Regulatory Impact Statement

EXECUTIVE SUMMARY

At present, issuers of debt and participatory securities, and interests in certain collective investment schemes, are required to obtain the services of a corporate trustee who will monitor the issuer's compliance with the terms of the offer of securities. A number of problems have been identified in the supervision of issuers by trustees, in particular, the competence, capacity and accountability of trustees conducting this supervision. Concerns have also been raised about the weaknesses of trust deeds, and a lack of clarity around the role trustees are expected to play when supervising issuers.

To address the weaknesses in trustees' supervision of issuers it is proposed that a licensing regime be established for trustees. This regime would be administered by the Securities Commission. For a trustee to be licensed they would have to meet approval criteria set out in regulations which relate to matters such as competency, monitoring systems and processes, and financial strength. The Commission would have an ongoing role in monitoring individual trustees' compliance with the approval criteria.

In addition, it is proposed that a range of other measures should be introduced to strengthen the quality of supervision provided by trustees. These measures include providing greater minimum standards for trust deeds, providing trustees with additional powers to call on in carrying out their supervisory role, and providing the Securities Commission with enhanced powers of enforcement in respect of trustees who have acted negligently or failed to carry out their role to the required standard.

It is expected that these measures will result in a major improvement in the quality of supervision provided by trustees, and that this benefit will outweigh the additional costs the proposals will place on trustees.

ADEQUACY STATEMENT

The Ministry of Economic Development has reviewed the RIS and considers that it is accurate according to the adequacy criteria.

STATUS QUO AND PROBLEM

The Securities Act 1978 requires entities that issue debt securities to the public to engage the services of a trustee corporation. It also requires entities that issue participatory securities to the public to engage the services of a statutory supervisor. There are two categories of entities which can act as a trustee or statutory supervisor. First are trustee corporations which are established by their own Acts of Parliament and given automatic authority to act under the Securities Act. The second group are individuals or entities holding Securities Commission approval to act as trustees or statutory supervisors. The current criteria for Securities Commission approval are based on factors such as competence and financial capacity, character, independence and accountability. In addition, unit trusts are also required to have a trustee who holds the assets and supervises the manager of the trust.

There are no accurate figures for the number of issuers who are supervised by trustees. However, a conservative estimate in 2006 suggested that there were 470 entities subject to supervision by trustees. It can also be assumed that the value of the securities issued by these issuers runs into billions of dollars.

Problems have been identified with the trustees' supervision of issuers. When the Financial Sector Assessment Programme (undertaken by the International Monetary Fund and World Bank) assessed New Zealand in 2004, one of the key issues identified was the heavy reliance on trustees without proper checks and balances or accountability in the performance of their role. In addition, as the monitoring of issuers is spread between a number of trustees (as opposed to a single entity), it is difficult for government to get whole-of sector data in order to monitor the sector.

In response to these issues, the Review of Financial Products and Providers (RFPP) proposed that a licensing regime for trustees be established. Consultation on this proposed licensing regime confirmed the problems with trustees' supervision of issuers identified by Financial Sector Assessment Programme, and Cabinet agreed to the establishment of a licensing regime for trustees in June 2007 (EDC Min (07) 11/13, CAB Min (07) 24/4 refer). This licensing regime has not yet been implemented.

The series of finance company collapses which took place between 2006 and 2008 has raised some more fundamental problems with trustees' supervision of issuers than those previously identified. The Registrar of Companies recently reported to the Commerce Committee on the recent series of finance company collapses and noted problems with the current regime including a lack of capability, poor reporting and weak trust deeds.

In summary, the key problems that have been identified with the trustee regime are:

- <u>A lack of capability or capacity</u>: trustee company resources and expertise have not always matched the size and complexity of the securities they supervise.

- <u>Weak trust deeds</u>: there is no minimum investor protection which must be contained in trust deeds.

- <u>A lack of role clarity</u>: a lack of clear definition of trustees' role has resulted in inconsistencies in the level of supervision provided by different trustees.

- <u>Potential for a lack of independence from the issuer</u>: issuers perform a quasi-public role of supervising issuers with a view to protecting investors' interests, while at the same time they are engaged and funded entirely by the entities they supervise.

- <u>Weak accountability</u>: for the statutorily-approved trustees the sole aspect of trustee accountability is the ability for individual investors to take court action.

OBJECTIVES

The primary objective of the proposals is to ensure that the frontline supervision of issuers effectively protects investors' interests.

Secondary objectives are to ensure that:

- Frontline supervisors have the capacity, industry knowledge and experience to undertake effective and risk based frontline monitoring of issuers;

- Frontline supervisors have the powers they need to carry out their role; and

- There is appropriate oversight to ensure that frontline supervisors carry out their role to the required standard, and effective remedies are available to use against frontline supervisors that fail to do so.

ALTERNATIVE OPTIONS

Regime agreed by Cabinet in 2007

One alternative to the regime being proposed is the Trustee Supervisory Model agreed by Cabinet in 2007. The Trustee Supervisory Model has formed the basis of the proposals in this paper, but does not include several aspects of the current proposal (the differences between the regime being proposed and the Trustee Supervisory Model are set out in full in appendix 1). Most importantly, it does not include:

- The proposal for the Securities Commission to have the power to order the trustee to comply with its duties or the terms of the trust deed, order the trustee to take action to address a breach by an issuer, or go to Court to seek a pecuniary penalty or compensatory order against the trustee; and

- The proposal that certain matters be prescribed as having to be addressed in all trust deeds, and that minimum terms for trust deeds be set out in regulations.

The benefits of this option would be lesser compliance costs as a result of there being no prescription around the content of trust deeds, and less need for additional resources to fund the Securities Commission intervening when an issuer gets into difficulties or when a trustee has acted negligently or failed to comply with the trust deed.

However, this option was discounted because it does not address the following problems with the status quo:

- Trustees' powers are set out in the trust deed, and the inadequate nature of some current supervision by trustees is attributable to weak trust deeds which do not keep pace with changing circumstances after the initial offer of securities is made;

- Recent finance company collapses have highlighted difficulties in obtaining adequate redress against trustees who fail to carry out their role to the required standard; and

- Inadequacies in the supervision provided by some trustees has highlighted the need for the Securities Commission to have a broader range of powers available to step in when an issuer gets into difficulties.

Centralised government regulator

An alternative to the existing regime of trustee supervision is a government regulator. The government regulator would provide direct supervision of entities issuing collective investment schemes and debt securities to the public.

The benefits of this option may be in applying a more even standard of supervision across different issuers, and the economies of scale that may arise out of having a single entity conducting supervision of all relevant issuers.

However, this option was discounted for the following reasons:

- It has the potential to result in a significant increase in costs;

- It may be difficult for the regulator to establish a sufficiently large pool of suitably qualified people to perform the supervisory function; and

- A regulator may be more distant from the market, and firms may be less willing to disclose information to a regulator than a trustee.

PREFERRED OPTION

The preferred option is to provide a licensing regime for trustees administered by the Securities Commission, along with additional proposals designed to improve the quality of trust deeds and the enforcement of trustees' obligations, as well as improving the supervision of issuers by trustees more generally. The preferred option is described in more detail below.

Scope of the proposal

The licensing regime would apply to trustees of debt issuers, statutory supervisors of issuers of participatory securities, and trustees of unit trusts.

It would not cover the trustees of superannuation schemes. Unlike other types of trustees, the trustee of a superannuation scheme is also the issuer. Superannuation schemes are also regulated by the Government Actuary rather than the Securities Commission.

Initial Licensing

This would entail establishing consistent minimum criteria for approval of trustees. The criteria would then apply to any trustee wanting to provide its services to issuers of debt or participatory securities to the public. The existing automatic authorisation for the six statutorily approved trustees would be revoked.

For a trustee to obtain approval they must be registered and independent from the issuer or any related parties. In addition they will need to satisfy criteria relating to the following matters: appropriate experience; "fit and proper" character requirements; infrastructure; appropriate governance standards; capital adequacy; monitoring systems and procedures; professional indemnity insurance; corporate form; and residency.

The Securities Commission will undertake the role of licensor and ongoing monitor of trustees as it already possesses the key skills required. This is because the Securities Commission is a market conduct regulator (i.e. it licences and monitors the conduct of a number of entities in the securities market) and the proposed supervision of trustees is focused on a trustee's conduct.

To minimise the costs of compliance the Securities Commission will take a tailored and risk-based approach to licensing and ongoing supervision of trustees. This will be achieved through a flexible, case by case approach by the Securities Commission, assessing whether a trustee has the necessary capability and expertise to fulfil its role.

Trustees who object to a decision of the Securities Commission on an application for a licence will be able to refer the decision back to the Commission for reconsideration. If the trustee remains unsatisfied with the decision, there will be a right of appeal to the High Court.

Ongoing monitoring

A licensed trustee will be required to regularly report to the Securities Commission to demonstrate ongoing satisfaction of approval criteria and ongoing fulfilment of responsibilities, as well as to provide statistical data.

A licensed trustee will also be required to report to the Commission on any breaches of its licence conditions, or material change in its circumstances.

The Securities Commission will be provided with appropriate powers to obtain necessary information and appropriate powers to rectify any breaches which may arise.

Breach of licence

Breaches of the trustees' obligations will vary in severity. Accordingly, the Commission will be provided with a graduated set of powers to deal with a trustee that appears to be in breach. These powers will consist of:

- The power to request further information from a trustee;
- The power to order the trustee to comply with the terms of the trust deed or the trustee's duties;
- The power to direct a trustee to fix a breach within a particular time frame, and to require the trustee to provide the Commission with details of how it proposes to address the breach;

- Where the Commission is not satisfied with the trustee's proposed course of action to rectify the identified breach, the Commission will have the power to direct what course of action the trustee will take with a right to be indemnified when acting under such direction;

- Suspension from taking on new appointments to act as a trustee for a particular issue of securities; and

- In a severe situation, the ability to apply to the High Court for an order removing a trustee from a specific appointment, or revoking a trustee's licence for particular class or classes of securities. In a very severe situation, it will be possible to revoke all the trustee's licences. A court order is necessary as such a move may have severe consequences for the livelihoods of those involved.

The suspension or removal of a trustee from a specific appointment, or appointments generally, may create a vacuum. In most cases, the market will readily absorb profitable appointments when a trustee is removed. There may be cases, however, where the issuer is unable to appoint a new trustee. In those cases, the Commission could appoint an 'interim trustee' for up to six months until the issuer finds a new trustee. The interim trustee will have assured funding from the Securities Commission, and indemnification from liability for any actions or omissions of the removed trustee.

Other measures to improve the quality of supervision

- <u>More prescription in trust deeds:</u> Regulations will be made requiring all trust deeds to address certain matters, such as the issuer's governance arrangements, the minimum capital requirement, and how the issuer will keep the trustee informed. There may also be certain substantive terms that could be implied into trust deeds under regulations.

- <u>Additional powers for trustees:</u> Trustees will be given additional powers to ensure that they are able to carry out their role effectively. These powers will be:

  - <u>Consent to changes:</u> The power for the trustee to agree to changes in the trust deed without having to obtain the consent of investors, when the issuer agrees and the amendment does not adversely affect investors or materially change their investment;

  - <u>Engage expert:</u> The power to engage, at the issuer's expense, an expert to review aspects of the issuer's systems and governance;[1] and

  - <u>Direct the issuer:</u> The power to give directions to the issuer when it is in breach of regulatory requirements, including direction to remove directors or senior management.

[1] This would involve expanding trustees existing power to appoint an independent expert to help ascertain the true financial position of the issuer.

- Additional enforcement powers for the Securities Commission: The Securities Commission will be given additional powers to take action when a trustee has acted negligently or failed to take adequate steps to supervise an issuer. These additional powers would be:

  - The power to seek a court order for one of a range of measures when it is of the opinion that the issuer is unlikely to be able to pay the money owing in respect of securities when it falls due, or the trust deed provisions no longer adequately protect investors (this would mirror the trustee's current powers under section 49 of the Securities Act);

  - The power to apply for a civil pecuniary order against the trustee where the trustee has breached the trust deed or their duties, and the breach materially prejudices the investors' interests; and

  - The power to apply to the Court for an order requiring the trustee to pay compensation to all investors who have suffered loss or damage as a result of the trustee's breach of the trust deed or their duties;

- Information sharing between Government agencies: A trustee must currently give notice to the Registrar of Companies when it believes a company it supervises is likely to become insolvent or to breach the terms of the offer, under section 11 of the Corporations (Investigation and Management) Act 1989. It also must report to the Reserve Bank when it has reasonable grounds to believe an issuer which is a non-bank deposit taker is likely to become insolvent or to breach the terms of the trust deed, the offer of securities or the Reserve Bank of New Zealand Act. The proposal would require a trustee to report to the Securities Commission as well, and to standardise these reporting requirements to government agencies, so that one report would be made concurrently to all agencies. The test applied would be the one currently applied under the Reserve Bank of New Zealand Act.

- Change to auditors' liability when reporting to trustees: Currently auditors of debt issuers must report to the trustee when the auditor has formed an opinion that a certain matter is relevant to the exercise or performance of the trustee's powers or duties. However, there is no requirement to form such an opinion, and the risk of liability if they are wrong deters some auditors from doing so. I propose to provide a statutory "safe harbour" from liability for auditors if they form such an opinion and inform trustees in good faith and without negligence.

Legislative changes required

The proposals will require changes to the Securities Act 1978; the Securities Regulations 1983; the Securities Regulations 2009 (once made); the Unit Trusts Act 1960; the Corporations (Investigation and Management) Act 1989; the Trustee Act 1956; the Trustee Companies Act 1967; and the Trustee Companies Management Act 1975. It is also likely that portions of the Acts of Parliament established for the automatic authorisation of trustee corporations will need to be revoked.

Benefits of the proposals

The preferred option will result in a significantly improved regime for the supervision of issuers of debt, participatory securities and unit trusts. In particular, it will address the specific problems identified with the current regime:

- Capability and competence: The proposal will address the lack of capability by including criteria requiring trustees to have appropriate experience, infrastructure, governance standards, capital adequacy and monitoring systems. The ongoing monitoring by the Commission will ensure the trustees maintain these standards. The Commission's power to impose conditions on a trustee's licence (such as limiting the size of issuers it can supervise) will ensure that trustees do not take on issuers for which they do not have the expertise or capacity.

- Trust deeds: The proposal will avoid weak trust deeds by giving a regulation making power to allow the stipulation of mandatory headings and minimum terms in trust deeds. These will ensure that all trust deeds at least address basic issues of investor protection.

- Role clarity: The licensing regime will give greater role clarity to trustees through the approval criteria and by imposing minimum requirements in trust deeds. This should ensure more consistency in the standard of supervision provided by different trustees.

- Independence: The proposal will ensure trustees' independence by requiring that they do not compete in the same market as an issuer they supervise.

- Accountability: The proposal will improve trustees' accountability by requiring them to report to the Securities Commission, both regularly and on occasion of a breach by the trustee or issuer. It also gives the Commission significant powers to punish trustees who are not fulfilling their duties including compelling trustees to act, revoking a trustee's licence and applying for a compensatory order. This will help to protect investors' interests.

More broadly, these measures as a whole will mean that trustees are more likely to identify any problems faced by issuers at an earlier stage and take appropriate action as a result, thereby protecting investors. In addition, the proposals will promote competition by allowing a broad range of new entities to enter the market, and generally modernise the trustee regime.

Costs of the Proposals

The total costs to the Securities Commission of operating the entire regime (including the costs of processing licence applications, supervising licensed trustees, and carrying out intervention or enforcement activities) is estimated at approximately $600,000 in the first year, rising to $640,000 in the second year, and $660,000 in the third year and out years. We anticipate that this would be wholly funded by third party fees and levies. Assuming around 13 trustees, this would require recovering an average of $50,000 from each trustee each year. Assuming that trustees pass that entire cost on to issuers in higher fees, this would work out at an average increase in fees of $1,400 per issuer per year (assuming on a conservative estimate that there are around 470 issuers supervised by trustees).

In some circumstances there will be indirect costs to trustees arising out of the need to carry out more intensive supervision of certain issuers (for example, through the need to scrutinise additional documentation that an issuer may be asked to provide to the trustee). However, this cost will in most cases be passed on to the issuer in the form of higher fees from trustees.

More intensive supervision of issuers by trustees will in some cases result in higher costs to issuers (for example, as a result of having to pay higher fees to their trustee, or to provide more information to trustees)

The magnitude of these indirect costs is impossible to quantify, as they rely on the specific circumstances of each issuer and trustee. In many cases there will be no additional costs to issuers short of the need to pay slightly higher fees to trustees. In the smaller number of cases where the supervision of issuers by trustees is currently inadequate the costs may be much more significant.

There will be costs in some cases arising out of the provision of regulations requiring minimum terms in trust deeds. These costs will be subject to a separate regulatory impact statement when policy decisions are sought on those regulations. Any other costs imposed by the additional non-licensing measures are likely to be largely indirect and have a relatively small impact on trustees or issuers in most circumstances.

IMPLEMENTATION AND REVIEW

The proposed legislation would come into force in late 2010 after a 6 months transition period. This will give trustees currently operating in the market adequate time to adjust to the new requirements, and the Securities Commission time to prepare for licensing applications. It is currently anticipated that there will be at most 15 trustees, so this should not place undue strain on the Securities Commission.

CONSULTATION

The initial licensing regime agreed by Cabinet in June 2007 was consulted on as part of the RFPP. This included initial testing of ideas with advisory groups, and public consultation on a discussion document at the end of 2006. No significant concerns were raised with the proposed licensing regime at that time.

Additional consultation was undertaken with the Trustee Corporations Association on the revised version of the licensing regime now being proposed. The Association suggested that trustees of superannuation schemes should also be included in this proposal. However, superannuation trustees have been excluded from this proposal due to their significantly different role as issuer of interests in a superannuation scheme. The Association also expressed concern that the proposal may result in the Commission second-guessing the trustee. However, the power for the Commission and direct a trustee to take a particular action is an essential part of the proposal, and careful design of this power should ensure that it will only be used as a last resort.

The following departments and agencies have been consulted on the proposals in this paper: The Treasury, Securities Commission, Reserve Bank, Ministry of Justice, Te Puni Kōkiri, the Office of the Ombudsman, and Registrar of Companies. The Department of Prime Minister and Cabinet has been informed.

Treasury supports all elements of this paper except for the requirements for trustees to report breaches in trust deeds to the Securities Commission in real-time and for the Commission to have the power to direct trustees to take a particular course of action to remedy breaches (as outlined in recommendations 25, 31.2, 31.3 and 31.4). They believe these elements are unnecessary and pose the following risks:

- ***Unnecessary in light of the wide range of other measures proposed here***. As a package, the other measures in this paper, should address the weaknesses identified in the trustee model. In particular, the introduction of a licensing and supervision model should ensure that trustees are effectively acting in investors' interests on an on-going basis. Likewise the introduction of a range of new sanctions (including, at the extreme, removal of the trustee's licence and court action taken by the Securities Commission) should sharpen incentives for trustees to act in investors' best interests.

- ***Significant compliance costs that are likely to be borne by firms seeking to raise capital*** The costs of trustees reporting breaches to the Commission in real-time and the Commission making judgements about the appropriateness of the trustee's actions in real-time could prove significant, even if the Commission exercises its power of direction rarely. The direct costs to the Commission of building and maintaining the capability for investigations and enforcement action are not insignificant (this activity is likely to account for a significant proportion of the $600,000 p.a. of on-going costs). In addition there will be indirect costs on trustees providing information and explanation to the Commission. All of these costs are likely to be ultimately borne by firms seeking to raise funding.

- ***Blur role clarity between trustees and the Securities Commission.*** Unlike the other changes proposed, this one blurs the boundary between the two regulators by allowing the Commission to step into the trustees shoes in certain, albeit limited, circumstances.

- ***Uncomfortable fit with the proposal to empower the Commission to take legal action against trustees.*** It seems unworkable for the Securities Commission to take legal action against a trustee if the trustee's choices have lead to investors losses, if the Commission also had the power and information to take action to prevent the losses and failed to do so.

- ***Inconsistent with the RBNZ's powers as prudential regulator of non-bank deposit takers (NBDTs).*** The RBNZ does not have the power to direct trustees for the non-bank deposit takers in the way proposed here. It is unclear why this power is necessary here when it is not considered necessary to ensure appropriate prudential oversight of NBDTs.

Notwithstanding the fact that the licensing regime will address the problems with trustee competency and accountability which have been identified, there is always the possibility that in very rare cases, a trustee will fail to act appropriately. In these circumstances, providing this power to the Securities Commission increases the likelihood that action will be taken to protect investor interests before the collapse of the issuer. In addition:

- The licensing regime in most instances will ensure that trustees act appropriately when an issuer gets into difficulties. However, as noted above, there is always the possibility that in rare cases a trustee may still fail to take appropriate action. Providing the Securities Commission with the power to direct trustees will address the risk of investors suffering loss as a result of the trustees failure to act;

- Providing the Commission with this power is likely to result in either significant compliance costs or a material blurring in role clarity between trustees and the Commission. As noted above, this would be a rarely used power, and I expect that it would only be exercised in circumstances where urgent action was required and the trustee had clearly or repeatedly failed to take adequate action; and

- The proposal is not inconsistent with giving the Commission the power to take action against trustees. This power is likely to be exercised at the same time as enforcement action is taken against trustees. In addition, if the trustee had failed to act consistently with its duty to investors, they will be liable irrespective of whether the Commission chose to intervene earlier or not. Unlike the trustee, the Commission does not have a legal duty to act in these cases.

- The Reserve Bank does not currently have an equivalent power to direct trustees of non-bank deposit takers to take particular action. Should the Commission exercise its power to direct a trustee, then this will require consultation with the Reserve Bank if the issuer in question is a non-bank deposit taker. However, the fact that the Reserve Bank does not have this power in relation to trustees does not in itself mean that the Commission to should not be able to direct trustees in rare circumstances.