Regulatory impact statement

10 February 2016

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

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

This regulatory impact statement analyses options considered in course of policy work leading to a final decision to exempt offerors of certain debt securities relying on the $750,000 minimum investment wholesale investor exclusion, on conditions, from having to include investor warnings on offer documents and obtain an investor acknowledgement.

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Executive summary

1. This regulatory impact statement (RIS) addresses the FMA's class exemption for offerors of certain debt securities seeking to rely on the $750,000 minimum investment wholesale investor exclusion ($750,000 investment exclusion) in Schedule 1 of the Financial Markets Conduct Act 2013 (FMC Act).
2. This document provides an analysis of options we considered in determining the final policy proposal. Our analysis was based on the statutory test that applies to use of the FMA's exemption power. This requires FMA to be satisfied that granting the exemption is necessary or desirable in order to promote one or more of the purpose of the FMC Act and that the extent of any exemption is not broader than reasonably necessary to address the matters giving rise to it. The purposes of the FMC Act include:
    - promoting the 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
    - avoiding unnecessary compliance costs.
3. After carefully considering both the regulatory and non-regulatory impacts, we have granted 12 months exemption relief to offerors of certain debt securities seeking to rely on the $750,000 investment exclusion with the effect that:
    - Kauri bond[1] offerors will not be required to include the prescribed investor warning on any terms sheet or obtain an investor acknowledgement
    - Unsubordinated debt security offerors will only be required to include the prescribed warning on the principal terms sheet given to the investor and will not be required to obtain an investor acknowledgment. For sales on the secondary market, the principal terms sheet (with the prescribed warning) can be provided by a link on the Bloomberg webpage for the debt security but if the principal terms sheet is given to the investor then it must contain the prescribed warning.
4. We intend to monitor use of the exemption over the 12-month term and carry out a general review of how the exemptions are working at the end of that period. This will enable us to determine whether the exemptions are appropriate on a longer-term basis.

[1] Kauri bonds are unsubordinated debt securities denominated in New Zealand dollars that are issued by an overseas issuer and registered on a financial product register in New Zealand.

Section 1: Introduction

Background

5. Schedule 1 of the FMC Act provides statutory exclusions from the standard disclosure requirements for regulated offers. This includes exclusions for offers of financial products made to certain categories of wholesale investors in clause 3 of that schedule.

6. One category of wholesale investors under this exclusion is investors who have paid a minimum subscription amount of at least $750,000 for their investment. The policy for this bright-line exclusion is that investors who make such a significant one-off investment should have enough money at stake and enough bargaining power to negotiate with the issuer and exercise due diligence.[2]

7. The key benefits of the $750,000 investment exclusion for the market are speed and efficiency. The offeror can set the minimum subscription amount above $750,000. This ensures that all investors who acquire the financial products, by definition, fall within the wholesale investor category and the offer will not require standard disclosure under the FMC Act.

8. To rely on this exclusion, however, a prescribed warning must be included on the front of *all* key offer documents, and an investor must acknowledge the content of the warning.[3] These requirements apply to all financial products, including debt securities.

9. The purpose of the investor warning and acknowledgement is to ensure investors know they are being treated as wholesale investors. This means they will not receive disclosures they would normally receive for a retail offer. A warning and acknowledgement is particularly important for those in the $750,000 minimum investment category because inexperienced investors could potentially invest a large sum without understanding the consequences.

Status quo and problem definition

10. Some market participants have raised concerns that the investor warning and acknowledgement is simply not practical in some circumstances and will significantly weaken the benefits and usability of the $750,000 investment exclusion. They expect the requirements to cause significant uncertainty around the ability to rely on the $750,000 investment exclusion (and therefore reduce reliance on it). Additionally, they expect the requirements to greatly increase the costs of raising capital compared to wholesale debt security offers under the Securities Act 1978. They fear these issues will have a negative impact on New Zealand's debt capital markets, leading to fewer overseas-based issuers offering wholesale debt securities. Many of the concerns outlined also apply to domestic issuers.

11. The main concern raised by participants is that overseas issuers, particularly issuers of Kauri bonds, are less likely to extend offers to the New Zealand debt capital market than when they were under

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[2] See paragraph 82 of the Ministry of Business, Innovation, and Employment's Regulatory Impact Statement: Financial Markets Conduct Regulations (June 2013)

[3] See clauses 4 and 5 of Schedule 8 of the Financial Markets Conduct Regulations 2014

the Securities Act regime. Under the Securities Act, there was a $500,000 minimum investment threshold with no requirements for an investor warning or acknowledgement. The following factors contribute to this concern:

- the absence of a straightforward and objective test to allow issuers to easily determine who is a wholesale investor (given the requirement for an investor warning and acknowledgement) increasing the potential for issuer liability
- standard offer documents not being able to be used across multiple jurisdictions if a New Zealand-specific warning is required
- compliance costs to establish procedures to monitor receipt of investor acknowledgements are likely to be significant given the relative size of New Zealand's market
- the warning and acknowledgement requirements detracting from harmonisation and competitiveness with Australia (which has a $500,000 threshold with no further requirements).

12. Another concern relates to the practicalities associated with receiving investor acknowledgements where transactions of debt securities occur electronically through a securities settlement system.
13. Businesses involved in the wholesale debt market and their professional advisers are concerned the acknowledgement and warning statement requirements might affect the sale of unsubordinated debt securities in the secondary market. They advise that secondary market transactions are conducted at a fast pace and in an informal way (through phone calls and emails) with little, if any, documentation. Information on the debt securities is often provided and accessed through Bloomberg rather than through a terms sheet. They consider that the investor warning and acknowledgment requirements would conflict with usual market practice in the secondary market and impose additional compliance costs.
14. The Ministry of Business, Innovation, and Employment's (MBIE) June 2013 Regulatory Impact Statement (June 2013 RIS) estimated that incorporating the warning information and acknowledgement into an existing or separate document would be relatively straightforward and low cost. While this may generally be the case for most financial products, it is expected to be problematic for some debt security offers. Moreover, the June 2013 RIS did not discuss the warnings being required across multiple offer documents in the manner subsequently expressed in the Financial Markets Conduct Regulations 2014 (FMC Regulations).
15. Businesses and their professional advisers do not think relying on the other categories of wholesale investor under the exclusion, instead of the $750,000 minimum investment category, is a practical solution in the longer term. In their view, the other categories of wholesale investor require a detailed analysis of an investor's characteristics and business, which has to be repeated on an ongoing basis. They consider this reduces the attractiveness of the other wholesale investor exclusion categories – particularly for an overseas issuer deciding whether to include New Zealand investors in the target investor group.
16. However, the New Zealand Shareholders' Association (NZSA) holds a strong view that the warning and investor acknowledgement requirements are important protections for the newly wealthy, but inexperienced retail investor, who needs to understand he or she will be treated as a wholesale

investor. NZSA is sceptical that the warning and acknowledgement will present a real barrier to participation in New Zealand's debt wholesale markets.

Objectives

17. Under section 556 of the FMC Act, the FMA may, on terms and conditions that it thinks fit, exempt any person or class of persons, or any transaction or class of transactions, from having to comply with any provisions of Part 2 to 7 of the FMC Act, and any of the schedules, or any regulations. However, we must be satisfied the exemption is necessary, or desirable, for the purposes of promoting either or both of the main purposes or any of the additional purposes of the FMC Act. The exemption cannot be broader than is reasonably necessary to address the matters that gave rise to the exemption (section 557).

18. 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.

19. 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.

20. The FMA has granted an exemption to relieve offerors of certain debt securities seeking to rely on the $750,000 investment exclusion from having to include investor warnings on offer documents and obtain an investor acknowledgement where this will result in burdensome compliance costs for these businesses that significantly outweigh the benefit to investors from the warning and acknowledgement requirements.

21. In applying the FMA's exemption power, the options in this RIS were measured against the following objectives (which include the purposes of the FMC Act we consider are most relevant to this matter):
    - 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
    - avoiding unnecessary compliance costs
    - any exemption not being broader than reasonably necessary to address the problem identified.

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

- offerors (both domestic and overseas) of debt securities for issue or sale
- law firms
- investors
- NZSA
- The New Zealand Bankers' Association (NZBA).

Section 2: Options and impact analysis

Options

23. Based on the submissions received, we have considered three options:

    Option 1: Tailored exemption and conditions for targeted classes of debt securities with a review after 12 months (preferred option)

    Option 2: Exemption for transactions using settlement systems

    Option 3: No exemption (status quo).

Option 1: Tailored exemption and conditions for targeted classes of debt securities with a review after 12 months (preferred option)

Description

24. Under this option, the exemption and conditions are tailored for targeted classes of debt securities set out in the following table. This option was developed in consultation with stakeholders.

	Warning in every document containing key terms of the offer (cl 4, Schedule 8, FMC Regulations)	**Investor acknowledgement** (cl 5, Schedule 8, FMC Regulations)	**Exemption condition** (single warning included in principal terms sheet provided to the investor)
Kauri bonds	Exempt	Exempt	No condition
Other unsubordinated debt securities	Exempt	Exempt	Condition applies
Subordinated debt securities	Not exempt	Not exempt	N/A

25. The effect of exemptions under this option would be limited to offerors of certain debt securities seeking to rely on the $750,000 investment exclusion. Specifically:

    - the investor warning and acknowledgement would not be required for offers of Kauri bonds

- for offers for issue of other unsubordinated debt securities, the investor warning would be in the principal terms sheet given to the investor rather than on every document that contains the key terms of the offer. No investor acknowledgement would be required
- for offers for sale of other unsubordinated debt securities on the secondary market, the investor warning would be on the principal terms sheet provided to the investor rather than on every document that contains the key terms of the offer. The principal terms sheet would not need to be given to the investor if the Bloomberg webpage for the debt security contains a link to the principal terms sheet with the investor warning. No investor acknowledgement would be required.

26. There would be no exemption from the investor warning or investor acknowledgement for subordinated debt securities.
27. The exemptions would be granted for 12 months.

Impact analysis

28. Option 1 would reduce unnecessary compliance costs, risks and complexity of wholesale debt issuances, particularly offers of Kauri bonds. This would minimise any potential dampening of activity in New Zealand's debt capital markets resulting from the requirements for the investor warning and acknowledgement.
29. This tailored approach – limiting the exemptions to certain types of debt security offers, and retaining an investor warning for all offers of unsubordinated debt securities other than offers of Kauri bonds – means this option would not be broader than reasonably necessary to address the specific transactional issues that have been raised with us as being unworkable. Additionally, limiting the application of the exemption to 12 months would enable us to review use of the exemption before considering extending relief on a longer term basis.
30. This option would exempt offerors of Kauri bonds and other unsubordinated debt securities from having to provide multiple warnings on offer documents. This would remove the risk of inadvertent non-compliance which is currently discouraging market participants from using the $750,000 investment exclusion.
31. This option would be unlikely to have a significant negative impact on investors if proposed conditions are imposed. While no investor warning or acknowledgement would be required for Kauri bonds, we understand that investors in these debt securities are predominantly financial institutions and institutional investors (see the discussion below). For offers of other unsubordinated debt securities the conditions of the exemption would require a prominent investor warning in the principal terms sheet. The general policy of the $750,000 investment exclusion requirements is to let investors know they are being treated as a wholesale investor and this would still be achieved by this option. The warning on the principal terms sheet would ensure that those investing $750,000 (who would be considered retail investors but for the level of their investment) understand that they will not receive the usual investor information when it comes to offers of these debt securities. Offers of subordinated debt securities, which are generally riskier and more complex, would not be exempt from the investor warning or acknowledgement requirement.

32. We consider a complete exemption for Kauri bond offerors from the investor warning and acknowledgement requirements is justified. Given the largely institutional investor base for these offers, in our view the benefits for investors of retaining the investor warning and acknowledgement if the exemption is not granted would be outweighed by the potentially negative effects on confidence and participation in New Zealand's wholesale markets.

33. The investor base for Kauri bond issues is largely local banks, fund managers, and insurance companies.[4] Retail investors do not tend to invest in Kauri bonds as they are a long-term investment with limited secondary market liquidity. They also have lower yield rates compared to other debt securities.

34. As Kauri bonds are highly rated, businesses hold Kauri bonds for a range of reasons including liquidity management purposes, or regulatory requirements stipulating assets with high credit ratings. In recent years, the international investor base has developed, and more offshore asset managers and central banks have started to invest in Kauri bonds.

35. Kauri bonds are recognised as a key component of the prudential liquidity of New Zealand's banking system and essential to New Zealand's capital markets. Excluding the government bond market, the Kauri bond market is larger than the rest of New Zealand's debt capital markets combined. As at 5 February 2016, there were $24.5 billion of Kauri bonds outstanding, issued in New Zealand by overseas issuers.[5]

36. Overseas issuers need objective certainty to extend wholesale debt offers to New Zealand. They also seek to use standard offer documents across multiple jurisdictions. The investor warning and acknowledgement requirements make reliance on the $750,000 investment exclusion problematic for these overseas issuers.

37. Considering the relative size of New Zealand's debt capital market and the importance of Kauri bond issues, exempting Kauri bonds from the warning and acknowledgement requirements removes the real risk that compliance costs and liability risks will discourage overseas issuers from extending wholesale debt offers into New Zealand. A lack of wholesale debt offers here would limit investment opportunities for New Zealand businesses. Granting the exemption would therefore promote the confident and informed participation of businesses, investors, and consumers in the financial markets. In view of the truly wholesale nature of the Kauri bond market, it is unlikely that investors will be negatively affected by the exemption. However, the short 12-month term proposed would allow for use of the exemption to be monitored and reviewed.

38. This option would provide flexibility in placement of the warning statement for offers of unsubordinated debt securities made predominantly in overseas markets. For these offers, the warning would have to be prominent but would not be required to be on the front of the principal terms sheet if this was not reasonably practicable given listing requirements, regulations or market convention in one or more overseas jurisdictions in which the offer is made.

39. This option would also address concerns that the investor warning and acknowledgement may restrict the usability of the $750,000 investment exclusion for secondary sales of unsubordinated debt securities. Under this option the warning would be required on the principal terms sheet given

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[4] *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.

[5] Based on information supplied to the FMA by the Reserve Bank of New Zealand on 9 February 2016.

to the investor but it would only be mandatory to give the principal terms sheet to the investor if the Bloomberg webpage for the debt security did not contain a link to the principal terms sheet with the warning.

40. Standard warning and acknowledgement requirements would apply to offers of debt securities that are subordinated. This is important because these securities are generally more complex and riskier. In these circumstances, it is particularly important for investors to receive the warning and actively acknowledge they understand they are being treated as wholesale investors.

41. The tailored approach of option 1 would avoid unnecessary compliance obligations and costs. Relief from providing investor warning and acknowledgement when these are not needed for investor protection helps promote and facilitate the development of fair, efficient and transparent financial markets.

42. Limiting the application of the exemption for 12 months would allow us to monitor the use of the exemptions over a 12-month period and carry out a general review of how the exemptions are working. During this time, we would consider whether there is any inappropriate use of the exemptions. At the end of the 12-month period, we would be able to decide whether the exemptions are appropriate on a longer-term basis.

Option 2: Exemption for transactions using settlement systems

Description

43. Option 2 is an exemption for offers of debt securities from the investor warning and acknowledgement requirements where those products are transferred through certain electronic settlement systems.

44. The option is driven by the rationale that transactions on certain settlement systems will be limited to institutional investors (for example, those coming under the 'investment business'[6] or 'large'[7] category of wholesale investor) who do not need the protection of the warnings or acknowledgement.

45. We identified NZClear as a settlement system to use as a proxy for this option based on the premise that we could be reasonably satisfied that members of NZClear are institutional investors who regularly use the settlement system. This initial view was based on the factors below.

    - 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.
    - In practice, most members are large institutional investors or financial institutions, although this is not a criterion for membership.
    - The membership and transaction fees for using the services provided by NZClear are likely to act as a barrier to entry for those not wanting to routinely settle securities transactions.

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[6] Cl 37, Schedule 1, Financial Markets Conduct Act 2013.

[7] Cl 39, Schedule 1, Financial Markets Conduct Act 2013.

- Kauri bonds are generally settled through NZClear.

Impact analysis

46. Option 2 would provide relief for offers of Kauri bonds and other unsubordinated debt securities settled through specified settlement systems from the compliance costs associated with the investor warning and acknowledgement requirements. Option 2 would also provide an objective bright-line test for determining whether the $750,000 investment exclusion can be relied on in relation to a particular investor. Offerors (particularly overseas offerors) see this as essential for them to participate confidently in New Zealand's wholesale debt markets.

47. However, this option would not provide assurance that investors are institutional investors or know that they are being treated as a wholesale investor. This is because of the possibility that transactions can be settled through a settlement system, such as NZClear, by a member on behalf of someone who is not a financial institution or other institutional investor. It also creates incentives for avoidance, such as settlement of certain transactions through a settlement system that would not have otherwise been dealt with in that way.

48. Therefore, this option doesn't achieve the objectives of:

    - 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.

49. Additionally, this option may be broader than reasonably necessary to address the problem identified because of the opportunities it creates for avoidance.

50. There is also a view that the $750,000 investment exclusion should not be used to supplement the usability of the other wholesale investor exclusions which specifically target institutional investors. This is because the policy behind the requirement for the investor warning and acknowledgement for the $750,000 investment exclusion is simply to ensure investors are aware that they are being treated as a wholesale investor, and the consequences of that. This is not achieved by limiting the $750,000 investment exclusion to those making offers to investors who fall in the other categories of wholesale investor.

Option 3: No exemption (status quo)

Description

51. Under this option no exemption would be granted and all offerors would be required to include prominent investor warnings on the front of all key offer documents and obtain investor acknowledgements to rely on the $750,000 investment exclusion.

Impact analysis

52. Under option 3 (status quo) the prescribed warning would be required in 'every document…that contains the key terms of the offer of the financial products'. In some cases, this requirement is impractical given the fluid nature of wholesale debt markets where the terms of an offer tend to be

communicated through numerous methods rather than formal offer documents. This requirement gives rise to some unnecessary compliance costs and there is a risk of inadvertent non-compliance and the potential for resulting liability that offerors may be unwilling to accept.

53. Investors would be required to actively acknowledge they understand that they are being treated as a wholesale investor and the consequences of that. Offerors will need to establish and maintain verification processes to ensure acknowledgements are in the correct form, and have been received from each investor, adding time, costs, and liability risks to the current offer process.

54. From our consultation with offerors and their advisers we understand that the likely impact is that offerors will not seek to rely on the $750,000 investment exclusion in its current form as they consider it unworkable in the context of the wholesale debt market, including for offers for sale of wholesale debt securities on the secondary market which are caught under Part 2 of Schedule 1.

55. Overseas issuers in particular may see these compliance costs as unjustified and the liability risks as unacceptable. Consequently, we consider there is a real risk that these issuers may decide not to extend wholesale offers into the NZ market.

56. If offerors are unable to use the $750,000 investment exclusion, they will need to rely on one of the other categories of wholesale investor exclusion in Schedule 1. We understand from consultation that market participants consider the other categories of wholesale investor exclusion to be generally problematic. One of the reasons raised by offerors was the on-going need to repeatedly undertake a detailed analysis of an investor's characteristics and business. Market participants consider the other categories of wholesale investor exclusion are unsuitable for wholesale debt offers.

57. A number of these concerns could potentially be addressed by using safe harbour certificates. We understand, however, from consultation that some investors may not be willing to provide safe harbour certificates. Additionally, issuers may not be willing to collect and monitor these certificates to ensure they are current at the relevant time, nor will they be willing to rely on them without due diligence. Businesses involved in wholesale debt markets and their professional advisers consider there is a limited ability to rely on safe harbour certificates due to:

    - the risk for large organisations, such as banks, that knowledge in one part of the business could be imputed under the FMC Act in a manner that removes the organisation's ability to have the protection of a safe harbour certificate
    - the fact that most wholesale debt markets, including the Kauri bond market, are not underwritten so issuers and arrangers do not know who the investors are until the yield is set. In most cases, investors will need legal advice to be able to provide safe harbour certificates. These factors add time and costs to the offer process.

58. Therefore, option 3 is likely to result in fewer wholesale debt offers being made by overseas issuers and increase the costs of wholesale debt issuances for New Zealand offerors. Both factors reduce investment opportunities for New Zealand businesses and overall participation in New Zealand's financial markets.

Summary assessment of options against objectives

	Option 1: Tailored exemption and conditions for targeted classes of debt securities with a review after 12 months	Option 2: Exemption for transactions using settlement systems	Option 3: No exemption (status quo)
Promotes confident and informed participation of businesses, investors, and consumers in the financial markets	Provides offerors with objective certainly as to whether the $750,000 investment exclusion applies. Unlikely to have a significant negative impact on investors because the investor warning and acknowledgement requirements will still apply where protection is needed. ✔✔	Provides offerors with objective certainly as to whether the $750,000 investment exclusion applies but investors may not be aware that they are being treated as a wholesale investor. ✔	Unnecessary compliance costs and lack of confidence by overseas issuers in their ability to comply with the requirements likely to deter wholesale debt offerors and reduce overall participation in New Zealand's financial markets. ✖
Promotes and facilitates the development of fair, efficient and transparent financial markets	Avoids unnecessary compliance obligations and resulting inefficiency in wholesale debt markets. ✔✔	Opportunities for avoidance reduce transparency and efficiency. ✖	Unnecessary compliance obligations likely to reduce efficiency. ✖

Avoids unnecessary compliance costs	Avoids unnecessary compliance costs of warning and acknowledgement requirements for offerors of certain debt securities in appropriate situations. ✓✓	Avoids compliance costs of the warning and acknowledgement requirements for offerors of debt securities but may not be limited to where those costs are unnecessary. ✓	Unnecessary compliance costs will add to the cost of capital in New Zealand and may deter wholesale debt offerors, particularly overseas issuers, from making offers in New Zealand. ✘
Not broader than reasonably necessary to address problem	Addresses specific transactional issues for offers of certain wholesale debt securities that have been raised as being particularly unworkable. Granted on a short-term basis to allow for monitoring and review. ✓✓	Creates opportunities for avoidance and unintended consequences. ✘	N/A

Key
✓✓ Meets the policy objectives
✓ Partially meets the policy objectives
✘ Does not meet the policy objectives

Section 3: Consultation

Process

59. Consultation for an exemption was signalled to stakeholders in a 13 March 2015 *Consultation paper: Financial Markets Conduct Act exemptions*.

60. This matter was then considered in detail in a paper released on 2 April 2015, *Consultation paper: Investor acknowledgement and warning for the $750,000 minimum investment wholesale investor exclusion*. This public consultation sought to test whether the compliance burden of the investor warnings and acknowledgement was really unreasonably high in some areas, and would deter issuers from offering wholesale debt securities in New Zealand. This effectively sought to question the need for any exemption. This is option 3 in this RIS analysis. Further, the consultation also sought information on the types of debt securities that would be negatively impacted by the requirements. This in particular tested whether there may be limited types of securities impacted, for example securities that are transferred through certain electronic settlement systems. This is option 2 in this RIS analysis.

61. We received eight submissions. They were from:

- ANZ
- NZBA
- Russell McVeagh
- Mayne Wetherell
- Kensington Swan
- Westpac
- Chapman Trip
- NZSA

62. The bank and law firm submitters expanded on concerns that were initially outlined in a joint industry submission to MBIE in August 2014. MBIE referred this to us for consideration.

63. We met with a number of the banks and law firms in late April 2015 to discuss their views on issues around the $750,000 investment exclusion, and to identify possible solutions for exemption relief. This lead to the development of option 1 – a tailored exemption and conditions for targeted classes of debt securities.

64. We also consulted further with NZSA after receiving their submissions and sought their feedback on the preliminary option 1 solution for exemptive relief that we had developed in light of feedback from banks and law firms. We further modified our exemption proposals in light of feedback from NZSA, particularly ensuring an investor warning was required where needed, and a review period for the exemption built in.

65. In May 2015, we approved the policy of the preferred option 1 exemption, namely short-term (12 month) exemptions for offerors of certain types of debt securities seeking to rely on the $750,000 investment exclusion from the investor acknowledgement and warnings requirements on the basis that:

- for kauri bonds offers, the warning and investor acknowledgement would not be required

- for offers of other unsubordinated debt securities, the investor acknowledgement would not be required, and a single warning would be required on the principal terms sheet given to the investor (and not on every document that contains the key terms of the offer) and
- the 12-month term would enable us to monitor the use of the exemptions, and carry out a general review of how the exemptions are working, including considering whether there was any inappropriate use of the exemptions.

66. Although the substantive policy had been determined, consultation continued. We consulted with submitters on a draft notice to give effect to the approved policy for an exemption. This resulted in modification of the original exemption proposals to take account of further feedback we received about the practical workability of the conditions in the particular market context.

Feedback from NZBA, law firms and banks on behalf of banks and overseas offerors

67. These submitters supported exemptions from the investor warning and acknowledgement requirements. They held the view that the compliance costs of these requirements would be unreasonably high. They emphasised offerors' need for an objective bright-line test to determine whether offers to a particular investor fall within the wholesale investor exclusion. They thought the need for a bright-line test was especially strong in the case of overseas offerors.
68. They said offerors would not seek to rely on the $750,000 investment exclusion in its current form because it was unworkable in the wholesale debt market and in particular the secondary market for the trading of wholesale debt securities. Their main reasons are listed below.
    - Investor acknowledgements would require verification processes to ensure acknowledgements are in the correct form and have been received for each investor, adding time, costs, and liability risks to the offer process.
    - Requiring the warning to be contained in '*every document…that contains the key terms of the offer of the financial products'* would be impractical, given the need to ensure every document which might have the key terms in it has the warning. This creates risks of inadvertent non-compliance.
    - The investor warning and acknowledgment requirements for the $750,000 investment exclusion were inconsistent with normal market practice on the secondary market where transactions were conducted at a fast pace and in an informal way (through phone calls, emails and with key terms provided on Bloomberg) with little, if any, documentation.
    - The general requirements were inappropriate (as costs exceeded benefits) for overseas issuers offering financial products in New Zealand, including Kauri bonds and other issuances. They saw the proposed changes leading to a 'lack of objective certainty' for issuers, market makers and other participants. This was because market makers (particularly, but not exclusively, offshore market makers) needed to be completely confident about the wholesale characteristics of their counterparts before they could trade. They would not necessarily have the time or resources to carry out the due diligence required by the investor warning and acknowledgement requirements, or the other

wholesale investor exclusion categories (eg the ‘investment business’ and ‘large’ categories of wholesale investor).

69. In addition to asking submitters whether the compliance burden of the warning and acknowledgement was unreasonably high, we also asked about any difficulties they anticipated if they were to operate under the other categories of wholesale investor exclusion, instead of the $750,000 investment exclusion. We asked this on the basis that if participants were unable to use the $750,000 investment exclusion due to anticipated compliance costs and unresolvable liability risks, they should be able to use one of the other categories of wholesale investor exclusion in Schedule 1. These submitters noted they viewed the other categories of wholesale investor as problematic because of the requirement to provide a detailed analysis of an investor’s characteristics and business on a repeated and ongoing basis. They thought this made the other categories unsuitable for wholesale debt offers.

70. Whilst clearly supporting an exemption, these submitters did not consider option 2 would be effective (the exemption for debt securities transferred through certain settlement systems). The main concern expressed was that an exemption of this nature could lead to potential for avoidance behaviour through financial products being removed from NZClear once issued and then distributed to the public. There was also the possibility that retail holders could obtain smaller interests in financial products through a chain of nominees and custodians given some members of NZClear are nominees and custodians. Some submitters also noted that NZClear was under review and might not continue.

71. As indicated in our summary of the consultation process above, the strong support for relief from aspects of the investor warning and acknowledgement requirement, and feedback on why the $750,000 investment exclusion would not work in practice, led to collaboration on the development of an effective exemption option – a tailored exemption and conditions for targeted classes of debt securities (option 1).

72. Feedback from the NZBA and banks on the draft exemption notice to give effect to option 1 was that:

    - it would be impractical for the offeror to provide the investor with the principal terms sheet (with the warning) when selling unsubordinated debt securities on the secondary market. They said there was no consistent market practice for the principal terms sheet to be provided to the purchaser on the secondary market and prospective purchasers would often find information about the debt securities from other sources, such as Bloomberg
    - if bonds were being issued by a New Zealand issuer under Euro or US note programmes, the form of the terms sheet in these markets might not accommodate a warning statement at the front.

73. As a result of this feedback, this option was amended to allow for the warning to be given on Bloomberg for offers for sale of unsubordinated debt securities on the secondary market. In addition a further amendment was made to allow for the warning to be prominent but not on the front of the principal terms sheet for offers made predominantly offshore where having the statement at the front would not be reasonably practicable due to market practice, laws or listing rules in the relevant overseas jurisdictions.

Feedback from NZSA on behalf of investors

74. NZSA was opposed to an exemption being given from investor warning and acknowledgement requirements. They noted that the investor warning and acknowledgement requirements were important protections for retail investors who were wealthy but inexperienced, and therefore needed to be aware that they would not receive standard disclosures. They queried if the compliance costs were actually material relative to the significant levels of investment involved. They were not convinced that the requirements in the FMC Act for identifying wholesale investors under other categories of wholesale investor exclusions would be a serious problem and questioned the industry's concern that the level of compliance costs would constrain the wholesale market. NZSA was of the view that these costs would be passed on to investors through fees and this was a legitimate cost of accessing wholesale offers.

75. NZSA additionally did not consider that option 2 for an exemption (based on use of the NZClear settlement system for transactions) would be a viable solution because of the risk that nominees could mask the status of underlying investors (who may not be institutional investors). Like other submitters, they also noted that the system was under review and might not continue. They also considered it was unwise to focus on process rather than on the nature of the transactions being processed.

76. In discussions following initial submissions and the collaborative development of option 1 (the tailored exemption, and conditions for targeted classes of debt securities), NZSA emphasised that it was crucial that there should be a requirement for a warning on the principal terms sheet if an exemption was considered essential for certain wholesale debt securities. They considered that a warning should be required for Kauri bonds as well as other unsubordinated debt securities. They did not think there was clear evidence that Kauri bonds were not sold to retail investors.

77. NZSA recommended that any exemption granted should be limited to a 12-month period. During that time they thought further work should be undertaken in particular to determine the extent to which retail investors are involved in the Kauri bond market. This would then allow a sensible analysis of cost, convenience and risk to occur and mitigate potential unintended consequences. NZSA thought it important that we consult on any proposals to extend relief at the end of the 12 months.

78. In light of NZSA's feedback, exemptions were limited to 12 months to allow us to monitor reliance on the exemptions and review whether relief under the exemption notice should be extended for a longer period.

79. Based on the submissions and discussions held, we consider exemptions and conditions proposed in option 1 will best achieve the objectives outlined in this RIS.

Section 4: Conclusion and preferred option

80. Overall, we consider option 1 (tailored exemption and conditions for targeted classes of wholesale debt securities) will best meet the objectives outlined in this RIS. This option will allow us to monitor the use of the exemptions over a 12-month period and carry out a general review of how the exemptions are working. At the end of the 12-month period, we will be able to review the impact, consult with stakeholders, and decide whether the exemptions are appropriate on a longer-term basis.

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