REGULATORY IMPACT STATEMENT

A POWER FOR THE FMA TO EXERCISE AN INVESTOR'S RIGHT OF ACTION

AGENCY DISCLOSURE STATEMENT

This Regulatory Impact Statement has been prepared by the Ministry of Economic Development.

It provides an analysis of options to allow the Financial Markets Authority (FMA) to take civil cases on another person's behalf.

The analysis is based on a proposal from the FMA Establishment Board and a preliminary analysis of some submissions on the Review of Securities Law discussion document. Because the FMA Establishment Board has only recently written to the Minister requesting this power officials have had limited time to analyse this proposal. The limited time available has not allowed for a full analysis of the costs and benefits of the preferred option nor for the development of alternative regulatory and non-regulatory options. There may be other approaches that could achieve the objectives of the proposal. For example, the FMA could be given specific powers to enforce new civil liabilities and criminal offences associated with breaches of directors' duties and other misconduct that the proposal is targeted towards. Another alternative would be to facilitate private enforcement, for example through reform of the law and court procedures around class actions and through greater funding of courts and legal aid. The options presented in this paper are therefore whether to proceed with a new power for the FMA now in the Financial Markets (Regulators and KiwiSaver) Bill, or to hold off until more evidence is collected and analysis performed as part of the securities law review.

Some of the options may have impacts that the Government Statement on Regulation states will require a particularly strong case. In particular, there is a risk that the preferred option will result in risk-averse behaviour by financial market participants, and this will impair the incentives on businesses to innovate and invest. Mitigating this risk is the high threshold that will be required for the FMA to use the proposed power, and the fact that the power does not change the duties of financial market participants – it simply provides for more effective enforcement of existing duties.

Bryan Chapple

Manager, Investment Law, Ministry of Economic Development

STATUS QUO AND PROBLEM DEFINITION

The FMA is intended to be established by 1 April 2011.

A key issue in establishing the FMA is whether it will have the necessary powers to achieve its objective of promoting fair, efficient and transparent markets.

The FMA will have the Securities Commission's current powers to enforce the criminal law. It will also be able to seek civil remedies on behalf of investors under the Securities Act and the Securities Markets Act in certain situations, for example where a prospectus or an investment statement contains an untrue statement or where a person has engaged in misleading or deceptive conduct in relation to any dealing in securities.

There are, however, situations where financial market participants, auditors and other people regulated by the FMA may have acted in a manner that gives rise to a civil right of action, but the Commission is unable to act. These include cases of negligence, breach of trust and breach of statutory duty (e.g. directors' duties).

It is rarely in the interests of individual investors to act in these cases because of the costs and risks involved or, in the case of debenture holders, because they have limited legal standing. Further, in the case of closely held companies, the company and its shareholders may not have the right incentives to bring action against directors. This is likely to have been the case with a number of finance companies, for example.

A majority of the FMA Establishment Board's members consider that there is a material risk of a mismatch between expectations and powers if the FMA does not have a more general power to take cases on behalf of investors. This has the potential to undermine the credibility of the FMA, especially if important cases arise during the critical establishment period and the FMA is unable to act.

OBJECTIVES

The objective is to facilitate the development of fair, efficient and transparent financial markets. The following are intermediate objectives:

1. Increasing the likelihood that duties owed to investors by financial market participants are enforced, particularly where large numbers of retail investors are affected.

2. Improving investor confidence in the regulator and financial markets more broadly.

3. Ensuring that experienced and competent directors and other financial market participants are not discouraged from participating in financial markets.

There are trade-offs between the first two intermediate objectives and the third. An increase in the number of cases against directors and other financial market participants may promote investor confidence. However, this may also result in directors and other financial market participants choosing not to participate, or acting in a risk-averse way. The best option would balance these intermediate objectives in a way that maximises achievement of the overall objective.

REGULATORY IMPACT ANALYSIS

Australian law

The Australian Securities and Investments Commission (ASIC) has a power under section 50 of its Act to exercise another person's right of action.

ASIC also enforces company director duties, which are a matter for private enforcement in New Zealand. In Australia this enforcement includes ASIC taking civil cases to impose civil pecuniary penalties and compensation, and also prosecuting criminal offences.

Proposal

Based on ASIC's section 50 power, a proposal has been developed to give the FMA a power to exercise a person's right to bring a civil action against a financial market participant, where it considers this to be in the public interest. The power would provide that where, as a result of an investigation or inquiry, the FMA considers it to be in the public interest to do so, the FMA may exercise a person's right of action by commencing and continuing proceedings against a specified person, or taking over proceedings. If the person on whose behalf action was to be taken objected or was taking its own action, the FMA would need to obtain the leave of the Court (the Court would grant leave if satisfied of the public interest).

The proposal does not change the duties of directors or others as the intention is to provide more effective enforcement of existing duties.

Option 1 (Preferred option): Introduce a new power for the FMA now

Benefits

Introducing such a power now is expected to benefit investor confidence in the regulator and financial markets.

This power will provide investors with confidence that the FMA will be able to take action on a much wider range of matters than previous regulators. This will include the FMA being able to act much earlier on misconduct – if detected – before issuers default on their obligations to creditors and issuers go into receivership or liquidation.

There may be greater compliance by financial market participants involved in public offerings of financial products. This is because civil cases will become possible that were not practical previously, such as where there were numerous investors with relatively small investments.

Costs and risks

A key risk of the proposal is the potential effect on directors' willingness to serve, due to the increase likelihood of civil cases being taken against them. A number of submitters held this concern, although the Institute of Directors considers that public enforcement of directors' duties would not significantly affect directors' willingness to serve.

Additionally, this proposal may make directors and issuers more risk-averse. A number of submitters were of this view.

There would be significant resourcing issues if the power were seen to be a simple substitute for investors taking private action, as the FMA will be looked upon to take action whenever an investor loses money. Detecting breaches of directors' duties could prove difficult. If so, providing such a power may cause the FMA to investigate a large number of cases without success.

The FMA may also have poorly aligned incentives in relation to enforcement of directors' duties, and there is a risk that the FMA takes actions that are not material or lack merits.

Requiring in legislation that FMA cases must meet a public interest test would help to mitigate resourcing and incentive risks. Before it could take a case, the FMA would be required to consider a number of matters. For example, whether the proceedings raise a significant point of law, or the exercise of the power is an efficient use of the FMA's resources.

There is also a risk that the FMA's actions block private settlement and enforcement. This can be dealt with by requiring that where a person on whose behalf action was to be taken objected or was taking its own action, the FMA would need to obtain the leave of the Court. Under the proposal, the Court would grant leave if satisfied of the public interest.

There is a risk that the review of securities law may result in proposals that impact on the new power, the most notable being that a specific public enforcement regime for director's duties would overlap with the FMA's new power. There would be an opportunity to revise the new power if this were to occur, although it is notable that Australia has both regimes.

Option 2: Wait until the securities law review is concluded

The securities law review is currently underway and is likely to result in legislation being introduced in 2011. Another option is therefore to wait until the securities law review is completed, and either introduce the proposal then, or introduce alternative regulatory or non-regulatory measures to achieve the proposal's objectives.

Benefits

Most of the benefits of option 1 could be obtained by waiting until the securities law review concludes. The FMA would gain any new powers 1-2 years later.

The costs and risks of option 1 would also be delayed for 1-2 years, and may be avoided altogether if superior regulatory or non-regulatory options were identified in the meantime.

Costs and risks

The FMA Establishment Board has identified a material risk of a mismatch between expectations and powers if the FMA does not have the ability to take cases on behalf of investors at its establishment. During the period before new legislation is passed, a number of cases may arise in which the FMA finds itself unable to act effectively. This would tend to reduce investor confidence in the regulator and financial markets more generally. There is a risk that this would undermine the credibility of the FMA during the critical establishment period.

CONSULTATION

The discussion paper on the review of securities law included questions on the desirability of the section 50 ASIC Act power and the issue of public enforcement of directors' duties. Both of these powers would be available to the FMA under the preferred option and submissions on them are therefore relevant to this issue. Submissions closed on 20 August, but late submissions are still arriving. We have undertaken an initial analysis of the submissions received by 26 August. Out of 80 submissions, 12 commented on the proposal for the FMA to have a power along the lines of section 50 of the ASIC Act. Of these 3 were supportive, 7 opposed and 2 were neutral. 13 commented on the regulator enforcing directors' duties as a civil action. 3 supported, 7 opposed and 3 were neutral.

A number of submitters who opposed new powers held contrary views about the problem definition, stating that they were unaware of any under-enforcement at present.

Benefits identified in relation to a section 50-like power were (with submitters identified):

- Improving corporate governance (RBNZ)
- Making possible litigation where investors hold small parcels of products and it is otherwise impossible for them to sustain the costs associated with individual litigation (Murray Lazelle)
- More efficient enforcement, compared to limited methods of action and requiring separate investigations to take place in relation to the same set of matters (PricewaterhouseCoopers)

Costs and risks identified in relation to a section 50-like power were:

- Would cut across the role of supervisors to enforce civil claims on behalf of investors (Trustees Executors)
- Would cause issuers to become risk-averse (Kensington Swan)

- Would discourage people from becoming directors (Kensington Swan)

Benefits identified in relation to the power of the regulator to enforce directors' duties (which would be enabled by the proposed power for the FMA) were:

- Would increase directors' standards (Craig Investment Partners, Institute of Directors, NZX)
- Would improve confidence in capital markets (Institute of Directors)
- Would enable cases to be taken where shareholders lack information, power and resources (Simpson Grierson, Institute of Directors)

Costs and risks identified in relation to the power of the regulator to enforce directors' duties were:

- Difficulties for the FMA establishing breach of directors' duties (RBNZ)
- Would act as a deterrent to high quality candidates agreeing to act as directors (Trustees Executors, Craigs Investment Partners, Simpson Grierson, NZX)
- Would make directors more risk-averse and conservative (Craigs Investment Partners, NZX)
- FMA civil claims may exclude shareholders' ability to control and settle their own claims (Business Roundtable, Bell Gully)
- The FMA has poorly aligned incentives in relation to enforcement of directors' duties, and may take too many actions that are not material or lack merits (Business Roundtable, Simpson Grierson)
- The FMA may lack the required resources and expertise (Business Roundtable, Bell Gully)
- It would not be an efficient use of FMA resources (Bell Gully)

The Treasury, Reserve Bank, Inland Revenue Department, State Services Commission, Ministry of Justice, Registrar of Companies, Securities Commission were consulted on the Cabinet paper containing the proposal. The Department of Prime Minister and Cabinet has been informed.

CONCLUSIONS, RECOMMENDATIONS, AND IMPLEMENTATION

Based on the benefits, costs and risks identified in this RIS, we recommend that the proposal be included in the Financial Markets (Regulators and KiwiSaver) Bill (option 1), rather than waiting until the review of securities law concludes (option 2). However, the select committee process will enable more specific submissions to be made on the new power than was possible under the review of securities law. If significant additional costs or risks are identified by submitters it may be appropriate for Cabinet to consider further the inclusion of this power in the Bill.

MONITORING, EVALUATION AND REVIEW

Providing for this power in the introduction version of the Bill allows for consultation at select committee on a concrete proposal rather than on the general concept. The proposal can be amended or removed following select committee consideration if that is required.

The mix of FMA powers will be reconsidered as part of the review of securities law. As a Crown entity, the FMA will be subject to ongoing monitoring. We also intend to monitor broader indications of public confidence in financial markets, such as investor confidence surveys.