**Financial Markets Conduct (Shares in Investment Companies) Designation Notice 2017**

Pursuant to section 562 of the Financial Markets Conduct Act 2013, the Financial Markets Authority, having complied with the requirements set out in section 563 of that Act, gives the following notice.

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**Notice**

# Title

This notice is the Financial Markets Conduct (Shares in Investment Companies) Designation Notice 2017.

# Commencement

This notice comes into force on [\*\*] 2017.

# Interpretation

1. In this notice, unless the context otherwise requires,—

**Act** means the Financial Markets Conduct Act 2013

**asset manager** means, in relation to an investment company, a person who monitors, maintains, or otherwise manages some or all of the investment property of the company

**financial advice** has the same meaning as in section 10 of the Financial Advisers Act 2008

**investment adviser** means, in relation to an investment company, a person who provides financial advice to the company

**investment company** means a company that holds itself out as being, or is primarily engaged, in the business of investing in investment property

**investment manager** means, in relation to an investment company, a person who manages the investment of some or all of the investment property of the company

**investment property** means 1 or more of the following—

1. a financial product:
2. a commodity:
3. foreign currency:
4. land or buildings

**key service provider** means a person who acts as an asset manager, investment adviser, or investment manager

**NZX main board** means the equity securities market operated by NZX Limited under that name

**NZX main board shares** means shares to which any of the following applies—

1. the shares are quoted on the NZX main board; or
2. it is a term of an offer of the shares that the shares will be approved for trading on the NZX main board immediately after the shares are issued

**Regulations** means the Financial Markets Conduct Regulations 2014.

1. Any term or expression that is defined in the Act or the Regulations and used, but not defined, in this notice has the same meaning as in the Act or the Regulations.

# Designations

* 1. Shares to which this notice applies are declared to be managed investment products.
  2. Companies that issue shares to which this notice applies are declared to be managed investment schemes in relation to those shares.

# Designation of offers through licensed intermediaries

An offer of shares to which this notice applies that would not otherwise require disclosure under Part 3 of the Act only because of the exclusion in clause 6 of Schedule 1 of the Act does require disclosure under Part 3.

# Application

This notice applies to shares only if—

1. the shares are issued after the commencement of this notice by an investment company; and
2. either or both of clauses 7 and 9 apply.
3. **Powers of shareholders**
4. This clause applies if the terms of any offer of the shares or the investment company’s constitution has the effect of 1 or more of the following:
5. the shares do not confer on the holder all of the rights set out in section 36(1)(a) of the Companies Act 1993:
6. a director of the investment company can be appointed or removed other than by a resolution of shareholders:
7. the rights of any holder of shares to vote on a resolution to appoint or remove a director are disproportionate to the amount to be paid for the shares when calculated using the formula in clause 8.
8. Subclause (1)(b) does not apply—
9. if the director appointment is made under sections 153(1) or 154 of the Companies Act 1993; or
10. if the director appointment is to fill a vacancy arising after an annual meeting of shareholders (**annual meeting**), provided that the terms of the appointment or the investment company’s constitution requires that the director must retire (but can be reappointed by shareholders) at the first annual meeting after their appointment.
11. **Calculation of disproportionate voting rights**
12. In clause 7(1)(c) the reference to rights to vote being **disproportionate to the amount to be paid for the shares** means the cost of the voting rights attached to the shares offered is disproportionately high when compared to the average cost of all voting rights on issue, calculated using the following formula—

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*offer price per share total equity*

*voting rights per share offered total voting rights*

1. In the formula—
2. **total equity** means a reasonable estimate of the total equity of the investment company immediately following the issue of the shares; and
3. **total voting rights** means a reasonable estimate of the total voting rights attached to all shares on issue in the investment company immediately following the issue of the shares.

**Example**

*Example 1*

ABC Limited (an investment company) is seeking to raise $25,000 by issuing 1,000 shares. The company offers Class B shares to investors for $25 per share. Each share confers 1/10 of a vote on a resolution to appoint or remove a director.

Prior to the offer, ABC Limited has 750 Class A shares on issue, held by the founders of the company. Each share confers 1 vote on a resolution to appoint or remove a director. The equity of the company prior to the offer is $750.

The formula is:

25/0.1 = 250

(25,000 + 750) / ((1000\*0.1) + 750) = 30

1 voting right will cost an investor $250. This is disproportionately high when compared to $30, being the average cost of a voting right.

*Example 2*

XYZ Limited (an investment company) is seeking to raise $25,000 by issuing 25,000 shares. The company offers shares to investors for $1 per share. Each share confers 1 vote on a resolution to appoint or remove a director.

Prior to the offer, XYZ Limited has 750 shares on issue, held by the founders of the company. Each share confers 1 vote on a resolution to appoint or remove a director. The equity of the company prior to the offer is $750.

The formula is:

1/1 = 1

(25,000+750) / (25,000+750) = 1

1 voting right will cost an investor $1. This is equal to the average cost of a voting right.

1. **Key service provider arrangements**
   1. This clause applies if the investment company (**A**) has entered into, or has agreed to enter into, a contract for services (**services agreement**) with a key service provider (**B**) and either or both of the following applies—
2. B owns or controls assets that:
3. are material to the operation of A’s primary business; and
4. that A could not reasonably obtain for materially similar cost from another person on arm’s-length terms if the services agreement with B is terminated:
5. the services agreement—
6. is on more favourable terms to B than arm’s-length terms; or
7. is, or will be, for a term longer than 3 years, and cannot be terminated by A without cause under the terms of the services agreement; or
8. requires A, or an associated person of A, to pay a fee for termination by A of the services agreement that exceeds the specified amount.
   1. In subclause (1) a reference to **arm’s-length terms** means terms that would be reasonable in the circumstances for parties connected or related only by the transaction in question, each acting independently, and each acting in its own best interests.
   2. Subclause (1)(a) does not apply if the key service provider exercises control over the assets only because of rights that it has under the services agreement with the company.
   3. In subclause (1)(a)(i), assets are **material to the operation of A’s primary business** if the removal of those assets would, or would be likely to, have a material adverse effect on A’s financial performance, or A’s ability to perform the usual activities and services related to its primary business on a continuous and satisfactory basis.
9. **Calculation of specified amount**
   1. For the purposes of clause 9(1)(b)(iii), **specified amount** means the lesser of—
10. 30% of the value of the payment required to be made to the key service provider for the entire term of the agreement or 5 years, whichever is shorter; and
11. 50% of the value of the payment required to be made to the key service provider for the remaining term of the agreement.
    1. The payment in subclause (1) excludes any reimbursable costs and expenses.

**Example**

Investment company A has entered into an investment management agreement with investment manager B under which A will pay B a management fee of $200,000 per year. The investment management agreement has a 6 year term.

|  |  |  |  |
| --- | --- | --- | --- |
| **Year of termination** | **30% of payment for shorter of entire term or 5 years** | **50% of payment for remaining term** | **Specified amount** |
| 0 | $300,000 | $600,000 | $300,000 |
| End of Year 1 | $300,000 | $500,000 | $300,000 |
| End of Year 2 | $300,000 | $400,000 | $300,000 |
| End of Year 3 | $300,000 | $300,000 | $300,000 |
| End of Year 4 | $300,000 | $200,000 | $200,000 |
| End of Year 5 | $300,000 | $100,000 | $100,000 |
| End of Year 6 | $300,000 | $0 | $0 |

* 1. If the fee for termination required to be provided to the key service provider for the purposes of clause 9(1)(b)(iii), or the payment required to be made to the key service provider for the purposes of subclause (1), is not a fixed amount in the services agreement, then a reasonable estimate of the amount of that fee or payment must be used.

**Example**

Investment company A has agreed to pay investment manager B an annual performance fee of 20% of net gains in the equity of the company. To calculate the fixed amount of the payment required to be made to investment manager B, A will need to make a reasonable estimate of the anticipated equity of the company at the end of each financial year over the remaining term of the agreement.

# Non-application to NZX main board shares

Despite clause 6, this notice does not apply to shares that are NZX main board shares.

Dated at Auckland this day of 2017.

General Counsel

**Statement of reasons**

This notice comes into force on [XXXXX]. The notice declares that certain shares in investment companies are managed investment products rather than equity securities for the purposes of the Financial Markets Conduct Act (**Act**); and that the company that issues the shares is a managed investment scheme. The notice also declares that an offer of the shares that could otherwise be made as an unregulated offer in reliance on the exclusion in Schedule 1 of the Act for offers made through a licensed intermediary (e.g. a licensed crowdfunding service provider) is required to be made as a regulated offer.

The notice applies to shares in investment companies (excluding shares quoted on the main board of NZX Limited) that satisfy the criteria set out in the notice. The criteria relate to circumstances where the shares offered do not confer usual shareholder governance rights (such as shareholder voting rights to appoint or remove a director or auditor, adopt or alter the constitution, approve a major transaction, approve a company amalgamation, or decide to liquidate the company), or where a key service provider to the company is entrenched to such a degree that the ability to terminate that service provider’s arrangements would be frustrated.

The Financial Markets Authority (**FMA**), having complied with the requirements set out in section 563 of the Act, considers that it is appropriate to grant the designations because—

The designation of the shares as managed investment products, and the consequential designation of the company issuing those shares as a managed investment scheme, is desirable because the shares are in economic substance managed investment products. This being the case, the requirements of the managed investment scheme regime will better address the purposes of the Act than the requirements of the equity securities regime, namely, the application of:

* Part 4 managed investment scheme governance requirements will ensure appropriate governance arrangements apply, and so provide for more effective monitoring and reduce governance risks associated with this class of shares;
* Part 3 managed investment scheme disclosure requirements will better enable investors offered these shares to make an informed decision as to whether to invest in the issuer. The ongoing disclosure requirements applying to managed investment schemes will better enable shareholders to monitor their investment.

These designations will promote the development of fair and transparent financial markets by reducing the ability of issuers to avoid the managed investment scheme requirements in the Act by issuing shares that are in economic substance more akin to managed investment products than equity securities.

A designation preventing shares, which would be designated under the class designation as managed investment products, from being offered through a crowdfunding platform as an unregulated offer will prevent issuers from circumventing the effect of the class designations of shares as managed investment products in a managed investment scheme.

* 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.

The FMA is therefore satisfied that making the declaration is necessary or desirable in order to promote one or more of the main or additional purposes of the Act, particularly being—

to promote and facilitate the development of fair and transparent financial markets;

to provide for timely, accurate, and understandable information to be provided to persons to assist those persons to make decisions relating to financial products; and

to ensure that appropriate governance arrangements apply to financial products that allow for effective monitoring and reduce governance risks.