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Attention: Jason Le Vaillant

Financial Markets Conduct Regulations: Third Exposure Draft

Thank you for the opportunity to comment on the Ministry's Third Exposure Draft of the Financial Markets Conduct Regulations. Our submission focuses only on prospective financial information (PFI) and FRS-42 *Prospective Financial Statements*, particularly as it applies to *Managed Investment Products in Other Schemes* (Schedule 4).

We note that the Commentary accompanying the Exposure Draft states that the general feedback from submitters to an earlier consultation was that they assumed that PFI would be, or that PFI should be required to be, based on FRS-42 (paras 129-130 of the Commentary). In the draft Regulations for Schedule 2 *Equity Securities*, where PFI is disclosed in the offer register, the information is required to be prepared in accordance with FRS-42 (unless the PFI would be likely to mislead or deceive) and where selected PFI is included in a Product Disclosure Statement (PDS), the information is derived from PFI drawn up in accordance with FRS-42. We agree with these proposals. It should be noted that FRS-42 was developed for this purpose.

The Commentary, in relation to Schedule 4 *Managed Investment Products in Other Schemes* states that some submitters raised concerns about whether FRS-42 can be complied with for PFI that span long periods due to the need for the assumptions to be reasonable and verified. The Commentary acknowledges that issues raised in relation to long forecast periods, especially in forestry schemes, may have been affected by the Financial Markets Authority's (FMA) guidance on Effective Disclosure (paras 222-223). Nevertheless, Schedule 4, clause 17 *Forecasts or projections*, proposes that the PDS may provide a summary of forecasts or projections of the scheme's income and expenses and returns to investors over the expected life of the scheme (or for any shorter period). However, two options are proposed and comments solicited:

- Option A proposes that the summary of forecasts or projections must be derived from prospective financial information prepared in accordance with FRS-42; and
- Option B does not require the information to be prepared in accordance with FRS-42 but must include a statement whether any prospective financial information has been prepared in accordance with FRS-42 and a statement whether the forecasts or projections have been reviewed by an independent expert (and, if so, a statement of the name of the expert and a reference to where a copy of the expert's report can be found on the offer register).

In relation to Schedule 4 schemes, we strongly recommend that the Regulations prescribe, consistent with the proposed prescription in Schedule 2, that the PFI in the offer register must be prepared in accordance with FRS-42 and that the summary of forecasts or projections in the PDS must be derived from PFI prepared in accordance with FRS-42 (Option A).

FRS-42 is a principle-based standard. It requires an entity to use the best information that could reasonably be expected to be available in determining the assumptions and other information used in the preparation of general purpose prospective financial statements. It requires the PFI be understandable, relevant, reliable and comparable and be reasonable and supportable. Among other considerations, FRS-42 requires the nature and length of the entity's operating cycle to be taken into account when drawing up the PFI. The Commentary (paragraph 222) states that concerns were raised about the applicability of FRS-42 for projections over long periods due to the need for assumptions to be reasonable and verified. It should be noted that FRS-42 requires assumptions to be "reasonable and supportable", not "reasonable and verified".

The underlying principle in FRS-42 is consistent with the Financial Markets Conduct Act 2013 which prohibits misleading or deceptive conduct and the making of false or misleading representations. Similarly, under the proposed regulations, an entity is not required to disclose any PFI if the information, in the opinion of the directors of the issuer, is likely to deceive or mislead, for example, because it is not practicable to formulate reasonable assumptions on which to base the PFI (see for example, proposed clause 37(d) of Schedule 2 *Equity Securities*). We acknowledge that preparing PFI for long periods can be difficult because of the increased uncertainty, hence the cautionary statements in this regard in FRS-42 (paragraph 46). However, we consider that if an entity is unable to meet the requirements of FRS-42 with regard to best information and reasonableness of assumptions, it is likely that it will also be unable to meet the requirements of the law.

The basis on which the PFI is drawn up should not depend on the entity's structure. Any PFI included in a PDS or in the offer register should be drawn up using a comparable and common standard, regardless of the manner in which the entity is structured. We note the comment in the Commentary that managed investment schemes tend to be more equity like (para 210). In that regard, we think it is inconsistent to permit the schemes in Schedule 4 to use a different basis from that of an equity issuer for drawing up its PFI.

The principle for disclosing PFI should be that PFI is disclosed only if its basis is reasonable. FRS-42, among other matters, provides a common framework for determining when the PFI and its underlying assumptions are considered to be reasonable. We note that the Commentary (paragraph 219) states that the provision of PFI is "critical" and "important" to investors. Departing from the requirement that PFI be drawn up in accordance with FRS-42 means that there needs to be requirements on how it should be prepared, otherwise there is a significant risk of poor quality information that is not comparable being used for investor decision-making. Departing from the requirement that PFI be drawn up in accordance with FRS-42 also means that an equity issuer that discloses PFI applies FRS-42 whereas a managed investment scheme would not need to do so notwithstanding that both entities may have the same long operating cycle (for example, a forestry company versus a forestry scheme). We think that this is inconsistent and unnecessary as FRS-42 deals adequately with such situations.

In relation to forestry schemes, it should be noted that the relevant accounting standard (NZ IAS 41 *Agriculture*) requires the forest to be measured at fair value. In practice, this involves a discounted cash flow calculation covering the life of the forest. It seems inconsistent that such

estimates of future cash flows are acceptable for inclusion in audited historical financial statements but similar information cannot meet the test of being "reasonable and supportable" in PFI.

It should also be noted that FRS-42 has been applied for a number of years in the public sector by local authorities for their long term plans (which cover a ten-year period). We are not aware that any particular concerns or issues have arisen with regard to providing PFI over a longer time period. In this regard, we do not consider that FRS-42 in itself poses problems for an entity with a long operating cycle. To the contrary, our view is that it is equally applicable.

Where assumptions can be formulated on some reasonable basis and PFI is disclosed, an entity should be required to apply FRS-42. We believe that compliance with FRS-42 will ensure that only reasonable and supportable information is included. Option B may inadvertently condone the inclusion of unreasonable or unsupported PFI. It will be difficult for a user of the information to determine if the assumptions using a non-GAAP basis are sufficiently robust. We question the usefulness of such information. We also question whether independent experts (for example, auditors) will be willing or able to review such PFI in the absence of a common framework against which to review the information.

We would be pleased to hear from the Ministry if it has any specific concerns about the practical application of FRS-42 as it relates to longer term PFI. We are happy to put any such concerns before the New Zealand Accounting Standards Board for it to consider whether the requirements of FRS-42 should be clarified further.

If you have any queries or require clarification of any matters in this submission, please do not hesitate to contact Lay Wee Ng at laywee.ng@xrb.govt.nz.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Tony Dale', with a stylized flourish at the end.

Tony Dale

Chief Executive