Consultation paper – 2 April 2015

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

Investor acknowledgement and warning for the $750,000 minimum investment wholesale investor exclusion

The Financial Markets Conduct Act 2013 (FMC Act) provides statutory exclusions from the standard requirements of the regulated offers regime. This includes exclusions for offers of financial products to defined categories of wholesale investors.

One category of wholesale investor where the exclusion applies is where the minimum investment is at least $750,000. However, to rely on this exclusion, a prescribed warning must be included on offer documents and an investor acknowledgement obtained.

Some businesses and professionals have raised concerns that the warning and investor acknowledgement is not practical in some circumstances and so will have a negative impact on New Zealand's debt capital markets. In particular, there is a concern fewer offers will be made by overseas-based issuers.

To determine whether a class exemption is appropriate we will consider whether, in some circumstances, the requirements for the $750,000 investment exclusion are unduly burdensome for the benefit they provide, or otherwise provide an inappropriate deterrent from reliance on the $750,000 minimum investment exclusion.

We want further information and your feedback on our initial proposal.

About this consultation:

This consultation is for:	It aims to:
Wholesale investors, banks, brokers, issuers, legal advisers	Test whether an exemption to the investor acknowledgement and warning requirements of the $750,000 minimum investment exclusion is needed in particular circumstances

Next steps

Transitional provisions in the Financial Markets Conduct Regulations 2014 (FMC Regulations) enable offerors to offer under the Securities Act 1978 (Securities Act) statutory exemptions for wholesale investors until 1 June 2015. This includes a $500,000 minimum subscription exemption.

We aim to determine whether support to the $750,000 minimum investment exclusion is appropriate, and have relief (if any) in place by 1 June 2015.

Submissions close on 22 April 2015. The form at the back provides more details.

Document history

This version was issued in March 2015 and is based on legislation as at the date of issue.

$750,000 minimum investment wholesale investor exclusion

1. To rely on the $750,000 minimum investment wholesale investor exclusion ($750,000 investment exclusion)[1], clauses 3 to 5 of Schedule 8 of the FMC Regulations require a prescribed warning on offer documents and an investor acknowledgement. The acknowledgement need only be obtained once from the investor. The offeror can use a previous acknowledgement for subsequent offers to the same person.[2] The offeror does not need to get any other information from the investor, or carry out any other due diligence.

2. The purpose of the investor warning and acknowledgement is to ensure investors know they are being treated as wholesale investors and what this means. A warning and acknowledgement is particularly important for this wholesale investor category because relatively inexperienced investors could potentially invest a large sum without understanding the consequences of that.

3. The key benefit of the $750,000 investment exclusion for the market is its speed and efficiency. The offeror can set the parameters of the offer at above $750,000 ensuring all investors who buy the financial products, by definition, will fall within the wholesale investor category.

Concerns about usability of $750,000 investment exclusion

4. Questions have been raised with us about whether the warning and investor acknowledgement will undermine these benefits by imposing significant compliance costs. Some businesses and professionals have also noted investors do not read the warning.

5. Both of these issues were considered by the Government and the Ministry of Business, Innovation, and Employment (MBIE) when the regulations were made. This included consideration of submissions supporting the investor warning and acknowledgement. We are not proposing to carry out an additional general cost/benefit analysis for the investor warning and acknowledgement requirements.

6. However, we will consider questions around whether there are specific types of transactions, or other circumstances, in which these requirements are either:
   - unduly burdensome for the benefit they provide, or
   - are of little benefit, because there is another way the investor will be adequately alerted to their treatment as a wholesale investor.

7. The main concern that has been raised with us by some businesses and professionals is whether offers by overseas issuers, particularly of 'Kauri bonds', are less likely to be extended to NZ's debt capital market than under the Securities Act regime. Contributing factors to this concern include:
   - the absence of a straightforward and objective test to enable issuers to easily determine who is a wholesale investor, increasing the potential for issuer liability

[1] See clause 3, Schedule 1, Financial Markets Conduct Act 2013.
[2] See regulation 5(1), Financial Markets Conduct Regulations 2014.

- standard offer documents cannot be used across multiple jurisdictions if an NZ-specific warning is required, and
- compliance costs from establishing procedures to monitor receipt of investor acknowledgements may be significant in light of the relative size of NZ's market.

8. Another concern that has been raised relates to the practical issues associated with receiving investor acknowledgements where transactions of debt securities occur electronically through a securities settlement system.

The Kauri bond market

9. Questions raised about the usability of the $750,000 investment exclusion requirements have focused on their use in the Kauri bond market. This is an institutional capital market consisting of NZ dollar denominated debt securities registered and issued in NZ by a foreign entity.[3]

10. For Part 3 of the FMC Act not to apply to offers of financial products (including Kauri bonds) in NZ by overseas issuers, overseas issuers need to take all reasonable steps to ensure only wholesale investors, close business associates, or relatives (as defined under clauses 3 to 5 of Schedule 1) may accept the offer in NZ.[4] For this reason, businesses and professionals value a straightforward objective test for determining who is a wholesale investor in NZ.

11. We recognise that Kauri bond issues need to be planned, offered and issued quickly when market conditions are favourable. Additionally, these offers are undertaken by issuers operating across international markets. We appreciate, in this context, the investor warning and acknowledgement process may impose obligations that are more significant than in other contexts. The concern that has been raised with us is that these obligations may reduce the attractiveness of NZ as a destination for Kauri bond offers.

12. However, we also understand that some form of investor certification is a common requirement for wholesale transactions in overseas markets, and that an obligation to obtain such a certificate is not likely to have a material impact on decisions whether to make offers in NZ. We would be interested to receive views from interested parties on whether this obligation is in fact likely to have a material impact, with information on the issuers or transactions that are expected to be affected.

Use of other wholesale investor exclusions

13. As part of considering the usability of the $750,000 investment exclusion, we have looked at the practicalities of relying on the other categories of wholesale investor to determine whether relief is appropriate in certain circumstances. The FMC Act requires businesses and professionals to take a new look at how they are doing business, and consider whether there are any new opportunities or different ways of doing business.

14. In our view the availability of other wholesale investor categories, including some bright-line options, reduces the need to rely on the $750,000 investment exclusion in the wholesale debt security market. In addition, the other

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[3] *Can't see the wood for the trees – shedding light on Kauri bonds*, Reserve Bank of New Zealand: *Bulletin,* Vol. 77, No. 2, June 2014, page 26.
[4] See section 47, Financial Markets Conduct Act 2013, which provides the territorial scope for the application of the disclosure provisions in Part 3 that in turn determine whether an offer is a regulated offer with disclosure requirements set out in Part 3 and governance requirements under Part 4.

wholesale investor categories in clause 3(2) of Schedule 1 have the option for investors to self-certify that they are a wholesale investor. If this certificate is provided, issuers must treat the investor as a wholesale investor.[5]

Kauri bonds

15. We understand the investor base for Kauri bond issues includes local banks, fund managers, and insurance companies. In recent years, the international investor base has developed, and more offshore asset managers and central banks have started to issue Kauri bonds. We expect the NZ investors will come under the 'investment business'[6] category of wholesale investor and potentially the 'investment activity criteria'[7], or 'large'[8] category.[9]

16. We understand an NZ-based 'dealer' or 'arranger' usually engages with the overseas issuer to facilitate the Kauri bond offer in NZ. This person will be in a good position to efficiently confirm NZ investors' wholesale status for the overseas issuer (or facilitate the provision of safe harbour certificates if necessary).[10] Given the investment business category of wholesale investor provides a bright-line test for these types of investors. This test should be straightforward for NZ-based dealers to apply (eg, by checking the relevant public register) and enable them to provide any necessary assurances to the overseas issuer. In most circumstances we expect safe harbour certificates will not be necessary.

17. NZ-based institutions interested in investing in Kauri bonds, such as registered banks, do also have opportunities to provide safe harbour certificates to overseas debt issuers before or at the time they make their application. Overseas issuers must then treat the registered bank as a wholesale investor. There is no need for an offeror to check publicly available information (such as the register of registered banks). Clause 45(1) of Schedule 1 provides that an offeror cannot rely on a safe harbour certificate if it knows the investor was not in fact a wholesale investor of the type specified in the certificate. We consider this will only be the case when the issuer actually holds information that reasonably brings the safe harbour certificate into question.

Wholesale debt securities

18. More broadly we think safe harbour certificates are a useful mechanism for offers of wholesale debt securities generally. They can be used to address uncertainties for those categories of wholesale investors that are less straightforward to apply to investors (for example, the 'large' category). A safe harbour certificate is not needed on a deal-by-deal basis. The status of a wholesale investor specified in the certificate is determined at the time it is given and lasts for two years from that date.[11] A change to an investor's status during the two-year period does not affect the validity of the certificate for the 'large' or 'investment activity criteria' categories. For the other categories of

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[5] See clause 44, Schedule 1, Financial Markets Conduct Act 2013, which provides that the purpose of safe harbour certificates is for particular categories of wholesale investors (those listed in clause 3(2) of Schedule 1) to be able to provide certainty to offerors that an investor is a wholesale investor for which no disclosure is required before an application in respect of an offer of financial products can be accepted.
[6] Clause 37, Schedule 1, Financial Markets Conduct Act 2013.
[7] Clause 38, Schedule 1, Financial Markets Conduct Act 2013.
[8] Clause 39, Schedule 1, Financial Markets Conduct Act 2013.
[9] We have seen typical term sheets for Kauri bonds that do not use the Securities Act $500,000 minimum subscription exemption. Denominations offered were a minimum of $100,000 with multiples of $1000, in addition to a selling restriction for NZ residents deemed to be retail investors.
[10] If a Kauri bond offer is only able to be accepted by wholesale investors in New Zealand, Part 3 of the FMC Act will not apply and the wholesale status of overseas investors will not need to be considered. If, however, the offer is received in New Zealand by investors other than wholesale investors, close business associates, or relatives (as defined under clauses 3 to 5 of Schedule 1), Part 3 will apply, unless the offeror demonstrates it took all reasonable steps to ensure these types of investors could not accept the offer. If Part 3 applies, the status of all investors, including overseas investors must be considered. See section 47, Financial Markets Conduct Act 2013.
[11] Clause 45, Schedule 1, Financial Markets Conduct Act 2013.

wholesale investor, ongoing use of safe harbour certificates during the two year period can continue unless the issuer knew immediately before a transaction that the investor was no longer in fact that type of wholesale investor.[12]

19. We expect NZ businesses taking part in the financial markets as investors will need to be able to readily identify which category of wholesale investor they are. This will be a key piece of information for a business to know at any point in time. They should also be in a position to provide safe harbour certificates to address uncertainties, or any perceived risks, that may arise when applying the wholesale investor categories in certain circumstances.

20. In addition, NZ institutions issuing, or selling, financial products should be able to efficiently get investor acknowledgements or safe harbour certificates (if necessary) from clients as part of their standard 'Know Your Customer' procedures.

Questions

1. Do you consider the compliance burden of the investor warning and acknowledgement requirements is unreasonable high in some circumstances and will deter issuers from offering wholesale debt securities in NZ? If so, please explain the basis for this, and the particular circumstances where this will be the case. In respect of particular compliance costs, please estimate the quantum and provide a breakdown of the costs.
2. What difficulties do you foresee in operating under the other categories of wholesale investor instead of the $750,000 investment exclusion? To the extent any concern is that the alternative means of operation raise significant compliance costs, please estimate the quantum and provide a breakdown of the costs.
3. What responsibilities does the NZ-based 'dealer' or 'arranger' carry out when facilitating a Kauri bond offer?
4. Are the dealers or arrangers in a good position to efficiently confirm an investor's wholesale status for the overseas issuer?
5. We understand the most significant concerns relate to the wholesale debt security market, particularly the Kauri bond market. Do you think there are issues for other markets, where the compliance burden of the investor warning and acknowledgement requirements (or the alternate use of other wholesale investor categories) would be unusually high, which should also be considered? If so, please explain.
6. For offers of debt securities other than Kauri bonds issues, what are the reasons for a reluctance to use safe harbour certificates to address any uncertainties or risks? (We consider that safe harbour certificates are particularly useful for the categories of wholesale investor that are less straightforward to apply to investors (for example, the 'large' category) given the certificates do not need to be provided on a deal-by-deal basis).
7. Do you agree with our interpretation that clause 45(1) of Schedule 1 does not require an offeror to check publicly available information when they receive a safe harbour certificate from an investor? If not, please explain.
8. What procedures are undertaken when a financial institution takes on new customers and is this information monitored and updated periodically? To what extent do these processes address matters related to an investor's wholesale/retail status? To the extent that these matters may not be specifically encompassed, do you think they could be incorporated efficiently? If not, please explain the quantum of costs and any issues for incorporating these checks into your 'Know Your Customer' procedures.

[12] Clause 45(3) and 49 , Schedule 1, Financial Markets Conduct Act 2013.

Questions

9. Do you agree with the view that NZ businesses taking part in the financial markets as investors will find it useful to identify which category of wholesale investor they are in and, if necessary, be in a position to readily provide safe harbour certificates to address uncertainties? If not, please explain.

The FMA's discretion to exempt

21. Under section 556 of the FMC Act, the FMA may, on terms and conditions that it thinks fit, exempt any person or class from compliance with any provision, or provisions, of Part 2 to 7 of the FMC Act. The FMA must not grant an exemption unless it is satisfied that it is necessary or desirable for the purposes of the FMC Act. The extent of the exemption cannot be broader than is reasonably necessary to address the matters that gave rise to the exemption.

22. The purposes of the FMC Act include (among other things):

- to promote the confident and informed participation of businesses, investors and consumers in the financial markets
- to promote and facilitate the development of fair, efficient and transparent financial markets
- to avoid unnecessary compliance costs, and
- to promote innovation and flexibility in the financial markets.

Exemption proposal (if relief is appropriate)

23. If we conclude that there is a real and significant difficulty caused by the $750,000 investment exclusion requirements following consideration of submission, we will consider what relief may be appropriate. Any exemptive solution would need to give us enough confidence, from the circumstances of the transaction, that the only investors are institutional investors who are aware they are participating in a wholesale market and the consequences of that.

24. One option may be to exempt offers of debt securities for issue from the investor warning and acknowledgement requirements for the $750,000 investment exclusion when those products are transferred through certain electronic settlement systems.

25. We want your feedback on whether this would be useful, how an exemption could be framed and whether certain settlement systems, such as NZClear, provide useful proxies to identify institutional investors.

26. If a case for exemptive relief is established, we will also consider providing the same relief from the investor warning and acknowledgement for secondary sales occurring within 12 months of issue that require disclosure under clause 31 of Schedule 1.

NZClear

27. We particularly want to test whether the NZClear settlement system may provide a good basis for an exemption. We think this may meet our objective of providing enough confidence, from the circumstances of the transaction, that the

only investors are institutional investors who are aware they are participating in a wholesale market and the consequences of that.

28. NZClear is a designated settlement system under the Reserve Bank of New Zealand Act 1989 and it provides a settlement service for New Zealand's wholesale financial market. The Reserve Bank, as the operator of NZClear, assesses applications for membership against the criteria set out in the NZClear Rules. This ensures members are of good standing and have the necessary resources to meet their obligations as a member.[13]

29. We understand members do not have to be institutions and can be individuals. In practice, most members are large institutional investors or financial institutions, but this is not a criterion for membership.[14] We understand further that there are also a few nominee companies that are members and so some transactions settled through NZClear are ultimately being carried out on behalf of non-members. Given this context, we recognise relying on NZClear membership does not always mean members (or the underlying investors) will always be large institutional investors or financial institutions.

30. The membership and transaction fees for using the services provided by NZClear are likely to however act as a barrier to entry for those not wanting to routinely settle securities transactions. We anticipate the combination of the features outlined above may mean we could be reasonably satisfied that members of NZClear are institutional investors that regularly use the system. We seek information to test this.

31. There are some additional limitations with this proposal. Following a strategic review late last year, the Reserve Bank sought registrations of interest from potential vendors for the procurement of a real-time gross settlement system and a security settlement system with a depository.[15] The intention is for these to replace the Reserve Bank's current payment and settlement systems, namely the exchange settlement account system and the NZClear securities settlement system. The future of NZClear in its current form with its specific membership criteria is uncertain and any exemption based on NZClear may need to be reviewed in the near future.

Avoidance opportunities for transactions on another's behalf

32. An exemption for the $750,000 investment exclusion based on transactions settled through certain settlement systems could create avoidance opportunities. This is because of the possibility that transactions can be settled through a settlement system, such as NZClear, on behalf of someone who is not a financial institution or other institutional investor. We also want information on the nature of these relationships and the type of businesses or professionals that settle transactions on behalf of others.

33. If a business or professional has decided to buy financial products on an investor's behalf through supplying discretionary investment management services (DIMS) and is also a DIMS licensee, this offer will not require disclosure by the offeror to the investor under clause 7 of Schedule 1. We recognise that beyond a DIMS licensee relationship, an underlying investor could instruct a business or professional to settle a securities transaction on their behalf. In these circumstances we question whether the underlying investor knows they are participating in a

[13] For further information see: Overview of NZClear.
[14] For further information see: NZClear Members.
[15] For further information see: http://www.rbnz.govt.nz/markets_and_payment_operations/payment_system_review/.

wholesale market, perhaps due to client agreements. If the underlying investor is aware of the consequences of a business or professional settling transactions on their behalf, the investor warning and acknowledgement may be redundant in these circumstances as well.

Questions

10. Do you think a proposal for relief based on debt security transactions settled through NZClear addresses the concerns about the practical use of the investor warning and acknowledgement?
11. Do you think this proposal will ensure the only investors participating in the transaction are institutional investors in respect of which warnings and investor acknowledgements are redundant because they already understand that the usual regulatory requirements will not apply and the consequences of this? If not, please explain.
12. Do you think this proposal may create opportunities for general avoidance? For example, by creating an incentive to settle certain debt security transactions through a settlement system that would not have otherwise been dealt with in this way? Please explain.
13. We understand that Kauri bonds transactions are usually settled through NZClear. What other settlement systems, dealing houses or platforms involved in wholesale debt security transactions, could be used as proxies to base an exemption on? What types of investors have access to these services?
14. What is the nature of the relationship between businesses and professionals that settle securities transactions on behalf of investors on settlement systems such as NZClear, and what sort of disclosures are provided and client agreements entered into in these circumstances?
15. Are there any other proxies we should consider as a base for an exemption in relation to the $750,000 investment exclusion where we can be confident the only investors are institutional investors that are aware the usual regulatory requirements do not apply to the offer?
16. More broadly, are there any alternative proposals for exemptive relief you think we should consider? If so, please explain the circumstances and basis justifying relief.

The next step

How do I make a submission?

Please use the form on the next page – this gives the details of what you need to do. Forms must be submitted electronically in both PDF and word formats and emailed to consultation@fma.govt.nz – please put 'Feedback: Investor acknowledgement and warning for $750,000 minimum investment wholesale investor exclusion' in the subject line.

Submissions close on Wednesday 22nd April 2015.

Where can I get more information?

You'll find more information on our website www.fma.govt.nz.

If you have questions about the consultation process, please get in touch on 0800 434 567.

Feedback: Investor acknowledgement and warning for the $750,000 minimum investment wholesale investor exclusion

Please submit this feedback form electronically in both PDF and MS Word formats and email it to us at consultation@fma.govt.nz with 'Feedback: Investor acknowledgement and warning for $750,000 minimum investment wholesale investor exclusion' in the subject line. Thank you. **Submissions close on Wednesday 22nd April 2015.**

Date: Number of pages:

Name of submitter:

Company or entity:

Organisation type:

Contact name (if different):

Contact email and Phone:

Paragraph or Question Number	Comment	Recommendation
You don't need to quote from the consultation document if you use part & paragraph numbers. *You may attach extra pages - please label each page with your name & organisation.*		

Feedback summary – *if you wish to highlight anything in particular*

Please note: Feedback received is subject to the Official Information Act 1982. We may make submissions available on our website, compile a summary of submissions, or draw attention to individual submissions in internal or external reports. If you want us to withhold any commercially sensitive or proprietary information in your submission, please clearly state this and note the specific section. We will consider your request in line with our obligations under the Official Information Act.

Thank you for your feedback – we appreciate your time and input.