Supervision Insights

An overview of the FMA's supervision activities and findings from our monitoring reviews of regulated entities

September 2020

FINANCIAL MARKETS AUTHORITY
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AOTEAROA - NEW ZEALAND

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Overview of our monitoring activities and findings

An overview of our supervision activities and the findings of our planned monitoring activity, along with our view of what we have seen, and the next steps for the FMA and regulated entities. This information will be useful for those charged with governance of the entities we monitor, as well as other stakeholders.

Detailed findings

Key findings from our monitoring activity, including examples and expectations for entities. This information will assist those responsible for compliance and conduct with reviewing their entity's policies, processes and practice against their obligations and our expectations.

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Foreword

When the FMA lists our strategic priorities in corporate documents, 'Governance and culture' always comes first. This reflects the importance we ascribe to this area. We expect our regulated entities to have the same focus.

The monitoring within the scope of this report is one of the ways we assess the state of entities' governance and culture. As set out in our Statement of Intent, we want to see that "financial service providers demonstrate an appropriate customer-centric culture and improvements in governance, incentive structures, sales and advice processes, and systems to mitigate conduct risk".

The insights in this report tell us that large parts of the industry are working hard to move towards the expectations we and other regulators have articulated. They also give a clear message of problem areas within the industry and how we expect these to be improved. Most of the issues we identified were the result of a casual or careless approach to conduct and compliance, rather than being deliberate misconduct. However, left unchecked, this disregard can escalate into poor outcomes for customers, in a way that may not be immediately obvious. We want there to be no doubt that providers will be culpable if they fail to take appropriate care of customers and their outcomes.

We have seen a lot of very good progress in entities shifting their focus to serving the needs of customers, especially since the publication of our Conduct and Culture reports and the increased public scrutiny on financial services as a whole. But too often this still feels like an afterthought – something that is tacked on rather than at the heart of governance and culture.

Throughout our monitoring, we also came across attitudes that good conduct is something that needs to be demonstrated only when the FMA is visiting, or that we should be hand-holding entities through their compliance obligations. I want to be very clear that good conduct and compliance should happen all the time, not just when the regulator is watching. If entities share our end objective of serving customers and investors, then appreciation of the value of investing effort in good conduct frameworks should be shared too.

Where we identify significant breaches of the rules, or where entities do not address our recommendations in an appropriate or timely manner, we may take further action. I anticipate this action will be increasingly strong. While we are awaiting a legislative framework for banking and insurance, we are at a point now where the volume of available guidance, level of engagement and maturity of the regulatory regime mean there are no excuses for conduct that presents the risk of harm to investors, customers and the integrity of the markets.

Rob Everett

FMA Chief Executive

Executive summary

Introduction

The FMA's overarching statutory objective is to promote and facilitate the development of fair, efficient and transparent markets for financial services and products. The FMA's supervision activity – where we monitor adherence to regulatory and legislative requirements by financial market participants – is integral to this outcome.

The purpose of this report is to provide an overview of the FMA's supervision activities and to share the key findings from the monitoring of some of the entities we supervise.

Our approach to monitoring is risk-based and seeks to focus our activity where we have the greatest opportunity of reducing harm to investors. This means we actively monitor only a portion of our regulated population in any given year. By sharing our findings more widely, we aim to highlight areas where we have seen conduct and compliance that falls short of our expectations, and provide guidance on how all entities can improve in these areas. More information about our monitoring approach is included in the Appendix.

Our reviews have been designed to identify deficiencies and breaches, rather than specifically highlight good practices. This report therefore focuses on adverse findings rather than examples of entities ensuring customers are treated fairly and provided with suitable products and services. We will seek mechanisms to share examples of good practices with the relevant industry sectors.

The weaknesses and opportunities for improvement highlighted in this report were by no means observed in all entities we monitored. However, we do expect all entities to review the findings, evaluate their conduct and compliance against our expectations, and take action where they do not meet our expectations.

Entity engagement

We found that most entities were open, engaged and cooperative during our monitoring reviews. However, there were some cases where entities did not disclose information or take action as required, including one instance where we needed to issue a notice under the Financial Markets Authority Act 2011 (FMA Act) to compel the entity to provide us with the information we needed.

We expect licensed and authorised entities to provide all notices and reports that are required by their obligations to the FMA in a timely manner. We also expect entities to engage with us in an open and transparent manner, particularly in relation to changes in their business and any breaches or issues they have identified.

Supervision activities July 2019-June 2020

The broad range of activities that comprise supervision – both proactive and in response to external complaints or queries – means that we are engaging with and monitoring a large portion of the entities we supervise.

Completed **135** monitoring engagements including:

- planned monitoring
- reviews of AML/CFT Reporting Entities[1]
- ongoing monitoring of entities involved in our bank and life insurer conduct & culture reviews
- reviews of default KiwiSaver providers

Responded to over **400** enquiries and information reports from market participants, industry bodies and members of the public.

Processed **1,200** notifications from entities that provided information required by regulations.

Conducted planned monitoring of the following entity types:

- Authorised Financial Advisers (AFAs)
- Qualifying Financial Entities (QFEs)
- Derivatives Issuers
- Managers of Managed Investment Schemes (MIS Managers)
- Discretionary Investment Management Service (DIMS) providers
- Licensed Supervisors

10 formal investigations opened in response to our monitoring findings.

Worked on **20** significant cases, with **11** cases resulting in formal warnings or censure being issued or the cancellation of the market participant's authorisation.

Worked on **11** projects and thematic reviews including responding to the impact of COVID-19 on the financial services sector

Assessed and responded to **180** reports about alleged misconduct by the entities we supervise.

53 meetings with strategically significant entities as part of our stakeholder relationship management programme

Assessed **20** applications for new or variations to existing licences and QFE status

1. Anti-Money Laundering and Countering Financing of Terrorism (AML/CFT) Reporting Entities. Many of these entities also hold a licence or other authorisation from the FMA under other financial markets legislation, such as the Financial Markets Conduct Act 2013 (FMC Act), the Financial Markets Supervisors Act 2011 and Financial Advisers Act (FA Act).

What we found

We identified some significant issues that are likely to have a material impact on entities' conduct and/or compliance with legislative obligations. These issues increase the chance of harm or poor outcomes for customers.

We grouped our findings (conclusions) into broad themes. Some are relevant for all entities to consider, and others are relevant for only certain entity types, because they relate to obligations specific to those entity types.

We were disappointed in particular with our findings in relation to AFAs and QFEs. The FMA has provided significant guidance to these sectors through publications and industry engagements. Given the maturity of the regulatory regime for these entities and the expansion of that regime to a broader range of advisers next year, we shouldn't be encountering non-compliance and complacency in relation to key obligations and customer outcomes.

Governance and oversight

We identified significant weaknesses in some boards, particularly in relation to board composition and performance. We were disappointed to encounter directors with limited understanding of their entity's obligations as a licensed or authorised entity, and with insufficient reporting from management or training to help address those gaps.

In some entities, we identified inadequate resourcing to manage compliance obligations and risks, and a lack of oversight of outsource providers and third parties. There are also opportunities for licensed Supervisors to enhance their proactive, risk-based monitoring of MIS Managers.

Conduct and culture

In 2017 we published the FMA's Conduct Guide and communicated our expectations in relation to conduct for entities licensed or authorised by the FMA. We expressed the hope that all parts of the financial services sector would test themselves against those expectations. Since then, industry has seen the findings of the Australian Royal Commission and the joint FMA/RBNZ reviews of conduct and culture in banks and life insurers, so there is all the more reason to expect entities to have responded to the guide, along with the findings of the conduct and culture reviews.

Over the last 18 months we have been monitoring conduct and culture in a wider range of entities. Some entities that were not involved in our conduct and culture reviews have taken very few, if any, steps to evaluate their internal practices and culture against those reviews, and improve their conduct and culture. Many of our findings for these entities were similar to what we observed in banks and life insurers. These included:

- weaknesses in the governance of conduct
- lack of mechanisms to identify and manage conduct risks
- lack of focus on customers' needs and the outcomes that customers receive from the entity's products and services
- failure to address the needs of vulnerable customers
- inadequate processes to manage customer complaints, or for staff to report conduct issues.

Effective management of conduct and culture is not a new concept, and we expect greater accountability of boards, executives and senior managers.

Compliance Assurance Programmes

We found that some FMC entities[2] did not have a Compliance Assurance Programme (CAP) that meets the minimum standards, or their CAP was not operating effectively. We published an information sheet in 2018 to provide further assistance with CAPs, so it is disappointing that our monitoring reviews continue to identify serious weaknesses and under-investment in this area.

Regulatory action

After each monitoring review we provide the entity with our findings and recommendations. We require entities to put in place a plan to address any recommendations. We monitor progress of the plan, and where we identify significant breaches, or where entities do not address our recommendations in an appropriate or timely manner, we may take further action, as outlined in some examples included in this report.

Regulatory actions that we have taken in response to non-compliance or misconduct include opening formal investigations, referring entities to other bodies[3] to investigate, suspending two AFA authorisations and cancelling one AFA authorisation, issuing a private warning under the FMA Act, issuing a censure under the FMC Act, and filing court proceedings against one entity.

Next steps

The insights from our monitoring activities inform our ongoing supervision, including influencing the focus of planned monitoring, thematic reviews and guidance.

Our planned monitoring programme for the coming year includes a strong focus on the areas of concern detailed in this report, namely governance and oversight, conduct and culture, and Compliance Assurance Programmes. We will also be paying particular attention to AFAs and QFEs, both as a result of our findings in these sectors, and in preparation for the transition to the new financial advice regime in 2021.

We expect all entities to consider the findings and recommendations in this report. Given the maturity of the regulatory regime and the clear expectations we have set, entities should anticipate a robust enforcement response from us if they fail to meet their obligations. This includes where we identify issues that would not have existed had the entity taken account of the findings and recommendations in this report. Our response will include seeking court-based sanctions where appropriate.

2: Derivatives Issuers, DIMS providers and MIS Managers who hold a licence under the FMC Act - collectively referred to as 'FMC entities' in this report.
3: Serious Fraud Office, Financial Advisers Disciplinary Committee

Industry-wide findings

The findings and expectations in this section are relevant for all of the types of entities covered in this report. Findings and expectations related to specific entity types are detailed in the subsequent section.

Governance and oversight

Corporate governance

Good corporate governance supports investor confidence and allows directors and executives to focus on growth, value creation and long-term sustainability. We expect all directors to devote sufficient time to understanding the entities they govern, relevant regulatory obligations, the industry they operate in, and risks, including conduct risks.

What we found

- Some directors did not have a good understanding of corporate governance in general, and/or their entity's obligations, limiting their ability to oversee the entity's compliance. This may be partly due to:
  - a lack of formal induction and ongoing training
  - no or limited reporting to the board on risk and compliance matters, and no discussion of these at board meetings.
- Some issues with board independence, including the following:
  - Directors being considered independent, despite extensive service on the board being likely to compromise that independence. On one board, five directors with a tenure of between 15 and 30 years each considered themselves independent.
  - An independent chairperson contracted to develop the entity's internal processes and having significant involvement in day-to-day activities.
- Reporting to the board lacking sufficient detail, or being too lengthy for directors to reasonably review.
- Failure to review the effectiveness of the board. One board had not conducted a review of its effectiveness for eight years.

Our expectations

We did not identify issues with governance in all of the entities that we monitored. However, the weaknesses we did observe are disappointing and are likely to compromise the governing body's ability to effectively oversee the entity and provide appropriate direction to management.

In one monitoring review, the directors suggested that the limited frequency of FMA's monitoring reviews was a key contributor to their lack of knowledge of their regulatory obligations. It is the responsibility of entities and their directors to ensure they understand and comply with their legal obligations. They should not rely on the FMA's monitoring to educate them.

The minimum standards for FMC entities, the QFE Adviser Business Statement guide and the Supervisor licensing guide clearly outline entities' governance obligations. Principles for good governance are also outlined in the FMA's Corporate Governance Handbook. The findings of our monitoring reviews suggest that boards would benefit from following the relevant principles, particularly those relating to board composition and performance, and risk management.

Risk and compliance resourcing

We expect all financial market participants to design risk and compliance frameworks that are fit for purpose for the size and nature of their business, and to devote adequate resources to implementing these.

What we found

We found some entities with insufficient resources to effectively support the management of risk and compliance. For example:

- Responsibilities for managing risk and compliance not clearly defined, or these functions assigned to roles that no longer exist.
- Compliance managers lacking an adequate knowledge of the entity's policies, operating model and/or obligations.
- Documented risk and compliance frameworks, policies and procedures not fit for purpose, not updated to reflect changes in the organisation, not fully implemented, or too ambitious to effectively implement.
- Insufficient resources in the risk and compliance functions to adequately support the business, or frontline teams not having the time and resources to adhere to the entity's obligations.

Our expectations

Some entities have well-structured and resourced risk and compliance functions. However, we are concerned that some others are not sufficiently resourced in the areas of risk and compliance, increasing the likelihood of a failure to identify and appropriately manage risk or comply with obligations. These obligations exist to prevent investor harm, and to ensure that financial markets operate in a fair, efficient and transparent way.

Entities need to clearly define risk and compliance responsibilities, both within teams dedicated to supporting these areas and for frontline staff who identify and manage risks and obligations on a day-to-day basis. Adequate resources should be allocated to risk and compliance, and their effectiveness should be monitored to ensure objectives are being achieved.

Oversight of outsource providers and other third parties

The entities we monitored outsourced a range of functions including investment management, distribution/sale of products, compliance assurance and IT services. We looked for evidence of how entities are overseeing functions outsourced or delegated to a third party. Entities remain responsible for any functions that they outsource.

What we found

The following weaknesses in the oversight of outsource providers were observed in some entities:

- No or inadequate formal agreements with the outsource provider, meaning that performance monitoring and action for non-performance may be difficult.
- Services provided by other entities in the same group of companies without a documented agreement in place, meaning the board may

be unable to assess if the services meet the licensed entity's obligations.
- Lack of a formal periodic review of outsource providers in order to assess the performance of the provider and associated risks.
- Delegation of key functions to an outsource provider with no documentation of the key controls in place and no ongoing independent verification and monitoring of the controls.
- A derivatives issuer did not have a process to ensure that Introducing Brokers they deal with have the required authorisation, licence or registration. The standard conditions for derivatives issuers prohibit dealing with unregulated financial service providers, to help prevent investor harm.

Our expectations

We expect entities to conduct due diligence before engaging an outsource provider. This should include looking at the outsource provider's processes and controls, as well as previous experience, public information about their service, any reported complaints, and any protections or controls imposed by the industry or jurisdiction they operate in.

Outsourcing arrangements should be reviewed at a frequency appropriate to the risk involved i.e. outsource providers who carry out a material function for the entity should be reviewed more frequently than providers who supply less-critical services. The ongoing performance of the outsource provider should be monitored; ideally monitoring will be conducted by the entity and go further than relying solely on reports from the outsource provider itself.

Supervisor monitoring programmes

Licensed Supervisors are required to have their own monitoring programmes for overseeing the operation of MIS Managers and certain other financial service providers.

In our monitoring reviews of Licensed Supervisors, we examined their monitoring programmes, which included seeing if they had taken on board previous feedback from us. We found that the development of proactive, risk-based monitoring programmes requires further work, to increase the likelihood that possible risk areas or serious issues will be identified earlier.

We expect Licensed Supervisors to continue developing their risk-based approaches, including ensuring that planned monitoring of MIS Managers includes relevant known risks. The use of sector-based risk assessments can assist in identifying areas for Licensed Supervisors to target.

MIS managers select and engage Licensed Supervisors, and there is a potential conflict of interest posed by this arrangement. We expect Licensed Supervisors to manage this conflict appropriately and prioritise their monitoring based on risk, not revenue, and to apply a sense of urgency and focus to any issues they identify.

Additionally, where Licensed Supervisors outsource custodial functions, the associated controls should be clearly documented and subject to monitoring by the Supervisor. This may require Licensed Supervisors to seek additional assurance over that provided by independent assurance reports.

Conduct and culture

The FMA is a conduct regulator and our focus is on the conduct of the entities that we supervise. We expect all financial service providers to effectively identify, manage, remediate and report on conduct risks and issues, to deliver consistently good outcomes for customers.

In 2018 and 2019, the FMA published reports based on substantive reviews of conduct and culture in banks and life insurers. Those reviews found significant variation in the maturity of banks' and life insurers' approaches to identifying, managing and remediating conduct risks and issues. We are continuing to monitor the banks' and life insurers' progress implementing the plans they developed to address our feedback. It is encouraging to see the commitment and efforts of many entities to improving their conduct and culture.

The recommendations in our conduct and culture reports were noted as being relevant for all types of financial service providers.

What we found

Where our monitoring reviews involved banks and life insurers that were the subject of our reviews in 2018, there was an opportunity to observe more closely the improvements they were making. In our monitoring reviews involving entities that were not subject to the 2018 reviews, we looked to understand what steps, if any, they had taken to identify and address conduct risks within their business.

Examples of conduct and culture issues we identified in some entities that did not meet our expectations included the following:

- Entities not comparing their conduct to the principles in the FMA Conduct Guide and not taking action where their conduct falls short of those principles. This expectation was widely communicated when the guide was published in early 2017.
- Lack of board commitment to prioritising customers' needs and the outcomes that customers receive from the entity's products and services.
- No clear understanding of conduct risks and no mechanisms to identify inappropriate conduct.
- Not proactively collecting and utilising feedback and insights from customers and advisers to improve products and customer outcomes.
- No policies or procedures to identify and manage the needs of vulnerable customers, and a lack of commitment to implementing improvements in this area.
- Internal policies and systems for staff to report conduct issues not providing sufficient independence or confidentiality, which is likely to impact willingness to report issues.
- Inconsistent approaches to identifying and handling customer complaints, including:
  - unclear or inconsistent definition of what constitutes a complaint
  - limited oversight for complaints that are not recorded centrally or escalated to management, and no analysis to identify trends and early indicators of issues
  - staff not following documented process for dealing with complaints
  - lack of reporting to management and the board about complaints, including how they are resolved and any underlying systemic issues.
- Inappropriate sales incentives that encourage

staff to sell more products, without adequate controls in place to address the conflict of interest posed by such incentives.

Our expectations

We expect all entities to undertake and document an assessment of their business against the principles in the FMA Conduct Guide and other conduct guidance we have issued, and to address any gaps. Weaknesses in the governance and management of conduct risks, and a lack of proactivity in identifying and remediating conduct issues and risks, has the potential to lead to widespread harm.

Entities should not wait for issues to be raised by customers or regulators before they adapt their conduct frameworks. Entities need to constantly revisit whether their processes and their treatment of customers lead to the best outcomes they can deliver for those customers.

Our monitoring seeks to reduce or eliminate potential risks before harm can manifest. Entities that object to our enforcement actions because there are not yet clearly identifiable 'victims' are missing the point of good conduct and culture.

To maintain trust and confidence in our financial institutions and systems, entities need to think and act beyond minimum legal and regulatory standards, and champion business models that focus on customer interests. Boards and senior leadership need to encourage good conduct and provide appropriate support and resources for their teams.

Compliance Assurance Programmes

FMC entities are required to have a Compliance Assurance Programme (CAP) that includes adequate and effective arrangements for challenging and independently testing their own compliance framework, processes and controls. A CAP provides the entity's oversight body with assurance that the compliance systems operate effectively and ensure the ongoing compliance of the business.

Licensed Supervisors are also required to have similar policies, procedures and key controls to ensure they are complying with their licence obligations and that non-compliance is identified and rectified.

What we found

We found numerous examples where CAPs did not meet the minimum standards or were poorly designed. This included the following:

- CAPs that focused on a narrow set of obligations – such as the NZX rules – and did not sufficiently consider the entity's other obligations.
- CAPs that covered a group of businesses or were focused largely on the compliance processes of an offshore parent company, and did not have sufficient detail about the licensed entity's obligations and controls.
- Lack of clarity of the roles and responsibilities for overseeing the operation of the CAP.
- CAPs that may not be fit for purpose, such as smaller entities having very complex and detailed CAPs they could not effectively operate.
- CAPs that did not include a clear testing plan, for example not detailing the scope,

methodology or process.
- A CAP that consisted of various statements in other internal policies and procedures, but no clear outline of the testing programme, creating a risk of some obligations being overlooked.

We also observed some entities with an incomplete CAP or no CAP, which is a breach of the minimum standards for licensed entities.

When we reviewed the implementation of CAPs, we found:

- Testing of processes and controls taking place less frequently than planned, testing not being performed for extended periods due to lack of resources, or testing not being performed at all.
- Testing not performed by a person independent of the person performing the control.
- Testing that does not provide assurance regarding the effectiveness of the process or control.
- Evidence of testing results not being retained, or incorrect evidence being recorded (for example, marking a control as effective despite it not operating as intended).

Entities need to review their CAPs from time to time to ensure they reflect current processes and controls. We also found a lack of evidence that CAPs had been reviewed and reported to the oversight body, and one board of directors that was not reviewing the CAP testing reports at their meetings as planned.

Our expectations

We expect all FMC entities and Licensed Supervisors to have a CAP in place that challenges and tests the design and operation of the entity's processes and controls, and the adequacy of governance and management information. The programme must meet the minimum standards, including independence of testing, and operate as intended.

It is disappointing that we are continuing to see CAPs that are poorly designed and/or implemented. We encourage all FMC entities and Licensed Supervisors to review our 2018 Compliance Assurance Programmes information sheet, and make any necessary changes. We expect boards to seek regular and comprehensive reporting on CAPs, and to challenge management regarding the outcomes of testing to obtain the assurance they need to exercise their duties.

Compliance and controls

Compliance with licensing obligations

We license and authorise entities on the basis of the information they submit to the FMA at a point in time. We expect entities to comply with all of their obligations on an ongoing basis, and to engage with the FMA when they identify any compliance issues.

What we found

We reviewed entities' compliance with their licensing obligations. These are the obligations they need to meet to obtain and maintain a licence or other authorisation from the FMA. We identified several instances of non-compliance with ongoing licensing obligations, including the following:

- An entity failed to fully implement all of the

Detailed findings

policies, processes and controls it told us it had in place at the time of licensing.

- Failing to meet the licence condition to "maintain the same or better standard of capability, governance and compliance as was the case when the FMA assessed its application".
- Concerns regarding the experience, skills and qualifications of directors, which could impact the licensed entity's ability to effectively perform its functions.
- An oversight body, in place to ensure independence, having no members.
- Failure to consider how a change of ownership of the licensed entity and subsequent integration into another business may affect its compliance with its FMC obligations[4].
- Providing information to the FMA in preparation for the monitoring review that was considered to be incorrect and potentially misleading.

Our expectations

If we receive early notice of potential issues, we are more able to assist entities to resolve these and minimise potential harm to investors, although early engagement with the FMA does not preclude us from taking regulatory action when the situation warrants it. If entities conceal non-compliance or do not have adequate processes to detect and resolve such issues, we will consider taking further regulatory action. In some cases this could result in additional conditions being added to a licence (or authorisation) or the licence being withdrawn.

Misleading information

We expect all entities to communicate clearly and honestly with their customers.

What we found

We did not encounter issues in this area for the majority of entities that we monitored, but we saw the following examples of conduct that could be considered misleading:

- A derivatives issuer's website that focused on the benefits of trading derivatives, but did not explain the risks. This approach does not provide customers with balanced information to consider as part of their decision-making, and could create a misleading impression regarding the potential downside of these transactions.
- An AFA promoted themselves as independent, despite not meeting the definition of 'independent' because they had contractual arrangements with certain product providers and received commissions from those providers.
- Some AFAs who do not offer a broking service have colloquially used the term 'broker' in relation to their financial adviser services. 'Broker' is a defined term under the FA Act, and should not be used by anyone who is not offering a broking service. It creates a misleading impression by suggesting the benefit of protections under the FA Act that are only available to customers of brokers.
- One QFE did not adequately explain the terms and conditions of an incentive to customers, which may lead customers to make decisions they would not otherwise make.

4: FMC obligations consist of those under the FMC Act, the Financial Markets Conduct Regulations 2014 (FMC Regulations), the licence conditions and minimum licensing standards for these entities.

Our expectations

Processes and controls should be designed to ensure that all obligations are complied with, and that disclosure documents, advertisements and other communications do not create a false or misleading impression. This is essential to ensure that customers' decisions are based on a fair understanding of the financial products and services, and their risks and benefits.

Some entities have a sign-off process for customer-facing documentation that involves different staff in the business – such as marketing, legal, and/or management – which can be helpful in identifying potentially misleading content.

Internal policies and procedures

We expect entities to comply with their obligations by having an appropriate set of policies and procedures that are suitable for the size and nature of their organisation.

What we found

We found numerous examples where entities' internal policies and procedures were not fit for purpose, and/or were not subject to regular reviews and monitoring. These included:

- Policies and procedures were at a group or parent company level, with insufficient detail specific to the entity.
- Policies and procedures did not sufficiently consider the entire scope of the entity's obligations under financial markets legislation.
- Documents were not suitable for the nature and size of the entity, including policies too complex for a small business and generic 'off-the-shelf' templates not sufficiently customised to the entity.
- Annual or other periodic reviews of policies and procedures not completed in a timely manner or at all. We saw instances where key documents, such as the risk management plan and business continuity plan, had not been reviewed and updated for two or three years. In some instances policies were updated only because the FMA was conducting a monitoring review. Some entities advised us that they had completed a review, but did not keep any evidence of the review and any changes that resulted.

Our expectations

There are requirements in the standard conditions and minimum licensing standards that require entities to maintain internal policies and procedures. Internal policies and procedures are important because they provide a framework for the entity's staff to operate within, and help ensure that customers receive fair and transparent outcomes.

Internal policies and procedures should be reviewed periodically, including when changes are made in the business, and updated to reflect the entity's situation. Policies and procedures also need to be effectively communicated to staff to ensure that they are understood and adhered to.

Training for staff

It is a requirement in the minimum standards, standard conditions or other obligations applying to the entities we supervise, that staff receive appropriate training.

What we found

While many entities had comprehensive training programmes, we found weaknesses in the design and delivery of training. These included:

- Limited training for senior managers and directors regarding FMC licence obligations.
- Training for staff on their obligations limited to reading articles and regulatory documents, or reading internal policy documents with no further interaction to embed the learnings.
- Reliance on 'on-the-job' training but no evidence of how this assists staff to build knowledge of their obligations.
- Out-of-date, inaccurate or unclear materials used as the basis for training.
- Training outlined in the entities' plans (for example, the QFE Adviser Business Statement) not taking place.

Our expectations

We expect all entities to comply with their obligations by ensuring that appropriate training is provided to staff and records of the training are maintained. Reading a policy document or article may be useful, but is unlikely to be sufficient by itself to provide staff with all the knowledge to effectively comply with obligations and serve the needs of customers.

We recommend that entities use a range of methods, such as facilitated sessions (either by internal or external persons), online learning modules, webinars, seminars or conferences, and formal study through a training institute, as well as reading documents and participating in discussion. Where possible, entities should measure employee understanding to determine the effectiveness of training.

Acting without authority

We expect all entities to hold the appropriate authority for the actions they take. A well-structured Compliance Assurance Programme may assist entities in identifying instances where this is not occurring.

Although we did not encounter issues in this area in the majority of monitoring reviews, we did find several instances of entities acting on behalf of customers without correctly obtaining the customer's consent. This included the following:

- A DIMS provider was managing non-discretionary portfolios for customers, but in some circumstances was exercising discretion in these portfolios and conducting transactions without the explicit agreement of the client.
- One entity treated customers as 'eligible investors' without obtaining the appropriate certification. An eligible investor is a person who is self-certified as having sufficient knowledge and experience dealing in financial products. By incorrectly treating customers as eligible investors, they will receive less protection under financial markets legislation.
- An AFA did not formally obtain agreement from all trustees of a trust before implementing their investment portfolio. There is a risk that some of the trustees may not have had a complete understanding of, or did not agree to, how their funds were being invested.

Sector-specific findings

Derivatives issuers

Product suitability assessments

We expect derivatives issuers to have effective mechanisms to assess the suitability of their products for investors.

What we found

In the majority of derivatives issuers that we monitored, we found significant weaknesses in the way they assessed customers' knowledge, experience and understanding of derivatives. These included the following:

- Insufficient information collected to support the product suitability assessment.
- Poorly designed assessment processes, including one derivatives issuer that could not explain how they determine if a prospective investor has passed the assessment.
- No or insufficient documentation of the rationale for approving proposed derivatives for particular investors.
- No or limited checks to ensure the assessments are processed correctly. For example, we identified an instance where an investor 'passed' the assessment despite only partially completing the survey.
- Minimal direct contact with prospective investors – including those who 'fail' the test – during the assessment process.
- No ongoing assessment to ensure the derivative products remain suitable for existing investors.

This is consistent with our Derivatives Issuer Sector Risk Assessment, where we asked the licensed derivatives issuers to complete an assessment of their own practices and compliance. We are concerned that these weaknesses may lead to vulnerable investors, who do not understand the risks associated with derivatives, being approved as suitable. Derivatives, especially those that involve leverage and therefore potentially magnify losses, are complex instruments with risks that may not be fully understood by many retail investors.

Our expectations

The standard conditions for derivatives issuers require that before they enter into a derivative with a retail investor, they must assess whether the derivative is suitable for the individual. This involves taking all reasonable steps to determine whether the investor has the ability to understand the particular type of derivative and the risks involved. This standard condition exists to reduce the possibility of derivatives being sold to people who do not have the ability to understand the transaction and its associated risks.

It is good practice for derivatives issuers to design robust processes to collect information about prospective investors, assess the information against predefined criteria, document the rationale for the assessment, and not allow investors who cannot pass the assessment to trade derivatives. It is also a good practice for derivatives issuers to assess the ongoing suitability of their products for existing investors.

Internal controls – client money

Derivatives issuers are required to have adequate and effective arrangements to receive, hold, use and disburse client money.

What we found

We found examples of derivatives issuers with no processes or policies to support their compliance with the procedural, record-keeping and audit requirements for handling client money. In one instance, a derivatives issuer was using an intermediary to facilitate the receipt and return of client money, which meant client money was not paid promptly into a trust account, as required by the FMC Regulations.

Our expectations

We expect derivatives issuers to comply with their obligations for handling client money, and to keep proper records of all transactions. Failure to comply with these requirements means investors could lose their money if a derivatives issuer encountered financial distress, such as a receivership. Applying appropriate controls to looking after people's money is absolutely essential to maintaining confidence in financial services. Instances where money has not been appropriately segregated can damage that confidence for other investors.

While our findings in this area related to derivatives issuers, our expectations are also relevant to AFAs. We identified two AFAs who failed to exercise care, diligence and skill when providing a broking service, including poor processes for reconciling their client monies account and failure to provide the appropriate disclosures to customers. We are continuing to investigate these findings, and will consider further regulatory action.

Case study – regulatory action

Regulatory actions taken in relation to derivatives issuers include the following.

- We suspended the licence of one derivatives issuer for breaching the disclosure requirements in the FMC Act, including making an offer without a compliant Product Disclosure Statement and failing to lodge audited financial statements.
- We issued a formal censure under the FMC Act to a derivatives issuer for failing to demonstrate that investor money was held in trust, not meeting prudential requirements, failing to document certain governance arrangements, and failing to meet audit requirements.

AFAs and QFEs

Overall, we were disappointed with the nature and number of issues identified in these sectors. While many AFAs will have invested significant effort in complying with the legislation, the regime has been in place long enough that all AFAs should be meeting their obligations. We have increased our focus and will be looking for significant improvement in the compliance and conduct of QFEs and AFAs under the current regime, and the new regime that will begin in 2021.

Adviser Business Statements

The Adviser Business Statement (ABS) is required to describe the entity's business and explain the systems and procedures (for AFAs) or the governance and compliance arrangements (for QFEs) in place to ensure they operate in a professional way.

What we found

While ABS documents generally followed the prescribed format, we found a number of weaknesses, including the following:

- ABS not being kept up to date, including when processes and procedures in the business change. For example, we were given a draft version of an ABS dated August 2017, and no steps had been taken to finalise or review the document by the time of our review in November 2019.
- Arrangements in the ABS not being adhered to, including one ABS stating that a director had been appointed to oversee adviser compliance to professional standards, even though the appointment had not been made.
- ABS not explaining processes in sufficient detail or at all, or not outlining responsibilities.
- Insufficient processes for review and approval of the ABS.

Our expectations

Some entities did have up-to-date ABS documents that are subject to robust approval process. However, it is disappointing to see some ABS documents not being maintained in a timely and accurate manner. We acknowledge that ABS documents will not be required under the new financial advice regime, but until that time AFAs and QFEs must have a current ABS in place.

We encourage all QFEs and AFAs to review their ABS against the guidelines[5] and make any necessary changes. Reviewing the ABS may be a useful step in preparing for the new regime.

Customer disclosure

We expect all AFAs and QFEs to comply with their disclosure obligations. These important obligations ensure customers have all the relevant information when choosing an adviser and choosing whether to follow the adviser's advice.

What we found

We looked at what entities and individuals (such as AFAs and QFE Advisers[6]) are disclosing to their customers, including how and when they make the disclosures. We reviewed the templates for written disclosures, listened to recorded disclosures (for example, those played to customers over the phone) and reviewed

5: AFA Authorisation Guide and QFE Adviser Business Statement Guide

6: The majority of our findings in relation to customer disclosure related to AFAs and QFEs, but there were a small number of findings relating to DIMS providers and derivatives issuers, which are also included in this section.

customer files and interactions to see how disclosures are delivered. We found numerous instances that did not meet the requirements.

- Providing disclosure on request only, rather than in all interactions as is the obligation. There is a risk that customers will not know what information is contained in disclosure documents and will not request it, meaning they do not receive information that should be considered in their decision-making process.
- Disclosing information regarding fees in a way that could be misleading, for example, not making it clear to customers that the total fees they will pay will increase when the size of their investment portfolio increases.
- AFAs failing to make customers aware of the scope of the service they provide, including when they offer a limited service. This is a breach of the Code of Professional Conduct for AFAs.
- QFE Advisers not demonstrating a good understanding of the purpose of QFE disclosure, and not associating the disclosure with the provision of advice. This means that disclosure may not be given as required, or may not be effective.
- Defective disclosure documents that:
  - failed to include all information required by the Regulations, such as sufficient information about fees and conflicts of interest in the Secondary Disclosure Statement
  - deviated from the prescribed format
  - contained inconsistencies between the disclosure documents, the ABS and/or the details on the Financial Service Providers Register
  - contained out-of-date information (including broken website links) and is therefore potentially misleading.

Our expectations

When customers make decisions based on incomplete information, they may experience poor outcomes. It is concerning when disclosure templates are incorrect, because all customers will receive incorrect or incomplete disclosure.

Providers must describe products and services in a way that customers can understand and can use to compare options. Customers need to be given disclosure about products and services in a way that does not conceal or complicate the information. Customers should also be regularly informed about how their financial products and services are performing.

We encourage all providers to consider how and when disclosure is delivered to ensure that it is useful for customers' decision-making, rather than simply satisfying a regulatory requirement. The new financial advice regime will introduce new disclosure requirements. It is therefore important that all financial advisers take the time to ensure their disclosure documents are correctly designed and deliver relevant and timely information to customers, and that their processes support this outcome.

QFEs

Providing financial advice

We expect QFEs to have arrangements to ensure customers can receive suitable advice, when they need it, from competent QFE Advisers. It was disappointing to learn that this is not always occurring in QFEs. QFEs should regularly examine their processes and look for ways to ensure customers can readily access financial advice. QFEs need to be proactive, and not wait until the new regime to make changes to achieve this outcome.

What we found

From our conversations with QFE Advisers, we found that some QFE processes made it difficult for the advisers to meet their obligations and deliver suitable advice. In particular:

- One QFE's processes were designed so as not to provide customers with personalised financial advice, even if the customer requested it or the circumstances suggested personalised advice was needed.
- Some QFEs had a lack of tools, guidelines or other mechanisms to help frontline QFE Advisers consistently recommend or guide customers towards suitable products.
- Some QFEs were not keeping a record of advice provided to customers, including why a particular recommendation was made. Record-keeping is important to ensure that any advice acted upon by the customer is correctly implemented and to provide a basis for future interactions with the customer.
- Some frontline QFE Advisers did not demonstrate a good understanding of what constitutes advice, who is permitted to provide advice and what it means to be a QFE or a QFE Adviser. This may contribute to customers not being able to readily access quality advice when they need it.

Quality assurance

QFEs should have governance and compliance arrangements to enable active oversight of QFE Advisers' behaviour, advice to customers and compliance with processes.

What we found

While QFEs generally had some form of quality assurance (QA) in place, we identified some weaknesses and opportunities for improvement. These included:

- Some teams or individual QFE Advisers were not subject to QA review, in some cases due to a lack of resources. For example:
  - A team providing advice was not subject to QA reviews for eight months due to a system malfunction. After identifying this issue, the QFE did not do any review of the advice provided during that period (which we would expect them to do) and did not introduce controls to prevent the issue reoccurring.
  - In one QFE, management was unaware that some branch managers did not complete any QA reviews for 12 months.

  - No mechanism to ensure customer interactions conducted in foreign languages are reviewed.
- QA programmes that are not risk-based, meaning higher-risk products, advice types or advisers are not subject to more frequent review.
- Failure to share QA results internally and/or take action when issues are identified, meaning that poor performance by QFE Advisers and issues with systems, products or processes are likely to continue.
- QA reviews that do not measure outputs against predefined criteria and/or do not review the suitability of advice provided. We saw examples of QA programmes that blurred the line between oversight and sales coaching, and were not effective in monitoring for inappropriate advice. In one QFE, feedback to staff was largely focused on how to sell more products, rather than providing suitable advice.
- Failure to review QA programmes periodically to ensure they remain appropriate for the business and deliver the assurance that management and the board require.

Our expectations

QFEs should consider what proportion of customer interactions they need to review, and how they will structure the reviews in order to obtain a reasonable level of assurance about the quality of advice.

We expect QFEs to act upon the results of QA reviews. This means providing feedback to advisers, and identifying systemic issues with products, systems and processes. QA results should be shared internally, and with the board or other body responsible for compliance oversight.

QA programmes should be appropriately resourced, and subject to review to ensure they remain fit for purpose and reflect changes in the business. Implementing a risk-based programme can assist in managing resources. If a QFE decides not to review the quality of advice in relation to a group of staff or particular products, this should be documented in the ABS, along with details of any compensating controls.

AFAs

Advice process

We expect all AFAs to comply with the Code of Professional Conduct, which includes ensuring the personalised service is suitable for the client.

We looked for evidence that AFAs take reasonable steps to ensure their personalised service is suitable for the client, having regard to the agreed nature and scope of the personalised service provided.

While some AFAs have well-defined advice processes, in our monitoring reviews we came across examples of AFAs who do not use any structured process to identify and match their clients' needs to specific recommendations. This creates a risk that the recommendations are not suitable. Any AFA who does not have a process in place should consider using a fact-find or other similar process to identify and record their clients' needs and how these can be most suitably met. We do not prescribe the use of any particular document or method of doing this.

Record keeping

Record keeping is important for AFAs because it helps them to evidence how their obligations under the Code of Professional Conduct have been met and show that the client received sufficient information about the financial adviser service.

AFAs have obligations under the Code of Professional Conduct to:

- record in writing adequate information about any personalised services provided to a retail client; and
- ensure that records of all information and documents required under this Code are kept for a minimum of 7 years.

What we found

We found numerous examples of AFAs who were not meeting their obligations. These included:

- No policies, processes or controls to assist the AFA to comply with the record keeping obligations.
- Insufficient evidence retained to show that key processes had been followed, such as:
  - not documenting the rationale for personalised advice provided to a client
  - failing to show that the scope of service had been communicated to the client
  - failing to document what information, disclosure documents and financial advice were provided to the client.
- Incomplete or insufficient records of discussions with clients, including agreements reached in those discussions.

Our expectations

We encourage AFAs to maintain accurate and complete records. The FMA does not prescribe any particular format for record keeping – what is important is that records are maintained and accessible. Where the record-keeping obligations are not met, not only will that cause us to consider what other non-compliance may be occurring, but it is in itself an enforcement matter.

Continuing professional development

Professional training is important for AFAs because it helps maintain their competence as an adviser and keep themselves up to date with relevant developments.

What we found

We encountered AFAs with no professional development plan (PDP), and PDPs that had not been kept up to date and/or did not adequately address the AFA's development needs. For example, one AFA had identified several gaps in their competence, knowledge and skills, but had not developed a plan for addressing these gaps.

Some AFAs told us they had completed training, but could not provide evidence. We also saw AFAs who were not undertaking training of sufficient duration or breadth to meet the

Detailed findings

requirements in the Code and maintain an appropriate level of knowledge and skill.

Our expectations

We expect AFAs to complete an honest evaluation of their competence, skills and knowledge, and develop a plan to address any gaps.

AFAs should participate in training that furthers their development, and keep a record of this.

We appreciate that facilitated training may not be readily available in all locations or in relation to all aspects of the AFA's business, but we encourage AFAs to look for alternative ways to develop their professional competence and keep up to date in their field, such as webinars and other online learning tools.

Case study – regulatory action

We took a range of regulatory actions in relation to the compliance and conduct of AFAs, including the following:

- The most serious case we dealt with resulted in a referral to the Serious Fraud Office (SFO) to investigate what turned out to be a Ponzi scheme. In addition to the SFO investigation, FMA used multiple regulatory tools to limit any ongoing harm to customers or potential customers. These included suspending and subsequently cancelling the AFA's authorisation, issuing multiple notices and directions[7] to three companies under the AFA's control, and applying to appoint interim liquidators to two of those companies.
- We suspended the authorisation of an AFA who was found to be receiving client funds despite not being registered to provide broking services, and who had misused client funds. The AFA voluntarily deregistered from the Financial Service Providers Register and ceased operating their adviser business before the FMA took any further action.
- An AFA has been referred to the Financial Advisers Disciplinary Committee for breaches of the AFA Code of Professional Conduct, including poor record keeping practices and lack of understanding of their obligations.
- A formal investigation has been opened to assess an AFA with insufficient advice and compliance processes, as well as poor client money handling procedures and reconciliation processes. The outcome of the investigation into this AFA will determine any regulatory actions.
- We issued a formal warning to a financial adviser who made recommendations to clients that they urgently move their investments to 'low-risk' funds during a period of high market volatility. The adviser failed to clarify that the advice was general in nature and may not be suitable for all clients. The advice in such a broad and non-conditional format was inappropriate and had the potential for significant harm. We have a low tolerance for poor conduct that poses risks to customers.

7: The notices and directions were issued under the Corporations (Investigation and Management) Act 1989.

Appendix

Supervision overview

The FMA's supervision activities include the following:

- **Licensing** – assessing applications from new and existing market participants seeking to obtain or vary a licence or other regulatory authorisation.
- **Monitoring** – reviewing and assessing the compliance, competency and conduct of financial market participants.
- **Market engagement** – maintaining close relationships with financial market participants through our stakeholder relationship management programme, participation in operational meetings with market participants and representing FMA at external forums and conferences.
- **Other activities** – issuing guidance to the market, taking regulatory action in relation to non-compliance, work to support the introduction of new legislation, and interacting with other regulators in New Zealand and overseas.

Monitoring – a closer look

Our monitoring activities generally fall into one of three broad categories:

- **Responsive monitoring** – undertaken in response to information received from market participants themselves or other parties, including complaints, and notification of changes to a market participant's business. It also includes the ongoing capture and assessment of information received through regular regulatory reports and notifications. We review all information received and determine the most appropriate action, which in many cases involves us interacting with the market participant to obtain more information, provide a response or take further action. Some of the regulatory actions we have taken as a result of responsive monitoring are explained in more detail in this report.
- **Thematic monitoring** – deep-dive style review work to better understand a particular market segment and/or issue. Some of this monitoring is exploratory in nature, to help

us understand a population or issue in more detail and to focus our future monitoring activity, while other thematic monitoring results in the publication of insights and guidance to the market.

- **Planned monitoring** – monitoring engagements that are planned in advance to take a more in-depth look at a particular entity. Some of these reviews are restricted to an examination of documents, such as board or committee papers and minutes, customer documentation, internal policies and procedures, and evidence of how these are applied in practice. Our planned monitoring reviews generally also involve onsite visits by FMA staff to conduct interviews with key staff, management and in some cases, directors.

The planned monitoring reviews that are detailed in the report were intensive reviews, with the onsite component of ranging from two hours up to three days, depending on the scope of the review and size of the entity. The entities we selected for review were based on a range of factors, including risks we have observed in the market, reporting provided to us by entities, and the potential risks posed to investors by individual entities.

Our reviews included looking at:

- conduct, culture and governance
- compliance with obligations under financial markets legislation and regulations, and the minimum standards and terms and conditions for the entity's licence or authorisation.

About the entities we monitored

In this section we provide a brief outline of the entity types that are covered by this report. During the period of the review, we also monitored other entity types such as AML/CFT Reporting Entities; the findings of that monitoring activity are covered in other reporting published by the FMA.

Supervisors	There are five Supervisors licensed under the Financial Markets Supervisors Act 2011 to oversee entities and look after investors' interests for: • debt securities • registered schemes, including KiwiSaver schemes, non-fund schemes, specified managed funds and superannuation schemes • retirement villages.
QFEs	QFE status enables an organisation to streamline the registration, disclosure, dispute resolution and supervision arrangements that will apply to its advisers. The 52 entities with QFE status under the FA Act include banks, insurers and finance companies. Under the new financial advice regime, QFE status will no longer exist. QFEs who wish to continue taking responsibility for the compliance of their financial advisers will need to become a Financial Advice Provider (FAP).
AFAs	AFAs are individual advisers who are permitted to provide personalised financial adviser services to retail clients. Around 2,000 AFAs are authorised under the FA Act. Under the new financial advice regime, the designation of AFA will no longer exist. AFAs who wish to continue providing advice will need to obtain a licence as a FAP, or work under the licence of a FAP.
FMC entities FMC entities are those who offer, issue, manage, supervise, deal in and trade financial products. Their obligations are covered in the FMC Act (and associated Regulations), which governs the way financial products and certain financial services are offered, promoted, issued and sold. This report covers the following FMC entity types.	
Derivatives Issuers	Derivatives Issuers sell or trade derivatives, which are contracts whose value is based on an agreed-upon underlying financial asset. Issuers of derivatives must be licensed to make a regulated offer of derivatives to retail investors. There are 25 licensed Derivatives Issuers.
Managed Investment Scheme (MIS) Managers	A MIS Manager manages the portfolio and investment strategy for funds or managed investment schemes. Under the FMC Act, the manager of a registered MIS, other than a restricted scheme, must be licensed. There are 69 licensed MIS Managers.
Discretionary Investment Management Service (DIMS)	A DIMS provider has the authority to make decisions about buying and selling financial products on behalf of investors. There are 53 entities licensed as DIMS providers under the FMC Act. A DIMS is different to a managed fund or scheme in that it makes decisions on behalf of individual investors, while a MIS manager makes decisions for the fund.

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