Consultation Paper: Proposed variations to standard conditions of market services licences

This consultation paper seeks to gather views on proposed variations to the standard conditions for Financial Markets Conduct Act 2013 (FMC Act) licences, including those for financial resources and audit requirements.

Submissions close at 5pm on Monday 14 December 2015.

This consultation is for the market services licensees listed below, applicants, their advisers (including qualified auditors) and interested parties.

- Derivative issuers
- Managed investment scheme (MIS) managers
- Discretionary investment management service (DIMS) providers
- Crowdfunding platform operators
- Peer-to-peer lending service providers

About this guidance note

This guidance note is for: market services licensees, applicants , advisers and interested parties.	It explains: proposed changes to standard conditions for FMC Act licences.

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Document history

This version was issued on 17 Novemeber and is based on legislation and regulations as at the date of issue. It

FMA document reference code 2781798

Background

The Financial Markets Authority (FMA) may impose, vary, revoke, add to or substitute conditions of a licence issued under the FMC Act. Based on our current experience of the licensing process and feedback from licensees and their advisers (in particular, qualified auditors), we are proposing to vary certain standard conditions of licences for market services issued under the FMC Act. The proposed changes include variations to auditors' procedures and the financial resources requirements.

Prior to varying, revoking, adding to or substituting any conditions of licences, we are required to give licensees no less than 10 working days' written notice, stating our reasons. We must also give licensees or their representatives an opportunity to make written submissions on the matter within the notice period. This consultation process satisfies these requirements.

Proposed amendments

We have been issuing FMC Act market service licences since April 2014. This has resulted in new obligations and conditions for licensees. This paper recognises the need to clarify and improve a number of licence conditions.

We outline the proposed variations to the standard licence conditions in the tables below. The first set of tables is relevant to derivatives issuer licensees only. The second set of tables is relevant to other types of FMC Act licensees. In some instances, we are proposing to make minor changes to terminology, or to clarify our expectations in terms of timing. Other proposed variations are more substantial. This is the case for auditors' procedures related to licensees' financial resources requirements. There will be consequential amendments, such as to cross references and numbering, which are not set out in this consultation paper but will be included in the final version of the standard conditions.

Comments sought

We would appreciate your comments on the proposed variations. We are interested to know your position on the paper's proposals and the reasons for your views.

Please contact us with your comments by 5pm on Monday 14 December 2015. Email your comments to us at consultation@fma.govt.nz with this subject line: 'Proposed variations to standard conditions of market services licences: [your entity name]'. If you have any questions, please email our senior solicitor Alexandra.McNair@fma.govt.nz.

We will consider all submissions and publish the final conditions after the consultation closes. We intend to consult, finalise and publish the varied standard conditions by March 2016.

Submissions will be subject to the Official Information Act 1982. We may also make submissions available on our website, or draw attention to submissions in internal or external reports. If you would like us to withhold any commercially sensitive, confidential or proprietary information you submit, please let us know. Any request to withhold information will be considered according to the Official Information Act 1982.

Effective date

Most of our proposed variations are meant to simplify or clarify the existing conditions. Therefore we intend to make our proposals effective immediately once published. This means that conditions that refer to accounting periods would affect any period that finishes on or after the publication date. For example, if the revised conditions are published on 1 March 2016, then licensees with a 31 March balance date would need to engage an auditor to perform the revised procedures for the accounting periods ending on 31 March 2016 (for the period the licence is held).

Section 1: Derivatives issuer licence conditions

Part A: Proposed variations for financial resources requirements

Audit requirements

1. Derivatives issuer – Standard Condition 11 – financial conditions – audit requirements	Current language 1. You must engage a qualified auditor to provide an assurance opinion, annually, to your board of directors or governing body and to the FMA on your compliance with the financial resource requirements that apply to you in respect of your most recently completed financial period. 2. The auditor's report referred to in this standard condition must be lodged with the FMA no later than one week after the audit report on your annual financial statements is signed, and no later than four months after the end of your financial year. 3. Except as provided below, the auditor's opinion required by this standard condition must state that, for the relevant period: (a) in the auditor's opinion, you: (i) complied with the NTA requirements in Standard Condition 9, and any other financial requirements applying to you; (ii) had, at all times, cash flow forecasts that purported to, and on their face appeared to, comply with Standard Condition 8(1); (iii) correctly calculated the cash flow forecasts based on your underlying assumptions; and (b) following an examination of the documents you relied on to create your cash flow forecasts, the auditor has no reason to believe that:

	(i) you did not satisfy the requirement of Standard Condition 10 to manage the risk of having insufficient funds to meet the NTA requirement, including the cash and liquid assets components of that requirement, in Standard Condition 9 and the solvency requirement in Standard Condition 7; (ii) you failed to: A prepare cash flow forecasts as required; B. have these forecasts approved by your board or governing body; C. document the calculations and assumptions used in creating the cash flow projections and explain why they are appropriate; D. update the cash flow projection where there was reason to suspect an updated projection would show you were not meeting the financial requirements applying to you; E. reconcile your actual cash flows with your forecast cash flows; and/or F. document your explanations of the reasons for any significant variations; (iii) the assumptions you used to create the cash flow projections were inappropriate; and (iv) your explanations of any significant variation from your cash flow forecast is materially incomplete or does not fairly reflect the cause of that variation. 4. If, in the auditors opinion, it is not appropriate to provide an opinion as to all of the matters in clause 3 without any qualification, modification or emphasis of matter, the auditor may modify the opinion in accordance with applicable provisions of auditing and assurance standards relating to modified audit opinions. Explanatory note: The opinion does not need to be addressed to the FMA. However, a copy of the opinion must be sent to the FMA. Additionally, if the report specifies the intended users or disclaims liability to any user, or for any use, other than that intended users and uses, the report should expressly provide that both the licensee's board or governing body and the FMA are intended users, and should not in any way limit the rights of the FMA to rely on that for the purposes of monitoring or enforcing compliance by the licensee with its market services licensee obligations (as defined in the FMC Act). The engagement required under this standard condition must be a compliance engagement to which SAE 3100: Compliance Engagements (and/or any assurance

	standard set by the External Reporting Board that replaces all, or any relevant part, of that standard) applies. The statements the auditor is required to express an opinion on under paragraph 3(i) must be based on a reasonable assurance engagement. The statements the auditor is required to express an opinion on under paragraph 3(ii) must be based on an examination which is no less comprehensive than a limited assurance engagement.

Comments and reasons

Under Standard Condition 11 *Audit Requirements,* derivative issuer licensees are required to engage an auditor to provide assurance of their compliance with the financial resources conditions. In summary this includes:

Reasonable assurance that, in the auditor's opinion, the licensee:

- complied, at all times, with their net tangible asset (NTA) requirements
- had, at all times, in place the required cash flow forecasts
- correctly calculated the cash flow forecasts based on their underlying assumptions; and

Limited assurance that, on the basis of the auditor's examination of the documents used to create the cash flow forecasts, the auditor had no reason to believe that the licensee failed to:

- satisfy what's required under Standard Condition 10 to manage the risk to meet the NTA and liquidity requirements of Standard Condition 9; and
- prepare and have cash flow forecasts approved, monitor them on an on-going basis, and use appropriate assumptions.

The purpose of Standard Condition 11 is to provide us information on whether the licensee is complying with their financial resources requirements. We want to be confident that the licensee maintains adequate financial resources, and informs us of any material, adverse changes in their financial position. We based our requirements on the Australian requirements for over-the-counter derivative issuers.

We've received feedback that the requirements need to change. The feedback broadly falls into two areas:

1. the FMA's expectations on the nature of the assurance engagement; and
2. whether the benefits of the current level of assurance outweigh the costs to derivative issuers (especially given the size of some New Zealand issuers relative to the Australian market).

Nature of the assurance engagement

On the first point, several audit firms and industry bodies have asked us to clarify key aspects of the required engagement. In particular, they believe that they may not be able to perform some procedures in accordance with assurance standards – for example, it may not be possible to provide assurance that a derivative issuer complied with a particular requirement 'at all times' when they are not continually auditing an entity.

We've also received feedback that it is complex for the auditor to give a mix of limited and reasonable assurance on the derivative issuer's compliance and controls. This is because the current standard condition results in an engagement based on multiple assurance standards including:

- ISAE (NZ) 3000 Assurance Engagements Other than Audits or Reviews of Historical Information;
- SAE 3100 Compliance Engagements; and
- SAE 3150 Assurance Engagements on Controls.

This is inconsistent with the FMA's explanatory note, which focuses only on SAE 3100 *Compliance Engagements*.

Cost *vs benefit*

We've also been told that the cost to licensees for some of the procedures appears onerous relative to the benefits to the FMA. Therefore we've been asked to consider whether the current procedures could be replaced with simpler and more cost effective ones. For example, providing assurance on the assumptions' underlying cash flow forecasts is very difficult and expensive, and may be of limited value when future cash flows are inherently subjective and can change significantly. Therefore, if future cash flow management is the concern, it may be more appropriate and cost effective for the auditor to check that the licensee is regularly monitoring their cash flows against cash flow forecasts, and reforecasting these as necessary.

The complexity of a mix of limited and reasonable assurance over the issuer's compliance and controls is also considered to add cost.

Other comments

We are considering simplifying the auditor's engagement to make it more cost effective. We are considering changing the assurance engagement. The primary focus will be on the controls the licensee has in place to manage their compliance with the financial resource requirements. This would be a reasonable assurance engagement to be performed under SAE 3150 *Assurance Engagements on Controls* – only one of the three assurance standards that auditors have identified that they would need to comply with under the current condition.

In theory, well-designed and operated controls should result in issues being detected and notified to the FMA. An unmodified assurance opinion would mean that the licensee and the FMA can place some reliance on controls to provide the required compliance outcome. A focus on controls is appropriate given that licensees must meet some requirements 'at all times' and it seems the most appropriate way to achieve cost-effective assurance. This is also

consistent with Standard Condition 10:

> *You must adequately manage the risks of having insufficient financial resources to meet your financial resource requirements.*

In addition to the controls assurance, we also intend to require the licensee to engage the auditor to perform some agreed upon procedures on their NTA calculation based on the audited financial statements. This will provide us with some substantive information on the licensee's year-end position and calculation. These procedures are similar to those required for other types of licensees. The licensee must send us both reports and a copy of the year-end calculation.

We also propose to make consequential amendments to Standard Condition 9(3) to make it clear that the licensee must prepare a NTA calculation on the basis of their audited financial statements.

Our view is it may be useful to have further guidance on our expectations of auditors performing these engagements. To that extent, we note that the Australian Assurance and Auditing Standards Board has recently revised its guidance on how to comply with ASIC's requirements for derivative issuers (see Guidance Statement *GS003 Assurance Relating to Australian Financial Services Licences issued under the Corporations Act 2001*).

Proposed changes:

11. Financial resources – Audit requirements

1. Each year, you must engage a qualified auditor to provide ~~an assurance opinion, annually,~~ to your board of directors or governing body and to the FMA:

   (a) an assurance report (the **Assurance Report**) on the design and operating effectiveness of your financial resources controls throughout ~~compliance with the financial resource requirements that apply to you in respect of~~ your most recently completed ~~financial~~ accounting period~~.~~; and

   (b) an agreed upon procedures report (the **AUP Report**) in respect of your NTA calculation as at the end of your most recently completed accounting period on the basis of your audited annual financial statements.

~~2. The auditor's opinion referred to in this standard condition must be lodged with the FMA no later than one week after the audit report on your annual financial statements has been signed four months after the end of your financial year.~~

2. You must send the FMA a copy of the Assurance Report and the AUP Report, including a copy of your NTA calculation as at your balance date based on the audited financial statements, by the earlier of: (i) one week after the audit report on your annual financial statements is signed; and (ii) four months after the end of your

accounting period.

3. The Assurance Report required by this condition must state that, in the auditor's opinion, for the most recently completed accounting period, in all material respects:

   (a) the controls within the scope of the engagement were suitably designed to achieve compliance with Standard Conditions 7 to 10; and

   (b) the controls operated effectively as designed.

4. If, in the auditor's opinion, it is not appropriate to provide an opinion as to all of the matters in clause 3 without any qualification, modification or emphasis of matter, the auditor may modify the opinion based on the applicable provisions of auditing and assurance standards related to modified audit opinions.

5. In order to provide the AUP Report, the agreed upon procedures (**AUP**) must include the following in the calculation of the NTA as at your balance date:

   (a) re-perform your NTA calculation in accordance with Appendix 1;

   (b) check each component of the NTA calculation agrees with the relevant information in your audited annual financial statements or appropriate accounting records;

   (c) if you have intangible assets or related-party receivables in your audited annual financial statements, determine whether an adjustment has been made for those in the NTA calculation;

   (d) for any adjustment for subordinated debt made when calculating adjusted liabilities, check that:

      i. an executed deed of subordination exists; and

      ii. the amount that has been classified as subordinated debt is not repayable within one year from the date of the NTA calculation; and

   (e) enquire of you whether you have provided any guarantees during the accounting period and note any that have not been included in the NTA calculation.

~~3. Except as provided below, the auditor's opinion required by this standard condition must state that, for the relevant period:~~

~~(f) in the auditor's opinion, you:~~

~~i. complied with the NTA requirements in Standard Condition 9, and any other financial requirements applying to you;~~

~~ii. had, at all times, cash flow forecasts that purported to, and on their face appeared to, comply with Standard Condition 8(1);~~

~~iii. correctly calculated the cash flow forecasts based on your underlying assumptions; and~~

~~(g) following an examination of the documents you relied on to create your cash flow forecasts, the~~

auditor has no reason to believe that:

i. you did not satisfy the requirement at Standard Condition 10 to manage the risk of having insufficient funds to meet the NTA requirement, including the cash and liquid assets components of that requirement, in Standard Condition 9 and the solvency requirement in Standard Condition 7;

ii. you failed to:

1. prepare cash flow forecasts as required;

2. have these forecasts approved by your board or governing body;

3. document the calculations and assumptions used in creating the cash flow projections and explain why they are appropriate;

4. update the cash flow projection where there was reason to suspect an updated projection would show you were not meeting the financial requirements applying to you;

5. reconcile your actual cash flows with your forecast cash flows; and/or

6. document your explanations of the reasons for any significant variations;

iii. the assumptions you used to create the cash flow projections were inappropriate; and

iv. your explanations of any significant variation from your cash flow forecast is materially incomplete or does not fairly reflect the cause of that variation.

6. If, in the auditors opinion, it is not appropriate to provide an opinion as to all of the matters in clause 3 without any qualification, modification or emphasis of matter, the auditor may modify the opinion in accordance with applicable provisions of auditing and assurance standards relating to modified audit opinions.

Explanatory note: The Assurance Report and the AUP Report opinion does not need to be addressed to the FMA. However, a copy of each report the opinion must be sent to the FMA. Additionally, if the report specifies the intended users or disclaims liability to any user, or for any use, other than that intended users and uses, the report should expressly provide that both the licensee's board or governing body and the FMA are intended users, and should not in any way limit the rights of the FMA to rely on that for the purposes of monitoring or enforcing compliance by the licensee with its market services licensee obligations (as defined in the FMC Act).

The Assurance Report engagement required under this standard condition must be a compliance engagement to which SAE 3150: *Assurance Engagements on Controls* SAE 3100: Compliance Engagements (and/or any assurance standard set by the External Reporting Board that replaces all, or any relevant part, of that standard) applies. The statements on which the auditor is required to express an opinion on under paragraph 3(i) must be based on a reasonable assurance engagement. The statements the auditor is required to express an opinion on under paragraph

~~3(ii) must be based on an examination which is no less comprehensive than a limited assurance engagement~~

Questions

1. Do you agree or disagree with the proposed changes? Please provide your reasons.
2. Do you think the changes will reduce the costs to licensees while still providing meaningful assurance to the FMA?
3. For the Assurance Report:
   a. Can the procedures be performed in accordance with SAE 3150?
   b. Do you believe the procedures should be performed annually? Do you think another period is justified? If so, how often do you think it would be appropriate to have the controls procedures performed?
4. Do you have any comments on the agreed upon procedures engagement?
5. Is our proposed timeframe for sending the reports to the FMA reasonable?
6. Do you think more guidance is needed?
7. Do you think additional guidance should be produced for the current conditions rather than amending the condition? If yes, why and what should it cover?

Net tangible asset (NTA) composition

2. Derivatives issuer - Standard Condition 9.2 – financial resources – net tangible assets	**Current language** You must have at least 50% of the required NTA in cash or cash equivalents (excluding any cash or cash equivalents that are held in respect of any liability or obligation to clients) and the remainder in liquid assets.

Comments and reasons

Standard Condition 9(2) sets out the minimum cash and liquid assets that derivative issuer licensees must hold. It is important that derivative issuer licensees hold appropriate levels of liquid assets so they can perform their services effectively. It also decreases the risk of a disorderly or non-compliant wind-up if their business fails or if there is a significant market disruption.

As currently drafted, there is a minor risk that cash and cash-equivalent balances could be double counted when calculating NTA. This is because cash and cash equivalents are liquid assets, and the same cash could be counted as part of the initial 50% of NTA as well as part of the 'remainder in liquid assets.' This would result in the licensee having lower levels of liquid assets than we anticipated.

We think it is desirable to clarify that at least 50% of the required NTA must be held in cash or cash equivalents and any remainder must be in *other* liquid assets.

Proposed changes

You must have at least 50% of the required NTA in cash or cash equivalents (excluding any cash or cash equivalents that are held in respect of any liability or obligation to clients) and <u>any</u> ~~the~~ remainder in <u>other</u> liquid assets.

Questions

8. Do you agree or disagree with the proposed changes? Please provide your reasons.

Part B: Proposed variations to other standard conditions and **Appendix 1**

Timing for notification of changes to governance and compliance arrangements

3. Derivative Issuers – Standard Condition 6 – governance arrangements	**Current language** Your governance and compliance arrangements must be substantially the same as, or better than, those in place, or which the FMA was advised of, at the time you applied for your licence (or any subsequent change advised to the FMA). You must notify the FMA of material changes to your governance and compliance arrangements. **Explanatory note**: This condition requires you to maintain your compliance and governance arrangements to at least the standard you have told us about, but it allows flexibility for these arrangements to be improved. This condition also requires you to notify us of material changes to your governance and compliance arrangements, which includes any material change to your outsource arrangements. For further information in relation to the requirements of your governance and compliance arrangements see the governance and compliance sections of the Licensing Application Guide.

Comments and reasons

The condition does not state the timeframe for notifying the FMA of material changes to the licensee's governance and compliance arrangements. For clarity, we consider it appropriate to include a timeframe.

We propose that material changes to the licensee's governance and compliance arrangements must be notified to the FMA as soon as practicable. This is consistent with the language used in section 412 of the FMC Act which requires licensees to report certain matters to the FMA.

In our view, this approach is preferable to specifying the number of working days to notify us of material changes. It is more flexible and practical. However, we would ordinarily expect notifications to be given within five working days. We consider this to be a reasonable timeframe, and consistent with the obligation to notify as soon as practicable.

Proposed changes

Your governance and compliance arrangements must be substantially the same as, or better than, those in place, or which the FMA was advised of, at the time you applied for your licence (or any subsequent change advised to the FMA). You must notify the FMA of material changes to your governance and compliance arrangements as soon as practicable.

Explanatory note: This condition requires you to maintain your compliance and governance arrangements to at least the standard you have told us about, but it allows flexibility for these arrangements to be improved. This condition

also requires you to notify us of material changes to your governance and compliance arrangements, which includes any material change to your outsource arrangements, as soon as practicable (which we would ordinarily consider to be within five working days). For further information in relation to the requirements of your governance and compliance arrangements see the governance and compliance sections of the Licensing Application Guide.

Question

9. Is our proposed timeframe for notifying a material change to governance or compliance arrangements to the FMA reasonable?

Adjusted assets – intangible assets

4. Derivatives issuer - Appendix 1: Net tangible assets (NTA) – adjusted assets	**Current language** Paragraph 3(f): **Adjusted assets** means, in relation to a market services licensee, the value of total assets as they would appear on a balance sheet at the time of calculation that has been prepared on the same basis as the market services licensee's financial statements required under part 7 of the FMC Act: (a) Minus the value of any intangible assets (i.e. non-monetary assets without physical substance) . . .

Comments and reasons

Under Standard Condition 9(1), derivative issuer licensees must hold a minimum level of net tangible assets. 'Net tangible assets' is calculated as adjusted assets minus adjusted liabilities (as defined in Appendix 1).

We have received feedback that it would be helpful to further clarify the scope of 'intangible assets'. We consider that intangible assets includes assets recognised under NZ IAS 38 *Intangible Assets,* such as brands and management rights, goodwill under NZ IFRS 3 *Business Combinations* and deferred tax assets under NZ IAS 12 *Income Taxes*. We propose to include an explanatory note about this.

Proposed changes

Adjusted assets means, in relation to a market services licensee, the value of total assets as they would appear on a balance sheet at the time of calculation that has been prepared on the same basis as the market services licensee's financial statements required under part 7 of the FMC Act:

(a) Minus the value of any intangible assets (i.e. non-monetary assets without physical substance)
Explanatory note: In this context, 'intangible assets' includes any intangible assets recognised under NZ IAS 38, such as brands and management rights, goodwill under NZ IFRS 3 Business Combinations, and deferred tax assets under NZ IAS 12 Income Taxes.

Question

10. Do you agree or disagree with the proposed changes? Please provide your reasons.

Adjusted assets – inclusion of eligible undertakings

5. Derivatives issuer - Appendix 1: Net tangible assets (NTA) – adjusted assets	**Current language** Paragraph 3(f): **Adjusted assets** means, in relation to a market services licensee, the value of total assets as they would appear on a balance sheet at the time of calculation that has been prepared on the same basis as the market services licensee's financial statements required under part 7 of the FMC Act: . . . (f) plus: (i) the amount of any eligible undertaking that is not an asset; or (ii) if the eligible undertaking is for an unlimited amount, an unlimited amount.
Comments and reasons Under Standard Condition 9(1), derivative issuer licensees must hold a minimum level of net tangible assets. 'Net tangible assets' are calculated as adjusted assets minus adjusted liabilities (as defined in Appendix 1). In their NTA calculation, licensees can include 'eligible undertakings' in their adjusted assets where 'eligible undertakings' are in effect commitments to inject equity from an eligible provider (usually a bank). Licensees can also include, in adjusted assets, receivables that may otherwise have to be excluded provided they are secured by an interest in certain financial products issued by an eligible provider. Our view is that when calculating adjusted assets, any eligible undertaking must be a fixed amount. Therefore, paragraph 3(f)(ii) is not relevant and we propose to delete it.	

Proposed changes

Adjusted assets means, in relation to a market services licensee, the value of total assets as they would appear on a balance sheet at the time of calculation that has been prepared on the same basis as the market services licensee's financial statements required under part 7 of the FMC Act:

. . .

(f) plus the amount of any eligible undertaking that is not an asset~~; or~~
~~(i) if the eligible undertaking is for an unlimited amount, an unlimited amount~~.

Question

11. Do you agree or disagree with the proposed changes? Please provide your reasons.

Inclusion of subordinated debt in adjusted liabilities

6. Derivatives issuer - Appendix 1: Net tangible assets (NTA) – adjusted liabilities	**Current language** Paragraph 11(a): **Adjusted liabilities** means, in relation to a market services licensee, the amount of total liabilities as they would appear on a balance sheet at the time of calculation that has been prepared on the same basis as the market services licensee's financial statements required under Part 7 of the Act: (a) minus the amount of any liability under any subordinated debt approved by us in writing; . . .

Comments and reasons

Approved by the FMA in writing

One of the purposes of imposing financial requirements is to provide owners of licensees with incentives to comply by having a minimum level of investment or net tangible assets (NTA) in the licensed entity. For derivative issuer licensees, this is achieved through the NTA requirement.

We appreciate that licensees may be funded through a combination of equity and debt, including loans from their shareholder(s). Therefore when calculating NTA, licensees are permitted to exclude shareholder loans from adjusted liabilities provided the loan is subordinated appropriately. The purpose of requiring the loan to be subordinated is to ensure that licensees meet their obligations to their clients and wind up in an orderly way when their business ceases or their licence ends.

Currently the FMA is required to approve all subordinated loans in writing. We note that the corresponding provision in the standard conditions for other licence types does not refer to subordinated debt approved by the FMA in writing. Our view is that the language should be aligned across the conditions for all licence types for consistency and clarity. We therefore propose to remove the words 'approved by us in writing'. We also propose to include the same explanatory language that is currently used in the definition of 'adjusted liabilities' for other licence types. This is to clarify that the subordinated debt must be documented in a formal agreement, a copy of which must be provided to the FMA or your auditor upon request.

One year time frame

While our licensing guide outlining the minimum standards for derivative issuers states that any subordinated debt cannot be repayable within a year, there is no mention of this one year timeframe in Appendix 1. Therefore we are proposing to clarify this in Appendix 1.

We have received feedback that the current language is unclear on when the one year timeframe is calculated from. For example, is it from the date to which the NTA calculation relates, or is it the date when the deed of subordination is entered into? Our view is that the debt repayment date must be at least one year from the date to which the NTA calculation relates.

We have also received questions about whether partial repayment is permitted within one year. We consider it acceptable if the debt agreement allows for partial repayment within one year. However, the debt documentation will need to clearly state the amount of the debt which is not repayable within a year. Only the amount that is not repayable within a year can be excluded from liabilities when calculating NTA. Any amount that is repayable or could be repaid within one year will not be subordinated debt and cannot be excluded from your liabilities for the purposes of your NTA calculation. We propose to include an illustrative example in the explanatory note.

Proposed changes

Adjusted liabilities means, in relation to a market services licensee, the amount of total liabilities as they would appear on a balance sheet at the time of calculation that has been prepared on the same basis as the market services licensee's financial statements required under Part 7 of the Act:

(a) minus the amount of any liability under any subordinated debt agreement (a copy of which must be provided to the FMA or your auditor upon request), where the obligation to repay the debt is subordinate to all other claims, demands, rights and causes of action of all unsubordinated creditors and the debt is not repayable within one year of the date to which the NTA calculation relates ~~approved by us in writing~~; . . .

Explanatory note: We consider it acceptable if the loan agreement allows for partial repayment within one year. However the loan agreement will need to clearly document the amount of the loan which is not repayable within a year. Only the amount that is not repayable within a year can be excluded from liabilities when calculating NTA. Any amount that is repayable or could be repaid within one year will not be subordinated debt and cannot be excluded from your liabilities for the purposes of your NTA calculation. For example, if there is a shareholder loan of $3m, the loan agreement could provide that:

- a clearly quantified amount of the loan is repayable on demand (eg $2m) – this amount cannot be classified as subordinated debt, and
- a clearly quantified amount of the loan is not repayable until a certain date, that is not within a year of the NTA calculation (eg $1m) – this portion of the loan could be classified as subordinated debt and excluded from liabilities in the NTA calculation.

Questions

12. Do you agree or disagree with the proposed changes? Please provide your reasons.

Definition of cash or cash equivalents

7.	Derivatives issuer - Appendix 1: Net tangible assets (NTA) – cash or cash equivalents	**Current language** Paragraph 13: **Cash or cash equivalents** means, in relation to a market services licensee: (a) cash on hand, demand deposits and money deposited with a registered bank regulated by RBNZ that is available for immediate withdrawal; (b) short-term, highly liquid investments that are readily convertible to known amounts of cash that are subject to an insignificant risk of changes in value; (c) the value of any eligible undertaking provided by an eligible provider; and (d) a commitment by an eligible provider to provide cash upon request within five business days: (i) which will not expire within the next six months and which cannot be withdrawn by the provider without giving at least six month written notice to the person to whom the commitment is made; and (ii) in relation to which any cash provided is not repayable for at least six months.

Comments and reasons

The definition of cash and cash equivalents impacts the liquidity required under Standard Condition 9(2). Some people have noticed that the definition is inconsistent with the definition of cash and cash equivalents under the accounting standard, NZ IAS 7 *Statement of Cash Flows*. They have asked us to consider aligning these.

While for many licensees there will be no difference in practice, there are important distinctions between our definition and the definition in NZ IAS 7. For example, our definition is narrower in that it covers money deposited with banks, whereas there is no restriction under NZ IAS 7 as to who could hold the cash. But, our definition is wider in that it can also include eligible undertakings and certain commitments from eligible providers (usually banks).

We think that these differences from NZ IAS 7 are appropriate here. However, we also think that the current language could be clearer, including by removing the term 'demand deposits' (which is not defined) and by using the term 'Bank', which is discussed further below instead of 'a registered bank regulated by RBNZ'. We also propose to replace the reference in paragraph 13(d) to 'business days' with 'working days' for consistency with the terminology used in the other standard conditions.

Proposed changes

Cash or **cash equivalents** means, in relation to a market services licensee:

(a) cash on hand~~, demand deposits and money deposited with a registered bank regulated by RBNZ that is available for immediate withdrawal;~~
(b) money deposited with a Bank that is available for immediate withdrawal;
(c) short-term, highly liquid investments that are readily convertible to known amounts of cash that are subject to an insignificant risk of changes in value;
(d) the value of any eligible undertaking provided by an eligible provider; and
(e) a commitment by an eligible provider to provide cash upon request within five ~~business~~ working days:
    1. which will not expire within the next six months and which cannot be withdrawn by the provider without giving at least six month written notice to the person to whom the commitment is made; and
    2. in relation to which any cash provided is not repayable for at least six months.

Questions

13. Do you agree or disagree with the proposed changes? Please provide your reasons.

Definition of bank

8. Derivatives issuer - Appendix 1: Net tangible assets (NTA) - bank	**Current language** Paragraph 14: **Bank** means: (a) a bank registered under the RBNZ Act; (b) a bank or financial institution which has a rating for its long-term unsecured and non-credit enhanced debt obligations of A- or higher by Standard & Poors rating agency or a comparable rating from an internationally recognised credit rating agency; or (c) any other bank or financial institution approved by the FMA.

Comments and reasons

The definition of 'bank' can impact the calculation of net tangible assets (NTA) for derivative issuers under Standard Condition 9(1). Licensees cannot normally include receivables from associated parties in their calculation of NTA. However, the licensee can include amounts receivable that are fees owed to it by an associated DIMS or registered schemes after netting off any amount the licensee owes it in return. If the licensee is a bank, when calculating the net amount receivable it can ignore any ordinary banking deposits it holds for the associated DIMS or scheme.

It also impacts the definition of 'cash and cash equivalents' for the liquidity requirements under Standard Condition 9(2).

The definition of 'bank' in Appendix 1 was drafted before the Financial Markets Conduct Regulations 2014 (the Regulations) were finalised. For consistency with the Regulations, we propose to replace clause (a) of the current definition with the definition of 'specified bank' in the Regulations. A 'specified bank' is defined in the Regulations as:

(a) a registered bank; or
(b) a bank that is authorised to accept deposits under the law of Australia, Canada, Hong Kong, Ireland, Singapore, the United Kingdom, or the United States of America; or
(c) any other overseas bank within the meaning of regulation 9 of the Financial Advisers (Definitions, Voluntary Authorisation, Prescribed Entities, and Exemptions) Regulations 2011.

This will result in a wider definition and recognises that certain licensees will hold funds in banks in foreign jurisdictions that we consider appropriate. We propose to retain clauses (b) and (c) of the current definition to provide further flexibility.

As a result of this amendment, we also propose to amend the references to 'a registered bank' in paragraph 5(a) and 'a registered bank regulated by RBNZ' in paragraph 13(b) of Appendix 1 to 'a Bank' for consistency.

Proposed changes

Bank means:

(a) ~~A bank registered under the RBNZ Acta~~ a 'specified bank' as defined in the Regulations; or
(b) a bank or financial institution which has a rating for its long-term unsecured and non-credit enhanced debt obligations of A- or higher by Standard & Poors rating agency or a comparable rating from an internationally recognised credit rating agency; or
(c) any other bank or financial institution approved by the FMA.

As noted above, we also propose to amend the references to 'a registered bank' in paragraph 5(a) and 'a registered bank regulated by RBNZ' in paragraph 13(a) of Appendix 1 to 'a Bank'.

Questions

14. Do you agree or disagree with the proposed amendments to the definition of 'Bank'? Please provide your reasons.
15. Do you agree or disagree with the proposed consequential amendments to paragraphs 5(a) and 13(a) of Appendix 1? Please provide your reasons.

Section 2: Other licence type conditions

Part A: Proposed variations in relation to financial resources requirements

NTA requirements

1. Financial resources	Current language
DIMS Standard Condition 8 Crowdfunding Standard Condition 7 Peer-to-peer Standard Condition 7 MIS Standard Condition 8	**Financial resources** You must calculate your **net tangible assets** (**NTA**) at least monthly, including as at your balance date each year. If your calculation shows that you did not have positive net tangible assets at any time, you must notify the FMA and provide an explanation, unless: (a) you have previously notified the FMA that you have negative net tangible assets and explained: i. the circumstances that cause you to have negative NTA, including the nature of any significant intangible assets or related party receivables, and ii. whether you consider having negative NTA adversely impacts on your ability to carry out the market service effectively on an ongoing basis and why, and (b) the FMA has advised in writing that you do not need to provide further notifications in respect of having negative NTA arising from those circumstances, and (c) there has been no material change from the position and circumstances described to the FMA in your most recent previous notification. You must also engage a qualified auditor and enter into agreed upon procedures terms with the auditor to provide for the auditor to review the calculation of your NTA as at your balance date each year. The auditor's report must include a statement that, as at your balance date, in the auditor's opinion, you calculated your net tangible assets correctly.

	Explanatory note: Net tangible assets (NTA) has the meaning set out in Appendix 1 of this document.

Comments and reasons

The standard condition currently requires licensees (excluding derivative issuers) to calculate their net tangible assets (**NTA**) on at least a monthly basis and notify the FMA if their NTA is not positive. In addition, licensees are required to engage an auditor to perform some procedures over their NTA calculation as at their balance date. The condition is designed to provide the FMA with some information to indicate that the licensee holder has a minimum level of financial resources and, through the notification requirement, provide us with an early warning if there are signs of potential financial distress.

However, we have received feedback that, in its current form, the condition is unclear about when licensees must notify the FMA and what auditor's procedures are required to be performed. We also note that the current language about auditors' procedures only focuses on whether the NTA calculation at the end of the licensee's financial year has been carried out correctly. Therefore, the FMA is not currently provided with any information about whether the licensee is performing the NTA calculation at least monthly throughout the year. We have also received feedback that some of the terminology used in the condition is inconsistent with an agreed upon procedures (**AUP**) engagement. We are therefore proposing certain clarification amendments to address this feedback.

In summary, we are proposing to:

- Clarify that licensees need to notify FMA 'as soon as practicable' once they identify that their NTA is not positive. We've also included an explanatory note that we generally expect 'as soon as practicable' to mean that licensees must notify us within five working days.
- Add a requirement for licensees to send us a copy of the report by the earlier of: (i) one week after the audit report on their annual financial statements is signed; and (ii) four months after the end of their accounting period.
- In respect of the auditors' procedures:
    - Clarify that we expect the auditor to have a more detailed look at the end of year calculation of NTA *based on the audited financial statements*, rather than the NTA calculation based on management accounts. As such, the auditor will be able to check if the calculation is consistent with their work on the financial statements.
    - Add additional explanatory notes on the type of procedures we'd expect in an AUP engagement, including procedures to check that the NTA calculation was performed at least monthly during the accounting period.
    - Remove terms that are inconsistent with an AUP engagement. For example 'in the auditor's opinion' and 'review' which imply assurance engagements.

Proposed changes:

Financial resources

You must calculate your **net tangible assets** (**NTA**) at least monthly, including as at your balance date each year on the basis of your audited financial statements. You must also calculate your NTA on any other date on which there is a reason to suspect that your NTA is not positive. If your calculation shows that you did not have positive NTA at any time, you must notify the FMA ~~and provide an explanation, unless~~: as soon as practicable and explain:

(a) ~~you have previously notified the FMA that you have negative net tanglibe assets and explained:~~the circumstances that caused you to have NTA that is not positive, including the nature of any significant intangible assets or related party receivables

(b) whether you consider having NTA that is not positive adversely impacts on your ability to carry out the market service effectively on an ongoing basis and why ~~and~~

You do not need to provide the notification referred to above if:

(a) you have previously notified the FMA that your NTA was not positive at any time and provided an explanation as set out above

(b) the FMA has advised in writing that you do not need to provide further notifications in respect of having ~~negative~~ NTA that is not positive arising from those circumstances

(c) there has been no material change from the position and circumstances described to the FMA in your most recent previous notification.

You must:

(a) ~~also~~ engage a qualified auditor ~~and enter into~~ to perform agreed upon procedures (**AUP**) ~~terms with the auditor to provide for the auditor to review the~~ and provide you with a report (the **Report**) in respect of the calculation of your NTA during your accounting period, including the calculation of your NTA as at your balance date ~~each year~~ performed on the basis of your audited annual financial statements. ~~The auditor's report must include a statement that, as at your balance date, in the auditor's opinion, you calculated your net tangible assets correctly;~~ and

(b) send the FMA a copy of the Report, including a copy of your NTA calculation as at your balance date, by the earlier of: (i) one week after the audit report on your annual financial statements is signed; and (ii) four months after the end of your accounting period.

Revised explanatory note: NTA has the meaning set out in Appendix 1 of this document.

If your calculations show that you did not have positive NTA, you must notify the FMA as soon as practicable which, ordinarily, we would consider to be within five working days.

The purpose of the AUP is to assist the FMA in determining whether you are complying with this condition. Ordinarily the AUP should include the procedures set out below. Procedure 1 is a simple check that you have performed the NTA calculations during the accounting period. Procedure 2 is a more detailed check of some aspects of your calculation based on your audited financial statements.

1. Obtain all NTA calculations performed by you during the accounting period and for each calculation include in the report:

    (a) the date that the calculation relates to;

    (b) the date the calculation is recorded as having been prepared; and

    (c) the value of NTA calculated.

2. For the calculation of NTA as at your balance date on the basis of the audited financial statements:

    (a) re-perform your NTA calculation in accordance with Appendix 1;

    (b) check each component of the NTA calculation agrees with the relevant information in your audited annual financial statements or appropriate accounting records;

    (c) if you have intangible assets or related party receivables in your audited annual financial statements determine whether an adjustment has been made for those in the NTA calculation;

    (d) for any adjustment for subordinated debt made when calculating adjusted liabilities, check that:

        i. an executed deed of subordination exists; and

        ii. the amount that has been classified as subordinated debt is not repayable within one year from the date of the NTA calculation; and

    (e) enquire with you whether any guarantees have been provided by you during the accounting period and note any that have not been included in the NTA calculation.

Please note that these proposed changes should be read together with the amendments proposed to this condition for DIMS licensees on page [30] of this consultation paper.

Questions

16. Do you agree or disagree with the proposed changes? Please provide your reasons.
17. Is our proposed timeframe for notifying the FMA, if your NTA calculation is not positive, reasonable?
18. Do you agree or disagree with the proposed changes regarding the scope of the AUP engagement that is required? Please provide your reasons.

Changes to Appendix 1

Clarification that - some of these terms have definitions that are similar to but not the same as generally accepted accounting practice.

Audit requirements

	Current language
2. DIMS, Standard Condition 8	You must also engage a qualified auditor and enter into agreed upon procedures terms with the auditor to provide for the auditor to review the calculation of your NTA as at your balance date each year. The auditor's report must include a statement that, as at your balance date, in the auditor's opinion, you calculated your net tangible assets correctly.

Comments and reasons

When the standard conditions were drafted there was an understanding that all DIMS licensees would be subject to external audit. The audit engagement required for NTA assumed that there would be some synergy with the financial audit already being undertaken and there would not be a significant additional cost burden for licensees.

Subsequent to the release of the standard conditions, an exemption from the financial reporting requirements of the FMC Act was provided for 'small' licensed DIMS providers (the Financial Markets Conduct (Financial Reporting – DIMS Licensees) Exemption Notice 2015 (the **Exemption**)). In summary this exemption provides that:

- licensed DIMS providers with less than $100m retail funds under management are exempt from preparing financial statements that comply with generally accepted accounting practice (**GAAP**)
- licensed DIMS providers with $100m to $250m retail funds under management are exempt from having financial statements audited (but are still required to prepare financial statements that comply with GAAP and to lodge them with the Registrar).

When the standard conditions for AFAs were amended to take account of personalised DIMS under the Financial Advisers Act 2008 (the **FA Act**), given that AFAs are individuals and are therefore not currently subject to external audit, it was considered appropriate to provide some relief to reflect this. The standard condition for 'financial resources' therefore requires AFAs to engage a qualified auditor only if requested by the FMA, rather than as a matter of course. In particular, the condition states:

'Upon request from the FMA the AFA must, within the time frame requested by the FMA, engage a qualified auditor and enter into agreed procedures to review the calculation of the AFAs NTA.'

Given the scope of the Exemption and the standard condition applicable to AFAs who are authorised to provide personalised DIMS under the FA Act, the FMA is considering amending the audit requirements in respect of NTA calculations for small licensed DIMS providers to make them consistent. The proposed amendments are intended to reflect that it may not be appropriate to require a qualified auditor to be engaged as a matter of course due to the cost implications relative to the size of the small DIMS provider's business. However, the FMA needs the ability to require this in certain circumstances.

Proposed changes

If you are not eligible to rely on the Financial Markets Conduct (Financial Reporting – DIMS Licensees) Exemption Notice 2015 or upon request from the FMA, you must ~~also~~ engage a qualified auditor . . .

Please note that these proposed changes should be read together with the amendments proposed to this condition on pages [25 to 29] of this consultation paper.

Questions

19. Do you agree or disagree with the proposed changes? Please provide your reasons.
20. Do you agree or disagree with excluding small licensed DIMS providers from the audit requirements in the 'financial resources' standard conditions, unless the FMA requests an audit to be undertaken? Please provide your reasons.
21. Do you agree or disagree with applying the same threshold for excluding the NTA audit as that which applies for excluding the financial statement audit under the Exemption? Please provide your reasons.

Exclusion of NZX Participants from NTA and audit requirements

	Current language
3. DIMS, MIS, crowdfunding, peer to peer – Standard Condition 8	This is proposed new text.

Comments and reasons

During the licensing process we have been asked to consider how the current financial resources NTA requirements in the standard condition (the **FMA NTA requirements**) would apply to a licensee who is also subject to the capital adequacy requirements under the NZX Limited Participant Rules (the **NZX capital adequacy requirements**).

We have reviewed the NZX capital adequacy requirements and in our view they are largely comparable with the FMA NTA requirements. The following points are noted.

- The capital measure in the NZX's capital adequacy requirements is of net tangible current assets (**NTCA**), which in most instances is more conservative than the NTA calculation in the FMA NTA requirements.
- The NZX capital adequacy requirements include a minimum NTCA level of at least $250,000. In comparison, under the FMA NTA requirements the licensee must have positive NTA (and notify the FMA if they do not).
- The NZX capital adequacy requirements include reporting obligations to NZX Limited (**NZX**) where the NTCA is at any time less than 120% of the prescribed minimum capital adequacy. In comparison, the FMA NTA requirements only require reporting when the NTA is not positive.

On this basis and to simplify matters for licensees who are also subject to the NZX capital adequacy requirements, we propose to exclude such licensees from the financial resources standard condition. Instead, we propose that they must comply with the NZX capital adequacy requirements, and if any notification is required to be provided to NZX under such requirements (other than standard monthly reporting), they must also provide a copy of such notification to the FMA at the same time. This will allow us to remain informed about these licensees' NTCA levels while not imposing additional NTA calculation and reporting requirements under the standard conditions. We consider that although licensees who are subject to the NZX capital adequacy requirements will not have to comply with the audit requirements in the standard condition, they are however subject to ongoing supervision by NZX.

Proposed changes

To be *included at the end of Standard Condition 8*:

If you are a market participant requiring capital under the NZX Limited Participant Rules (the **NZX Rules**), then you do not need to comply with the requirements in paragraphs 1 and 2 above, provided that:

- you are not exempt from the capital adequacy requirements in the NZX Rules (the **NZX capital adequacy requirements**)
- you comply with the NZX capital adequacy requirements
- you provide the FMA with copies of any notification given by you to NZX if your NTCA is at any time less than 120% of your prescribed minimum capital adequacy (at the same time this information is provided to NZX)
- you provide the FMA with copies of any reports from NZX relating to the compliance or non-compliance with the NZX capital adequacy requirements
- you notify the FMA if you cease to be subject to regulation by NZX as soon as reasonably practicable after becoming aware of the same.

If you cease to be subject to the NZX capital adequacy requirements or to regulation by NZX, you must comply with the requirements set out above in paragraphs 1 and 2 instead.

Questions

22. Do you agree or disagree with the proposed changes? Please provide your reasons.

23. Is it appropriate for small DIMS businesses licensed under the Financial Markets Conduct Act to be granted relief from the NTA audit engagement? Please provide your reasons.

24. Should the same threshold apply to the NTA audit as that for the exemption for financial statement audit? Please provide your reasons.

Part B: Proposed variations to other standard conditions and Appendix 1

Timing for notification of changes to governance and compliance arrangements

1. DIMS, Standard Condition 7 MIS, Standard Condition 7 Peer to peer, Standard Condition 6 Crowdfunding, Standard Condition 6 Independent trustee (corporate), Standard Condition 7 - governance arrangements	Current language Your governance and compliance arrangements must be substantially the same as, or better than, those in place, or which the FMA was advised of, at the time you applied for your licence (or any subsequent change advised to the FMA). You must notify the FMA of material changes to your governance and compliance arrangements. Explanatory note: This condition requires you to maintain your compliance and governance arrangements to at least the standard you have told us about, but it allows flexibility for these arrangements to be improved. This condition also requires you to notify us of material changes to your governance and compliance arrangements, which includes any material change to your outsource arrangements. For further information in relation to the requirements of your governance and compliance arrangements see the governance and compliance sections of the Licensing Application Guide.

Comments and reasons

The condition does not state the timeframe within which material changes to the licensee's governance and compliance arrangements must be notified to the FMA. The FMA considers it appropriate to include a timeframe for clarity.

We propose that material changes to the licensee's governance and compliance arrangements must be notified to the FMA as soon as practicable. This is consistent with the language used in section 412 of the FMC Act which requires licensees to report certain matters to the FMA. In our view, this approach is preferable to including a specific number of working days as the notification period as it allows flexibility for what is practicable in the circumstances. However, we also consider that it would be helpful to confirm in the explanatory note that we would ordinarily expect notifications to be given within five working days as we consider this to be a reasonable timeframe and consistent with the obligation to notify as soon as practicable.

Proposed changes

Your governance and compliance arrangements must be substantially the same as, or better than, those in place, or which the FMA was advised of, at the time you applied for your licence (or any subsequent change advised to the FMA). You must notify the FMA of material changes to your governance and compliance arrangements as soon as practicable.

Explanatory note: This condition requires you to maintain your compliance and governance arrangements to at least the standard you have told us about, but it allows flexibility for these arrangements to be improved. This condition also requires you to notify us of material changes to your governance and compliance arrangements, which includes any material change to your outsource arrangements, as soon as practicable (which we would ordinarily consider to be within five working days). For further information in relation to the requirements of your governance and compliance arrangements, see the governance and compliance sections of the Licensing Application Guide.

Question

25. Do you agree or disagree with the proposed changes? Please provide your reasons.

26. Is the proposed timeframe for notifying the FMA of material changes to your governance and compliance arrangements reasonable?

Excluded assets – intangible assets

2. DIMS - Appendix 1: Net tangible assets (NTA) – paragraph 4, excluded assets MIS – Appendix 1: Net tangible assets (NTA) – paragraph 4, excluded assets Peer-to-peer – Appendix 1: Net tangible assets (NTA) – paragraph 4, excluded assets Crowdfunding – Appendix 1: Net tangible assets (NTA) – paragraph 4, excluded assets	**Current language** 4. **Excluded assets** means: (a) The value of any intangible assets (i.e. non-monetary assets without physical substance), plus . . .

Comments and reasons

Under the standard conditions, licensees must calculate their net tangible assets (**NTA**) at least monthly. 'Net tangible assets' is calculated as adjusted assets minus adjusted liabilities (as defined in Appendix 1). The definition of 'adjusted assets' refers to 'excluded assets', which in turn refers to the value of any 'intangible assets'.

We have received feedback that it would be helpful to further clarify the scope of 'intangible assets'. We consider that this will include intangible assets within the scope of NZ IAS 38 *Intangible Assets,* such as brands and management rights, goodwill under NZ IFRS 3 *Business Combinations,* as well as deferred tax assets recognised under NZ IAS 12 *Income Taxes*. We propose to include an explanatory note about this.

Proposed changes

4. **Excluded assets** means:

(a) The value of any intangible assets (i.e. non-monetary assets without physical substance)

Explanatory note: In this context, 'intangible assets' includes any intangible assets recognised under NZ IAS 38 Intangible Assets such as brands and management rights, goodwill under NZ IFRS 3 Business

Combinations, as well as deferred tax assets recognised under NZIAS 12 Income Taxes.

Question

27. Do you agree or disagree with the proposed changes? Please provide your reasons.

Inclusion of subordinated debt in adjusted liabilities

3. DIMS, Appendix 1: Net tangible assets (NTA), paragraph 9(a) MIS, Appendix 1: Net tangible assets (NTA), paragraph 9(a) Peer to peer, Appendix 1: Net tangible assets (NTA), paragraph 9(a) Crowdfunding, Appendix 1: Net tangible assets (NTA), paragraph 9(a)	Current condition **Adjusted liabilities** means, in relation to a market services licensee, the amount of total liabilities as they would appear on a balance sheet at the time of calculation that has been prepared on the same basis as the market services licensee's financial statements required under Part 7 of the Act: (a) minus the amount of any liability under any subordinated debt, where the obligation to repay the debt is subordinate to all other claims, demands, rights and causes of action of all unsubordinated creditors and the debt is not repayable within one year; . . .

Comments and reasons

One of the purposes of imposing financial requirements is to provide owners of licensees with incentives to comply by having a minimum level of investment or net tangible assets (NTA) in the licensed entity. We appreciate that licensees may be funded through a combination of equity and debt, including loans from their shareholder(s). Therefore, when calculating their NTA licensees are permitted to exclude loans from their owners from adjusted liabilities provided the loan is subordinated appropriately. Requiring the loan to be subordinated is to help ensure that licensees meet their obligations to their clients, and wind up in an orderly way when their business ceases or their licence ends.

However, we have received feedback that is not clear from the current language when the one year timeframe is calculated from. For example, is it from the date when the NTA calculation is being performed or is it the date when the deed of subordination is entered into? The FMA's view is that the date of the repayment of the debt (in full or part) must be at least one year after the date on which you exclude the debt from your liabilities for the purposes of the NTA calculation. That is, a year from the date to which the NTA calculation relates. We also consider it desirable

to clarify that the subordinated debt must be documented in a formal agreement, a copy of which must be provided to the FMA or your auditor upon request.

We have also received questions about whether partial repayment is permitted within one year. We consider it acceptable if the debt document allows for partial repayment within one year. However, the debt documentation will need to clearly state the amount of the debt which is not repayable within a year. Only the amount that is not repayable within a year can be excluded from liabilities when calculating NTA. Any amount that is repayable or could be repaid within one year will not be subordinated debt, and cannot be excluded from your liabilities for the purposes of your NTA calculation. We propose to include an illustrative example in the Explanatory Note.

Proposed changes

Adjusted liabilities means, in relation to a market services licensee, the amount of total liabilities as they would appear on a balance sheet at the time of calculation that has been prepared on the same basis as the market services licensee's financial statements required under Part 7 of the Act:

(a) 'minus the amount of any liability under any subordinated debt agreement (a copy of which must be provided to the FMA or your auditor upon request), where the obligation to repay the debt is subordinate to all other claims, demands, rights and causes of action of all unsubordinated creditors and the debt is not repayable within one year of the date to which the NTA calculation relates. . '.

Explanatory note: We consider it acceptable if the loan agreement allows for partial repayment within one year. However the loan agreement will need to clearly document the amount of the loan which is not repayable within a year. Only the amount that is not repayable within a year can be excluded from liabilities when calculating NTA. Any amount that is repayable or could be repaid within one year will not be subordinated debt and cannot be excluded from your liabilities for the purposes of your NTA calculation. For example, if there is a shareholder loan of $3m, the loan agreement could provide that:

- a clearly quantified amount of the loan is repayable on demand (eg $2m) – this amount cannot be classified as subordinated debt, and
- a clearly quantified amount of the loan is not repayable until a certain date, that is not within a year of the NTA calculation (eg $1m) – this portion of the loan could be classified as subordinated debt, and excluded from liabilities in the NTA calculation.

Questions

28. Do you agree or disagree with the proposed changes? Please provide your reasons.
29. Do you agree or disagree that the one year timeframe should be calculated from the date to which the NTA calculation relates? Please provide your reasons.
30. Should partial repayment be permitted within one year provided that the relevant debt documentation clearly states the amount of the debt which is not repayable within a year?

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