Inquiries, Investigations and Enforcement Report

Key issues and themes arising from inquiries, investigations, and enforcement activities

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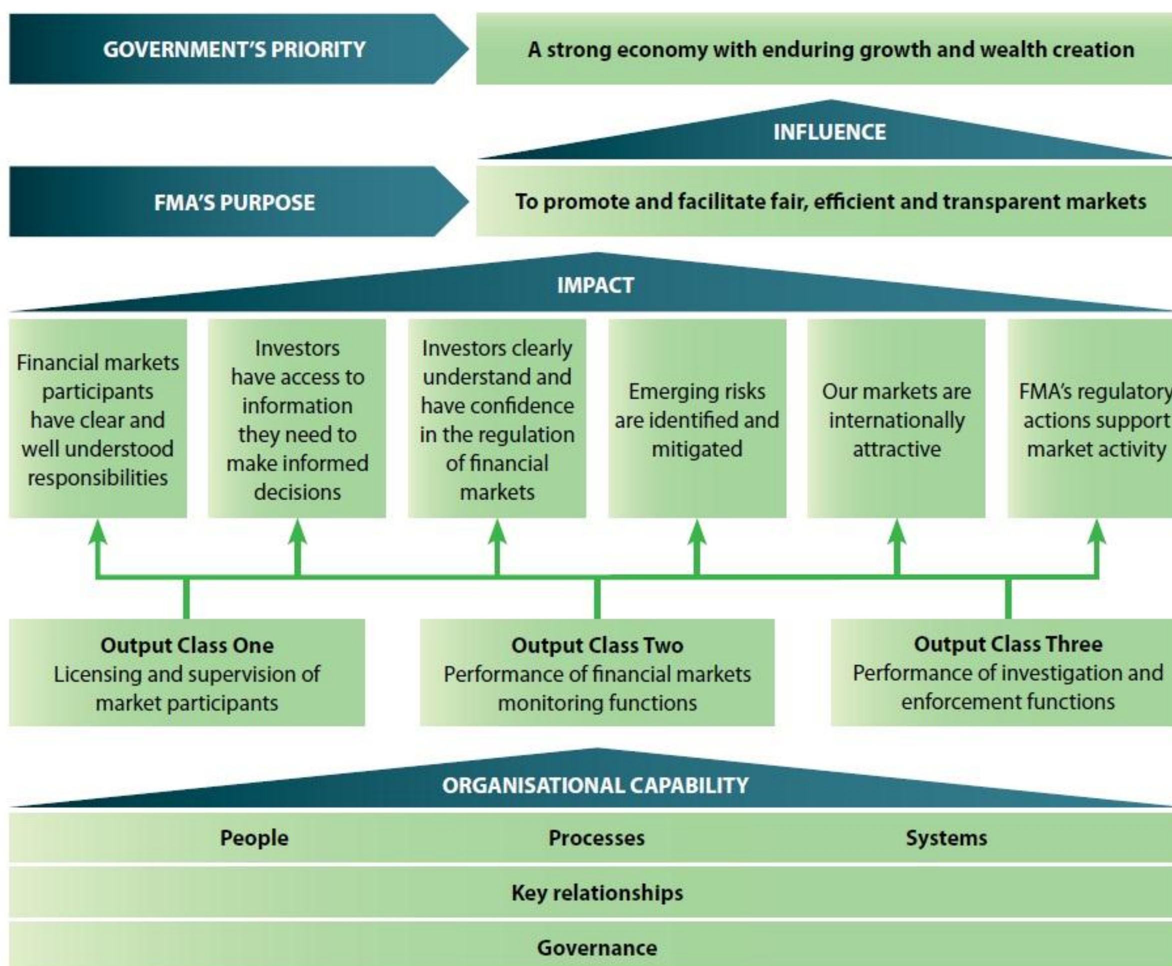
Introduction

Our role as a regulator is to assist and monitor compliance, enforce the law, and help set stakeholder and market expectations. Since our establishment on 1 May 2011, FMA has worked on key strategic outcomes, as set down in our Statement of Intent, to 'Increase confidence and participation in New Zealand's financial markets'. (See FMA's outcomes framework 2011-2014).

For many participants, regulation is new. For financial markets to function well, participants need to be clear about their roles and responsibilities. FMA will use all the tools in its 'regulatory toolbox' to help achieve this, and has spent considerable time over the last year engaging with participants to ensure compliance with regulatory requirements are met through responding to enquiries and through investigation and enforcement activity. FMA's compliance continuum is illustrated on page 10.

This has produced some positive outcomes for the market and sent clear messages as to what New Zealanders should be able to expect from financial market participants. This report highlights the key issues and themes that have emerged through FMA's inquiries, investigations and enforcement activities over the last 12 months.

Ultimately, good laws, sound governance and the right ethical behaviour go some way to increased investor confidence, but FMA also needs to ensure its enforcement activities have the right deterrent impact on those market participants who may risk breaking the law.



Overview

During the 2011-12 financial year FMA received 4239 complaints and enquiries. The majority of these related to people or entities providing financial advice, the new financial advisers regime, securities issuers, and failed finance companies. In addition to these, FMA fielded numerous enquiries in regard to KiwiSaver, trustees and statutory supervisors, and foreign exchange dealers.

The largest areas of concern raised through these contacts, related to three key issues: fraud and scams within financial markets; people or entities operating without the necessary authorisation or registration; and concerns regarding disclosure and advice. Some of these enquiries related to matters FMA was already dealing with, such as finance companies and adviser registration, and others were outside FMA's jurisdiction and subsequently referred to other agencies. Investigations into breaches of laws involving financial markets participants and enforcing compliance with such laws, are undertaken by a range of public bodies, not just FMA.

These contacts are only one source of information used to determine action taken by FMA. FMA's own intelligence and information gathering processes, including our monitoring and compliance

functions have enabled FMA to enquire into and take action with respect to a broad range of matters.

Since May 2011, FMA has moved quickly to engage with the market and to use its new powers across wide-ranging issues. Some examples include:

- Action taken against market participants who made misleading offers. For more information visit the Enforcement section on FMA's website.
- Issuing warnings to caution investors against unacceptable KiwiSaver sales practices and issuing warnings to those involved.
- Initiating inquiries into misleading offer documents resulting in the withdrawal of a prospectus and suspension of allotment of securities and provision of enforceable undertakings.
- Obtaining voluntary compliance from financial market participants with respect to requirements of offer documents.
- Commencing monitoring visits with financial advisers around the country.
- Reaching a settlement with Kiwi Finance and full recovery for investors following investigation into misleading offer documents.
- Initiating and continuing the court action and investigations into failed finance companies.

As detailed in FMA's enforcement policy, the focus of FMA's inquiries, investigations and enforcement activity is to ensure compliance with financial markets legislation, and to take action with respect to conduct that harms or presents the greatest likelihood of harm, to the function of open, transparent and efficient financial markets. FMA uses its full range of functions and powers when taking such action. Key themes and issues emerging over the last 12 months are set out below.

Failed finance company investigations and litigation

Since March 2006, 65 New Zealand finance companies have failed: closed; in liquidation; receivership; moratorium or have been suspended. An estimated $3.1 billion has already been lost and around $8.6 billion is still at risk. Approximately 205,000 people have been affected as a result.

FMA inherited 26 cases from the Securities Commission and the National Enforcement Unit of the (former) Ministry of Economic Development. We have undertaken an initial assessment of these cases and will determine over the next six months which ones are worth pursuing from an economic public interest perspective. This is not an easy task given the direct pain felt by many individuals as a result of the collapse of the large number of finance companies here in New Zealand.

A common theme in FMA's finance company prosecutions[1] has been the significantly inadequate and incomplete disclosure in offer documents and advertisements, and at times the failure of corporate governance in the operation of the companies. The courts have held directors responsible

[1] *R v Moses and Ors* (CRI 2009-04-1388) *"Nathans", R v Graham and Ors* [2012] NZHC 265 *"Lombard", R v Petricevic and Ors*[2012] NZHC 665 *"Bridgecorp"*

for putting into the market, prospectuses offering debt securities to members of the public that are materially misleading and contain untrue statements. Some directors have been found guilty of dishonesty, recklessness or gross negligence. Common themes emerging from these cases include inappropriate reliance on the advice of third parties, conflicts of interest arising from related party transactions, inadequate risk management, and a failure to disclose to investors material changes in the financial position of the company, either on a timely or complete basis.

The outcome of these prosecutions has illustrated that many of the directors of these finance companies and others involved in their operations, were not fulfilling their obligations to investors to the standard required in law. The cases have sent a clear message to the issuing corporate community that the law imposes on them clear responsibilities to ensure the accuracy and adequacy of their disclosure documents. Specific themes and issues from these cases include:

- more is required of directors than mere honesty;
- directors are expected to have an understanding of the fundamentals of the business and of financial reporting;
- disclosure obligations are assessed by an overall impression conveyed by offer documents not a painstaking analysis of individual statements;
- directors must review the statements in disclosure documents from the point of view of a prudent but non-expert person, setting aside their own insider knowledge; and
- the obligation not to make misleading or untrue statements in offer documents is not a delegable duty.

The themes from these cases are discussed in more detail below.

Reliance

While directors may rely upon advice of others, they must not do so unquestionably (see *Lombard* paragraph 35), and must not do so where the statute holds the director personally responsible. Directors have an obligation to form their own opinion on legal compliance of offer documents, and to make enquiry when such enquiry is reasonably necessary. The quality of advice provided by third parties is important, and those advisors whose opinions or counsel fell below that expected by the companies concerned or their investors, may also be brought to account.

In order to discharge their obligations, directors of public issuers must have more than just a basic knowledge of accounting concepts. They must have a working understanding of accounting principles to enable them to properly understand the documents they are required to approve. The level of financial literacy required of a director of a finance company is arguably likely to be higher. Such a director is assumed to understand and be aware of the nature of the company's business, and to have the ability to read and understand financial statements. This is necessary if they are to comprehend basic financial information about the company, so that they can raise any concerns about the performance of the company, and ensure that the financial position of the company is accurately disclosed to investors:

"The statutory duty for ensuring that offer documents go into the market without misleading statements rests on directors of the issuer. Directors have a non-delegable duty to form their own opinions on that issue, in reliance on information provided by others that they have no reason to suspect may be wrong. The problem for directors, in this particular case, is that they, in effect, purported to delegate to senior management the task of determining whether the investment statement and prospectus were compliant with regulatory requirements and failed to bring independent minds to bear on the topic." (Nathans, paragraph 420)

Disclosure

Inadequate disclosure by finance companies has included failure to adequately disclose:

- Growth and diversification of lending *(Nathans).*
- The actual standard of corporate governance *(Nathans).*
- Deterioration in the liquidity profile *(Nathans, Bridgecorp).*
- Liquidity risk *(Lombard).*
- Indebtedness to the parent company *(Nathans).*
- True nature of transactions with related parties, the actual state of the company's financial health and the risks of investment *(Nathans and Bridgecorp).*
- Circumstances which could adversely affect trading or profitability, value of assets or ability to pay liabilities falling due *(Bridgecorp).*
- Missed interest and principal payments (*Bridgecorp).*

In *Lombard* the Court confirmed that liability under the Securities Act is not limited to misleading statements, but includes liability for material omissions from offer documents. Offer documents which are accurate when placed before the public, must be amended or removed as soon as they become materially false or misleading. For as long as the offer document is before the public, directors must be satisfied of the accuracy of those documents on an on-going basis.

The *Bridgecorp* decision and certain finance company directors' convictions obtained by the Serious Fraud Office, illustrates that particularly egregious (conspicuously and outrageously bad or reprehensible) conduct will attract liability under both the Securities Act and the Crimes Act.

Prudent but non-expert investor

A general theme emerging from these cases is that directors failed to review their companies' prospectuses, investment statements and other advertisements from the point of view of a prudent but non-expert reader. In *Nathans,* Justice Heath held that compliance with the Securities Act obligations is to be assessed objectively from the perspective of a "*prudent but non-expert person" (Nathans).*

"*There was a fundamental failure, on the part of all directors, to review the content of the offer documents and to ask themselves whether the information conveyed presented, to a prudent but non-expert person, an accurate impression of Nathan's business and the associated risks. That exercise should have been undertaken by excluding their own insider*

> *knowledge. That is one of the reasons why a collective approach at board meetings would likely have resulted in a different outcome. A discussion among the directors, properly led by the chairman, was likely to tease out a number of issues of concern." (Nathans, paragraph 421).*

The purpose of offer documents is to provide investors with adequate information on material matters so they can make their own investment decisions. Such documents must therefore contain everything of relevance to an investment decision, at the time it is to be made.

The reasonable belief defence

An honest belief in the truth of statements in a prospectus is not enough to excuse a misleading statement in an offer document. Any belief that statements made are true must be reasonably held. Such belief is not reasonably held if directors have failed to give "*sufficient personal attention to the content of the relevant offer document" (Nathans).*

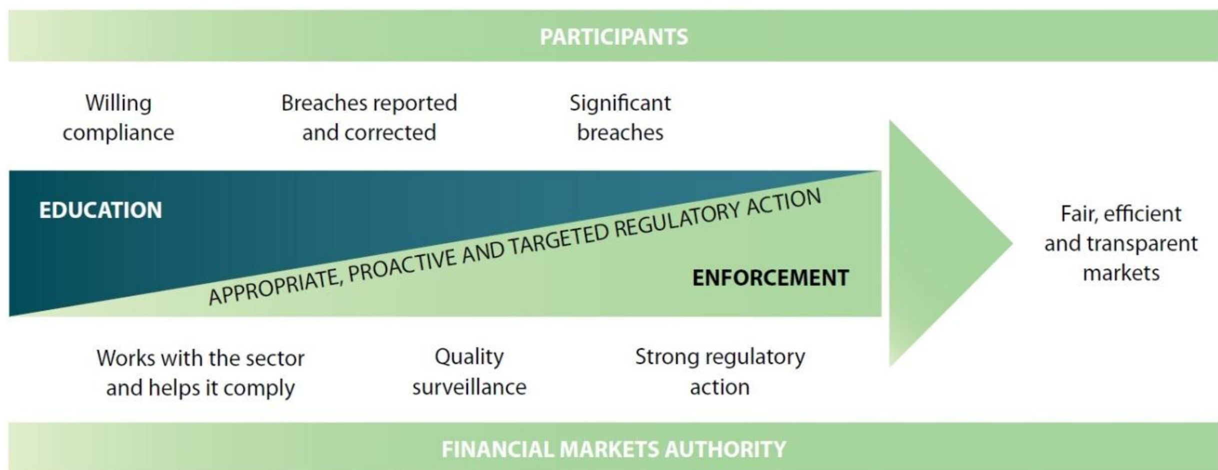
The finance company cases illustrate that a director cannot form a reasonably held belief, if they did not know enough to form a proper view on whether or not the documents contained untrue statements.

Asset preservation orders

FMA has acted to maintain asset preservation orders obtained under sections 60G and 60H of the Securities Act. In December 2010, the Securities Commission obtained asset preservation orders against Mr Mark Hotchin, a director of the Hanover Group of companies. The Securities Commission was investigating Mr Hotchin and other directors for breaches of the Securities Act. FMA concluded this investigation and filed civil proceedings against the directors, including Mr Hotchin, in March 2012.

Mr Hotchin and the trustees of the KA3 and KA4 Trusts, have sought to challenge these asset preservation orders in the courts on several occasions. To date FMA has been largely successful in maintaining these orders. Recently the Court of Appeal dismissed appeals both by Mr Hotchin personally and by the trustees of the KA3 and KA4 Trusts.

This is a new and complex area of the law and FMA will consider utilising asset preservation orders in other cases in the future, where it is appropriate, recognising the public interest balance which must be struck.



FMA's compliance continuum

Perimeter surveillance

FMA has been involved in a number of surveillance activities regarding financial markets participants including financial advisers, brokers and consumer credit providers. Our primary activity has been making inquiries into individuals or entities who appear to be non-compliant with the new Financial Service Providers (Registration and Dispute Resolution) Act 2008. For example they may be holding themselves out as financial advisers without being registered as a financial adviser under that Act. Some may also be providing personalised services to retail clients without authorisation under the Financial Advisers Act 2008 (the FA Act).

In most cases, FMA has addressed this by educating the individual or entity concerned about the requirements of the relevant legislation. They have then curtailed their activities or sought registration and the appropriate authorisation.

FMA may consider that stronger enforcement action is warranted, should non-compliance by an individual or entity persist, or (on its face) appear to be deliberate.

Financial advisers

Misconduct

FMA will investigate allegations of misconduct by financial advisers in breach of the Code of Professional Conduct for Authorised Financial Advisers. Complaints can either be made by external parties or initiated by FMA. Where FMA has investigated a complaint about an authorised financial adviser, it must refer the complaint to the Financial Advisers Disciplinary Committee (FADC) if, in FMA's opinion, the conduct complained of amounts to a breach of the Code. If the authorised financial adviser has breached the FA Act or their terms and conditions, FMA may also take action to cancel or suspend an adviser's authorisation.

FMA's focus in the last 12 months has been on education and engagement with AFAs, which is appropriate for a previously un-regulated market adapting to a new legislative regime. However, the pendulum is now swinging towards testing compliance and enforcing the law. While to date no complaints have been referred to the FADC, FMA has made clear to AFAs and their industry bodies that our expectations will continue to rise and that we expect to see more proactive and willing compliance.

Appeal against decline of authorisation application

FMA has defended a claim in relation to declining an applicant for authorisation as a financial adviser. FMA considered the applications under section 54 of the FA Act and decided to decline the application based on its determination that the applicant did not meet the threshold of 'good character' requirements of the FA Act. The applicant appealed the decision under section 138 of the FA Act (the first such appeal). The grounds for the appeal were that FMA gave disproportionate weight to the appellant's convictions and inadequate weight to the applicant's explanations, and to all other indications that the applicant was of good character.

The District Court confirmed FMA's decision to decline authorisation, and dismissed the appeal. The judge noted that FMA had proceeded fairly and that the factors considered by FMA in reaching its decision, and the criteria applied by FMA to assessing 'good character' were appropriate.

Offer of securities without prospectus

FMA has dealt with cases where it appears that offers of securities are, or were being made to the public without a registered prospectus or investment statement. This is in breach of sections 37 and 37A of the Securities Act 1978. These documents are key tools in ensuring that investors are well informed and understand financial risk and return, prior to subscribing for securities. In most cases, FMA considered that engagement and education was the most effective regulatory tool available. In those instances, after contact by FMA, the issuer either took steps to prepare and issue a prospectus or withdrew the offer.

In a small number of more serious cases, where significant allotments had been made and/or loss suffered, FMA is making further enquiries and may take other more formal enforcement action.

Unsolicited offers

FMA has issued several warnings about unsolicited offers to purchase shares in the last 12 months, and wants investors who receive these offers to be able to make informed decisions about whether it is in their best interests to sell their investments. The warnings are a signal to investors to take care, and to ensure that they have read and understood the terms of the offer.

FMA has also accepted enforceable undertakings from a number of people making unsolicited offers, to include a warning statement in their offer documents. FMA consider that a fair, efficient

and transparent financial market requires investors to make fully informed decisions with the best information available to them. FMA has sought such warnings and undertakings to ensure that investors interests are protected.

Under section 49 of the Financial Markets Authority Act 2011 (the FMA Act), if FMA has issued a warning, it may make an order that it be disclosed, including requiring any offer documents to contain a copy of the warning or be accompanied by a copy of the FMA warning.

Secondary markets issues

Through its market oversight role, FMA has a strong focus on ensuring compliance with the Securities Markets Act 1988, and working with NZX to ensure that appropriate action is taken with respect to potential secondary market misconduct pursuant to the Act, such as insider trading, market manipulation, delayed filing of substantial shareholder (SSH) notices, and breaches of continuous disclosure obligations. In terms of market manipulation, FMA has carried out inquiries into instances of market manipulation where false or misleading information may have been disseminated affecting the price or the trading of securities, or where acts or omissions may have given a false or misleading appearance of trading, when the party knows or ought to know, that it will likely have that effect.

FMA has considered possible misleading trading, where trading has been used to create a false appearance of liquidity, supply, demand or price. For example, this technique may be used where an entity endeavours to manipulate price during a volume-weighted average price (VWAP) period, or where an entity acts as both buyer and seller to drive the share price up. Review of SSH filing has revealed some poor administrative practices by SSH holders, resulting in delayed filing of these notices. Compliance in this space will be an area of focus for FMA in 2012-2013.

Continuous disclosure inquiries have reinforced that listed issuers need to be cognisant of the importance of comprehensive disclosure to the market, especially when directors and officers are actively trading. We are also discussing with our 'twin peaks' co-regulator, the Reserve Bank of New Zealand (RBNZ), how best to manage disclosure issues regarding listed entities which are also subject to RBNZ oversight.

Third party claims – section 34

In addition to its ability to take direct action under the legislation which it enforces, FMA also has the ability, through section 34 of the FMA Act, to initiate or take over civil actions against financial markets participants. However, such action must result from an inquiry or investigation carried out by FMA and only where FMA considers that it is in the public interest to do so. FMA is considering potential investor and company claims under section 34 in relation to various matters it inherited in 2011, as well as more recent instances of misconduct.

The threshold for FMA taking a case is set high. FMA can only take a case under section 34 if it is satisfied that it is in the public interest to do so, having regard to the relevant matters set out in the FMA Act. This does not permit FMA to take a case merely because parties cannot or will not bear the cost of private litigation. Some of the principle policy considerations to which FMA has had regard in considering these cases (not in any order of priority or weighting) includes whether the potential claim:

(a) will promote the fairness, efficiency and transparency of New Zealand's financial markets;
(b) clearly advance FMA's regulatory objectives; and
(c) use FMA's resources effectively.

The use of the section 34 power is an important instrument in FMA's enforcement toolkit.

This report provides a snapshot of the work in which FMA has been engaged and themes and issues identified. FMA publishes the outcome of cases on its website, along with updates on litigation and finance company investigations.

FINANCIAL MARKETS AUTHORITY

TE MANA TATAI HOKOHOKO ~ NEW ZEALAND