

Financial Law Update

JUNE | 2009

Welcome to the June 2009 edition of Financial Law Update, your regular update on the latest developments in financial services law. It's been a busy few months, with plenty of new things to comment on. The team at Kensington Swan are sure you will find the information in this issue of interest.

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Start a conversation with us...

Your team of specialists at Kensington Swan are on top of the issues and can provide you practical advice on operating in today's dynamic business environment.

If you would like further information call your usual Kensington Swan adviser or contact the team at financiallawupdate@kensingtonswan.com.

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Managed funds and superannuation

Securities Disclosure and Financial Advisers Amendment Bill update

The Securities Disclosure and Financial Advisers Amendment Bill 2009 was reported back from the Commerce Committee in late April and, at the time of writing, was awaiting its third reading. Draft Simplified Disclosure Prospectus Regulations have also been released for public comment.

The key focus of the Bill, explained in more detail in our [March Financial Law Update](#), is on removing unnecessary impediments to raising capital. The principal way the Bill aims to achieve this is through the introduction of a 'simplified disclosure prospectus' regime. This regime will, in theory at least, allow listed issuers who are subject to continuous disclosure obligations to offer certain debt and equity securities without duplicating previously disclosed public information.

The Bill also proposes minor changes to the exemptions contained in section 3(2) of the Securities Act, dealing with people deemed not to be members of the public and 'eligible persons' for whom disclosure under the Act is not required. It also makes some remedial amendments to the new (and yet to commence) financial advisers legislation.

Select Committee Report

The Select Committee received 19 submissions on the Bill, and heard six oral submissions. Many of the submissions, including Kensington Swan's, which is available on our [website](#), raised other impediments to capital raising which could be addressed. Unfortunately, the Select Committee considered most substantive suggestions to be outside the scope of the Bill or better dealt with in the wider review of the Securities Act, and have made few changes.

The most notable changes are:

- extending the exemption for subsequent subscriptions by persons who have previously paid \$500,000 or more for securities to cover different types of

securities issued within 18 months of the original issue by the same issuer (the original exemption only applied to identical securities to those originally issued, and only within 12 months of the original issue)

- requiring an 'experienced person' (in terms of the 'eligible persons' exemption from the Act's usual disclosure requirements) to also acknowledge that as a consequence of not receiving an investment statement or prospectus the investor will not receive the information usually provided for an offer to the public.

Most of the remaining changes made by the Select Committee are technical in nature.

Draft Regulations

The Ministry of Economic Development has released the draft Securities (Simplified Disclosure Prospectus) Amendment Regulations 2009 for public comment. The Regulations outline which listed issuers will be able to use the SDP regime, and when they can use it. They also prescribe the content of SDPs for equity and debt securities.

At present, the Regulations are drafted so as to permit the use of an SDP for all listed and some unlisted equity and debt securities (including convertible securities). However, the Ministry is still considering whether the availability of the regime should be limited to 'vanilla' securities—watch this space.

The required content for both equity and debt SPDs is reasonably detailed, picking up much of the information which would ordinarily be disclosed in an investment statement. In addition, there is a catch-all provision which in each case would require the disclosure of 'all information that investors and their professional advisers would reasonably require to make an informed assessment of the offer'.

This requirement to disclose (in effect) all material information reflects a general obligation under the Securities Act, the application of which to SPDs has not been altered by the Bill. However, given the objective of the SDP regime is to avoid duplicating information available elsewhere, this requirement does seem unhelpful, particularly given the way in which the provisions are currently drafted. This is an issue raised in our [submission](#) on the Regulations.

Want to know more?

If you would like further information in relation to the proposed amendments made by the Bill and the draft Regulations, and the opportunities these may present for your business, please contact [Gerald Fitzgerald](#) on (04) 498 0835 or [Nick Summerfield](#) on (04) 498 0876, or contact the team at financiallawupdate@kensingtonswan.com.

Where to from here?

It seems likely that the Bill will become law reasonably soon and that the Regulations will be promulgated shortly afterwards. The speed of the Bill is welcome and shows that the Government is serious about responding to the international financial crisis in a meaningful way. However, it remains to be seen just how effective the SDP regime will be—particularly given the proposed content requirements for SPDs.

While we are naturally disappointed that wider submissions on the Bill weren't considered by the Select Committee, the upside is that there seems little prospect of the Bill delaying the long overdue review of the Securities Act any further. At the end of the day, that review will be a much better forum for addressing these wider issues.

Review of Securities Regulations

The Ministry of Economic Development recently released a discussion document setting out proposed changes to the Securities Regulations 1983. The focus of the changes is on the financial statement requirements of the Regulations, but a number of other changes aimed at improving the quality of disclosure, and addressing a number of minor points, have also been proposed.

In essence, the main change proposed is that financial statement content required under the Regulations would be prepared in accordance with GAAP, rather than the present situation where the Regulations themselves prescribe the required content.

The change would apply to full financial statements, summaries of financial statements, and interim financial statements. The rationale is that bringing financial reporting for Securities Act purposes into line with general accounting requirements is sensible

and will result in reduced compliance costs. This cost reduction is because, at present, many issuers need to prepare two separate sets of financial statements, one for general purposes and one for Securities Act purposes.

The use of interim financial statements prepared in accordance with NZ IAS 34 will require an amendment to that standard, which is currently drafted so as not to apply when the interim financial statements are included in a prospectus. The New Zealand Institute of Chartered Accountants has released for comment an exposure draft including an amendment to NZ IAS 34 to address this point.

Other changes proposed by the Ministry include:

- requiring a full set of prospective financial statements in the few circumstances where the Regulations currently only require a prospective statement of cashflows
- expanding the definition of 'borrowing group' to include guaranteeing parent and sister companies as well as guaranteeing subsidiaries in order to provide more meaningful disclosure
- allowing information about the net assets or the amount of assets and liabilities of an issuer from interim financial statements and unaudited full or interim financial statements to be cited in advertisements in certain circumstances
- allowing prospective financial information to be included in advertisements where the information is not included in a prospectus, either generally or only where the information in the advertisement provides commentary on information in the prospectus (the Ministry is considering these as alternative options)
- requiring a summary of the principal terms of the deed of participation in a prospectus for participatory securities
- allowing the cross referencing of addresses in investment statements (but continuing to prohibit any other cross referencing of prescribed information)
- allowing 'Regulation 17' certificates (required before any advertisement for a security can be distributed) to be signed by an agent of a director authorised in writing
- extending the prohibition on statements regarding safety to cover any implication as to safety
- redrafting the Regulations to, amongst other things, remove obsolete references and make them technologically neutral.

The discussion document also asked for feedback on whether availability of the simplified disclosure prospectus should be limited to certain types of securities, although that point has subsequently been picked up by the Ministry in the draft SDP regulations, discussed earlier in this edition of Financial Law Update.

Our view

The financial reporting changes—and in particular the likelihood of being able to prepare interim financial statements for Securities Act purposes in accordance with NZ IAS 34—are overdue. For most issuers the change should reduce compliance costs, although the need to restate historic summaries of financial statements for Securities Act purposes may impose a one-off compliance cost.

While most of the other changes are logical and welcome, we are concerned that some of the changes will impose additional costs on issuers by requiring them to update their disclosure documents without any meaningful improvement in disclosure, particularly as further and more fundamental changes are likely in the medium term following the wider review of the Securities Act. In addition, some of the changes—particularly the proposed

prohibition on implications as to safety—will result in uncertainty for issuers.

What next?

Submissions on the discussion document closed on 8 May 2009. A copy of Kensington Swan's submission is available on our [website](#).

The Ministry is currently considering the submissions and, we understand, will be putting proposals to Cabinet within the next month or so. It seems likely that the revised Regulations will be promulgated towards the end of this year.

Want to know more?

If you would like further information in relation to the proposed changes and the opportunities and challenges these may present for your business, please contact [Catriona Grover](#) on (04) 498 0816 or [Nick Summerfield](#) on (04) 498 0876 or email the team at financiallawupdate@kensingtonswan.com.

A further update on PIE tax rates

In the March Financial Law Update we speculated on the timing of changes to prescribed investor rates and applicable thresholds given last year's tax cuts. Officials have now confirmed that any changes are likely to be introduced from 1 April 2010 after further consultation with the managed funds industry.

The savings industry has conveyed to officials that fund managers would not be able to implement a change in PIE rates before 1 April 2010 unless legislation was passed by 31 July 2009. This was to allow sufficient time for the systems changes that would be required, particularly in the introduction of a further 12.5% rate. That is the rate applicable for income up to \$14,000 and can apply to children, many of whom are KiwiSaver investors, and also to large numbers of pensioners and non-working spouses who invest in PIEs.

Prior to the Government back-peddalling on next year's tax cuts, the industry had proposed to officials that the PIE rates should range from 1 April 2010 be 0%, 12.5%, 20%, and 30% (with a threshold of \$50,000). In principal, the

officials thought this might well be acceptable even though the 20% rate was in anticipation of a tax cut that would not occur until the 2011/2012 tax year. It would now seem highly likely that there will be a reversion to 0%, 12.5%, 21%, and 30% (applying from \$48,000) in line with the tax rates applicable for the 2009/2010 year.

Given the number of PIEs that were eligible for significant tax rebates as at 1 April 2009, principally through hedging losses as the New Zealand dollar fell against most other major currencies, the Government may well be looking for more tax out of this sector as soon as it can. The 19.5% rate as a final tax is out of line with the present tax rate of 21% on income from \$14,000 to \$48,000 so there may be some temptation to increase this rate to 21%

as soon as possible and possibly prior to 1 April 2010.

If any change is to be made to PIE rates at an earlier time, perhaps 1 October 2009, then legislation will need to be added to the Tax Bill

currently before a Select Committee, which is not expected to become law until August or September of this year. The industry would find it difficult to cope with that timeframe. Our money is on a 1 April 2010 start for PIE rates of 0%, 12.5%, 21%, and 30%.

Want to know more?

The Kensington Swan financial services team is keeping a close eye on developments in this area. Partner, Tony Lines, is a member of the ISI Tax Committee that will help shape and convey the industry view. If you would like more information, or to discuss how these changes may impact on your business, please contact [Tony Lines](mailto:Tony.Lines@kingsingtonswan.com) on (04) 498 0805 or email the team at financiallawupdate@kingsingtonswan.com.

Closure of mortgage diversion facility and other KiwiSaver developments

The Taxation (Budget Tax Measures) Act has been rushed through Parliament. As foreshadowed in the Budget the Act has amended the KiwiSaver Act 2006 by closing the mortgage diversion facility to new participants. A number of other more technical amendments to the KiwiSaver Act also look set to be made by the Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill.

The Taxation (Budget Tax Measures) Act closes off the mortgage diversion facility to new participants in KiwiSaver schemes and complying superannuation funds from 1 June 2009. In doing so, it backs out a concession that had always been an anomaly in the KiwiSaver framework—and a costly frustration for providers.

Mortgage diversion will continue to be available to members who requested the facility prior to 1 June 2009. However, depending on the disclosures contained in a scheme's prospectus and investment statement, providers may be able to cease providing the facility to these members as well.

The Act contains some good news for KiwiSaver providers, who are given blanket relief from non-compliance with securities law starting before 31 July 2009 and not continuing after that date, and for any prospectus

registered before 1 June 2009, and investment statements dated before 1 June 2009 (even if non compliance continues after 31 July 2009).

A number of technical changes to the KiwiSaver Act are also proposed in the Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill, which is due to report back from Select Committee by the end of this month. These include amendments relating to automatic enrolment for education related employment, and a limited 'grace period' for employer contributions.

One issue, which we hope will be addressed in the Bill, will be a change to the KiwiSaver Rules to allow providers to pay out small balances following the death of a member without needing a Court-ordered grant of probate or letters of administration. This is possible where less than \$15,000 is payable

from a superannuation scheme, and there is no reason to treat an amount due from a KiwiSaver scheme any differently.

Want to know more?

If you have any questions about the changes please contact [David Ireland](#) on (04) 498 0840 or [Nick Summerfield](#) on (04) 498 0876 or email the team at financiallawupdate@kensingtonswan.com.

Recent court decisions

As always, the Courts have been considering a range of interesting and unique issues. We outline below two recent decisions that are likely to be of interest.

Clarifying 'habitual investors'

In *Ministry of Economic Development v Stakeholder Finance Ltd, Agnes Water Acquisitions Ltd and Robert Daniel McEwan* the Court considered who would not constitute a 'habitual investor' for the purposes of the Securities Act 1978.

Mr McEwan ran a property investment school and established a forum for people interested in investment to join for a fee. After becoming a member of the forum, members could apply for classification as 'habitual investors' so that they could participate in non-public property investment opportunities through companies associated with Mr McEwan. Under section 3(2) of the Securities Act, offers to habitual investors (amongst others) are not regarded as offers of securities to the public, and no prospectus or investment statement is required.

The Securities Commission became aware of advertising by the McEwan group of companies and entered into correspondence with Mr McEwan regarding his practices. The Commission was dissatisfied with the McEwan group's classification of investors as 'habitual investors' and prosecution eventually ensued.

The case centred on Mr and Mrs Gale. The couple had invested money in two McEwan group developments, neither of which was successful. As it happened, Mr Gale was also a regional development coordinator of the forum, in which capacity he marketed the forum's products in Otago and Southland. Mr and Mrs Gale had been categorised as habitual investors by Mr McEwan's solicitors on the basis that they had completed seven investment transactions in the last 10 years.

Under section 3(2)(a)(ii) of the Act, habitual investors are 'persons whose principal business is the investment of money or who, in the course of and for the purposes of their business, habitually invest money'. Because neither Mr nor Mrs Gale's principal business was the investment of money, only the second limb was considered.

The Court noted that the word 'habitual' was not defined in the Act. It agreed with the Ministry of Economic Development's submission that 'habitual' should be given its dictionary meaning of 'constant or continual'. In addition to the number of investments made, the Court held that other factors, including the period of time, the nature of the investment and, potentially, the amounts of money involved, and the success of the investments were factors in

determining whether someone was a habitual investor for business purposes.

Ultimately the Court formed the view that Mr and Mrs Gale were not habitual investors, and that as a consequence Mr McEwan and the defendant companies had breached the Securities Act. It did, however, find that Mr Gale (but not Mrs Gale) could be regarded as having been selected otherwise than as a member of the public. This is largely because of Mr Gale's role as a regional development coordinator in the forum, which allowed him access to more information than most people had about the investment.

The Court was critical of Mr McEwan's practice of deferring to his solicitors for the assessment of persons as habitual investors. It made it very clear that an issuer cannot delegate this task absolutely and must itself have enough of an understanding of the legal test and processes involved to be satisfied that the individuals to whom it is offering an investment, fall within one of the exceptions from the public.

The fact that this is a decision of the District Court, rather than a higher court, does detract slightly from its precedent value. However, the case remains useful insofar as it provides further guidance on how the courts will likely apply what is a very vague and uncertain concept. This case also reinforces the point that those involved in securities offerings cannot completely delegate the performance of their obligations to others and expect to be relieved of liability under the Act.

Unilateral amendments to constitutional documents

A recent decision of the New South Wales Supreme Court—*ING Funds Management Limited v ANZ Nominees Limited*—provides some very useful observations for those with the power to amend documents affecting the rights of others. While the decision was in the context of a unit trust, the observations of the Court are of general application.

ING was the responsible entity/trustee of two managed investment schemes.

Due to concern that there may be a run on both schemes, ING amended the terms of each constitution to freeze redemptions for sufficient time to allow a meeting of members to be held. This meeting would consider a resolution for the modification of the constitution so as to impose a further embargo on redemptions. In the case of one scheme, the amendment was to be subsequently ratified by members by special resolution.

ING was empowered to amend the constitutions in accordance with the Corporations Act (Cth), which permitted amendments if the responsible entity reasonably considered that the 'change will not adversely affect members' rights'.

The two supplemental deeds to effect the amendments were signed on behalf of ING by its General Counsel and Company Secretary.

The Court was required to consider two issues: first, whether the document purported to be executed on behalf of ING was of effect and, secondly, whether the condition precedent to the variation had been satisfied (i.e. whether the responsible entity reasonably considered that the amendment would not adversely affect the interests of the members).

This case note focuses on the second issue. The Court considered that this issue involved an inquiry into the meanings of 'members' rights', 'adversely affect', and 'reasonably considers'.

Justice Barrett drew a distinction between 'members' rights', as that term appeared in the legislation, and the much broader 'members' interests', noting that the 'rights of members' had previously been interpreted to mean 'the contractual and equitable rights conferred on members by the deed'.

Aside from the equitable rights, the rights of members were those provided for in the constitutional document. Justice Barrett concluded that the task of the responsible entity

was, first, to ascertain the rights of the members created by the constitution, as they exist immediately before the amendment, and determine whether those rights, as distinct from the enjoyment of those rights or their value, will be changed or impinged. If they will, the responsible entity must do a comparison and assess whether the impact is within the 'adversely affect' description.

Justice Barrett considered that it was the responsible entity's task to decide whether the change would 'remove, curtail or impair existing rights in a way that is disadvantageous' to the rights enjoyed by members. In this case, the term 'adversely affect' was not qualified by an adjective such as 'unreasonably' or 'materially' and, accordingly, any adverse affect (no matter how minor) would be sufficient to deny the right to modify. The question was not whether the members would be 'worse off', which was a question of 'interests', but whether the members' rights would be adversely affected.

Finally, in considering the term 'reasonably considers', it was held there was a twofold requirement: first, that the relevant belief or opinion was actually held, and, secondly, that the facts are such that an independent reasonable person could have formed that relevant belief or opinion. Because ING was required to 'reasonably' form the opinion, the Court considered 'what were the considerations that led the responsible entity to the conclusion it reached?' Justice Barrett concluded that it is the basis for the decision and the rationale for it, as actually existed in the mind of the decision-maker, which must be found to conform to the standard of reasonableness.

Want to know more?

If you would like any further information in relation to the above cases please contact [Nick Summerfield](mailto:Nick.Summerfield@kensingtonswan.com) on (04) 498 0876, [Maria George](mailto:Maria.George@kensingtonswan.com) on (09) 914 7290 or email the team at financiallawupdate@kensingtonswan.com.

The Court noted the absence of any real debate by ING on the affect the amendment would have on 'members' rights' and that there was a lack of evidence pointing to any considerations 'by which the process was undertaken and the thinking that led the officers' to the decision to pass the amendment. The Court concluded that ING's officers had failed to prove the grounds on which they had concluded the modification would not adversely affect members' rights.

Because the purpose of the amendment was to postpone the right of members to redeem units, the Court concluded that the members' rights would be affected because it would have denied the immediate efficacy of redemption requests lodged within the relevant period. It was 'not possible that a reasonable person would have come to any conclusion other than that the modification would adversely affect members' rights.' It was irrelevant that the proposed amendments were brought about because of the falling value of the funds, as this consideration only went towards the value or enjoyment of the right to have units redeemed, and was accordingly relevant to members' interests, rather than 'rights'.

The case highlights some key considerations which must be taken into account when modifying constitutional documents and emphasises that even in troubled financial times, care must be taken to ensure that each requirement is satisfied.

Banking and finance

Australian Personal Property Securities Bill update

The Australian Senate Legal & Constitutional Affairs Committee has tabled its report in the Senate on the Exposure Draft of the Australian Personal Property Securities Bill. The Committee recommended, among other things, that the commencement of the scheme contemplated by the Bill be delayed by at least 12 months to May 2011.

The Personal Property Securities Bill 2008 is largely Australia's equivalent to the New Zealand Personal Property Securities Act 1999. The Australian Bill seeks to reform the law relating to:

- the creation of valid security interests in personal property
- the priority of competing security interests in personal property
- acquiring personal property free of security interests
- enforcing security agreements upon default by a debtor.

It is proposed that Australia will have a 'PPS Register' so that security interests can be searched on a centralised online database.

Once introduced, the Australian personal property securities legislation will streamline the taking of security in Australia. It is proposed that the Bill is to replace over 70 pieces of Commonwealth, State, and Territory legislation. Not only will lenders and suppliers benefit from one set of rules for all States; it will also provide a familiar platform for banks and other lenders that are operating in New Zealand as well as Australia.

Want to know more?

If you would like further information in relation to the proposal please contact [Nick Lodder](mailto:Nick.Lodder@kensingtonswan.com) on (09) 375 1194 or contact the team at financiallawupdate@kensingtonswan.com.

Emission Trading Scheme: amendments to the Personal Property Securities Act

The Climate Change Response (Emission Trading) Amendment Act 2008 has amended the Personal Properties Securities Act 1999.

The definition of 'investment security' in section 16(1) of the PPSA is amended by including an 'emissions unit'. As a result an emissions unit now constitutes personal property and is subject to the PPSA.

Suppliers can now register their security interest in emissions units on the PPSR and take advantage of the protection given by the PPSA.

It is worth noting that the PPSA has been amended to include special rules for taking possession of emissions units. This is relevant to a secured party's priority, as possession of an emissions unit will, in some cases, have priority over registration of a security interest on the PPSR.

As a result of the amendment a person can take possession of an emissions unit if the emissions unit is, in the ordinary course of business:

- traded or settled through a clearing house or securities depository, and the clearing house or securities depository records the

interest of the person in the emissions unit

- not traded or settled through a clearing house or securities depository, if the unit register records the name of the person as the possessor of the unit; or
- held by a nominee, if the records of the nominee record the interest of the person in the emissions unit.

The amendments to the PPSA now give emissions units the same security status as other readily traded assets. Whether emissions units are widely traded and used as security has yet to be seen.

Want to know more?

If you would like further information in relation to the amendments, and how they might impact on your business, please contact [Nick Lodder](mailto:Nick.Lodder@kensingtonswan.com) on (09) 375 1194 or contact the team at financiallawupdate@kensingtonswan.com.

Securities Commission bans advertising for moratorium restructure

In April 2009 the Securities Commission announced that it banned advertisements by Propertyfinance Securities Limited for a proposed restructure of its moratorium arrangements.

PFSL is a finance company that has been in a moratorium since December 2007. Before then it had been in receivership since August 2007. Since failing to meet a scheduled payment in December 2008, PFSL has been developing a proposal to restructure its moratorium.

PFSL advertised its proposed restructure in roadshow presentations to investors and in briefing notes published on its website.

The Commission stated that PFSL's proposal sought to vary the terms of the existing securities held by debenture holders, and therefore amounted to a new offer of securities under New Zealand securities law. The Commission was of the view that the offer did

not comply with the law because no registered prospectus was available.

In the Commission's opinion, the PFSL's roadshow presentations and website material were also likely to mislead investors because they only set out the positive aspects of the proposal and the negative aspects of the receivership option. This was not seen as providing balanced information upon which investors could make informed decisions.

The Commission has advised that PFSL directors had received legal advice on their presentation and believed the contents to be true and accurate, however they respect the Commission's views and findings.

Want to know more?

If you would like further information please contact [Nick Lodder](mailto:Nick.Lodder@kensingtonswan.com) on (09) 375 1194 or contact the team at financiallawupdate@kensingtonswan.com.

Recent court decisions

As always, the Courts have been kept busy by banking and finance matters. We outline below two recent decisions that are likely to be interest.

Credit Contracts and Consumer Finance Act 2003: reasonable prepayment fees

The Commerce Commission has been proactive in reviewing compliance by credit providers with the Credit Contracts and Consumer Finance Act 2003 and, in particular, the break fees charged by credit providers. In addition to issuing guidelines outlining its view on how the Act should be interpreted, it has taken action against credit providers who it considers have not complied with the Act.

Under the Act, in the event that a consumer credit contract is fully prepaid, the credit provider is entitled to charge 'a reasonable estimate of the creditor's loss arising from the full prepayment.' To assist in determining what a 'reasonable estimate' is, the regulations outline a 'safe-harbour' formula which a creditor can adopt. If the creditor adopts the prescribed formula, any amount recovered is deemed to be reasonable. However, a creditor is not obligated to use the safe-harbour provision and may adopt its own formula for determining its reasonable loss.

The decision in *Commerce Commission v Avanti Finance* is the most recent handed down by the Courts considering the reasonableness of prepayment fees. As you may recall, the District Court had earlier found that the formula adopted by Avanti resulted in it recovering a reasonable loss and, therefore,

not acting in breach of the Act. The Commission appealed that decision to the High Court.

The formula adopted by Avanti was based upon an assessment of the loss it would suffer on the unearned interest on the loan. Notwithstanding that Avanti's experience was that loans were prepaid, on average, 15.7 months early, Avanti elected to cap the interest period for calculating the prepayment fee at 90 days at the contracted interest rate.

The Commission argued that Avanti's formula was inappropriate, and that creditors were required to calculate their loss on the assumption that if the funds were prepaid, they would be re-lent at the prevailing interest rate. The reasonable loss suffered, therefore, was the difference between the original interest rate charged on the loan prepaid and the rate at which the funds could be lent at the then prevailing interest rates, as applied in the safe-harbour formula. In effect, the Commission argued that if a creditor elected to adopt its own formula, that formula could not be inconsistent with that prescribed by the regulations.

While noting that the purpose of the Act was consumer protection, the Court held that this purpose did not mean that a creditor should accept a loss on prepayment. Rather, the issue is whether what the creditor seeks to recover is 'reasonable' based upon an

objective analysis at the time the credit contract was entered into. A fee would be 'reasonable' if it did no more than compensate the creditor for the actual losses it could expect to sustain in the event of prepayment but unreasonable if it enabled the creditor to recover 'significantly' more than the actual loss arising from prepayment.

In the present circumstances, the Court found Avanti had not breached the Act because its excess lending capacity meant that it was not dependent upon the outstanding loans being repaid before new loans could be made. It was, therefore, incorrect that reasonableness would always be linked to the ability to re-lend the particular funds. The loss suffered by Avanti was, therefore, not the difference between the interest rate charged on the initial loan and the interest rate at which the funds *could* be lent at, but the profit on the interest Avanti charged had the loan gone to maturity. The Court concluding that it 'is perfectly reasonable for a loss to take into account the fact that a new loan will not replace the old, and that the profit on a loan is lost through prepayment.'

The Court also rejected a submission that an adopted formula had to be consistent with the safe-harbour formula and noted that the two possibilities for determining loss were 'true alternatives'. It concluded that 'it makes no logical sense for the legislature to have provided two alternative methods for calculation of a reasonable estimate of loss, but have one essentially driven by the terms of the other.'

The decision of the Court does not, however, give creditors complete discretion to determine their 'reasonable losses'. Central to the Court's decision was not only Avanti's excess lending capacity, but that:

- the formula was not arbitrary but based upon Avanti's past experience
- legal guidance had been sought in fixing the formula

- the interest period for calculating the prepayment fee was capped
- the formula was applied notwithstanding changing conditions, which meant that Avanti recovered less than it would have had it applied the safe-harbour formula.

In the present climate, with the Commerce Commission likely to remain conscious of the amounts charged by credit providers, it is an opportune time for credit providers to review their prepayment formulas to take account of the Court's observations in *Avanti*.

Mortgagee's application to purchase mortgaged property

The Property Law Act 2007 permits a mortgagee who is entitled to sell the mortgaged property to apply to the Court for permission to purchase the mortgaged property in question.

In *Canterbury Building Society*, the mortgagee was entitled to sell the mortgaged property and applied to the High Court in Christchurch for an order permitting it to purchase the property.

The Court stated that information about the price at which the applicant wished to purchase the property was essential in an application of this kind.

The applicant was the registered mortgagee of three units in Kaikoura. The mortgagor defaulted in 2008 and, after serving a section 119 notice, the mortgagee decided to exercise its powers of sale in September 2008.

The mortgagee obtained a valuation of the properties from a registered valuer in September 2008. From September 2008, the properties were marketed extensively.

Several conditional agreements failed to settle and the mortgagee rejected a number of offers which it believed did not reflect market value.

The mortgagee then decided that it would purchase the property itself. The application

was served on the mortgagor, guarantor, and subsequent mortgagee as required by the Act.

The Court noted that, in this instance, there was no prejudice to any subsequent mortgagees because that there was no possibility of the building society recovering the full amount secured by its mortgages.

The Court noted that the ability for a mortgagee to purchase a mortgaged property was introduced by the 2007 Act and that the legislation does not set out any criteria for the Court to look upon for guidance. However, the Court was of the view that the application must be considered in the context of the

mortgagee's obligations when conducting a mortgagee sale: namely the duty to exercise the power of sale in good faith, and to obtain the best price reasonably obtainable.

Thus, before granting an order of this nature, the Court held that a mortgagee should look to its obligations under the Act in relation to the conduct of a mortgagee sale for guidance when applying to purchase a mortgaged property.

Want to know more?

If you would like further information in relation to the above cases please contact [Nick Lodder](mailto:Nick.Lodder@kensingtonswan.com) on (09) 375 1194 or contact the team at financiallawupdate@kensingtonswan.com.

Financial intermediaries

Financial adviser regulation update

The Securities Commission released its Staff Paper on Authorised Financial Adviser Competence in April 2009, as part of the wider reworking of the financial adviser regime. Submissions on the Staff Paper were required by 29 May 2009, and as we go to print we are still awaiting the outcome of that process, which has generated much debate.

The Financial Advisers Act 2008 (FAA) aims to increase investor confidence in investment advisers by increasing the standards of professionalism and accountability of investment advisers. We anticipate the FAA coming into effect near the end of 2010, once the raft of regulations underpinning it and its sister Act, the Financial Service Providers (Registration and Dispute Resolution) Act 2008 have been put in place.

The Securities Commission's Staff Paper sets out a possible approach to the interaction between the FAA and the levels of competence required of authorised financial advisers. The FAA requires authorised financial advisers to reach standards of competence, which will be set by the Code Committee and the Commissioner for Financial Advisers in the Code of Professional Conduct in due course. The Code will provide for minimum standards of competence, knowledge and skills, ethical behaviour, and client care. The Code will also provide a framework for ongoing professional training for authorised financial advisers.

The Staff Paper discusses the National Qualifications Framework currently in place in respect of qualifications for financial advisers and examines the possibility of the adoption of this established framework to set the standards of adviser competence in a generic and measurable form. It also proposes liaison with ETITO (the Industry Training Organisation for the finance industry), the wider industry, and educators, to define existing qualifications

using the National Qualifications Framework standards.

Feedback was sought on the process to be put in place for existing financial advisers who do not have qualifications that meet the standard required by the National Qualifications Framework. The Staff Paper suggests an assessment of the adviser's 'baseline' competence, possibly within the parameters of the existing National Qualifications Framework. Submissions were also sought on the process to be put in place in respect of existing advisers who are at first unsuccessful in attaining a baseline standard.

The wider reform of the financial services industry aims to boost public confidence in the industry and its integrity. The introduction of a uniform baseline standard which must be met by all advisers in order for them to be authorised is a logical approach under the reforms.

Whether the proposed baseline standard of a National Certificate in Financial Services (Financial Advice) (Level 5) is an appropriate baseline standard to adopt will be just one of the key challenges confronting the Code Committee once appointed. Another will be whether or not to allow existing advisers to continue advising their clients if they are unsuccessful in reaching the baseline at first attempt, and if so, on what basis. The continuity benefits of allowing existing and trusted advisers to continue advising their

clients must not be allowed to undermine the integrity of the new regime.

Identification and supervision of any advisers who require further training is likely to be a dominant feature of the initial implementation of the Code.

The transition period to the baseline standard may need to be a relatively long period to allow existing and new advisers time to demonstrate competence to the level required. In many ways it is a straight question of logistics—once the Code has been sorted, the wider industry needs enough time to train and appoint enough appropriately qualified assessors to carry out the assessment of advisers. Demonstrating adequate competence will need to go well beyond mere baseline standards where particularly complex or specialised financial adviser services are to be performed—we do not see the Code leaving things on a ‘one size fits all’ basis.

The approaches and proposals outlined in the Staff Paper were preliminary and only intended to set the scene for discussion of the consultation processes and decision making in respect of competence matters. Future editions of Financial Law Update will contain information on any conclusions drawn from the submission process once these are released by the Securities Commission, as well as updates on the development of the Code as these come to hand.

Of course, the development of the Code of Professional Conduct for authorised financial advisers is just one piece of the regulatory jigsaw that needs to be pieced together over the next 18 months. A raft of consultation

papers has been signalled, beginning with a couple of papers from the Ministry of Consumer Affairs on the financial service providers dispute resolution scheme arrangements, and a further staff paper from the Securities Commission on regulating and supervising financial advisers. This latest paper, released on 18 June, sheds light on proposals for qualifying financial entities under the FAA and what that status entails.

Submissions on those two most recent papers are required by the end of July. This further emphasises the fact that the year ahead presents the financial advisory industry with a one-off opportunity to mould the shape of the rules that will govern participants’ operations for years to come—it is incumbent on us all to help get it right.

As part of Kensington Swan’s commitment to this process, Partner, David Ireland will be chairing the Conferenz Financial and Investment Advisers Summit in Wellington on 27 August 2009. This action follows on from the session David provided at the 2008 Summit and his 2009 national road show for the New Zealand Institute of Chartered Accountants that focused on the new rules for financial advice. David will be speaking at the Summit on the breadth of the financial adviser net. Other industry participants and Government officials will be speaking on a raft of topics relevant to the provision of financial adviser services in the future. For more information on the Summit, go to:

www.conferenz.co.nz.

Want to know more?

If you would like further information in relation to authorised financial adviser competence, or would like further information on the dispute resolution scheme papers or the paper on regulating and supervising financial advisers, please contact [David Ireland](#) on (04) 498 0840 or [Catriona Grover](#) on (04) 498 0816 or email the team at financiallawupdate@kensingtonswan.com.

Insurance

Insurance (Prudential Supervision) Bill

The draft Insurance (Prudential Supervision) Bill was released for consultation purposes on 20 April 2009. Submissions were due on 22 June 2009. Set out is our view on some key issues. We have also prepared a full summary of the Bill. If you would like a copy, please email the team at financiallawupdate@kingsingtonswan.com.

The Bill will be introduced to Parliament later in the year, with the full scope of the Act likely to be phased in through 2010. No transitional provisions have been included in the draft Bill, although a two year transition period is likely to be granted to existing insurers in order for them to comply with the requirements of the new Act.

The Reserve Bank ('Bank'), which will become the regulatory authority, has asked that submitters focus particular attention on whether key insurance concepts are correctly captured by the Bill, including the definitions of 'life insurance' and 'continuous disability policy'.

Kingsington Swan has concerns that the current definition of 'insurer' is too broad and may therefore include those to whom the Bill need not apply. The definition of 'insurer', at present, is simply tied to the concept of a 'contract of insurance'. However, a 'contract of insurance' is not defined. As such the concept of 'insurer' may extend to reinsurance businesses, captive insurers, and potentially to superannuation schemes offering death and disability benefits.

In order to narrow the scope of the Act to core insurance providers a definition of insurance business could be developed. This definition could be tied to the concept of 'insurer' so that an 'insurer' must be performing or undertaking insurance business to fall within the ambit of the Bill.

The Bank is also seeking input into the 'workability' of the statutory fund provisions and the treatment of 'composite policies'. At present the definition of 'life insurance', and the related definitions of 'life insurer' and 'life policy', makes the workability of the statutory fund concept problematic. The definition of 'life insurance' does not include 'health insurance' as this is specifically excluded by virtue of the definition of 'continuous disability insurance'.

Life insurers are restricted to referring no more than 5% of composite policies to a life insurance statutory fund. Many life insurance policies include health components and as such will be treated as composite policies under the Bill. The concern is that the Bill is too restrictive in the manner in which it deals with statutory funds and this is compounded by the various related definitions. Life insurance funds cannot be held with non-life policy funds, thus an insurer dealing with composite life and health policies will need to operate two independent funds in order to satisfy the 5% restriction. Such a restriction will create administrative difficulties and ultimately add to compliance costs.

'Continuous disability insurance' is restricted to insurance which pays a benefit for injury or illness in regular payments over a period of two or more years. There is the potential for a continuous disability policy to pay benefits for periods less than two years (for example, income protection for less than 12 months). As such, these policies will fall outside the definition of 'life insurance' and will subsequently cause further difficulties under

the suggested 5% composite policy fund limitations.

There is also concern that the Bill does not effectively consider the provision of total and permanent disability insurance policies, particularly in the context of 'life insurance' and 'continuous disability insurance'. At present 'continuous disability insurance' is defined to include 'a person being found to have a stated condition or disease'. It is not clear whether or not permanent disablement can be said to be a 'stated condition'. If not, total and permanent disability insurance will fall within the definition of 'health insurance' which is defined as insurance against loss connected to the provision of a 'health service'. In our view this is not a logical fit.

The Bill also places restrictions on the investment of statutory funds. The Bill restricts life insurers from investing assets of a statutory fund in an associated person that is not a subsidiary of the life insurer without the approval of the Bank. Although there is an exemption to this restriction, its application is limited. Put simply, life insurers may invest in associated persons only if such investments do not exceed 2.5% of the value of the assets of the particular fund. Associated person is defined broadly so as to include situations where more than half of the relevant 'ordinary' voting securities are held either by the other or by a group of related companies.

Such a restriction will be problematic for many insurers. The restriction, as currently proposed, would prevent investments in

company based investment products and, potentially, unit trusts and other similar schemes. A unit trust, if the sum of all associated persons investing in the same fund held more than 50% of the units, would itself become an associated person, with the Bill providing scope to look at both 'direct' and 'indirect' ownership.

It is common practice for statutory funds to be invested in funds managed by associated persons. Therefore, in our view, it would be appropriate for the Bill to be amended to expressly permit such investments or to provide clearer guidance on when such investments will be approved by the Bank.

Finally, in addition to the existing Companies Act, Takeovers Act, and Income Tax Act obligations involved in any corporate merger, acquisition, purchase, sale, or transfer involving a New Zealand insurer, the Bank will be granted approval powers regarding ownership and changes in ownership. Unfortunately for insurers, the complex takeover and amalgamation requirements of the Companies Act 1993 will still need to be satisfied in addition to the new approval requirements.

Although, overall, the Bill is on the right track, further refinement is required to ensure that more flexibility is provided to insurers. The various definitions that are integral to the Bill's operation will also need to be revisited in order to ensure that the Bill, once enacted, achieves the Bank's desired 'workability'.

Want to know more?

If you would like further information in relation to the draft consultation Bill please contact [Catriona Grover](mailto:Catriona.Grover@kingsingtonswan.com) on (04) 498 0816 or email the team at financiallawupdate@kingsingtonswan.com.

Life insurance tax changes

The Finance and Expenditure Select Committee is currently reviewing the Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill and is due to report back to Parliament at the end of June. A key component of the Bill is changes to the taxation of life insurance companies.

Substantial submissions have been made on the proposed life insurance tax changes which are designed to increase the amount of tax paid by life insurers over what has been historically the case. The Society of Actuaries has been liaising with officials over drafting and technical changes required to the proposed legislation and it is understood that the Select Committee is likely to accept a deferred start date for the new regime of 1 July 2010.

Issues still surround what constitutes participating business but a paper circulated by Inland Revenue officials on this has received widespread industry support. Difficulties have been identified with a similar paper on premium smoothing reserves and the Select Committee has signalled that the legislation is likely to address this by having the legislation establish just principles which

would then permit insurers to take approaches suitable for them so long as they have actuarial sign-off. There are still unresolved matters concerning what policies can retain their prior tax status after the start of the new regime. These matters include the question of whether policies that may be changed as a consequence of a change in tax law can be grandfathered and the treatment of group life, in particular whether the grandfathering period will be three years or four years.

The Select Committee is expected to report back to Parliament at the end of June 2009 and the Bill will likely pass through the House and receive Royal Assent either in August or September of this year. The version of the Bill reported back should contain a number of rewritten provisions pertinent to the proposed 'reformed' life regime and will be eagerly awaited by the industry.

Want to know more?

If you would like further information in relation to the proposed amendments, please contact **Tony Lines** on (04) 498 0805 or email the team at financiallawupdate@kensingtonswan.com.

General

Trust company supervision reforms

Following a report by the Companies Office which addressed the role of corporate trustees in the failure of many finance companies, a review by the Ministry of Economic Development ('MED') of the powers and responsibilities of corporate trustees is currently underway.

This review forms part of a wider review of the Securities Act 1978 ('Act'). In light of the current economic climate and recent events, including the collapse of a number of finance companies, a review of the role of corporate trustees, has become a priority.

Commerce Minister, Simon Power has asked MED for advice on the timing of the review, in particular for opportunities to advance elements of the review quickly. The Minister is considering fast-tracking the development of a trustee supervisory model—a model suggested in the course of the MED's Review of Financial Products and Providers process. This model would retain trustees as the 'frontline' supervisors of debt security issuers, collective investment schemes, and non-bank deposit takers however it would also subject trustees to:

- registration with the Registrar of Financial Service Providers
- approval from the Securities Commission to obtain a trustee licence
- ongoing oversight by the Securities Commission.

Want to know more?

If you would like further information, please contact [David Ireland](#) on (04) 498 0840 or [Maria George](#) on (09) 914 7290 or email the team at financiallawupdate@kensingtonswan.com.

The role of corporate trustees is also likely to be considered by the Capital Market Development Taskforce which is due to report to the Minister later in the year.

Following the Commerce Select Committee's review of the Securities Commission, the Commerce Select Committee has called for closer supervision of trustee companies. The current economic situation has thrown up some weaknesses in the current trustee company supervisory model, as well as weaknesses in aspects of the trust deeds under which they exercise their supervisory powers. The Commerce Select Committee has expressed support for the proposal to appoint the Securities Commission as supervisor of trustee company performance.

The Minister has been clear that he intends to make substantive changes in order to achieve accountability and sufficient competency of trustees. Trustee companies are on notice that changes will be anything but cosmetic, but the precise shape of those changes remains to be seen.

Securities Act (Short Form Prospectus) Exemption Notice

The Securities Commission has introduced a substitute exemption notice, the Securities Act (Short Form Prospectus) Exemption Notice 2009 ('2009 Notice'). The 2009 Notice replaces the Securities Act (Short Form Prospectus) Exemption Notice 2002 ('2002 Notice').

The 2009 Notice, which came into effect on 23 March 2009, retains the existing exemptions and conditions contained in the 2002 Notice, which exempted issuers from the requirement to include financial statements in a short form prospectus for the offer of certain securities to existing shareholders, provided that a copy of the most recent financial statements have previously been given to the shareholders.

Clause 6 of the 2009 Notice now allows issuers to make their annual report available to shareholders by advising them of their right to receive an annual report rather than sending them the report. This is consistent with the amendment made to section 209 of the


Companies Act 1993 in June 2007, which also allows an issuer to simply inform shareholders of their right to receive an annual report.

Clause 7 of the 2009 Notice contains a further exemption – allowing the provision of condensed interim financial statements in a short form prospectus in accordance with NZ IAS 34.

These amendments are part of a general movement towards reducing compliance costs for issuers, and acknowledging that a reduction in the level of information to existing investors is appropriate.

Want to know more?

If you would like further information, please contact [Maria George](#) on (09) 914 7290 or email the team at financiallawupdate@kensingtonswan.com.



Financial service providers dispute resolution arrangements

The Ministry of Consumer Affairs has now released a couple of papers on proposed dispute resolution arrangements that will apply under the Financial Service Providers (Registration and Dispute Resolution) Act 2008. These arrangements will impact on all providers registered under that Act who provide financial services to the public.

The papers from the Ministry of Consumer Affairs, one for the proposed reserve scheme, the other for dispute resolution schemes in general, were released on 22 June 2009—literally the day before this edition of Financial Law Update was scheduled for release.

The Ministry is holding stakeholder meetings on 30 June (Wellington) and 2 July (Auckland) to present the main points, along with presentations on proposed financial adviser regulations. Submissions on the papers are required by 31 July 2009.

Want to know more?

If you would like further information on the two discussion papers or would like assistance with formulating your own submission on the proposals, please contact [Catriona Grover](mailto:Catriona.Grover@kensingtonswan.com) on (04) 498 0816 or [Nick Summerfield](mailto:Nick.Summerfield@kensingtonswan.com) on (04) 498 0876 or email the team at financiallawupdate@kensingtonswan.com.

Start a conversation with us...

Your team of specialists at Kensington Swan are on top of the issues and can provide you practical advice on operating in today's dynamic business environment.

If you would like further information call your usual Kensington Swan adviser or contact the team at financiallawupdate@kensingtonswan.com.

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