

Class designation of shares to MIPs in an MIS

About this consultation paper

We are seeking views on proposed designations under sections 562(1)(b) and 562(1)(f) of the Financial Markets Conduct Act 2013, which would result in certain types of shares being treated as managed investment products (MIPs) in a managed investment scheme (MIS) rather than as equity securities in a company.

This consultation is for offerors, managers, supervisors, investors, legal advisers and anyone who might be affected by these proposed class designations. This paper includes a draft declaration in appendix 1 for technical experts for their review and comment.

Submissions close on 19 February 2016. Please use the feedback form for your submissions.

About this consultation:

This consultation is for: offerors, managers, supervisors, investors, legal advisers and interested parties.

It aims to: gain feedback on the impact of class designations that would treat shares as managed investment products in a managed investment scheme.

Document history

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

FMA document reference code 2807006

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Issue

1. Companies can be used as an alternative collective investment tool in place of MIS. We have seen examples of companies offering shares with certain features that raise questions regarding where the boundaries should lie between an MIS and an investment company. This consultation paper considers when to subject such investment companies to similar licensing, disclosure, and governance requirements of an MIS.

Background

Purposes of the FMC Act

2. The Financial Markets Conduct Act 2013 (FMC Act) governs how financial products are created, promoted and sold, and the ongoing responsibilities of those who offer, deal and trade them. It also regulates some financial services. One of the main objectives of the FMC Act is to promote confident and informed participation in financial markets, in order to help businesses to grow and to provide individuals with opportunities to develop their personal wealth.
3. For this objective to be achieved, investors need to be satisfied that they and their advisers have the information required to make confident and informed decisions, that there will be appropriate governance arrangements in place for financial products and that obligations on offerors and others will be generally observed. Offerors need investor participation for successful capital raisings while regulation needs to achieve the desired objectives at minimum cost.

Definitions of financial products

4. A central feature of the FMC Act is how financial products are defined. A criticism of the definitions in the Securities Act 1978 was that they were largely based on the legal form of the security, rather than on their economic substance. This meant that some securities were not categorised appropriately, allowing the issuer to avoid the legal requirements appropriate for them. The FMC Act remedies this by focusing on the underlying economic substance of financial products. The FMC Act also provides a degree of certainty around the treatment of common products.
5. Where the definitions do not result in appropriate outcomes, the Financial Markets Authority has the power to designate products into the appropriate category. For example, we can declare shares that are, in economic substance, MIPs as MIPs, regardless of whether the shares would fall within the definition of equity securities.
6. This ensures that the regime is flexible enough to deal with novel product types in the market and to prevent avoidance.
7. 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.
8. Under the FMC Act, each type of financial product has its own tailored regime, which might include specialised licensing, disclosure, reporting and governance requirements. Each regime has been designed to be 'fit for purpose' for that financial product.

Regime for MIPs/MISs

9. Where any retail investors hold MIPs in an MIS, the MIS is required to have a licensed manager and an independent licensed supervisor. Scheme property must be held by the independent supervisor or another independent custodian.
10. 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'.
11. Within the MIS regime, there are two types of MIPs: a) 'managed funds' and b) 'other'. The FMC Act defines managed funds as having certain characteristics relating to asset liquidity and the manner in which 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 provide highly prescriptive, short product disclosure statements. These disclosures are designed for comparative purposes and need to be updated quarterly. 'Other MIPs' have more flexibility to describe the nature of their scheme and are not required to provide fund updates.
12. The key to achieving the objectives of the FMC Act is having 'fit for purpose' and effective governing documents and SIPOs, and holding MIS managers and supervisors to account through the range of licensing, disclosure, and governance requirements tailored for MIS.

Setting the scope

13. While a standard managed fund is easy to recognise, there is a question of whether the test set out in the definitions for equity securities and MIPs is always appropriate on the fringes between a company and an MIS. A key consideration, when designating shares as MIPs, is whether the FMC Act regime for MIS would provide more appropriate investor protection in light of the features of the offeror and its shares. Broadly:
 - Investing in an MIS provides an investor with no direct control over the MIS. In this case, the licensing and additional governance requirements in the FMC Act are designed to provide investors with certain additional protection that ensures, among other things, that the SIPO is followed and that the MIS manager and its supervisors can be held to account.
 - Investing in equity securities conventionally 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). Through that influence, investors can set the strategic direction of the company and hold management to account.
14. This means that it is important that we look at the economic substance of an offeror and its shares when determining whether the shares are appropriately classified as equity securities or MIPs. We are considering whether it is necessary and desirable, in order for us to promote the purposes of the FMC Act, for us to use our designation powers to declare shares in an investment company, which do not confer the usual investor protections relevant to equity securities, as MIPs so investors will have the benefit of the MIS protections in the FMC Act instead.

Our proposal

15. We are proposing a class designation test that designates shares to MIPs where the offeror is an ‘investment company’ and any one of the following applies:
 - the shares offered do not confer key voting rights
 - there is an entrenched manager or other costly service provider
 - the company has the word ‘fund’ in its name.
16. We are further proposing that companies that have shares quoted on a licensed market (or which will be quoted on a licensed market) should be excluded from the scope of this designation.
17. This proposed class designation test is discussed in more detail below. Appendix 1 provides a more technical snapshot of the proposed criteria.

Questions

1. Do you agree that there is a need for us to use our designation powers to declare shares as MIPs (either on a class or an individual basis)? Please provide your reasons.
2. What impact do you believe this class designation test might have on investment companies? We are particularly interested in the estimated additional costs incurred by an investment company if its shares are designated as MIPs at the time of issue.
3. What impact do you believe this class designation test might have on investors? We are particularly interested in any benefits you consider investors will receive, or additional costs they might incur, as a result of this proposed designation.

a. Applies to investment companies

18. We propose that, for a company to be caught by the class designation, the company’s main purpose must be to make investments, so that investors can contribute money to the company in order to receive financial benefits (see definition of ‘Investment company’ in appendix 1).
19. We have seen three broad categories of investment companies being used for different collective investment purposes:
 - a collective investment in financial products (for example, shares)
 - a collective investment in multiple assets (for example, a portfolio of commercial properties or businesses)
 - a collective investment in a single asset (for example, a commercial property).
20. In certain circumstances, we believe that shares in the above company structures will be appropriately categorised as equity securities. In other circumstances, such shares might be more appropriately categorised as MIPs. We believe that these circumstances are where any of the following also applies:
 - the shares in an investment company do not confer key voting rights
 - the manager (or another service provider) of the company is entrenched or

- the company uses the word ‘fund’ in its name.

b. Shareholder voting rights

21. In a conventional company, the management runs the day-to-day activities of the company, while the board of directors (voted in by the shareholders) is responsible for setting the company’s strategic direction and making associated decisions. An important feature for investors is their ability to appoint the company’s directors to act on their behalf and to vote on critical and strategic matters.
22. Investors in an MIS do not have a comparable level of control over management and do not expect that level of control. The SIPO sets the investment governance and management framework, philosophy, strategies and objectives of an MIS and its investment funds or portfolios. An investor does not need the same degree of control as the manager will be required to comply with the SIPO and can be held to account if that doesn’t occur.
23. We believe it is necessary and desirable to provide investors with the MIS protections set out in the FMC Act where an investment company offers shares and those shares do not confer voting rights on all of the following critical and strategic matters:
 - appointment or removal of a director or auditor
 - adoption or alteration of the constitution
 - approval of a major transaction
 - approval of a company amalgamation
 - a decision to put the company into liquidation.¹
24. We expect the voting rights of investors to be broadly proportionate to the amount of capital they have invested in the company. We are considering whether the class designation test should also contain this proportionality requirement and how that requirement might be applied. Even if we do not include a proportionality component in the class designation test, in order to prevent the class designation test from being circumvented, where an investment company offers shares with substantively disproportionate voting rights to the amount of capital contributed for such shares, we may consider whether those shares should be individually designated as MIP.

c. Nature of the arrangements under which assets are managed / traded

25. The nature of any management or other significant service arrangements are also key factors to determine whether shares in an investment company should be designated as MIP. It is important that investors can hold management and significant service providers to account for their performance.
26. In a conventional company, an investor can use its power to vote to appoint directors and, through the board of directors, hold management to account. In a conventional MIS, an independent licensed manager:
 - actively manages the investments and trading activities of the scheme in accordance with the SIPO
 - is subject to the duties under the FMC Act
 - can be held to account under the FMC Act.
27. We are concerned with situations where an investment company has an entrenched investment manager or other significant service provider, such that the investors have no practical power to hold that manager or service provider to account by removing them.

¹ This list originated from section 36(1) of the Companies Act 1993.

28. We propose that an investment company would have an entrenched manager or service provider where there is a service arrangement with a value of 5% or more of the company's total revenue; and either:
- the arrangement extends for a period longer than three years and cannot be terminated at the election of the company without reasonable notice or
 - the termination of the arrangement would result in the company being obliged to pay compensation in excess of what it would have been required to pay over the life of the arrangement.
29. We acknowledge that there may be circumstances where an entrenched manager or significant service provider provides value for investors that is proportionate to the value received by the manager or service provider under the arrangement. We are keen to hear views on when it might be appropriate for shares in these investment companies to not be designated as MIPs.

d. Using 'fund' in a name

30. In our experience, where an offeror uses the word 'fund' in its name, that is usually indicative that the economic substance of the offeror is a fund. Additionally, if the offeror's name includes the word 'fund' and the economic substance of that offeror is not a fund, we believe that potential investors may be misled that the offeror is a managed fund under the FMC Act and will be regulated in the same way as other managed funds. Therefore, we want to strongly deter investment companies that are not managed funds from using the word 'fund' in their name. For both these reasons, we believe that it is necessary and desirable to designate the shares in these offerors as MIPs.

e. Not listed companies

31. Our preliminary view is that all companies with shares quoted on a licensed market (or which have made an application for their shares to be quoted) should be excluded from the scope of this class designation. While a listed investment company might be in economic substance an MIS, we believe that the designation of its shares as MIPs is not necessary. This is because these investors already have the benefit of a number of additional protections that reduce the necessity of the shares being designated as MIPs. These additional protections include:
- being subject to more extensive requirements relating to governance, reporting, disclosure and related-party transactions
 - those investors being able to sell their shares on market.

f. Other features

32. We have considered other characteristics typically associated with a MIP in an MIS. They include whether or not there are regular returns to shareholders, whether fees are charged, the liquidity and how the shares are priced (eg, on the net asset value of the company). However, we believe these features are not determinative of MIPs in an MIS in the context of an investment company. For this reason, we have not included these features as part of our proposed class designation test. However, such features may remain relevant to any decision to individually designate shares as MIPs.

Questions

4. Do you agree in principle with the approach we have taken for the class designation test? If not, what

approach would you take?

Applies to investment companies

5. Do you agree that the three broad categories of collective investments set out in paragraph 21 are often determinative of investment companies? If you do not agree, please explain why not. In your view, how likely is it that each of these categories is being used for investment purposes versus conventional corporate purposes?
6. Are you aware of any other types of equity structures that might be used for investment purposes? In your view, how likely is it that each of these categories is being used for investment purposes versus conventional corporate purposes?
7. Do you agree with our definition of 'investment company' (see appendix 1)? If not, what definition would you use?

Shareholder voting rights

8. Do you agree that when shares in an investment company do not convey basic voting rights, those shares should be designated as MIPs? If not, why? If yes, do you agree with the list of key voting rights we have included in paragraph 25 of our paper? If not, what other voting rights would you include or omit from that list?
9. Do you believe that proportionality between investors' rights and the value of their contribution for their shares is a relevant factor when determining whether shares should be designated as MIP? Are there circumstances where you believe designation to MIP would not be appropriate even though investors will be provided with no voting rights, or voting rights that are disproportionate to the contribution those investors have made to the company for their shares?
10. Do you believe our proposal in relation to shareholder voting rights might alter the costs to, or behavior of, investment companies and/or their investors? If yes, please explain why and how that might occur?

Nature of the arrangements under which assets are managed / traded

11. Do you agree with our criteria for establishing whether there is an entrenched manager? If not, what criteria would you use?
12. We believe that it is appropriate to focus on an investment company's significant services arrangements. We have used a threshold amount of 5% of total revenue to determine significant value. Do you think that we should use a value of [x] % of assets under management as an alternative threshold? If you do, what % might be appropriate? If you do not agree with either of these approaches, what approach would you use?
13. We believe that the length of significant services arrangements is a relevant factor when determining whether to designate shares in an investment company as MIPs. We believe that three years is an appropriate threshold time period. Do you agree with this assessment of what constitutes a substantial period of time? If not, please explain why not.
14. Are there circumstances where you believe that designation to MIP would not be appropriate even

though an investment company has an entrenched manager (according to our proposed criteria)? If yes, what are those circumstances?

15. Do you believe that our proposed definition of entrenched manager might alter the costs to, or behavior of, investment companies and/or their significant service providers? If yes, please explain why and how that might occur?

Using 'fund' in a name

16. Do you agree that including the word fund in a company name is indicative of that company being a fund? Do you agree that including the word fund in a company name may mislead investors if that company is not, in economic substance, a fund?

Not listed companies

17. Do you agree that companies that have their shares quoted on a licensed market (or about to be quoted) should be excluded from this class designation? If not, what approach would you use?
18. Do you agree with our reasons for excluding these companies?
19. Do you believe that it would make a significant difference if the shares of these companies are or become illiquid? If you believe that liquidity is an important factor when determining whether shares in listed companies should be designated as MIPs, what liquidity threshold or measurement would you use?

Other features

20. Do you believe that any of the other features we have mentioned in paragraph 32 strongly indicate MIPs in an MIS? If yes, do you believe that they should be included in this proposed class designation test or in any individual decision to designate shares as MIPs?
21. Are there any additional features of MIP or MIS that you consider are relevant to us designating shares as MIPs which have not been mentioned in this consultation paper?

Class designation versus individualised designation

33. We intend to define how shares will be designated as MIPs on a class basis. This is because we expect that a class designation from shares to MIPs will:
- increase certainty for issuers, by providing issuers with advance warning of when shares will be treated as MIPs
 - reduce issuer costs, by enabling issuers to design their offer with advance notice of when shares will be designated as MIPs.
34. In our view, it is important to capture those shares in a company that are in economic substance MIPs, without over capturing shares that would not be designated if an individualised test was used. Individual designations may still be required in limited circumstances. This is because the scope of test may not capture every instance where an individualised assessment would result in designation to MIPs. The class designation test might need to be reviewed and amended if further important factors come to our attention or as market practice develops.

Questions

22. What advantages or disadvantages do you see in having a class designation in place, bearing in mind that we may also make individual designations of shares to MIP in other limited circumstances?
23. Do you agree that a class designation of shares to MIPs will increase certainty of process for offerors and reduce offerors' costs, when compared with the impact of making individual designations? We are particularly interested in the estimated additional costs incurred by an offeror if their shares are individually designated at the pre-vetting stage (ie, with no prior warning) compared with them being designated by way of a class designation (with warning).

Designation to MIS

35. Section 562(1)(f) of the FMC Act provides that an offeror may be designated as an MIS following the designation of that offeror's shares as MIPs under section 562(1)(b). In our view, where shares are designated as MIPs, the investment company offering those shares should also be designated as an MIS. We are seeking your views on the risks, advantages and disadvantages of making this corresponding designation.

Question

24. Our designation proposal is that the investment company will be automatically designated as MIS when its shares are designated as MIPs. Do you agree with this approach? If not, why not and what approach would you use?
25. What advantages, disadvantages or risks do you see in us using our power to designate investment companies to MIS?
26. What potential issues do you believe might arise for existing issuers of shares, given that we are unable to designate already-issued shares as MIPs?
27. What impact do you believe this class designation test might have on investment companies if they are declared to be MIS? We are particularly interested in the estimated additional costs incurred by an investment company if it is declared to be an MIS.

Consequences of designation

36. Where an investment company meets the proposed class designation test, its shares will be automatically designated as MIPs and it will be automatically designated to be an MIS. We have tried to formulate the test where offerors of shares that are designated as MIP under the proposed class designation should be appropriately designated as MIS. There might be special circumstances where it is not appropriate for certain MIS requirements

to apply to an offeror. In those cases, the offeror would still be able to approach us to discuss how the MIS requirements might be applied.

Question

28. Do you believe there may be instances where not all MIS obligations are appropriate for an offer which has had its shares designated as MIP? If you do, please explain why not.

Appendix 1

We will declare each 'corporate MIP' to be a managed investment product for the purposes of the FMC Act and the Financial Conduct Regulations 2014, on the following basis:

Corporate MIP means shares in an investment company.

Investment company means a company, other than any company that is listed or when an application has been made for its shares to be quoted on a licensed market, where:

1. the main purpose of that company is to make investments, so that investors can contribute money to the company in order to receive financial benefits; and
2. either:
 - i. the name of the company includes the word 'fund' or
 - ii. each share offered fails to confer a right to one vote on a poll at a meeting of the company on any resolution to:
 - appoint or remove a director or audit
 - adopt or alter the constitution
 - approve a major transaction
 - approve a company amalgamation
 - put the company into liquidation or
 - iii. the company has entered into, or has agreed to enter into, a services arrangement where the value received by the services provider for the services under that arrangement may, in any year, be reasonably likely to exceed 5% of the company's total revenue in that year and either:
 - the services arrangement extends for a period longer than three years and cannot be terminated by the company at will (by the company providing reasonable notice) or
 - the termination of the services arrangement would result in the company having to pay compensation to the services provider in excess of what would be payable to them for the remaining term of the arrangement.

Glossary

Financial Markets Conduct Act 2013 (FMC Act)	The FMA Act governs how financial products are created, promoted and sold, and the ongoing responsibilities of those who offer, deal and trade them.
Management investment product (MIP)	A MIP means the interest in a managed investment scheme.
Managed investment scheme (MIS)	Is defined in section 9(1) of the FMC Act. Broadly, MIS pool investors' money for the purpose of investments.
Statement of Investment Policy and Objectives (SIPO)	SIPOs are a mandated document under the FMC Act. SIPOs provide the management framework, philosophy, strategies and objectives of a managed investment scheme and its investment funds or portfolio.
Investment company	As defined in appendix 1.

Feedback form: Consultation: Class designation of shares to managed investment products

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: TITLE' in the subject line. Thank you. **Submissions close on 19 February 2016.**

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
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*You don't need to quote from the consultation document if you use question numbers.
 You may attach extra pages - please label each page with your name & organisation.
 You don't need to give an answer to every question if you don't want to.*

Q1		
Q2		

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.

AUCKLAND OFFICE
Level 5, Ernst & Young Building
2 Takutai Square, Britomart
PO Box 106 672
Auckland 1143

WELLINGTON OFFICE
Level 2
1 Grey Street
PO Box 1179
Wellington 6140

www.fma.govt.nz

