Regulatory Impact Statement - Proposed Unsolicited Offer Regulations under the Securities Markets Act 1988

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by the Ministry of Economic Development.

Cabinet has already agreed [CAB Min (11) 10/1] that a person making an unsolicited offer to buy securities will be required to provide prospective sellers with an offer document specifying, amongst other things a fair estimate of the value of the securities that are the subject of the offer and an explanation of how the estimate was arrived at, and a cooling-off period.

During the passage of the Financial Markets Authority Bill, the Select Committee made several recommendations for changes to the Securities Markets Act 1988 (the SMA) to address perceived issues with low ball unsolicited offers. These recommendations are now found in s48DA to 48DC of the SMA and include definitions of scope, a regulation making power, the purposes of regulations and also set out are specific provisions that may be included.

The proposals in this paper therefore are about options to give effect to these decisions, specifically the appropriate content and detail of regulations. Securities law in New Zealand aims to facilitate the development of capital markets by encouraging participation by confident and informed investors, and assisting businesses in accessing capital.

Unsolicited offers are not prohibited and it is not desirable to prevent the transfer of capital within financial markets through the making of such offers.

A higher level of prescription will reduce uncertainty and will not impair private property rights, market competition, or the incentives on businesses to innovate and invest, or override fundamental common law principles.

The policy options have been developed with the regulator, the Financial Markets Authority. The Ministry of Economic Development considers the policy aligns with the commitments in the *Government Statement on Regulation*.

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Status Quo and Problem Definition

Securities law in New Zealand aims to facilitate the development of capital markets by encouraging participation of confident and informed investors, and assisting businesses in accessing capital. Offers to purchase securities are a mechanism to enable the transfer of capital within financial markets. Trades are usually arranged through stockbrokers and a brokerage fee will be charged. However, there is also a range of offers that can be 'unsolicited'

An 'unsolicited offer' is essentially where holders of securities are approached by a potential buyer with an offer they have not requested or invited or consented to receiving. Offers can be received by direct mail or circular, could be an invitation to express an interest and could be by electronic or other means.

There is a range of offers that can be 'unsolicited', such as an acquisition or redemption by a company of its shares under the Companies Act 1993 or offers for securities under the Takeovers Code. In these cases there are explicit statutory or regulatory requirements (both for form and process) and often with supervision an appropriate body.

This paper concerns the regulation of those unsolicited offers that are not made on a registered market and where requirements regarding form and content are largely outside current legislation. These offers are also called 'predatory', 'low ball' or 'unfair' and are characterised by:

- Low information disclosure (including what the market price of the security is at the time of the offer[1]);
- A sense of urgency to the offer; and
- Payment terms and conditions different to normal business practice.

The lack of clarity about what exactly a low ball unsolicited offer is and is not and what the rules are surrounding these offers results in behaviours from offerors that undermines the confident and informed participation of investors and consumers in financial markets. Offers may be intentionally designed to prevent well-informed decision-making especially by targeting those with low financial literacy skills. This behaviour ultimately impedes access to capital by business and individuals.

At present the regulator, the Financial Markets Authority (the FMA), is only able to act reactively to low ball unsolicited offers. Under the Financial Markets Authority Act 2011, the FMA is able to issue warning notices to investors about specific, already identified unsolicited offers. It has issued seven of these so far in 2011. The notices are intended to provide the information considered to be missing from the offer to enable security holders to make an informed decision about whether or not to sell their shares.

The FMA can also order disclosure of such warnings in general, in subsequent unsolicited offer documents and on websites. The FMA has issued two of these in 2011. Non-compliance with a disclosure order is an offence under s51 of the Financial Markets Authority Act 2011.

However, it is considered that the current non-regulatory interventions, will not sufficiently address the problems associated with low ball unsolicited offers.

[1] However, it is not, and not proposed to be, an offence to offer to buy securities for below their market value.

Cabinet has already agreed [CAB Min (11) 10/1] that a person making an unsolicited offer to buy securities will be required to provide prospective sellers with an offer document specifying, amongst other things, a fair estimate of the value of the securities that are the subject of the offer and an explanation of how the estimate was arrived at, and a 'cooling-off' period.

During the passage of the Financial Markets Authority Bill, the Select Committee made several recommendations for changes to the Securities Markets Act 1988 (the SMA) to address perceived issues with low ball unsolicited offers. These recommendations are now found in s48DA to 48DC of the SMA and include definitions of scope, a regulation making power, the purposes of regulations and specific provisions that may be included in regulations. In addition, the FMA will be able to issue unsolicited offer orders under s42EA of the SMA once obligations are in force. Non-compliance with an unsolicited offer order is an offence under s42J of the SMA.

The proposals in this paper therefore are about options to give effect to these decisions, specifically the appropriate content and detail of regulations.

Objectives

The objective is to give effect to the previous Cabinet decisions and other measures as already reflected in the SMA to regulate unsolicited offers. It is desirable that regulations provide:

- Clarity of scope;
- Sufficient information to enable security holders to make informed decisions;
- Clarity of process;
- Enforceable rights and remedies.

Options Analysis

Options revolve around regulations being more or less prescriptive. Less prescriptive regulations would outline general principles that would govern the creation and promotion of unsolicited offers and the behaviour expected of those who offer them. More prescription would set out what the rules actually are.

Scope of unsolicited offer regulations

The SMA already sets out types of offers that are and are not defined as 'unsolicited' for the purposes of the regulations and the FMA also has exemption powers. In order for clarity and to allow a proactive response by the FMA, it is proposed to refine this scope as envisaged by s48DC(a) of the SMA. This will set out further classes that will be caught by the regulations and those that will not.

Offers that will be caught

1. Offers designed to avoid the regulations. Therefore, the regulations will include explicit offers but also invitations to treat in any form whatsoever (electronic, on websites, in printed media or by circular or targeted mail).
2. The rules relating to unsolicited offers will also apply to an associated person of an offeror (as defined in s49(7)(b) of the Financial Markets Authority Act 2011).

Offers that will not be caught

1. The regulations will not apply to a scheme or arrangement made under the Companies Act 1993. Rules around schemes and arrangements are already under set out in the Companies Act and are often supervised by the Courts.
2. The regulations will also not apply to unsolicited offers when they are made to:
    - Public issuers (s2 Securities Act 1988) or issuers (s2(1) SMA);
    - Relatives or close business associates of the offeror;
    - Persons who, in the course of and for the purposes of their business, habitually invest money (s3(2)(a)(ii) Securities Act 1988).

    This is to recognise that the regulations are intended to assist security holders who are not familiar with either the offeror or the transactions and implications involved in the trading of securities. The security holders mentioned above are assumed to be able to make informed decisions.

3. The regulations will not apply to counter-offers made by the security holder on different terms. A security holder who makes a counter-offer is someone who has a clear desire to sell to the offeror and is sufficiently informed to not require the protection of regulations.

It is also proposed to clarify the meaning of 'unsolicited' as provided for under s48DA(2)(c) of the SMA. The key concept is that there has been no consent to receive the offer. This is similar to the way the term 'unsolicited' is used by legislation such as the Unsolicited Electronic Messages Act 2007.

Form and Content

Currently, there is no prescription to the quality and content of information to be provided in or with unsolicited offer documents to assist a security holder to make an informed decision. It is up to the offeror about what information will be shared with security holders.

When the FMA issues warnings it sets out, for the security holder, a variety of information not otherwise disclosed by the offeror. In addition, when the FMA orders disclosure of warnings it also requires the offeror to print them on one A4 page, on white paper and black font no smaller than the font contained in the warning and in the same layout as used in the warning.

Offerors may feel obliged to compile and disclose the additional information as expected by the FMA as in most cases the offeror should already either have, or is able to easily source, the information. However, this information cannot be required in general and only applies to specific offers if the FMA was to make a disclosure order. In fact, many offers have failed to meet FMA expectations. In a recent set of offers, the consideration of the acquisition of the shares largely amounted to (but not in a clear way) an unsecured loan to an entity about which no information was given. The FMA took immediate legal action against these offers but not before many security holders had accepted the offer.

A possible option is to provide a general principle based disclosure requirement, for example, that 'sufficient information to enable an informed decision by a prudent investor is made available to them'. However, it is clear from past offers that merely expecting offerors to comply with general principles is not always appropriate or reliable. The way some of these offers are set out have been described by the High Court as providing 'bait' to catch security holders that may not understand the implications for them.

A higher level of prescription is therefore proposed to increase transparency of the offer by requiring that security holders are provided with what is considered to be the minimum information to enable an informed decision i.e. information that is material to decision-making[2], at the beginning of any unsolicited offer document (and in a clear, concise and effective manner).

Any relevant warnings required by the FMA or the Courts to be disclosed must also be included in unsolicited offer documents.

The regulations will also clarify the information that security holders need to assess the effects of deferred payment offers including an explanation that money loses value over time and a comparison of the total present value of the instalments and the total current value of the security.

Process Requirements

There are currently no requirements around process and how an offer should be managed. The SMA sets out that the objective of regulations is to "prevent unfair practices". As a general principle of process, this is open to interpretation by each offeror.

The FMA can advise on what it thinks is a good process but this is not enforceable. There are a number of factors where some guidance on process would be useful such as variation and correction and withdrawal of offers which are standard procedural requirements for unsolicited offers in other contexts e.g. takeovers.

It is proposed to prescribe various process requirements to align these offers with the general policy direction for securities law by promoting fairness and transparency and providing protection for market participants by regulating conduct and governance. The process requirements will be set out as obligations in the regulations so that they are enforceable by the FMA.

Offer Period

The regulations will provide that offers must remain open for a minimum of 30 days from the date of the offer. This is to provide certainty for both offerors and security holders and to preclude any suggestion of urgency for the security holder i.e. that a decision needs to be made within the next few days otherwise the offer closes and the opportunity is lost. Thirty days is considered to be a sufficient time for security holders to adequately consider an offer, especially when sufficient information is provided at the time of the offer to enable an informed decision.

It is not considered necessary to prescribe a maximum offer period as envisaged by s48DB(2)(d) of the SMA. This gives offerors flexibility and it is likely they will not want or need a long offer period due to potential price fluctuations and wanting to finalise the transactions.

[2] This includes the name and address of offeror; date of offer; the price of a listed security or, for a non-listed security, a fair estimate of the value of the security and the basis for making that estimate; information for security holder about how to work out/find out current price of securities; the price at which the offeror wishes to purchase; terms of payment (including information on instalments); a recommendation to get independent financial/legal advice; the terms of acceptance (including the right of return); an explanation of rights and remedies (including the ability to cancel); information on how to find a stockbroker and, if a financial service provider, information on access to the relevant Dispute Resolution Scheme; the expiry date of the offer (if any).

Variation

No variation or correction of an unsolicited offer document will be permitted but the document can be withdrawn and a new offer made (with same rules applying as for the first offer). The form of withdrawal will be set out in the regulations. Offers accepted prior to notice of withdrawal will stand unless the right of return or cancellation is exercised by the security holder.

Several options were considered that might be more flexible for the offeror such as no variation except to update the market prices (as is the case under the Australian legislation) or that some or all details could be varied by supplementary offer(s). The Australian regime requires offerors to notify security holders of a change in market price of plus or minus 50%. However, the offer price is not permitted to change. While it is recognised that price is the key component of any offer and is of most interest to security holders, it is considered that upfront information on how to find the current market price or how to work out the fair estimate would obviate the need for such a mechanism.

Allowing some or all details to be varied creates monitoring and enforcement difficulties for the FMA. A mechanism would need to be established to determine that a variation for significant or material details (which would then need defining) was acceptable and that contracts with security holders could then be legitimately voided.

On balance, it is proposed that the first option, no variation, also provides greater certainty for security holders as variation or multiple variations could be potentially confusing e.g. for complex matters such as instalment amounts, for those the regulations are intended to protect.

Right of Return

Another of the purposes of regulations is to ensure that no agreement to transfer may bind security holders for a minimum period for the purpose of enabling security holders to consider, and reconsider, any decision to accept an offer. Section 48DC(b) allows for the prescription of requirements in relation to unsolicited offers and the making of those offers.

This purpose of the ‘cooling-off’ period is to allow security holders to consider the offer and be able to consult a financial or other advisor if they so wish and thus mitigate the sense of urgency generated by some offers of very short offer periods.

Drawing on the consumer protection regime, it is proposed that the security holder or their agent will have an unconditional right to have the security returned by giving written notice within 10 working days of the date of acceptance and paying back any money or advance received within another 10 working days of the date notice was given. The offeror must promptly return the security documents.

Written notice may be expressed in any way that shows the intention to withdraw from the agreement. On the exercise of the security holder’s right, the contract is terminated without penalty to the seller.

Notification

The offeror will also be required to send a copy of the unsolicited offer documentation to the issuer or public issuer for their information and action if desired and as envisaged by s48DB(2)(b) of the SMA. This will aid with monitoring of the market. The FMA is confident that any offers that may not meet unsolicited offer obligations will be forwarded to them by the issuer or public issuer and have not sought inclusion in any notification procedure.

The regulations will not be able to be contracted out of (s48DC(h)(ii)).

Rights and Remedies

While the FMA can seek redress in a reactive manner only, there are also no rights or remedies for security holders specific to low ball unsolicited offers that will address a situation of loss for them where the current rules are not met.

Obligations centre on the information and process requirements already set out and it will be an obligation for an offeror to:

- include the information required by the regulations in any unsolicited offer documents, in the manner prescribed by the regulations;
- notify the issuer or public issuer of their intention to make an unsolicited offer, either when the securities register is requested, or at least three working days prior to the offer being made;
- register the transfer of the security within the time frame set down in the agreement, or if the agreement does not provide a specific time frame for the transfer to be completed, within 20 working days of the receipt of the signed agreement;
- pay for the security within the time frame set down in the agreement, or if the agreement does not provide a specific time frame for payment, within 10 working days of the receipt of notification of the transfer;
- transfer the security back to the seller, if the seller has indicated that they wish to cancel the agreement during the cooling off period or where obligations have not been met and the security holder has given notice of a refusal to complete the transfer.

In addition, it is proposed that it become an obligation to ensure that unsolicited offer documents are not confusing, misleading or deceptive or likely to confuse, mislead or deceive. This allows the FMA to also take immediate action by order under the SMA as well as by way of the Courts.

If the obligations are not met, the security holder can refuse to complete a transfer and seek return of the security by giving written notice within 30 working days of the date of acceptance and paying back any money or advance received within another 10 working days of the date notice was given.

Written notice may be expressed in any way that shows the intention to withdraw from the agreement. On the exercise of the security holder's right, the contract is terminated without penalty to the seller.

Public issuers, issuers or their agents in connection with transfers under an unsolicited offer and persons administering a register of securities are persons protected from liability in connection with unsolicited offer obligations under s47AA of the SMA (not liable for any act done or omitted to be done by that person in good faith subject to certain conditions).

The rules around unsolicited offers will be set out as obligations in the regulations so that they are also enforceable by the current powers of the FMA. Once regulations are in place, the FMA also has the power to issue unsolicited offer orders under the SMA where a person has breached a rule relating to unsolicited offers. A person who contravenes an unsolicited order made by the FMA commits an offence and is liable on summary conviction to a fine not exceeding $300,000.

Summary

	Objective			
	Clarity of Scope	Sufficient Information	Clarity of process	Enforceable rights and remedies
Regulation	Proactive definition, will be certain and enforceable.	Yes	Yes	Yes

Costs and benefits

The Regulator

In the past two years there has been an increase in the numbers of unsolicited offers and more complexity surrounding their design. Over the last six months, the FMA has become aware of 44 requests from four parties to access share registers. The FMA considers that these requests may be driven by an intention to make low ball unsolicited offers and use of the warning power has already been made in relation to two of these companies. All offerors that have been given warnings by the FMA are Australian based or have Australian connections. Given the tightening of rules in Australia[3], the FMA believe there is a real risk of regulatory arbitrage unless similar action is taken in New Zealand.

The current arrangements limit the FMA to a reactive response. The FMA expects the level of unsolicited offers to remain steady, requiring continued resources from it to monitor the market. Each offer will have a substantively different approach depending on the expertise and intent of the offeror. The FMA must decide if it considers the offer to be unfair (against internally derived criteria) and devote the resources it assesses as necessary in the circumstances.

There are also opportunity costs of committing resources to this area instead of spending time on other work and projects.

WITHHELD UNDER s9(ba) of the Official Information Act 1982

In addition, the FMA must recourse to the Courts for functions it would otherwise be able to exercise on its own volition e.g. preventing the transfer of securities.

The status quo does not provide clear parameters for the FMA to follow when assessing unsolicited offers and taking action. Consequently, the rules are unclear for offerors when making such offers (such that behaviour considered to be unfair is often inspired). Security holders are also unclear on what the rules are.

[3] Division 5A Corporations Act 2001 http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/ and rules around the use of share registers for "improper purposes". The regime includes definitions of scope, sets out how offers are to be made, prohibits invitations to sell, sets out duration and allows for withdrawal of offers in a stated manner, specifies that terms of an offer cannot be varied, prescribes the contents of an offer document, provides an obligation to update that market value, sets out rights and prescribes information on instalment payments.

Due to the increased publicity about unsolicited offers, two new offerors have pro-actively consulted the FMA about offers that would meet FMA expectations. While this is positive, it still requires hands on guidance from the FMA on a case by case basis. The Act envisages the promulgation of regulations to clarify the arrangements and enable the FMA to take a proactive approach, which would be a more efficient use of limited resources.

There are no additional costs to the regulator of a regulatory regime. The current powers of the FMA will remain and the additional powers under the unsolicited offer orders will be available. It is likely the current resource of the FMA devoted to monitoring the market for unsolicited offers will decline and revert to an enforcement role only.

Third party companies

Companies whose shares have been targeted by these offers report increased legal costs to monitor the offers and increased transactions costs with concerned shareholders. Many of these companies also choose to issue their own cautions to shareholders, advising them to seek independent financial advice and may still choose to do so on a case by case basis even once regulations are in force.

Shareholders

During March 2011, a Mr Bernard Whimp made unsolicited offers to over 100,000 shareholders in six major companies listed on the NZX. Despite media coverage and direct communications by company directors, more than 1100 shareholders holding almost $7.2 million worth of shares accepted the series of offers. The offer was significantly less than the market price over the ten year deferred payment period. Unsophisticated investors report they did not understand the documents provided. Affidavits demonstrate that investors felt "duped" and did not understand the value of their shares or the conditions of the offer well enough to appreciate they would be foregoing money on the deal.

Media reports suggest that Bernard Whimp, through his various associated limited partnerships, appears to have made about $2 million profit from buying securities over this time at less than the market value (representing a $2 million loss for those investors).

Some security holders may benefit from the status quo if they are unconcerned about the price received and wish to take advantage of the ease of relinquishing their securities without having to locate a stockbroker and pay brokerage fees. Security holders will incur no additional costs of regulation.

Offerors

The status quo allows offerors discretion on how they structure unsolicited offers. The only prescription is that they must not be misleading or deceptive and, as a matter of course, must follow applicable contract law in order to enforce acceptances of the offer.

Regulation will clarify the scope, information requirements, process and obligations for offerors but will also impose some costs. Offerors will now have a prescriptive format of offer imposed on them with a set of information that they will have to compile and disclose to security holders. However, the information necessary to comply with the requirements will either be held by the offeror or easily compiled and formatted to the required specification.

Offerors will already have existing administrative processes to provide for the issue of and cancellations and/or amendments of their own offers. These processes may need to be modified to enable right of returns. However, it is unlikely, for example, that a date of acceptance of an offer would not already be recorded in these systems or that the ability to deal with security holders on a one to one basis was not already enabled. For example, in many current offers, security holders that do not fill in the forms correctly need to be personally contacted and forms sent back etc. Therefore, it is expected additional costs of regulation will either not be incurred or be negligible. It is also expected that once information requirements are in force and being disclosed by offerors, there should be little call on the right of return.

A higher level of prescription might be argued to stifle innovation of and within offers by forcing a more standardised format. However, there is still scope to vary many aspects of offers, such as terms of payment, length of offer and terms of acceptance. The regulations merely require that the design is disclosed. Further innovation beyond this could be construed as attempting to undermine the regulatory intent in exactly the manner the regulations seek to discourage.

It is expected that the qualitative benefits will greatly outweigh any costs described above and leave a market regulated, in more or less to the same degree as other unsolicited offers, to operate without further scrutiny or impediment.

Conclusions and Recommendations

Taking into account the problems associated with low ball unsolicited offers, the size of the market and the cost of regulation, we recommend the more prescriptive approach as detailed. The emphasis on clearly setting out information disclosure requirements in particular will have the biggest long term beneficial impact on the quality of low ball unsolicited offers.

Consultation

The issue of low ball unsolicited offers was considered in the Review of Securities Law Discussion Paper released in June 2010 and 27 submissions were received in response to the questions asked.

Several submitters thought there would be some benefit in limiting access to share registers for purposes that were “improper” (as recently introduced by Australia) and which would include the use of the registers to make low ball unsolicited offers.

However, Cabinet only agreed to include a strict liability offence where a person uses information about a person obtained from a register to contact or send material to the person, for example advertising material, or where they disclose the information knowing it is likely to be used for that purpose, except where the use or disclosure is relevant to the holding of interests or exercising rights or where it has been approved by the issuer. In relation specifically to unsolicited offers, the Cabinet agreed to separate measures as described above. Therefore, whether or not access to share registers should also be limited was not considered further.

Submitters also recognised that solicitation of off-market purchases is not necessarily an improper purpose and that a possible solution to low ball unsolicited offers could be to impose minimum standards or content requirements around disclosure when such an offer is made such as traded price and warnings from the regulator about the offer.

Government department/agency consultation

The following agencies have been consulted on the proposals set out in these regulations: The Financial Market Authority, the Treasury, the Reserve Bank and the Ministry of Justice and their views have been reflected. The Department of Prime Minister and Cabinet has been informed.

Implementation

The new obligations will not impact on offers that have been made prior to the passing of the regulations but to all offers made after that date. The usual 28 day Gazettal period would apply.

Monitoring, Evaluation and Review

The FMA will be the regulator, thus the primary monitoring and evaluation agency. The effectiveness of the regulations will be reviewed two years after the regulations are enacted subject to approval by the Minister of the day. The review will evaluate whether any enhancements could be made to address any outstanding or new issues.