AUCKLAND DISTRICT LAW SOCIETY INC
HERE TO SUPPORT YOU

23 April 2012

Commerce Select Committee

By online submission only

Dear Sir/Madam

Submission by Auckland District Law Society Inc. Commercial Law Committee

The Auckland District Law Society Inc. Commercial Law Committee ("the Committee") is grateful for the opportunity to comment on the Financial Markets Conduct Bill. The Committee's submission is **enclosed.**

The Committee hopes these comments will be of some assistance. Please do not hesitate to contact the undersigned with any queries.

Yours faithfully,

P.P.

Frank Chan
Convenor of Commercial Law Committee
Director
FC Law Partners
m +64 21868623
e. frank.chan@fclawpartners.co.nz

Frank Godinet
President
Auckland District Law Society Inc.
t. 09 303 5270
e. frank@frankgodinet.co.nz
www.adls.org.nz

Auckland District Law Society Inc., Commercial Law Committee

Submissions to the Commerce Select Committee on the Financial Markets Conduct Bill

Introduction

1. Thank you for the opportunity to make submissions.

Summary

2. In our view, the following aspects of the Bill ought to be reconsidered and amended:

   a. the rules regarding excluded offers are inconsistent and in particular should be changed to help smaller issuers;

   b. the Financial Markets Authority's (**FMA**'s) call-in power is too wide and should be changed to give greater procedural certainty;

   c. the Product Disclosure Statement (**PDS**) offer document lodgement process should be made more certain; and

   d. the provisions on liability of individuals for offers should be clarified.

Rules for excluded offers should be consistent and help smaller issuers

3. First, we urge the Committee to reconsider the basis of the application of the disclosure regime under the Bill to smaller issuers. In the case of larger issuers (often listed entities such as Telecom and Chorus, large unlisted entities such as Fonterra, or SOEs such as Genesis and NZ Post) that can bear the costs of raising capital, they are already well catered for. The costs of compliance are not a critical issue for them due to their resources.

4. Typically, the costs of compliance will mean that the base fixed costs, such as legal, accounting, tax and financial advice, for raising amounts up to $1 million will be similar to raising $5 million. The variable cost component diminishes as the amount to be raised increases. Not all smaller issuers wish to raise money by floating on a regulated exchange. Increasingly, smaller issuers are not able to access institutional debt due to the stricter lending criteria of banks and the absence in the market place of other lenders, due in part to the departure or collapse of many finance companies following the GFC and subsequent increased regulation for non-bank deposit takers.

5. Larger issuers have well paid advisers to argue their case for more liberal rules to enable them to raise capital, but smaller issuers are unable to organise themselves into persuasive pressure groups to argue their plight. For smaller issuers that are representative of the many small to medium sized enterprises in New Zealand, the Bill does very little to assist their cause. Larger issuers raising large amounts of capital will in

most part not be subject to the full compliance with the disclosure regime. The burden of full compliance will fall on smaller issuers, who are least able to shoulder that burden.

6. If the Bill does not provide smaller issuers with means to access capital that addresses their needs, smaller issuers will continue to struggle to raise capital, and investors will have little or no ability to invest in anything other than larger issuers. As a result, the mainstays of business in New Zealand will remain stagnant. In its present form, the Bill represents a significant barrier to entry into the capital market for smaller issuers. The Bill's purpose of promoting participation for businesses, the greater majority of which are smaller issuers, will not be achieved.

7. The proposal to apply one model of disclosure except if excluded is problematic. An offer is in or out. There is no lower level of compliance or concessions made except by exemptions at the discretion of the FMA. The exclusions are also somewhat inconsistent in terms of their underlying policy basis. A larger issuer is no more or less likely to be a better investment than a smaller issuer merely by virtue of its size (for example, Feltex). If the exclusions for investors are based on a need to know basis, rather than separating retail from wholesale investors, this needs to be consistently applied.

8. While the content of the disclosure is a policy issue for the regulations, it is curious that any start-up business that does not have any trading history is treated the same as one that does have a trading history. This has an impact on whether potential investors can access information about the issuer. It is also curious that a large amount of money, somewhat arbitrarily set at $500,000 or more, can be invested without compliance, but investors are precluded from investing smaller amounts. The assumption that a larger investment correlates with a wealthier investor who is either better advised or is able to put that amount at risk lacks logic. Applying the same assumed logic, an investor surely must be permitted put at risk a smaller sum relative to the investor's resources. To then add a further layer of protection is unwarranted.

9. For the wholesale investor exclusion, the basis for exclusion is experience that allows the person to assess the merits of an offer. In contrast, for the close relationship exclusion, the basis for exclusion is that the relationship allows the person to obtain the information that will enable the assessment of the merits of the offer and the adequacy of any information provided. Is primacy to be given to access to information, or the ability to assess the merits, or both? There is nothing in the Bill that suggests that the ability of the investor is important, except that any information must be likely to assist a prudent but non-expert person to decide whether to acquire the product (clause 36).

10. The proposed new small offers exclusion is too narrow and internally inconsistent. It seems to be a hybrid of the existing wealthy person exception and an attempt to bring in a small offer exclusion. The result is that it does neither. Few smaller issuers will benefit from the exclusion. This exclusion is inconsistent because it combines criteria relating to the offeror (investor) and the issuer in a manner that is not consistent with the policy basis for other exclusions. It is unclear what relevance the income qualification for the offeror has, as opposed to an asset qualification that applied under the current wealthy persons exception. It is not clear what characteristics that an angel investor is to be judged upon, other than giving such networks a statutory preference. The combined

effect of the restrictions on the class of potential offerors is not consistent with other exclusions. In other exclusions, the relationship is important because of the ability to access information. Why should smaller issuers be penalised by introducing an income test? If the offeror is being assessed in terms of ability to sustain the loss of investment, is an assets test equally or more relevant?

11. In our view, it would be preferable to have *three* exclusions instead of the one proposed in the Bill. The *first* would be for angel investors that is more tightly drafted, because the present drafting is extremely wide and is capable of abuse. This could be easily drafted with co-operation from recognised angel networks, and would be along the lines of the wholesale investor exclusion (taking into account any potential overlap).

12. The *second* exclusion would be for those with a relationship with the issuer, along the lines of the proposed exclusion.

13. The *third* exclusion would be a new one that we urge the Committee to carefully consider. This would focus on a minimum dollar value of investment or the proportion of the investor's income or assets, without restrictions on advertising, but with attendant health warnings. This exclusion would have much wider application and usefulness than the proposed exclusion. We refer the Committee to the recent 'crowdfunding' reform to US federal securities laws. We believe that there is a much more compelling case for introducing an equivalent reform in New Zealand rather than the small offers proposal. For this exclusion, we favour health warnings over either the use of an intermediary in the US or any form of certification, for the reasons set out below.

14. In our view, adequate protection under this exclusion could be achieved by use of health warnings instead of certification. If an offeror knows in advance that the offer is being made under an exclusion, the effect of the exclusion, and decides to participate, then there is no reason why participation in the offer should not be permitted. Surely, a prudent but non-expert person must be assumed to be able to understand generic written health warnings, without the necessity of obtaining advice. The warning would contain a statement that advice ought to be obtained if the offeror does not understand the warning.

15. The concept of certification is cumbersome and imposes an additional transaction cost on the offeror who chooses to become an investor (assuming the adviser is independent of the issuer- see below). Often, the time involved and the cost of certification for an investor is sufficient to deter the investor from making the investment, as it must be paid up front and amounts to a reduction in the return expected on the relatively smaller investment in these circumstances. In this case, certification would amount to no more than a simple mathematical exercise that a prudent but non-expert person could easily complete.

16. In relation to certification generally, we believe that the person advising on any certification ought not to be interested in the issuer or its advisers. The use of the associated person test in the Bill seems cumbersome and is not as wide or relevant as an interest test.

FMA's call-in power must be more procedurally certain

17. Secondly, we submit that the Bill in its current form confers too much power upon the FMA. We fully appreciate the need to balance both certainty and flexibility in dealing with fast moving market developments. However, it is Parliament's role to make law, and for the FMA to apply the law.

18. We accept that the so-called 'call-in' power (clause 533) is likely to be used only in exceptional circumstances. On the other hand, the ability to exercise this power and its far-reaching consequences potentially affects all participants. For example, to treat an equity offer as debt would add the additional expense and corresponding obligations of a supervisor.

19. Businesses demand certainty above all else. Businesses can legitimately expect that the basis on which any such significant power might be exercised should be clearly set out, or that a business can in advance obtain directly or indirectly some comfort from the FMA. Unfortunately, the FMA does not have any power to give binding rulings to give certainty to businesses. Any guidance policy from the FMA lacks formal standing and it is unclear what, if any, reliance may be placed on any such guidance. While the FMA's attempt to provide guidance is to be applauded, this does not give the level of certainty that most businesses would desire. Nor does there exist any right of appeal process that is likely to be quick and effective other than recourse to the Courts. Given this background, the process in the Bill lacks clarity, transparency and fairness.

20. The proposed process for making an order lacks procedural fairness. The process refers to consultation, and not a hearing. There is also no fixed timetable for consultation and for the FMA to make its decision. There needs to be more certainty in the form of prescribed timetable for the FMA to issue a notice, a date for any submissions, a hearing date, and a date for a decision.

21. Of concern is the FMA's ability to itself make an interim order without notice (clause 536). The grounds for making such an order are far too wide. The principal ground is whether to do so would be in the public interest. The FMA is only required to be considering exercising its powers. The FMA does not have to attain any higher evidential standard, such as reasonable grounds to suspect or believe, or to have formed a view. This very broad power could conceivably be used to halt a legitimate offer to the detriment of an issuer in circumstances that would amount to what is commonly referred to as a fishing expedition. Such interim powers are usually coupled with specific grounds and a standard to be attained to prevent use of the power on a wider scale than Parliament intended.

22. A business seeking to raise capital is not likely to wish to incur significant costs or wait for a Court hearing to challenge the FMA. Therefore, much depends on having certainty of the process of the FMA. Businesses should have the ability to be heard as a matter of urgency and the timetable made known to both the FMA and the issuer at the outset.

23. The process for these interim orders is fraught with potential negative consequences for the issuer. The current timeframes (clause 537) for the interim orders to remain in force are too long and should be shortened to correspond with a fixed timetable and give a faster result. Once an order is made, it is unclear what the process will involve and when the FMA must reach a decision. If an interim order is not proceeded with, the issuer is penalised without any ability to recover lost time and money. The negative public relations impact of an interim order being made public beyond the offerors is in itself likely to taint and derail the offer. For that reason, there ought to be a power to make confidentiality orders.

Offer document lodgement process must be more certain

24. Thirdly, we believe there needs to be more certainty on the process for lodgement of the PDS offer document. It is important that the process be clearly enshrined in the Act, rather than left to the FMA's discretion. This is for two reasons. First, the FMA is to be the sole gatekeeper, with the only recourse being to the High Court. In the past, the Registrar was the gatekeeper, with a right of appeal to the then Securities Commission.

25. Previously, issuers were faced with addressing any issues raised by the Registrar before registration was permitted. There was not any fixed timetable (although the Registrar in practice operated a booking system and was able to turn around initial comments on an offer document within 24 hours), but there was a right of appeal. While this right of appeal was used only once as far as we are aware, the need to have a fast moving process that is conducive to issuers being able to raise capital in relatively small windows of opportunity is a paramount concern. An issuer does not want to be tied up in an uncertain process with uncertain timetable, without an effective means of appeal.

26. Secondly, it is unclear what is to occur if the FMA extends the waiting period after lodgement of the PDS and issues with the PDS or the offer remain unresolved (under clauses 49 and 50, contrast with clause 52 if issues are resolved before the end of the waiting period). Presumably, the FMA would in that case raise any issues with the PDS and the offer within the waiting period. If issues remain to be resolved after the extended 10 working day period lapses, what is the status of the offer?

27. The Bill currently would permit the issuer to proceed with the offer, but the issuer is not able to place any reliance on the fact that the waiting period has elapsed (clause 54). In practice, the FMA would be able to exercise its powers if it believed the PDS to be misleading. If the unresolved issue is finely balanced, then the issuer is faced with no practical alternative but to comply in order for the offer to not be at risk from subsequent attack by the FMA. Given the importance of the gatekeeper function, a higher level of procedural certainty needs to be contained in the Bill rather than left to the FMA's discretion, so the path is clearly set out for issuers.

Liability and defences for persons involved in offers must be clearer

28. Fourthly, we believe there must be greater certainty in relation to the liability provisions of the Bill. Persons who are involved in raising capital should be able to do so with a clear understanding of when they might be liable. There should not be any effective change to

the law so that a person acting honestly and reasonably is pursued in either a criminal capacity or in a civil claim where a business has failed. It is not for the FMA to enforce what may amount to a personal guarantee on the part of a person involved in a capital raising.

29. For civil liability, it is not clear what taking reasonable precautions and exercising due diligence means. Is it sufficient to rely on adviser, particularly persons other than primary persons? To what standard are persons held to? For a director, is it a standard higher than that demanded of directors under company law? Is it subjective or objective? The Bill must be clear so that persons involved in any offer know the requisite standard to attain, rather than be open to attack because a standard is applied that they are not aware of. For criminal liability, it appears the relevant issues are whether the person has knowledge or has acted recklessly. There appears to be no defence of acting honestly and reasonably. It does not help advisers or business people seeking to raise money when they must wait until a Court issues a judgment on new law for there to be any certainty.

30. We wish to appear before the Committee.