Information sheet
February 2018

Designation of certain shares in investment companies as managed investment products

This information sheet explains the class notice which designates certain shares in investment companies as managed investment products, and the company which issues them as a managed investment scheme.

We also explain when we will consider individually designating particular shares to be issued by an investment company as managed investment products.

If you believe you will or may be caught by the class designation, we encourage you to approach us in the early stages of your offer design process to discuss how this impacts your obligations.

Our class designation

We have issued a notice that designates certain shares in investment companies as managed investment products ('MIPs') rather than equity securities, and the company issuing the shares as a managed investment scheme ('MIS'). We have issued this designation because we consider that the shares the designation applies to are, in economic substance, managed investment products. Therefore it is appropriate that the requirements of the MIS regime apply, rather than the requirements of the equity regime.

The designation applies to new shares issued after the commencement of the designation notice.

Designation test

The notice designates shares as MIPS where they fall within the following test:

1. The shares are issued by an *investment company;* and
2. There are *reduced powers of shareholders* and/or *unreasonably entrenched key service provider arrangements*; and
3. The shares are not quoted on the NZX main board or on the ASX (ie NZX main board shares and ASX shares are excluded); and
4. The shares are not redeemable shares that are classed as debt securities under the FMC Act.

This test supports two key principles:

- *Reduced powers of shareholders:* Where shares offered in an investment company do not confer usual equity voting rights, or confer limited voting rights, or disproportionately restricted rights to vote, they are in economic substance MIPs in a MIS.
- *Entrenched key service provider arrangements:* Where shares are offered in an investment company and their key service provider(s) is entrenched to such a degree that it is impossible or impractical to terminate that service provider's arrangements, those shares are in economic substance MIPs in a MIS.

If an issuer structures its offer to avoid being caught by the tests in our class designation notice but breaches either of these key principles, the shares may still be in economic substance MIPs. In these circumstances we may consider whether to individually designate the shares as MIPs. We provide guidance below to help issuers understand the offer features we believe could subvert these key principles. These are indicative examples only.

What is an 'investment company'?

The designation only applies to certain shares issued by an investment company. An investment company is a company:

- whose principal business consists of investing in investment property; and/or
- that holds itself out as being a company whose principal business consists of investing in investment property.

'Investment property' covers a broad range of investment asset types usually held by MISs. These include any FMC Act financial products, commodities, foreign currencies and real property (eg land or buildings). An investment company's investment property may be a single asset, or it may have a portfolio of assets.

The definition does not distinguish between active investment strategies (eg actively buying and selling a portfolio of liquid securities) and passive investment strategies (eg buying a building and holding this as a long-term investment). The definition also does not distinguish between direct investment and indirect investment strategies (eg buying shares in a MIS). Companies may fall within the definition regardless of how they structure the ownership of their investments. This includes direct ownership of the relevant investment property or indirect ownership.

For example, an investment company may choose to purchase investment property through a subsidiary acquisition special purpose vehicle ('SPV') rather than directly in its own name. In these cases the SPV should not be treated as a separate investment company, because it is merely part of the structuring by which the parent investment company implements its investment strategy, not running an investment business in its own right. The 'business' of the SPV in that case may be more properly regarded as holding property for its parent company. However in other cases, a subsidiary of an investment company may be an investment company in its own right. The business of each entity in a group structure needs to be assessed on the facts of each case.

Companies whose principal business is not investment will not fall within this definition. For example, we would not expect a farm operation that owns land for the purpose of farming to be caught.

We encourage businesses (and their advisers) who think they may be caught by this class designation to approach us early in the offer design process, to discuss how the designation and the MIS requirements under the FMC Act will apply to the proposed structure. Companies (and their advisers) should also consider whether any exemptions may be appropriate in the circumstances. Where shares are designed as MIPs, the standard MIPs requirements will usually apply, but in some cases modifications will be appropriate.

Additional requirements

An investment company can legitimately be used as an alternative collective investment structure in place of a MIS. For this reason, being an investment company is not enough to qualify shares for designation as MIPs. Shares will only be designated if one or both of two additional requirements apply (reduced powers of shareholders and/or entrenched key service provider arrangements).

Reduced powers of shareholders

The class designation notice sets out three bright-line tests for instances where shareholder voting rights have been eliminated, restricted or disproportionately reduced. If any one or more of these tests apply, the shares in the investment company will be designated as MIPs.

The three tests are:

- The shares do not confer on the holder all of the rights set out in section 36(1)(a) of the Companies Act 1993.

  These are: appointment or removal of a director or auditor; adoption or alteration of the constitution; approval of a major transaction; approval of a company amalgamation; and putting the company into liquidation.

- A director of the investment company can be appointed or removed other than by a resolution of shareholders.

  This does not apply in certain limited circumstances. For example, a board appointment made to fill a casual vacancy that arises during the year, for example due to a director resignation, until the next shareholder AGM. It also does not apply where the investment company's constitution permits a director of the company to appoint an alternate director.

- The shareholders' rights to vote on the appointment or removal of directors (defined in the notice as 'voting rights concerning directors') are disproportionate to the amount to be paid for the shares.

  This test is directed at offers structured so the voting rights concerning directors investors receive are disproportionate to the amount of capital they invest in the company. For example, this could be by structuring the terms of an offer so that (post issue) investors will have contributed 97% of the capital of the company but have only 25% of the voting rights (including on resolutions to appoint or remove directors).

  Whether these voting rights are disproportionate is determined by a formula set out in the notice. The formula compares the offer price for 1 voting right about directors (ie the price that an investor will pay for 1 voting right about directors) with the average cost of a voting right about directors (ie the cost if all voting rights concerning directors in the company were priced equally).

  The average cost of a voting right about directors is calculated by dividing the anticipated aggregate fair value of all shares carrying voting rights concerning directors in the company immediately after the issue of the shares being offered by the anticipated total number of voting rights concerning directors attached to all shares on issue in the company immediately after the issue of the shares being offered. The 'fair value' of the shares is determined in accordance with generally accepted accounting practice. This means that investment companies will have a variety of options for valuing the shares using the IFRS 13 Fair Value Measurement standard.

If the issuer is offering more than one class of shares, the tests will need to be applied on a 'per class' basis. This is necessary because different classes of shares may confer different voting rights and have different offer pricing. Voting rights attached to shares should be counted as 'voting rights concerning directors' if they confer a right to vote on a resolution to appoint or remove a director, whether or not they also confer a right to vote on other matters.

Even where none of the bright-line tests are triggered, we may consider individually designating shares as MIPs when:

- An investor's ability to exercise the rights and powers attached to their shares is restricted (as compared to sections 104-109 of the Companies Act 1993), making it more difficult for them to vote on the appointment or removal of a director.
- An issuer structures the terms of its share offer in a manner which avoids the shares being classed as disproportionate immediately after the issue of those shares, but raises concerns that investor voting rights will be disproportionate when a vote on director appointments or removals is held.

Entrenched key service provider arrangements

The notice also sets out bright-line tests directed at entrenched key service provider arrangements. A key service provider is an asset manager, investment manager, or investment adviser. If one or more of the following tests apply, the shares in the investment company will be designated as MIPs:

- The key service provider owns or controls assets material to the operation of the investment company's principal business, the benefit of which the company could not reasonably obtain for materially similar cost on arm's-length terms if the services agreement is terminated.

  Assets would include intangible assets such as intellectual property or strategic information. The test does not apply if the key service provider only owns or controls the assets because of rights it has under the service agreement with the investment company. In that case, we would expect the service provider would be required to return the assets to the company (or a replacement service provider), or relinquish control of them, if the service agreement were terminated.

- The services agreement is on more favourable terms to the key service provider than arm's-length terms.

  'Arms-length terms' is defined in the notice as terms that would be reasonable in the circumstances for parties connected or related only by the transaction in question, each acting independently and in its own best interests. This assessment should be undertaken in light of the contract as a whole, rather than by conducting a term-by-term analysis.

- The services agreement is, or will be, for a term longer than 3 years, and cannot be terminated by the investment company without cause under the terms of the agreement.

  This test is directed at agreements that only permit termination if a specified event of default occurs (for example, breach of contract; negligence, fraud or misconduct; insolvency event of the other party), instead of permitting the investment company to terminate the agreement 'for convenience' or 'on notice'.

  This test only applies to services agreements that are for a term longer than 3 years.

- The services agreement requires the investment company (or an associated person such as a subsidiary) to pay a termination fee (also known as a break fee) for terminating the services agreement that is more than the lesser of:

  (a) 30% of the value of the payment required to be made to the key service provider for the entire term of the agreement (but for any agreement over 5 years, assume a fixed term of 5 years); and

  (b) 50% of the value of the payment required to be made to the key service provider for the remaining term of the agreement.

  Some services agreements will have variable fees payable under the agreement. For example, performance fees based on a percentage of net gains in the equity of the company, or management fees calculated as a percentage of the value of the investment property. In these cases, the company should make a reasonable estimate of what the anticipated fees would be for the term of the agreement.

These tests only apply to key service providers. However we may use our individual designation power to designate new shares in an investment company as MIPs in a MIS where other service provider arrangements are unreasonably entrenched in a way that makes us believe the company is operating more like a MIS in economic substance. For example:

- Where a person and the issuer enter into a services arrangement that is not for asset management, investment management or investment advisory services, but the amount payable to that person (whether money or payment in kind) is significant when compared with the amounts payable to the company's other service providers. This may raise concerns that this service provider is a key service provider to the company and may be unreasonably entrenched (when assessed against the tests in the notice).
- Where investor shareholders are directly liable for fees and expenses under the terms of a key service provider's arrangements. This may raise concerns that the services agreement terms are not arm's-length.

Exclusion for NZX main board shares and ASX shares

Shares will not be designated if these are quoted on the NZX main board or on the ASX (or it is a term of the offer that the shares will be approved for trading). This is because the voting, quorum and other governance requirements that apply to NZX main board listed companies and ASX listed companies mean that these shares should retain equity-like characteristics (and not be in economic substance MIPs).

Some companies apply for governance/continuous disclosure waivers when applying for their NZX main board listing or ASX listing. We may individually designate any new shares as MIPs in a MIS if an investment company has significant waivers and its shares would be designated if the shares were not NZX main board shares or ASX shares.

Exclusion for redeemable shares

Shares will also not be designated if they are redeemable shares that are classed as debt securities under the FMC Act[1]. This exclusion recognises that these shares are in economic substance debt securities, rather than managed investment products, and are appropriately regulated under the disclosure and governance requirements of the debt securities regime.

Designation of company as a MIS

Where shares in an investment company are designated as MIPs, the company issuing those shares is designated as a MIS.

We encourage companies and their advisers to approach us early in the offer design process 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.

Given the likely variety of company structures and offer types, it is impractical to provide detailed technical analysis regarding how the MIS requirements will apply to investment companies designated as MISs as a class. However,

[1] See s8(1)(b)(iii) of the FMC Act.

except in unusual cases, unless an exclusion otherwise applies (eg under Schedule 1 of the FMC Act), 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).

We may use our individual exemption power to modify standard MIS requirements that apply to the shares, and the investment company. We would only do this if the grounds for granting an exemption set out in section 557 of the FMC Act were met. This enables us to help with further tailoring of obligations, to ensure the MIS requirements are fit for purpose for the investment company and its shares.

Investment companies should also note existing class exemptions from the MIS requirements under the FMC Act that might apply if it is designated as a MIS. For example, the Financial Markets Conduct (Property Schemes – Custody of Assets) Exemption Notice 2016. This exempts custodians of property schemes from reconciling scheme cash records daily, if those records are reconciled at a frequency suited to the level of transactions for the scheme. It also exempts them from having an annual assurance engagement with a qualified auditor, if they get an assurance engagement when the supervisor thinks this is necessary to provide reasonable assurance for custody of the scheme property.

Designation to prevent use of crowd funding exclusion

Shares designated as MIPs should not be offered using an equity crowd funding service. The notice includes a designation that prevents issuers from offering shares as an unregulated offer by using the exclusion (in Schedule 1 of the FMC Act) for equity crowd funding offers made through a licensed intermediary (eg a licensed crowd funding service provider). The other exclusions in Schedule 1 of the FMC Act remain available, if they apply.

Companies inadvertently caught

Please approach us if you believe your shares will be inadvertently caught by the designation. For example if:

- you believe you are an 'ordinary' company but are caught by the definition of 'investment company' in the notice
- your offer terms, company constitution or services agreement technically triggers one of the 'bright-line' tests in the notice, but you don't think your offer breaches the key principles underlying those tests (as described in this Information Sheet).

We'll be monitoring the impact of the notice to check it is operating in the intended manner and may consider using our individual designation or exemption powers where appropriate. We may also reconsider the scope of the designation 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.

Australian and other overseas issuers

The designation applies to any investment company offering shares that meet the designation criteria, whether the offer originates in or outside New Zealand. Therefore, all companies offering shares into New Zealand should consider the impact the designation has on the requirements for their offers and ongoing obligations on the issue of shares.

How this affects shares offered under the Mutual Recognition of Securities Offerings regime (MRSO)

Many Australian investment companies offer shares into New Zealand by relying on the Mutual Recognition of Securities Offerings regime (MRSO). MRSO is available for offers of certain types of financial products, including equity securities, and MIPs that are interests in an Australian registered scheme.

Australian investment company shares that **do not** meet the designation criteria are equity securities; therefore, they **are eligible** to be offered under MRSO. However, Australian investment company shares that **do** meet the designation criteria are **not eligible** to be offered into New Zealand under MRSO. This is because while they are MIPS, they are **not** interests in an Australian registered scheme (which by definition excludes body corporates).

These issuers would need to consider different options for offering shares into New Zealand (eg under a standard regulated offer of MIPs, or under an available exclusion in Schedule 1 of the FMC Act or FMA exemption notice).

The designation does not apply to shares quoted on the ASX. This means ASX listed companies can continue to offer shares to New Zealand investors under MRSO.

What do I need to do?

Investment companies, their managers (if external), and advisers should:

- read the FMC designation carefully and become familiar with its requirements
- consider whether the designation will apply to any proposed new issue of shares. We recommend this analysis is undertaken early in the offer design process
- consider seeking legal advice on how the FMC Act and the designation notice apply
- get in touch with us early in the offer design process if the class designation will or may apply to the proposed offer.

To get in touch, please phone 0800 434 567 or email questions@fma.govt.nz.