CYGNUS LAW

T: +64 9 390 3228
M: +64 22 644 7193
E: simon@cygnuslaw.nz

Cygnus Law Ltd
6 Clayton Street
Newmarket
Auckland

PO Box 8142
Symonds Street
Auckland 1150

cygnuslaw.nz

17 February 2017

Financial Markets Authority
Level 2, 1 Grey Street
Wellington 6140

Attention: Debbie McLean

By email only: Debbie.McLean@fma.govt.nz

Consultation draft of the notice designating certain investment company shares as managed investment products

Thank you for the opportunity to provide feedback on the FMA's draft designation notice that designates certain investment company shares as managed investment products (**MIPs**). Cygnus Law Ltd is submitting feedback jointly with Wynn Williams, and this is set out below.

We support FMA's goal of putting some restrictions in place to address specific types of poor behaviour that has arisen in the market with respect to the actions of management companies; provided those restrictions appropriately and effectively address that poor behaviour. The feedback below addresses technical aspects of the designation not its overall aim to produce better outcomes for investors.

1. Crowdfunding Exclusions

1.1 The intention of clause 5 is to deem investment company shares offered pursuant to the crowdfunding exclusion in Schedule 1 of the FMC Act to be a regulated offer. However, given that the effect of the designation is to convert the shares in investment companies to MIPs, this is not necessary. That's because a licensed crowdfunding platform cannot be used (and accordingly the corresponding exclusion is not available) to offer shares "that will be converted, or is or may become convertible, into another financial product" (see regulation 185(4)(b) of the FMC Regulations). In our view there is no doubt that shares subject to that designation would be caught by the regulation 185(4)(b) definition of shares that cannot be crowdfunded. Accordingly, clause 5 is unnecessary.

1.2 For completeness, we note that condition 8 of the FMA's standard conditions for equity crowdfunding licensees (relating to nominees) ensures that a MIS cannot avoid the MIS regulatory regime by issuing MIPs to a nominee company, that itself uses the crowdfunding exclusion in Schedule 1 of the FMC Act, to avoid being a MIS regulated offer.

1.3 If FMA retained clause 5 (even though unnecessary) we suggest that the reasons for clause 5 in the statement of reasons be amended. The reasons stated include that clause 5 "will prevent issuers from circumventing the effect of the class designations of shares as managed investment products in a managed investment scheme." Given that the Schedule 1 exclusion for crowdfunded shares is only one of a long list of exclusions that can still apply to offers of shares subject to the designation, our view is that it's necessary to explain why only the crowdfunding exemption is being singled out in the

notice in isolation of other 'offer structure' specific exemptions (compared with investor status focussed exemptions), for example the small offers exemption. Presumably it has something to do with the breadth of the exclusion? At the same time it would be helpful to know why the existence of the other prescribed controls, including the obligation to make offers through a licensed platform and the $2m cap on investment, aren't sufficient in themselves to justify retention of the exclusion.

2. Excluded Offers

2.1 A matter that doesn't seem to have been considered to date, other than in the context of crowdfunding, is the impact of the designation where offers of shares in investment companies are not regulated offers. The purpose of the designation is to "ensure appropriate [Part 4 of the FMC Act] governance arrangements apply, and so provide for more effective monitoring and reduce governance risks associated with this class of shares". However, the Part 4 governance obligations only apply to a **registered** MIS. A MIS must be registered where the offer of MIPs in the MIS is made pursuant to a regulated offer or the MIS opts to register even though there is not a regulated offer (section 125 of the FMC Act). Accordingly, non-regulated offers of shares in an investment company that cause them to be converted to MIPs under the designation will not cause the Part 4 governance obligations to apply (unless the company choses to register voluntarily). In essence, an unregistered MIS is a MIS in 'name only'. In that scenario there appears to be no benefit in the designation. In fact, it is very likely to add costs and complexity to the offer with no corresponding benefit to the offeror or the investors. Anyone making a non-regulated offer, but who still wanted to register as a MIS, would be very unlikely to choose a company vehicle.

2.2 Non-regulated offers may arise because one or more of the Schedule 1 exclusions apply to the investors and/or the investors are located outside New Zealand. It would be a very significant change of policy to designate those offers as regulated offers and, if FMA proposed to do so, our view is that it would be necessary to consult on such a change, and such consultation should be open rather than targeted consultation.

2.3 Accordingly, we think it would be appropriate to exclude from the scope of the designation (or provide that the designation does not apply to) offers that will not be regulated offers. Such a company would be pulled into the scope of the designation as soon as it made a regulated offer or otherwise chose to register.

3. Powers of shareholders

3.1 An investment company that issues shares where any limb of clause 7(1) applies will be caught by the designation notice (subject to limited exclusions). In our view, clause 7(1)(b) as drafted is too broad.

3.2 Clause 7(1)(b) states "a director of the investment company can be appointed or removed other than by resolution of shareholders". It is a common feature for private companies to confer a contractual right on a shareholder that holds less than, but close to, 50% of the voting shares to appoint a director to the board. This situation should not be caught by the designation notice. In our view clause 7(b) should read "a **majority of the** directors of the investment company can be appointed or removed other than by resolution of the shareholders".

4. Guidance Note

4.1 You note that "We also intend to publish an accompanying guidance note which will explain how we interpret key concepts in the designation notice". FMA regularly issues guidance on the interpretation of the law, including in relation to statutes and regulations. In those cases the FMA is not the framer or promulgator of the law and so necessarily has to address uncertainties and ambiguities that may arise in guidance. In this case FMA itself is, in effect, changing the law. Our

view is it would be preferable that, if the FMA thinks there is uncertainty as to interpretation, it addresses that in the designation itself, by expanding the operative provisions or by including more detailed definitions. Otherwise, we query whether FMA is, in effect, varying the designation by way of guidance and not in accordance with its designation power. "Certainty" is one of the reasons given for the designation yet the need for guidance suggests that that is not being achieved in the notice.

4.2 Given the likely impact that the guidance will have on how the designation is interpreted, it would be appropriate for FMA to consult on the guidance before it is finalised and issued. In that case we would appreciate an opportunity to review and comment on the guidance.

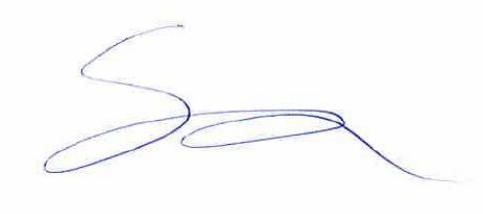
5. Other Matters

5.1 FMA's consultation paper dated 10 December 2015 noted that the proposed designations were to be made under sections 562(1)(b) and 562(1)(f) of the FMC Act. It appears that the designations in the draft notice in clause 4 are made under those respective sections. As a matter of good practice, so it is clear which specific powers FMA is relying on to make designations (and so to assist with interpretation of the designations), we suggest that the specific subsection of section 562 being relied on by FMA is stated in the notice. For example, clause 4(1) could state "Pursuant to section 562(1)(b) of the Act, shares to which this notice applies are declared to be managed investment products." In addition, it appears that the clause 5 designation is being made pursuant to section 562(1)(d)- again our view is that this should also be stated (assuming FMA retains that designation).

5.2 A reason stated for the designation is that "The certainty provided by these class designations will better enable issuers to consider the potential impacts of these designations on their offer and themselves early in their offer design process and this promotes the informed participation of issuers in New Zealand's financial markets". We do not consider that is a valid reason as, prior to the FMA's announcement that it was considering this designation, we are not aware that there was any uncertainty as to how the FMC Act applied with respect to investment companies . Until that announcement the position regarding shares being excluded from MIPs was absolute and, accordingly, there was no absence of informed participation of issuers in New Zealand's financial markets in that regard. We don't consider it appropriate to justify a designation on the grounds of certainty when the only uncertainty is that which FMA itself creates.

Yours sincerely

Cygnus Law Ltd



Simon Papa
Director

Wynn Williams

Hayley Buckley
Partner