NEW ZEALAND BUSINESS ROUNDTABLE

Submission on the Ministry of Economic Development Discussion Paper *Review of Securities Law*

August 2010

1. Introduction

1.1 This submission on the Ministry of Economic Development's (MED) discussion paper, *Review of Securities Law*, published on 22 June 2010 (Discussion Paper), is made by the New Zealand Business Roundtable, an organisation comprising primarily chief executives of major New Zealand business firms. The purpose of the Business Roundtable is to contribute to the development of sound public policies that reflect New Zealand's overall interests.

1.2 The Business Roundtable does not propose to individually address each of the 204 questions presented in the Discussion Paper but instead address five key issues arising from it:

(a) The public policy framework for evaluating New Zealand's securities laws, including:

(i) The principles which underpin the framework of securities regulation, and

(ii) The importance of carrying out a cost-benefit analysis of the proposals which emerge from this reform process;

(b) The scope of the securities laws, which encompasses Chapters 1 and 2 of the Discussion Paper;

(c) The substantive duties of disclosure, which encompasses Chapter 3 of the Discussion Paper;

(d) The standards of liability under the securities laws, the mechanisms for enforcing the securities laws, and the sanctions for contraventions of the securities laws, which encompasses Chapter 5 of the Discussion Paper; and

(e) The securities law reform process, including the importance of:

(i) Publishing an exposure draft of the legislation which emerges from this reform process prior to its introduction to Parliament, and

(ii) Preparing a robust regulatory impact statement, which should be subject to certification as to its adequacy by the Regulatory Impact Analysis Team of the Treasury.

1.3 In summary, the Business Roundtable:

(a) strongly supports measures which would liberalise New Zealand's securities laws (including clarifying and widening the exemptions from the securities laws and giving investors the choice to opt-out of certain aspects of the securities regime);

(b) supports measures which would provide the Financial Markets Authority (FMA) with a more effective 'toolbox' of regulatory options, such as the power to give binding rulings or issue 'no action' letters;

(c) supports measures which would impose condign sanctions against dishonest participants in the financial markets (e.g., dishonest directors and culpable bankrupts) while making the standards of liability consistent with the protections of the New Zealand Bill of Rights Act 1990 (Bill of Rights) (e.g., removing the reverse onus provisions of the securities laws);

(d) strongly opposes measures which would increase the uncertainty of the securities laws, including any generalised obligation to act "fairly".

2. Policy framework

Asking the right questions

2.1 The Business Roundtable submits that a fundamental revision to New Zealand's securities laws, as envisaged by the Discussion Paper, raises the following questions:

(a) First, what are the problems with securities markets which the government seeks to address?

(b) Second, what are the alternatives for addressing each of these problems (whether by legislation or private market-based arrangements)?

(c) Third, which options produce the best outcomes, having regard to:

(i) the costs and benefits of each option;

(ii) the imperfect information available to legislative decision-makers and the potential for unintended consequences; and

(iii) the due respect required for the principles underpinning the social order such as the protection of private property rights and the rule of law?

2.2 The Hon. Stephen Breyer (then a judge of the United States Court of Appeals for the First Circuit and later a judge of the United States Supreme Court) proposed a similar framework in *Regulation and Its Reform*:[1]

> The framework is built upon a simple axiom for creating and implementing any program: determine the objectives, examine the alternative methods of obtaining these objectives, and choose the best method for doing so. In regulatory matters, this axiom is often honoured in the breach … Too often arguments made in favour of governmental regulation assume that regulation, at least in principle, is a perfect solution to any perceived problem with the unregulated marketplace. Of course, regulation embodies its own typical defects.

2.3 This framework accords with the principles set out in the *Government Statement on Regulation: Better Regulation, Less Regulation*, dated 17 August 2009. As the government acknowledges:

> We look to regulation to help ensure we live safer lives, get treated fairly, protect and manage our environment, have a competitive and efficient economy, and much more.

---

[1] Stephen Breyer, *Regulation and Its Reform*, 1984, Harvard University Press, page 5.

> But regulation also has costs and can have unintended effects. Outdated, poorly conceived and poorly implemented regulation can significantly hinder individual freedom, innovation, and productivity. Reducing the burden imposed by such regulation will help unshackle our economy and give New Zealanders more ability to shape and improve their own lives.

2.4 The Discussion Paper premises its approach to securities regulation on 'market failure'.[2] Since markets fail, the MED reasons, regulation is required to address those failures. This approach is analytically incomplete. Regulatory regimes also are also vulnerable to failure. Ill-considered regulation or the disproportionate enforcement of regulation can impose greater social costs than the underlying harms which the regime seeks to address.[3,4]

2.5 In his seminal treatise, *Economic Analysis of Law*, Justice Posner cautioned against uncritical acceptance of the rationales for securities regulation:[5]

> Securities regulation is rooted in part in a misconception about the great depression of the 1930s. It was natural to think that the 1929 stock market crash must have been the result of fraud, speculative fever, and other abuses, and in turn a cause of the depression: *post hoc ergo propter hoc*. But a precipitous decline in stock prices is much more likely to result from the expectation of a decline in economic activity than to cause the decline, which suggests that the crash was less likely the result of abuses in the securities markets than an anticipation of the depression. If this is right, one is entitled to be sceptical about aspects of securities regulation that are designed to prevent another 1929-type crash, such as the requirement that new issues of stock may be sold only by means of a prospectus which must be submitted to the SEC in advance for review to make sure it contains all the information (including adverse information) that the SEC deems material to investors.

2.6 For example, George Stigler's study of the performance of stock issued before and after the 1933 securities law reforms in the United

---

2 The basic philosophy of the securities regime in New Zealand, and in most other countries, is that investors are responsible for the investments that they make. However, financial products are prone to 'market failures'" (Discussion Paper, paragraph 13).

3 Moreover, there is a risk of regulatory capture. As the Nobel laureate economist, George Stigler, explains: "as a rule, regulation is acquired by the industry and designed and operated principally for its benefit", often at the expense of consumers and the national interest: see George Stigler, 'The Theory of Economic Regulation', *Bell Journal of Economics,* The RAND Corporation, 1971, vol. 2(1), page 3.

4 See also David Friedman, *Private and Political Markets Both fail: A Cautionary Tale About Government Intervention*, New Zealand Business Roundtable, 2004.

5 Richard Posner, *Economic Analysis of Law*, 6th ed., 2003, page 458.

States showed that purchasers appeared to be, on average, no better off than before federal intervention.[6]

2.7 Accordingly, the assertion that regulation is an inevitable response to market failure suffers from what Professor Harold Demsetz calls the "nirvana fallacy"[7].

> The view that now pervades much public policy economics implicitly presents the relevant choice as between an ideal norm and an existing 'imperfect' institutional arrangement. This *nirvana* approach differs considerably from a *comparative institution* approach in which the relevant choice is between alternative real institutional arrangements.

2.8 In the Business Roundtable's view, the important public policy questions are not whether there is a risk of market failure but, first, whether markets or regulators are better suited to deal with the problems which are expected to arise in a specific field of economic activity; and, second, whether the economic benefits of the regulatory regime outweigh the costs associated with that system. The answers to these questions are rarely obvious and the complexity of the issues which they raise counsels caution.

Analysis of problems

2.9 The MED asserts that two problems exist in the financial markets which justify disclosure regulation:[8]

(a) First, the MED identifies a problem of information asymmetries in relation to financial products. The Business Roundtable considers this analysis incomplete for the reasons described above. Information asymmetry is a feature of nearly all markets. The questions are, first, whether the benefits of removing information asymmetries exceed the costs and, second, whether information asymmetries are better addressed

---

6 George Stigler, 'Public Regulation of the Securities Market', 1964, 37 *Journal of Business* 117.

7 Harold Demsetz, 'Information and Efficiency: Another Viewpoint', *Journal of Law & Economics* (1969), page 12.

8 *Discussion Paper*, page 75.

by governments or markets. (These questions are briefly considered in the balance of this section.)

(b) Second, the MED notes (though without particular emphasis) that the absence of disclosure would affect "secondary audiences" (i.e., financial advisers, market analysts, and regulators). The MED acknowledges that these secondary audiences could obtain the information in other ways (most obviously by voluntary disclosure) and it seems clear that this is at best a subsidiary rationale for regulation.

2.10 The analysis contained in the report prepared by Professor George Benston for the Business Roundtable, *Voluntary vs. Mandated Disclosure*, is noted by the Discussion Paper only in passing.[9] In that paper Professor Benston questioned whether mandatory disclosure was superior to voluntary disclosure, backed by laws prohibiting dishonest or misleading statements.[10] The MED makes no attempt to engage with Professor Benston's conclusions and simply notes that its view is that specific regulation is required and that the MED's view accords with that of regulators in New Zealand's trading partners.

2.11 The Business Roundtable is disappointed that the MED did not closely evaluate Professor Benston's analysis (which reflects orthodox economic principles) in the course of preparing its recommendations. In particular, Professor Benston explains the importance of three market dynamics which apply to the offering of financial products to the public:[11]

> (a) product providers bear the cost of under-informing investors; (b) competition among product providers ensures the optimal production and distribution of information ... [subject to certain externalities problems, which are normally addressed by specialist information

---

9 *Discussion Paper*, page 75, footnote 61.

10 George Benston, *Voluntary vs. Mandatory Disclosure: An Evaluation of the Basis for the Recommendations of the Working Group on Improved Investment Product and Adviser Disclosure*, New Zealand Business Roundtable, May, 1997.

11 *Ibid*, chapter 2.2.

> services such as ratings agencies]; and (c) some product providers have incentives to misinform or under-inform investors.

2.12 The last set of incentives will apply to issuers with inferior products who deceive investors. This mischief can be addressed through criminal and civil punishments against misinformation and deception. These prohibitions under the general law pre-date the securities regime.

2.13 In relation to the first two sets of incentives, it is not obvious that mandatory disclosure is superior to voluntary disclosure in response to market forces. As Professor Benston notes:[12]

> An important and telling fact is that financial accounting statements were offered to investors long before they were required by law. In the United States, prior to passage of the Securities and Exchange Act of 1934 which first required disclosure, all corporations with stock listed on the major exchange, the New York Stock Exchange, … provided fairly complete financial statements to investors and all but one company was audited by certified public accountants.

2.14 The same observation can be made in respect of the rules of the London Stock Exchange (LSE), as noted in an insightful recent monograph published by the Institute for Economic Affairs, entitled *Does Britain Need a Financial Regulator?*[13] During the nineteenth century, the LSE became the world's premier financial market based on private rules, which were enforced by its own internal disciplinary systems. Prior to 1986, the LSE was subject only to its own private regulation and from 1986-2000 under a largely self-regulatory framework. Arthur and Booth conclude that there is no strong evidence that statutory financial regulation have improved market conditions and therefore recommend that responsibility for market regulation should be restored to market institutions.

2.15 Despite these reservations, the balance of this submission addresses the specific regulatory measures contemplated by the Discussion Paper.

---

12 *Ibid*, chapter 2.2.1.

13 Terry Arthur and Philip Booth, *Does Britain Need a Financial Regulator*, Institute of Economic Affairs, 2010.

Policy objectives

2.16 The Business Roundtable supports certain of the high level principles espoused by the Capital Market Development Taskforce (Taskforce) in its report, *Capital Markets Matter*, in which the Taskforce concluded that the Government has a role in providing, among other things, "regulatory settings that produce the best choices and outcomes for investors and issuers, and an environment that encourages capital markets and growth."[14] Similarly, the Business Roundtable agrees with the Taskforce that the objective of allowing New Zealand's capital markets to be an "engine of growth" requires freeing up private markets by, among other things, "review[ing] the Securities Act and revis[ing] current Securities Act exemptions to provide a set of clearer, broader exemptions to the Act."[15]

2.17 Accordingly, the Business Roundtable believes that the Discussion Paper provides a useful opportunity to re-evaluate the objectives of the securities laws, whether the current regulatory settings achieve those objectives in a less costly way than other alternatives, and to consider reforms to improve New Zealand's regulatory settings and free up its financial markets.

3. Ambit of the securities regime

Exemptions

3.1 The Business Roundtable agrees with the assessments by the Taskforce and the MED that the existing qualitative exceptions are unduly vague and the bright-line exceptions are unacceptably narrow. The decision of the District Court in *Ministry of Economic Development v Stakeholder Finance Ltd*, to which the discussion paper refers, renders the habitual investor exception practically

---

14 Report of the Capital Market Development Taskforce, *Capital Markets Matter*, December 2009, page 9.

15 *Ibid*, page 17.

unworkable for anyone other than a professional investor.[16] In that case, the Court indicated that, in addition to factors such as the number of investments, the amount invested, and the timing of investments, it was also relevant to consider "the success or otherwise of those investments".[17] The Business Roundtable concurs with the MED's view that "the complexity of these considerations suggests that this exemption can only safely be used for offers to professional investors."[18]

3.2 Accordingly, the Business Roundtable agrees that the exemptions to the securities laws should be broadened and clarified. In the interests of clear and principled regulation, the Business Roundtable prefers that bright-line general exemptions to the securities regime are preferable to ad hoc exemptions or no action letters in particular cases. Nevertheless, it acknowledges that exemption powers and no action letters are necessary "safety valve" mechanisms to deal with potentially perverse consequences associated with complex securities regulations.

Opt-out mechanism

3.3 The most straightforward exemption would be to permit an investor to opt-out of the protection of the securities laws by signing a model agreement.

3.4 The utility of this mechanism would be undermined if, as the Discussion Paper contemplates, it is subject to numerous qualifying conditions (such as requiring minimum previous qualifying investments, education standards, or third party financial certification). The Business Roundtable considers the suggestions for certifying the sophistication of investors are likely to be unwieldy. This problem stems from the Discussion Paper's omission to fully analyse the problems which it seeks to solve. The implicit

---

16 *Ministry of Economic Development v Stakeholder Finance Ltd* (unreported, DC AK CRI-2007-004-028150, 9 December 2008).

17 *Ibid*, paragraph 69.

18 *Discussion Paper*, page 48.

assumption in the Discussion Paper is that the law should limit the extent to which unsophisticated investors may expose themselves to risk. This assumption is illustrated by the suggestion that it should be a criminal offence for the *investor* to certify that he or she is sufficiently sophisticated to participate in the issuer's investment opportunity. The consequence is that a potentially simple proposal becomes entangled with an unnecessarily complicated and expensive certification system. The Business Roundtable would prefer a simple opt-out mechanism, under which investors would choose whether to forgo the protections of the securities regime.

Public register of exempt investors

The Business Roundtable strongly opposes the creation of a public register of certified investors. The Discussion Paper's passing observation that this register "also has privacy implications" fails to acknowledge the seriousness of this proposed incursion into investors' privacy. Similarly, the suggested duty for investors to update their status on the register creates unnecessary compliance obligations and legal risk for no obvious benefit to investors. Again, the Discussion Paper's omission to properly explain the problems that the register seeks to solve leads it to suggest measures which prejudice rather than advance the interests of investors.

Other exemptions

3.5 The Business Roundtable does not comment in detail on the other proposed exemptions set out in the Discussion Paper. In the absence of a proper analytical framework (including a clear explanation of the problem which the MED seeks to solve), it is not possible to discuss the details of the MED's suggested criteria for qualifying as an exempt investor in any meaningful way. For example, the MED suggests that an investor is sufficiently sophisticated if he or she has, among other things, entered into "20 or more financial product transactions of over $2,000 in the last two

years".[19] Since the threshold for the number of transaction and the size of each transaction appears to have been arbitrarily selected it is difficult to comment on the economic rationality of the thresholds (for example, why not 10 transactions of over $4,000?).

4. Substantive obligations

Product disclosure statements

4.1 The Discussion Paper observes that, "strong anecdotal evidence that the preparation of disclosure documents is sometimes seen as an exercise in risk management and fear of liability, rather than a genuinely useful mechanism for conveying information".[20] This is an unintended consequence of the statutory disclosure regime. Strict liability rules, which were intended to ensure full disclosure to the investing public, have led to the disclosure documents becoming risk averse legal compliance documents rather than a means of communicating effectively with investors.

4.2 The MED proposes to address this problem by replacing the existing regime with requirements for a two page statement setting out certain information in a prescribed format and a longer disclosure document which would be made available through a public register of securities. The Business Roundtable believes that this is likely to constitute an improvement on the present system.

Sophistication warnings

4.3 The Discussion Paper suggests two levels of risk assessment in relation to financial products:

(a) First, the MED proposes that an issuer should be required to express an overall risk assessment in relation to its financial product (which may be based on "a risk-meter or some other graphical representation such as a scale of, for example, one to

---

19 *Discussion Paper*, page 65.

20 *Discussion Paper*, page 79.

five, or use a predetermined descriptor, with specific risks identified in the body of the document");[21] and

(b) Second, the MED suggests that "it would be useful to consider whether the Authority should have the power to place a sophistication warning on a product to indicate that it is highly complex and/or likely to be more suitable for experienced investors".[22]

4.4 The Business Roundtable considers that these proposals would be of questionable benefit to the investing public for two principal reasons.

4.5 First, it is inherently problematic to describe the riskiness of a financial product in the form of a "risk-meter" or some other form of graphical representation. In the pursuit of simplicity, the mandated labels may merely give rise to misleadingly simplistic representations to the investing public.

4.6 Second, the MED correctly notes that there is a risk that the FMA's decision not to apply a sophistication warning on a product may "imply that the Authority was taking responsibility for the product in any way".[23] It is not clear how the MED proposes to avoid this risk. As the MED acknowledges, the FMA "would be stepping beyond checking whether disclosures comply with the law, into making more of a substantive judgement on the security".[24] In those circumstances, notwithstanding a disclaimer of liability by the FMA, investors may consider that the product has been "vetted" in some sense by the FMA. As a consequence, investors may be led into misplaced reliance on the evaluation of the FMA. While it would obviously be possible to reduce this risk by unequivocally stating that the FMA's assessment should not be relied upon, such a disclaimer

---

21 *Discussion Paper*, page 87.

22 *Discussion Paper*, page 92.

23 *Discussion Paper*, page 92.

24 *Discussion Paper*, page 92.

would tend to raise the question of what value the sophistication warnings provide to the investing public.

4.7 The difficulties associated with these proposals reflect the aphorism that one should seek simplicity but distrust it. While it is true that, in some senses, simple descriptions are easier for investors to understand, it does not follow that mandating the form in which information is presented is the most efficient solution. As Professor Benston notes, issuers "have strong incentives to determine the kind of information and mode of presentation that investors prefer", whereas "much disclosure that is mandated by law or government regulation ... is likely to be of no value to some or all investors and even possibly misleading."[25]

Duty of "fairness"

4.8 The Discussion Paper has raised the possibility of imposing an overarching duty of "fairness", which it describes as follows:[26]

> The objective would be to establish principles that would allow market participants to be held to account for behaviour that did not treat customers fairly, even if it would otherwise not be contrary to the requirements of the law.

4.9 The Business Roundtable opposes this. It suffers from at least three serious defects and should not proceed. First, it is inconsistent with the Discussion Paper's stated objectives of ensuring that regulation should be clearly targeted and minimise unnecessary compliance costs. The concept does not appear to have been tested against the principles set out in the *Government Statement on Regulation* and the Business Roundtable doubts that the proposal would survive scrutiny under those principles.

4.10 Second, while fairness and other abstract goals may motivate the set of rules contained in legislation, it is poor legislative practice to directly legislate for "fairness". The proper course would be to first

---

25 George Benston, *Voluntary vs. Mandatory Disclosure: An Evaluation of the Basis for the Recommendations of the Working Group on Improved Investment Product and Adviser Disclosure*, New Zealand Business Roundtable, May, 1997, chapter 2.2.1(a).

26 *Discussion Paper*, page 165.

determine what specific duties are necessary to ensure that an investor is treated fairly (e.g., appropriate disclosure of information) and then to provide for specific rules to address those concerns.

4.11 Third, it is inimical to the Rule of Law to impose vague prohibitions which deprive citizens of the opportunity to understand what the rule requires of them. The Hon Murray Gleeson (then Chief Justice of the High Court of Australia) explained the importance of the ability of citizens to foresee how the law will affect them as follows:[27]

> In a liberal democracy, the idea of the rule of law is bound up with individual autonomy – the freedom to make choices. It is only if people know, in advance, the rules by which conduct is permitted or forbidden, and the rights and obligations that flow from their conduct, that they are free to set their personal goals and decide how to pursue them. That is the purpose of having law in the form of general rules, of reasonable clarity and certainty, capable of being known by people in advance of choosing to act in a certain way.

4.12 To similar effect, the Nobel laureate economist and political philosopher, Friedrich Hayek explained:[28]

> Nothing distinguishes more clearly conditions in a free country from those under arbitrary government than the observance in the former of the great principles known as the Rule of Law. Stripped of all its technicalities this means that government in all its actions is bound by rules fixed and announced beforehand – rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances, and to plan one's individual affairs on the basis of this knowledge.

4.13 The Discussion Paper acknowledges the lack of certainty that would be associated with the proposal for an overarching duty of fairness. It suggests that "this disadvantage could, at least partially, be dealt with by the regulator issuing guidance on how it interprets the principles."[29] That is an unsatisfactory suggestion. As the Privy Council indicated in *de Freitas v Permanent Secretary of Ministry of Agriculture, Fisheries, Lands and Housing*, "legal provisions which interfere with individual rights must be . . . formulated with sufficient precision to enable the citizen to regulate his conduct."[30] Murky rules which leave

---

27 The Hon Murray Gleeson, 'A Core Value', Judicial Conference of Australia, Annual Colloquium, 6 October 2006. Available at http://www.jca.asn.au/attachments/2006-cj_6oct06.pdf.

28 Friedrich Hayek, *The Road to Serfdom*, 1944, pages75-76.

29 *Discussion Paper*, page 165.

30 [1998] 3 WLR 675, page 682.

market participants to follow non-binding guidance notes (which inevitably cannot provide much more certainty than the vague rule which they seek to explain) are unfair, inefficient, and unprincipled.

4.14 Accordingly, the Business Roundtable objects to the proposals contemplated at page 165 of the Discussion Paper.

5. Enforcement

FMA's power to bring proceedings on behalf of investors

5.1 As a starting point, the Business Roundtable agrees with the MED that the present reform process is an inappropriate vehicle to consider reforms to class action rules. In particular, it would be undesirable to cut across the work being carried out by the High Court Rules Committee in relation to possible class actions reforms.

5.2 The Business Roundtable considers that the most sensible approach would be to carry over the provisions of the Securities Markets Act which enable the Securities Commission to obtain a declaration that a person has contravened a provision of the Act, which enables investors to obtain compensatory orders in reliance on the declaration (i.e., without having to establish the contravention).

5.3 The Discussion Paper also asks whether the FMA should have the power to enforce directors' duties.[31]

5.4 The Business Roundtable opposes such a proposal for the following reasons:

(a) It would be undesirable if the FMA's ability to bring a civil claim for breach of directors' duties excluded the ability of shareholders to control and settle their own claims. For example, a shareholder might prefer to settle his or her claim quickly in order to avoid litigation risk. It would be undesirable if

[31] *Discussion Paper*, page 186.

shareholders' causes of action were effectively nationalised by a system of public enforcement.

(b) It may be better for the FMA to focus on bringing proceedings for civil penalties or criminal sanctions, without crowding out private litigants seeking compensation. This is effectively the regime which operates under the Commerce Act 1986, which provides for the Commerce Commission to seek pecuniary penalties while private litigants seek compensation.

(c) Public regulators have poorly aligned incentives in relation to the enforcement of directors' duties.

(d) There is a question about whether public regulators have sufficient resources and expertise to undertake the substantial responsibility of enforcing directors' duties. As such, it is necessary to consider whether the FMA's resources might be better focused on its core responsibilities, such as the oversight and enforcement of the securities laws.

Relationship between FMA and Commerce Commission

5.5 The Discussion Paper asks whether the FMA "should be given the ability, in relation to dealings in securities, to use its investigation powers in relation to suspected breaches of the Fair Trading Act, and to be given enforcement powers that sit alongside the Commerce Commission's powers."[32]

5.6 In the Business Roundtable's view, there is no reason for the Fair Trading Act to apply to securities given section 13 of the Securities Markets Act, which provides:

> "**13 Misleading or deceptive conduct generally (for dealings in listed and non-listed securities)**

[32] *Discussion Paper*, page 177.

(1) A person must not engage in conduct, in relation to any dealings in securities, that is misleading or deceptive or likely to mislead or deceive.

(2) To make the position clear, this section applies more broadly than the rest of this Part and so applies to securities whether listed or non-listed and to all dealings in securities (not only trading)."

5.7 Rather than permit parallel enforcement of the Fair Trading Act by both the Commerce Commission and the FMA, the sensible approach would be to provide that the Fair Trading Act does not apply to securities. This could be achieved simply by amending section 5A of the Fair Trading Act to provide that no proceedings can be brought under the Fair Trading Act in respect of conduct that is regulated under the successors to the Securities Act and Securities Markets Act.

Specialist tribunals

5.8 The Business Roundtable is, in principle, receptive to the concept of a specialist commercial court. However, it has two significant reservations about the creation of what the Discussion Paper describes as a "specialist civil judicial-type body" to deal with civil breaches of the securities laws.[33]

5.9 First, the Business Roundtable doubts that the current review of the securities laws is an appropriate vehicle for substantial institutional reforms of the court system.

5.10 Second, the Business Roundtable opposes the concept of a quasi-judicial tribunal and notes the concerns identified by Bernard Robertson in relation to such tribunals in his paper, *The Status and Jurisdiction of the New Zealand Employment Court*.[34] As such the

---

33 *Discussion Paper*, page 195.

34 Bernard Robertson, *The Status and Jurisdiction of The New Zealand Employment Court*, New Zealand Business Roundtable, August 1996.

Business Roundtable believes that any specialist financial court should be constituted as a division of the High Court. The Business Roundtable does not consider it feasible to create a commercially focused court designed only to address securities law matters.

No action letters

5.11 The Business Roundtable supports the Discussion Paper's suggestions that the FMA should be given the power to issue a no action letter, which would legally prevent the FMA from subsequently taking action in relation to the subject matter of the no action letter (and subject to its terms and conditions).

5.12 The Business Roundtable considers that no action letters have proven to be an effective part of the regulatory 'tool kit' in overseas jurisdictions and would be conducive to efficiency and certainty in the New Zealand capital markets. The Business Roundtable disagrees with the MED that it may be unnecessary for the FMA's power to issue no action letters to be provided for by legislation. It would be preferable, in the interests of certainty, for the power to issue no action letters (and, correspondingly, the ability for market participants to rely upon them as conclusive) to have statutory backing.

6. Punishment for misconduct

Conceptual framework

6.1 Effective regulation requires credible and efficient enforcement of the law's justified prescriptions and prohibitions. Society should seek to optimise its policy settings for dealing with unlawful conduct, which include expenditures on enforcement, the modes of enforcement, and the punishments imposed.

6.2 On the one hand, under-enforcement of the rules reduces respect for the rule of law, reduces the deterrence against misconduct, indirectly penalises firms that adhere to the rules, and (assuming that the rules are sensibly designed) will lead to inefficient levels of social harm

arising from contraventions of the rules. Poorly enforced rules may therefore be contrary to the national interest.

6.3 On the other hand, a disproportionate approach to regulatory enforcement is also contrary to the national interest. Indeed, the rigorous enforcement of poorly conceived laws creates immediate adverse outcomes for the persons subject to enforcement action and imposes indirect harms on society (including, in some cases, a lessening of respect for the law). Conceptually, a regulatory enforcement agent should endeavour to take enforcement actions with a view to minimising the sum of the damage associated with regulatory contraventions *plus* the enforcement costs (i.e., the associated costs for both the regulator and the regulated).[35] As George Stigler noted, this criterion for effective regulatory enforcement serves two goals:[36]

> The first is to set the scale of enforcement, namely where marginal return equals marginal cost. If the scale of enforcement is correct, society is not spending two dollars to save itself one dollar of damage, or failing to spend one dollar where it will save more than that amount of damage. The second function is to guide the selection of cases: the agency will not (as often now) seek numerous, easy cases to dress up its record but will pursue the frequent violator and the violator who does much damage.

6.4 Accordingly, the design of regulatory incentives and powers should be evaluated with a view to optimising enforcement.

Criminal sanctions

6.5 The Business Roundtable considers that it is inappropriate for strict liability offences under the securities laws to carry criminal penalties

---

35 George Stigler, 'The Optimum Enforcement of Laws', in Becker and Landes, *Essays in the Economics of Crime and Punishment*, 1974, page 62:

> In the area of economic regulation, guilt is often an inappropriate notion, and when it is inappropriate all costs of compliance must be reckoned in to the social costs of enforcement. The utility's costs in preparing a rate case or Texas Gulf Sulfur's costs in defending itself against the Securities and Exchange Commission are social costs of the regulatory process. Reimbursement is now achieved by charging the consumers of the products and the owners of specialised resources of these industries: they bear the private costs of the regulatory process. This is at least an accidental allocation of costs, and when regulation seeks to aid the poorer consumers or resource owners, a perverse allocation.

36 George Stigler, 'The Optimum Enforcement of Laws', in Becker and Landes, *Essays in the Economics of Crime and Punishment*, 1974 page 63.

and, therefore, the strict liability provisions of the new legislation ought to be subject to civil sanctions only. The recent decision of the District Court in *MED v Feeney* illustrates the significant potential for unfairness for strict liability criminal offences. In that case Judge Doogue concluded, in relation to the former directors of Feltex Carpets Limited:[37]

> There is also overwhelming evidence that these directors are all honest men, and that they conducted themselves at all times with unimpeachable integrity. There is not one skerrick of evidence to suggest any intention by them to mislead the regulatory authorities, market, shareholders, creditors, potential investors, or any other person.

6.6 Nevertheless section 36A of the Financial Reporting Act 1993 provides that a director commits an offence if any statement prepared by the reporting entity does not comply with any applicable financial reporting standard. The directors therefore would have been criminally liable notwithstanding the absence of any evidence of conscious wrongdoing unless they were able to discharge the onus of establishing that they took reasonable and proper steps to ensure that the reporting entity would comply with the applicable financial reporting standard.

6.7 The Business Roundtable believes that the *Legislation Advisory Committee Guidelines on Process and Content of Legislation*, to which the Discussion Paper refers, correctly focus on the types of questions which ought to be considered when determining whether conduct should be regulated by the civil or criminal law.[38] In the Business Roundtable's view, an honest failure to comply with (often complex) securities laws is a matter more appropriately addressed by the civil justice system than the criminal law.

Reverse onuses

6.8 The Business Roundtable agrees with the MED that there is a "need to reconsider reverse onus offences in light of the New Zealand Bill of

---

37 *Ministry of Economic Development v Feeney* (unreported DC AK CRI-2008-004-029199 2 August 2010), paragraph 9.

38 *Discussion Paper*, page 185.

Rights Act 1990."[39] The applicable offences in the Securities Act predate the Bill of Rights and, to the best knowledge of the Business Roundtable, have not been subject to formal scrutiny for compliance with the Bill of Rights. Section 25(c) of the Bill of Rights provides:

> **25. Minimum standards of criminal procedure** —
>
> Everyone who is charged with an offence has, in relation to the determination of the charge, the following minimum rights: [...]
>
> (c) The right to be presumed innocent until proved guilty according to law

6.9 The Business Roundtable notes the decision of the Supreme Court in *R v Hansen* [2007] 3 NZLR 1 (SC), which considered a reverse onus provision contained in the Misuse of Drugs Act 1975 which deemed a person in possession of more than a specified amount of drugs to possess that drug for supply "unless the contrary is proved". The Supreme Court held that this reverse onus provision was inconsistent with the Bill of Rights and that the inconsistency could not be demonstrably justified in a free and democratic society. Justice Anderson stated:

> I see no justification for the proposition which seems to underpin s 6(6) of the Misuse of Drugs Act, namely that because it is difficult for the prosecution to prove an element of a crime it does not have to. That is an unprincipled expedient.

6.10 The Business Roundtable agrees with this analysis and therefore supports the removal of reverse onus provisions from the Securities Act.

7. Law reform process

Regulatory Impact Analysis

7.1 The Business Roundtable notes that the Cabinet Manual requires a regulatory impact analysis (or an equivalent analysis) to be included in official discussion papers. The Business Roundtable does not believe that the Discussion Paper contains a sufficient equivalent to a regulatory impact analysis.

---

[39] *Discussion Paper*, page 194.

7.2 Accordingly, the Business Roundtable considers that it is important that any policy proposals which arise from the securities law review should be subject to a regulatory impact analysis. The Business Roundtable believes that the policy proposals are likely to have a significant impact on the New Zealand economy and therefore the Regulatory Impact Analysis Team of the Treasury should be responsible for certifying the adequacy of the regulatory impact analysis.

Exposure Draft

7.3 The Discussion Paper contemplates a range of complex reforms to numerous aspects of New Zealand's financial regulatory regime. The level of scrutiny applied to those reforms should be commensurate with their substantial implications for New Zealand's economy.

7.4 The Business Roundtable's submission has focused on the high level principles arising from the Discussion Paper. For the reasons set out in this submission, those high level questions ought to be asked (and the failure to do so would skew the resulting policy decisions). It is therefore important that an exposure draft of any bill should be made publicly available well before the bill is introduced to Parliament in order to allow market participants and legal experts the opportunity to:

(a) evaluate the suite of reforms as a package; and

(b) examine the machinery provisions of the draft bill in detail and identify any technical flaws.

7.5 The Business Roundtable notes that the Select Committee process is not an appropriate forum for substantial corrections to legislation. In recent years, Select Committees have been required to substantially change important pieces of legislation which had passed their first reading in the House on the basis that the relevant Select Committee would address their defects. This approach prejudices the ability of submitters to make informed submissions because their efforts are inevitably directed towards the correction of flaws in the bill, as

introduced. Since there is no significant opportunity to make submissions on the revised legislation which emerges from the Select Committee, it then becomes necessary to try to correct additional defects by Supplementary Order Papers.

7.6 There is also a point of principle to be made about the importance of due legislative care. The Business Roundtable notes the criticism which Professor Jeremy Waldron has directed to the undue legislative haste that frequently characterises New Zealand's Parliamentary proceedings. Professor Waldron explained:[40]

> What if Courts were to perform the functions entrusted to them as carelessly, as impetuously, and as peremptorily as Parliament performs its law-making functions? We would be outraged if trials were rushed ... if new items could be added to an indictment by supplementary order paper ... Yet we do not raise a complaint about something essentially equivalent going on in the House, where legislative due process is similarly sacrificed to efficiency, to executive impatience, and to political expediency.

7.7 The Business Roundtable shares Professor Waldron's concerns. His comments confirm the Business Roundtable's view that legislation should be subjected to careful consideration. The Discussion Paper contemplates fundamental reforms to the securities regime, which will likely establish a framework that may last for decades. Accordingly, it is proper to set aside the time necessary for extensive consultation on both the economic rationale and the technical details of any reforms.

---

[40] Jeremy Waldron,'Compared to what?' [2005] NZLJ 441, page 443.