the risk posed by the issue. For example, the Securities Commission will examine the frequency with which a trustee will require reports from the issuer on a particular issue; if the Securities Commission does not believe that the trustee is requiring reports frequently enough for the risk level of that product, then they will not approve the trustee (or may impose a more frequent reporting requirement as a condition on their approval – see below).

[119] Securities Commission, *Commission Policy for Approval of Trustees and Statutory Supervisors*, 2. Available at www.sec-com.govt.nz.
[120] Securities Commission, *Commission Policy for Approval of Trustees and Statutory Supervisors*, 2. Available at www.sec-com.govt.nz.

d. *Infrastructure.* The Securities Commission should be able to assess structural elements of an applicant, including having adequate staff (both in terms of numbers and experience/skill); and sufficient other resources. Currently, an applicant company is expected to provide a brief description about its level of resources and its staff, including a profile of key management staff responsible for carrying out the duties of the trustee on a day-to-day basis, and whether the applicant needs to delegate any of its duties to an external body, and if so, the reasons for that delegation and the procedures to ensure the proper performance of those duties.

e. *Appropriate governance standards.* The trustee will need to have appropriate governance standards in place. For example, procedures for dealing for conflicts of interest, and requirements that the trustee be independent from the issuer. Again, there may be particular issues about how the Securities Commission will apply this test to existing stand-alone employer superannuation schemes. This is discussed further in section 4.3.3.1 of the *Collective Investment Schemes* discussion document. Currently, the Securities Commission requires that the applicant (and the applicant's sponsoring firm) provide a written undertaking that neither they nor any of their employees, shareholders, or officers will at any time hold any office or appointment or have any involvement, relationship, or interest (including involvement as an auditor) in respect of any issuer or any securities offered by the issuer for which the applicant acts as a trustee.[121] The Securities Commission also requires that, where an applicant is a company, it will be required (as a condition of approval) to not engage in any business other than as a trustee or as approved by the Securities Commission.[122]

f. *Professional indemnity insurance.* The Securities Commission currently requires applicants to demonstrate that they have adequate professional indemnity insurance. In order to satisfy the requirement, the Securities Commission insists that applicants provide: a statement from the applicant's insurer in relation to the amount and currency of the applicant's professional indemnity insurance and a confirmation that it is currently in force; a statement that, on the basis of independent expert advice, their professional indemnity insurance is adequate; and an undertaking that adequate professional indemnity insurance cover will be maintained.

g. *Satisfaction of character requirements.* An individual or entity applying to be a trustee will need to satisfy certain base-level character requirements for the purpose of Financial Action Task Force requirements, and Anti Money-Laundering standards. Currently the Securities Commission requires that the applicant (and, if the applicant is a company, any of its directors) and any senior staff must not: have been convicted of a serious offence, in particular a crime involving dishonesty, including theft and fraud; be prevented from acting as a director under the Companies Act; have been bankrupt at any time; or have been disqualified, banned, or

[121] Securities Commission, *Commission Policy for Approval of Trustees and Statutory Supervisors*, 2. Available at www.sec-com.govt.nz.
[122] Securities Commission, *Commission Policy for Approval of Trustees and Statutory Supervisors*, 2. Available at www.sec-com.govt.nz.

suspended for more than six months from holding a licence or authorisation to practice under the law or membership rules of any professional association at any time.[123]

h. *Corporate form.* It has been suggested that all trustees should have corporate form. Corporate form is almost necessary to fulfil the obligations as outlined above, so perhaps having it as an additional requirement is unnecessary. Even if individuals can fulfil all the other requirements without corporate form, it has been suggested there may be a problem with non-corporate-form trustees in terms of legal and accounting separation of assets from, for example, relationship property. Insisting upon corporate form would ensure the isolation necessary to examine the capacity and infrastructure of the applicant clearly. However, this would cause problems with trustees of stand-alone employer superannuation schemes, who are likely to remain more or less in their current form – i.e. individuals, making up boards. The application of fit and proper requirements to these schemes is addressed in section 4.3.3.1 of the *Collective Investment Schemes* discussion document.

203. The requirements discussed above will not limit the scope of the Securities Commission's approval process, and it will be able to place terms and conditions on an appointment as it sees fit, so long as such conditions are in compliance with the objectives of the regime.

204. There is currently a power in section 70A (2) of the Securities Act for the Governor-General to make regulations prescribing fees and charges to be paid for the purposes of the Act. This will appropriately be used to establish fees in connection with the application and approval procedure. Any fees imposed would be consulted on.

Questions for Submission

17. Do you agree with the proposed entry requirements? If no, why? Are any of the proposed entry requirements too lenient or too onerous?

18. Are there any other requirements that trustees should be required to demonstrate to the Securities Commission before they are approved?

    a. For example, section 3 of the Superannuation Schemes Act requires that at least one trustee be a New Zealand resident before the trustees of the superannuation scheme can apply to the Government Actuary for registration of the scheme. Should such a residency requirement be extended to all trustees? Should a trustee company be required to have a physical presence or place of business in New Zealand before it receives Securities Commission approval?

19. Do you consider any of the proposed entry requirements are inappropriate? If they are only inappropriate for a particular kind of trustee, could this be addressed through an exemption?

[123] Securities Commission, *Commission Policy for Approval of Trustees and Statutory Supervisors*, 3. Available at www.sec-com.govt.nz.

20. Should the proposed entry requirements be placed in primary legislation, or in regulation?

Appeals

205. It is important that trustees have some protection and avenues for redress in the application process.

206. If the Securities Commission declines an application to be a trustee, it will be obliged to give the applicant its reasons for doing so. Of course, the Securities Commission's decisions will always be subject to judicial review.

207. We need to consider whether this is sufficient protection. We could include additional protection by an appeal process. There are several options, as outlined below.

    a. Adopt a process akin to that currently applying to superannuation schemes. Superannuation schemes are currently registered by the Government Actuary. If an application is declined, they first bring their case back to the Government Actuary for reconsideration, who will provide an opportunity for the applicant to be heard. If this process fails, there remains in place a right of appeal to the High Court.

    b. Retain the current regime of appealing directly to the High Court, as currently provided in section 69P of the Securities Act, which states that every decision of the Securities Commission is final and binding on the parties to the proceedings, however, if a party to proceedings before the Commission considers that the decision of the Commission is wrong in law, the party may appeal to the High Court on a question of law only.[124] Having appeals only on points of law may be appropriate in light of the Securities Commission's establishment as an expert body.

    c. However, as the decision to decline an application may have serious implications for the applicant's livelihood, there is a strong argument that there should be full appeal rights to the court on merits as well as law. Other regimes, such as the approval of Approved Professional Bodies under the co-regulatory model for financial intermediaries and the relationship between the Securities Commission and NZX, have the Minister approving on the recommendation of the Commission, which could potentially provide a balance between the powers of the regulator and the entity being regulated. However, due to the potential volume of trustee applications this would probably not be appropriate.

Questions for Submission

21. What sort of appeal process do you think is appropriate for the application process?

[124] Note that this provision does not apply to decisions that may be appealed under s 68G of the Securities Act, which are essentially those related to the Commission's exercise of powers of inspection.

22. Would it be desirable to have the Minister making approvals on the recommendation of the Securities Commission? Would the benefits (e.g. independence, balance) outweigh the costs (e.g. length of time for approval to be given)?

6.5.2.2 Ongoing Monitoring by the Securities Commission

208. The Securities Commission's second key role is the ongoing monitoring of a trustee once it has been approved.

209. The Securities Commission's monitoring of trustees is the key area where any tensions are likely to arise. The trustee supervisory model has to allow room for both parties to effectively undertake their roles.

210. On one hand, the Securities Commission has to have the ability to effectively monitor and enforce a trustee's compliance with the supervisory regime (i.e. whether the trustee is fulfilling its obligations under its entry requirements). Some breaches will be clear and uncomplicated – for example, whether or not a trustee has its required level of professional indemnity insurance, or whether or not a trustee is delivering its periodic reports on time. However, some breaches will not be so immediately clear, and this is where any tensions are most likely to arise. In particular, the Securities Commission will need to ensure that any risk-assessment, reporting, or intervention frameworks that a trustee develops for monitoring an issuer or issuers (for the purposes of meeting its entry requirements) are actually being carried out.

211. On the other hand, the trustee has to be able to exercise discretion, judgement on how to deal with certain issuers, and what mechanisms to employ in particular circumstances, without fear of being second-guessed. The possibility of the Securities Commission's questioning of trustees' handling of individual situations and how they carry out supervision in particular circumstances would undermine many of the benefits of having trustees as frontline supervisors (as discussed above).

212. Finding a balance between the two roles is crucially important to the success of the trustee supervisory model.

213. The Securities Commission will also have the role of enforcing the law other than the supervisory model requirements, such as breaches of trustee duties (i.e. not holding the money on trust, or failure to comply with the trust deed). This role, along with thresholds for when the Securities Commission may act, is discussed in Part D of this discussion document (at paragraphs 271 to 273) in relation to debt securities and in the discussion document *Collective Investment Schemes* in relation to CIS and superannuation.

214. In the event of a failure where investors have suffered loss, and there is evidence to suggest that the trustee breached its duties, the Securities Commission may be able to seek compensation for investors.

How the Securities Commission will get Information

215. To ensure the Securities Commission has sufficient information to monitor the trustee, the trustee will be required to report to the Commission.

216. There will be two types of reports to the Securities Commission:

a. Periodic reporting; and

b. Event-based reporting.

Periodic Reports

217. Periodic Reports: These reports will be provided to the Securities Commission on a regular basis. While the default frequency will be annual, the Securities Commission will be able to specify a more frequent reporting regime upon approval of a particular trustee. The periodic reports will be designed to reveal:

a. *Ongoing satisfaction of entry requirements*. The trustee will need to demonstrate continued fulfilment of its entry criteria. For example, this will encompass information on the trustee's financial strength, information on personnel and continued satisfaction of character requirements for FATF purposes; and

b. *Ongoing fulfilment of trustee responsibilities*. The trustee will need to show that it is both maintaining and effectively using the systems outlined at its approval; and

c. *Statistical data, to contribute to a high-level overview of the financial sector*. The information will be gathered in order to monitor the sector and evaluate the effects of law reform, as well as giving information on how the trustee is fulfilling their role. The ability to gather such statistical data is an existing mechanism of the Government Actuary, who gathers such information for superannuation trustees. We would like to expand that role to encompass CIS and debt securities. The information gathered may, however, be slightly different. For example, the Securities Commission might require some sort of data on how many issuers a trustee is supervising, how many have defaulted in a particular year, or how many complaints they have received about its issuers.

218. Regulations could set out what would be required in the periodic reports to the Securities Commission (though there would probably need to be scope for the Securities Commission to add to such a list for a particular trustee) and what statistical data would be gathered. It is recognised that the gathering of statistical data is not without cost to the trustee, so any requirement needs to be put in place only after careful consideration of, for example, the necessity of the information, and whether the trustee is the best source of the information.

219. It is likely there will be a distinction between data that will be made public and data (particularly commercial data) given in confidence that will be kept private. The data that is made public will generally be amalgamated with that of other trustees to provide an overview of the whole sector. It has been suggested there be a degree of statutory protection provided to information passed between a trustee and the Securities Commission (including protection from the Official Information Act 1982). A similar provision is contained in Section 23 of the Corporations (Investigation and Management) Act 1989, which restricts the disclosure of certain information obtained by the Registrar of Companies and exempts such information from the application of the Official Information Act 1982. The Reserve Bank Act 1989 contains similar

provisions with regard to information, data, and forecasts supplied to, disclosed to, or obtained by the Reserve Bank for the purposes of registration or prudential supervision of Banks.[125] Again, this Act makes it clear that the Official Information Act 1982 does not apply to such information.[126]

Event-based Reporting

220. There will be a requirement that the trustee self-report to the Securities Commission upon the occurrence of any breach of its particular approval requirements, and how the trustee is addressing the breach.

221. Any material changes that fall short of a breach of an entry requirement will also need to be reported to the Securities Commission.

Complaints

222. The Securities Commission may also receive complaints about a trustee from an investor or issuer/manager.

Other ways the Securities Commission can get Information

223. Currently the Securities Commission has the power to inspect documents (including on-site inspection)[127] if that inspection is for the purposes of the Securities Act, the Securities Markets Act 1988, or various other Acts including the Trustee Companies Act 1967 and the Unit Trusts Act 1960.[128] The Securities Commission may only do so if it considers, along with any other relevant matters, any matters relating to the necessity or expediency of carrying out an inspection.[129] Essentially, the Securities Commission already has an ad-hoc power of inspection, although such an inspection may be challenged under section 68G of the Securities Act.

224. We want the Securities Commission to be able to collect information as necessary for the purposes of carrying out Securities Commission functions under the supervisory model. However, as discussed above, this may need to be balanced somehow with ensuring that the trustee has the space to take decisions as the frontline regulator of issuers under their supervision. We suggest that the current threshold (i.e. "for the purposes of the Act") is appropriate for the trustee supervisory model and should be retained. We seek your feedback on this matter.

Questions for Submission

23. Do you agree with the proposed reporting requirements? If no, why?

24. Are any of the requirements likely to be too onerous?

25. What sort of data do you think should be kept confidential, and what should be able to be made public?

[125] Reserve Bank Act 1989, s 105.
[126] Reserve Bank Act 1989, s 105(8).
[127] Securities Act 1978, s 67.
[128] Securities Act 1978, s 68.
[129] Securities Act 1978, s 68.

26. Should there be some statutory protection given to the information passed between a trustee and the Securities Commission (like that given in Section 23 of the Corporations (Investigation and Management) Act 1989 or the Reserve Bank Act 1989)? If so, to what extent?

27. Are the Securities Commission's powers of inspection appropriate in relation to trustees? Is there any reason that the Securities Commission should not have these powers in relation to trustees?

6.5.2.3 Breach of the Trustee Supervisory Relationship

225. A breach of the obligations under the supervisory model would exist where the trustee is no longer satisfying the entry requirements with which they were approved – for example, if a trustee could no longer meet the capital adequacy standards specified at its approval. A breach would also exist where a trustee is failing to carry out its obligations under those requirements – for example, is not carrying out the required monitoring systems and processes. Similarly, a trustee's failure to report to the Securities Commission under its reporting obligations would be a breach – for example, if the level of experience amongst a trustee's staff changed significantly, and this was not reported, there would be a breach of the event-based reporting obligation. If a trustee was late with a periodic report, this would also be a breach.

226. Of course, there will be varying degrees of the severity of breaches – being a week late with an annual periodic report should not incur the same consequence as, in an extreme example, failure of a trustee to report to the Securities Commission that they were on the brink of insolvency. There needs, then, to be a graduated system of mechanisms and penalties for dealing with problems. The powers that have been suggested in the case of a breach are:

a. The power to request further information from a trustee.

b. Powers of direction – if the Securities Commission became aware of a breach, it could direct the trustee to fix that breach in a certain time frame. Such a direction may be in greater or lesser degrees of specificity – i.e. the Securities Commission may, if it sees fit, direct the trustee as to *how* to fix the breach.

c. Suspension from taking on new appointments.

d. Power to require that the directors/management of the trustee be added to, removed, or replaced.

e. In a severe situation, the ability to remove a trustee from a specific appointment, or in a very severe situation, from a general appointment.

227. We want to make sure the incentives on the parties will lead to the smooth operation of the model, as outlined above.

228. Trustees should receive indemnity from liability when acting under the direction of the Securities Commission.

229. Removing or replacing the board or management of a trustee, or removing a trustee from specific or general appointment, may have very severe consequences for that trustee (and the livelihood of those involved). It is therefore suggested that in this case the Securities Commission must seek an order from the court.

230. In the event of removal of the board, or the removal of a trustee from specific or general appointment, there will need to be a mechanism for the appointment of a substitute.

Questions for Submission

28. Do you agree with the suggested Securities Commission powers and actions in case of a breach? Are any of them inappropriate?

29. Should the Securities Commission have to go to court for orders to do certain things? If so, which ones?

30. Will there ever be a situation where the market will not step in and take on an appointment where the trustee has been removed? If so, what should happen?

6.6 ROLE OF TRUSTEES UNDER THE TRUSTEE SUPERVISORY MODEL

231. The trustees' role will be twofold: to monitor issuers, and to comply with the obligations placed on them by the Securities Commission, legislation, and common law.

232. Other parts of the RFPP are addressing the sufficiency and adequacy of trustee powers and obligations – see part D of this document, and the discussion document *Collective Investment Schemes.*

233. The key obligations on trustees have been discussed above. Essentially, they are continued compliance with their approval criteria; periodic reporting to the Securities Commission as per their approval; and event-based reporting.

6.7 ROLE OF OTHER PARTIES

6.7.1 Registrar of Companies

234. The current duties of the Registrar of Companies are to register trust deeds, deeds of participation, and prospectuses; and to administer the Corporations (Investigation and Management) Act 1989. It is proposed that the current role is retained.

235. There will need to be a clear division between the role of the Securities Commission and the role of the Registrar. The Securities Commission will be responsible for the supervisory relationship and supervision of trustees.

236. There may be a question of overlap in how the Securities Commission's powers in relation to trustee supervision should fit with the trustee's obligations under the Corporations (Investigation and Management) Act 1989. In the case of a breach that has been uncovered it could, upon discovery, need to be reported to both the

Securities Commission (as a failing by the trustee) and to the Registrar. The Registrar can declare the issuer to be at risk, but can only give directions about assets with the Securities Commission's prior consent. We seek your input as to whether any overlap might exist, and whether the effects of this are significant.

237. When an issuer is in difficulty, some trustees will inform the Securities Commission of the situation and how they are addressing it, prior to taking the steps under section 11 of the Corporations (Investigation and Management) Act 1989 and giving notice to the Registrar of its concerns. The Securities Commission has noted that it would find this useful in its role as supervisor of trustees, as it would demonstrate how a trustee is complying with their duties. As an added benefit, it would be useful in the context of the Securities Commission's role in relation to the offer documents of the issuer. The Securities Commission would like to see an obligation for trustees to be in dialogue with it at this stage. We seek your feedback on this proposal.

238. It has also been suggested that the section 11 notice be given to both the Registrar and the Securities Commission, for the purposes of the Securities Commission's role as the general overseer of all trustees.

239. It is not in any way intended to undermine the Registrar's functions under the Corporations (Investigation and Management) Act. If such provisions were to be put in place, they would only be for the purposes of the Securities Commission's monitoring role. We seek your feedback as to the practicality of these suggestions.

6.7.2 Ministry of Justice

240. The Ministry of Justice currently administers the Trustee Companies Act. The Act deals with all the other things that trustees do, not just their role as Corporate Trustees. It is not proposed to change the current role of the Ministry of Justice.

Questions for Submission

31. Do you see a potential overlap between the Securities Commission and the Registrar of Companies? If so, what? What problems might arise? Are they significant? How might they be addressed

32. Do you think there should be an obligation on trustees to consult with the Securities Commission at an earlier stage than giving notice under s 11? Is this practical? What sort of threshold would be required to trigger the obligation to inform the Securities Commission?

33. Do you think that a trustee should also be required to give a section 11 notice to the Securities Commission (for the purposes of the Securities Commission's role as the general overseer of trustees)?

7. PART D: TRUSTEE SUPERVISION OF DEBT ISSUERS

7.1 INTRODUCTION

241. This part of the discussion document addresses whether trustee supervision provides appropriate and consistent protections for debt investors, without reducing the flexibility of trustees to use a risk-based approach to supervision of debt issuers.

242. When an issuer makes an offer of debt securities, it is making a promise to the investor that it will repay that debt. Before an issuer can make an offer of debt securities to the public investor, the issuer must appoint a trustee and register a trust deed with the Registrar of Companies.[130] The purpose of imposing trustee supervision on debt issuers is to provide investors with confidence that there is an independent party to assess whether the issuer is meeting its obligations under the trust deed and offer document and to take appropriate action where either the trust deed or offer document has been or is likely to be breached.

243. There are some legislative provisions that relate to trustee supervision of debt issuers. For example, the duty of the trustee to report to the Registrar of Companies under the Corporations (Investigations and Management) Act 1989 (CIMA). However, the relationship between the trustee and issuer is largely governed by the trust deed. The trust deed is a contract between the issuer and trustee and sets out the rules of the issue. These rules are designed to enable the issuer to meet its promise to the investor and define how the trustee and issuer will deal with each other. While there are certain clauses deemed into every trust deed, for example the trustee's duties and rights to information, and how an issuer can be compelled to convene a meeting of securities holders, the majority of the trust deed covenants are negotiated between the trustee and issuer. A fuller description of the current regulation relating to trustee supervision of debt issuers (including duties, functions and powers) is set out in part B of this document (at 25 to 30).

244. Whether the duties, functions and powers of the debt trustee should be prescribed in legislation, regulation or implied into debt trust deeds, will be considered during the legislation drafting process.

7.2 PROBLEMS IDENTIFIED

245. We are concerned that current regulation of trustee supervision of debt issuers does not achieve an appropriate balance between the regulatory objectives of transparency and flexibility. We consider that trustee supervision of debt issuers suffers from a lack of transparency for two reasons. First, there is no regulatory oversight and monitoring of trustees. There are limited checks and balances to ensure that trustees are carrying out their role effectively, and that they are subject to appropriate accountabilities.

246. We intend to address this concern by introducing a trustee supervisory model for the supervision of debt issuers. Under this trustee supervisory model, trustees will continue as the frontline supervisors of debt issuers and will be subject to oversight

[130] Securities Act 1978, s 33(2).

by the Securities Commission of the performance of their trustee functions. Trustees will need to satisfy various entry requirements, and through reporting obligations, will need to demonstrate to the Securities Commission their continued satisfaction of these entry requirements. There will also be increased accountability mechanisms on trustees. This proposal is discussed in detail in Part C of this discussion document, at pages 40 to 60.

247. Second, trustee supervision of debt issuers is largely governed by the trust deed and the terms of the trust deed are, in the main, negotiated between the trustee and issuer. While this does provide the trustee with the flexibility to take a risk-based approach to its supervision of debt issuers, there is no assurance for the Government that trustees have adequate and sufficient duties and powers to carry out their role effectively; and that investors are receiving consistent minimum protections.

248. We intend to address this concern by considering whether trustees do have adequate and sufficient duties, powers and accountabilities and by considering what consistent minimum protections should be provided for all debt investors.

7.3 TRUSTEE DUTIES

249. As described at pages 26 and 27, the duties of a debt trustee are a combination of statutory duties, common law duties and duties implied into the trust deed. We are not aware of any problems with the duties of debt trustees. However, we seek feedback on whether the duties of debt trustees are sufficient and adequate.

Question for Submission

34. Are the trustee duties, specified in the Fifth Schedule to the Securities Regulations and implied into all debt trust deeds, adequate and sufficient?

7.4 TRUSTEE POWERS

7.4.1 Power of Trustee to Obtain Information from Issuers

250. As described at pages 28 and 29, it is an implied term in all debt trust deeds that the trustee has the right to obtain information from the issuer regarding meetings; and that the trustee has the power to request from the issuer, from time to time, the accounting and other records of the issuer and information relating to those records. However, periodic reporting requirements are not a statutory requirement, nor are they a term implied into trust deeds. Instead, it is a term that is negotiated between the trustee and issuer and disclosed in the trust deed.

251. We want to question whether the trustee's right to obtain information from the issuer from time to time and the power of the trustee to require periodic reporting from the issuer should be set out in law. The advantage of doing this is that it would provide assurance to investors that all debt issuers are subject to reporting requirements. It would also give the trustees an additional lever to obtain information from issuers.

252. We do not propose that minimum periodic reporting requirements be prescribed in law. While minimum requirements would ensure that all debt issuers are subject to

consistent minimum periodic reporting requirements, it would provide a "one size fits all" approach, which may reduce the flexibility of trustee supervision. The appropriate periodic reporting obligations may differ for different products and issuers and may need to be dynamic to cope with changing circumstances and risks. Further, the trustee supervisory model should provide assurance that there is regular reporting from issuers to trustees, as the appropriateness of the trustees' monitoring systems, including minimum reporting systems, will be considered by the Securities Commission when considering whether the trustee meets the entry criteria. The entry criteria for trustees are discussed further in Part C of this discussion document (at pages 49 to 54).

Questions for Submission

35. Do trustees have sufficient and adequate powers to obtain information from issuers?

36. Should the trustee's right to obtain information from the issuer, as currently specified in the Fifth Schedule to the Securities Regulations, be stated in law rather than implied into trust deeds? If no, why?

37. Should trustees have a statutory power to require periodic reporting from the issuer? If no, why?

7.4.2 Duty of Auditors to Provide Ad Hoc Information to Trustees

253. Where an auditor of an issuer of debt securities becomes aware of any matter that, in the auditor's opinion, is relevant to the exercise or performance of the powers or duties of the trustee, the auditor must report the matter to the issuer and the trustee.[131]

254. Section 50 is designed for spontaneous offerings of views from auditors to trustees. The auditor is not required to furnish the report until it has "formed an opinion", and there is no obligation on the auditor to "form an opinion".[132]

255. We have received feedback that auditors are reluctant to form an opinion because of the liability they face if that opinion is wrong. We are told this reluctance frustrates the flow of information between trustees and auditors.

256. We consider it important there is effective dialogue between the auditor and trustee. For effective supervision of debt issues, the trustee needs to be made aware of all information relevant to the performance of their powers or duties.

257. We have identified two options to encourage a more effective dialogue between auditors and trustees.

258. The first option is to impose a positive statutory duty on the auditor to report to the trustee once the auditor has become aware of any matter that is likely to be relevant to the exercise of the powers or duties of the trustee. This may be achieved by

[131] Securities Act 1978, ss 50(2), (3).
[132] *Deloitte Haskins & Sells v National Mutual Life Nominees Ltd* [1993] 3 NZLR 1; (1993) 6 NZCLC 68, 501 (PC).

removing the words “in the auditor’s opinion”. The duty would then not be contingent on the auditor “forming an opinion”. The advantage is that the trustee would receive more information from the auditor. The risks are that it may discourage the flow of information between issuers and auditors; or may discourage auditors from taking on appointments, particularly those which involve higher risk debt issues; or it could result in auditors being over-cautious and providing too much information to the trustee.

259. The second option is to provide a statutory safe harbour for auditors who provide an opinion to trustees, so the auditor is only liable if the opinion is given in bad faith or given negligently. We consider there is little risk in providing this safe harbour for auditors. The information that the auditor provides to the trustee should merely act as a trigger for the trustee to undertake its own investigation.

260. In a separate review of auditor regulation, the Ministry will raise for public consultation a question about whether to introduce auditor whistle-blowing laws. A whistle-blowing provision would be aimed at requiring auditors to report to a regulator, if the auditor suspects there has been an offence committed under certain pieces of legislation, including the Securities Act. If implemented, this provision could be modelled on the obligations imposed on liquidators under section 258A of the Companies Act. This can be distinguished from section 50, which is designed to encourage auditors to report to the trustee if they come across information that is relevant to the exercise of the trustee’s duties or powers. Such information may not necessarily consist of an offence being committed.

Questions for Submission

38. Is there a problem with section 50 of the Securities Act?

39. If yes, how should that problem be addressed?

40. Do you agree that auditors should have a positive duty to report to trustees if they are aware of information that is relevant to the exercise of the trustees’ powers and duties?

41. What are the costs of imposing this positive duty?

42. Do you agree that auditors should be protected from liability for an opinion provided voluntarily to trustees, unless that opinion is given in bad faith or given negligently?

43. What are the costs of providing this safe harbour?

7.4.3 Power of Trustee to Change the Trust Deed

261. Neither the Securities Act nor the Regulations specify when a trust deed may be amended. Instead, it is left to the issuer and trustee to negotiate a trust deed amendment. If the change is material, the trustee will need to go to a meeting of the investors and obtain directions.

262. Amendments to the trust deed may be necessary for a number of reasons. For example, if there has been a change in legislation or best practice guidelines which impacts on the trust deed provisions. Or, if there has been a change in market

conditions that has changed the risk profile of the issuer. If market changes are favourable to the issuer, the issuer may want the trust deed provisions relaxed. If market changes are not favourable to the issuer, the trustee may want the trust deed provisions tightened.

263. We have received feedback that amending the trust deed can be difficult for both trustees and issuers; there may be circumstances where both the trustee and the issuer want to amend the trust deed, but it is impractical or too costly to obtain directions from the investors. We are told that current practice for some trustees is to include a provision in the trust deed that enables the trustee and issuer to update the trust deed in certain circumstances, without recourse to investors, for example, if a change is required by, or in consequence of, or is consistent with, a legislative change and it does not materially affect the interests of the security holders.

264. There may also be circumstances where either the trustee or issuer may want to change the trust deed, but the change is resisted by one of the parties to the deed. If a trustee resists change, there is little the issuer can do. If an issuer resists change, the trustee can apply to the court, if it is of the opinion that the provisions of the deed are no longer adequate to give proper protection to the security holder. The court can grant various orders, including an order to amend the provisions of the deed.[133] However, it can be expensive to go to court for orders.

265. The trustee and issuer need a practical mechanism to amend the trust deed. However, it is also important to have some restrictions on when trust deeds can be amended without recourse to investors, so investors have some assurance that they will not be adversely affected by any change and that the nature of their investment does not change without their consent.

266. We propose that if both the trustee and issuer agree to an amendment, and the amendment does not adversely affect the interests of the investor, nor materially change the nature of the investor's investment, the amendment should be allowed without recourse to investors. A regulator could play a role in approving the amendment. This may give greater assurance that neither the rights of the investors have been adversely affected, nor the nature of their investment materially changed.

267. We also propose that if one party to the trust deed wants to amend the trust deed and the amendment neither adversely affects the interests of the investor, nor materially changes the nature of the investor's investment, the other party to the trust deed should not unreasonably withhold their consent to the amendment. If the issuer and trustee are unable to agree to an amendment, the regulator could play a role in determining whether the consent to the amendment was reasonably withheld.

Questions for Submission

44. Under what circumstances should an issuer and trustee be able to amend the trust deed without recourse to investors? Why?

45. Should a regulator confirm that the amendment does not adversely affect the interests of the investor, nor materially change the nature of the investor's investment? Why?

[133] Securities Act 1978, s 49.

46. If one party to the trust deed does not agree to a change in the trust deed, should a regulator have the ability to approve the change? Why?

7.4.4 Other Trustee Powers

268. Most trustees will negotiate powers additional to those that are already set out in law or implied into trust deeds, some of which are set out at paragraph 97 above.

269. We propose that trustees should have the power, without having to negotiate the power with the issuer, to:

a. Engage, at the issuer's expense, a third party expert to review specified aspects of the issuer's systems, controls and governance;

b. Give directions to the issuer, where it is in breach or regulatory requirements, including direction to remove or replace directors or senior management.

270. We seek feedback on whether these powers are appropriate.

Questions for Submission

47. Are there any other trustee powers that the trustee should not have to negotiate with the issuer? For example, should trustees have the power to:

a. Engage, at the issuer's expense, a third party expert to review specified aspects of the issuer's systems, controls and governance?

b. Give directions to the issuer, where it is in breach or regulatory requirements, including direction to remove or replace directors or senior management?

48. What would be the costs and benefits of doing so?

7.5 TRUSTEE ACCOUNTABILITY

271. We want to ensure that trustees are held accountable in their role and that where an investor suffers loss from a breach of trustee duties, that the investor has adequate recourse against the trustee.

272. As described in paragraphs 98 to 103 above, trustees are subject to a number of accountabilities. For example, investors are able to call a meeting of investors and provide directions to the trustee, provided they meet quorum and resolution thresholds; investors are able to take an action in court to seek compensation for loss caused by a breach by the trustee of any of its duties or the terms of the trust deed; and the Securities Commission has wide-ranging powers of inspection and to obtain information.

273. We propose the following additional accountabilities for trustees.

a. *Compliance orders.* The Securities Commission will have the power to order the trustee to comply with the terms of the trust deed or the trustee's duties. The Securities Commission will be able to exercise this power where: the Securities Commission is of the opinion that the trustee has breached or is likely to breach either the trust deed or its duties; and a compliance order is necessary for the protection of investors and in the public interest.

   It is proposed that where a trustee acts on the directions of the Securities Commission they will be indemnified against any liabilities in complying with those directions.

b. *Court orders*. We note that under section 49 of the Securities Act, the trustee may apply to the court for orders where, at any time after due inquiry it is of the opinion that either: the issuer and any guarantor of the securities are unlikely to be able to pay all money owing in respect of the securities when it becomes due; or the provisions of the trust deed relating to the securities are no longer adequate to give proper protection to the security holders. The court may order, amongst other orders, that: provisions of the trust deed be amended; restrictions be imposed on the issuer; the issuer or trustee convene a meeting of security holders. The court may give other directions as it considers necessary to protect the interests of security holders, other holders of securities of the issuer, any guarantor of the securities, or the public. We seek feedback on whether the Securities Commission should have a similar ability to apply to the court for similar orders.

c. *Civil pecuniary orders.* We propose that the court have the power, on the application of the Securities Commission, to make a civil pecuniary order where the trustee has breached the trust deed or has otherwise breached their duties, and the breach either: materially prejudices the interests of the subscribers for the securities involved; or is likely to materially damage the integrity or reputation of any of New Zealand's securities markets; or is otherwise serious. There is precedent for civil pecuniary orders in the Securities Legislation Bill in respect of civil liability events.

d. *Compensatory orders.* We propose that if a trustee fails to comply with the trust deed, or otherwise breaches their duties, the court have the power to, on the application of either the Securities Commission or a subscriber, order the trustee to pay compensation to all subscribers who have suffered loss or damage by reason of the trustee's breach of the terms of the trust deed or breach of duty. Currently, if the trustee breaches their duties and the investor suffers loss or damage, the investor can pursue the issuer or the trustee through the court system. However, the loss or damage caused to individual investors may not be sufficient to justify any one of them bearing the cost of litigation. There is precedent for the Securities Commission to apply for compensatory orders in the Securities Legislation Bill in respect of civil liability events.

Questions for Submission

49. Should the Securities Commission have the power to order the trustee to comply with the terms of the trust deed or the trustee's duties, where the Securities Commission is of the opinion that the trustee has breached or is likely to breach either the trust deed or its duties; and a compliance order is necessary for the protection of investors? If no, why?

50. Should the Securities Commission have the ability to apply to the court for orders similar to those, and in similar circumstances to that, set out in section 49 of the Securities Act?

51. Should the court have the power, on the application of the Securities Commission, to make a civil pecuniary penalty order, where the trustee fails to comply with the trust deed, or otherwise breaches its duties, and the breach either: materially prejudices the interests of the subscribers for the securities involved; or is likely to materially damage the integrity or reputation of any of New Zealand's securities markets; or is otherwise serious. If no, why?

52. Should the court have the power, on the application of either the Securities Commission or a subscriber, to order the trustee to pay compensation to all subscribers who have suffered loss or damage by reason of the trustee's breach of the terms of the trust deed or breach of duty? If no, why?

53. What other remedies and penalties are appropriate where the trustee has breached its duties to investors?

7.5.1 Meetings

274. There is some statutory guidance as to how a meeting of debt investors may be called, but there is no statutory guidance as to the process of the meeting once it is called.

275. The trustee, issuer or investors may want to call a meeting. If changing market conditions have impacted on the issuer, all three may want the trust deed amended accordingly. Or, either the trustee or investor may be concerned that the issuer, while not technically in breach of either the trust deed or the offer documents, may be creeping its activities or exposure into areas that are higher risk. Or, the investor may be unhappy with the performance of the trustee and may want to either give directions to the trustee or to remove the trustee.

276. We consider there are two aspects of meetings that need to be addressed at law to give all parties sufficient certainty about how meetings can be conducted, and the rights of investors at meetings. First, the ability of investors to initiate a meeting. Second, what will constitute a quorum at a meeting and the majorities that are required to pass a resolution at a meeting.

7.5.1.1 Initiation of a Meeting

277. It is an implied term in all trust deeds that on receiving a written request from the trustee under a trust deed for debt securities or from the holders of 10 percent in nominal value of the debt securities, the issuer must call a meeting of the security

holders for the purpose of considering its financial statements or giving directions to the trustee in relation to the exercise of the trustee's powers.[134]

278. We have received feedback that it can be difficult for debt investors to initiate a meeting because the threshold (10 percent in nominal value of the debt securities) is too high. The number of debt investors in a debt issue can be large and it can be difficult for debt investors to effectively coordinate a large number of investors in order to call a meeting. And, we are told that many debt investors (bar institutional debt investors) are simply not interested in attending a meeting. This can be contrasted with equity investors, who as co-owners of the business are more likely to take an active interest in the performance of their security. We note that we also received feedback from the Trustee Corporations Association that the 10 percent threshold was not an issue.

279. This concern could be addressed by reducing the threshold for debt investors who want to initiate a meeting. However, it is important that the threshold is set at a level that allows interested debt investors to initiate a meeting but deters vexatious meeting requests. The expense of convening the meeting will fall on the issuer, so there needs to be some restrictions on the ability of investors to compel the issuer to convene a meeting.

280. The Companies Act 1993 enables shareholders, who are entitled to vote on an issue, to call a special meeting on the request of shareholders with not less than five percent of the voting rights entitled to be exercised on the issue.[135] However, as stated above, equity investors are more likely to take an active interest in the performance of their security than debt investors, because they are co-owners of the business. Because of this, a threshold of 5 percent may be easier for equity investors to meet. The threshold may need to be lower for debt investors, so that a meeting can actually happen.

281. The Unit Trusts Act 1960 currently enables unit holders to call a meeting on the request of either ten percent in number of unit holders, or of unit holders with over 10 percent of value of units in the scheme.[136] The Securities Act enables participatory security holders with over 10 percent of the value of securities to summon a meeting.[137] It is being proposed in the section of this discussion document dealing with collective investment schemes, for reasons similar to those discussed above for debt investors, that the thresholds in the Unit Trusts Act be reduced to 5 percent in number of unit holders, or of unit holders with over 5 percent of value of units in the scheme. It is also being suggested that a fixed number threshold could be used, for example 100 unit holders.

Questions for Submission

54. Do debt investors find it difficult to initiate a meeting?

[134] Securities Regulations 1983, Fifth Schedule, cl 3(1).
[135] Companies Act 1993, section 121.
[136] Unit Trusts Act 1960, section 12(d).
[137] Securities Regulations 1983, Seventh Schedule, cl 4(1)(b).

55. Should the current threshold for debt investors to initiate a meeting (10 percent in nominal value of the debt securities), be reduced?

56. If yes, what should the threshold be for debt investors to initiate a meeting?

57. Should the threshold be reduced to 5 percent of nominal value of the debt securities, similar to that proposed for collective investment schemes? If no, why not? Is there any reason to distinguish between debt securities and collective investment schemes?

58. Should there be alternative thresholds relating to a fixed number, or percentage of the number, of debt investors? If no, why not?

7.5.1.2 Quorum and Resolutions

282. There is no statutory guidance as to what will constitute a quorum at a meeting of debt security holders or what level of votes must be cast to pass a resolution at the meeting.

283. The Unit Trusts Act provides that a resolution to direct the trustee can be passed by unit holders with 75 percent of the value of interests in the unit trust, which are held by unit holders who are present (in person or by proxy) or making written votes, and who hold not less than one-quarter of the value of all the interests in the unit trust.[138]

284. The thresholds are lower in the Companies Act. The Companies Act requires a quorum of shareholders who are between them able to exercise a majority of the votes to be cast on the business to be transacted by the meeting. Depending on the nature of the resolution, it can then be passed by either an ordinary resolution (a simple majority) or a special resolution (75 percent majority).[139]

285. The lower threshold in the Companies Act reflects the fact that an equity investor is a co-owner of the business. As a co-owner, it is commonly accepted that the equity investor should have a say in how that business is run. The equity investor is therefore afforded an ability to exercise control in accordance with their level of ownership.

286. In contrast, an investor in a collective investment scheme is not a co-owner of the underlying business or businesses. Instead, the investor owns a share in a fund and has in practice invested in the strategy of the fund manager. The investor therefore has less ability to interfere in how the fund is run.

287. Similarly, a debt investor has no ownership of the underlying business. However, a debt security is a promise by the issuer that it will repay that debt to the investor. For this reason, it may be that a debt investor should have some ability to have a say (for example, requesting an amendment to the trust deed) if it believes that the issuer will not meet that promise.

[138] Unit Trusts Act 1960, s 18(2).
[139] Companies Act 1993, ss 105, 106.

Questions for Submission

59. What should constitute a quorum at a meeting of debt security holders and what level of votes must be cast to pass a resolution at the meeting?

60. Is there any reason to distinguish between the thresholds required in respect of a debt security and an equity security?

61. Is there any reason to distinguish between the thresholds required in respect of a debt security and an equity security?

7.6 MATTERS TO BE ADDRESSED AND DISCLOSED IN TRUST DEEDS

288. We consider there are a number of matters that should be addressed and disclosed in every debt trust deed. We propose to prescribe high-level headings rather than specific provisions that prescribe how these matters must be addressed. This will provide assurance to the Government that minimum protections are being addressed and disclosed in trust deeds, whilst retaining flexibility for the trustee and issuer to determine how those minimum protections are met. It will also allow comparisons of protections across different trust deeds.

289. However, there are some matters that may need greater specification. These are identified below.

7.6.1 Corporate Governance

290. The trust deed should disclose the corporate form of the debt issuer so the investor knows what corporate governance requirements the debt issuer must comply with.

291. The trust deed should also disclose what additional corporate governance requirements apply to the debt issuer. For example, the entry criteria for registration as a debt issuer. All debt issuers will be required to satisfy negative assurance requirements. However, if the debt issuer is a Tier 2 NBDT it may be subject to qualitative entry requirements. For example, a Tier 2 NBDT that wants to issue debt securities may be required to have: sufficient experience and capital to run a financial institution; a minimum number of directors and independent directors on, and an independent chair of, the board; and possibly a credit rating. This proposal for Tier 2 NBDTs is discussed in detail in the discussion document *Non-Bank Deposit-Takers*.

292. If the debt issuer is listed, the trust deed should disclose that the debt issuer is also subject to the governance requirements set out in the applicable NZX Listing Rules.

7.6.1.1 Terms of the Securities

293. The trust deed should disclose what restrictions there are on the variation of securities after issue. For example, it is important for the investor to know whether the issuer is able to issue new securities, and if so, what impact the new securities will have on the investor's securities.

7.6.1.2 Financial Covenants

294. The trust deed should disclose what financial ratios are used and what financial covenant definitions are used.

295. It is proposed that trust deeds for Tier 2 NBDTs use a standardised capital adequacy measurement framework, most probably Basel II standardised, as the framework for measuring capital adequacy relative to on- and off-balance sheet exposures. It is also proposed that trust deeds for Tier 2 NBDTs specify a minimum Tier 1 capital ratio, probably measured using the Basel II framework. An option is being raised regarding whether the minimum capital ratio should be left for the trustee to negotiate with the issuer, or whether a minimum capital ratio be prescribed for all Tier 2 NBDTs with the trustee still able to negotiate a capital ratio above the minimum. These proposals for Tier 2 NBDTs are discussed in detail in the discussion document *Non-Bank Deposit-Takers.*

7.6.1.3 Minimum Capital

296. The trust deed should disclose the minimum capital requirement that has been negotiated with the issuer.

297. It is proposed that Tier 2 NBDTs must have a minimum capital in the region of $500,000 to $2 million, with trustees able to negotiate a higher minimum capital requirement, where appropriate. The trust deed should clearly disclose the minimum capital and whether the minimum capital is over and above the regulatory minimum capital requirement.

7.6.1.4 Exposure

298. The trust deed should disclose what restrictions there are on any related party transactions. The trust deed should use the definitions of related parties and related party transactions as set out in NZIAS 24 *Related Party Disclosures*.

299. We seek feedback on whether trust deeds must specify a maximum limit for credit exposures to related parties.

300. The trust deed should also disclose, if applicable, whether there are any restrictions on concentration levels.

7.6.1.5 Reporting

301. The trust deed should disclose how the issuer will keep the trustee informed. As discussed above, we question whether trustees should have a power in law to require periodic reporting from the issuer. We consider that at the least, the trustee should consider what minimum reporting requirements are appropriate and to disclose the reporting obligations in the trust deed.

7.6.1.6 Trustee Duties and Powers

302. The trust deed should set out the duties and powers the trustee has, as set out in law or implied into the trust deed, and those negotiated under the trust deed.

7.6.1.7 Meetings

303. As discussed above, we are proposing that the process for meetings should be addressed at law. We consider that the process for meetings should also be explained in the trust deed, to give all parties sufficient certainty about how meetings can be initiated and conducted, and the rights of the parties during the meetings.

7.6.1.8 Appointment and Removal of Trustees

304. The trust deed should disclose the process for appointment and removal of trustees.

Questions for Submission

62. Do these headings cover all the key matters that should be addressed and disclosed in all debt trust deeds?

63. If no, what other key matters should be addressed and disclosed in all debt trust deeds?

64. Should the proposal that trust deeds for Tier 2 NBDTs use a standardised capital adequacy measurement framework, most probably Basel II standardised, as the framework for measuring capital adequacy relative to on- and off-balance sheet exposures be extended to all debt issuers? If no, why?

65. Should the proposal that trust deeds for Tier 2 NBDTs specify a minimum Tier 1 capital ratio, probably measured using the Basel II framework, be extended to all debt issuers? If no, why? If yes, should the minimum capital ratio be left for the trustee to negotiate with the issuer, or prescribed (with the trustee still able to negotiate a capital ratio above the minimum)?

66. Should all debt trust deeds specify a maximum limit to related party exposures? If no, why?

67. Should trust deeds for Tier 2 NBDTs specify a maximum limit to related party exposures? If no, why?

APPENDIX: SUMMARY OF QUESTIONS FOR SUBMISSION

Supervision and Enforcement of Disclosure Regime

1. Should the Securities Commission have the power to specify in the exemption notice the consequences for the issuer of breaching that exemption notice and how the issuer may remedy that breach? If no, why?

2. Should the Securities Commission have the power to declare a product to be a particular type of security? If no, why?

3. Should the Securities Commission have the power to declare a product to be a security or a derivative? If no, why?

4. Does the Registrar of Companies have a sufficient and adequate role in supervising the disclosure regime? If not, why?

5. Can the respective roles of the Registrar of Companies and the Securities Commission in registering the prospectus be better clarified in legislation?

6. Are the liabilities in the Securities Act sufficient and adequate? If no, why?

7. Is the scope of section 56 too narrow?

8. Are the defences to these liabilities sufficient and adequate? If no, why?

9. Are the penalties in the Securities Act sufficient and adequate? If no, why?

10. Should the Securities Commission have the power to make corrective orders if a person contravenes the disclosure regime?

Proposed Trustee Supervisory Model

11. Are there any other benefits of the current regimes that need to be considered in the development of a new regime?

12. Do you agree with the problems identified with the status quo? What do you consider to be the size of these problems?

13. Are there any other costs of the current regimes that need to be considered in the development of a new regime?

14. Can you see any other tensions that may arise?

15. What do you see as the objectives of the trustee supervisory relationship? Should these be included in legislation?

16. Is it appropriate that the Securities Commission may approve trustees on an all-securities basis? Would there be any benefit in requiring a trustee to hold separate approvals for different classes of issue (i.e. debt or CIS)? If so, would this be outweighed by the cost of having to make two separate applications?

17. Do you agree with the proposed entry requirements? If no, why? Are any of the proposed entry requirements too lenient or too onerous?

18. Are there any other requirements that trustees should be required to demonstrate to the Securities Commission before they are approved?

    a. For example, section 3 of the Superannuation Schemes Act requires that at least one trustee be a New Zealand resident before the trustees of the superannuation scheme can apply to the Government Actuary for registration of the scheme. Should such a residency requirement be extended to all trustees? Should a trustee company be required to have a physical presence or place of business in New Zealand before it receives Securities Commission approval?

19. Do you consider any of the proposed entry requirements are inappropriate? If they are only inappropriate for a particular kind of trustee, could this be addressed through an exemption?

20. Should the proposed entry requirements be placed in primary legislation, or in regulation?

21. What sort of appeal process do you think is appropriate for the application process?

22. Would it be desirable to have the Minister making approvals on the recommendation of the Securities Commission? Would the benefits (e.g. independence, balance) outweigh the costs (e.g. length of time for approval to be given)?

23. Do you agree with the proposed reporting requirements? If no, why?

24. Are any of the requirements likely to be too onerous?

25. What sort of data do you think should be kept confidential, and what should be able to be made public?

26. Should there be some statutory protection given to the information passed between a trustee and the Securities Commission (like that given in Section 23 of the Corporations (Investigation and Management) Act 1989 or the Reserve Bank Act 1989)? If so, to what extent?

27. Are the Securities Commission's powers of inspection appropriate in relation to trustees? Is there any reason that the Securities Commission should not have these powers in relation to trustees?

28. Do you agree with the suggested Securities Commission powers and actions in case of a breach? Are any of them inappropriate?

29. Should the Securities Commission have to go to court for orders to do certain things? If so, which ones?

30. Will there ever be a situation where the market will not step in and take on an appointment where the trustee has been removed? If so, what should happen?

31. Do you see a potential overlap between the Securities Commission and the Registrar

of Companies? If so, what? What problems might arise? Are they significant? How might they be addressed

32. Do you think there should be an obligation on trustees to consult with the Securities Commission at an earlier stage than giving notice under s 11? Is this practical? What sort of threshold would be required to trigger the obligation to inform the Securities Commission?

33. Do you think that a trustee should also be required to give a section 11 notice to the Securities Commission (for the purposes of the Commission's role as the general overseer of trustees)?

Trustee Supervision of Debt Issuers

34. Are the trustee duties, specified in the Fifth Schedule to the Securities Regulations and implied into all debt trust deeds, adequate and sufficient?

35. Do trustees have sufficient and adequate powers to obtain information from issuers?

36. Should the trustee's right to obtain information from the issuer, as currently specified in the Fifth Schedule to the Securities Regulations, be stated in law rather than implied into trust deeds? If no, why?

37. Should trustees have a statutory power to require periodic reporting from the issuer? If no, why?

38. Is there a problem with section 50 of the Securities Act?

39. If yes, how should that problem be addressed?

40. Do you agree that auditors should have a positive duty to report to trustees if they are aware of information that is relevant to the exercise of the trustees' powers and duties?

41. What are the costs of imposing this positive duty?

42. Do you agree that auditors should be protected from liability for an opinion provided voluntarily to trustees, unless that opinion is given in bad faith or given negligently?

43. What are the costs of providing this safe harbour?

44. Under what circumstances should an issuer and trustee be able to amend the trust deed without recourse to investors? Why?

45. Should a regulator confirm that the amendment does not adversely affect the interests of the investor, nor materially change the nature of the investor's investment? Why?

46. If one party to the trust deed does not agree to a change in the trust deed, should a regulator have the ability to approve the change? Why?

47. Are there any other trustee powers that the trustee should not have to negotiate with the issuer? For example, should trustees have the power to:

    a. Engage, at the issuer's expense, a third party expert to review specified

aspects of the issuer's systems, controls and governance?

b. Give directions to the issuer, where it is in breach or regulatory requirements, including direction to remove or replace directors or senior management?

48. What would be the costs and benefits of doing so?

49. Should the Securities Commission have the power to order the trustee to comply with the terms of the trust deed or the trustee's duties, where the Securities Commission is of the opinion that the trustee has breached or is likely to breach either the trust deed or its duties; and a compliance order is necessary for the protection of investors? If no, why?

50. Should the Securities Commission have the ability to apply to the court for orders similar to those, and in similar circumstances to that, set out in section 49 of the Securities Act?

51. Should the court have the power, on the application of the Securities Commission, to make a civil pecuniary penalty order, where the trustee fails to comply with the trust deed, or otherwise breaches its duties, and the breach either: materially prejudices the interests of the subscribers for the securities involved; or is likely to materially damage the integrity or reputation of any of New Zealand's securities markets; or is otherwise serious. If no, why?

52. Should the court have the power, on the application of either the Securities Commission or a subscriber, to order the trustee to pay compensation to all subscribers who have suffered loss or damage by reason of the trustee's breach of the terms of the trust deed or breach of duty? If no, why?

53. What other remedies and penalties are appropriate where the trustee has breached its duties to investors?

54. Do debt investors find it difficult to initiate a meeting?

55. Should the current threshold for debt investors to initiate a meeting (10 percent in nominal value of the debt securities), be reduced?

56. If yes, what should the threshold be for debt investors to initiate a meeting?

57. Should the threshold be reduced to 5 percent of nominal value of the debt securities, similar to that proposed for collective investment schemes? If no, why not? Is there any reason to distinguish between debt securities and collective investment schemes?

58. Should there be alternative thresholds relating to a fixed number, or percentage of the number, of debt investors? If no, why not?

59. What should constitute a quorum at a meeting of debt security holders and what level of votes must be cast to pass a resolution at the meeting?

60. Is there any reason to distinguish between the thresholds required in respect of a debt security and an equity security?

61. Is there any reason to distinguish between the thresholds required in respect of a debt security and an equity security?

62. Do these headings cover all the key matters that should be addressed and disclosed in all debt trust deeds?

63. If no, what other key matters should be addressed and disclosed in all debt trust deeds?

64. Should the proposal that trust deeds for Tier 2 NBDTs use a standardised capital adequacy measurement framework, most probably Basel II standardised, as the framework for measuring capital adequacy relative to on- and off-balance sheet exposures be extended to all debt issuers? If no, why?

65. Should the proposal that trust deeds for Tier 2 NBDTs specify a minimum Tier 1 capital ratio, probably measured using the Basel II framework, be extended to all debt issuers? If no, why? If yes, should the minimum capital ratio be left for the trustee to negotiate with the issuer, or prescribed (with the trustee still able to negotiate a capital ratio above the minimum)?

66. Should all debt trust deeds specify a maximum limit to related party exposures? If no, why?

67. Should trust deeds for Tier 2 NBDTs specify a maximum limit to related party exposures? If no, why?