



UPDATE

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INCREASED REGULATORY RISK PROFILE FOR FINANCIAL MARKETS PARTICIPANTS AND AUDITORS



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Parliament sent two bills to the Commerce Select Committee yesterday which have important implications for participants in New Zealand's financial markets:

- The [Financial Markets \(Regulators and KiwiSaver\) Bill](#) will establish the Financial Markets Authority (**FMA**) to take over the regulatory functions of the Securities Commission and the Government Actuary (as well as several tasks currently performed by the Ministry of Economic Development (**MED**) and the Minister of Commerce). The FMA will also have oversight of the NZX.
- The [Auditor Regulation and External Reporting Bill](#) will replace the largely self-regulatory system of auditing with a centralised licensing function, a standard-setting regime under an External Reporting Board (which will be a reconstituted form of the Accounting Standards Review Board) and an investigative and enforcement function through the FMA.

The detail of these Bills will require close consideration by the Select Committee and we are happy to assist clients who wish to make submissions to the Committee on any

aspect of these Bills. The Select Committee is expected to open submissions on the Bills next week and is to report back to Parliament on the Financial Markets (Regulators and KiwiSaver) Bill on 28 February 2011 and on the Auditor Regulation and External Reporting Bill on 23 March 2011.

Two enforcement measures contained in the Bills are of particular significance:

- First, the FMA will have the power to bring civil proceedings (or take over existing proceedings) on behalf of investors in the financial markets against certain specified classes of persons – including issuers, promoters, company directors, trustees or auditors.
- Second, auditors of reporting entities will be subject to criminal liability for failing to comply with auditing and assurance standards “without reasonable excuse”.

These two measures will materially increase the regulatory risk profile for issuers, promoters, directors, trustees and auditors. Whether they will improve the efficiency of New Zealand's financial markets remains to be seen.

“... the government proposes that the FMA will have the power to bring civil proceedings under financial markets legislation or civil proceedings seeking damages for fraud, negligence, default, breach of duty or other misconduct in connection with the financial markets...”

Public enforcement of private causes of action

Under the Financial Markets (Regulators and KiwiSaver) Bill the government proposes that the FMA will have the power to bring civil proceedings under financial markets legislation or civil proceedings seeking damages for fraud, negligence, default, breach of duty or other misconduct in connection with the financial markets (defined as “specified proceedings”) against the following categories of defendants (defined as “specified persons”):

- registered financial service providers, (as well as their directors, controlling owners, senior managers, holding companies, and subsidiaries);
- public issuers of securities (as well as their directors, controlling owners and senior managers);
- promoters, managers, trustees, statutory supervisors, and contributory mortgage brokers;
- auditors; and
- experts that authorise the distribution of advertisements and prospectuses containing their expert statements.

The FMA can either commence an action on an investor’s behalf or take over such an existing proceeding:

- If the person having the right of action has not commenced proceedings, the FMA can give that person 10 working days’ notice to either bring a claim or object before the FMA commences proceedings on his or her behalf;
- If the person has already commenced proceedings, the FMA can seek the High Court’s leave to take over the proceedings.

When exercising these powers, the FMA will be required to act in the public interest and the High Court will have a broad discretion to make orders controlling the conduct of the proceedings.

Significant change to present enforcement powers

This proposal represents a significant change from the status quo. The present powers of the Securities Commission under the Securities Act 1978 and Securities Markets Act 1988 relate to false or misleading conduct, including in the form of non-disclosure of information required to be disclosed, and to insider trading. In addition to its ability to bring criminal proceedings, the Securities Commission can currently seek the following types of civil remedies for investors:

- A compensation order under the Securities Act for the payment of damages to investors who suffered loss based on an untrue statement in an advertisement or registered prospectus;
- A declaration of civil liability under the Securities Act or the Securities Markets Act (which investors may use as conclusive evidence of a contravention of the securities laws for the purpose of pursuing their own claims for compensation); and
- Pecuniary penalties for breaches of the securities laws.

These regulatory proceedings are different in type from the majority of directors’ duties which consist of civil law concepts based on an assumption of obligations by a person accepting appointment as a company director. Those civil law duties are more appropriately a matter for private enforcement and remedies than for enforcement by a regulator.

“The MED has noted the difficulties associated with the decision to include this proposal in the Financial Markets (Regulators and KiwiSaver) Bill rather than continue to assess its merits in the context of the ongoing Securities Law Review.”

Questionable benefits to New Zealand's financial markets

It is questionable whether the proposal will produce net benefits to New Zealand's financial markets:

- Serious cases of breach of directors' duties generally come to light in the context of companies in receivership or liquidation. In those circumstances, receivers and liquidators (and in some cases statutory managers) have sufficient powers and incentives to take action in respect of any breach of directors' duties. Shareholders of public companies are also able to bring class or representative actions and obtain litigation funding to meet the costs of doing so. Bell Gully therefore questions the need for the FMA to assume this role.
- 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.
- The FMA's resources might be better focused on its core responsibilities, such as the oversight and enforcement of securities laws. The Australian provision on which the proposal is modelled is infrequently used.
- There is a risk of discouraging talented people from accepting appointments as directors or causing them to adopt an unduly conservative approach to company management, risk taking, and innovation.

The MED has noted the difficulties associated with the decision to include this proposal in the Financial Markets (Regulators and KiwiSaver) Bill rather than continue to assess its merits in the context

of the ongoing Securities Law Review. In its regulatory impact statement, the MED has noted that “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.”

Criminal liability for auditors

The Auditor Regulation and External Reporting Bill will insert a new criminal offence into the Financial Reporting Act 1993 for an auditor of a reporting entity who fails to comply with auditing and assurance standards “without reasonable excuse”. This will not apply to public audits under the Public Audit Act 2001 or audits of entities that are not reporting entities under the Financial Reporting Act.

Threshold for liability unduly harsh

Based on the applicable criminal case law on the concept of “reasonable excuse”, an auditor would commit an offence by negligently failing to comply with auditing standards. Bell Gully considers that this threshold for criminal liability is unnecessary and unduly harsh:

- In the absence of recklessness or dishonesty, a negligent failure to comply with professional standards is normally a matter dealt with by the civil law and professional regulatory bodies, as opposed to the criminal law.
- Even if the auditor is ultimately acquitted, a criminal prosecution may exact an entirely disproportionate financial, reputational, and emotional toll.
- Auditors are already adequately incentivised to comply with auditing standards because a breach of those standards exposes them to civil liability, disciplinary action by NZICA, and damage to their reputations.

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Threshold of recklessness or dishonesty for criminal liability more appropriate

Orthodox principles of criminal law require that (unless there are good reasons for creating a strict liability offence), the prosecution should be required to prove that a criminal defendant has a “guilty mind” (or *mens rea*). Bell Gully is concerned about the proliferation of strict liability offences in the commercial context. We note the testimony last year of Dick Thornburgh, a former Attorney-General of the United States before the Judiciary Committee of the United States House of Representatives in which he criticised what he described as the “current phenomenon of overcriminalization”. He testified that:

- the legislative goal should be: “to have criminal statutes that punish actual criminal acts, and do not seek to criminalize conduct that is better dealt with by the seeking of civil and regulatory remedies”; and
- “the stigma, public condemnation and potential deprivation of liberty that go along with that sanction demand that it should be utilized only when specific mental states and behaviors are present”.

He concluded, “With respect to the problem of overcriminalization, let me report that reform is needed. True crimes should be met with true punishment. While we must be ‘tough on crime,’ we must also be intellectually honest. Those acts that are not criminal should be countered with civil or administrative penalties to ensure that true criminality retains its importance and value in the legal system.”

Bell Gully considers that a threshold of recklessness or dishonesty for criminal liability would strike a more appropriate balance. This is the position in the United Kingdom under the Companies Act 2006

(which provides that an auditor commits a criminal offence by “knowingly or recklessly” failing to comply with the requirements for an auditor’s report).

Conclusion

The Financial Markets (Regulators and KiwiSaver) Bill and the Auditor Regulation and External Reporting Bill have important implications for participants in New Zealand’s financial markets. Bell Gully will monitor the progress of these Bills through the House and we are happy to assist clients in preparing submissions to the Select Committee.

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