

15 May 2017

Regulatory Impact Statement: Designation of shares in investment companies

This document is for:
Investment companies, managers, advisers

It discusses a class designation of certain shares in investment companies as managed investment products.

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Document code # 3394448

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Executive summary

This Regulatory Impact Statement (RIS) is about a class designation for certain shares in investment companies as managed investment products (MIPs), and the company which issues them as a managed investment scheme (MIS). It summarises the problem we are seeking to address, our objectives, the options and their associated impacts, and the consultation feedback we considered before deciding on the designation.

We think this class designation is necessary to achieve the consumer protection objectives of the MIS regime. Without this designation, it would be possible to offer shares to investors without an appropriate level of disclosure and protection. This could disadvantage some investors and lead to poor investment outcomes.

This designation creates a more level playing field for providers operating under the MIS regime and others issuing shares which are (in economic substance) MIPs. It also prevents shares which are MIPs (in economic substance) from being inappropriately offered through crowd funding platforms.

A share in a company is normally defined as an equity security, but certain types of shares in investment companies have characteristics that make them (in economic substance) MIPs. For these types of shares, the MIS regime is likely to be more effective than the equity securities regime for achieving the purposes of the FMC Act. The FMA has the power to designate shares into a more appropriate financial product category, when that helps achieve the purposes of the FMC Act.

Our analysis of whether to issue a class designation or not was based on the statutory tests that apply to use of the FMA's designation power. These require the FMA:

To be satisfied that making the designation is necessary or desirable in order to promote one or more of the purposes of the Financial Markets Conduct Act 2013 ('FMC Act'), to have regard to the economic substance of the relevant security, and to have consulted with the persons that it considers will be substantially affected by the designation.

After considering regulatory and non-regulatory impacts, we decided on a class designation notice with the following designations:

- Designation of certain shares in investment companies as MIPs. Shares will fall within the designation if they are issued by an investment company, there are reduced powers of shareholders and/or entrenched key service provider arrangements; and the shares are not quoted on the NZX main board.
- Designation of the company issuing the shares as a MIS. This ensures MIS regime requirements will apply to the structure.
- Designation to prevent issuers from avoiding the effect of the designation by offering designated shares as an unregulated offer through an equity crowd funding service.

Introduction

Background

How financial products are defined under the FMC Act

Financial product definitions in the Securities Act 1978 were largely based on the legal form of the security, rather than on their economic substance. This meant some securities were not categorised appropriately, allowing the issuer to avoid legal requirements that would have otherwise been applicable. The FMC Act remedies this by focusing on the underlying economic substance of financial products.

Where product definitions do not result in the right outcomes, the FMA has the power to designate products into a more appropriate category. For example we can declare shares that are (in economic substance) MIPs to be MIPs, regardless of whether they would fall within the definition of equity securities. This ensures the regime is flexible enough to deal with novel product types in the market, and prevents avoidance.

The FMC Act defines four types of financial product: debt securities, equity securities, MIPs and derivatives. An equity security is broadly defined as including any share in a company. The definition of MIP excludes both equity securities and debt securities.

Under the FMC Act, each type of financial product has its own tailored regime, which might include specialised disclosure and governance requirements. Each regime has been designed to be ‘fit for purpose’ for that financial product.

The regime for equity securities focuses on disclosure requirements

Investing in equity securities usually gives an investor ownership of a portion of a company, and various voting rights associated with ownership such as the right to vote for directors. Investors can use those rights to set the strategic direction of the company and hold management to account.

The FMC Act equity securities regime focuses on disclosure requirements to enable investors to assess the underlying business. This includes assessing the current state of the business, the value of assets and future growth prospects, and understanding how any capital raised will be used.

The regime for MIS also imposes governance requirements

MIS investors don’t usually have any direct control over the MIS. This is why the FMC Act MIS regime imposes governance requirements to provide extra protection for retail investors, in addition to disclosure requirements.

Where retail investors hold MIPs in an MIS, the MIS must have a licensed manager and an independent licensed supervisor. Scheme property must be held by the independent supervisor or another independent custodian.

The FMC Act also establishes statutory duties for both the MIS manager and supervisor. These duties include a duty to act honestly and with reasonable diligence, to act in the best interests of investors, and to comply with a professional standard of care. These duties, together with the fair dealing duties in part 2 of the FMC Act, act as overarching

duties. They set the scene for how the MIS manager and supervisor meet their specific responsibilities, and for the relationships and accountabilities they have. The overarching duties also require governing documents, statements of investment policy and objectives (SIPOs), and business systems and processes for the MIS that are ‘fit for purpose’.

Within the MIS regime, there are two types of MIPs:

- ‘managed funds’
- ‘other’.

The FMC Act defines managed funds as having certain characteristics relating to asset liquidity and the way products are continuously offered and redeemed. ‘Other MIPs’ are MIPs that are not MIPs in a managed fund. Both have their own tailored disclosure requirements. For example, managed funds need to comply with prescriptive rules for product disclosure statements (PDS). PDS disclosures for managed funds are designed for comparative purposes and need to be updated quarterly. PDS requirements for ‘other MIPs’ allow more flexibility to describe the nature of the scheme and don’t have to provide fund updates. The focus of MIS regime disclosure requirements is to help investors to understand the scheme’s investment philosophy and objectives (including the risk and return trade-offs) and fees.

The broad objectives of the MIS regime are to:

- have ‘fit for purpose’ and effective governing documents and SIPOs
- hold MIS managers and supervisors to account through tailored requirements across licensing, disclosure, and governance.

Why we decided to consider a class designation

MIS regime requirements provide important protection for investors, but impose a higher regulatory burden than the equity securities regime.

Members of the managed funds industry have raised concerns about investment companies they believe are operating like MISs (and issuing MIP-like shares), but avoiding FMC Act MIS requirements. They have said these companies are doing this by offering shares under the equity securities regime, using a company structure as a loophole to offer products without having to be licensed or comply with MIS regime requirements. They believe these products are no different in substance to those offered by MIS providers.

In addition, during our PDS review process we have seen examples of share offers with terms that make the economic substance of the shares offered less like equity securities and more like MIPs. We think an investment company can be used as a legitimate alternative collective investment structure to a MIS. But in some of the cases we have seen, the proposed terms of the investment company shares did not confer shareholder rights characteristic of equity securities, such as equity voting rights. In some cases, founding shareholders have entrenched themselves as key service providers to such a degree that it is impossible or impractical remove them. We believe shares issued by an investment company with these MIS (rather than equity) characteristics are (in economic substance) MIPs rather than equity securities. Therefore it may be appropriate for the FMC Act MIS regime to apply. If we didn’t use our designation powers, the equity securities regime would apply to these shares.

FMC Act objectives informed our decision

Where the definitions of financial products in the FMC Act do not result in the right outcomes, the FMA can designate products into a more appropriate category. Any designations we make must promote one or more of the purposes of the FMC Act regime. We must have regard to the economic substance of the relevant security. We also have to consult the people (or representatives of the people) we think will be substantially affected by the designation.

The main purposes of the FMC Act in section 3 are:

- promoting confident and informed participation of businesses, investors, and consumers in the financial markets
- promoting and facilitating the development of fair, efficient, and transparent financial markets.

The additional purposes of the FMC Act in section 4 are:

- providing for timely, accurate, and understandable information to help those making decisions relating to financial products or financial services
- ensuring appropriate governance arrangements apply to financial products and certain financial services that allow these to be effectively monitored and reduce governance risks
- avoiding unnecessary compliance costs
- promoting innovation and flexibility in the financial markets.

Before deciding to use our designation power, we measured the two options outlined in this RIS against the FMC Act objectives we think are most relevant:

- promoting and facilitating the development of fair, efficient, and transparent financial markets
- providing for timely, accurate, and understandable information to be provided to persons to assist them to make decisions on financial products
- ensuring appropriate governance arrangements apply to financial products that allow for effective monitoring and reduce governance risks.

As part of our policy process we worked and consulted with the following stakeholders (or their representatives):

- investment companies
- investment company investors (shareholders)
- investment company managers and other key service providers
- supervisors.

Options and impact analysis

We considered two options

- Option 1: Class designation (preferred option)
- Option 2: No designation (status quo).

Option 1: Class designation

Description

Option 1 was to issue a class designation notice. Under this option, developed in consultation with stakeholders, we would designate shares as MIPs where the shares have all of the following characteristics:

- The shares are issued by an investment company. An investment company is a company whose principal business consists of investing in investment property (eg financial products, commodities, land or buildings), or which holds itself out as being a company whose principal business consists of investing in investment property.
- There are reduced powers of shareholders and/or entrenched key service provider arrangements
- The shares are not quoted on the NZX main board (ie NZX main board shares are excluded).

The designation would apply to shares issued after the class designation notice comes into force.

Where shares are designated as MIPs, we would also designate the company issuing those shares as a MIS. Except in unusual cases, and unless an exclusion otherwise applies (eg under schedule 1 of the FMC Act), this designation means an investment company designated as a MIS will require:

- a licensed manager and an independent (licensed) supervisor
- its assets to be held by an independent custodian
- its governing documents to comply with the MIS requirements under the FMC Act
- a SIPO (statement of investment policy and objectives).

Under Option 1 we would also designate to prevent issuers from offering designated shares as an unregulated offer through an equity crowd funding service. This is necessary because 'crowd funding service' is defined by reference to an offer of 'shares in a company' rather than 'equity securities'. So without this designation it would still be possible to offer designated shares through an equity crowd funding service.

Impact analysis

Option 1 allows for understandable information to be provided to investors to assist decision making, and for appropriate governance arrangements to apply

Where the designation applies, the requirements of the MIS regime apply to those shares and to the company issuing the shares. This includes:

- **Initial and ongoing MIS disclosure requirements.** These requirements have a different focus from the equity securities regime. In broad terms, the MIS disclosures focus on the investment rather than on the issuer. Tailored requirements for ‘managed funds’ and ‘other funds’ better enable investors to make an informed decision about whether to invest, and to monitor their investment.
- **MIS governance requirements, including having a licensed MIS manager, licensed supervisor, a custodian and a SIPO.** These enhanced governance requirements better reflect the reduced level of control shareholders would have in structures that fall within the designation. Having a licensed supervisor provides investors with an independent representative acting in their interests in circumstances where they may be less able (than equity shareholders with usual governance rights) to hold the company’s board and management to account.

We designed the designation to apply to shares with characteristics that make them (in economic substance) MIPs rather than equity securities. It is appropriate that this information and these governance obligations apply. It is also appropriate that, like other MIPs, the shares could not be offered through an equity crowd funding service.

Option 1 promotes fair and efficient markets

Option 1 promotes the development of fair and efficient financial markets by ensuring designated shares which are in economic substance MIPs are treated in the same way as other MIPs. This creates a more level playing field with providers operating under the MIS regime.

Under Option 1, the designated shares (and the company issuing those shares) would be subject to the same compliance requirements as other MIPs (and MISs). This reduces issuers’ ability to use investment company structures that operate in the same way as MISs to avoid the more extensive compliance requirements of the MIS regime, and associated costs.

Preventing designated MIP shares from being offered through an equity crowd funding service as an unregulated offer would stop issuers from circumventing the effect of the designation and MIS regime requirements. This ensures equal treatment of the designated shares with other MIPs, which cannot be offered through equity crowd funding platforms. The other exclusions in Schedule 1 of the FMC Act remain available, if they apply.

Option 1 would have significant cost implications for investment companies with designated shares. This is due to the higher regulatory burden imposed by the MIS regime when compared to requirements for issuing equity securities. We understand from consultation that investment companies within the designation may incur materially increased compliance costs. This may make offering the shares uneconomic. This was raised as a particular issue for single asset companies. Consultation feedback indicated that costs may be passed on to investors, or result in schemes not being offered to investors. This would reduce investor choice.

Having considered the cost impacts of Option 1, our view is that although issuers would incur compliance costs, these costs are necessary to achieve the consumer protection objectives of the MIS regime. The costs would be no greater than those incurred by other MISs operating in compliance with the MIS regime. This ensures a level playing field.

We would have the power to review the MIS requirements for each issuer on a case-by-case basis, and consider exemptions where appropriate. As noted above, investment companies who don't want to operate under the MIS regime could structure their offerings so the shares retain equity characteristics and don't fall within the scope of the designation.

Issuing a class designation would provide issuers with certainty about the treatment of shares with these characteristics. We think this is more beneficial than notifying businesses and/or potential investors of our concern about whether these types of investments are appropriate, and noting the option to issue individual designations where we believe harm may result. A class designation would enable issuers to consider the potential impact of the designations on their structures early in their offer design process. Investment companies could then choose to design their share offers so the shares retain equity characteristics and don't fall within the class designation test. In these circumstances, it would be appropriate for the requirements of the equity securities regime to apply to those shares.

How we will respond if shares fall within or outside notice scope, and impact appears inappropriate

There is a risk that some structures may be inadvertently caught by the designation. For example, it's possible that:

- an 'ordinary' commercial company may technically fall within the definition of 'investment company'; or
- the offer terms, company constitution or key service provider agreements may trigger one of the designation tests in the notice, in circumstances where we wouldn't propose to individually designate the shares offered if we had considered the matter as a standalone case.

There is also a risk under Option 1 that some investment companies may offer shares that are (in economic substance) MIPs but do not fall within the tests in the notice. We will monitor the impact of the notice to check it is operating in the intended manner, and may consider an individual designation or exemption where appropriate. We may also reconsider the scope of the notice and amend it if we see instances of shares being designated when we would not intend them to be, or we see repeated offers of shares with characteristics warranting individual designation.

Option 2: No designation (status quo)

Description

Under this option we would not make any class designation. Investment company shares would be issued as equity securities and the issuer would comply with requirements for equity securities under the FMC Act. Obligations under the Companies Act 1993 would also apply to protect the shareholders' interests (such as directors' duties).

Impact analysis

Option 2 does not allow for understandable information to be provided to investors to assist decision making, and for appropriate governance arrangements to apply

Under Option 2, it would be possible to offer shares that are in economic substance MIPs to investors in a manner that does not provide parity to the MIS regime. The equity securities regime is not designed for MIPs so the disclosures provided to investors may not be 'fit for purpose'. Investors would not receive the tailored disclosures that would be provided under the MIS regime to assist them to make their investment decisions. Investors would also miss out on the enhanced protections the MIS governance requirements provide. This could expose them to increased governance risks. This would disadvantage these investors compared to investors in MISs operating under the MIS regime and

could result in poor investor outcomes. These shares (which are actually MIPs in substance) could also be inappropriately offered through crowd funding platforms.

Option 2 does not promote fair and efficient markets

Option 2 would leave opportunities open for regulatory arbitrage. Issuers would be able to avoid the requirements of the MIS regime by using an investment company structure to offer products which, in economic substance, are no different to those offered by MIS providers. This would enable them to operate on a different legislative playing field to MIS providers. Issuers would also be able to offer shares that are in economic substance MIPs as unregulated offers through equity crowd funding platforms. These issuers would be subject to a lower regulatory burden and incur lower compliance costs. This could enable them to gain an unfair competitive advantage over providers complying with the MIS regime.

In the absence of a class designation, we would need to consider using our individual designation powers to designate shares that are in substance MIPs. As we would consider individual designations as particular offers come to our attention, this may occur later in the offer design process when a market participant has already incurred significant costs. It may also contribute to an uneven playing field, as we do not review every offer.

Summary assessment of options against objectives

	Option 1: Class designation (preferred)	Option 2: No designation (status quo)
Promotes and facilitates the development of fair, efficient and transparent financial markets	<p>Designated shares which are in economic substance MIPs will be subject to the same compliance requirements as other MIPs. This reduces the ability for issuers to use investment company structures as a means of avoiding operating under the MIS regime and creates a more level playing field with other MIS providers. ✓✓</p> <p>Issuers will be prevented from avoiding the effect of the designation by offering designated shares through equity crowd funding platforms. ✓✓</p> <p>The designation notice will provide issuers with certainty regarding the treatment of shares with these characteristics. Issuers could choose to design their offers so that shares retain equity characteristics and do not fall within the scope of the designation. ✓✓</p>	<p>Issuers can use the investment company structure to avoid the regulatory requirements (and higher compliance costs) of the MIS regime. They can offer shares that are in economic substance MIPs as unregulated offers through equity crowd funding platforms, thereby gaining an unfair competitive advantage over providers complying with the MIS regime. ✗</p> <p>We might individually designate shares late in the offer design process as particular offers come to our attention. Participants will already have incurred significant costs developing the offer. This creates uncertainty for issuers and could result in an uneven playing field as we do not review every offer. ✗</p>

Provides for timely, accurate and understandable information to be provided to persons to assist those persons to make decisions relating to financial products

Offers of designated shares will comply with tailored disclosure obligations under the MIS regime that suit the characteristics of these investment products. This will better enable investors to make an informed investment decision and to monitor their investment. ✓✓

Shares that are in economic substance MIPs will be offered in compliance with the equity securities disclosure regime, which is not designed for this type of product. This will leave investors in a less informed position and may result in poor investor outcomes. ✗

Ensures appropriate governance arrangements apply that allow for effective monitoring and reduce governance risks

Designated shares and companies will be subject to fit for purpose governance requirements under the MIS regime. This better reflects the reduced level of control investors have in structures falling within the designation. ✓✓

Holders of shares that are in economic substance MIPs would not have the 'usual' level of control or ability to hold the board and management to account. They would not have the enhanced governance protections of the MIS regime, exposing them to increased governance risks. ✗

KEY: ✓✓ Meets the policy objectives ✓ Partially meets the policy objectives ✗ Does not meet the policy objectives

Consultation

Consultation process

In December 2015, we published [Consultation Paper: Class Designation of shares to MIPs in an MIS](#) to seek feedback on our proposed class designation.

We also consulted extensively with submitters and their advisers as we developed the proposal and settled a designation notice. In response to consultation feedback we made a number of refinements to our proposal and the designation notice. This includes amending the definition of 'investment company' to avoid capturing 'ordinary' commercial companies.

Summary of submissions

The key themes raised in submissions and our response to these are summarised below.

Submissions	Our response
<p>Were concerned that the designation would result in materially increased costs for investment companies with designated shares to comply with the MIS regime. Feedback indicated that these costs could be passed on to investors or could make offering the shares uneconomic, reducing investment choice for investors.</p>	<p>We expect issuers will consider the designation tests and design their offers so shares retain equity characteristics. This means they can be appropriately offered under the equity regime and issuers will not incur these costs.</p> <p>Where issuers do offer shares that fall within the designation, the regulatory requirements (and costs) would be appropriate, and no greater than the costs incurred by other MISs complying with the MIS regime.</p>

Preferred we use our powers to individually designate shares as MIPs rather than making a class designation.

Relying on our individual designation powers alone may create uncertainty for issuers. This is because we would only be able to exercise our individual designation power later in the offer design process as particular offers come to our attention. This may create an uneven playing field as we do not review every offer.

We prefer a class designation because this will provide issuers with advance notice of the nature of structures that would be designated as MIPs/MIS. This enables them to consider the impact of the designation when designing their offers. We will also publish an information sheet to explain when we will consider individually designating shares that fall outside the scope of the designation as MIPs.

Thought that it is critical that 'ordinary' commercial companies are not inadvertently caught by the class designation.

We engaged with submitters to develop a definition that we believe avoids catching 'ordinary' commercial companies.

We will monitor the impact of the notice and may consider individual designations or exemptions where appropriate. We may also reconsider its scope if we see instances where companies are designated when we would not intend them to be.

Were concerned that the proposed class designation tests might be easily defeated given the availability of alternative structures.

The designation is directed at shares with particular characteristics that we think makes them (in economic substance) MIPs in a MIS.

If an issuer structures its offer to avoid its shares falling within the scope of the designation, but in substance those shares continue to be (in economic substance) MIPs in a MIS, we may consider using our individual designation powers. We will publish an information sheet to help issuers understand the types of circumstances where we may consider an individual designation.

Were concerned about the difficulty of devising a test to identify circumstances where an issuer's key service providers could be considered to be entrenched to a degree that the shares should be designated as MIPs.

We revised our test to address the matters raised by submitters.

Were concerned that we were not proposing to issue detailed guidance regarding the application of the MIS regime to companies designated as MIS.

Given the likely variety of company structures and offer types, we don't think it's practical to provide detailed technical analysis on how the MIS requirements will apply to investment companies designated as MISs as a class. We encourage issuers and their advisers to approach us early in the offer design process. This enables us to discuss how the designation and MIS requirements under the FMC Act will apply to the proposed structure, and whether any exemptions will be appropriate.

Conclusion and preferred option

Having carefully considered regulatory and non-regulatory impacts, we decided that Option 1 (class designation) addresses the identified problems and will achieve the objectives of:

- promoting and facilitating the development of fair, efficient and transparent financial markets
- providing for timely, accurate, and understandable information to be provided to persons to assist them to make decisions on financial products
- ensuring appropriate governance arrangements apply to financial products that allow for effective monitoring and reduce governance risks.

Option 2 would not achieve these objectives and would continue the current environment. Currently investment company structures can be used as a mechanism to avoid the requirements of the MIS regime, resulting in reduced safeguards for investors and heightened risk of poor investor outcomes.

On this basis we have issued a class designation notice to implement our policy proposal. This contains the following designations:

- Designation of certain shares in investment companies as MIPs. Shares will fall within the designation if they are issued by an investment company, there are reduced powers of shareholders and/or entrenched key service provider arrangements; and the shares are not quoted on the NZX main board
- Designation of the company issuing the shares as a MIS. This ensures MIS regime requirements will apply to the structure.
- Designation to prevent issuers from avoiding the effect of the designation by offering designated shares as an unregulated offer through an equity crowd funding service.