

FMA'S COMPLIANCE FOCUS FOR 2013



FINANCIAL MARKETS AUTHORITY

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INTRODUCTION

This document outlines the Financial Markets Authority's (FMA's) priority areas for monitoring and surveillance in 2013. It provides an opportunity for participants to assess their activities and take steps to improve behaviours and compliance controls in these areas. Four major themes will influence our priorities:

- 1. Building customer trust** – participants need to be fair and transparent in their dealings with customers, with customers' interests central to their activities.
- 2. Raising standards in existing regimes** – we expect participants to demonstrate behaviour above the bare minimum required, with a focus on good conduct, ethics and integrity.
- 3. Embedding new regimes** – participants need to adapt to new regulatory regimes so as to realise the intended benefits for markets and customers.
- 4. KiwiSaver** – participants involved in the management, distribution and oversight of KiwiSaver must ensure they meet regulatory standards and act with customer interests in mind.

Our priorities will evolve as we monitor financial markets and evaluate emerging risks, but it is anticipated that the themes will remain beyond 2013.

This document outlines our priorities, it is not intended to be a complete list of all the work we will do in 2013. It also outlines our overall regulatory approach.

PRIORITIES FOR 2013:

1: Building customer trust

Investors rely on market participants to act with integrity in their dealings with them. This integrity is crucial to building customer trust and confidence, promoting the long term success of participants and growing New Zealand's capital base. We expect participants to make customers' interests central to their activities.

By necessity market participants continually evolve their business models and strategies to increase profitability and control costs. As markets change, we encourage innovation in both product development and distribution, but we expect market participants to put customer interests first when designing, marketing or selling new products and in relation to their financial market activities more generally.

At the same time, we expect investors to take responsibility for their financial decisions. To assist, FMA will work with other agencies to make information available to help investors better understand risk and make informed decisions.

Focus areas

Saving for later years – FMA has made KiwiSaver a priority over the coming 12 months. Section 4 sets out steps we will take to encourage market participants to raise standards and ensure investors get the information they need to make informed decisions.

Search for higher yield – A low interest rate environment can encourage investors into higher risk products as they search for yield, particularly if they are reliant on the income from their investments. Where participants design products to achieve higher yield, they should ensure that the product is properly explained, the risks are transparent, and information is made available to allow investors to determine if the price or return appropriately reflects the risk. We will be conscious of this in our monitoring of offer documents.

Retirees are one group that may be affected by the search for higher yielding products, but are less able to recover from loss of capital. FMA expects participants to take into account the vulnerability of these customers when advising on, or delivering financial products.

Perimeter activities – New Zealand investors and financial markets can be impacted by activities or products outside FMA's regulatory perimeter, particularly if the market assumes they are regulated by FMA. We will review complaints about perimeter activities and products, and will issue warnings or involve other agencies as appropriate.

Unsolicited offers – New regulations came into force on 1 December 2012, which require greater disclosure from a person making an unsolicited offer, and ensures stronger rights and remedies for shareholders. FMA will undertake monitoring to ensure that future offers comply with the new regulations.

Inappropriate conduct – Tips and complaints are an important source of information for FMA and we encourage market participants to advise FMA of any poor conduct or behaviour. Participants should have processes in place to facilitate and encourage internal whistleblowing if an employee believes there is inappropriate conduct within an organisation. Processes should deal fairly with those employees and ensure prompt investigation. In some circumstances, employees can also make protected disclosures directly to FMA. FMA's website explains more about this and how anonymous tip-offs can be made.



2: Raising standards in existing regimes

FMA's overarching focus is on raising standards of good conduct, ethics and integrity amongst market participants. Where activities have been subject to regulation for some time, FMA has higher expectations that participants will operate above the bare minimum required, and expects senior management to sponsor a culture of integrity and good conduct.

As New Zealand's regulatory relationships continue to mature, FMA looks forward to working in 'constructive tension' with participants to bring about higher standards of conduct and compliance, while ensuring a proportionate regulatory approach.

Focus areas by regulated sector

Securities exchanges and futures markets – FMA has conducted a number of enquiries into trading on registered securities exchanges, including some that revealed poor administrative practice by substantial shareholders, directors and officers, resulting in delays in notifying the market of trading. Over the next 12 months, our work will include a focus on this issue to help ensure market transparency. We will take action where our inquiries identify serious failure to comply with continuous disclosure obligations, or any insider trading or market manipulation.

NZX oversees the fair, orderly and transparent operation of its securities exchange and futures markets. NZX replaced its trading system during 2012. Our annual report on NZX's compliance will take this into account and will review matters raised in our 2011 report, including changes NZX has made to improve management of the conflict between its roles as market operator and monitoring agency. NZX also implemented the new TAF market late in 2012 and our work during 2013 will consider the new market as it develops.

Futures dealers – Initial visits to authorised futures dealers have indicated that some firms had poor compliance controls in place for meeting capital requirements and safeguarding client money and assets, and also indicated a lack of robustness in the work undertaken by external reviewers. We will publish a summary of our findings and these areas will be a focus in our monitoring work.

Issuers – FMA is concerned about a lack of focus on obligations to investors by some issuers and their directors. Areas of particular concern are the inadequate handling and disclosure of conflicts of interest and disclosure of business changes. We will focus on these issues as part of our review of prospectuses and offer documents during 2013. We will also focus on those issuers currently offering securities where we are aware that they are experiencing trading or financing difficulties.

Some issuers are subject to oversight by securities trustees and statutory supervisors, who must report to FMA if they believe an issuer has breached, or may breach, a disclosure requirement. The report must indicate what action the trustee or supervisor intends to take and FMA may also act on these reports.

Our Effective Disclosure guidance highlights the need for product transparency from the perspective of a prudent but non-expert investor. As part of our 2013 work programme, we will monitor how issuers adapt to our guidance.

Property related investments may seem attractive in the current economic environment, but may be higher risk than they seem. We will consider the transparency of investment structure and risks, and will also issue disclosure guidance for proportionate property ownership schemes. We will monitor scheme compliance with the disclosure requirements following the expiry of previous exemptions.

Non-GAAP financial information can be useful for investors, but has the potential to be misleading. We will monitor how issuers adapt to our guidance on disclosing such information. We will undertake themed reviews of other financial reporting, including a focus on hybrid instruments.

Handling client money and property as intermediary ('Brokers') – Any person who holds money or property as an intermediary for a client in the purchase, sale or holding of a financial product is a 'broker' under the Financial Advisers Act. This is likely to include NZX brokers, custodians, and some banks and building societies, firms with AFAs, mortgage and insurance brokers and wrap platforms. Brokers are required to keep retail clients' money and property separate from their own and on trust. We will visit a number of brokers to monitor their compliance with these requirements. We will focus on reconciliations of internal and external records, plus segregation of roles, and will take into account how the broker has assured itself of compliance, for example through internal or external review.

Financial advisers, including Qualifying Financial Entities (QFEs) – AFAs provide advice and other services dealing with investments. FMA has identified a number of concerns about compliance with the Code of Professional Conduct, including suitability of advice, the clarity of the nature and scope of services provided, and standards of client care¹. These issues will be the focus of monitoring visits to AFAs in 2013. Our work will also include a focus on the provision of discretionary investment management services (DIMS). We will be alert to pressures on advisers which may lead to poor conduct, such as reduced income arising from lower funds under advice and investors' search for higher yield.

QFEs are responsible for overseeing compliance by their advisers. We expect to increase our proactive monitoring of QFEs in 2013 with a focus on: competence and supervision of advisers; processes for ensuring suitability of advice; and compliance assurance.

FMA's monitoring approach and focus areas for compliance by financial advisers are set out on our website. We publish summaries of our findings and expect advisers to review their compliance in areas identified so that overall market standards are raised. We will follow up any intelligence which suggests that Registered Financial Advisers (RFAs) are providing personalised advice on investments or have demonstrated poor conduct.

¹FMA's AFA Monitoring Reports in 2012 identified these concerns.

3: Embedding new regimes

It is important that market participants adapt to new regulatory obligations in a timely manner so that the regimes can achieve their objectives and generate benefits for both investors and the financial markets.

2013 will see the introduction of some important new regulatory regimes. FMA's initial focus will be on embedding these new regimes by educating market participants, setting clear expectations and monitoring compliance with their obligations.

The next major change to New Zealand's financial markets regulatory regime will be the Financial Markets Conduct Bill (FMC Bill). During 2013 we will work to help raise awareness amongst participants in preparation for the implementation of the Bill.

Focus areas by regulated sector

FMA is responsible for regulating or monitoring securities trustees, statutory supervisors and accredited bodies, who are referred to as frontline regulators and have new and important roles to play in our financial markets.

Securities trustees and statutory supervisors – Our monitoring will include reviewing: compliance with individual licence conditions, any areas of potential weakness identified during licensing, and whether processes and controls are in place, operating, and being overseen by management.

FMA will issue guidance on our expectations of how trustees and supervisors should undertake their oversight responsibilities and their six monthly reporting to FMA. We will respond to matters raised in these reports, such as any changes which may affect a licensee's ability to perform its role to the required standard.

Issuer auditors and accredited bodies – FMA's regulation and oversight of auditors² will include quality reviews of audit firms in 2013. These reviews will be informed by experiences of past issuer disclosure failures, and will focus on compliance with audit standards and how audit firms achieve the following: identifying and managing their own potential conflicts of interest, dealing with related party transactions by the issuer, and understanding the issuer and its environment to assess and address the risks of material misstatement.

Our work with accredited bodies includes a focus on ensuring that their approach to licensing auditors is robust. We will review NZICA's approach to oversight of auditors by carrying out a 'shadow accreditation' (NZICA was automatically accredited under the legislation).

Anti-money laundering and countering financing of terrorism (AML/CFT) – FMA is working with the other AML/CFT supervisors to set expectations in advance of the implementation of the regime. FMA has met with over 100 reporting entities to assess their readiness and the size and nature of their business. We will take this into account when setting our monitoring priorities. We expect all businesses to be ready to comply from the start of the regime.

From 30 June 2013, we will monitor how entities assess and manage AML/CFT risks, with a focus on customer due diligence. We will take action in instances of non-compliance.

Fund managers – We expect fund managers to act with integrity in their dealings with customers and market participants, including in their activities as issuers and managers of KiwiSaver schemes. The FMC Bill is expected to require fund managers to be licensed by FMA and we encourage them to review the robustness of their operational arrangements, including their controls, monitoring and governance in preparation for future licensing.

² Please see FMA's Auditor Regulation and Oversight Plan for more information.



4: KiwiSaver

For many New Zealanders, KiwiSaver will be their first investment and will impact their future financial security. Participants involved in KiwiSaver management, distribution and oversight must ensure they meet regulatory standards and act with customer interests in mind. This is important for members who are relying on KiwiSaver as a key pillar of their retirement savings strategy, but also for consumer confidence in New Zealand's financial system and for the economy more broadly.

FMA is one of several government agencies with a role in regulating the KiwiSaver sector. Trustees (for non-restricted schemes) also have a responsibility as frontline regulators for supervising management and administration of the scheme.

FMA has already taken a number of steps to raise standards in the market and help investors get the information they need to make informed decisions. We have issued guidance on Effective Disclosure for product issuers, KiwiSaver Performance Fees, and Sale and Distribution. We have also issued warnings and taken action in relation to some sales practices, and issued guidance for investors.

Focus areas

Investments – Managers must exercise care, diligence and skill in the investment of scheme assets, and act in accordance with the stated investment policy and objectives. We will complete our initial review of how KiwiSaver trustees monitor the investment activities of managers, with a focus on processes and controls. The review will identify what further monitoring work should be undertaken.

Unit Pricing – Unit pricing errors can have adverse implications for investors. FMA will consider how KiwiSaver scheme trustees monitor managers' pricing activities.

Disclosure – FMA will review KiwiSaver scheme offer documents in conjunction with the statement of investment policy and objectives to test whether: investment strategies are appropriately disclosed, and disclosure documents are understandable to investors.

KiwiSaver scheme trustees – Trustees' responsibility as frontline regulators is crucial to the effective operation of KiwiSaver schemes. We will include a focus on KiwiSaver as part of our ongoing monitoring of trustees. FMA will also work to clarify our expectations of trustees in respect of KiwiSaver schemes.

Advice – FMA has already issued guidance on KiwiSaver sales and distribution and will monitor how distributors adjust to the guidance. We expect distributors to monitor sales practices and avoid inappropriate customer incentives. We will issue information for customers on the selection of non-advice or advice services, in response to feedback and will take action in the event of mis-selling.

Fees – Two new sets of requirements aim to increase transparency of fees and allow easier comparison between schemes. Once implemented, we will monitor compliance with these new requirements, which include quarterly reporting on fees to members and fee disclosure in trustee annual reports. After a period of 'settling in' of the Guidance Note: KiwiSaver Performance Fees, we will undertake a review to determine to what extent this guidance is being met.

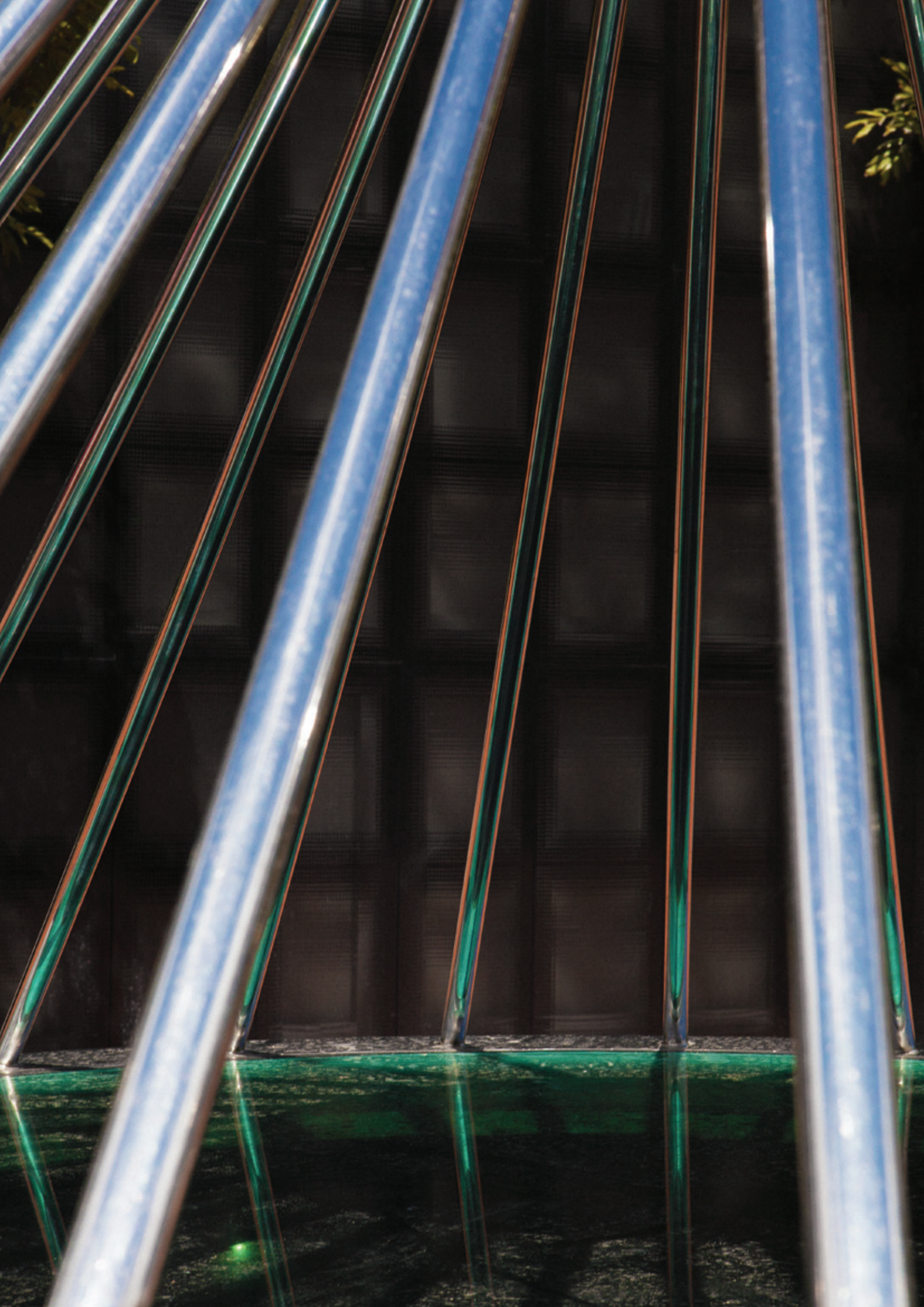
CHRISTCHURCH

In addition to the four major priorities outlined, FMA is also mindful of the need to support participants and investors throughout the reconstruction of Christchurch.

The Christchurch rebuild presents a unique environment in which poor conduct could significantly impact a vulnerable community. Many Cantabrians are looking to invest compensation or insurance money whilst they plan their futures and FMA expects participants to deal appropriately with these investors. We will maintain surveillance of advice practices in Christchurch and will continue to provide information for investors where needed throughout the reconstruction of Christchurch to promote a confident, healthy marketplace.

While FMA is supportive of capital raising to facilitate the Christchurch rebuild, we expect this to be undertaken with customer needs in mind. FMA is conscious that the situation in Christchurch presents some unique challenges for participants and we will work to assist them. It is important that high standards are maintained in this market.



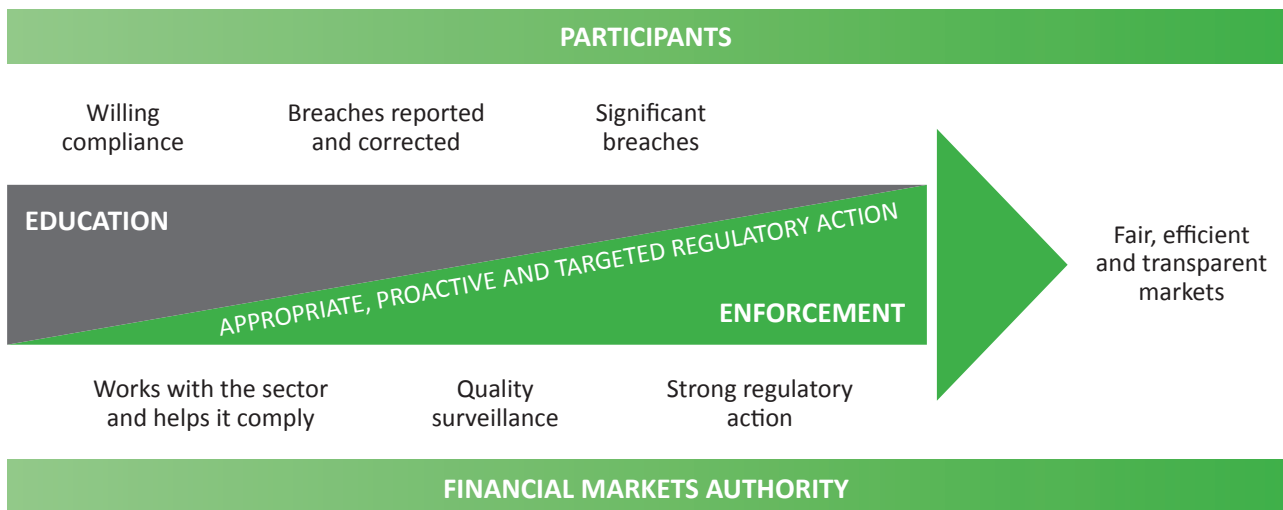


REGULATORY APPROACH

FMA compliance strategy

Our compliance strategy emphasises a ‘top of the cliff’ approach and focuses on lifting standards by market participants. We are seeking to foster a culture in which market participants proactively work to set appropriate standards, put in place a robust approach to managing and monitoring compliance, and willingly share information with us (including reporting breaches).

Figure 1: FMA’s compliance strategy:



Our monitoring and surveillance work is outcome focused, so we consider whether compliance is achieved and the desired outcomes for customers are delivered.

To this end, our activities often start by asking senior management *“how do you know your organisation is compliant and adopting appropriate behaviours?”*

We expect senior management of participants to: champion a culture of ‘doing the right thing’ by their customers, put in place appropriate monitoring activities such as independent compliance checks or internal audits, receive information tracking key compliance controls and deal with any breaches and associated remedial actions, and to challenge management on results when necessary.

Our monitoring and enquiries may be conducted from our offices (for example the review of documents or files). They may involve visits to participants’ premises and review of documents or files, interviews with relevant staff, testing of compliance processes and outcomes, or review of the findings of the participant’s own monitoring.

Intelligence and risk-based approach

We take a risk-based approach to our monitoring and surveillance activities, meaning we prioritise resources to those participants or practices that present the greatest risk to fair, efficient and transparent financial markets.

In considering risk, we use our market intelligence and research to identify potential problems, assess the likelihood that poor practice or non-compliance will occur, and consider its impact on consumers or the market. For example, we take into account the numbers and types of retail customers at risk, the size of their potential losses, and the proportion of the market affected.

As part of our risk-based approach, we seek to proactively monitor a range of market participants and business models. In this way, we can identify new risks, and any compliance themes or areas of poor practice across the market or market sector. This work helps us identify any need for guidance and ensure our expectations are practical.

Monitoring outcomes

Where our monitoring or enquiries identify non-compliance, we have a range of tools available to deliver a timely, effective and proportionate response. We may undertake further inquiry or expect the participant to adjust its compliance, and we may follow up to ensure that this is done. In some cases notices, warnings, directions or enforceable undertakings may be appropriate. Further or serious non-compliance might result in stronger action, such as suspension or removal of licences or other enforcement action.

FMA is committed to an open and educative approach so that all financial markets participants have clear and well-understood responsibilities. We publish summaries of the aggregate findings from our monitoring and surveillance to assist participants in understanding our expectations and enable them to check their compliance and raise standards if necessary.

Even with an open and educative approach, strong oversight of participants, and good market intelligence, there will be some participants who do the wrong thing. FMA aims to identify this behaviour as early as possible and take appropriate action to rectify or deter similar behaviour in the future.

Regulatory co-operation

FMA co-ordinates efforts and shares intelligence with other government agencies to ensure our work is informed, proportionate and effective. Those agencies include: the Reserve Bank, Companies Office, Department of Internal Affairs, Commerce Commission, Serious Fraud Office and the Inland Revenue Department.

We regularly liaise with co-regulators in New Zealand, including formal quarterly meetings of the Council of Financial Regulators. We also work with New Zealand's frontline regulators and supervisors and oversee their monitoring of other participants.

Our policy is to refer any matters best investigated or enforced by other agencies, including the Serious Fraud Office, the Police and overseas regulators.

We also liaise with overseas regulatory agencies and continue to leverage our close relationship with peer agencies in Australia and the Asia Pacific region. We work with the Australian Securities and Investments Commission (ASIC) to streamline trans-Tasman regulation, to reduce compliance costs and facilitate opportunities for New Zealand investors.





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