Regulatory Impact Statement

FINANCIAL SECTOR REGULATORY AGENCIES

AGENCY DISCLOSURE STATEMENT

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

It provides an analysis of options to establish a more effective, efficient and coherent arrangement of regulatory bodies in the financial sector. It also provides an analysis of the potential options for additional powers that might be provided to financial sector regulatory bodies in order to ensure that they are able to carry out their role effectively.

The analysis here builds on work that has been undertaken, particularly over the past year as part of the process used by the Capital Market Development Taskforce (the Taskforce). A range of papers by industry groups and outside observers have raised similar concerns with current institutional arrangements and have all proposed a similar model. While it is impossible to prove, ex ante, that one regulatory regime will be superior to another, our judgement is that the fact that a range of people approaching the issue from different perspectives have come to similar conclusions provides strong support for change.

We acknowledge that the activities of regulators are conditioned by their resourcing, culture, and powers, as well as the degree of consolidation or fragmentation of powers across different financial sector regulators. The analysis in this regulatory impact statement focuses on those problems arising out of the fragmentation of powers across different financial sector regulators, and the culture of financial sector regulators. It does not intend to directly address problems relating to the resources of regulators or (except to a limited extent) the powers of regulators. Instead these matters will be addressed through further work on the funding of the proposed Financial Markets Authority, and the powers of regulator which will be conducted over the next 18 months.

In terms of the timing of any change, judgement has to be exercised and there are arguments in favour of both rapid and more gradual change. Our judgement is that more rapid change is desirable for two reasons. The first is that financial markets depend heavily on confidence and trust – including in the regulatory agencies. Currently, media commentary and comment by industry participants suggest that there are increasing concerns about the robustness of regulatory agencies. Left unchanged for any significant period of time, our judgement is that this will undermine confidence and participation in financial markets. The second reason is that because the government has announced it is seriously considering consolidation, it is important to move quickly to establish a new regulator in order to ensure that the existing regulators are not undermined while carrying out their current functions. However, we acknowledge that in the time available it has not been possible to provide detailed costing for the preferred option.

Bryan Chapple, Manager, Investment Law, Ministry of Economic Development

[Signature of person] [Date]

STATUS QUO AND PROBLEM DEFINITION

Status Quo

In recent years, developments at both the national and international levels have thrown the spotlight on the role of financial sector regulatory agencies. Internationally, the global financial crisis has raised a series of fundamental issues with the regulation of financial markets and the quality of supervision provided by regulatory agencies. In New Zealand there have been a large number of finance company collapses that have put billions of dollars of investors' money at risk. More recently still there have been concerns raised in the media about the regulation of KiwiSaver.

There are a large number of regulatory agencies in New Zealand with responsibility for financial sector issues. We note that the number of relevant regulatory agencies and their varied and sometimes overlapping roles reflects the long evolution of regulatory arrangements over time. More specifically, it also reflects the large number of new regulatory functions that agencies have been tasked with in the past decade. Some of the most significant of these additional functions include the prudential regulation of non-bank deposit takers, the regulation of financial advisers and the regulation of secondary markets in respect of insider trading and market manipulation rules. Several of these functions, such as the regulation of financial advisers, have not yet come into effect and are still in the process of being implemented.

Securities Commission

Established under the Securities Act 1978, the Securities Commission was initially a report-writing and advisory body that has developed over time into the primary market conduct regulator in the financial sector. The Commission's functions are to:

- Keep under review the law relating to securities;
- Keep under review the practice of securities;
- Co-operation with overseas regulators;
- Review activities on securities markets;
- Advise on changes to the rules of registered exchanges;
- Promote public understanding of law and practice relating to securities; and
- Provide administrative and support services to the Takeovers Panel.

In addition the Commission is responsible for a range of enforcement matters under the Securities Act, which mainly, but not exclusively, relate to disclosure by issuers. The Commission lays criminal charges, and can seek civil remedies (including pecuniary penalties), and management banning orders. It has powers to prohibit misleading advertisements and prospectuses.

Under the Securities Markets Act, the Securities Commission also advises the Minister on the registration of securities exchanges, and the rules proposed by registered exchanges. It has a role in authorising futures exchanges and futures dealers. The Commission is responsible for the enforcement of more serious matters in relation to trading (i.e. serious breaches relating to continuous disclosure, market manipulation, and insider trading).

The Commission grants exemptions from the Securities Act and Securities Markets Act. There are currently over 180 class and individual exemptions that have been granted by the Commission, and these play an essential role in ensuring that the current regime operates effectively.

In recent years the Commission has been tasked with the role of regulating financial advisers, and under the Securities Trustees and Statutory Supervisors Bill currently before Parliament will be responsible for the licensing and oversight of trustees and statutory supervisors.

The Securities Commission has joint responsibility with the Reserve Bank for overseeing clearance and settlement systems.

Reserve Bank of New Zealand

The Reserve Bank carries of the core functions of most central banks in other jurisdictions, including the formulation and implementation of monetary policy, dealing in foreign exchange, issuing currency, and acting as lender of last resort.
In respect of financial sector regulation, it was agreed in 2005 that the Reserve Bank would be the prudential regulator of financial market participants. To this end the Reserve Bank also carries out the prudential regulation of banks, is implementing the prudential regulation of non-bank deposit takers, and under the Insurance (Prudential Supervision) Bill will be tasked with the prudential supervision of insurance companies.

The Reserve Bank has joint responsibility with the Securities Commission for overseeing clearance and settlement systems.

Registrar of Companies

The Registrar of Companies (the Registrar) is a part of the Business Services Branch of MED. Amongst its many other roles, the Registrar is responsible for the registration of various legal forms and the enforcement of various offences under the Securities Act, Companies Act, and other legislation. The Registrar also has powers of inspection in relation to companies and certain other legal forms, and can declare a corporation to be at risk and appoint a statutory manager for insolvent corporations.

The Registrar of Financial Service Providers was established by the Financial Service Providers (Registration and Dispute Resolution) Act 2008. The Registrar will be a part of the Business Services Branch of MED and will be responsible for the registration of all financial service providers, which includes all issuers.

The Registrar has two key roles in respect of current securities law. The first is to register prospectuses, and the second is to conduct enforcement action under the Securities Act when matters are referred to it by the Securities Commission. Prior to registering a prospectus the Registrar will check that prospectus. The Registrar may choose to not register the prospectus if it fails to comply with the Act, and must not register the prospectus if, in his or her opinion, it is false or misleading in a material particular. Unless there is a particularly obvious aspect of the prospectus that is false or misleading, the Registrar will not intensively investigate prospectuses for false or misleading particulars.

NZX

NZX is the country's sole registered exchange under the Securities Markets Act. It operates three separate markets: the Stock Market (NZSX), Alternatives Market (NZAX), and Debt Market (NZDX).

NZX operates under conduct rules that are approved (or in some cases not disallowed) by the Minister of Commerce on the advice of the Securities Commission. NZX rules are contracts between NZX and issuers and NZX and market participants (e.g. share brokers). NZX's rules provide for enforcement by NZX through fines, suspension and other remedies, either by NZX direct or through the New Zealand Markets Disciplinary Tribunal (NZMDT) set up under the rules.

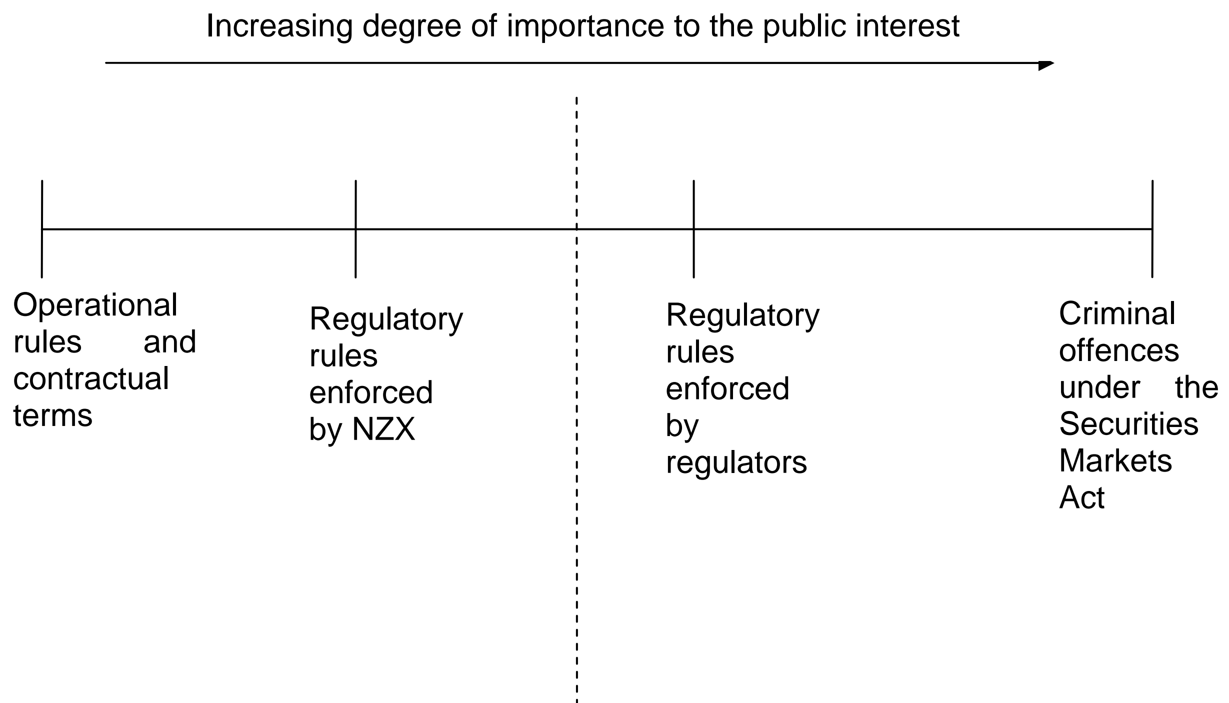
NZX's primary regulatory functions are:

- Supervising advice given by NZX participants;
- Supervising market related practices;
- Supervising NZX participant capital and client funds;
- Authorising and regulating some futures and options dealers;
- Conducting market surveillance and overseeing on-market trading;
- Carrying out market operations in respect to issuers' announcements and securities;
- Granting waivers and issuing rulings;
- Handling listing applications;
- Enforcing NZX rules; and
- Formulating exchange rules.

In addition, the Securities Markets Act provides a statutory overlay for registered markets. Certain behaviour such as insider trading or market manipulation by participants on registered markets is illegal, and NZX detects potential breaches of these laws and refers them to the Securities Commission. The Securities Markets Act also requires that that rules of registered exchanges must provide for continuous disclosure by issuers, non-compliance with which is a breach of the law.

NZX's conduct rules vary greatly in the degree to which they are relevant to the public interest. Rules may be placed on a spectrum from purely operational requirements to serious criminal offences:

Figure: Market rules



As a private service provider, NZX formulates and enforces many of the operational rules and contractual terms that govern its market. Its conduct rules currently include matters such as application procedures, trading and listing fees, discretion about what type of issuers and participants use its exchange, and detailed rules governing order entry and operating hours. As these rules are detailed and specific to NZX's business needs, it is likely to continue to administer these rules under any regulatory regime.

At the other end of the spectrum are Securities Markets Act prohibitions on insider trading and market manipulation, and requirements for directors, officers and substantial security holders to disclose trading activity. NZX conduct rules reproduce these provisions, such that a breach of the law is also a breach of the conduct rules.

Between these two extremes, NZX also enforces a wide range of rules that are significant to the public interest, because they concern investor protection, systemic risk, or impact on the efficiency of other markets, but which are not part of the law. These include listing rules that govern the conduct of boards of directors (e.g. requirements for independent directors, and procedures for electing boards and setting remuneration), rules that ensure new share issues are fair to existing shareholders, and restrictions on related party transactions. In a number of overseas jurisdictions some or all of these rules are part of the law or regulations and are enforced by public regulators.

Insurance and Superannuation Unit

The Insurance and Superannuation Unit (ISU) is a part of the Business Services Branch of MED. The Government Actuary (GA), which is a part of the ISU, is the body that has current responsibility for the regulation of superannuation funds. The Government Actuary's broad regulatory role in respect of superannuation and KiwiSaver schemes is to:

- Register and deregister schemes;
- Oversee the operation of schemes and respond to complaints for superannuation scheme members; and
- Examine trust deed amendments, trustee annual reports, and actuarial valuations.

The ISU is also responsible for certain aspects of the regulation of insurance companies, primarily under the Insurance Companies (Ratings and Inspections) Act 1994. However, responsibility for regulating insurance companies is being transferred to the Reserve Bank under the forthcoming Insurance (Prudential Supervision) Bill.

National Enforcement Unit

The National Enforcement Unit (NEU) is a part of the Business Services Branch of MED. The NEU is responsible for the investigation and enforcement of offences under the following legislation:

- Insolvency Act 2006;
- Companies Act 1993;
- Financial Reporting Act 1993;
- Securities Act 1978 (on referral from the Securities Commission);
- Securities Act (Contributory Mortgage) Regulations 1988;
- Electricity Act 1992;
- Radiocommunications Act 1989;
- Superannuation Schemes Act 1989;
- Motor Vehicle Sales Act 2003; and
- Some offences under the Crimes Act 1961.

The NEU will only take proceedings under the Securities Act 1978 or the Securities (Contributory Mortgage) Regulations 1988 if these proceedings are referred to them by the Securities Commission.

Trustees and statutory supervisors

Certain types of issuers are required to appoint trustees or statutory supervisors who have varying kind of supervisory roles in relation to the different kinds of issuer. Specifically:

- Issuers of debt securities: Debt issuers are required to appoint a trustee, who holds a charge over the security on behalf of investors. The duty of the trustee is to exercise reasonable diligence to ascertain whether or not any breach of the terms of the trust deed or offer of debt securities has occurred, and if so, to do all such things as it is empowered to do to cause any breach to be remedied. The trustee is also required to exercise reasonable diligence to ascertain whether or not the assets of the borrowing group are sufficient, or likely to be sufficient, to discharge the amounts of the debt securities as they fall due;
- Issuers of participatory securities: Issuers of participatory securities are required to appoint a statutory supervisor, who is required to exercise reasonable diligence to ascertain whether or not any breach of the terms of the deed or the offer of participatory securities has occurred, and if so, to do all such things as they are empowered to do to remedy the breach;
- Unit Trusts: Unit Trusts are required to have a trustee that holds the assets of the trust. The trustee must not act on any direction of the manager of the unit trust to dispose of, or acquire, any property on behalf of the trust if the trustee is of the opinion that this is manifestly not in the interests of unit holders;
- Superannuation schemes: Superannuation schemes are required to have a trustee who is the issuer of interests in the scheme and holds the property of the scheme. The trustee is required to manage the scheme, and act in accordance with the relevant duties in the Trustees Act; and
- KiwiSaver schemes: KiwiSaver schemes are structured like superannuation schemes, but are also required to have at least one independent trustee. The independent trustee must, in managing the affairs of the KiwiSaver scheme, exercise the care, diligence, and skill that a prudent person engaged in the profession or business of managing trusts must exercise.

Other regulatory agencies with a role in the financial sector

The Takeovers Panel, Commerce Commission, and Serious Fraud Office also have more limited interests in financial sector issues. The Takeovers Panel regulates the conduct of takeovers and enforces compliance with the Takeovers Code. The Commerce Commission enforces competition law and has a number of general regulatory functions in respect of competition issues. It also enforces breaches of the Fair Trading Act. The Serious Fraud Office investigates and takes proceedings relating to cases of serious fraud, including by directors of issuers.

PROBLEM DEFINITION

The overarching problem is a lack of confidence in financial markets which has been exacerbated by the finance company collapses, the global financial crisis and recent concerns about the quality of regulation of KiwiSaver.

Confidence in financial markets is influenced by a range of factors, including the effectiveness of regulators in supervising financial markets and the enforcement of market rules. In recent times the performance of regulators has been criticised, and in particular, the effectiveness of the regulators in response to recent market events such as the finance company collapses.

The effectiveness of regulatory agencies is conditioned by a number of factors, the most important of which are:

- The degree of fragmentation or consolidation of regulatory powers across the financial sector;
- The culture of regulators;
- The powers of regulators; and
- The resourcing of regulators.

As discussed below, we think that there are a number of problems with the performance of financial sector regulatory agencies. In the discussion that follows, we have grouped these problems into these four categories.

Part 1: Problems associated with the fragmentation of regulatory functions

Lack of proactive enforcement

In recent years there have been increasing concerns about the quality of enforcement in securities markets. Failures of a number of finance companies, and more recently concerns around the KiwiSaver regulatory environment, have highlighted these issues, which were also raised by the Capital Market Development Taskforce in its final report. More broadly, a lack of proactive enforcement, whether actual or perceived, has the potential to seriously damage confidence and participation in financial markets.

We consider that one of the key underlying drivers of a lack of more proactive enforcement is the dispersal of enforcement roles across regulators including the Securities Commission, Registrar of Companies, NZX, and the Government Actuary.

Our judgement is that the dispersal of regulatory roles affects the culture of the different regulatory agencies involved, by encouraging those regulators to read their roles narrowly, and to treat matters that were not squarely within their responsibility as matters that should be considered by other agencies.

Duplication of roles creates extra costs and reduces accountability

Existing regulatory arrangements create a high degree of duplication of functions across different regulatory agencies. Some examples of this are:

- Listed issuers potentially having to deal with the Registrar of Companies, Securities Commission, and NZX when issuing a prospectus; and
- The Securities Commission and Registrar of Companies have responsibility in regard to directors of issuers in certain respects. For example, the Commission is responsible for directors' compliance with disclosure requirements under the Securities Act and the Registrar has responsibility for directors' compliance with the Companies Act.

This creates confusion and extra costs for market participants who must deal with multiple regulators on the same matters. It also makes it difficult to hold individual regulators accountable for their functions. Finally, it creates problems for parties with complaints about financial market participants, because it can be unclear who a compliant should be made to. This problem is a direct result of the fragmentation of regulatory roles and the consequent lack of role clarity and clear boundaries between regulators. Frequently, letters to the Minister of Commerce from members of the public contain a trial of letters to regulators in the author's attempt to find out which regulator has responsibility for precisely which area of market activity.

Potential for issues to fall within the gaps between regulators

Dispersal of regulatory roles across different regulatory agencies runs the risk of issues falling into the gaps between regulators, irrespective of how well those regulators' activities are co-ordinated. As noted in a recent article by the Securities Commission Chair "the result is time consuming, confusing to the public, and often requires duplication".[1]

There is a strong perception in the market that this was part of the reason for the lack of initial response to the finance company failures. As with the duplication of regulatory functions, the potential for issues to fall within the gaps between different regulators has the potential to adversely impact on confidence in the market. Once again, the principle driver of this issue is the degree of fragmentation in regulatory roles in the current system. The lack of role clarity that this results in, and the fact that it does not provide a proper level of system wide oversight, in our judgement encourages regulatory agencies to read their role narrowly and treat matters that are not squarely within their remit as not their responsibility.

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[1] Jane Diplock, *Unify regulatory framework and confidence will grow*, New Zealand Herald, 27 March 2010.

Slow or hesitant reactions to emerging issues

The dispersal of regulatory roles arguably encourages regulatory agencies to be hesitant or slow in reacting to emerging issues, because of the lack of a lack of system wide oversight and a lack of role clarity amongst the different regulatory agencies arising out of this dispersal reduces the responsiveness of regulators in respect of issues that do not come within the direct remit.

The finance company collapses were the most obvious recent example of this trend. There is strong anecdotal evidence that serious problems were known to exist in the finance company sector before the collapses took place. However, notwithstanding this, no regulator took effective action before the collapses occurred.

Slow or hesitant responses to emerging issues have the potential to damage market confidence and lower the overall level of investor participation.

Failure to achieve economies of scale

Existing regulatory arrangements prevent the development of economies of scale in important regulatory functions. The key examples of this are in market supervision and enforcement functions.

Investigative and enforcement expertise is dispersed across the Ministry of Economic Development, the Securities Commission, NZX, and several other agencies. This is a particularly acute issue in that the pool of investigative expertise is fairly small. This kind of dispersal arguably has the potential to reduce the quality of enforcement provided across the whole financial sector by failing to achieve the benefits of pooling this expertise (i.e. developing a centre of excellence, and removing current impediments to the sharing of information between regulators).

Supervision of different market participants and sectors is also highly dispersed. For example, the Securities Commission, NZX, the Insurance and Superannuation Unit, the Registrar of Companies, all supervise parts of the market. The lack of economies of scale and scope arguably reduces the overall quality of supervision that can be provided, because it means that no regulator is responsible for supervising all of the activities of particular entities, with the result that the linkages between the activities of an entity in different areas may not be picked up. It also hinders the development of a centre of excellence in supervisory expertise.

The problems caused by a potential loss of economies of scale and scope are more acute in a small jurisdiction like New Zealand where regulatory functions need to be supported by a smaller level of overall expertise than would be the case in larger countries.

Lack of system wide oversight

A related problem is the lack of system wide oversight that results from the current arrangement of regulatory functions. There is currently no regulatory agency tasked with responsibility for overseeing the financial sector (at least at the micro level – the Reserve Bank and Treasury carry out this role in respect of macro economic issues).

As noted earlier this also encourages a tendency to be slow in identifying emerging issues and a tendency to respond to these issues in a tentative way.

Part 2: Problems associated with the culture of regulators

Lack of proactive enforcement

As outlined above, there may been a range of concerns raised in respect of the quality of enforcement provided by regulatory agencies, and in particular, the view that regulators are not proactive or forceful enough in enforcing market rules.

While this problem is partly, in our view, a result of the fragmentation of regulatory functions across the financial sector as a whole, it also arises out of the particular culture of the regulators concerned.

Hesitant or slow responses to emerging issues

We consider that there is also an arguable case that the culture of current regulatory agencies makes them reluctant to intervene in situations where the other agencies may also have jurisdiction, or in cases where there are only suspicions of potential wrongdoing rather than clear evidence (although of course, interventions in cases where there is only a suspicion of wrongdoing need to be handled carefully).

Risk of conflicts of interest in securities markets regulation

It has been noted in the past that there is a potential conflict of interest between NZX acting as a listed company and regulator, and between NZX commercial and regulatory functions. These potential conflicts can include:

- Unwillingness to create or enforce rules against itself and related entities;
- Unwillingness to create and enforce rules against its customers (listed companies and market participants) to maximise fee revenue;
- Creating and enforcing rules that harm competitors; and
- Under-resourcing regulatory activity to reduce costs.

Potential conflicts of interest in regulation tend to undermine confidence in securities markets. Conflicts that are not adequately managed reduce the quality of market regulation carried out by the exchange operator, and can result in losses to investors if rules are inadequate or inadequately enforced.

It can be argued that these conflicts are adequately managed at present. The New Zealand Markets Disciplinary Tribunal (NZMDT) adjudicates breaches of the NZX conduct rules, and is structurally separate from the commercial parts of NZX's business. NZMDT includes a "Special Division" charged with monitoring NZX's compliance with the NZX Listing Rules. NZX operates a comprehensive conflict of interest policy designed to address other conflicts. Furthermore, NZX has shown a strong commitment to effective regulation (a well regulated market is more likely to attract issuers and participants over the long term), no actual conflicts of interest have been identified in the Securities Commission's annual oversight reviews of NZX, and there is limited evidence of direct regulatory failures in this context.

However, there is ongoing media comment about alleged or potential conflicts of interest at NZX, and this may have an effect on market confidence. Internationally, reliance on self-regulation by financial institutions is increasingly being called into question following the Global Financial Crisis. In many cases entities subject to self-regulation appear not only to have severely damaged the companies they dealt with, but also undermined their own long-term success in pursuit of short-term returns.

There remain risks under the current settings that actual conflicts of interest will arise in future, either in NZX or in other securities markets, and that these will result in regulatory failures. This is because:

a Although there is a disallowance process for exchange rules, exchanges have sole responsibility for formulating rules, including those that aim to achieve regulatory outcomes. Conflicts of interest may cause exchanges to ignore emerging issues that require rule changes. Exchanges can also introduce rules that are detrimental to regulatory objectives, but where the evidence that this is the case is not sufficiently compelling to meet the high test for disallowance ("not in the public interest");

b Market surveillance is heavily reliant on an exchange's willingness to devote resources to detecting breaches of its conduct rules and the law. Although the Securities Commission can request information from a registered exchange to carry out its own investigations in regards to laws against activities like insider trading and market manipulation, it does not have continuous access to trading information. Enforcement of the Securities Markets Act is therefore dependent on an exchange referring detected breaches to the regulator. Similarly compliance with exchange conduct rules is monitored by the exchange. In the case of NZX, the NZMDT is reliant on NZX referring breaches of its conduct rules to it; and

c Because an exchange's conduct rules are contractual terms between the exchange and issuers, and the exchange and market participants, there are limited mechanisms to enforce these rules in the event that an exchange is unwilling to do so due to conflicts of interest.

Part 3: Problems associated with specific functions or powers

Auditor regulation

As noted by the Financial Crisis Advisory Group last year, financial reporting is of great importance to investors and other financial market participants in their resource allocation decisions and to regulators and other users. All users need to be confident that general purpose financial reports (GPFR) provide unbiased, transparent and relevant information about the economic performance and position of businesses. Thus, effective financial reporting depends on all of the following:

- High quality financial reporting standards;
- The consistent and faithful application of those standards by preparers;

- Rigorous independent audit to ensure that the standards are being applied; and
- Rigorous independent enforcement of those standards.

There were a number of large corporate collapses in the United States, Europe, Japan and Australia early this century in which the auditors were found to have been negligent or complicit in the production of misleading financial statements. OECD countries have generally responded by questioning the efficacy of self-regulation and replacing it with government regulation or introducing independent oversight.

In New Zealand there are strong indications that the auditors of some failed finance companies lacked the necessary competence to carry out those audits or did not have a sufficient degree of independence. In addition, New Zealand's self-regulatory model is no longer within the range of acceptable auditor regulation systems. New Zealand needs to change in order to obtain the right to practise in Australia and retain the right to practise in other jurisdictions, such as the European Union.

In October 2009 EGI agreed to strengthen auditor regulation in relation to audits that are statutorily required to be carried out by members of the New Zealand Institute of Chartered Accountants (NZICA) and suitably qualified overseas persons. The main elements were as follows:

- To require the New Zealand Institute of Chartered Accountants (NZICA) and any other professional accounting bodies to regulate auditors as a specialist profession;
- To reconstitute the Accounting Standards Review Board as the External Reporting Board (XRB);
- To require the XRB to:
  - Accredit professional accounting bodies;
  - Monitor and report on the adequacy and effectiveness of professional accounting bodies systems and processes for regulating auditors; and
  - Be able, at the request of auditors and auditing firms, to carry out practice reviews where that is needed for the purposes of recognition by overseas regulators (e.g. the European Commission);
- To empower the Securities Commission to commence or take over investigations against auditors and auditing firms if necessary, and be able to take cases to the District Court; and
- To require the Registrar of Companies to establish and maintain a register of licensed auditors.

Subsequent developments suggest that the scope of the regulatory system and the split of functions should be reconsidered. More specifically, problems with the regulatory regime are:

- That the scope of the regime (i.e. covering all statutory audits) is too broad given that only issuers are likely to have a filing obligation, and that as a result, there is less risk associated with the quality of non-issuer audits; and
- That the regulatory functions planned for the XRB may not fit most efficiently with that body if the regime will only cover issuer audits (i.e. the synergies between this narrower role and the functions carried out by other regulators may be greater than the synergies with the XRB's other roles).

Offer document vetting

Currently the Registrar of Companies is responsible for the pre-registration vetting of prospectuses. As noted earlier the Registrar may choose to not register the prospectus if it fails to comply with the Act, and must not register the prospectus if, in his or her opinion, it is false or misleading in a material particular.

There are a number of specific problems with the current process for vetting prospectuses before registration. Specifically:

- The current vetting process focuses to narrowly on financial information;
- The need to vet all prospectuses hinders the ability to take a more risk based approach to document vetting;
- The existing process creates unnecessary delays for low risk issuers, as the level of scrutiny provided is disproportionate to the risks involved; and
- Untrue or misleading statements are often identified after the prospectuses has been registered, but there is no effective way of stopping trading in the security while the regulator investigates (deregistering a prospectuses does not have the effect of stopping all trading in a prospectuses, it merely stop these securities being offered by the issuer).

Scope of securities law

At present certain financial instruments can be structured to come within the scope of statutory exemptions from the Securities Act, notwithstanding the fact that these financial statements may be akin to securities covered by the Act. The most often cited example of this was Bluechip, which was offering instruments that involved interests in land, and hence came within the scope of the Securities Act exemption covering estates or interests in land.

Use of exemption making power

The Securities Commission's exemption making power is used to make both class and individual exemptions. There are currently over 180 exemptions in force, or which a minority are class exemptions.

Class exemptions often amount to substantive law making, in that they can be used to establish special regimes for classes of issuers or offers, rather than providing a simple exemption. It is inconsistent with best practice in the making of legislation for instruments with this substantive effect to be made by a Crown entity rather than through the normal legislation making process.

Accessibility and comparability of offer documents

Currently registered prospectuses are registered on the Companies Office website along with the companies record register of the issuer, or separate registers of unit trusts, participatory securities, and superannuation and KiwiSaver schemes.

At the same time other disclosures, such as investment statements, are not required to be registered.

This creates two problems. Firstly it is difficult to access all of the disclosures produced by an entity, because these may be found in a range of different places. Secondly, it makes it hard to compare offers from different issuers because offers cannot be searched on the Companies Office website because of the way that the registered prospectuses are registered against the Companies register record of the issuer.

Ongoing role for regulators over the lifetime of a security

The Securities Commission's enforcement powers largely relate to initial disclosure when an issuer makes an offer of securities to the public (e.g. the Commission has the power to ban prospectuses and advertisements, and most of the key offences under the Securities Act relate to disclosure obligations in prospectuses and advertisements.

Likewise, the enforcement role of the Registrar of Companies under the Companies Act relates to breaches of certain requirements of the Act, such as complying with particular requirements around the issuing of shares and distributions, liquidations, and procedures around annual general meetings, record keeping and other matters.

In no instance however, do regulators have an enforcement power relating to general conduct by directors, unless that conduct amounts to fraud or breaches the Securities Act Companies Act, or other relevant legislation. As such, regulators will be unable to enforce general conduct obligations on directors, and may often be led to take proceedings for more minor matters such as a failure to keep proper accounting records, when the conduct in question actually raises a more serious set of issues around the behaviour of directors, and may amount to a breach of directors duties (which can only be enforced by the company itself, or shareholders acting on behalf of the company).

Part 4: Problems associated with resourcing

There may potentially be issues with regulatory agencies' level of resourcing. This is an issue that we have not fully analysed, but which we will be considering over the next 12 months.

OBJECTIVES

The primary objective against which the options are assessed below is to improve confidence and participation in financial markets. In respect of the role of the regulator, this means achieving the following objectives:

- Improving the level of market engagement provided by financial sector regulatory agencies;[2]
- Improving the quality of market supervision provided by regulatory agencies; [3]and
- Improving the quality of enforcement by financial sector regulatory agencies.[4]

Underpinning these key objectives are the following design principles:

- Ensure role clarity for regulatory agencies;
- Eliminate duplication in regulatory functions;
- Encourage the development of economies of scale;
- Fill gaps between regulators jurisdictions and ensure a integrated system; and
- Ensure actual and perceived independence in regulatory functions.

REGULATORY IMPACT ANALYSIS

This section of the RIS is divided into three parts. Part 1 considers the appropriate structure of financial sector regulators at a high level. As noted in the "Conclusions and Recommendations" section of the RIS, we consider that the preferred option is option 3, which is a new Financial Markets Authority incorporating existing functions of the Securities Commission, and parts of the Registrar of Companies, NZX and Insurance and Superannuation Unit. We note that it has not been possible to describe all of the potential costs and benefits of the options in Part 1, as this would require an assessment of how the different options might affect all of the different regulatory functions carried out by the agencies concerned. For this reason our analysis in Part 1 has focused on the high level costs and benefits of the general options.

Part 2 considers the options for boundaries between the Authority and the Registrar of Companies, Government Actuary, and NZX, should Cabinet elect to proceed with the establishment of a new Financial Markets Authority.

[2] By market engagement we mean the general responsiveness of the regulator to market developments, and in particular, the regulators' ability to assist firms in complying with the legal framework (for example, the guidance material and related measures designed to provide certainty to market participants).
[3] By market supervision we mean the monitoring and supervision of financial markets and market participants to indentify any issues requiring further action, and in particular, enforcement action.
[4] By enforcement we mean the decision on whether to take enforcement proceedings against a party for a breach of market rules, and the process of taking such proceedings.

Part 3 then considers a set of discrete problems with the current regulatory framework. Part 3 does not propose to address all of the additional functions and powers that regulators may require, as several of these will need further consideration as part of the Securities Act review.

Part 1: Appropriate structure of regulatory agencies

Option 1: Closer co-operation between regulators

This could involve possible co-location of regulators and enhanced memoranda of understanding to ensure that the regulators jointly investigate issues and cases and respond to events in a coordinated manner. This option would not result in any changes to the number of regulators, or to a large extent the roles and responsibilities of regulators.

Benefits

Our judgement is that this option would be the least cost and fastest to implement due to the way that it avoids having to amend legislation and make structural changes to any of the regulators concerned. It would also go some way towards providing greater role clarity between regulators and filling gaps in the regulatory system.

Costs

This option does not address questions around the adequacy of regulators' powers (so additional powers may still be necessary for some or all regulators) and it does not address problems relating to the culture of regulators noted in the "Problem Definition" section of this RIS. More fundamentally, it would not encourage the development of economies of scale in regulatory functions.

Furthermore, while this option would go a limited way towards addressing issues of duplication in regulatory functions and filling gaps in the regulatory framework, this is unlikely to result in a major improvement for consumers and businesses in dealing with regulatory agencies, because there would still be a degree of uncertainty around the roles of different regulators, and the need for investors and firms to deal with multiple regulators on many issues.

Option 2: Merging functions into the existing Securities Commission

This option would involve combining some of the regulatory functions or the Registrar of Companies and NZX into the Securities Commission to establish a consolidated market conduct regulator. The specific functions that would be shifted to the Securities Commission from the Registrar of Companies and Government Actuary are:

- Vetting of offer documents;
- Regulation of superannuation and KiwiSaver schemes; and

- Enforcement of securities law and other business law offences as the relate to financial service providers (e.g. Companies Act offences).

The specific functions of NZX that would be shifted to the Securities Commission would be:

- Operation of the New Zealand Markets Disciplinary Tribunal;
- Enforcement of NZX rules with a public interest component;
- Some real time market surveillance; and
- The regulation of financial advice provided by NZX participants.

This option would be carried out separately from the rest of the Securities Act review, and result in a new reconstituted Securities Commission being established by earlier 2011, while the rest of the Securities Act review would not be completed until late 2011.

Benefits

This option would address many of the identified problems around role clarity for regulators, eliminating regulatory gaps and removing duplication in regulatory roles. In this way it is likely to result in improved outcomes for investors and businesses interacting with financial sector regulatory agencies. It would deal with issues associated with NZX having a perceived conflict of interest. It would also result in a regulatory regime more similar to that in place in Australia with consolidated market conduct and prudential regulators.

This option would also provide greater role clarity for regulators, and certainty for third parties. In turn this should reduce costs of firms by ensuring that there a fewer circumstances in which they would have to deal with multiple regulators. It may also result in a greater level of confidence amongst investors.

It would also remove the need to go through the process of establishing an entirely new entity.

Costs

This option would not address all of the problems associated with the culture of regulators. In particular, the extent to which regulators are prepared to conduct more proactive enforcement, and respond more promptly to emerging issues.

There are also certain risks associated with this option in that it would involve providing the Securities Commission with additional powers and functions at the same time as it would be working to implement the regulation of financial advisers and trustees.

Option 3: Creation of a new market conduct regulator

This option would involve the establishment of a new market conduct regulator responsible for the existing functions of the Securities Commission and Government Actuary, and some of the current regulatory roles of the Registrar of Companies and NZX. The new agency would be entitled the Financial Markets Authority.

The purpose of the Authority would (subject to drafting) be to facilitate the efficient performance of financial markets by:

- Promoting the confident and informed participation of investors and consumers in financial markets; and
- Facilitating capital raising and promoting commercial certainty.

The functions the Authority would (subject to drafting) be to:

- Monitor and enforce compliance by financial service providers with specified laws applying to financial service providers;
- Facilitate financial markets by providing education, guidelines, information and warnings;
- Monitor financial service providers and financial markets activities, and to carry out and make publicly available reviews, studies, and inquiries into any matter relating to them;
- Cooperate and exchange confidential and non-confidential information with other law-enforcement agencies, including overseas regulators;
- Consider and approve rules for registered securities markets; and
- Perform specific functions imposed on it under any Act.

The laws monitored and enforced by the Authority would be:

- Fundraising law (currently the Securities Act);
- Securities markets law (currently the Securities Markets Act);
- Governance Acts specific to financial services including the Unit Trusts Act, Superannuation Schemes Act, KiwiSaver Act;
- Governance, reporting and supervision Acts so far as they apply to financial service providers, particularly the Companies Act, Financial Reporting Act and the Corporations Investigation and Management Act; and
- Occupational regulation of financial service providers, including financial advisers, securities trustees and statutory supervisors.

The Authority would not monitor and enforce compliance of:

- Prudential regulation (Reserve Back of New Zealand Act 1989 and Insurance and Prudential Supervision Act (once enacted));
- Laws enforced by the Commerce Commission (Fair Trading Act 1986, Commerce Act 1986);
- Laws monitored and enforced by the Ministry of Economic Development (company and other governance laws for non-financial service providers, insolvency, personal property securities);
- Registrar and associated functions under any of the relevant Acts;
- Takeovers code compliance;
- Occupational regulation of professions involved in the provision of financial services, including lawyers, accountants, tax agents and real estate agents; and
- Insolvency.

This option would result in the Financial Markets Authority being established by early 2011, while the remainder of the Securities Act Review would be completed by late 2011.

Benefits

This option would largely address all of the problems that have been identified around role clarity for regulators, eliminating regulatory gaps and removing duplication in regulatory roles. In this way it is likely to result in improved outcomes for investors and businesses interacting with financial sector regulatory agencies. It would also deal with issues associated with NZX having a perceived conflict of interest. It would result in a regulatory regime more similar to that in place in Australia with consolidated market conduct and prudential regulators.

However, the key advantage of this option over option 2 is that it sends a clear signal to both the market participants and the regulator that Government is looking for a different approach from the regulator. It also provides the opportunity to address the problems that have been identified in the culture of regulators by establishing an entirely new entity.

Importantly, it also ensures that the Authority is established before changes arising out of the Securities Act review come into effect, thereby ensuring that the regulator is able to respond to the changes arising out of the Securities Act review from the beginning, without the need to work through issues arising out of its own establishment at the same time.

Costs

This option raises some generic risks associated with establishing a new entity (for example, there are risks around the Authority not being adequately resourced or staffed before becoming operational or losing institutional knowledge when transferring staff to the new regulator) It also raises some risks around establishing a new regulator while certain regulatory functions like the regulation of financial advisers is being implemented. It also runs the risk of the functions of the Authority needing to be amended once the rest of the Securities Act review is completed in late 2011.

The existing funding of the Securities Commission, and parts of the relevant Ministry of Economic Development funding under Vote Commerce, would be transferred to the Authority. To the extent necessary, additional funding would be likely to be third party recovered through fees and levies.

Option 4: Single financial sector regulator carrying out prudential and market conduct functions

This option would involve the establishment of a single financial sector regulator with responsibility for prudential and market conduct issues. This would require consolidation of the regulatory roles of the Securities Commission, Companies Office, and NZX, along with the prudential regulatory functions of the Reserve Bank in relation to non-bank deposit takers and insurance companies.

Benefits

The adoption of a single regulator model may appear to better achieve some of the desired objectives, such as the encouraging the development of economies of scale and the reduction of duplication. It would also provide a high level of role clarity and reduce costs for firms and investors by making it clear who they should deal with on particular issues.

Costs

It is not clear that a single regulator would result in improved market engagement, supervision, or enforcement on behalf of the regulator when compared with the establishment of a model based on consolidated prudential and market conduct regulators (options 2 and 3). The Global Financial Crisis suggests little difference in the performance of regulators in countries where the twin peaks or single regulator models have been adopted. There are also problems that can arise from making an organisation to large (i.e. the separate parts of a very large organisation may not work together any better that two separate organisations).

There is also the need to consider what level of synergy there is between the functions of prudential and market conduct regulators. While prudential functions may often link to market conduct issues, there are unlikely to be major problems distinguishing between prudential and market conduct roles.

Part 2: Allocation of functions between Financial Markets Authority, Companies Office and NZX

Allocation of functions between the Registrar of Companies and the Financial Markets Authority

Option 1: Shift securities law functions to the new market conduct regulator

The Registrar carries out relatively few functions that relate directly to securities law, so this option would only involve shifting the vetting of offer documents from the Registrar to the new market conduct regulator. Both the Securities Commission and the Registrar of Companies are able to seek management banning orders from the Court under section 60A of the Securities Act. This option would mean that only the Authority would be able to carry out this role under the new securities legislation in respect of financial service providers.

This option has the benefit of ensuring role clarity for the two regulators. However, it does not achieve potential economies of scale in respect of regulatory functions. It also has the significant disadvantage of multiple regulators having to investigate and prosecute when behaviour raises issues under several different pieces of legislation (e.g. the Securities Act and Companies Act).

Option 2: Shift all regulatory functions relating to financial service providers to the new market conduct regulator

This option would involve the market conduct regulator being responsible for all regulatory functions in respect of financial service providers. This would include the enforcement of financial service providers' obligations under any of the following Acts:

- Companies Act 1993;
- Co-operative Companies Act 1996;
- Friendly Societies and Credit Unions Act 1982;
- Industrial and Provident Societies Act 1908;
- Building Societies Act 1965;
- Incorporated Societies Act 1908;
- Limited Partnerships Act 2008;
- Charitable Trusts Act 1957;
- Unit Trusts Act 1960;
- Retirement Villages Act 2003;
- Personal Property Securities Act 1999;
- Securities Act 1978;
- Securities Markets Act 1988;
- Corporations (Investigations and Management) Act 1989;

- Superannuation Schemes Act 1989;
- KiwiSaver Act 2006;
- Financial Reporting Act 1993;
- Financial Advisers Act 2008; and
- Financial Service Providers (Registration and Disputes Resolution) Act 2008.

In respect of entities that are not financial service providers, the Registrar would continue to carry out its existing regulatory role under these Acts. The Registrar would also continue to maintain registers under all of these Acts irrespective of whether the entities being registered are financial service providers or not.

The advantages of this approach are that it eliminates duplication of regulatory roles in respect of financial service providers and encourages the development of greater economies of scale in respect of financial market supervision and enforcement. This would also provide greater clarity and certainty for investors and firms.

The disadvantage of this approach is that it results in a duplication of regulatory roles between the regulation of financial service providers and the regulation of other entities.

Option 3: Market conduct regulator carries out all regulatory functions and Registrar maintains registers:

This would involve the merger of regulatory functions currently carried out by the Registrar with those to be carried out by the market conduct regulator. Under this model, the Registrar would only continue to carry out registry functions, and the Authority would carry out all regulatory roles.

This option achieves the objectives of removing duplication and achieving economies of scale, but this arrangement would make the Authority into a corporate rather than financial sector regulator, and has the potential to dilute the focus of the Authority on financial sector issues. It also runs the risk of losing the Registrar's existing expertise in dealing with small closely held companies.

Option 4: Registrar merged with market conduct regulator

This would involve the complete merger of the Registrar with the Authority. The remaining functions of BSB would be unaffected.

As with option 3, this option achieves the objectives of removing duplication and achieving economies of scale. It also provides some benefits by providing synergies between regulatory and registration functions. For example, a failure to file financial statements may indicate more significant underlying problems, and having the Registrar within the Authority may mean that this warning sign is picked up at an earlier stage.

Again, like option 3 this option would make the Authority into a corporate rather than financial sector regulator, and has the potential to dilute the focus of the Authority on financial sector issues. It also runs the risk of losing the Registrar's existing expertise in dealing with small closely held companies. Furthermore, the synergies between the regulation and registration functions can be adequately accommodated through information sharing and other arrangements between the Authority and Registrar. For example, the Registrar could pass on to the Authority information about a regular failure to file financial statements by a financial services provider.

Allocation of functions between the Insurance and Superannuation Unit and the Financial Markets Authority

Option 1: Shift all regulatory functions of the Government Actuary to the Financial Markets Authority

This option would involve the following roles of the Government Actuary being shifted to the Authority:

- registering eligible schemes,
- investigating and directing schemes; and
- exercising a limited power to wind up non-complying schemes; and
- acting as the Registrar of KiwiSaver and Superannuation schemes.

Under this option, references in legislation to regulatory powers carried out by the Government Actuary would be replaced with references to the Authority carrying out those functions. The Government Actuary's registry functions under the Superannuation Schemes and KiwiSaver Acts would be transferred to the Registrar of Securities (see the discussion below on the proposed Registrar of Securities).

The Insurance and Superannuation unit currently has a role in relation to the regulation of insurance companies. This role will be superseded by changes contained in the Insurance (Prudential Supervision) Bill which provides the Reserve Bank with the responsibility for the prudential regulation of insurance companies.
Should this Bill not be enacted before the establishment of the Authority, then this option would involve carrying over the existing functions of the Insurance and Superannuation Unit in respect of insurance companies to the Authority on a temporary basis, until the Reserve Bank commences its new role. This option would shift the function to the Authority on a temporary basis because, once the functions of the Government Actuary are shifted to the new Authority there will no longer be any capacity within MED relating to the regulation of insurance companies.

Under this option the Insurance and Superannuation Unit should also be transferred to the Authority. Its work in relation to insurance will eventually be taken over by the Reserve Bank, following the implementation of the new prudential regime for insurance set out in the Insurance (Prudential Supervision) Bill currently before Parliament.

Option 2: Shift all of the regulatory functions of the Government Actuary to the Financial Markets Authority and retain the Government Actuary's actuarial functions in the Companies Office

This option would be the same as option 1 except the actuarial functions of the Government Actuary would remain with the Business Services Branch of MED rather than be shifted to the Authority. However, there are limited connections between the actuarial role and the other functions of the Companies Office, so there is likely to be little additional benefit from this option when compared to option 1.

Allocation of functions between the NZX and the Financial Markets Authority

Option 3: Shift all of the regulatory functions of the Government Actuary to the Financial Markets Authority, retain the Government Actuary's register related roles in the Companies Office, and abolish the Government Actuary's remaining actuarial functions.

This option would be the same as option 1, except that the Government Actuary's role in registering KiwiSaver and superannuation schemes would be shifted to the Registrar of Companies, and the Government Actuary's remaining role in advising on actuarial matters would be abolished, as this advice could be carried out by any suitably qualified actuary.

The benefits of this option are that it is consistent with the registration of other legal forms being carried out by the Registrar of Companies, which encourages the development of economies of scale and allows access to the Registrar's existing expertise in this area.

The abolition of the Government Actuary's remaining actuarial roles has the benefit of avoiding the need to maintain a level of in house actuarial expertise that would be required to carry out this role, and would mean that the function could be carried out more efficiently through the contracting of a suitably qualified actuary where necessary.

The costs of this option are that agencies that formerly relied on actuarial advice from the Government Actuary would have to fund this advice themselves, possibly through contracting it out.

Allocation of regulatory functions between the Financial Markets Authority and NZX

Option 1: Shift the New Zealand Markets Disciplinary Tribunal to the Financial Markets Authority

This option would involve shifting the New Zealand Markets Disciplinary Tribunal to the Authority.

The benefits of this option are that it addresses a part of the concern around NZX having a potential conflict of interest in respect of adjudication of its conduct rules by bringing the NZDMT within the remit of an independent party. However, this benefit is likely to be more perceived than actual in that it has been possible to ensure a high degree of independence for the NZDMT within the current framework.

This option would not address other perceived conflicts of interest in NZX performing rule-making, monitoring, investigation, and enforcement of its conduct rules. It would not resolve other duplication between the Authority and NZX in respect of the enforcement of rules regulating behaviour on the exchange.

Option 2: Provide the Financial Markets Authority with a more involved role in the regulation of NZX

Under this proposal there would be changes to the approval of rules, more public enforcement of rules, and greater public oversight of registered exchanges. The Authority would authorise and monitor securities and derivatives exchanges (such as NZX), approve exchange rules, enforce and grant exemptions for certain market rules, adjudicate market conduct breaches through an independent panel, and regulate financial advice by NZX participants. It would have powers necessary for it to undertake market surveillance; however in the case of NZX it would be expected to leave responsibility for much of this activity to the exchange. The consequences of adopting this option are discussed in more detail below.

1. Rule making

Under this proposal, NZX would continue to have a primary role in formulating its conduct rules, but there would be changes to the way these are approved, and the Securities Markets Act would provide for regulations to replace conduct rules where government policy has particular aims and the Authority was judged to be a more effective regulator.

Currently, exchange rules automatically come into force unless they are disallowed by the Minister of Commerce. The Minister may disallow a rule if he or she is satisfied that the rule is not in the public interest. This is a very high test.

This proposal would modify the procedure for rule approval, so that a rule must be approved by the Authority. The Authority will also be able to request that NZX propose a rule on a specific matter.

The powers under the Securities Markets Act to make regulations governing continuous disclosure provisions would be extended to regulation-making powers for other conduct rules, and be able to be used in a wider range of circumstances. Any such regulations would replace or be deemed to be included in the conduct rules of the exchange.

2. Enforcement

The Authority would be responsible for enforcing market conduct breaches under the Securities Markets Act and regulations. NZX would retain its role enforcing breaches of its rules, and continue to be responsible for referring matters to the Authority where the Authority has enforcement powers.

NZX would be expected to retain its current role in conducting front-line market surveillance, but the Authority would be given powers to undertake its own surveillance if desired, such as where this is required by the entry of new exchanges or alternative trading systems, or if it is not satisfied with an exchange's own surveillance.

The Special Division of the NZMDT is currently responsible for enforcing NZX's compliance with the NZX listing rules, due to the conflict of interest in NZX being both a listed issuer and the supervisor of listed issuers. This function would shift to the Authority.

3. Adjudication of conduct rules

The NZMDT would remain independent, but would be reformed as a statutory Rulings Panel serviced by the Authority.

The Rulings Panel would initially have jurisdiction over significant breaches of NZX's conduct rules, and any regulations that replace those rules.

Minor breaches of the NZX conduct rules would continue to be dealt with expeditiously by NZX. The matters that may be dealt with by NZX would continue to be specified in its conduct rules.

4. Approval of issuers and market participants

The NZX would continue to approve issuers and market participants on its exchange. The Authority would have responsibility for ensuring that issuers' offer documentation complies with the law, while NZX would review documentation for compliance with listing rules.

5. Regulation of financial advice by NZX market participants

Regulation of financial advice given by market participants would largely shift from NZX to the Authority. The NZX currently has a set of participant rules for financial advice that includes competency requirements, fit and proper person tests, conduct and ethical standards, anti-money laundering measures, and administration by NZX (registration and fees for accredited NZX Advisers). The Authority would become the regulator of financial advisers under the Financial Advisers Act, including those NZX participants who provide advice. The role of NZX in accrediting advisers and its current adviser rules are likely be scaled back, however NZX would be free to create its own brand for NZX-accredited advisers if it wished to impose and monitor special requirements for some advisers.

6. Oversight role

The Authority would have a formal oversight role over NZX. At present the Securities Commission's annual Oversight Review is not a requirement of the Securities Markets Act, and the Commission has limited powers to obtain information from NZX. Both the Commission and NZX have called for more clarity about how the Commission should monitor NZX.

The Authority would be required to produce an annual oversight review of registered exchanges. To perform this role, the Authority would also be given powers to inspect documents that could reasonably be related to their oversight review, and exchanges would be required to make staff available for interviews.

7. Costs and benefits

This option has the benefits of providing for greater economies of scale in the enforcement of key rules relating to the operation of the exchange, although there remains some significant duplication with NZX in that the exchange will also be responsible for the enforcement of market rules where there is no overriding public interest in having public enforcement.

More broadly, it also deals with a significant range of the concerns relating to NZX having a potential conflict of interest by providing the Authority with a clearer and more intensive role in the regulation of registered exchanges. This option does not deal directly with certain areas where a potential conflict of interest may remain (for example, in relation to the enforcement of exchange rules and the handling of issuers' announcements). However, these risks are mitigated by:

- The Authority having the role of approving exchange rules and having the power to request changes to the rules;
- The government having a regulation making power that could, if appropriate, be used to override the rules; and
- The Authority having a clearer and more effective oversight role in respect of NZX.

This option also acknowledges the fact that NZX is a business and as such, should have control over its operations where there is no a clear public interest in overriding NZX's autonomy in particular areas. For example, NZX should have the power to choose who to take on the exchange, the power to impose additional rules over and above the statutory minimum, and the power to determine its own operational matters in cases where there is no countervailing public interest.

In addition, by providing clarity a round the respective responsibilities of the Authority and NZX, it provides for an integrated regime and addresses concerns about gaps in the regulatory system in respect of registered exchanges.

In total, by ensuring that the most important areas of potential conflicts of interest are dealt with, and by providing more certainty about the respective roles of NZX and the Authority, this option should most effectively improve investor confidence.

Option 3: Shift all regulatory functions from NZX to the Financial Markets Authority

This option would involve shifting sole responsibility for regulating the markets operated by NZX to the Authority. This option would involve the Authority carrying out all of the regulation of issuers and participants who operate on the exchange. More specifically, it would involve the Authority being responsible for:

- Rule making and adjudication of exchange rules;
- All market surveillance and investigation;
- The approval of issuers and market participants; and
- The regulation of all financial advice provided by NZX participants.

Exchanges would continue to submit initial rule sets, request changes to rules, formulate the operational terms of their contracts with issuers and market participants, monitor some of these contractual terms, and approve issuers and participants who had received prior approval from the regulator. Exchanges would otherwise be focussed entirely on their operation of trading platforms and related systems.

The benefits of this option would be eliminating risks of conflicts of interest, and role duplication. However, the Authority is likely to have less knowledge than exchanges of the operation of markets and market products, and be less responsive to changing market circumstances. It also has weaker incentives to maintain an efficient, low-cost and orderly market, and is more likely to be bureaucratic and rigid in its approach to issuers and market participants.

Part 3: Additional powers and functions required to achieve objectives

In order to achieve the key objectives of achieving more effective supervision and enforcement there are a number of aspects of the existing powers and functions of regulatory agencies which are deficient. Several of these matters are addressed below. Other deficiencies in powers and functions raise more complex issues, and it is expected that these other issues will be considered separately in the review of the Securities Act 1978.

Auditor Regulation

The scope – Option 1 (Statutory audits) v Option 2 (Issuer audits)

The main reason for reconsidering narrowing the scope from statutory audits to issuer audits is to reflect a decision made by the Government in February 2010 to not require large non-issuer companies to file general purpose financial reports (GPFR). The only reason to require large non-issuers to have audit carried out by a licensed auditor would be to protect the interests of external users who cannot demand the GPFR. The filing-related decision means that there are no such external users.

The remaining users can largely protect their own interests. External users who can demand that GPFR be prepared (e.g. banks) will also be able to require the preparer to engage a licensed auditor to carry out the audit. Shareholders will also be collectively able to protect their interests by requiring a licensed auditor to carry out the audit, if they consider that is necessary or desirable.

Other than issuer audits, the only other classes of audits remaining within the definition of statutory audits (e.g. the Racing Board audit and commodity levy fund audits) have little in common with each other and are of considerably less significant than issuer audits. Including those secondary statutory audits will subject a larger number of auditors to the regulatory system, make the auditor regulation system more complex, and raise the possibility of needing to create an additional tier of licences. Approximately 100 auditors within the Big 4 plus four or five other firms would be subject to the regulatory system if it was to be limited to issuer audits. We do not have reliable information about the number if all statutory audits were to be included.

The current provisions that require statutory audits (other than issuer audits) to be carried out by an NZICA member or a suitably qualified overseas auditor will be retained.

Practice review (Option 1 (On request by the XRB) v Option 2 (Mandatory by the FMA)

The independence of the practice review system is an essential part of the credibility of auditor regulation. The current proposals are that NZICA would continue to be responsible for practice review but that individual firms could request the XRB to carry out the review of its practice should review by a government body be a requirement in an overseas jurisdiction.

This opt-in provision was included mainly to meet the requirements of a European Union Directive which states that professional bodies should not take the lead in organising inspections. However, the Directive permits professional associations to be allowed to assist in inspections. The European Commission has advised MED Officials that opt-in would not provide sufficient certainty to meet its needs. In order to obtain EU recognition, the law would need to state that the reviews of practices that audit New Zealand companies that are issuers in the EU must be the responsibility of a specified body that is independent of the interests of the profession. EU recognition of New Zealand's regulatory system only matters in relation to the small number[5] of New Zealand companies that are listed on an EU exchange.

[5] In 2008, seven companies, whose audits were carried out by six firms, were affected.

Our discussions with the Australian Securities and Investments Commission indicate that they have the same expectation. Their view is that audit inspection must be independent and seen to be independent. In addition, ASIC is currently trying to obtain recognition from the United States Public Company Accounting Oversight Board (PCAOB) for inspection purposes. They are very concerned that registration of New Zealand auditors under the Trans-Tasman Mutual Recognition Agreement would place their PCAOB recognition aspirations at risk if our inspections process is not seen to be fully independent of the interests of the profession.

A consequential question is whether New Zealand should have two sets of rules for practice review; one for overseas purposes and another for domestic purposes. The two-tiered approach is a lower cost option. However, it also gives the impression that New Zealand cares less about audit quality than other jurisdictions. In addition, the differences may not be major for the following reasons:

- 95% of issuer audits are carried out by the Big Four, with the remainder spread among three or four other firms. Most of those firms are likely to need practice review to be under the control of a government agency for overseas recognition purposes; and

- Although the government regulator would have overall control of and responsibility for the practice review, it is likely that it would contract NZICA to do much of the work to access their skills and knowledge and achieve economies of scale.

Our preferred option is to require quality reviews of all practices that carry out audits of issuers to be carried out by a government regulator. The choice is between the FMA and the XRB. The main arguments favouring the FMA are:

- To promote coordinated service delivery – For the reasons explained above, the quality and independence of auditing is an essential element of promoting high quality financial reporting which, in turn, is an essential element of promoting financial market confidence; and

- The functions associated with practice review will fit better with the culture of the FMA – The agency that carries out practice review must, among other things, have the power to carry out on-site inspections and require auditing firms and firms that are being audited to furnish audit files and other supporting documents. These types of powers will be needed in relation to other FMA functions. However, such powers are not needed or used by standards-setting bodies.

Accreditation and oversight – Option 1 (XRB) v Option 2 (FMA)

The other regulatory functions that need to be considered are:

- The accreditation of professional accounting bodies; and

- Monitoring and reporting on the adequacy and effectiveness of accredited bodies' auditor regulation systems and processes.

The main reason for confirming that the XRB shall perform those functions is to recognise that oversight is a softer regulatory function that may fit better with the

XRB's culture. The main argument in favour of the FMA is that there will be a significant risk that the FMA will need to duplicate much of the XRB's activities. This has happened in Australia, where inspection and monitoring and carried out by different bodies. ASIC carries out the inspection function and the Financial Reporting Council (FRC) is responsible for producing an annual auditor inspection report. The Australian Treasury released a strategic review report in March 2010 entitled "Audit Quality in Australia". It noted that the FRC's report is largely based on the annual report that ASIC prepares on its audit inspection programme. It asks for stakeholders to consider whether the status quo should be retained or to remove the auditor independence function from the FRC.

Offer document vetting

Option 1: Enhanced pre-registration vetting

This option would involve enhancing the current pre-registration vetting of prospectuses and shifting it to the Authority. This would involve a greater focus on assessing the non-financial information in the prospectus to ensure that it does not include statements that may be misleading or deceptive.

The benefits of this option are increased scrutiny of prospectuses reducing the likelihood of misleading or deceptive statements being provided to the market.

The costs of this option are the delays to issuers in having prospectuses registered, the cost to government involved in more rigorous vetting of prospectuses, and the potential moral hazard risk being taken on by the government if it is seen as responsible for the accuracy of statements in prospectuses.

Option 2: Post registration vetting

Under this option the current functions of the Registrar of Companies in relation to vetting of offer documents for false or misleading statements would be changed to more closely align with the approach taken in Australia.

Prospectuses would be lodged with a Registrar. The Registrar would ensure the documentation provided was correctly completed and to maintain the accuracy and completeness of the register. The Registrar would not have a role in determining whether the prospectus is false or misleading.

The Authority would be advised of each new prospectus lodged with the Registrar. As in Australia, no allotment may be made during the period immediately after registration. This would allow the regulator time to review the document and decide to impose a stop order. In Australia the period is 7 days, with an ability to extend by a further 7 days on notice.

Under this option, the Authority must take an active role in monitoring and reviewing registered disclosure documents, and use suspension and cancellation, and a new power to delay or prohibit allotment. The Authority would be expected to take a risk based approach to this function.

The Registrar would also establish a new public register of securities. This register would replace the practice of registering securities offer documents against the companies register record of the issuer, or on separate registers of unit trusts, participatory securities, superannuation schemes and KiwiSaver schemes. The current practice severely limits accessibility. The Registrar of Companies would be the first Registrar of Securities.

The new register would contain information that will enable the public to search for and access information about securities offers and disclosures about securities that have been issued.

The benefits of this option are that the level of scrutiny provided to prospectuses would be more proportionate to the risks associated with particular issuers and the financial products being issued, and that it would speed up the process for vetting the majority of prospectuses.

A drawback of this option is that no regulator formally seeks to assess the offer documents for false or misleading statements prior to registration. However, it is generally difficult to determine whether a statement in an offer document is false or misleading at the point of registration, and the ability to act on false or misleading statements after the point of registration is likely to be more useful.

Designations and Exemptions

Option 1: Revised designation and exemption making power

The core part of the current definition of security is that it means “any interest or right to participate in the capital, asses, earnings, royalties, or property of any person”. Through regulations, any such rights or interests can be specified to be a security, and can be allocated to one of five classes of securities: equity, debt, units in a unit trust, interests in a superannuation scheme, life insurance policies. If not allocated to any other class, the security is a “participatory security”.

Some offers of interests or rights that would otherwise be securities are exempted from the Act, such as most estates or interests in land. The Commission can also exempt, on any terms and conditions, any person or class of person or any transaction or class of transaction from compliance with any of the rules for disclosure, product regulation and advertising securities, or the regulations.
The power to designate securities has never been used. This is likely to be because the definition of security is so wide and the Commission’s exemption power is so flexible, that it is easiest to establish a suitable regime through the terms and conditions of a class exemption.

This option would involve the following changes:

- The statutory exemptions would be able to be overridden by regulations. This is required to properly regulate structures like Blue Chip which avoided the Securities Act by structuring its transactions as property investments.
- The exemption powers would be changed to provide that:

- Class designations and exemptions be made by regulations, on the recommendation of the Minister after consulting with the Authority; and
- Individual exemptions are made by the Authority. These would be deemed regulations.
- The Authority may also make class exemptions for periods of up to one year. Unless made into a regulation on the recommendation of the Minister, these exemptions would lapse.

One benefit of this option are that it provides that class exemptions and designations are made through a standard regulation making process that more appropriately reflects the nature of these instruments as substantive law. The other benefit of this option is that the providing for a regulation making power that overrides the statutory exemptions from the definition of security will ensure that financial instruments cannot be structured in such a way as to avoid the scope of the Securities Act.

The costs of this option are that the process for making class exemptions will be slower than is currently the case. However, this cost is mitigated through the Authority having the power to issue temporary class exemptions, which can then be confirmed through regulations if appropriate.

Option 2: All class exemptions to be made by regulations

This option is identical to option 1 except that the Authority would not have the power to grant temporary class exemptions and designations. The advantages of this option are that, like option 1, it would ensure that class exemptions and designations are made through a standard regulation making process that more appropriately reflects the nature of these instruments as substantive law.

The costs of this option are that the process for making class exemptions would be slower than is currently the case due to the need to make all class exemptions through regulations. This would reduce the level of responsive which the Authority could show in response to emerging issues, and could encourage a proliferation of individual exemptions to compensate for the slow process required to make class exemptions.

Availability and comparability of offer documents

Option 1: Establish a register of securities

This option would involve the Registrar establishing a new public register of securities. This register would replace the practice of registering securities offer documents against the companies register record of the issuer, or on separate registers of unit trusts, participatory securities, superannuation schemes and KiwiSaver schemes. The current practice severely limits accessibility. The Registrar of Companies would be the first Registrar of Securities.

The new register would contain information that will enable the public to search for and access information about securities offers and disclosures about securities that have been issued. It would also facilitate comparison between different securities on the register.

CONSULTATION

The following departments and agencies have been consulted in the contents of the Cabinet paper and RIS: Treasury, State Services Commission, Department of Prime Minister and Cabinet, Ministry of Justice, Reserve Bank. Initial discussions have also been held with the Securities Commission, Registrar of Companies, National Enforcement Unit, Insurance and Superannuation Unit, and NZX.

Treasury is comfortable with the idea of announcing an intention to move towards the establishment of a single market conduct regulator. However, Treasury does not support the proposed fast-tracking of the creation of the regulator ahead of the completion of the other key components of the Securities Act review. They view the risks of seeking to significantly advance the establishment of the new regulator before a full picture of the regulatory regime it will operate within is finalised as significant. They are also not convinced that accelerating the establishment of the new regulator by a matter of months will make a material difference to investor confidence in the long term. In Treasury's view, the fact that the new regulator will have a large degree of independence from government once it has been established makes it particularly important that there is a high degree of clarity from the outset (including where appropriate in legislation), about any changes in emphasis, behaviour or culture that are sought. These changes will not necessarily flow from the proposed consolidation of regulators alone and in Treasury's view achieving this clarity could be compromised by a rushed process.

The Ministry of Economic Development considers on balance that it is likely that fast tracking the creation of the Authority is likely to assist investor confidence in the short to medium term when compared with the option of creating the Authority at the same time as implementing the rest of the Securities Act review. [Withheld under sections 9(2)(f)(iv) and 9(2)(g)(i) of the Official Information Act 1982]. In addition, the proposed allocation of functions between the Authority and the other regulatory agencies is underpinned by principles that should make it clear where any new functions should be situated. Finally, we consider that at this stage we can make a reasonable judgement that the Securities Act review is unlikely to fundamentally change the purpose or functions of the Authority as proposed. For these reasons we do not propose to depart from the proposed fast tracked timeframes.

In respect of stakeholder consultation, the Financial Markets Authority as proposed in this regulatory impact statement builds upon a number of earlier reports, several of which involved detailed consultation with stakeholders. In particular:

- the recommendations of the Capital Market Development Taskforce in its final report;
- the conclusions of the Prada and Walter report into the effectiveness of the Securities Commission;
- the NZX discussion document *The Allocation of Certain Regulatory Functions Across New Zealand*; and
- the New Zealand Shareholders Association and Chartered Secretaries of New Zealand paper *A discussion paper in support of changes to the capital markets regulatory functions.*

Proposed changes regarding auditor regulation

The Accounting Standards Review Board and the Securities Commission both support the proposed changes in relation to auditor regulation, while NZICA opposes all of the auditor-related proposals. Our impression is that NZICA's concerns mainly relate mainly to expected cultural differences between the XRB and FMA. Their concern is that the FMA will have a more heavy-handed approach than is desirable. Two members of the Capital Market Development Taskforce were consulted and both support the proposal for government auditor regulation functions to be carried out by the Financial Markets Authority.

CONCLUSIONS AND RECOMMENDATIONS

The creation of a new consolidated market conduct regulator is our preferred option. This option would involve the consolidation of the existing regulatory functions of the Securities Commission and Government Actuary, and some of the regulatory roles of the Registrar of Companies and NZX into a new Financial Markets Authority.

We consider that this option most effectively achieves the objectives of:

- Ensuring role clarity for regulatory agencies;
- Eliminating duplication in regulatory functions;
- Encouraging the development of economies of scale;
- Filling gaps between regulators jurisdictions and ensure a integrated system; and
- Ensuring actual and perceived independence in regulatory functions.

We consider that this option also is likely to have the greatest impact in encouraging the development of greater confidence in financial markets. Consolidating regulatory functions in one place will provide greater clarity and certainty for investors and firms. It also provides for a greater degree of alignment with Australia through creating a twin peaks model of financial sector regulation with consolidated prudential and market conduct regulators.

We consider that this option is preferable to consolidating these functions within the existing Securities Commission as it is more likely to provide the desired cultural shift required to focus the regulator more strongly on enforcement matters.

We also consider that this option is preferable to the option of combining prudential and market conduct functions into a single regulator, which is unlikely to achieve the desired objectives more efficiently that the option of having separate prudential and market conduct regulators, while at the same time creating substantial additional costs.

We consider that shifting all of the regulatory functions of the Registrar of Companies relating to financial service providers, and the regulatory functions of the Government Actuary, to the Authority provides the advantages of:

- establishing a single regulatory with responsibility for all issues relating to financial service provides;
- providing for the maximum economies of scale in financial sector regulation; and
- removing duplication in regulatory functions in respect of financial service providers.

While this approach does create duplication in certain regulatory roles between the Authority and the Registrar of Companies, we think that there remains good reason for having separate regulators for financial service providers and for closely held private companies and other organisations. In particular, this ensures that the Registrar’s existing skills in the regulation of private companies, while at the same time allowing the Authority to focus its attention on financial market participants.

We also consider that the option of providing the Authority with a more involved role in the regulation of NZX, as described above most effectively deals with concerns about NZX having a potential conflict of interest as a market participant and regulator, while at the same time acknowledging NZX’s right to control certain key matters relating to the exchanges (for example, the right to decide whether an entity may list on the exchange). This option also ensures role clarity on the parts of the Authority and NZX. Finally, we consider that this option is likely to have a more positive effect on market confidence than simply moving the NZMDT to the new Authority.

We also consider that to effectively achieve the desired objectives, certain additional or amended regulator functions are required. In particular, we consider that:

- Post-registration vetting of offer documents based upon an effective risk assessment more effectively addresses concerns around the quality of offer documents, while at the same time reducing cost and delay for many firms seeking to raise capital;
- The establishment of a single register of securities offers will more effectively facilitate public access to offer documents and comparability between offers;
- The making of permanent class exemptions through regulations more appropriately reflect the status of class exemptions as substantive law; and

- That providing for a power to override statutory exemptions from the definition of security under the Securities Act will ensure that financial instruments cannot be inappropriately structured to avoid the scope of the Securities Act.

We are also of the view that the proposed auditor regulation regime should be limited to issuer audits given the government's decision earlier this year to not require large non-issuer companies to file financial statements. As a result, we consider that this function would be most efficiently be carried out by the Authority rather than the proposed XRB, and than given this narrower scope, the Authority should also conduct practice reviews of auditors who come within the regime.

Finally, we consider that there may still be some additional functions or powers missing from the proposed framework. Because these additional matters may raise a number of more complex issues requiring further consultation, we propose that these matters be considered as part of the review of the Securities Act 1978.

IMPLEMENTATION

If Cabinet agreed to the preferred option, an establishment board will be established to manage the process of establishing the Authority. The establishment board will be responsible for, amongst other things, the following matters:

- The selection of a chief executive designate;
- The appointment of the necessary staff, and the transition of current staff from the Securities Commission, the Ministry of Economic Development, and potentially NZX to the new Authority; and
- The establishment of suitable premises and infrastructure.

The establishment of the new regulator will involve the disestablishment of the Securities Commission, as a result, officials will conduct a process for advising the Minister of Commerce on new board appointments

There are certain risks associated with the implementation of the preferred option. Some of these risks are inherent in setting up a new organisation, while others stem from establishing a new organisation before the completion of the Securities Act review and while other work is underway (such as the implementation of the financial advisers or trustee licensing regimes).

The inherent risks are the danger of not allocating the correct functions to the Authority, failing to adequately funding the organisation, and the risk that the new organisation will not be able to commence its role within the expected timeframes. We anticipate that these risks will be managed trough close liaison between the affected regulators, the establishment board, and the Ministry of Economic Development.

The risks associated with the Authority being established according to the fast tracked timeframes are that the rest of the Securities Act review may result in the functions or powers of the Authority having to change as a result of proposals arising out of the Securities Act.

[Withheld under sections 9(2)(f)(iv) and 9(2)(g)(i) of the Official Information Act 1982]. In addition, the proposed allocation of functions between the Authority and the other regulatory agencies is underpinned by principles that should make it clear where any new functions should be situated. Finally, we consider that at this stage we can make a reasonable judgement that the Securities Act review is unlikely to fundamentally change the purpose or functions of the Authority as proposed.

MONITORING, EVALUATION AND REVIEW

The performance of the Authority will be monitored and evaluated through the standard crown entity monitoring process. This process will also be used to provide the necessary qualitative and quantitative data required to evaluate the performance of the new Authority over time.

We propose the operation of the Authority be reviewed two years after its establishment in order to assess how effectively the Authority has been implemented and is carrying out its role. In addition, as part of the overall review of the Securities Act, officials are developing a detailed evaluation plan. That plan will also involve evaluating the changes proposed here.