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International Debt Offerings In New Zealand and The Wider Context Of The Global Eurokiwi Market

INTERNATIONAL DEBT OFFERINGS IN NEW ZEALAND

AND THE WIDER CONTEXT OF THE GLOBAL EUROKIWI MARKET

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TABLE OF CONTENTS

INTRODUCTION AND COVERAGE

The New Zealand debt capital market has recently surged, more than trebling in a two-year period. This has occurred in close alignment with milestone international retail issues and the emergence of the Kauri Bond market. These issues have put strains on a regulatory framework designed in the 1970s around local productive enterprises of the time and against a dramatically different market framework.

The focus of this paper is the domestic debt capital market and the emerging contribution of international issuers to that market. It seeks to place this market in the wider context of the obscure colossus of global New Zealand dollar issuance and describes the emergence of the Kauri bond, an instrument that has a footprint in each of these markets. It also explores some of the dynamics that shape these markets and the derivative markets that have grown in concert with them.

There has been a growing recognition of the critical importance a vibrant and credible domestic capital market places in keeping our economy one in which the international community of issuers and investors has confidence. This paper concludes with suggestions of some matters requiring attention in our securities laws if we are to encourage both confidence and high quality and diverse issuance, whether local or international.

The structure of this paper is as follows:

- The recent expansion of the New Zealand corporate bond market and the basic features of the wholesale and retail Kiwi debt capital markets.

- The steps required for retail issuance, the roles the various participants play in the process and the steps that they should take to minimise their respective risks.

- Regulation of information flows in a retail context: who can say what, to whom, and when.

- Lessons to be drawn from recent international issues, including the Rabobank Nederland and Crédit Agricole issues Tier 1 issues and the World Bank retail Kauri issue.

- The emergence of the Kauri bond market and legal and operational aspects of those offerings.

- The wider context of New Zealand Dollar issuance, including the New Zealand government, Uridashi and Eurokiwi bond markets, and the dynamics that shape all those markets.

- General exemptions available to facilitate international issuance of debt securities, the limitations of the same, and the process for obtaining issuer-specific exemptions, including Trans-Tasman harmonisation and the new mutual recognition regime.

- Liability and risk management in the context of international offerings.

- Reform initiatives, including the Review of Financial Products and Providers and tax reforms, including some suggestions as to aspects of the securities laws requiring urgent attention if high quality issuance is to be encouraged in this market.

DEVELOPMENT AND SHAPE OF NEW ZEALAND'S DEBT CAPITAL MARKETS

New Zealand's corporate bond market is a recent phenomenon, having begun to develop in the late 1980s, stimulated by the floating of the exchange rate in 1985 and the corporatisation or privatisation of significant state-owned enterprises.[25] Those SOEs were among the first issuers of corporate bonds in New Zealand, which is unsurprising given their size, the creditworthy nature of their financial structure and activities and their need for finance.

Until the past couple of years, the growth of the domestic debt capital market was incremental at best. Since then it has been explosive:

Much of what accounts for the steep trajectory of recent growth is international issuance. However, despite this recent growth New Zealand's capital markets are smaller than most OECD countries relative to GDP — in fact they are the smallest among all developed countries.[26]

Less well known were developments in New Zealand dollar issuance taking place at the same time around the globe and the financial innovations that accompanied them. In particular, the mid-1980s saw the birth of the Eurokiwi and Uridashi markets and the swap market that now forms the basis for New Zealand's most ubiquitous financial

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25 See generally Simon Tyler "The New Zealand Corporate Bond Market" (BIS Papers, No 26, 2005).

26 "Deepening Financial Markets" (*OECD Economic Surveys*), Paris, April 2007, pg 79 at pg 80. New Zealand's domestic corporate bond market is less than 5% of GDP compared with an OECD average of 39% (2005 figures).

instrument — the fixed rate mortgage. This market has had a recent resurgence to hit a new peak of almost $60 billion, a fact which has attracted international attention.[27]

The New Zealand corporate bond market at its inception was, and still remains, very undiversified by sector. Domestic issuance is dominated by financial, utilities and primary goods companies, which make up more than three-quarters of the market. This feature of the market amplifies the importance of international issuance, in terms of supplying much-needed diversification and credit quality.[28]

Liquidity is also a perennial concern in New Zealand, which has only a small and shallow secondary market for corporate bonds. There are a number of reasons for this, including the small stock of issuance, the fact that many issues are wholesale and thus restricted in distribution, the lack of clear benchmarks on which to base pricing, the persistence of paper based trading for securities that are neither listed nor held in Austraclear New Zealand, and the small institutional dealer pool.

Forms of issuance

The primary classification of the debt issuance is based on tenor, constituting the money market for terms of up to one year and the bond or medium term note market for longer terms. The commercial paper market has been particularly affected by the credit crunch, particularly in terms of conduit issuance.

The term debt capital markets break down into two basic components: the retail market (listed and unlisted) and the wholesale medium term note market. Another way to categorise the market is into investment grade issuers (primarily the banks and utilities) and sub-investment grade (of whom the most regular and prominent are debentures issued by finance companies, a market that has proved extremely problematic in recent times). The New Zealand listed debt market (NZDX) currently has a market capitalisation of $12.5 billion.[29]

Most New Zealand corporate investment grade issuance is conducted in the offshore — particularly the US private placement and Euro MTN markets — and in the domestic wholesale medium term note markets. It is therefore unavailable, at least on a direct basis, to local retail investors.

Against this context, international securities offerings offer a significant opportunity for a number of reasons. First, they will invariably be undertaken by an investment grade name as there would be no prospect of clearing an offering for an issuer who is both unfamiliar and of uncertain credit. Second, in order to make offering in this jurisdiction worthwhile, the tranches offered are likely to be of a size that gives scope for a liquid secondary market to develop, particularly where the securities are listed. Third, they offer at least geographic, if not sectoral, diversity.

Regulatory capital offerings

A major development in New Zealand in the past year has been the tapping of this market by international banks for their Tier 1 capital raisings. In a sense these too are "Kauri" issues but they are sometimes treated separately, as Kauri bond issuance is

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27 Peter Garnham, Gillian Tett and David Turner "Carried Away? Why the yen borrowing game could end in players taking a tumble" (*Financial Times*) London, 15 February 2008.

28 See generally "Deepening Financial Markets" (*OECD Economic Surveys*), Paris, April 2007, pg 79.

29 A further level of categorisation would carve out the asset-backed markets (particularly RMBS and ABS) and the structured product market, including CDO and capital guaranteed products. The former have been a significant part of the wholesale market and the latter have comprised a comparatively substantial part of the retail market. These are outside the scope of this paper, as is the money market.

often viewed as involving senior-ranking fixed or floating rate debt securities with a fixed maturity.

This market was initiated by Rabobank Nederland in a deal led by Credit Suisse, and locally by First NZ Capital and ASB Securities. This listed deal exceeded all expectations, being more than two-times over-subscribed and breaking local records for a corporate bond issue of this sort.

The Rabobank Nederland deal was followed closely by a similar Tier 1 offering by Crédit Agricole. Although on the surface these transactions were similar, Crédit Agricole did not enjoy the benefit of the class exemption notice for registered banks in New Zealand so its offering exposed more of the intricacies of New Zealand's securities laws.

In similar vein but in a wholesale context, IAG undertook a regulatory offering under the capital adequacy rules applying in Australia to insurance companies (and which soon may be required of such companies in New Zealand).

Wholesale issuance

From a legal and operational perspective, wholesale offers in New Zealand are very straightforward. There is no stamp duty in New Zealand, nor are there any foreign exchange restrictions. In the great majority of cases, there are no regulatory consents or filings required.[30]

Where the offer is made only into the wholesale market or to investor under a $500,000 minimum subscription, legal compliance is restricted to not being misleading or deceptive. There are no positive disclosure obligations nor any general market expectation for a formal and specific information memorandum. Freedom of contract is respected, leaving issuers and arrangers to frame their transaction and offering documents as they see fit.

The disadvantages of a wholesale issue are the liquidity limitations and the fact that the issuer foregoes the opportunity to widely publicise its offering.

Until recently, all Kauri bonds had been wholesale offers, available only to institutional investors or to subscribers for at least $500,000 of bonds. This changed with the World Bank retail Kauri bond offer launched in June of this year, which is described later in this paper.

RETAIL ISSUES — CORE REQUIREMENTS AND MARKET NORMS

Opting for a retail issue

The advantages of a retail issue, of course, are in opening up the liquidity of the issue. This factor may become increasingly significant in current market conditions, where wholesale spreads have blown out considerably and liquidity has become a highly sought after feature of interest rate securities.

The liquidity advantages have a price in terms of higher upfront and ongoing costs. The primary cost differential between wholesale and legal offerings come in the form of audit, registry and trustee fees, printing and public marketing costs, and the increased legal

[30] For issuers with the word "bank" (or derivations thereof) in their names, consideration would need to be given to the restrictions on the use of such term contained in section 64 of the Reserve Bank of New Zealand Act 1989. The regulators, however, have typically had no objection to the use of the word "bank" in a name in wholesale or one-off transactions.

costs that the additional documentation and due diligence for a public issue require. It also exposes the issuer and any "promoter" of the issue to potential liabilities for breach of securities laws, the management of which is primarily the responsibility of issuer's counsel.

Core legal requirements for a retail offer

In the absence of an exemption, an offer of debt securities to the public in New Zealand can only be made under the following documentation in terms of the applicable securities legislation (primarily the Securities Act 1978 and the Securities Regulations 1983):

- **Investment Statement**: An Investment Statement must be provided to each investor before they invest. An Investment Statement is similar to a prospectus but is aimed at providing key information in a way understandable to the prudent but non-expert investor. It is a combined marketing and legal compliance document in the sense that it must contain specified disclosures (but no detailed financial information, MD&A and the like) but the issuer generally speaking is not restricted in how it is formatted or what additional information it contains.

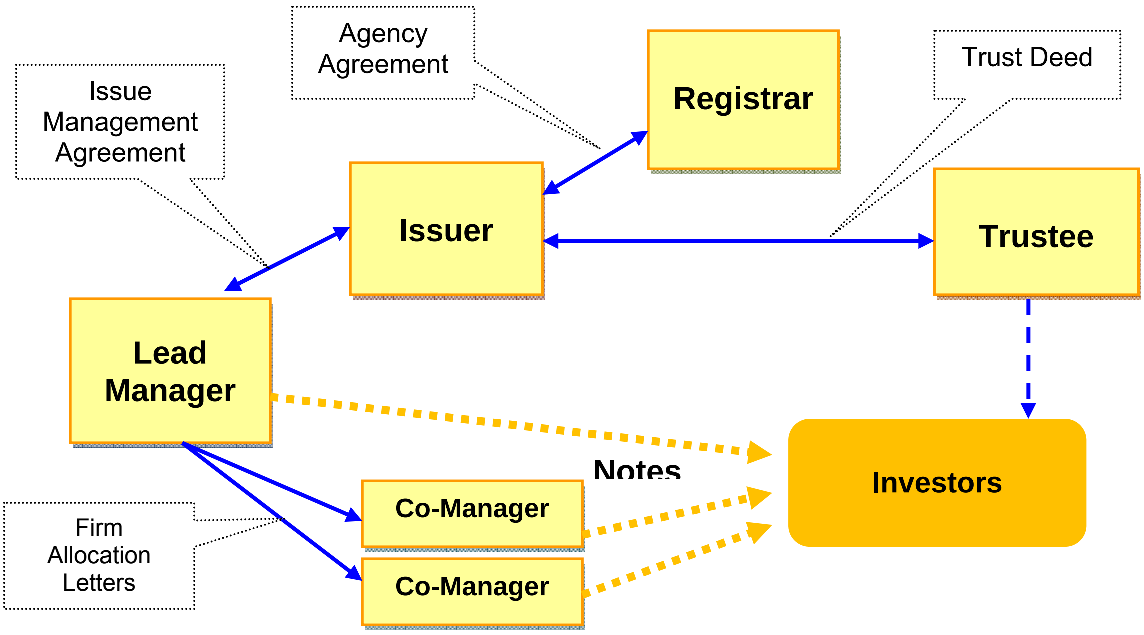
- **Prospectus**: A prospectus must be publicly registered with the Registrar of Companies but need not be provided to investors unless they request it. This document (unlike the Investment Statement) contains or incorporates by reference financial statements of the issuer and is also generally seen as containing more detailed and technical disclosures.

- **Trustee**: A statutory trustee must be appointed, whose primary role is to monitor the issuer's ability to comply with its obligations. It must be one of the authorised trustee companies in New Zealand.

- **Trust Deed**: A trust deed must be signed by the issuer and the trustee and a copy of it must be registered with the Registrar of Companies. This document is a combination of the normal constitutive document for the securities (usually a deed poll in wholesale issues) and a document setting out the rights and obligations of the statutory trustee.

In addition to these statutory requirements, contractual arrangements will need to be made for the distribution of the bonds and paying and registry functions in relation to them (unless these can be performed by the issuer). The following diagram sets out the relevant parties and documents in almost any retail transaction.

Fig. 1 - Transaction documents and parties for a retail transaction



Distribution arrangements for retail issues

The distribution arrangements for retail bonds depends on the relevant sector of the market. For example, finance company debentures tend to be distributed on a tap basis via retail brokers and financial advisers. Listed issues, on the other hand, require the formal appointment of an Organising Participant to coordinate the issue and take responsibility for compliance with Listing Rules.

Beyond that, the New Zealand market is relatively unusual in lacking a systematic set of market norms and documentation for underwriting and distribution arrangements. This is by contrast, for example, to the U.S. securities market, which has a standard Agreement Among Underwriters entered into by the dealer group by way of a confirmation telex and an only slightly less Underwriting Agreement entered into with the issuer. Similarly, in the Euromarkets the distribution arrangements are recorded in standard form terms or subscription agreements included in the programme documentation and increasingly the offer itself is (at least in theory) conducted according to formally documented operating procedures.

In New Zealand, commonly one or more lead managers will be mandated to undertake the issue under an engagement letter, providing for the basic terms of the offering, scope of the engagement, exclusivity and clear market undertakings, arrangement fees and brokerage, undertakings and indemnities.

In the lead-up to the launch of the offer, the lead manager(s) will conduct a book-build that will normally involve a road show to institutional investors and other financial intermediaries. This process customarily will lead to various dealers and brokers entering into firm allocation letters, where they agree to "bid firm" for a specific allocation of the bonds at the agreed pricing. For a sufficiently significant allocation, those intermediaries may be invited to be co-managers of the offering.

Beyond this, market standard documentation in the retail market in relation to either the primary lead manager role or the subsidiary co-manager roles has yet to fully emerge. The various interests of the parties in undertaking a successful issue that complies with applicable laws, and allocating the risks of this not being the case, mean that the market is evolving toward issue management agreements specifying the issuer's and lead/co-managers' respective obligations in relation to the offer, based on their roles in the offering and their responsibilities under the securities laws (as outlined later in this paper). Such documents had been a standard feature of the wholesale debt capital markets and were normally contained in a "dealer agreement".

Underwriting in the New Zealand corporate bond market exhibits unusual characteristics as it is ordinarily on a "best endeavours" basis — that is, it is not a true underwriting in the sense that the dealers agree to purchase a specific allocation of bonds and take the risk of their on-sale. This contrasts to major overseas markets where the dealer panel will acquire bonds from the issuer and will then make their arrangements with investors. This distinction, however, can sometimes be more apparent than real, as the "true" underwriting agreements customarily have detailed conditions precedent (including company and market MAC clauses) and the New Zealand "best endeavours" underwritings are often seen by arrangers as a morally binding commitment.

Similarly, there is rarely any explicit obligation in relation to later support of an issue. It is usually expected of lead managers, however, that they will maintain a two-way market in securities for which they arranged the primary issuance and will otherwise facilitate a secondary market. Failure to do so can be a factor against dealers in pitching for future primary issuance. This is particularly important for unlisted securities, for which there is a unlikely to be a regularly published market price or benchmark and paper-based trading is still the norm.

REGULATORY REQUIREMENTS FOR RETAIL ISSUES

Content of investment Statements

Where an investment statement is required under the Act (which will be the case in respect of debt securities unless an exemption applies or is obtained), the investor must receive a copy of the investment statement before subscribing for the security. If an investor does not receive a copy of the investment statement, the allotment is voidable at the instance of the investor. The investment statement does not have to be registered or to be updated or renewed provided its contents have not become misleading as a result of adverse circumstances prior to allotment.

The detailed requirements in respect of the content of investment statements are set out in Schedule 3D to the Securities Regulations. Apart from those requirements, there are no limits on the content of advertisements provided that the investment statement is not likely to deceive, mislead or confuse potential investors. Accordingly, in general terms, the issuer is entitled to use the investment statement as a marketing document with whatever content and in whatever style it chooses.

The directors of the issuer are not required to sign the Investment Statement itself, but must sign a certificate which confirms that the advertisement is not likely to deceive, mislead or confuse prior to the advertisement being distributed to the public.

Requirements in relation to prospectuses

A prospectus needs to be prepared which gives certain details about the issuer and has the issuer's audited financial statements included in or attached to it, but does not need to be given to investors unless they ask for it. Therefore, to reduce costs, it may be just a "word-processed" document, rather than a marketing document.

The Securities Regulations contain rules about the financial statements to be included or referred to in a prospectus which, as discussed below, can provide particular headaches for international issuers.

There are also rules as to how much time can lapse after the date to which those financial statements were prepared. Specifically, securities cannot be offered if the date of allotment would be more than 9 months after the date of the statement of financial position or interim statement of financial position contained or referred to in the prospectus. If the issue is being kept open or further securities are being issued under it, is it also possible to extend the life of the prospectus by a further nine months by registering of a director's certificate containing certain representations and accompanied by interim accounts.

Thus the prospectus effectively has to be rolled over at 9 month intervals, with new accounts prepared. This will need to be considered well in advance and taking account of the time taken to prepare the offering and distribute the securities. For example, if it seems that the issuer might run close counting back to the audited annual financial statements, then it will be necessary to engage the auditors to perform an audit of the interim financial statements. As noted above, however, this only applies during the period that securities are being offered. There is no need to update the prospectus merely because securities are outstanding.

Unlike the investment statement, the prospectus needs to be signed by directors of the issuer and any promoters and registered at the Companies Office.

Other certifications

A certificate, known as a Reg 17 certificate, must be prepared and signed by at least two directors of the issuer for all advertisements (which includes the investment statement but not the prospectus), but need not be registered or delivered to any person. This certificate states that the relevant offer documents comply with law and are not likely to mislead, deceive or confuse. A similar certificate must be completed for each advertisement released in relation to the offer (including oral presentations).

Audit and financial information requirements

Unless the issuer has the benefit of an exemption from the requirement for a prospectus altogether, it is important to engage audit assistance at the outset of the offering process. If financial statements are required to be included or incorporated by reference in the prospectus, then there will need to an audit sign-off that all the requirements of the relevant schedule to the Securities Regulations are met. Time will need to be set aside for this, as this is more than a simple sign-off as to compliance with generally accepted accounting practice, which is International Financial Reporting Standards (IFRS) since its adoption by New Zealand from 1 January 2007.

After an overseas company issues securities to the public in New Zealand, it will be required to register its audited annual financial statements in New Zealand under the Financial Reporting Act 1993, which contains New Zealand's financial reporting requirements.

The financial requirements in the Securities Regulations are quite specific and are not restricted to IFRS even where it is possible to incorporate by reference financial statements that are required to be registered under the Financial Reporting Act. Most relevantly, in the case of debt securities, the auditors will need to attest to compliance with clauses 16 to 32 of Schedule 2 to the Securities Regulations. At a general level, these requirements should not yield any difficulties. They call for inclusion of the standard suite of financial statements, being statements of financial position (balance sheet), financial performance (P&L), cash flows, and movements in equity.

The devil, regrettably, is in the detail. For instance, a number of international issuers could have problems with requirements of the following sort: liabilities and assets must be presented as current and non-current; fixed assets on the balance sheet need to be classified into land, buildings, machinery and other fixed assets and include details of valuations and depreciation; a detailed maturity profile is needed for issuers whose monetary assets exceed two-thirds of their total tangible assets; and the equity method of accounting may not be used in respect of any amounts.

Overall, the requirements yield an impression of being frozen in time and contemplating productive enterprises that would have predominated in New Zealand at the time the regulations were conceived, more than 20 years ago. They certainly do not contemplate modern multinational financial institutions with predominantly financial assets and whose balance sheet can, in the case of Crédit Agricole for example, exceed €1 trillion. Nor do they incorporate full flexibility for changes in accounting standards either in general or as applied by the auditors in relation to a particular entity or class of entities.

This is not an issue at all for those entities which have an exemption from the prospectus requirements, notably registered banks. This was the case with the offer made by Rabobank Nederland but not with that of Crédit Agricole. In the case of the latter, it was therefore necessary to obtain an exemption from the relevant requirements of the regulations, subject to the conditions that Crédit Agricole's audited financial statements published in France accompany the prospectus and contain a description of the differences between IFRS as applied in France and as applied in New Zealand. It is reasonably likely that similarly placed issuers would need to consider obtaining similar exemptions for offerings in the New Zealand market.

Other administrative requirements

Aside from the above requirements, the Securities Act also imposes various administrative obligations on issuers including:

- keeping and maintaining of registers of securities;
- opening registers for inspection;
- keeping proper accounting records;
- issuing certificates evidencing securities;
- having accounts audited at least annually by a "qualified auditor";
- sending documents and other information prescribed by regulation to security holders; and
- sending a copy of the registered prospectus, financial statements, and other information to security holders or prospective investors on request.

The majority of these requirements should present no real difficulties for international issuers because matters relating to the securities register and making documents and information available may be delegated to the New Zealand registrar and paying agent for the securities. This is not to say that the provisions of the Securities Act with respect to the maintenance of accounting records make any sense. In view of that all entities which issue securities to the public thereby become subject to the requirements of the

Financial Reporting Act, they have no proper place in the Securities Act and should be repealed.[31]

Two requirements of this little-explored part of the Securities Act that could be problematical for international issuers, however, are the stipulations that:

- The accounting records be "kept either in written form in the English language or so as to enable the accounting records to be readily accessible and readily convertible into written form in the English language" (section 53B) and that they are kept at the registered office of the issuer, provided that, under section 53A(2):

  > The accounting records may be kept at a place outside New Zealand only if there is sent to, and kept at a place in, New Zealand such documents in respect of the business dealt with in those accounting records as will disclose with reasonable accuracy the financial position of that business at intervals not exceeding 6 months and will enable to be prepared the financial statements of the issuer or scheme, and any document annexed to any of those documents giving information that is required by any enactment.

- The financial statements of the issuer are audited at least annually by a "qualified auditor" (section 53E).

Recalling that the "accounting records" as defined in section 53 include all invoices issued for goods or services, this would pose substantial difficulties if it were applied at face value. For all enterprises of greater sophistication than the corner dairy, however, the relevant accounting records will be maintained electronically and backed up under relevant business continuity and document retention policies. Are these records taken to be "at the place" where the relevant server is housed? Surely not.

Of more meaningful difficulty is the requirement for a "qualified auditor". In any sensible world that would be a person qualified by applicable GAAP to audit the accounts of a public issuer. However, this is not yet such a world, and the requirements essentially are for a New Zealand chartered accountant or another person specifically authorised in this capacity by the Securities Commission. Since this is matter properly regulated under the Financial Reporting Act, to which all public issuers are automatically subject and which (by recent innovation) has exemption provisions specifically relevant to international enterprises, this requirement should be repealed. Until it is, however, international issuers will need to obtain an exemption under the Securities Act in addition to that they will likely seek under the Financial Reporting Act.

UNDERTAKING AN OFFERING

Regulatory approval process

In New Zealand, the Securities Act requires the prospectus for an offer to be registered with the Companies Office, but not the investment statement, unless combined with the prospectus. In practice, this means that the prospectus should be pre-vetted by the staff of the Registrar of Companies, whose focus tends to be on technical compliance issues, particularly around the detailed requirements of the relevant schedules to the Securities Regulations. Following the approval of the prospectus it must then be signed by all of the

[31] For example, the "accounting records" as defined in section 53 include all invoices relating to either goods or services and must be kept at the registered office of the issuer and retained for at least 7 years. There is no conceivable justification for such a requirement.

directors of the issuer, and all of the directors of any promoter, and delivered to the Companies Office for registration.

For listed issues, the NZX Listing Rules require both the draft investment statement and prospectus, and all other advertisements to be used in connection with the offer, to be reviewed by NZX staff before distribution. The offer documents must be submitted to NZX in draft form for approval at least 10 business days before the they are intended to be circulated, executed or printing is intended to commence. The NZX approval is also a standard condition of the Companies Office before they will accept the prospectus for registration.

The actual registration process can take some time, but the document in normal circumstances is treated as having been registered from the date of submission. This is the effective date which brings an end to the pre-offering "quiet period" and allows the marketing of the offer to commence.

Project management and anticipation of regulatory roadblocks

Timing is important to capital markets offerings anywhere and particularly so in New Zealand conditions, where supply and demand factors in terms of redemptions and competing offers can make the difference between the success or failure of an issue. In addition, the coupon that can be offered will be sensitive to movements in the swap rate and, for international issuers, the basis swap.

For wholesale offers, this is both less significant, because of the different investor base, and easier to manage. Retail offers, on the other hand, have many more moving parts; particularly where the issuer needs to complete a prospectus and comply with related financial schedules (ie does not have an exemption from this requirement, such as that applicable to registered banks). In addition, there are aspects of the process over which neither the issuer nor the arranger will have complete control. These include:

- **Regulatory approvals**: As discussed above, this process should be manageable so long as no unexpected issues arise. The key, then, is to identify at an early stage any matter that could present issues for the Registrar of Companies in relation to the prospectus or related signing and submission requirements and, for listed issues, for NZX in relation to any of the offering documents.

- **Exemptions and waivers**: Attention needs to be given at the earliest possible stage to any exemptions from the Securities Act and Financial Reporting Act and (for listed issues) any waivers of the NZX Listing Rules that may be required. Some of these matters are routine, for example the technical waivers that invariably must be given to customary minimum subscription amounts as transfer restrictions for the purposes of the Listing Rules. Others may not be so obvious, particularly for the circumstances of an issue or an issuer that is new in the market.

- **Preparation of audited financial statements**. Because of the "life of prospectus" rules in section 37A of the Securities Act, it is important to be aware of any significant deadlines in terms of the age of the accounts and whether, for example, an audit of interim financial statements may need to be planned for.

As a result of these factors as well as the general due diligence requirements in relation to all offering materials, project management of a securities offering assumes great importance. This is especially important in relation to offerings by international issuers, who cannot be assumed to have any familiarity with local processes and laws. It will therefore be beneficial at an early stage to prepare a detailed week-by-week timetable for the steps that will be required in the lead up to the launch of the offer and then the closing and issuance that will take place after the offering period has concluded.

Signing by directors and its direct relation to liability

Certain documents (prospectus, certificates relating to advertisements and investment statements, listing agreement with New Zealand's main stock exchange, NZX) are required to be signed by the directors of an issuer. These requirements, which are generally viewed as appropriate for New Zealand companies (i.e., relatively small with a high degree of director involvement by international standards) may cause difficulty where top level governors of an issuer are not accustomed to, or may not have the ability to, sign such documents, this being left largely to the executive management. This may especially be the case where governors reside in different cities or countries. This issue may have to be addressed through an exemptions from the New Zealand regulators (Securities Commission, Companies Office and NZX).

A more conceptual aspect of this issue is that the individual accountability and liability aspects of New Zealand's securities law regime are triggered by the relevant person (being directors of the issuer and any promoter and any person making statements as an "expert" in the offering documents) signing the prospectus. This tends to focus the attention of senior governors of large corporations on these matters, even if the risk is more theoretical than real in the light of the degree of due diligence and scrutiny that takes place in producing compliant offering documents. This contrasts to the situation obtaining in, for example, the United Kingdom and the United States, where directorial liability is a feature of the securities laws but is not directly tied to the signing of any document and is also subject to certain formal defence mechanisms that has led to well understood legal and due diligence requirements (such as the provision of "10b-5 opinions" and comfort letters).

ROLES AND RESPONSIBILITIES OF THE VARIOUS PARTICIPANTS

A wholesale issue is straightforward in terms of participants, generally involving only the issuer and relevant lead manager(s), and their counsel. By contrast, retail issues involve the coordination of a large team with various roles and responsibilities, typically including some or all of the following:

- **Issuer**: The issuer is ultimately responsible for all aspects of the offering, because it is the only person who will not have any defence at all under the liability provisions of the Securities Act if there is a breach and will most directly suffer any resultant reputational consequences. It therefore bears the responsibility, but it is the nature of the offering process that much of the implementation will be carried out by other people (most notably in the distribution of the securities). Accordingly, the issuer will generally wish to bind the dealers and other relevant parties to enforceable agreements related to compliance with applicable laws and will also wish to closely manage all aspects of the due diligence and compliance process, particularly in view of the potential directorial liability if this is not managed properly.

- **Intermediaries**: For a significant securities offering there will normally be an investment bank appointed as lead managers (one or more of whom may also be anointed as arrangers — although there is not much practical relevance to the particular terminology). They will be closely involved in the preparation of offering documents in particular and in managing the book build / price discovery process and ultimately the distribution of the bonds, although the latter will likely also involve other intermediaries with wide retail distribution capacity. There may also be one or more co-managers appointed to the offer, although this may not occur until during the book build as it may be based on the level of bonds at which relevant institutions are prepared to bid firm.

- **Trustee**: Unless an exemption is available (as for example is the case for registered banks) the Securities Act requires a qualified trustee company to be appointed under a trust deed if the offer of the bonds is made to members of the public. The trustee represents the interests of the bondholders and allows the issuer to deal with one person on behalf of the bondholders. Its main role is in the negotiation of the trust instrument, in particular to provide for the reporting obligations that will enable it to fulfil its role, and which recently have been augmented by statute in relation to finance companies.[32] The trustee is also required to provide a statement for inclusion in the prospectus pursuant to clause 13(3) of the Second Schedule to the Securities Regulations confirming that the offer complies with relevant provisions of the Trust Deed.

- **Registrar**: Most issuers will wish to appoint a registrar and paying agent in relation to the relevant securities. Due to the way the offering process is conducted in New Zealand, this person will likely have a key part to play in the implementation of the offering process and in allotting the securities. Specifically, it is normally the case that applications will be sent by individual subscribers, or by brokers on their behalf, to the Agent, who will then need to bank the subscription cheques into a trust account (as required by section 36A of the Securities Act). The Agent will also be responsible for organising the applications into those stamped by brokers and clean-skins, for the purpose of calculating any brokerage that is payable. Following the closing of the offer, the Agent may need to organise the payment of any "early bird interest" that is payable following close or on the first interest payment date. Thereafter they will be responsible for all payments and fiscal requirements, including withholding of resident and non-resident withholding taxes, conducting transfers, sending information to investors, and otherwise administering the offering.

- **Auditors**: The role of auditors will be significant if there is no exemption from the prospectus requirements. Aside from practical questions of producing relevant audited financial statements, clause 36 of the Second Schedule to the Securities Regulations requires an opinion from qualified auditors that the financial statements contained or referred to in the prospectus comply with clauses 16 to 32 of the Second Schedule, that amounts used in the 5-year summary financial table are correctly taken from audited accounts of the issuer and that the statement about the ranking of the securities under clause 12 of the Second Schedule similarly is correctly taken from audited accounts of the issuer. These matters all require a specific engagement in addition to the normal audit duties performed in respect of the company.

- **Lawyers**: The issuer, lead managers and trustee are all likely to be represented by legal counsel. The key role is assigned to the issuer's counsel, which generally will draft the offering documents and will be responsible for the issuer's compliance with all the various requirements (including signing of Reg 17 certificates and other documents). They will also need to coordinate the meeting of the registration requirements in relation to the prospectus under section 41 and 42 of the Securities Act, which is not always straightforward. In international offerings, the issuer is also likely to be represented by counsel in its home jurisdiction and/or in the place where its programme is listed.

Each of these parties (other than the lawyers and (other than through their engagement letter) the auditors) is likely to be tied contractually to the issuer by various documents:

[32] Securities Amendment Regulations 2007.

the trust deed in the case of the trustee, an issue management agreement and/or co-managers' appointment letters in the case of the various intermediaries, and an agency agreement with the registrar. These comprise the primary transaction documents for an offering, that need to be prepared in addition to the offering documents. Where the issue is listed, there is substantial additional documentation that needs to be agreed with NZX, including the Listing Agreement.

Arranger's and dealers' liability in relation to retail offerings

The appointed dealers or joint lead managers on a transaction will have the most immediate connection with subscribers and generally will have responsibility (implicit or explicit) to ensure that investors receive a copy of the investment statement before investing. The question of the extent of their responsibilities under or stemming from the Securities Act will depend on:

(a) whether or not the arranger in particular (and its directors) is a "promoter" of the securities (discussed below);

(b) the contractual obligations and indemnities it may have assumed under any Issue Management or Dealer Agreement entered into with the issuer;

(c) to the extent investment advice is being provided (which will not be the case if the lead managers and dealers are merely transmitting information received from the issuer), disclosure statements will need to be provided under Part 4 of the Securities Markets Act 1988;

(d) potential responsibility in tort to investors (eg for negligence or misrepresentation), eg in relation to the suitability of the product for the particular investor;

(e) in certain specific circumstances, whether they could be construed as an "expert" making statements.

That aside, in general the obligations in the Securities Act apply only to the issuer of the securities, that is, the person on whose behalf any money paid in consideration of the allotment of the securities is received.

Promoters and their liability

A promoter is defined in the Securities Act as a person who is instrumental in the formulation of a plan or programme pursuant to which securities are offered to the public, and includes directors of that person, but excludes persons who act solely in a professional capacity.

This creates a particular issue in the case of offerings by international issuers because the unfamiliarity of those issuers with this market increases their reliance on arrangers in structuring and implementing an issue. As against this, they will generally be sophisticated institutions who are often continuously issuing in various jurisdictions around the world.

For offerings by international issuers or otherwise, an issue that therefore needs to be managed by arrangers of retail securities offerings in New Zealand is to avoid being seen as so influential in the offer process or structuring as to be a "promoter". If that is the case, both the arranger itself and its directors will be required to sign the prospectus and will be liable for its contents. Although the considerations around this issue can be complex, particularly in relation to structured securities offerings that may be proprietary to the arranger, for most securities offerings the arranger will be viewed as acting solely in a professional capacity in relation to the offering, which will disqualify the arranger from any possibility of being a promoter.[33]

Beyond this, the main compliance issues for the arranger and dealers to manage relate to ensuring that all advertising material or information of any sort in relation to the offering is appropriately vetted and formally signed off by the issuer through the Reg 17 certificate previously described and that traders stick to the script in relation to the offering document disclosures. The reason (as discussed further below) is that the issuer is exposed to civil and criminal liability on such communications.

REGULATION OF INFORMATION FLOWS IN A RETAIL CONTEXT

One of the core issues in any retail offer in New Zealand is that the flow of information is a heavily regulated matter — indeed, this is the *raison d'être* of New Zealand's disclosure-based securities laws. The two main guiding principles (subject to exceptions and other details discussed below) are that:

- communication about an offering cannot begin before the prospectus is registered; and

- thereafter, all marketing is to be driven through the investment statement, which must be received by all investors, and through authorised advertisements[34].

There will always be a tension between the desire of the lead manager(s) to publicise the offer as early and as widely as possible, in order to determine basic issue parameters of offering size and margin-setting, and the need to manage securities law risk on behalf of the issuer (and, by statutory or contractual extension, the offeror).

The issues in this regard fall into two main categories:

- **Pre-prospectus publicity**: What can be said, and to whom, before the official marketing period commences (following the registration of the prospectus, if there is one).

- **Control of advertisements**: What materials can be distributed or otherwise communicated to investors during the offering period and meeting of the various (and comparatively stringent) regulatory requirements in relation to these.

QUIET PERIODS AND PRE-PROSPECTUS PUBLICITY

When can marketing commence?

Where a prospectus is required for an offering, the position is straightforward. You can commence marketing (using the investment statement and authorised advertisements) when the prospectus in the form agreed with the Companies Office and including the agreed and sign-off attachments is submitted to the Companies Office for registration. The prospectus is not actually registered until the certificate of registration is received under section 42(5) of the Securities Act, but this is effectively back-dated to the time of submission. (Section 42(4)(b) of the Act expressly permits the Registrar to register a prospectus that does not comply with the formal requirements in section 41 of the Act if

[33] For structured offerings conducted through an SPV incorporated by the arranger, it (or at least some substantial company in its group) will almost inevitably be a promoter of those offerings.

[34] That is, advertisements , that refer to that investment statement, are consistent with the investment statement and prospectus and meet other detailed rules discussed below.

the Registrar is satisfied that it otherwise complies with all provisions of the Act and is a satisfactory prospectus.)

Where no prospectus is required (for example an issue by a registered bank or one of the overseas companies exemption notices), the marketing can begin when the investment is made available (normally in printed form) and authorised by the issuer for release.

Communication with and involvement of the issuer

The question of how the issuer should be involved in communications depends on the business understanding with the particular issuer. Some wish to defer all matters to the lead managers and others insist on being more hands-on.

Regardless of the issuer's preferences, however, the issuer should be kept closely involved in all matters relating to:

(a) Registration of the prospectus, commencement of the offering and any changes to the offering timetable.

(b) Any advertisements or roadshow materials to be distributed in connection with the offering. Amongst other things, the issuer will be exposed to civil and potentially criminal liability on such communications and will likely need to prepare a Reg 17 certificate for them and (if listed) submit them to NZX for approval.

Permitted communications during the pre-registration "quiet period"

In relation to pre-prospectus publicity, there are two main exceptions on the face of the Securities Act and some argue that a third should be implied. These exceptions (each of which is discussed in more detail below) are:

(a) **"Tombstone" exception under s 5(2CA)**: Advertisements containing **only** certain specified information are exempted under section 5(2CA) of the Securities Act from the prohibition on pre-prospectus publicity. This exception has the advantage that it can be distributed to all clients. The disadvantage is that it is restrictive in terms of information and any information that is given that isn't among the listed types will render it non-compliant.

(b) **"Underwriting" exception under s 3(2)(b)**: An invitation to a person to enter into a bona fide underwriting or sub-underwriting agreement with respect to an offer of securities is not an offer of securities to the public. This is generally interpreted as permitting Lead Managers for an offer to undertake their book-build with institutional intermediaries and brokers.

(c) **Implied "Wholesale investors" exception**: It is argued by some that there is an implied exception from the Securities Act for communications made only with institutional and other wholesale investors (ie communications that, if they were an offer of securities, would be exempted under section 3(2)(a) of the Securities Act).

In summary overall, the Tombstone exception involves narrow information but a wide audience and the Underwriting and Wholesale exceptions involve a narrow audience but wide information.

Tombstone exception (5(2CA))

Generally, the Securities Act prohibits advertising before an investment statement is distributed or prospectus is registered, where the Act requires such registration for an offer of securities. However, there is a limited exception to this under section 5(2CA) of the Securities Act, commonly referred to as the "tombstone" exception. Advertisements made under this must state that:

(a) the issuer is considering making an offer of securities to the public; and

(b) no money is currently being sought and that no applications for securities will be accepted or money received unless the subscriber has received an investment statement.

The advertisement then may state any or all of the information specified under section 5(2CA) (and nothing else). There is reasonable scope for communication under the stated matters, which for example include " a description of the securities intended to be offered" and "the terms of the intended offer", the interest rate, and the date at which the issuer expects that the offer will be made. The quoted paragraphs in particular permit a wider range of information than is sometimes appreciated.

The advertisement may also state that the issuer is seeking preliminary indications of interest and, if so, must state how indications of interest may be made and that no indication of interest will involve an obligation or commitment of any kind.

The advertisement must not contain any other information about the proposed offer and must strictly conform with the above. In particular, we note that no mention may be made of listing of the securities by NZX due to the strict wording requirements of regulation 23 of the Securities Regulations 1983 and there is also no room to mention any rating or indicative rating for the issuer or the securities (unless, for example, the obtaining of a minimum rating is a condition to the offer being made and thus a "term of the offer").

It is important to note that the pre-prospectus publicity is not limited to communications in any particular medium, and can include spoken presentations or audio-visual communications, to the extent such communications are authorised or instigated by, or on behalf of the issuer or prepared with its co-operation. As a result, the Tombstone exception can also be used for phone arounds, so long as the statutory statement is read and the dealer sticks closely to the script.

Bona fide underwriting exception — Book-build process

Section 3(2)(b) of the Securities Act provides that the following shall not constitute an offer of securities to the public:

> An invitation to a person to enter into a bona fide underwriting or sub-underwriting agreement with respect to an offer of securities.

This section provides the basis for Lead Managers in the New Zealand market to undertake their pre-launch book-build activities (including, but not necessarily limited to, the roadshow).

The key issue in applying the section is what is meant by the entry into a bona fide "underwriting or sub-underwriting agreement". It is likely that this concept would include standard firm allocation arrangements, since the intent and effect of those is to bind the relevant broker or dealer to acquire the securities for which it has bid.

Implied wholesale investors exception

Prudence would dictate not going beyond the explicit pre-prospectus exceptions discussed above. The implied wholesale investors exception, if it truly exists, is more difficult to rely on because it results from an interpretation of the Securities Act that not necessarily all even knowledgeable securities law advisers would agree with, whereas the other exceptions are clearly available on the face of the Act.

Caution about use of the exceptions in unison

The final point is that the various exceptions cannot be seen in isolation, as there is potential for an exception of one sort to taint the application of another. In this regard, section 2A(6) of the Securities Act provides:

> Where—
>
> (a) An advertisement within the meaning of this section appears in association with another advertisement that is not an advertisement within the meaning of this section; and
>
> (b) Both advertisements are authorised or instigated by, or on behalf of, the same person or prepared with the co-operation of, or by arrangement with, the same person,—
>
> those advertisements are deemed to be a single advertisement within the meaning of this section.

In particular, there can be a fundamental inconsistency between invoking the tombstone exception and the underwriting (or the wholesale) exceptions at the same time, particularly to an audience that might crossover (ie where it is possible that members of the wholesale audience may have clients who would receive the tombstone ads). The issue is that the natural tendency in such cases would be for the retail clients to make inquiries of the wholesale independent financial advisers, and (even in spite of confidentiality undertakings) the latter may be tempted to share information from the wholesale presentation. Any information imparted in this fashion would mean that communications have been made to retail investors outside the bounds of section 5(2CA) of the Securities Act. As a result, there would then be a non-complying offering of securities to the public, in addition to a breach of the advertising rules.

The key point is that there can be no leakage of any wholesale information to retail investors or any framework which would encourage or enable the same.

CONTROL OF THE CONTENT AND DISTRIBUTION OF ADVERTISEMENTS

One of the most difficult issues to manage in relation to a retail offering of debt securities relates to the controls tight imposed on all forms of communications in relation to the offering and the resultant compliance procedures that need to be implemented.

The Securities Regulations continue the historic antipathy of New Zealand regulators toward public advertising of securities by imposing a number of requirements that go well beyond the need not to mislead and by requiring formal issuer sign-off in the form of a "Reg 17" certificate.

It is an area that, because of the breadth of the definition of "advertisement", can lead to frustration on the lead manager and others responsible for marketing the bonds. Equally, because of the severe consequences potentially attached to non-compliance (including civil and criminal penalties and directorial liability) it is an area where there is no reasonable alternative to applying a cautious and meticulous approach. In practical terms this is exacerbated because advertisements are "low hanging fruit" when it comes to enforcement, as by nature they are in the public domain and readily accessible. As a result the Securities Commission can, and does, review them, with what appears to be a fine tooth comb.

Another factor that needs to be stressed is that the Commission is entitled to, and does, look beyond the detailed words of the advertisement to its overall impact in determining whether it may be unbalanced or otherwise misleading. In this connection, section 55 of the Securities Act defines "untrue" for the purposes of the liability sections in a way that indicates that provides some justification for this approach. Specifically, section 55 of the Securities Act provides that a statement included in an advertisement or registered prospectus is deemed to be untrue if—

> (i) It is misleading **in the form and context in which it is included**; or
>
> (ii) It is misleading by reason of the omission of a particular which is material to the statement **in the form and context in which it is included**. (Emphasis added.)

Meaning of advertisement

Section 2A(1) of the Securities Act defines "advertisement" as follows:

> In this Act, unless the context otherwise requires, advertisement means a form of communication—
>
> (a) That—
>
> (i) Contains or refers to an offer of securities to the public for subscription; **or**
>
> (ii) Is reasonably likely to induce persons to subscribe for securities of an issuer, being securities to which the communication relates and that have been, or are to be, offered to the public for subscription; and
>
> (b) That is authorised or instigated by, or on behalf of, the issuer of the securities or prepared with the co-operation of, or by arrangement with, the issuer of the securities; and
>
> (c) That is to be, or has been, distributed to a person.

This is a very inclusive definition that goes well beyond the notion of an advertisement as used in common parlance. It covers all forms of communication and extends to anything that "encourages the acceptance of an offer".[35] This would include audiovisual advertisements and oral presentations. The issuer's website, if it refers to an offer, will also be an advertisement for the purposes of the Securities Act.[36]

The Securities Act provides a list of things that are not advertisements. These are:

[35] Refer *Securities Commission Bulletin* No.2, 1 May 1984.
[36] Refer Securities Commission News Release, 29 May 2001.

(a) A registered prospectus;

(b) A statement made to or for the purposes of a general meeting of the members of the issuer, or a report of such a meeting;

(c) A statement relating to the affairs of the issuer made to any stock exchange for the purpose of complying with the listing requirements of that stock exchange;

(d) A disclosure statement published by a registered bank (under section 81 of the Reserve Bank of New Zealand Act 1989).

When a lead manager or arranger make communications in relation to an offering, it is highly likely that the issuer will need to prepare a Reg 17 certificate for them and (if listed) submit them to NZX for approval. The Issuer will also be exposed to civil and potentially criminal liability on such communications. As a result, it is crucial to ensure that all communication in relation to a public offering is tightly managed and subject to appropriate due diligence and legal compliance checks.

Issues commonly arising from the regulatory restrictions

The nature of the restrictions on advertisements contained in the Securities Act and, in particular, in Parts 2 and 3 of the Securities Regulations is such that, as suggested above, there is little alternative to implementing a compliance procedure which involves every published communication relating to the offer to be scrutinised against the relevant rules (preferably by way of a detailed checklist).

Among the issues in relation to advertisements from these requirements, the following tend to crop up regularly:

- **Investment statement**: It is mandatory in all advertisements (other than the investment statement itself) to refer to the investment statement (section 38 of the Securities Act).

- **Guarantees**: If an advertisement states or implies securities are guaranteed, advertisement must state nature and amount of guarantee; name of guarantor; and whether or not guarantee secured and if so, nature and extent of security (Reg 11).

- **Assets**: An advertisement must not state any persons assets without also stating their liabilities (Reg 13).

- **Ranking**: An advertisement may not refer to debt securities without stating they are unsecured or nature and ranking of security if they are (Reg 14).

- **Shareholders**: An advertisement must not state that a person is a shareholder of the issuer without also stating whether or not the securities are guaranteed by that person (which then invokes Reg 11) (Reg 18).

- **Safety**: An advertisement must not state that the investment is safe or free from risk (Reg 20). (This particularly rankles with ad executives and marketing departments who appear to share an almost irresistible urge to insist that their securities are "as safe (or safer) than houses".)

- **Interest rates**: An advertisement cannot refer to the interest rates unless it also states the minimum amount of securities that have to be held (ie the minimum subscription amount), and minimum periods for which securities to be held (which would be the relevant interest payment dates), to earn the interest rate (Reg 21(1)).

- **Impact of tax**: An advertisement cannot state a rate of interest adjusted for taxation or otherwise refer to taxation of interest; but it can contain a statement regarding tax advantages if there is a full description of those in prospectus (Reg 21(2)). This is particularly relevant in the current context of the PIE regime.

- **Listing**: There cannot be any mention at all of listing other than the relevant prescribed "Reg 23" statement (Reg 23).

The above requirements will often result in sub-optimal changes having to be made to the wording of advertisements and/or the inclusion of fine print statements of seeming insignificance. It is important, of course, also to ensure that the marketing message does not get lost in the compliance process.

Issuer sign-off — when a Regulation 17 certificate is required

Regulation 17 provides that no advertisement may be distributed unless a certificate that complies with the Regulation has been signed by at least directors of the issuer. The general rule is that all advertisements must have a Regulation 17 certificate prepared for them, however Regulation 17(3) states that a certificate is not required if the advertisement contains no information other than the following matters (which are similar to the matters permitted to be disclosed under the "tombstone" exception referred to previously):

(a) name and contact details;

(b) description of securities and terms;

(c) rates of interest that may be earned;

(d) matters specified in Regulation 11 (guarantees), Regulation 14 (secured and unsecured securities), Regulation 21 (interest rates);

(e) names of principal stockbroker and underwriters;

(f) description of fees and charges payable to the subscriber; and

(g) a statement that an investment statement has been prepared and is available.

Every certificate must be held by the issuer for at least 12 months from the date of the last distribution of any advertisement to which it relates. Failure to comply with this is an offence under the Securities Act. If the advertisement is distributed without a complying certificate the party that distributed the advertisement will be committing an offence. The issuer (including its directors and principal officers) of the securities that the advertisement relates to will also be committing an offence. Any party committing such offence may be liable on summary conviction for a fine of up to $5,000.

Consequences of non-compliance with the advertising provisions

Section 38(b) of the Securities Act deals with the prohibition of advertisements. Under section 38(b)(1), the Securities Commission may order the prohibition of distribution of an advertisement or of any other advertisement which relates to the same offer of securities if the Securities Commission believes that the advertisement:

(a) is likely to deceive, mislead or confuse with regard to any particular that is material to the offer of securities; or

(b) is inconsistent with any registered prospectus referred to in it; or

(c) does not comply with the Securities Act or the Regulations.

It is an offence to ignore such an order made by the Securities Commission under section 38(b) and the party committing the offence may be liable on summary conviction for a fine of up to $5,000.

Section 56 deals with civil liability from the statements in an advertisement. Where an advertisement contains a statement that is untrue and someone suffers loss or damage as a result, the directors of the issuer and the promoter of the securities may be liable for such a loss. The aggrieved party must prove that the untrue statement induced them to subscribe and that the subsequent loss was related to that statement. However, section 56(3) provides a defence if the directors of the issuer or the promoter believed on reasonable grounds that the statement made was true.

Section 58 deals with criminal liability for misstatements in an advertisement or distributing an advertisement that does not comply with the Securities Act or Regulations. Again, where an advertisement includes any untrue statement or is non-compliant and is distributed, every director of the issuer commits an offence. Under section 58(5) every person who commits an offence under the section may be liable for

(a) on conviction on indictment to -

  (i) imprisonment for up to five years; or

  (ii) a fine up to $300,000;

(b) on summary conviction to -

  (i) imprisonment for a term not exceeding three months; or

  (ii) a fine not exceeding $300,000.

However, similar to the civil liability section, each director of the issuer has a defence if they can prove that they believed on reasonable grounds that the statement was true, or that the contravention was immaterial.

SOME LESSONS FROM RECENT INTERNATIONAL RETAIL OFFERS

Rabobank Nederland Capital Securities offer

The Rabobank Nederland was launched in September 2007. It was an offer of Capital Securities qualifying as Tier 1 capital for the issuer in the Netherlands. The offer raised $900 million, making it the largest unwrapped corporate bond issue in New Zealand.

Rabobank Nederland is a registered bank in New Zealand so had the benefit of the exemption under section 5(2C) of the Securities Act applicable to debt securities issued by registered banks. This is particularly advantageous in a retail offering where a substantial part of the compliance costs come from the requirement to produce a prospectus.

The governing law of the Capital Securities was the law of the Netherlands, which (like New Zealand law) recognises registered, book entry only securities. As such the terms and conditions for the Notes could simply be included within the Investment Statement (no trust deed being required as a result of the exemption just mentioned). However, for reasons relating to the regulatory capital treatment of the notes and the need for a "trust deed" under the Listing Rules, the terms and conditions of the Notes were appended to the Agency Agreement entered into with the New Zealand registrar.

Crédit Agricole Perpetual Deeply Subordinated Notes offer

This was another listed offer of notes counting as Tier 1 regulatory capital for the issuer in its home jurisdiction (France). This offer was launched in November 2007 and raised $250 million.

There were two primary challenges in relation to the Crédit Agricole offering, by contrast to the earlier Rabobank Nederland Capital Securities Offcer. First, Crédit Agricole is not a registered bank in New Zealand so did not enjoy an exception to the requirements for a prospectus and a to appoint an authorised trustee under a trust deed. Secondly, the offering took place against a backdrop of an emerging financial crisis that has since become known as the "credit crunch".

In relation to the New Zealand prospectus requirements, the primary issue that the Crédit Agricole transaction brought out was the inflexible nature of the detailed financial reporting requirements of clauses 16 to 32 of Schedule 2 to the Securities Regulations, as previously mentioned in this paper. This resulted in the need for an exemption from the Securities Commission, subject to the condition of describing the differences between IFRS as applied in the European Union and IFRS as applied in New Zealand. These differences would strike all but the most ardent financial statements reader as somewhat esoteric and it seems at odds with the policy behind the implementation of "international financial reporting standards" that such would be required. At a deeper level, it is not clear in policy terms why there should be any requirements in relation to audited financial statements other than compliance with GAAP and relevant legislation (most notably that the financial statements "give a true and fair view" of the financial performance and position of the issuer).

One of the parameters of the issuer was to undertake the offering as much as possible in accordance with its underlying EMTN programme documentation, in part in order to facilitate obtaining the desired regulatory treatment from the French banking authority. As a result, the Trust Deed entered into was governed by English law.

World Bank retail Kauri bond offer

Until recently, all "vanilla" Kauri bonds had been issued only into the wholesale market. This changed with the launch on 23 June 2008 of the International Bank for Reconstruction and Development (World Bank) retail medium term note offer.

This offer was facilitated by exemptions obtained from the Securities and Financial Reporting Acts. The Securities Act (World Bank) Exemption Notice 2007 permitted the World Bank to offer debt securities under its global debt issuance facility to New Zealand retail investors under an investment statement, but without a prospectus or New Zealand trustee (that is, it is substantively similar to the exemption for registered banks). The conditions for the exemption included that the World Bank would make available to New Zealand investors its most recent prospectus for its global programme and the most recent Information Statement that it prepares annually in accordance with its charter.

The policy reasons underlying the exemption included the very high credit quality of the World Bank (which has maintained a AAA rating continuously since 1959), the fact that

New Zealand is a member of the organisation, and the high quality of the information that the World Bank regularly publishes about its operations and financial condition.

The World Bank also obtained an exemption from the requirements of the Financial Reporting Act on the condition that it submit audited annual financial statements in accordance with US GAAP.

Some general observations

Offerings from international issuers, whether Kauri bond issues or retail issues, throw up a number of challenges and issues in addition to those for a purely domestic offering. These include:

- **Time differences**: In so far as debt capital markets issuance is concerned, New Zealand is alone on its latitude, so there will always be a time difference to factor in, both when putting deals together and when administering them (particularly by way of making payments on issue, interest payment dates and maturity). In many cases (notably Europe), there will be no business day cross-over at all and there are two days per week when it is a business day in one place and not in the other. This all gives rise to a new concept of the working day / week, particularly for the legal advisers.

- **Legal documentation**: The legal documentation for securities offerings around the world has developed a much more standardised framework for bond offerings than is apparent in New Zealand. It will often be expected by issuers, and in particular their home jurisdiction counsel, that documentation of this nature will be entered into in a substantially consistent manner wherever they offer securities. This will sometimes create problems in New Zealand either because market norms are different (for example in relation to distribution arrangements, closing conditions or due diligence requirements) or because institutional and legal forms differ (eg the legal form of notes).

- **Unfamiliar laws**: In an international offering, it is never safe to assume that local laws will be familiar to the international counterparties and their counsel. There is a great deal more educating that therefore needs to take place about basic regulatory and compliance requirements. It is also important for New Zealand counsel to be alert to local requirements that could cause difficulties for overseas entities, such as requirements as to signing and audit related matters.

- **Institutional differences**: New Zealand lacks a custodial sector dominated by large banks and trust institutions such as Bank of New York, Citibank and JPMorgan Chase. Instead, there are only local registry institutions, of whom Computershare Investor Services Limited has undertaken the registrar and paying agency role in relation to debt capital markets offerings by international issuers. This can lead to issues in terms of approved credit exposures for payment flows and the need to build a framework that can replicate the custodial relations that are a customary part of the Euromarkets.

- **Settlement mechanics**: Because of time zone differences, clearing and settlement of international bond issues cannot take place using customary delivery-versus-payment (DVP) mechanics, which operates to eliminate settlement and credit risk in normal trades conducted via clearing systems. As a result, Kauri bonds transactions need to be subscribed for by means of a funding method referred to as a "MT103" instruction, which is an authenticated and unconditional transfer of funds among international correspondent banks.[37]

- **Clearing systems**: The primary clearing systems for international offerings are Euroclear and Clearstream in the Euromarkets and DTC in the United States and most institutional holdings are through these systems. There is no direct access to Euroclear and Clearstream for issues cleared through Austraclear New Zealand — rather than system operates through a one-way sub-custodial "bridge" system (one way because issues cleared initially through Austraclear can trade through Euroclear and Clearstream, but not vice versa). There is no bridge between Austraclear New Zealand and DTC at all.

- **Form of Note holdings**: Most international offerings will take place using Global Notes, as opposed to the almost universal framework now adopted in New Zealand of issuing book-entry notes under a deed poll. This has implications both in terms of the legal documentation for offers and operational considerations, as physical notes cannot be held within the Austraclear New Zealand System. Other issues that can arise in this regard relate to transfer restrictions applicable in the international capital markets to securities that can be initially sold into the U.S. institutional market (Rule 144A issues) and ones that may be distributed to U.S. persons only after the expiry of a restricted period (Reg S Notes). In practice this invokes some very arcane and technical securities and tax rules (notably the so-called TEFRA rules[38]). Specific procedures need to be undertaken to issue Rule 144A notes in a Kauri format.

- **Culture and expectations**: Since international offerings in New Zealand are by definition done across different markets, they run up against different conventions and expectations in those markets. It therefore becomes important to explain the operational features of this market in a way that would not be expected for a domestic offering. It is also important to maintain a flexibility in undertaking offerings of this type with a view to keeping all sides as happy as the circumstances will allow.

THE EMERGENCE OF KAURI BONDS

Kauri bonds are New Zealand dollar denominated bonds issues by overseas issuers and cleared through Austraclear New Zealand.

The Kauri bond market is new, having started in 2004 with debut issues by Telstra, Morgan Stanley and Merrill Lynch. It has quickly become the largest corporate bond market in New Zealand. It has also proved to be very resilient through the credit crunch — for example, in July and August of 2007, the New Zealand market was one of the very few markets around the world seeing more than a trickle of new deal flow.[39]

New Zealand's debt capital markets in 2007 were dominated by Kauri bond issuance, particularly since July when the Reserve Bank opened up its repo-eligibility window to

[37] MT103 is a SWIFT message type (hence "MT") and is a format commonly banks use when they effect a wire transfer.
[38] Which rolls off the tongue somewhat better than their real name, being section 1.163-5(c)(2)(i)(D)(3)(i)(C)(iii)(B) of the U.S. Treasury Regulations.
[39] "After the Gold Rush" *Kanga News* (March 2008) pg 6.

supranational, sovereign / semi-governmental and agency issuers (referred to in this market as "SSAs") who meet its criteria.[40]

Against a backdrop of annual issuance typically in the range of $2 - 3 billion, in 2007 there was total debt capital market issuance of $10.8 billion, of which $6.3 billion comprised Kauri bond issuance and, in all, more than three-quarters was from international issuers. To date 2008 the New Zealand market has seen a further $6.2 billion of issuance, dominated by financial institutions (59%) and Kauri bonds (35%), with local authority issues making up the remainder.[41]

In addition to the four issuers who had initiated the Kauri bond market from 2004, in the past year fifteen new issuers have tapped this market and many others have made enhancements to their Australian or Euro MTN programmes to facilitate this.

There have been four significant developments recently in the Kauri bond market:

- First, it has proved possible to undertake Kauri issues from the full range of major international bond programmes — EMTN, Australian MTN (AMTN) and Global Programmes — and the initial bias in favour of AMTNs because of execution preference resulting from the book entry clearing framework shared by Australia and New Zealand has subsided. The question of which programme to use is now almost always straightforwardly one of issuer preference.

- Second, once an issuer has undertaken its debut issue, execution of subsequent trades is something that can be done with relative ease and with as little as a few working days turnaround.

- Third, of particular importance to generating a sound international investor base, an issue by Queensland Treasury Corporation laid the groundwork for initial issuance into the United States institutional market through Rule 144A issuance, cleared through Euroclear and Clearstream Luxembourg, via the bridge operating with Austraclear New Zealand.

- Fourth, the market has had its debut retail issue, with the $100 million World Bank medium term notes launched on 23 June 2008 (lead manager Westpac Institutional Bank with ANZ National Bank and Bank of New Zealand as co-managers).

Repo eligibility under the Reserve Bank's liquidity facilities

The most significant breakthrough in the Kauri Bond market came with the announcement by the Reserve Bank on 17 July 2007 that it will accept SSA bonds meeting specified criteria into its Overnight Reverse Repo Facility ("**ORRF**"). This change was part of the Reserve Bank's efforts to reliquefy the banking system, which have resulted in settlement cash in the banking system being increased from $20 million in 2006 to its current level of $7 billion. Although many banks have taken the opportunity to have Kauri bonds in their liquidity books, none have yet used those securities to raise cash.[42]

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[40] Both the criteria and the process for obtaining repo-eligibility have proved reasonably straightforward. The criteria are published on the Reserve Bank's website (www.rbnz.govt.nz/finmarkets/liquiditymanagement).

[41] The United States bond market, by way of comparison, currently stands at US$30.5 trillion (ref sifma.org). As the New Zealand corporate bond market is less than 5% of GDP compared with an OECD average of 39%, this implies there is plenty of growth potential yet.

[42] Reserve Bank *Financial Stability Report* (May 2008), pg 13.

The requirements for this are discretionary, and application must be made for acceptance prior to the securities being lodged in Austraclear New Zealand.[43] The primary criteria are that (in summary):

(a) The issuer and issue have a long term AAA rating from at least two acceptable ratings agencies.

(b) The issuer (other than supranationals) must be domiciled in one of the following jurisdictions: Austria, Australia, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Hong Kong, Hungary, Ireland, Italy, Japan, Luxembourg, Malta, Netherlands, New Zealand, Norway, Singapore, Slovenia, Spain, Sweden, Switzerland, United Kingdom and United States.

(c) The issuer is an institution with which the Reserve Bank has no supervisory conflict (i.e., restricted to supranational, foreign sovereign, “agencies” and semi-government issuers).

(d) The issue is plain vanilla (e.g., a bond with no optionality and not subordinated).

(e) The issue’s pricing convention follows price and yield formulae as used by the Reserve Bank — in particular bonds should have a semi-annual coupon.

(f) The issue must be denominated in New Zealand dollars.

(g) The security is not already on issue in Austraclear.

(h) The issue will be lodged in Austraclear. Eligibility criteria for lodgement into Austraclear include having a suitable New Zealand-based registrar, and a paying agent (not the Reserve Bank) who must be an Austraclear member.

(i) The issue has more than three days to maturity.

Recent changes to the repo eligibility regime

On 7 May 2008 the Reserve Bank announced that it is abandoning its current exposure limits on the amount of SSA securities it will accept for repo purposes. Instead, SSA Kauri bonds are accepted by the Reserve Bank under a graduated haircut regime involving a 3% "haircut" for AAA securities having a maturity of up to 3 years and 5% on longer dated securities. This haircut is a risk margin, whereby securities offered in a repurchase transaction are required to have a market value greater than the cash or other securities supplied. The varies depending on the type of security, its credit quality and tenure.[44]

The removal of the caps is a positive step for a number of SSAs who had already issued to their limit and would otherwise have needed a fresh authorisation to tap this market. In a wider sense, it removes a barrier for the Kauri market to compete with the Eurokiwi market as the preferred format for New Zealand Dollar issuance.

At the same time the Reserve Bank also announced that from 3 June 2008 it will accept domestic bank, local authority and state-owned enterprise securities rated AA- or above (being the New Zealand Government's credit rating outside New Zealand) and from 31 July 2008 will accept New Zealand dollar denominated Residential Mortgage-Backed Securities rated AAA. It is yet to be seen what influence the freeing up of the repo-eligibility rules will have on the Kauri market, although clearly issuers and arrangers

[43] Refer to the guidelines at http://www.rbnz.govt.nz/finmarkets/liquiditymanagement/3067314.html.
[44] Reserve Bank *Financial Stability Report* (May 2008) pg 38.

already need to look outside of bank liquidity books for demand. In addition, a similar move by the Reserve Bank of Australia in 2007 had little impact on demand for SSA Kangaroo bonds.[45]

Some of these changes may prove to be a temporary response to the current conditions of strained liquidity and pressure on financial institutions, as the Reserve Bank is to review the new repo-eligibility regime in July 2009.

Benchmarking issues and new indices

New Zealand fund managers have traditionally used a government bond only benchmark, leading to tracking error and under-performance, particularly given the lack of supply and illiquidity in the NZ government bond market.[46] This has led to a search for alternative benchmarks, including a developing trend for using the NZD Swap index, which has the disadvantage that it incorporates credit risk.[47] Partly because of the recent elevated swap spreads and the lack of clarity about their cause, the OECD in its recent economic survey of New Zealand questioned whether the swap market is able to provide a sufficient benchmark yield for the economy as a whole.

This factor is important to the development of the Kauri bond market because the benchmark indices influence the demand for Kauri Bonds among fund managers. The issue is that SSA Kauri Bonds usually offer a significant yield pick up over benchmark government bonds (usually of the order of 70 to 100 basis points) but equally trade through swap (usually by between 15 and 30 basis points).

The surge in SSA issuance has spurred the creation of two new indices, developed by ANZ and NZX. The NZX Kauri Bond Index and the NZX Composite AAA Bond Index (which is a composite of SSA and New Zealand government bonds) were launched on 2 May 2008.[48] As of 30 April 2008, the NZX Kauri Bond Index had a market value of $5.3 billion and the NZX Composite AAA Bond Index had a market value of $31.5 billion.

The development of appropriate indices has been a significant development in both the Canadian Maple and the Australian Kangaroo markets. It is too early to predict what sort of impact it might have on the development of the Kauri bond market.

Incentives for Kauri bond issuers

For the Kauri bond market to succeed, there needs to be willing issuers and willing investors. In relation to the former, ultimately to achieve issuance, local arrangers need to be able to deliver issuance at the issuer's funding targets, which are almost universally on the basis of a margin under USD Libor or Euribor benchmarks. Accordingly, Kauri bond transactions are priced below (or "through" in market parlance) swap and are swapped back into the relevant funding benchmark through basis swaps (as described in the next section of this paper).

The issuers who have chosen to access the Kauri market are in a diverse range. Initially the market was dominated by financial institutions — investment banks, including Merrill Lynch and Morgan Stanley, and overseas banking groups including HBOS, Rabobank, Citigroup and Bank of America. Since the credit crunch and repo eligibility changes (both beginning in July 2007), the predominant issuers have been SSAs, including:

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[45] "RBNZ repo changes are positive, triple-As say" *Kanga News* (June 2008) pg 6.

[46] "New Indices are first to include SSA Kauris" *Kanga News* (June 2008) pg 5. See also "Assessing the Indices" *Kanga News* (April 2008), pg 26..

[47] The spread between swap and government bonds widened even prior to the credit crunch to 88 basis points on average in 2006 — refer OECD Economic Survey *Deepening Financial Markets* at pg 86-87.

[48] Refer http://www.nzx.com/markets/nzdx/nzx_debt_indices/nzx_nz_kauri_bond_indices.

- supranational development agencies such as the World Bank, European Investment Bank, Nordic Investment Bank and African Development Bank;
- agency issuers (who undertake borrowing on behalf of municipalities or utilities) such as BNG and Rentenbank; and
- semi-governmental issuers, such as Queensland Treasury Corporation.

SSA issuers typically have very large annual funding targets (eg the World Bank has a target of between US$10-15 billion in each year) and therefore are almost continually issuing in a number of separate markets. For sustainability and liquidity, the larger issuers will endeavour to "build a curve" by having tranches of bonds at differing maturities across the yield curve (which, in the Kauri bond market as it stands means tenors of between 2 and 10 years) as part of their benchmark programmes.

Part of the attraction of a market such as the Kauri bond market is that it expands and diversifies the investment base for the SSA issuers. Although this is not necessarily the case where Kauri bonds are issued to overseas investors, issuers equally recognise that the latter investment base is important to liquidity in the market and its vitality generally. Where issues are done on a retail basis (such as the World Bank issue launched in June of this year) it can also increase the profile of the institution in member country markets.

Investor base for Kauri bonds

The initial investor base for Kauri bonds was focused on bank liquidity managers, as the new repo eligibility rules allowed banks to meet their requirements for holding repo-eligibility securities while getting a significant yield pick-up over New Zealand government bonds. There has also been some uptake from New Zealand fund managers, but demand from such "real money" investors has thus far been constrained by a combination of mandate restrictions, benchmarking issues, and a "wait and see" approach in terms of how liquidity will develop in the market.

In line with the experience in the Kangaroo bond market, a large part of the investor base for Kauri bonds has been drawn from overseas institutional buyers, particularly from central banks and Asian sovereign funds. This is significant because the further development of the Kauri bond market requires a broadening of the investor base to include more investors who have traditionally had an appetite for Eurokiwi issuance (a potentially massive market by comparison to the New Zealand domestic capital market).

LEGAL AND OPERATIONAL CONSIDERATIONS FOR KAURI BOND ISSUES

The Kauri bond market is characterised by a relative ease of execution because issuers can utilise their Global, Euro MTN or Australian MTN programmes with minimal need for specific New Zealand documentation. It has this in common with the Canadian Maple bond market, but in other markets this has not been possible for tax, operational or legal reasons. Notably to access the Kangaroo bond market, issuers typically will have to enter into a full suite of Australian law governed programme documents and prepare an Australian information memorandum.

Initially, the majority of Kauri issues were undertaken pursuant to Australian MTN programmes. The advantages of using such programmes are that Australia and New Zealand have very similar legal documentation and operational processes. Specifically, both jurisdictions employ a fully dematerialised book entry system for both wholesale and retail note offerings. However, an issue that commonly arose with Australian programmes is that they were commonly restricted to issuance in Australian dollars and/or Australian domestic issuance, making them unsuitable for Kauri issuance without amendment. This issue has abated as many SSA issuers have modified their AMTN programmes in the past year to provide explicitly for Kauri bond issuances as part of their routine re-documentation processes.

Alternatively, Euro or Global Medium Term Note Programme documentation can form the basis for a Kauri issue. These programmes are very unlikely to be restricted in terms of currency or territory of issue, but are often subject to operational issues that will need to be worked through depending on the particular documentation. In particular, there may be inflexibility about the form of global notes that must be used in offerings (bearer and not registered), the use of alternative clearing systems or registrars, or operational procedures more generally.

Regardless of whether AMTN, EMTN or Global Programmes are utilised for a Kauri bond issue, the documentation generally consists of the following:

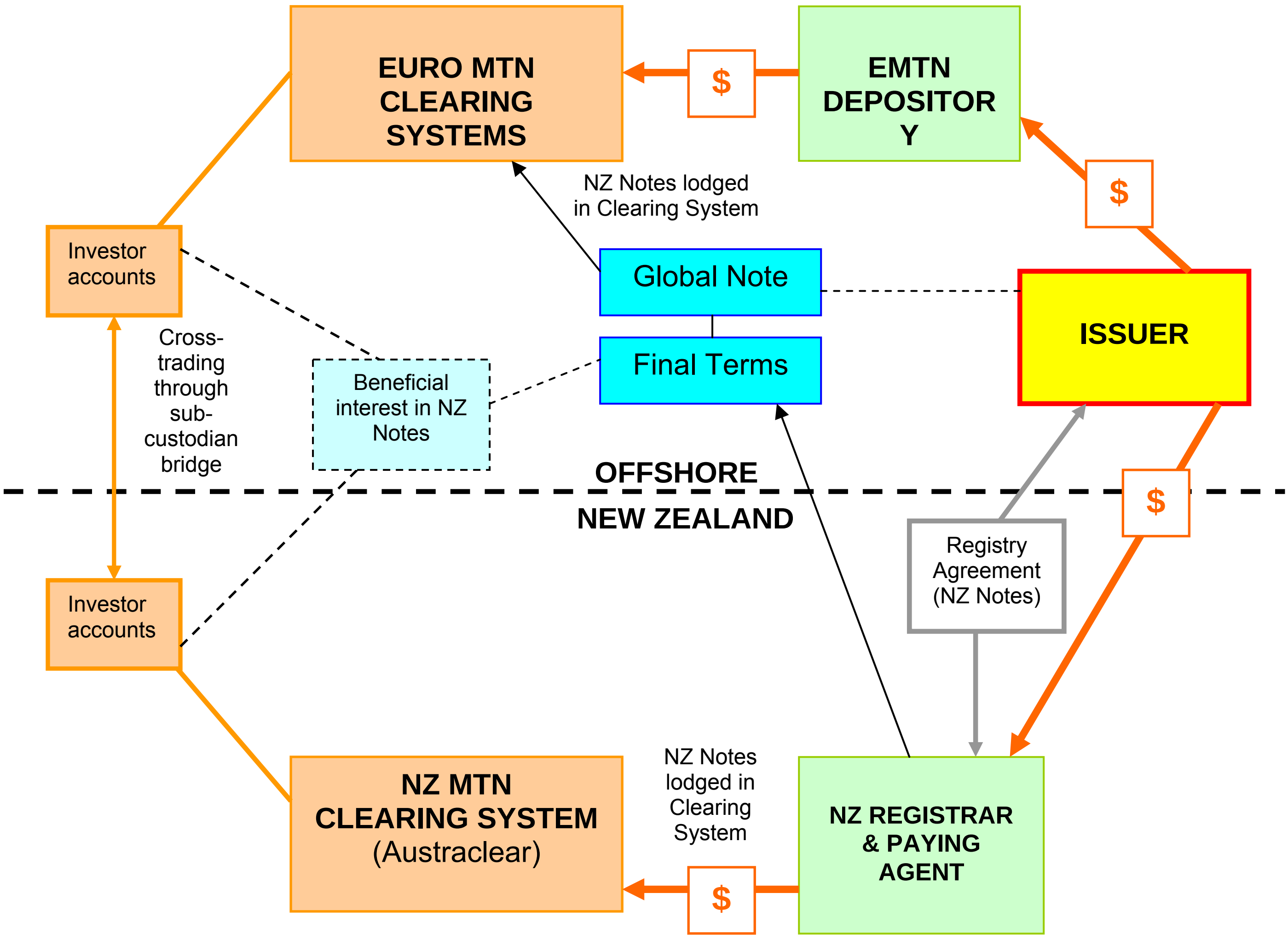
- **Pricing Supplement/Final Terms:** A pricing supplement or final terms document in the customary form, setting out the terms and conditions of the notes by way of supplementing, modifying or replacing the terms and conditions as contained in the underlying deed poll or fiscal agency agreement. This document for a Kauri bond will incorporate a "wrap" by having appended to it amending provisions or supplemental information.

- **Subscription/Terms Agreement or Dealer Accession Letter**. The lead manager(s) for the offering will become dealers-for-a-day under the programme (if they are not already programme dealers) by executing the relevant accession documentation (normally either a Subscription Agreement or a Dealer Accession Letter). The Terms or Subscription Agreement will also provide for the subscription of the bonds at the relevant all-in pricing, conditions precedent and distribution provisions, usually by reference to an underlying Programme or Dealer Agreement.

- **NZ Agency agreement:** The appointment of a New Zealand registrar and paying agent will be undertaken under an agency agreement, which is normally the only document that will be governed by New Zealand law. In addition to providing for normal roles such as keeping the register and making payments, this agreement may also provide for the New Zealand registrar to meet any other requirements in relation to the issue, such as collecting and holding U.S. tax forms, acting as the custodian for any required global note, or making floating rate or other calculations

A deal (in this case based on an EMTN programme) is structured as follows in terms of the relevant clearing arrangements:

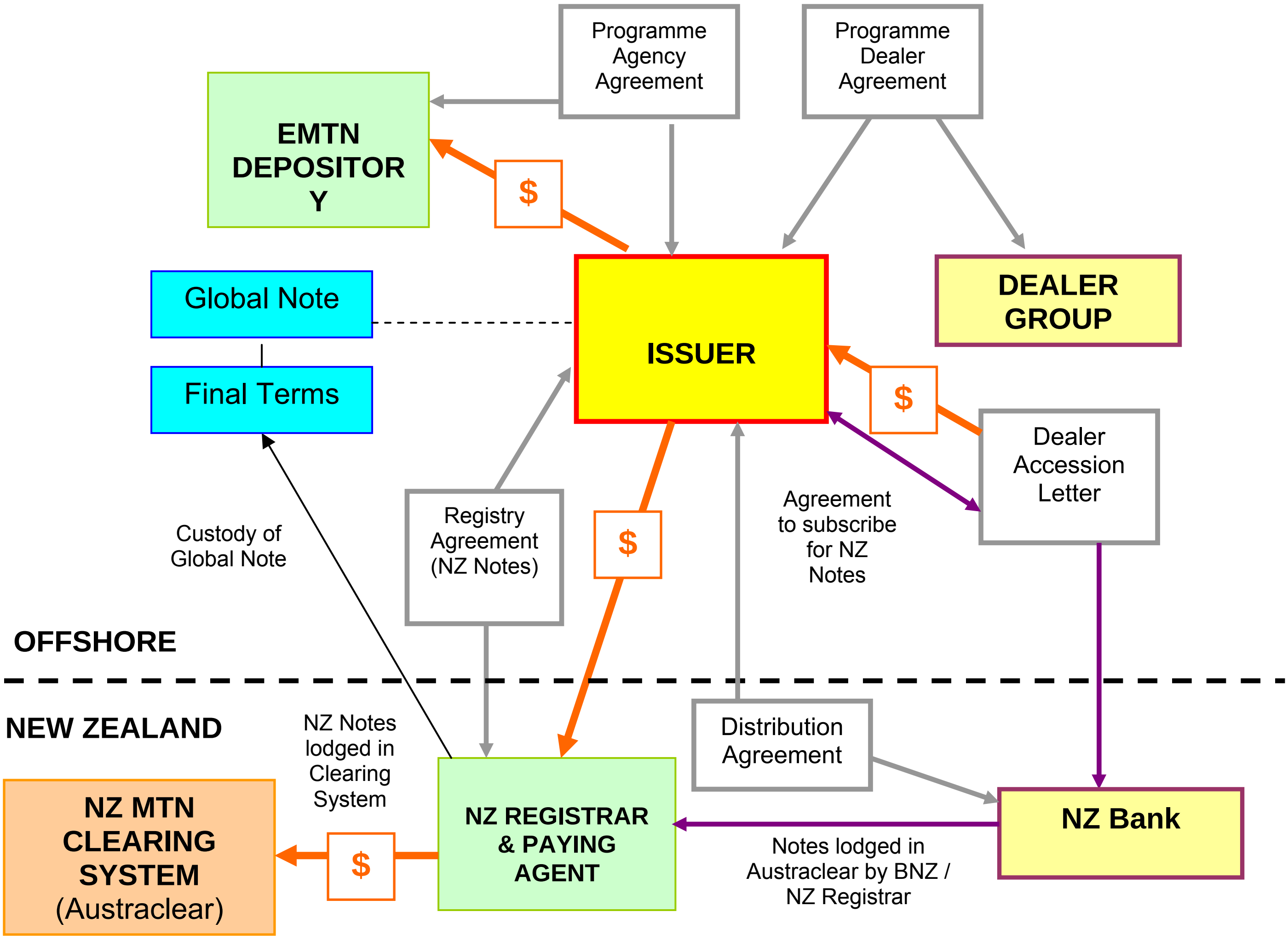
Fig. 2 - Kauri Bond clearing and settlement arrangements



In relation to the respective clearing systems, where bonds are cleared initially through Austraclear New Zealand (which is the case with Kauri bonds but not with Eurokiwis or Uridashis) there is full cross-trading available among the Austraclear, Euroclear and Clearstream systems through the sub-custodian bridge described on the left hand side of the above charts. In these cases, the trading through Euroclear and Clearstream is on the basis of the beneficial interests in the bonds held by the relevant sub-custodians in their Austraclear accounts (ANZ Nominees Limited for Clearstream and HSBC Nominees Limited for Euroclear). While the mechanics of this are quite complex, it appears to be robust, and does allow for normal DVP trading within the respective systems.

In terms of the distribution arrangements for Kauri bonds, these are as follows:

Fig. 3 - Kauri Bond distribution arrangements



Holding and trading of Notes

The usual position in the New Zealand wholesale capital markets is that notes may be held and traded through Austraclear NZ, but are not required to be — that is, the investor has a choice as to whether to hold through its own or a custodian's Austraclear NZ security account or to be recorded directly on the Register for the not (either as principal or through a custodian). This position has also been the starting point for Kauri Bond issues, but has been modified for some issues where it was stipulated that notes must be held within Austraclear NZ.

It is crucial to a Kauri bond issue that the relevant notes upon issue will be "acceptable securities" that are capable of being cleared and settled through the Austraclear NZ System. The policy of the Reserve Bank of New Zealand as operator of the Austraclear New Zealand system is that not all securities will be accepted into the Austraclear New Zealand system — the operator essentially has discretion as to which securities will be accepted as suitable.

The principal criteria considered by the operator are:

- **Registry arrangements:** A register for the Notes must be maintained in New Zealand.

- **Paying agency:** A New Zealand paying agent who is a member of Austraclear New Zealand must be appointed who undertakes to pay the beneficial holders directly in irrevocable funds through the Austraclear New Zealand system.

- **General characteristics:** The characteristics of the security must be able to be accommodated in Austraclear New Zealand. In practice this means that the New Zealand Paying Agent must be satisfied as to the compatibility of the payment mechanics on the Note with the Austraclear New Zealand system.

In common with Australia, the New Zealand capital markets employ a book entry system for both wholesale (including Kauri) and retail bond issues. Austraclear NZ is an electronic system only. It does not cater for the physical custody of, or settlement of transactions involving, paper securities (refer clause 2.1 of the Austraclear New Zealand System Rules). Lodging of securities into Austraclear NZ is effected by transfer of the securities into the name of the depository, New Zealand Central Securities Depository Limited (NZCSD), on the Register. Where there is an EMTN issue with a registered global note, this will be held by the NZ Agent as custodian for NZCSD.

Cross-trading between Austraclear, Euroclear and Clearstream

Where the securities are initially lodged in the Austraclear New Zealand system, it is possible to use the pooling accounts (via Austraclear New Zealand's sub-custodians) to have a New Zealand dollar bond that can trade and settle in both Austraclear NZ and in Euroclear and Clearstream. These trades are conducted DVP in these respective systems among the buying/selling institutional members and the relevant nominee with payments and instructions passing through SWIFT or other payment systems on an overnight basis because of the time zone differences.

There is no bridge between Austraclear NZ and the United States Depository Trust Corporation (DTC). Where Bonds are to be issued into the U.S. market under Rule 144A, these will be held through Euroclear or Clearstream by the relevant investors.

THE WIDER CONTEXT OF NEW ZEALAND DOLLAR DEBT ISSUANCE

The New Zealand domestic debt capital markets comprise only a small part of New Zealand dollar issuance. The New Zealand currency is one of the most widely issued and widely swapped currencies around the globe.

Such offshore New Zealand dollar issuance (which is often referred to collectively as the "Eurokiwi" market)[49] can be broken down more specifically by reference to the capital market into which it is issued:

- **Global Kiwi** (for bonds that are issued off U.S.-based global debt facilities providing for offering in more than one market and capable of clearance through the Depository Trust Corporation (DTC);

- **Uridashi** (and more rarely, Samurai[50]) bonds which are foreign-denominated bonds issued into the Japanese retail market; and

[49] Which is accurate since the "euro" epithet used accurately does not relate to securities issued in Europe but to any issuance of currency outside its home jurisdiction.
[50] Samurai bonds are also foreign-denominated bonds offered to Japanese retail investors but they have higher administrative costs as a result of a continuous disclosure regime and the fact that all documents

- **Eurokiwi**, which are issued into the Euro MTN market and cleared through Euroclear and Clearstream, Luxembourg.

The Kauri bond, in effect, complements or competes with these forms of issuance.

The other major New Zealand dollar market is the New Zealand government bond market, which performs an important benchmarking role in relation to other issues. The next section of this paper briefly describes these markets and the economic influence that shape (and are shaped by) them.

New Zealand government bond Market

As at 31 May 2008, there were $26.3 billion of New Zealand government bonds on issue, of which around $20 billion is available to the market.[51] However, this amount considerably overstates the amounts available to New Zealand fund managers and other local investors, as more than 70% of government bonds are currently held offshore and rarely traded.[52]

In order to create transparency and an orderly market, the New Zealand Government announces its bond programme annually in advance at the time of the Budget, and the bonds are then issued in periodic tenders organised into benchmark maturities in order to enhance liquidity. Thus, on 22 May 2008 the New Zealand Debt Management Office (NZDMO), which manages the government bond programme, announced that it intends to issue up to $3.4 billion of bonds in 2008/09, an amount which falls short of covering maturities for that period — a continuation of the gradual shrinkage of the government bond market that has been the product of consistent fiscal surpluses in recent years.

The NZDMO endeavours to maintain a relatively even maturity profile across the yield curve, but maturities and issuance of government bonds can still be lumpy. For example, on 15 July 2008 $3.8 billion of New Zealand government bonds matures, accounting for almost 15% of total government debt.

There have been persistent criticisms of the illiquidity of the New Zealand government bond market and its resulting impact on both price and benchmarking for fixed interest managers. This is despite the fact that average monthly turnover is nearly three times the amount of bonds on issue, of which around four-fifths comprises repo transactions.[53] The NZDMO has recognised this and responded by announcing in May 2008 that it will attempt to address this in part by introducing tap and reverse tap tenders. However, there is no current prospect of this market being increased to any meaningful extent (indeed, as mentioned above, it is continuing to shrink). In addition to that, daily turnover in New Zealand government bonds has been in steep decline since 2006.

Eurokiwi and Uridashi markets

As noted above, Eurokiwis are defined most broadly as New Zealand dollar bonds issued (in general) by non-New Zealand borrowers to investors offshore. In this regard, a Kauri bond offer is exactly the same, with the key distinguishing feature that it is cleared initially through the Austraclear New Zealand system.

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need to be translated into Japanese. This market has had something of a comeback recently with Westpac, ANZ and NAB undertaking issues in 2008 for a total of ¥303 billion (around A$3.3 billion).

[51] $3 billion were within the Earthquake Commission and $4.3 billion were held by the Reserve Bank (including bonds on repo as part of the Bank's liquidity management).

[52] The amount of New Zealand government bonds held offshore has fluctuated in recent times between 20% and 70% depending on economic conditions, including the level and direction of the exchange rate.

[53] John Farrell "Facing Challenges to Bond Market Development - Lessons from the New Zealand Experience" (2005) Asian Development Bank Institute.

Because it is impractical for New Zealand households to borrow offshore directly[54] and there is insufficient local saving to fund the mortgage market domestically, the Eurokiwi and Uridashi markets essentially provide an intermediation channel through which offshore investors can access the high yields available in the New Zealand market and domestic borrowers can obtain New Zealand dollar funding.[55]

Eurokiwi and Uridashi issuance fluctuates markedly in its levels from year to year. It is driven by three main factors, being the yield differential, currency level and direction, and swap spreads. Issuance is currently at very high levels, with the New Zealand dollar accounting for half of all new Uridashi issuance since the beginning of the year.[56]

Eurokiwi and Uridashi bonds usually have two- to three-year maturities, and are issued mainly by internationally known overseas institutions (such as the World Bank), and sold to overseas investors, particularly in the Benelux and Japan. At the same time, many New Zealand corporates and banks have found it more efficient to raise funds in the offshore capital markets (mainly in US dollars) — principally because offshore markets can provide greater volumes of longer-term funding than the domestic markets can — and swap these funds back into NZD.

A practical aspect of the arbitrage results from the fact that New Zealand banks (who need New Zealand dollars) have more limited access to the NZD market than do AAA rated supranational issuers such as the World Bank (who generally have little or no "natural" need for New Zealand dollar funding). Accordingly an organisation such as the World Bank can, through the swap market, raise and on-lend New Zealand dollars to a New Zealand bank, which raises and on-lends the currency required by the SSA (usually USD or Euro). As described by Kelly Eckhold:

> What is happening here is that the World Bank and the New Zealand bank each borrow in the market in which they have a **comparative** advantage, and share the net benefit. Even if, as generally will be the case, the New Zealand bank can access US dollars only at a margin above the World Bank's cost of borrowing USDs, so long as this margin is less than the advantage the World Bank enjoys in the offshore NZD market, there exists an opportunity for both to 'gain from trade'. The end result is that each ends up with the currency they need, and at a lower all-up funding cost than if they each borrowed the currencies they require directly.

Essentially the arbitrage results from the fact that the Eurokiwi market allows the issuer to separate currency risk from credit and country risk.[57] As a result, the Eurokiwi and Uridashi issues have provided New Zealand issuers with a cost-effective mechanism for converting (ie swapping, and thus hedging) their overseas borrowings into New Zealand dollars. In effect the New Zealand market has evolved to enable domestic and global participants to exploit their respective niches, which has improved the overall access to capital.

54 Although this has happened before, for example the Swiss franc loans that enjoyed a brief period of popularity in the 1980s, but ended in disaster for a lot of those borrowers as a result of adverse exchange rate movements. It is currently, also, a popular practice in Hungary, Latvia and Romania.

55 David Drage, Anella Munro and Cath Sleeman "An Update on Eurokiwi and Uridashi Bonds" (*Reserve Bank Bulletin*, Vol 68, 2005), pg 28 at 30.

56 *Kanga News* (February 2008), pg 26 and Reserve Bank *Financial Stability Report* (May 2008), pg 12.

57 David Drage, Anella Munro and Cath Sleeman "An Update on Eurokiwi and Uridashi Bonds" (*Reserve Bank Bulletin*, Vol 68, 2005), pg 28 at 31.

Backdrop of New Zealand's deficit financing requirements

New Zealand is heavily indebted.[58] The value of what we buy from the world exceeds the value of what we sell to it. As a result, we have run current account deficits extending continuously back to 1973. This shortfall has to be financed somehow and, with the fall-off in the comparatively stable funding channel of foreign direct investment, that collective shortfall is overwhelmingly funded by debt. Since 1998, New Zealand banks have taken on $73 billion in net funding from offshore markets, almost exactly matching the accumulated deficits over the same period. Our cumulative current account deficits and "dis-saving" (the Reserve Bank's term) have resulted in net international liabilities of around 80% of gross domestic product — making New Zealand one of the most indebted nations in the world on that measure.

At around 8% of GDP, New Zealand's current account deficit is also among the highest in the OECD. The public sector has been running a surplus for some years and the excess of investment over savings in the economy reflects the decisions of the private sector to borrow to finance activity or transactions. In particular, it reflects consumption decisions from the household sector and the favourite national pastime with buying and doing up houses. According to a report by the Reserve Bank:[59]

> New Zealand's dependence on international capital (both debt and equity) has increased substantially, to the point that New Zealand is more dependent on net external capital than any other developed country is currently, or probably has been at any time in recent decades. … Households' appetite for debt has been the largest single factor in our increased need for foreign capital – and, with few exceptions, households cannot directly borrow from abroad.

To reduce exposure to exchange rate risk, the Government's net foreign currency debt position was reduced to zero more than a decade ago and has been maintained at that since. Similarly a very high percentage of private sector borrowings are hedged, with the Eurokiwi market providing much of this need.

Between 1990 and 1997, offshore funding doubled, to constitute 30% of total bank borrowing. Foreign borrowing then underwent a further major expansion, reach 50% of total bank borrowing in 2000. New Zealand's reliance on foreign capital is by some margin the greatest among developed countries.[60] The fact that a substantial proportion of local banks' funding is drawn from offshore and in foreign currency, but without exposing banks for exchange rate risk, is a product of financial innovation — particularly the growth of the swap market.

On the investment side of the equation, around 50% of household funds available for investment in New Zealand are held in bank deposits, which is a high percentage by OECD comparisons. For many New Zealanders, the need to consider an investment strategy for their new Kiwisaver schemes will be their first foray into more complex financial assets. This in turn invokes one of the most significant issues facing the New Zealand savings market in general, which is the low level of financial literacy among the New Zealand public. This is a theme which is at the heart of the Government's systematic Review of Financial Products and Providers, although it has comes too late to

[58] The total value of outstanding mortgages in New Zealand reached $155 billion by December 2007, more than double the level as recently as 2002, and the ratio of household debt to income is now 160%: Bank *Financial Stability Report* (May 2008), pg 16.

[59] Ian Woolford, Michael Reddel and Sean Comber "International Capital Flows, External Debt, and New Zealand Financial Stability" (*Reserve Bank Bulletin*, Vol 64, No.4) pg 4 at pg 6.

[60] Figures as at 2001, Woolford, Reddel and Comber (*Reserve Bank Bulletin*, Vol 64, No.4) pg 4 at pg 12.

save many investors from their disastrous decisions to concentrate their savings on speculative grade debenture issuers.

How the New Zealand dollar debt markets work and why it matters

Regardless of the form that non-government New Zealand dollar debt issuance takes, it will tend to result in the following investment flows and related impacts for the various participants (and, vicariously, the New Zealand householder):[61]

- **NZ Householder** borrows a 3-year fixed rate mortgage from NZ Bank.

- **NZ Bank** borrows NZD at a fixed rate in the interest rate swap market and funds USD in the short term floating rate US inter-bank market.

- **SSA Issuer** issues fixed rate NZD bonds under a Eurokiwi or Uridashi issue and "lends" the NZD to NZ Bank via an interest rate swap in exchange for US dollars or euros at a margin to (or under) 3-month USD Libor or Euribor. The NZD interest rate swap plus the USD floating rate swap is known as a cross-currency swap.

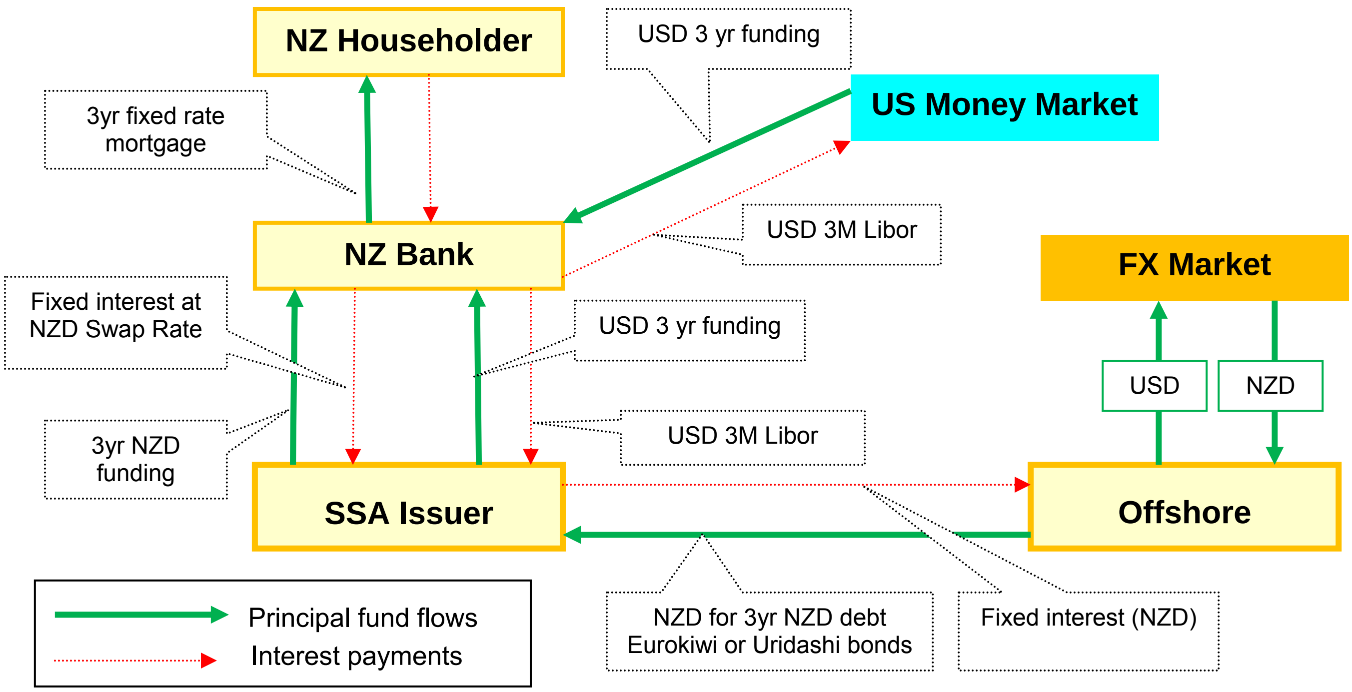
- **Offshore retail investors** (the colloquial Belgian dentists and Japanese housewives), attracted by the NZD yields and strong brand and credit of the SSA Issuer, purchase New Zealand dollars and subscribe for the Eurokiwi or Uridashi securities.

In essence, NZ Bank and SSA Issuer each borrows the currency required by the other and exchange the proceeds through a swap. The swap is a combined interest rate and currency (cross-currency) swap and involves the exchange of both funding and associated interest streams (see Figs 4 and 6).

This activity is normally organised by an international investment bank, which brings the parties together, underwrites the issue and organises the sale of the bonds in the relevant market.

[61] This discussion and the related flow charts draw heavily on an excellent article by Kelly Eckhold of the Financial Markets Depart of the Reserve Bank of New Zealand, "Developments in the Eurokiwi bond market" (*Reserve Bank Bulletin*, Vol 61, No 2), as updated by David Drage, Anella Munro and Cath Sleeman "An Update on Eurokiwi and Uridashi Bonds" (*Reserve Bank Bulletin*, Vol 68, 2005), pg 28.

Fig. 4 - Stylised Eurokiwi transaction flows



As a result of all this:

- **NZ Householder** gets a fixed rate mortgage loan at a lower rate than would be possible without the Eurokiwi market.

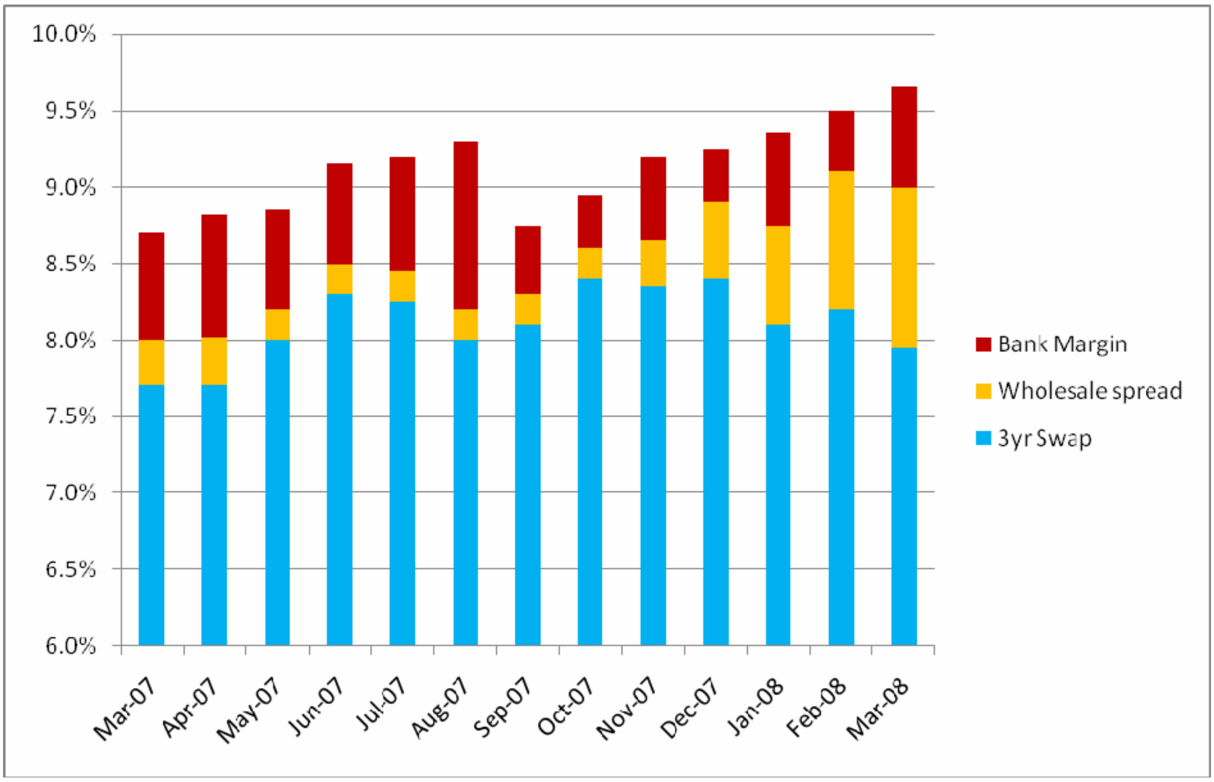
- **NZ Bank** makes a gross margin on the mortgage loan at the difference between its wholesale cost of funds (the swap rate) and the retail mortgage rate. This margin fluctuates according to competitive conditions.

- **SSA Issuer** obtains funding for its development or agency purposes in its preferred currency (USD or Euro) and at its desired cost of funds against the relevant benchmark (eg 3M USD-Libor / Euribor).

- **Offshore retail investors** gets a high-yield low risk investment and in return for this assumes the currency risk (of a depreciation in NZD such that they will obtain a lower return on exchange back into the home currency — of course the opposite is also true: if the NZD appreciates the return will be increased).

One of the prime regulatory consequences of this manner of funding New Zealand's mortgage market is that the Reserve Bank's primary tool for implementing monetary policy — changes in the Overnight Cash Rate or OCR — only have an indirect impact on key borrowing and consumption decisions. In fact, the credit crunch and the resultant blowout in wholesale interest rate spreads has had far more impact for those facing fixed rate resets, as indicated by the chart below.

Fig. 5 - Impact of wholesale interest rate spreads on mortgage rates



One impact that the firm monetary policy stance has had is that the yield curve is sharply inverse so that floating rate mortgages have generally had much higher rates than fixed rate mortgages.

Incentives for offshore investors in investing in New Zealand dollar debt

The high yields on New Zealand dollar denominated assets have made NZD investment very popular with global investors. Both the level of Eurokiwi issuance and of offshore holdings of New Zealand government bonds are closely correlated to the bond yield differential.[62]

There are two elements to the total return that an offshore investor receives from an investment in a Eurokiwi bond held to maturity:

- The yield differential between the Eurokiwi bond and other fixed income investments available to that investor.
- The movement in the value of the New Zealand dollar relative to the investor's home currency between the date of subscription and the maturity date (if the NZD depreciates, this reduces the return, and if it appreciates the total return increases).

The Reserve Bank conducted an analysis of effective returns on Eurokiwi bonds in the period from 1996 to 2005, assuming that investors exchanged Euros for NZD at the spot rate on issue and converted their returns back into Euro on maturity, again at spot.[63] On this basis, NZD/EUR exchange rate movements resulted in considerable volatility of

[62] Drage, Munro and Sleeman at pg 33.
[63] David Drage, Anella Munro and Cath Sleeman "An Update on Eurokiwi and Uridashi Bonds" (*Reserve Bank Bulletin*, Vol 68, 2005), pg 28 at 34.

returns (-5% to 24%) and the average return of 4.11% was only marginally higher than German bonds for the period. However, the Reserve Bank itself noted that the sample period is brief and their analysis does not take account of the fact that (for example) the investors could have hedged the currency by purchasing NZD at a forward rate. In addition, there are other ways to deal with long positions in depreciated currencies, such as ski holidays and coastal real estate.

Partly as a result of increasing monetary policy divergence, the current differentials between New Zealand and other countries is very significant. For example, the spread between the New Zealand Overnight Cash Rate and the US Fed Funds Rate is the highest it has been since OCR was introduced in 1999.[64] In part it is a product of very strong credit growth (approximately 15% year-on-year), which drives up interest rates directly through demand and supply mechanics and indirectly through putting pressure on inflation which in turn leads to tighter monetary policy.[65]

Of course it is impossible for an offshore investor (or anyone else) to know with certainty at the time of subscription what direction the currency is going to travel in over the term of the relevant bonds. (This may be more easy in other jurisdictions which have a pegged or otherwise managed exchange rate — a factor that encourages participation in the "carry trade".)

Relationship between the swap (wholesale funding) and Eurokiwi markets

The growth in fixed rate mortgage lending thus has given rise to an increased fixed rate NZD funding requirement for the New Zealand banking sector and has fuelled an expansion in the interest rate swaps market (which in essence is a wholesale market for borrowing and lending at fixed rates).

The swap spread provides an indication of the funding advantage of the Eurokiwi market. A widening of these spreads makes offering of Eurokiwi bonds more attractive to issuers because it indicates a wider margin between their cost of borrower (from offshore retail investors) and on-lending, via a cross-currency swap, with a New Zealand bank. From the perspective of investors, a wider margin can also be appealing because it gives rise to a potential increase in the value of the bonds if the swap spreads contract.[66] Accordingly, Eurokiwi, Uridashi and Kauri bond issuance tends to increase as the swap spreads widen.

In addition, the Eurokiwi markets assist the New Zealand banking sector in resolving potential maturity mismatches that could result from the significant demand for fixed rate mortgages (which demand itself is partly a result of the inverse yield curve). By swapping the NZ Bank's short term foreign currency and floating obligations for longer term New Zealand dollar funding and fixed interest rate obligations, the banks are better able to manage interest rate risk.[67]

Basis swaps

Basis swaps are an important factor in Kauri bond issuance because SSA issuers in particular are driven by funding targets such that (as is usually the case) where the basis swap is positive this improves the yield that can be provided to investors while enabling

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[64] Reserve Bank *Financial Stability Report* (May 2008), pg 11.

[65] David Drage, Anella Munro and Cath Sleeman "An Update on Eurokiwi and Uridashi Bonds" (*Reserve Bank Bulletin*, Vol 68, 2005), pg 28 at 29-30.

[66] Kelly Eckhold "Developments in the Eurokiwi bond market" (*Reserve Bank Bulletin*, Vol 61, No 2), pg 100 at pg 104; see also David Drage, Anella Munro and Cath Sleeman "An Update on Eurokiwi and Uridashi Bonds" (*Reserve Bank Bulletin*, Vol 68, 2005), pg 28 at 30.

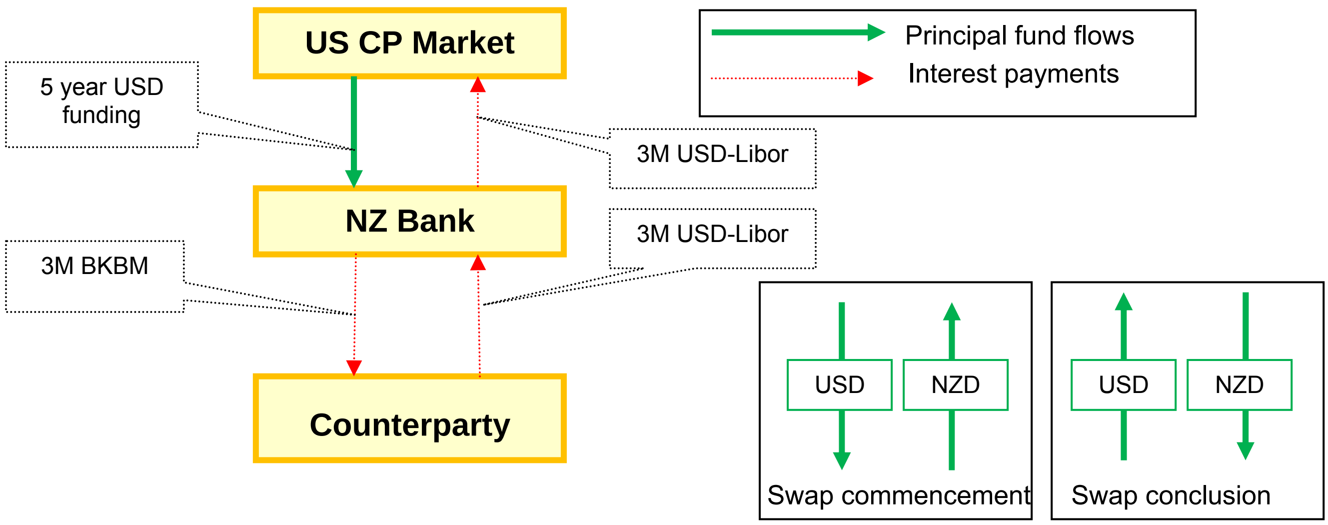
[67] David Drage, Anella Munro and Cath Sleeman "An Update on Eurokiwi and Uridashi Bonds" (*Reserve Bank Bulletin*, Vol 68, 2005), pg 28 at 32.

the issuers to meet their USD-Libor or Euribor funding targets. The reason the basis swap is normally positive (typically between around 5 to 8 basis points) is that, particularly in the two to three year part of the curve, the weight of Uridashi, Eurokiwi and Kauri issuance offsets domestic bank and corporate offshore funding.[68]

A basis swap is floating-floating interest rate swap, ie a swap which involves the exchange of two floating rate instruments denominated in the same or different currencies. Essentially this form of basis swap exchanges one reference rate for another.[69] A basis swap is generally entered into in order to limit the interest rate risk that arises from having differing lending and borrowing rates. For example, if a bank lends at a floating rate that is tied to LIBOR but borrows money based on the New Zealand bank bill rate (BKBM), the difference between these borrowing and lending rates (the spread) leads to interest rate risk which can be eliminated by into a BKBM-for-LIBOR basis swap.

In this context, basis swaps are significant in that they facilitate New Zealand banks' avoidance of the exchange rate risk they would otherwise have on their foreign currency liabilities:

Fig. 6 - Basis swap cash flows



Here, NZ Bank is seeking to fund NZD floating assets, for example loans to New Zealand corporate borrowers with interest payable at the prevailing New Zealand bank bill rate. It does this by borrowing term debt in the US or Euro markets at the relevant floating rate prevailing in those markets (3-month USD-Libor in the US example used here or Euribor in the Euromarket). This achieves the required funding and the remainder of the steps in the basis swap involve avoiding foreign exchange and basis risk.

NZ Bank "lends" its US dollars or Euros to the Swap Counterparty by way of an initial exchange of the notional amounts respectively of USD/EUR for NZD at the pre-determined exchange rate. NZ Bank pays 3-month BKBM + the basis swap premium and receives 3-month USD-Libor or Euribor (as applicable). Thus NZ Bank has:

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68 "Watching the Basis Swap" *Kanga News* (April 2008), pg 12.

69 This is not their only use, for example they can also be used to change exposures to different points on the yield curve (eg swap 3-month USD Libor for 6-month USD Libor).

- swapped the currency of its funding (it receives New Zealand dollars in the initial exchange and pays New Zealand dollars in the final exchange at the pre-agreed exchange rate); and

- swapped the reference rate basis for its funding from USD-Libor / Euribor to BKBM (hence "basis swap"), in order to match the basis for its assets (in the form of loans to New Zealand corporates).

NZ Bank benefits by funding its borrowings without exchange or basis risk and the Swap Counterparty benefits by achieving a higher interest rate than they would otherwise on their New Zealand dollars by virtue of the basis swap premium.

Size of the Eurokiwi market

The amount of annual Eurokiwi issuance varies considerably depending on economic conditions affecting the flow of international capital. Since the market began in the mid-1980s, issuance in any one year can vary from almost nil during trough times (for example 1994 and 1995) to tens of billions.[70] Eurokiwi and Uridashi instruments reached peaks in 1985 to 1987 (peaking at around $10 billion total outstandings), 1996 to 2000 (peaking at around $20 billion total outstandings), and 2004 to 2008 (peaking recently at around $57 billion total outstandings and currently just over $50 billion). In that latter period, Kauri bonds have also come into the mix and, if added to the other international NZD issuance, bring the overall market to $59 billion, almost 500% growth in the six years since the last trough in the market.

This, of course, all makes for some very large maturities coming up over the next five years, for example almost $5 billion in one month alone in 2009, something that has periodically caused consternation in the past but did not in those cases cause any material dislocation in the interest or exchange rate markets.

Economic causes and effects of the Eurokiwi market

The relationship of this market to the housing boom / bubble in New Zealand is dramatic. The total outstanding issuance of New Zealand dollar debt in offshore markets (including Kauri bonds) almost exactly tracks the surge in the New Zealand median house price from the late 1990s to the present, raising interesting questions about cause and effect.[71]

New Zealand dollar issuance internationally is heavily influenced by the high demand for credit in New Zealand, which pushes up interest rates and for the substantial interest rate differential between New Zealand and other countries (especially Europe and Asia, though more recently the United States too as a result of their post-credit crunch monetary policy easing).

Investors in low interest rate markets tend to look for higher yielding investments. This demand for New Zealand dollar debt creates the potential for borrowers to borrow New Zealand dollars more cheaply than if they were constrained to the New Zealand market alone, as the foreign investors effectively expand the supply of New Zealand dollar funding available.[72] There is little "natural" demand for New Zealand dollar assets internationally, so the main reason for continued demand for them is the relatively high yields offered on those assets in comparison to other developed countries.

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[70] Kelly Eckhold "Developments in the Eurokiwi bond market" (*Reserve Bank Bulletin*, Vol 61, No 2).
[71] OECD Survey "Deepening Financial Markets", April 2007, pg 87.
[72] Simon Tyler "The New Zealand Corporate Bond Market" (BIS Papers, No 26, 2005), pg 129 at pg 134, Kelly Eckhold "Developments in the Eurokiwi bond market" (*Reserve Bank Bulletin*, Vol 61, No 2).

This reliance on international capital raises questions about what the impact would be if offshore appetite for NZ dollar investments were to suddenly dissipate — a question that is periodically raised as we approach major maturities in the Eurokiwi and Uridashi markets.

There are a number of reasons in theory that this could occur, including:[73]

- A decline in terms of economic fundamentals (for example as the result of a significant change in monetary or wider economic policy or a sustained recession adversely impacting on the quality of bank assets and corporate balance sheets generally).

- A significant exchange rate depreciation resulting in investors in existing Eurokiwi issues experiencing disappointing returns (this factor has caused a dampening of the market following past periods of NZD depreciation).

- A sharp increase in risk aversion with respect to peripheral indebted countries, particularly those with large current account deficits.

- A reduction in the differential between interest rates in New Zealand and overseas, for example resulting from easing monetary policy in New Zealand at the same time as tightening in other countries (currently the opposite is true).

- A general retreat in cross-border capital flows for whatever reason.

This vulnerability is a matter of concern for New Zealand because of the degree of reliance on international debt capital markets and the relatively sharp increase in that reliance over a short period. However, the experience of the past has demonstrated that the invisible hand is working well as such changes have tended to take place in a measured and orderly fashion, permitting smooth adjustments to the new conditions. The Reserve Bank certainly has not been alarmist on such issues:[74]

> It is perhaps worth stressing that, since capital account liberalisation 17 years ago, the increasingly large external financing requirement has been met remarkably smoothly, and in a series of different forms, through a variety of international crises and changing domestic economic conditions.

In summary, the Reserve Bank notes that this vulnerability highlights the continued need for a stable and transparent macro-economic framework and strong risk management among New Zealand's banking and corporate sectors.

Macro-economic impacts of Eurokiwi issuance

Eurokiwi issuance has macro-economic impacts on New Zealand interest rates, the exchange rate and the current account. In terms of capital flows, Eurokiwi issuance is treated analytically as a hedge rather than as a capital inflow. Thus, offshore bond issues do not increase the current account deficit directly, but they do increase the available supply of credit and let the demand and supply of credit clear at a lower interest rate, implying a higher level of borrowing and spending by New Zealanders than would otherwise be the case.[75]

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[73] Ian Woolford, Michael Reddel and Sean Comber "International Capital Flows, External Debt, and New Zealand Financial Stability" (*Reserve Bank Bulletin*, Vol 64, No.4) pg 4 at pg 15 and Kelly Eckhold (*Reserve Bank Bulletin*, Vol 61, No 2) pg 100 at 109.
[74] Woolford, Reddell and Comber, at pg 14.
[75] Drage, Munro and Sleeman at pg 35.

All other things being equal, a rise in demand for borrowing should require an increase in interest rates to entice investors to supply the marginal credit demand. The existence of the Eurokiwi market operates to reduce overall interest rates on the supply side of the equation by expanding the pool of investors in New Zealand dollar assets. Essentially Eurokiwi and Uridashi issuance are a means of providing an exposure to New Zealand dollars for offshore retail investors who would otherwise have no easy way of doing so.[76] This provides another means for New Zealand banks to hedge their substantial foreign currency borrowings.

Another macro-economic impact of the Eurokiwi market is on exchange rates. Because Eurokiwi and Uridashi issues expand the demand for New Zealand dollars (which the investors have to acquire in order to subscribe for those bonds), this tends to apply upward pressure on the New Zealand exchange rate.[77]

Conventional economic theory suggests that the currencies of economies with large current account deficits should depreciate relative to those of countries with surpluses. However, recent experience has been the exact opposite. For example, despite a current account surplus of 4.9% of GDP, Japan's trade-weighted exchange rate depreciated 13% between 2002 and 2007. In the same period, New Zealand, with a current account deficit of 8% of GDP, experienced a 28% gain in the trade-weighted value of the New Zealand dollar over the same period.[78]

The reasons for this include the "carry trade", where hedge funds and other investors borrow cheaply in Yen (for example) and invest in high-yielding currencies such as the New Zealand dollar, and the continued popularity of Eurokiwis and Uridashis, which involve the purchase of New Zealand dollars. Notably, however, the volume of selling Yen to buy overseas currencies for Uridashi and similar issuance far exceeds the flows relating to the carry trade (¥30 trillion versus ¥10 trillion).[79]

This phenomenon, however, appears to be on the wane, as the carry trade is being unwound and "surplus country" currencies such as the Yen and Swiss franc have been appreciating while deficit country currencies (including the New Zealand dollar) are losing ground. It is difficult to predict whether this will have a dislocative effect, however, as there are a large number of factors in play. In relation to the Uridashi market, for example, Japanese interest rates are still only around half to 1 per cent and, despite the size of the Uridashi market, it represents only about 1% of Japanese financial assets.[80] The current experience is that Uridashi issuance is ongoing even though the carry trade is being unwound and the Yen is appreciating.

EXEMPTIONS — BY CLASS AND ISSUER-SPECIFIC

There is a process under which the Securities Commission can (and regularly does) grant to particular issuers or kinds of issuers exemptions from various aspects of the Securities Act. Exemptions may be of a class nature or may be specific to the issuer.

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[76] Refer Woolford, Reddell and Comber, cited previously.

[77] International trade for goods and services accounts for less than 2% of foreign exchange turnover: Anella Munro "What Drives the New Zealand Dollar" *Reserve Bank Bulletin* Vol 67, No. 2, pg 21 at 22.

[78] "The Domino Effect" *The Economist* 5 July 2008, pg 82. See generally Anella Munro "What Drives the New Zealand Dollar" *Reserve Bank Bulletin* Vol 67, No. 2, pg 21.

[79] Peter Garnham, Gillian Tett and David Turner "Carried Away: Why the Yen Borrowing Game Could End in Players Taking a Tumble" *Financial Times* (London, 15 February 2007).

[80] Peter Alford "Cash-rich Japanese Funds Eying Australia as Investment Destination" *The Australian*, 26 March 2008. Japanese household financial assets currently stand at ¥1,545 trillion, or US$14.7 trillion.

The basis for these exemptions is section 5(5) of the Securities Act, which confers upon the Securities Commission the power to exempt any person or class of persons or any transaction or class of transactions from any provisions of Part 2 of the Securities Act (which contains the substantive disclosure and other obligations for retail securities offerings) or from the Securities Regulations. This power is at the Commission's discretion and may be granted subject to such terms and conditions as it sees fit.

Class exemptions relevant to overseas issuers

Examples of class exemption notices that may be applicable to international securities offerings are the Overseas Companies, Overseas Listed Issues, Australian Issuers and Australian Registered Management Schemes (ARMIS) Exemption Notices. These class exemption notices, however, have requirements or conditions attaching to them that can restrict their application in particular cases. For example, they may be restricted to offers made only to existing holders of listed securities on specified exchanges, or the securities at the relevant time are also open for acceptance in the relevant overseas country.

In addition, Part 5 of the Securities Act provides a statutory basis for "recognition regimes", whereby (where relevant empowering regulations have been promulgated) issuers can offer securities in New Zealand in accordance with the securities laws of their home country. This Part was enacted in 2002 and has been inactive until this year, when regulations were put forward for a debut recognition regime allowing simultaneous New Zealand and Australian offers under Australian offering documents (discussed below under "Trans-Tasman Mutual Recognition Regime").

Specific exemptions

In relation to specific offerings, the requirements in relation to obtaining exemptions are published by the Securities Commission, to whom essentially a case needs to be made that the requested exemption is appropriate. In practice, it is very useful to have a precedent exemption notice from a similar situation that can be adapted. A case will also need to be made for the exemption in policy terms, generally on the basis that compliance would be disproportionately costly for the issuer and that the interests of investors may be served by other means, for example by making available financial or other disclosures from the issuer's home jurisdiction.

For the reasons previously given, exemptions from the requirements for prospectuses and as to audit and other financial requirements are often requested. The following are some of the provisions of Part 2 of the Securities Act and the Securities Regulations which are commonly the subject of exemptions:

- **Section 33(2)**: No debt security can be offered unless a New Zealand trustee has been appointed and a complying trust deed has been entered into and registered.

- **Section 37**: No allotment of a security can be made unless a prospectus has been prepared and registered in relation to the security. (There are also requirements as to minimum subscriptions etc.)

- **Section 37A**: No allotment of a security can be made if the subscriber did not receive an investment statement before subscribing (subsection (1)(a)), the date of allotment restrictions are breached or the total issue exceeds any specified maximum amount.

- **Section 38**: Meaning of authorised investment (generally an investment statement or an advertisement that refers to an investment statement).

- **Sections 51-54**: Miscellaneous obligations of issuers, including in relation to the keeping of a register of securities and proper accounting records and issuing of security certificates.

- **Section 53E**: Requirement for an annual audit of accounts by a "qualified auditor".

- **Section 54B**: Requirements for information that must be disclosed to investors on request.

- **Regulation 17**: Requirements for signing of certificates in relation to advertisements.

Conversely, it is regularly the case that general exemptions will be subject to the continued application of one of more of the following: **section 38B** (relating to misleading advertisements), **section 58** (criminal liability for untrue statements in an advertisement or prospectus), and **regulation 8**, which prohibits misleading information in an advertisement.

Financial Reporting Act

A separate process is in place for requirements under the Financial Reporting Act 1993, most particularly from the requirement to produce separate financial statements compliance with New Zealand IFRS and audited in New Zealand. This exemption is also to be obtained from the Securities Commission, and would permit the issuer to file its annual accounts that conform to either US GAAP or IFRS in place of NZ GAAP-compliant annual audited accounts otherwise required to be filed annually pursuant to the Financial Reporting Act. It is often filed in tandem with any exemption that may need to be sought under the Securities Act.

Using the powers in section 35A of the Financial Reporting Act, the Commission has granted a class exemption to issuers relying on the Securities Act (Overseas Companies) Exemption Notice 2002 and its precursors. Accordingly, pursuant to the Financial Reporting Act (Overseas Companies) Exemption Notice 2007 issuers can register audited financial statements that comply with their home country's laws and public filing requirements provided that the GAAP in relation to those accounts is either US GAAP or EU-IFRS.

Process and timing for exemptions

Exemptions to be obtained from the Securities Act through the Securities Commission generally take between four and six weeks; however, in exceptional circumstances this time may be reduced. Equally, if the proposed exemption notice is novel or raises material policy issues, the process can take a lot longer. (It is for this reason that it is prudent not to ask for too much and to carefully couch the exemption application in conventional policy terms.) There is no immediate time pressure regarding a Financial Reporting Act exemption as the requirement to report does not begin until five months after the close of the first financial year post issue; however, as noted above it is useful to file this in tandem with the Securities Act exemption and the issuer will generally wish to be sure of the position before offering.

Where listing is sought for a retail offer, NZX will review all offer documentation and process any exemption applications within ten business days. However, an issue may also be dealt with urgently.

TRANS-TASMAN MUTUAL RECOGNITION REGIME

Trans-Tasman harmonisation of securities offerings has long been on the agenda for ministerial and official working groups. These efforts at last have borne fruit with the joint announcement on 13 June 2008 by ASIC and the Securities Commission of a new regime for Trans-Tasman securities offerings.

Background

In February 2006, the governments of Australia and New Zealand signed a treaty entitled "Agreement between the Government of Australia and the Government of New Zealand in relation to the Mutual Recognition of Securities Offerings". The intent of the treaty is to establish a regime that will enable an issuer in either Australia or New Zealand to extend an offer of securities lawfully made in that country to investors in the other country, without that issuer being required to comply with most of the substantive requirements of the other country's securities laws.

The establishment of such a regime required legislation or regulations on both sides of the Tasman. These have now been enacted under the Securities (Mutual Recognition of Securities Offerings - Australia) Regulations 2006 ("**Mutual Recognition Regulations**") in New Zealand and the Corporations Amendment Regulations 2008 (No 2) in Australia.

As noted previously, Part 5 of the Securities Act permits "recognition regimes" to be implemented, which may themselves grant exemptions from the requirements of the Securities Act and Regulations. Under a recognition regime, issuers from a designated country can offer securities in New Zealand in accordance with the securities laws of that designated country.

The Mutual Recognition Regulations implement the treaty between New Zealand and Australia by creating a recognition regime for Australia under Part 5 of the Securities Act. Australian issuers will therefore be able to make offers in New Zealand in accordance with Australian law and pursuant to their Australian offer documents. No New Zealand prospectus or investment statement will be required, but certain procedural steps must be taken. This should result in a substantial reduction in costs for Australian issuers in extending offers to New Zealand.

The Mutual Recognition Regulations

The Mutual Recognition Regulations will apply to an offer of securities made in New Zealand by an "Australian offeror", being an offeror who:

(a) if a natural person, is resident in Australia; or

(b) if not a natural person, is incorporated or established under Australian law or registered as an overseas company under Australian law.

A "security" means any of the following:

(a) an equity or debt security;

(b) an interest in a "collective investment scheme" (including a managed investment scheme as defined in section 9 of the Corporations Act 2001 (Cth)); and

(c) any interest in, or any option to acquire, any of the securities in (a) or (b).

Entry requirements for issuers under the new regulations

A number of entry requirements will need to be met by an Australian issuer. These are set out below. However, an Australian issuer will not be able to utilise the Mutual Recognition Regulations if:

(a) the issuer, or an associated person of the issuer, has, in relation to any previous offering of securities in New Zealand in reliance on the Mutual Recognition Regulations, breached the ongoing requirements of those regulations for that offer (described below); and

(b) the Commission has given notice to that issuer that it must not make further offers to the New Zealand public in reliance on the Mutual Recognition Regulations.

The Mutual Recognition Regulations provide for the following entry requirements:

(a) The issuer must be entitled to offer securities to the public under Australian law. For example, this would mean that all offer documents required to be filed with ASIC must have been filed and any “waiting period” following such filing must have expired.

(b) The offer must be one in respect of which a product disclosure statement (PDS) or similar offer document is required under Australian law;

(c) The issuer must, before making the offer in New Zealand, give notice to the New Zealand Registrar of Companies. The notice must:

    (i) state that the issuer intends to make an offer in accordance with the Mutual Recognition Regulations;

    (ii) specify the name of the issuer and the securities to be offered;

    (iii) specify the period in which it is proposed to offer the securities in Australia and New Zealand;

    (iv) state the name and address of a New Zealand process agent;

    (v) state that the issuer submits to the jurisdiction of the courts of New Zealand;

    (vi) be signed by a person with authority to act on the issuer’s behalf;

    (vii) be accompanied by the following documents:

        (aa) the offer documents (as filed with the Australian regulator if filing is required);

        (bb) a copy of any exemption relevant to the offer granted by the Australian regulator that is specific to the offer or the issuer;

        (cc) particulars of any general exemptions relevant to the offer granted by the Australian regulator;

        (dd) the constitutional documents of the issuer or the securities offered.

The offer document is also required to include a warning statement as set out below:

> "This offer is made in both Australia and New Zealand and is regulated under the securities legislation of Australia. The securities legislation of New Zealand does not generally apply to the offer made in New Zealand. However, sections 35 (restrictions on door to door sales), 38B (prohibition of advertisements), and 58 (criminal liability for misstatement in advertisement or registered prospectus) of the Securities Act 1978 do apply to the offer made in New Zealand.
>
> Under the agreement between Australia and New Zealand in relation to mutual recognition of securities offerings, both the New Zealand Securities Commission and the Australian Securities and Investments Commission (ASIC) have enforcement responsibilities relating to this offer. In the first instance, you should make any complaint to the New Zealand Securities Commission who will pass on your complaint to ASIC if necessary. New Zealand investors should satisfy themselves as to the tax implications of investing in these securities and should be aware that investing in Australian securities may involve a currency exchange risk."

If the Commission is satisfied that a failure to meet any of the notice requirements of (c) is technical and minor only, it may declare in writing that such breach is non-material. The effect of that declaration is that the offeror is deemed to have complied with that requirement.

If an Australian issuer does not comply with any of the entry requirements referred to above, it will be unable to rely upon the Mutual Recognition Regulations. Any offer of securities by that issuer to the public in New Zealand would therefore need to fully comply with the substantive New Zealand securities laws.

Exemptions under the new regulations

Under the Mutual Recognition Regulations, the offer of securities in New Zealand would be exempt from all requirements of the Act and Regulations (including the requirement to prepare a New Zealand prospectus and investment statement), except for sections 35, 38B and 58 of the Securities Act, which provide as follows (in summary):

- **Section 35** prohibits persons going from house to house offering securities to members of the public in New Zealand.

- **Section 38B**, in effect, imposes an obligation on an issuer to ensure that any advertisement relating to an offer is not likely to deceive, mislead or confuse, and complies with the Securities Act and Regulations. If the Securities Commission is of the opinion that an advertisement does not meet those requirements it may make an order prohibiting the distribution of that advertisement.

- **Section 58** imposes criminal liability for untrue statements in an advertisement. Where an advertisement is distributed that contains an untrue statement, criminal liability is imposed on the issuer (if an individual), or (otherwise) every director of the issuer at the time the advertisement is distributed. Persons committing an offence in breach of section 58 are liable to imprisonment of up to five years, or a fine of up to $300,000, and if the offence is continuing, a further fine of up to $10,000 for every day or part day the offence continues.

As a result of the latter two provisions, there would need to be some element of local due diligence and preferably a legal sign-off in relation to securities law compliance of the offering documents and any relevant advertisements.

Ongoing requirements for issuers under the new regulations

Once the entry requirements of the Mutual Recognition Regulations have been met (in relation to any offer of securities), a number of ongoing obligations must continue to be met by the issuer of those securities. Those ongoing requirements are:

(a) The offer must be open for acceptance in Australia at all times when it is open for acceptance in New Zealand.

(b) The offer must remain an offer in respect of which a PDS or similar offer document is required under Australian legislation at all times when open for acceptance in New Zealand, and must comply with Australian legislation.

(c) The offer documents for the offer must be accompanied by a "warning statement", in the form set out above. That "warning statement" could be contained in the offer document, or set out in a document that accompanies the offer document, such that when the offer document is distributed, the "warning statement" is also distributed.

(d) The issuer must:

 (i) provide an investor, upon request, with copies of the relevant constitutional documents of the issuer or the securities; and

 (ii) ensure that any person prohibited by New Zealand legislation from being concerned in the management of a company in New Zealand, is not concerned in the management of the issuer.

There are also event-based filing requirements if any of the following occur:

- Change made to an offer document or any other document required by the law of Australia in relation to the offer.
- A change in issuer's address for service.
- A supplementary or replacement offer document is required by the law of Australia.
- A change made to a relevant constitutional document in respect of the issuer or the securities offered.
- An Australian regulator grants, amends, or revokes a general exemption relevant to the offer.
- An Australian regulator grants, amends, or revokes an exemption relevant to the offer that is specific to the offer or the issuer.
- An Australian regulator begins an enforcement action, or exercises a power it has under law, in relation to the offer or the issuer.

It is apparent from this list that the ongoing requirements are mild and certainly fall well short of being a continuous disclosure regime of any description (this would apply separately under the NZX Listing Rules if the securities were listed). One matter that is not clear is what if any exemptions will be available on a class basis under the Financial Reporting Act. This does not seem to be contemplated in that Act itself and is not covered by the Financial Reporting Act (Overseas Companies) Exemption Notice 2007 described previously. In the absence of an exemption, Australian issuers would face the prospect of needing to prepare and file annual financial statements under NZ GAAP (NZ-IFRS).

Consequences of breach of ongoing requirements

A breach of any of the ongoing requirements set out above will not invalidate the exemptions granted by the Mutual Recognition Regulations. Accordingly, the Australian issuer would still have the benefit of those exemptions.

However, under section 76 of the Act, if there is a contravention of the ongoing requirements of the Mutual Recognition Regulations, a criminal offence is committed by the following persons:

(a) the issuer; and

(b) every principal officer of the issuer at the time of the contravention; and

(c) every promoter of the security; and

(d) every person who authorised himself or herself to be named (and is named) in any advertisement relating to that security as a director of the issuer (or as having agreed to become a director).

A person who commits such a criminal offence is liable to a fine not exceeding $300,000, and if the offence is continuing, a further fine of up to $10,000 for every day or part day the offence continues.

LIABILITY AND RISK MANAGEMENT ISSUES

Liability issues have a particular significance in relation to international offerings because of the unfamiliarity the issuers, and their directors and executives, will have with New Zealand's securities laws. This is exacerbated by the peculiarities of the New Zealand regime, with its strict liability regime and potential criminal penalties and lack of a formal due diligence defence. It also has practical difficulties for any large multi-national enterprise, in which the directors on whom liability may be imposed will have delegated all aspects of compliance in connection with funding operations and who as a result will have very limited direct knowledge of the details of individual offerings around the world.

Criminal and civil liability under the Securities Act

Section 56(1) specifies who may be liable for a "pecuniary penalty order" under section 55C of the Securities Act, and for compensation under section 55G, for distribution of an advertisement or registered prospectus that includes an untrue statement. As previously mentioned, "untrue" in this context is defined by section 55 of the Act to include any statement that is "misleading in the form and context in which it is included", including by omission of a material particular. Those who may be liable include:

- the issuer itself;
- for advertisements, directors of the issuer at the time of distribution;
- for a prospectus, anyone who has signed, or authorised signature, of the prospectus as a director; and
- promoters and their directors.

Distribution of an advertisement or a registered prospectus that includes an untrue statement is also a "civil liability event" under section 55B of the Securities Act, giving rise to the following potential civil remedies:

- a pecuniary penalty order and declaration of civil liability (on application by the Commission only) under section 55C of the Securities Act; and
- compensation under section 55G of the Securities Act.

Pecuniary penalty orders

If the Securities Commission applies for a pecuniary penalty order under section 55C, the Court is required to decide whether a "civil liability event" has occurred, and whether the person against whom the order is sought is liable under sections 56 through 57A.

If the Court concludes that both those tests have been met, it must make a declaration of civil liability. It may additionally order a pecuniary penalty be paid to the Crown if the civil liability event:

(a) materially prejudices subscribers for the securities;

(b) is likely to materially damage the integrity or reputation of any of New Zealand's securities markets; or

(c) is otherwise serious.

The maximum amount of pecuniary penalty under the Securities Act is $500,000 for an individual, and $5,000,000 for a body corporate. The Court is required to take into account the following matters when setting pecuniary penalties:

(a) nature and extent of the civil liability event;

(b) likelihood, nature and extent of any resultant damage to the integrity or reputation of New Zealand's securities markets;

(c) nature and extent of resultant loss or damage suffered by subscribers;

(d) surrounding circumstances; and

(e) court findings under the Act on previous conduct.

This new regime, which is a hybrid of criminal and civil law, is part of an emerging trend to have regulatory regimes enforced by civil penalties and thus avoid the cost of prosecution resources and the process of criminal sanctions.[81]

[81] Simon Haines " Civil Penalties - Compliance at a Cost" *NZ Lawyer* (16 May 2008), pg 12).

Compensation orders

Section 55G(1) provides for compensation to be payable to securities subscribers who have suffered loss or damage by reason of an untrue statement in an advertisement (which includes an investment statement) or a registered prospectus (together "**offering documents**"). Subscribers must have subscribed for the securities "on the faith of" the offering document that included the untrue statement. Application for compensation may be made by the Securities Commission or by subscribers. A person bringing a compensation proceeding can rely on a declaration of civil liability as conclusive evidence of a civil liability event without further evidence.

Section 55G(1) contains two basic elements — reliance and causation. To be entitled to compensation an investor must have subscribed for securities on the faith of an offering document which included an untrue statement and sustained loss or damage by reason of the untrue statement.

Section 55G(1) does not require that faith be placed on the untrue statement or misstatement itself but merely on the relevant offering document. The concept of "faith" is not defined in the Act but seems to be equivalent to reliance.[82] The investor must show that he or she received or saw the offering document before subscribing (noting in this regard that each investor must receive the investment statement before subscribing and that, for this reason, the application form for retail securities is almost invariably attached to the investment statement). Liability is determined at the date the investor subscribes for the securities.

The plaintiff must show that the misstatement caused loss or damage. In most circumstances this would equate to any reduction in the market value of the securities in question plus associated costs of enforcement.

Due diligence defences and other protections

In relation to civil liability for misstatements, relevant persons have a "noisy withdrawal" defence where they have withdrawn consent to the distribution of the prospectus and given written notice of the reasons to the Securities Commission: section 56(2). Similarly, in relation to the distribution offences, it is a defence if the relevant offering document was distributed without the person's knowledge or consent, and on becoming aware of the distribution or registration the person gave notice forthwith to the trustee, the Registrar, and the Securities Commission: section 56(1).

In relation to the potential civil liability for both pecuniary penalty and compensation orders, directors also have a defence is they prove they "had reasonable grounds to believe and did believe, up to the time of the distribution of the advertisement or registered prospectus, that the statement was true" (section 56(3) of the Securities Act).

The reference to reasonable grounds essentially imports a due diligence defence, ie that the person took such steps as are reasonable in the circumstances to verify the relevant facts or engaged advisers to do the same on whom reliance would be reasonable. However, a person may not rely on this defence (that is, claim that he or she had reasonable grounds to believe the statement was true) if he or she knows the true position on an issue but the prospectus contains a mistake.[83]

Although audit letters will be provided in connection with the offering and issuer's counsel generally will be expected to sign off on the legal compliance of the offering documents,

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[82] *Black's Law Dictionary: Definitions of the Terms and Phrases of American and English Jurisprudence, Ancient and Modern* (6^{th} ed).
[83] *District Registrar of Companies v Heenan* (1997) 8 NZCLC 261,334.

there is no equivalent in New Zealand of a "10b-5" letter or comfort letter, that form the basis for formal due diligence defences in United States and other jurisdictions. Indeed, New Zealand does not have a market norm of requiring comfort letters for securities offerings at all.

Grants of relief where a director has acted honestly and reasonably

The Securities Act also makes provision for the Courts to grant relief to any person for negligence, default, breach of duty or breach of trust in connection with an offer or allotment of securities or distribution of offering documents: section 63. This will rely on the director or other person establishing that he or she had acted honestly and reasonably and ought fairly to be excused for the relevant negligence or default. The following are guidelines from case law as to what may constitute reasonable grounds:[84]

(a) a director is not expected to be able to verify the truth of all the statements in a prospectus from his or her own knowledge;

(b) an intending director is not expected to adopt a lawyer's or accountant's role by making specific inquiries into facts or figures;

(c) other directors' investigations and the fact that other directors had signed the prospectus are not enough for a director relying on s 56(3)(c) to prove reasonableness — a director cannot simply rely on statements made by a promoter or another director but should sek verification of relevant statements; and

(d) a director is entitled to rely on audit reports and reports from internal personnel who are reliable and competent.

Criminal liability

Section 58 creates criminal liability for misstatements in an advertisement (including an investment statement) or registered prospectus (again these will be referred to generically as offering documents).

Section 58(1) provides that where any advertisement is distributed that contains an untrue statement (within the wider meaning of that term set out in section 55) the issuer will be criminally liable (where the issuer is an individual) or if the issuer is a body, every director of the issuer at the time the advertisement is distributed will be liable. Where a registered prospectus is distributed that includes an untrue statement, every person who signed the prospectus, or on whose behalf the registered prospectus was signed, commits an offence. Despite the potential severity of the penalties, these are strict liability offences that do not require proof of any *mens rea*.[85] While the civil liability sections require an investor to subscribe on the "faith" or "reliance" of the advertisement or registered prospectus, section 58 merely requires that an untrue statement was "included". The prosecution is not required to demonstrate that any investor was actually misled by the untrue statement, suffered loss, or even read the particular statement.[86]

The criminal liability provisions incorporate a similar due diligence type defence (that the person had reasonable grounds to believe, and did, up to the time of the distribution of the offering document, believe that the statement was true). It also has the additional

[84] *Adams v Thrift* [1915] 2 Ch 21 (CA) (at p 24*), Bundle v Davies* [1932] NZLR 1097*, R v Reid* (1990) 5 NZCLC 66,483*, and Escott v Barchris Construction Corp* 283 F Supp 643 (1968) (US DC).
[85] *District Registrar of Companies v Heenan* (1997) 8 NZCLC 261,334; *R v Baxter* [1998] 3 NZLR 144; (1998) 15 CRNZ 580 (CA) (at p 157; p 592).
[86] *R v Rada Corp Ltd (No 2)* [1990] 3 NZLR 453 at 477.

defence of proving that the relevant untrue statement was immaterial (section 58(4) of the Securities Act).

REFORM PROCESS AND MATTERS REQUIRING URGENT ATTENTION

The state of New Zealand's savings and capital markets does not present a pretty picture. In an OECD survey of New Zealand conducted in 2007, New Zealand appeared at the extreme wrong end of virtually every measure of savings and indebtedness among developed nation counterparts. Notably New Zealand has:

- The smallest capital market per GDP in the OECD (the corporate bond market would have to grow by 800% to attain the OECD average).
- Net international liabilities amounting to 80% of GDP, exposing our economy to exchange and interest rate risks and, more generally, to the whims of international capital flows.
- The lowest level of pension fund assets and insurance investments (less than 20% of GDP compared to almost 120% of GDP for the U.S. and U.K and almost 100% for Australia).

A former head of New Zealand's Securities Commission, John Farrell, considers that the high level of borrowing by New Zealanders throws up the following regulatory challenges:[87]

> to maintain and enhance the standards of transparency in securities markets, both primary and secondary, both wholesale and retail, in respect of both market transactions and market participants;
>
> to maintain and enhance corporate governance in the banks and other financial institutions, and in the borrowers, particularly in the evaluation of risk;
>
> to ensure that the law contributes to the efficient intermediation of investors' funds, at the same time as it contributes to the development of markets of integrity, markets in which both issuers and investors, whether domestic or overseas, can have confidence;
>
> to encourage New Zealand citizens to save more.

Recent policy initiatives to address these matters have included the RFPP process, the introduction of the New Zealand Superannuation Fund and the Kiwisaver scheme to make public and private provision for retirement income, reforms in the taxation of investment (notably the new Portfolio Investment Entity, or PIE, regime), and funding of investor literacy, particularly through the Retirement Commission.

Current reform initiatives

In August 2006 the New Zealand government recently launched a comprehensive reform packaging in relation to laws relating to financial products and providers. The securities offerings discussion paper includes proposals to remove the investment statement/ prospectus split and having only one offer document albeit with two compulsory parts and to mandate the inclusion of educational materials.

Submissions have been received on the proposals, which in the case of securities offerings have yet to obtain a settled form. Although it is hoped that that they will tidy up

87 John Farrell "Facing Challenges to Bond Market Development - Lessons from the New Zealand Experience" (2005) Asian Development Bank Institute.

a number of the deficiencies in the current regime, it is unlikely that any enactment will be made in before 2009 or even 2010 — the financial intermediaries aspect of the reform is currently being treated as a higher priority, along with some specific changes in relation to finance companies and their supervision.

Matters requiring urgent attention

Due to the importance of strengthening the domestic capital markets and the length of time it is likely to take to implement the full suite of changes under the RFPP, it is important to address on a more urgent basis some of the more pressing defects in the current offering regime. These include:

- **Inconsistency between the requirements for prospectuses and GAAP**: As mentioned earlier in this paper, the Second Schedule to the Securities Regulations impose specific requirements in relation to financial statements for debt securities that are both frozen and are inconsistent with GAAP (for example, they pre-date New Zealand's adoption of IFRS). These impose very material costs for no benefit whatsoever. There is also a very easy fix for this: where an issuer has or is to file financial statements under the Financial Reporting Act (including under an exception pursuant to section 35A or 35B thereof), those financial statements should be able to used without any additional requirement that those accounts contain "the information required to be contained in a registered prospectus by clauses 16 to 31" (see clause 15(2)(a) of the Second Schedule).

- **Duplicative and irrelevant accounting requirements**: With the enactment of the Financial Reporting Act in 1993, which issuers automatically will be bound by, the Securities Act ceased to be a place where there should be substantive additional audit and accounting record requirements. These requirements are problematic, particularly for overseas issuers, and do not make much sense in the context of modern business. They should be repealed.

- **'Widely offered' exception to withholding tax**: It was recognised by the OECD in its recent survey of New Zealand's financial markets that the Non-Resident Withholding Tax and Approved Issuer Levy regime provide a significant impediment to the development of the New Zealand capital markets.[88] These provisions are also completely out of step with the position in Australia, which has a widely held exception (section 128F) which facilitates capital markets activity. The AIL and NRWT regimes are particularly damaging (and ineffective from the perspective of revenue-gathering) because they do not apply to any of the significant overseas funding markets, including the Eurokiwi and Uridashi markets and the New Zealand banks' offshore funding activities.

- **Eligible persons exception**: The anomaly that wholesale offerings can only be made to institutional investors and others enjoying an exception under section 3(2)(a) of the Securities Act, or to "eligible persons" (wealthy and experienced investors) meeting the relevant tests in sections 5(2CB) to 5(2CF) of the Securities Act, but not to both at the same time, should be removed. This restriction has no policy basis and prevents extension of appropriate offerings into the very large wealth management / private banking sector, which holds much of New Zealand's financial assets, to the detriment both of those savers and of small productive enterprises who could benefit from an alternative source of funding to bank lending.

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Russell McVeagh

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[88] "Deepening Financial Markets" (*OECD Economic Surveys*), Paris, April 2007, pg 79 at pg 87.