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LAWYERS

# Compliance and Enforcement – The Role of the Financial Markets Authority

Cathy Quinn

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# Outline

- FMA's enforcement and compliance role; its relevance to you.
- Expectation of increased enforcement: key basis for legislation.
- Consequences of greater enforcement action.
- Extent of FMA's enforcement powers.
- The need for balance.
- FMA's enforcement policy and priorities.
- Section 34 power.
- Prediction of more focus on non-jail enforcement.
- FMA approach to compliance.

## **FMA Role**

FMA says:

- it enforces securities, financial reporting and company law as they apply to financial services and securities markets;
- it regulates securities exchanges, financial advisers and brokers, trustees and issuers including issuers of Kiwisaver and superannuation schemes.

# Why should you care?

- You are mostly bankers or advisers to banks.
- **FMA is clearly relevant to banks.**
- Banks:
  - are issuers of a variety of financial products;
  - employ and are themselves financial advisers;
  - offer Kiwisaver and superannuation products.
- Banks are therefore subject to the scrutiny of the FMA.

# Why should you care?

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- Banks also finance other providers of financial products. If those providers breach financial services laws – the Banks funding to those customers can be at risk.
- Banks are also interested in financial markets that are “healthy” and which investors have confidence in.
- Bank customers who lose money in bad financial investments may become financially stressed bank customers.

# Summary of why you should care?

- Bad for business to breach the law – negative PR, financial cost to compensate investors, also possibility of fines and jail.
- Customers financial position can be put at risk – can impact on bank's profits.
- Can put "system" at risk.
- Good corporate citizens.

# Expectations of the FMA

- When the Bill establishing the FMA was introduced into Parliament the Government outlined its expectations of the FMA.
- Nathan Guy on behalf of the Minister of Commerce said:
  - “... it is essential that the financial sector is subject to **clear rules** that investors can be **confident will be enforced actively and consistently** ...

# Expectations of the FMA

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- The market also called for more active enforcement by the regulator and was critical of what was considered a lack of enforcement by the Securities Commission.

# Legislation itself gives FMA wide enforcement powers

- The FMA has broad enforcement powers.
- It is expected to use them.
- It has recruited people with enforcement backgrounds.
- Sean Hughes is ex ASIC – ASIC has long been an “active enforcer”.
- It has a bigger budget than the Securities Commission.
- Expect enforcement.

# Legislation itself gives FMA wide enforcement powers

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- My prediction is that you will not always like it.
- Indeed some of you will complain.
- It has a bigger “toolbox” than the Securities Commission and intends to use all its tools.
- There is more scope for compensation to investors from individuals (as opposed to jail time).
- The FMA has said it will look to hold accountable directors, senior executives, shadow directors and advisers where appropriate.

# Legislation itself gives FMA wide enforcement powers

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- I expect to see the FMA seek financial compensation from individuals (eg directors) rather than seeking criminal sentences.
- I expect this will result in more litigation in respect of financial services legislation and a perception of greater risk by market participants.
- It remains an open question as to whether the market will price that risk.

# Outline of enforcement powers of FMA

- FMA has broad enforcement powers and additional powers are contemplated under the FMC Bill.
- These powers include:
  - ability to make stop orders, eg if a PDS is misleading or deceptive. The order can prohibit the issue of securities under the PDS;
  - ability to make interim stop orders if it is considering making a stop order and thinks it desirable in the public interest to make an interim order;

# Outline of enforcement powers of FMA .../2

- ability to make direction orders (direct someone to comply) if FMA is satisfied has/would contravene certain provisions of the Bill;
- can apply to High Court to injunct a market participant from engaging in conduct that would contravene legislation;
- can apply for a declaration of contravention of a civil remedy provision;

# Outline of enforcement powers of FMA .../3

- can issue “infringement notice” if FMA believes on reasonable grounds that a person is committing/has committed an infringement offence;
- can apply to the Court to make a banning order against a person;
- can apply to Court for an order to protect interests of aggrieved persons in case of financial market investigation/proceedings. Wide range of orders can be made, eg prohibiting a person from transferring \$\$;

# Outline of enforcement powers of FMA .../4

- can exercise the right of action of a person against a financial market participant if it considers it in the public interest to do so, eg to enforce a breach of directors duties under the Companies Act.

## Balance by the FMA will be key

- In my view it will be important that the FMA gets the balance right.
- Sometimes mistakes happen.
- Decisions made in times of crisis can often be second guessed later.
- An overly sanctimonious FMA could harm the market.
- However, the public/political/regulatory mood is for enforcement action.

## Balance by the FMA will be key .../2

- Regulatory action against even those considered the “good guys” can improve market standards.
- The FMA should be careful about taking cases to send a “regulatory message” when it is not on firm ground or it is a “grey area”.
- Enforcement action invariably harms issuers and individuals reputations.

## Balance by the FMA will be key .../3

- In announcing FMA's enforcement policy, the chairman said:

"FMA will focus its energy not across every act of misbehaviour or insignificant breach but primarily on those areas of misconduct where the failings or breaches are intentional or reckless or involve other serious unlawful conduct, and where the perpetrator set out to intentionally mislead or deceive innocent investors or third parties."

- The FMA has stated that 4 important principles underpin its enforcement policy.
  - (1) It will use “the full regulatory toolbox’ including criminal prosecution and its new power to take action on investors behalf.
  - (2) FMA’s resources will be prioritised. Matters that will gain full force of FMA’s scrutiny:
    - Those that involve large numbers of investors at risk of significant/potential loss;
    - Where there is evidence of intentional unlawful behaviour;
    - Where there is a need to send a clear regulatory signal to the market;

- (3) FMA is committed to an open and educative approach so participants can meet best practice standards of compliance;
- (4) FMA will use its powers to bring “test cases” to clarify “grey areas”.

# Early enforcement priorities of the FMA

The FMA has given guidance on its early priorities.

These are:

- (1) **Compliance with new legislation** – FMA has said it will actively enforce new licensing regimes. Eg Registration of financial service providers, trustees and statutory supervisors.
- (2) **Kiwisaver** – FMA has said it will act decisively against misconduct in Kiwisaver sales and distribution practices.

# Early enforcement priorities of the FMA .../2

- (3) **Trading conduct** – FMA will work with NZX in relation to trading conduct.
- (4) **AML/CFT** – FMA has said it will move swiftly to monitor policies and procedures used by financial institutions to assess and manage risks of money laundering and terrorist financing from 30 June 2013 (date for compliance – given 2 year lead in).

# My perception of biggest areas of cultural change

- (1) More active and aggressive enforcement.
- (2) Increased emphasis on significant financial consequences for breach.
- (3) FMA's power to exercise person's right of action against market participants.

# FMA's power to exercise person's right of action

- Section 34, FMA Act 2011
- ASIC had a similar power for some years
- Power sought by chair of Securities Commission
- Seen as a missing enforcement tool

## Section 34

- FMA can exercise right of action of a person against a financial market participant
- FMA can also takeover proceedings
- FMA needs to consider it in the public interest to do so

## Section 34

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- Regarding proceedings:
  - Concerning Financial markets legislation or;
  - Seeking damages or other relief for fraud, negligence, default, breach of duty, or other misconduct in connection with a matter FMA inquired about/investigated.
- FMA needs to take into account a specified range of factors before proceeding.

## Section 34

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- In some cases leave of the High Court is needed.
- Individuals can decline the FMA taking over their rights of action.
- ASIC has used its power sparingly.
- Expect FMA however to use the power more frequently.
- ASIC has express power to enforce directors duties and other market misconduct.
- I expect FMA will use section 34 in respect of breaches of directors duties.

# Likely Increased emphasis on financial compensation/penalties rather than jail time

- Bill does continue to provide for criminal offences.
- For “egregious” behaviour there will be the potential for significant jail time.

eg potential 10 years jail if there is defective disclosure in a PDS, it is material and a person knew of the contravention or was reckless about it.

- Also ability for the FMA to issue “infringement notices” for lesser offences.

## Likely Increased emphasis on financial compensation/penalties rather than jail time .../2

- The Court can also impose significant fines of up to \$1 million against individuals and \$5 million for others.
- I think you will see the FMA looking for fines rather than jail time in many instances.
- The scope of matters that can fall under the “civil remedy” provisions are also expanded.

## Likely Increased emphasis on financial compensation/penalties rather than jail time .../3

- Contraventions of civil remedy provisions can result in significant pecuniary penalties. Some of these can be as much as (the greater of) the consideration for the transaction, 3 x gain made/loss avoided and \$1 million for individuals and \$5 million in any other case.
- Civil remedy regime significantly increases the likelihood of enforcement/litigation by investors.

## Likely Increased emphasis on financial compensation/penalties rather than jail time .../4

- FMA has said if a market participant is considering settling – it should do so early before the FMA has committed to pursuing an enforcement matter. Need to take that into account.

# Compliance

- In addition to encouraging compliance via enforcement the FMA pro-actively encourages compliance by education.
- A section of its website is specifically committed to this: “Help Me Comply”.
- The FMA publishes guidance notes and general guidance.
- The FMA actively participates in conferences such as this and, in the media, to highlight the law, areas of interest and best practice.

# Compliance

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- The FMA has a regular practice of “meeting the market”. These forums all go to educating the market and encouraging compliance.
- The FMA’s staff have continued to be open to market participants pro-actively seeking guidance on an individual basis.
- The FMA has also set about seeking and taking on board market feed back on its guidance policies. eg the process followed in respect of the guidance note on Effective Disclosure.

# Compliance

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- Achieving compliance via education and positive engagement with the market is obviously better than costly enforcement.

- Sean Hughes has said:

“Mature regulators don’t see their job as simply enforcing a set of laws which Parliament has passed.”

“FMA will work hard to ensure participants understand how we will interpret the rules.”

“We are hopeful our education programs, our market consultation, and our guidance and policy notes will bring about a new era of professionalism, good governance, increased confidence.”

# Conclusion

- FMA has extensive powers of enforcement.
- Use of those powers is critical to the development of NZ's capital markets.
- Getting the balance right is key.
- We all have our role to play in supporting the FMA doing so.