

2 September 2010

Introduction

1. The Listed Companies Association Inc. (**Association**) is pleased to provide its submissions on the discussion paper entitled "*Review of Securities Law*" released by the Ministry. In these submissions, the Association has not dealt with all of the specific questions posed by the Ministry, but rather has focussed on certain issues of particular interest to listed issuers.
2. The Association's submissions are based on initial draft submissions prepared by Harmos Horton Lusk Limited (**HHL**), which have been adapted and modified with comments from members of the Association's Executive Committee. Accordingly there is a degree of similarity between some of these submissions and those of HHL.
3. The Association is an independent and voluntary non-profit organisation established in 1981. Its members are NZSX, NZAX and NZDX listed companies. Its main purposes are:
 - (a) to help listed companies further the long-term interests of their shareholders by working for a fair, adequate and efficient regulatory system;
 - (b) to help listed companies maximise the benefits of listing and to make the requirements that come with that status appropriate and reasonable to comply with; and
 - (c) to promote confidence in and growth of business and capital markets in New Zealand.

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Regulated Products

4. Paragraphs 38, 39, 64 and 66. To avoid uncertainty, the Association suggests that one of the categories be a "catch all" category to deal with instruments which do not fall within any of the four categories currently listed in paragraph 37, but which nevertheless require regulation under securities legislation. Under the present structure, anything which is a "security" as defined is caught by the Securities Act. If it does not fall within one of specific categories, it falls within the catch-all of a "participatory security".

Equity Securities

5. Paragraph 42. "Equity Security" is limited to investments in "companies and similar entities". Conceptually, if an investment in any sort of entity meets the tests in paragraphs (i), (ii) and (iii) of paragraph 42, should it not be an "equity security"? That also answers the question in paragraph 44.
6. Paragraph 42(ii). Presumably an exception to paragraph 42(ii) would be the delivery of cash or financial assets in the liquidation of the entity.

Convertible Securities

7. Paragraph 88 of the paper proposes that the new legislation treat convertible securities in the same way as the existing class exemption for convertible securities. The Association suggests that a different conceptual approach might be adopted in respect

of convertible securities depending on the manner in which the convertible security may be converted. The position is:

- (a) A convertible security may be convertible to another security (for example a debt instrument of a company converting into a share in that company) at the option of the holder, at the option of the company, or compulsorily on a date or on the occurrence of a certain event.
 - (b) The analysis in terms of securities legislation is in our view quite different in respect of a security convertible at the option of the company, or compulsorily (which we will call a ("Company Convertible") and a security convertible at the option of the holder a ("Holder Convertible").
 - (c) In the case of a Company Convertible, the holder is effectively stuck with the security which will be issued on conversion (the "New Security") at the time that the holder subscribes for the original security, whatever might occur after the issue of the original security. The important thing is to provide as much information as possible (in respect of both the original security and the New Security) before the holder makes the decision to invest in the original security.
 - (d) However in respect of a Holder Convertible, the holder has the option whether or not effectively to invest in the New Security. A good example is a debt instrument where, five years after the issue of the debt instrument, the holder may exercise an option either to get his money back, or to convert the instrument into shares of the company. In that circumstance, the holder should be given the same level of information before the decision to convert is made as if the shares were being issued in a new issue (either at the time of initial subscription with subsequent updates of material changes, or ahead of conversion). The judgement to be made by the holder is in substance the same judgement. However, exceptions might apply where the issuer, in respect of the security to be issued, is subject to continuous disclosure obligations.
8. The distinction we draw in the previous paragraph is already reflected in the provisions of the Securities Act (Rights, Options, and Convertible Securities) Exemption Notice 2002 that relate to section 37A(1)(b) of the Securities Act (see clauses 13 and 14). Our submission is that that distinction should be applied more broadly to the treatment of convertible securities.
9. Question 27 asks what other "class exemptions" should be reflected in legislation. One of these is the general provisions relating to rights issues presently contained in regulations 6 and 7 of the Securities Regulations 2009, and the Securities Act (Renewals and Variations) Exemption Notice 2002 which is frequently relied on by listed debt issuers at the time of rollover to new terms.

Previously Allotted Securities

10. Question 29. An issue which has been the subject of debate is whose "view" is relevant for the purposes of section 6(2) of the Securities Act – is it the view of the allotter, the initial holder, or both? The consensus view seems to be that it is the allotter's intention that is relevant, and that seems to us clearly right. It would be useful to record this in the legislation.

CHAPTER 2 OF THE PAPER

11. Paragraphs 26 to 33. If offers are made to persons who fall within exemptions, none of the provisions of the Securities Act or registration requirements should apply. An offer should be either wholly within, or wholly outside, the securities legislation. Satisfactory

remedies exist under statutes other than the securities legislation (for example the Fair Trading Act and the Crimes Act) and at common law, to protect investors in offers not subject to the Securities Act.

Sophisticated Investors

12. Paragraph 42. The Association supports the concept of exemptions for sophisticated investors. However, the criteria in paragraphs (i) and (ii) are odd. They require that a person has an investment portfolio of at least \$1 million (which in itself is low, especially as it may be heavily geared and so be even smaller on a net value test) but has carried out at least 80 miniscule investment transactions over the last two years. Very few people would meet that requirement, which in a sense may classify them as a trader for tax purposes anyway. We support the idea in the first bullet point in paragraph 45.

Employee Share Offers

13. Paragraphs 62 to 71. Our comments on the proposal for exemptions for employee share schemes are as follows:
 - (a) The detailed provisions will need to deal with company groups (allowing for offers to employees of subsidiaries, and counting together the assets of a group).
 - (b) With reference to paragraph 66, we would favour a restriction by size per employee as a percentage of employee remuneration, applying up to a certain specified level of remuneration (the thinking being that senior management is better equipped to make a decision to take a large percentage of remuneration in shares than a person on the factory floor).
 - (c) Query whether the provision should extend to debt securities, as well as to equity.
 - (d) Is the reference in paragraph 70 to 15% of assets or 15% of the outstanding value of securities on a “whichever is greater” or “whichever is lesser” basis? Presumably the limits are on a maximum amount of securities that may be outstanding at any time, and not on a “per offer” basis.
 - (e) If a provision is to be introduced that an employee share offering be a “single discrete offering not integrated with any other offers” (see paragraph 70) there should be an allowance for employee share offerings made at the same time as an IPO or a rights issue.

Certification

14. Paragraphs 111 to 116 of the paper. The problem with the existing “professional investor” exemption in section 3(2)(a)(ii) is that it requires the issuer to make an enquiry into the business and history of a potential investor that it is not practical to make. If an exemption depends on facts not within the knowledge of the issuer, there needs to be some system for certification on which the issuer can rely.

The Association agrees that certification by an independent party such as an accountant or financial adviser adds cost and formality. However, if a potential investor does not already have access to the services of an accountant or financial adviser, that may in itself be an indication that the investor requires the protection of securities legislation. The Association does not favour the concept of certification by the Authority or some other public body.

Void Allotments

15. The Association considers the reform should go further than changing 'void' to 'voidable'. A preferable approach, adopted in all other jurisdictions we are aware of, is to rely on criminal offence or civil remedies for non compliance with the securities law, rather than declaring the transaction unenforceable – the present approach can unjustifiably adversely affect third party rights – such as funders to issuers, or subsequent transferees, and results in unnecessary complexity.

CHAPTER 3 OF THE PAPER

16. An entity producing disclosure documents under the present law is faced with a choice between two largely conflicting objectives.

The first is to produce a description of the entity, the investment, and the risks of the investment which is reasonably easy for a potential investor to understand on a brief reading.

However the second objective is to protect the issuer and its directors against civil and criminal liability for inadequate disclosure. In considering this, directors and their advisors are likely to have regard to:

- (a) the fact that the level of disclosure is usually judged with the benefit of hindsight, after something has gone wrong, and in the clinical atmosphere of a courtroom where every word and nuance of meaning is examined in detail;
 - (b) the degree of publicity, and damage to the reputation of individuals, which results when any allegation of breach of the securities legislation is made, whatever may be the final outcome.
17. In reality, the second objective is likely to win over the first. The best way to avoid a later allegation of inadequate disclosure is to disclose every relevant (and irrelevant) issue in detail. That is why disclosure documents have developed into lengthy and difficult to follow documents. A prime example is the statement of risks required in an investment statement. That has developed into a turgid description of ten pages or more describing every possible risk, including many which are general to most investments and readily apparent.
18. It is not easy to know how to deal with the issue outlined in the preceding paragraphs. In our view, a good start would be to address the issue in the liability provisions of the securities legislation (like sections 55 to 59 of the present Securities Act). That could perhaps be done by provisions to the following effect:
 - (a) recording that the level of disclosure must be judged against the need for concise and easily understood documents;
 - (b) stating that a person is not to be liable solely because of an endeavour in good faith to disclose relevant matters in a concise and easily understood fashion.
19. The paper proceeds on the basis that under the existing law, the prospectus and investment statement are separate documents. In fact, these are frequently combined in one document, and the whole combined document is sent to potential investors, which defeats the purpose of the investment statement. The reason for issuers adopting this approach is the same as that outlined above. There is a hope that something which might not be disclosed in the investment statement portion of the document will be covered in the prospectus portion.

Product Disclosure Statement

20. Paragraphs 60, 64 and 65 propose prescribing the maximum length of PDSs. If that is done, then:
- (a) the liability provisions in the legislation need to reflect the fact that issuers are required to keep their disclosures to a certain length (see paragraph 19 above); and
 - (b) the liability provisions also need to reflect clearly that issuers are entitled to effect disclosure by reference to other sources, such as a website or the proposed register of securities.
21. Paragraphs 72 to 90. The Association does not favour any proposal to quantify risk by reference to some scale.

Sophisticated Warnings

22. Paragraph 114. The Association does not support the concept of a “sophistication warning” applied by the Authority. A fundamental concept of the securities legislation as it stands, and the legislation proposed by the paper, is that the regulator does not attempt to make merit judgments in respect of investments. That is exactly what a warning of the nature referred to in paragraphs 114 to 116 would constitute.

Continuous disclosure and rights issues

23. Paragraph 118. The Association strongly supports reduced compliance obligations for listed issuer subject to continuous disclosure obligations, as reflected in the simplified disclosure prospectus framework – although we think that regime could be further simplified. We also support reduced compliance requirements for offers to existing security holders through rights issues, share purchase plans and offers.

Principles based disclosure

24. Paragraphs 136 to 177. An additional disclosure obligation in the nature of “all material matters” should be retained. It is not possible to devise a list of specific questions which cover all issues which might be materially relevant to a potential investor. Under the present regime, most genuinely significant disclosures in prospectuses and investment statements are not made in response to the specific questions in the schedules to the securities regulations.

Materiality

25. The Association supports in principle the proposal in paragraph 182 of the paper.

Disclosure and liability

26. Paragraph 192. The provisions of the Securities Act which render an allotment void or voidable, and render the directors jointly and severally liable to repay the subscriptions, are draconian and arbitrary in their effect. There is a real question whether there is a need for an express provision in the legislation rendering allotments void or voidable in certain circumstances. It may be that the risk of civil and criminal liability is a sufficient deterrent to actions in breach of the legislation. Generally, civil remedies or criminal penalties decided by a court are tailored to the nature and consequences of the breach of legislation involved. However to avoid allotments and require repayment is an arbitrary remedy which may be completely out of proportion to the nature of the breach.

Promoters

27. Paragraphs 193 to 197. The concept of “promoter” in the Securities Act causes constant difficulty. A question to consider is why it is necessary to have the concept of “promoter” in the legislation at all. The issuer and its directors are liable for the offer documents, and the directors must all be individuals. What is the policy reason for having some other party which is liable, only in some offers, but not in others?

Experts

28. Paragraph 199. Of the requirements listed in paragraph 199 for references to experts in advertisements, only the second (statement of qualifications) should cause any difficulty. It seems appropriate that the expert should approve the wording of the expert’s statement in the advertisement, and that the advertisement should disclose specifically if the expert has a relationship with the issuer.
29. Paragraphs 204 to 215. We agree that the restrictions on pre-prospectus advertising should be abolished. We suggest that the liability of issuers and their directors for the contents of advertisements relating to securities offerings, and the rules which govern advertisements (other than those which rely on the existence of a prospectus or other offering document) should be the same for advertisements published before the prospectus is issued (or its equivalent under the new legislation) as apply to advertisements published after that time.

General redrafting

30. Paragraphs 221 to 224. The Association agrees that a “principle based” approach to the regulation of advertising is appropriate. The present specific restrictions on advertising in the securities regulations are largely irrelevant.
31. The proposal in paragraph 228 seems to be that the securities legislation should apply to false or misleading statements in communications not made to the public. That is in the Association’s view wrong in principle. The securities legislation should apply only to dealings with the public. There are adequate remedies already to deal with misrepresentation in non-public communications (at common law, and in legislation such as the Fair Trading Act and the Crimes Act).

CHAPTER 5 – OTHER MATTERS

Treating customers fairly

32. Paragraphs 8 to 13. The Association does not favour the introduction of a provision that those providing financial services must treat investors “fairly”. That is a vague and uncertain concept. An important principle of securities law should be that it provides clear rules.

Access to securities registers

33. Paragraphs 26 to 35. The Association favours a rule which would prohibit access to securities registers for improper purposes (i.e. purposes not relating to communications proposed to be made to security holders in their capacity as such). It might even be appropriate to require a person seeking to access a register to provide evidence of their purposes, with potential liability for misleading statements in this regard. Care must be taken in designing the rules, however, so as to prevent denials of access which might be desirable (e.g. for the purpose of making a genuine takeover offer, or security holders communicating with each other regarding their investment).

34. The Association would also favour a power for the FMA to make regulations requiring clear disclosure of how the price offer relates to any market price or estimate of fair value, and reasonable time for investor consideration of unsolicited security offers - along the lines set out in Part 7.9, Division 5A of the Corporations Act 2001.

Guidance and certainty

35. In terms of the issues raised in this section:
- (a) The Association favours a retrospective exemption making power. It is difficult to see the difference in principle between an exemption granted before an act, and an exemption granted after that act, particularly to remedy minor technical matters.
 - (b) The Association also supports an express power to issue “no action” letters, and guidance.

Validity of settlements

36. Paragraphs 78 to 81. The Association does not support a change in the law. Such a change would, as the paper indicates, discourage settlements. The power to initiate criminal proceedings of course survives any settlement.

Directors’ duties

37. Paragraphs 107 to 126. The Association sees no reason for establishing a system whereby the State is entitled to enforce directors’ duties. A company represents a commercial arrangement amongst its shareholders and directors, which the State has no direct interest in. There is, so far as we know, no evidence of any problem which public enforcement would correct. As the paper notes, there are already provisions in the Companies Act for derivative actions. Those provisions are aimed expressly at giving shareholders a realistic way to enforce directors’ duties. Note that the court may order that the costs of a derivative action be borne by the company itself (section 166 of the Companies Act). This is not dealt with in paragraph 122(a) of the paper.
38. Also, it is not clear why directors’ duties should be picked out of the various provisions of the Companies Act as provisions which are able to be enforced by a regulator. If public enforcement is to apply to directors’ duties, why should it not also apply to (for example) minority oppression actions under section 174, or actions to avoid contracts under section 141?
39. Paragraphs 127 to 135. The Association has no difficulty in principle with the concept of making “dishonest or reckless conduct” in the context of directors’ duties a criminal offence. Dishonesty is within the proper domain of the criminal law. However, an obvious question is whether the offences which already exist in the Crimes Act and the Companies Act are sufficient to deal with this.

The Association believes that the paper underestimates the damage done to individuals by a criminal prosecution, whatever the eventual outcome may be. A criminal prosecution in corporate matters always attracts huge publicity, usually takes at least a year to resolve, and costs a very significant amount in legal fees. It is relatively easy for a regulator to initiate a criminal prosecution. However, a person who is acquitted in criminal proceedings has no effective remedy for the cost, strain and damage to reputation involved. Great care should be taken in introducing new criminal offences in the corporate and securities area. The result is likely to be to further discourage competent and sensible people from acting as company directors.

Further information

40. The Association would be pleased to discuss any of the points raised in our submissions.

Yours faithfully

Linda Cox

Chair