FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

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Derivatives Issuer Sector Risk Assessment

This sector risk assessment summarises the key risks posed by licensed Derivatives Issuers (DIs) to the FMA's objective of promoting fair, efficient and transparent financial markets. It is based on a self-assessment completed by DIs, as well as our interactions with DIs and their clients since FMC Act licensing began. We will continue to take action to address these risks by conducting further monitoring and improving DIs' compliance. This information will be useful to help licensed DIs understand our focus areas and ensure they comply with our expectations and best practice.

Introduction

Derivatives[1] are complex financial instruments, and trading them is generally not a suitable 'investment' for most retail customers. Derivatives can be used to mitigate risk, but their speculative, contract-based nature means that investors do not always fully understand the risks before entering into an agreement. Retail customers can experience losses far in excess of what they expected.

A DI who makes a regulated offer of derivatives must be licensed by the FMA. A regulated offer includes any offer of derivatives where disclosure must be made to one or more investors, for example, because they are a retail investor[2].

The FMA assesses DI licence applications against minimum standards. Where a licence is granted, the DI must adhere to the minimum standards they were assessed against, standard licence conditions, and all other relevant financial markets legislation, including Financial Markets Conduct Act 2013 (FMC Act) disclosure obligations. The DI licensing regime and its obligations have been in place since 2016.

We monitor licensed DIs on an ongoing basis, and want to continue developing this monitoring in accordance with our risk-based approach. In our 2019/2020 Annual Corporate Plan we stated our intention to carry out a sector risk assessment (SRA), in alignment with our 'Governance, culture, systems and controls' strategic priority.

The SRA involved a survey of 24 licensed DIs, which required them to self-assess the state of their governance, culture, systems and controls used to meet their compliance obligations and serve the needs of customers. The topics covered in our survey were based on the minimum standards, standard conditions, and relevant financial markets legislation. We wish to thank all DIs who took part in the survey.

For each risk identified, we applied one of the following residual risk ratings:

Rating	Description
High	Priority monitoring attention. Greatest risk of client harms and non-compliance with key regulatory requirements.
Medium-High	Planned monitoring attention. Inadequate demonstration of customer-centric culture, improvements required to governance and controls.
Medium-Low	Planned monitoring attention. Focus is placed on improvement areas to better serve the needs of customers.
Low	Focus for longer-term planned monitoring.

These ratings are in relation to our objective of promoting fair, efficient and transparent financial

1: A contract whose value or amount of consideration is derived from an agreed-upon underlying financial asset (like a share in a company), rate (like an interest rate or exchange rate), index (like a share market index), or commodity (like gold or milk powder). Derivatives are a financial product under section 7(1)(d) of the FMC Act and defined under section 8(4) of the FMC Act.

2: A person who does not meet the definition of wholesale investor in clause 3 of Schedule 1 of the FMC Act in relation to an offer of derivatives.

markets. Residual risk is the remaining risk after assessing the current state of each DI's governance, culture, systems and controls to manage risk and compliance.

In the survey, DIs were able to respond to questions as 'not applicable' if the topic was not relevant to their particular business model. 'Not applicable' responses did not receive a rating, and therefore did not negatively affect the residual risk ratings.

Understanding the ratings will help DIs review their ongoing compliance obligations, and understand our focus areas. The risks will also inform individual FMA support and monitoring activity, as covered in the 'Future focus' section on page 7.

Overview of the sector

There are currently 25 licensed DIs, 24 of which participated in this SRA. Halifax New Zealand Limited was not asked to complete the survey; its licence is suspended and it is currently in liquidation. Three additional DIs who did participate in the survey had suspended licences at the time of this report:

- AxiCorp Financial Services, as a result of material breaches of the FMC Act relating to disclosure, financial statements and auditing, as well as contravention of its licence conditions.
- EncoreFX, as it was put into voluntary administration by its parent company and is now in liquidation.
- BL Global Markets, which voluntarily suspended its licence.

Five DIs are banks, which are also licensed and prudentially regulated under the Reserve Bank of New Zealand Act 1989.

The DI sector collectively reported approximately 23,000 accounts operated by retail customers.

Licensed DIs offer 'over the counter' (OTC) derivatives, which are derivatives between two parties that are not traded on an exchange, and do not have standard pricing, settlement and trading terms. Thirteen DIs offer OTC contracts for difference (CFDs), which are leveraged OTC derivatives that allow the client to speculate on the change of value of an underlying asset, without actually owning it. CFDs provide limited investment or economic utility, and retail customers generally use them to speculate on short-term price movements in an underlying asset.

Some DIs offer currency forwards and options, which are more commonly used as cash-flow hedging and risk management tools. Five DIs offer swap contracts, where the underlying cash flows relate to foreign currencies and interest rates.

What we found

We asked DIs to self-assess the state of their own governance, culture, systems and controls. The sector risks summarised below are based solely on our assessment of the responses provided by DIs.

Risk rating: High

There is a risk DIs do not comply with applicable regulations for handling client money.

Although DIs view their controls for handling client money as very strong, we found instances of potential risks. Eight DIs also told us some or all client money and/or property is held offshore. These DIs may rely on the processes and controls of overseas entities to manage client money.

We expect all DIs to have adequate and effective arrangements to receive, hold, use and disburse client money in compliance with the Applicable Regulations (Client Money Minimum Standard 1). These applicable regulations are the Financial Markets Conduct Regulations (FMC Regulations) 238-250.

We already monitor DIs for handling client money, including the requirement for assurance reporting. This will continue to be a key focus in our monitoring activities. Specifically, we will examine how client money procedures and controls are operating in practice.

There is a risk DIs may not be taking reasonable steps to determine whether derivatives are suitable for their retail investors.

Standard condition 12 requires DIs to take all reasonable steps to determine whether retail investors have the ability to understand the particular type of derivative and the risks involved. Some survey responses indicate that DIs do not take into consideration a customer's prior trading experience, understanding of leverage[3], or understanding of risk when assessing suitability. Some DIs told us they do not keep written records of assessments they carry out when they accept a new customer; some stated they do not keep these records because they consider their product offering to be less complex.

The SRA also highlighted factors that increase the residual risks of product suitability, such as:

- CFDs offered where cryptocurrencies are the underlying asset. The prices of cryptocurrencies can be opaque and highly volatile, and therefore CFDs on these assets generally entail heightened risk.
- High amounts of leverage. Leveraged positions magnify potential returns, but can also magnify losses when markets move against a position.
- Offering exotic options, such as binary options. These options provide an all-or-nothing pay-out structure and are highly speculative. The FMA has published information about binary options on our website. Binary options may promise to make money quickly, but like gambling, investors could lose all of the money invested.

Overall, we consider that cryptocurrency CFDs, high leverage, and binary options are not suitable for most retail investors. We will be monitoring DIs who offer these, and examining how product suitability procedures and controls are operating in practice to ensure that only appropriately qualified retail investors trade them.

There is a risk that the oversight body does not review its governance and compliance arrangements in a timely and adequate manner.

Some DIs told us they only completed an informal review of their governance framework[4], rather than formal. In addition, some DIs told us they had not scheduled a review of their governance framework, had not conducted a review on an annual basis, or had not completed a review since licensing. Informal or infrequent reviews could result in inadequate governance arrangements to oversee risk and compliance. This is a potential breach of Governance Minimum Standard 4, which states that the oversight body considers the adequacy and robustness of its governance and compliance arrangements at least annually.

DIs may be unable to identify and treat vulnerable customers appropriately, which may result in poor customer outcomes.

A vulnerable customer is someone who, due to their personal circumstances, is especially susceptible to harm, in particular when a firm is not acting with appropriate levels of care[5].

14 DIs (58%) do not have a vulnerable customer policy in respect of their DI services. It is important for DIs to have the appropriate process and procedures to identify and deal with customers who display vulnerability factors. This may include indicators of gambling addiction, language issues, lack of financial literacy, or inadequate understanding of derivative products and associated risks.

We encourage all financial services firms to review their policies and practices for vulnerable customers in light of COVID-19, as we are seeing an increased

3: The ratio between the total notional position value (that to which the retail investors is exposed) and the amount deposited by the investor (i.e. the minimum initial margin payment). The investor is effectively 'borrowing' the remaining amount.

4: The processes, policies and guidelines that support all aspects of reporting and governance, including operation of the oversight body, and compliance obligations and key risks.

5: Based on definition from Customer Vulnerability, published by the UK's Financial Conduct Authority in 2015.

need for consideration in this space. We recently published an information sheet on customer vulnerability.

Risk rating: Medium-High

Retail customers may be getting poor outcomes from margin trading.

We asked DIs a series of questions around margin trading.

- The majority of DIs told us they offer margin trading, where the customer deposits a portion of the value of the underlying asset upfront, but will need to pay the full amount of the change in value of the underlying asset if they lose. Trading on margin amplifies minor fluctuations in the value of the investor's position, and in some cases exponentially increases the investor's losses or gains.
- Some DIs accept credit to establish a facility or post margin, which may include credit cards. Retail customers might use borrowed funds to open an account, post margin or cover large trading losses, without understanding the downsides of this practice.
- Some DIs offering a large amount of leverage, in some cases greater than 200:1. We are concerned about whether these leverage amounts are appropriate for retail customers. For DIs offering high leverage, our future monitoring will address how they operate these limits, including product suitability processes and controls in place to ensure clients understand the risks.
- We asked about the proportion of clients who had their open positions closed due to their inability to meet margin calls. In the past 12 months, most DIs had 10-25% of retail investors with one or more positions closed due to margin call. In some instances this was higher than 50%, and was below 10% at only a small number of DIs. Some DIs also had a substantial proportion of retail investors with negative account balances, where the investor's losses exceed their investment and they now owe money to the DI.
- We explored risk management techniques offered to clients to limit losses associated with trading. The majority of DIs offer limits on position sizes (setting a maximum value of a customer's exposure to a derivatives contract) and stop losses (an instruction to buy or sell when the underlying asset reaches a certain price). However, only a few offer guaranteed stop losses, which guarantee order execution at specified price, or negative balance protection, which ensures customers cannot lose more than the funds in their trading account and prevents firms from recovering any losses that exceed the clients' deposited funds or funds invested for each trade. These techniques offer a cap on potential losses that retail customers are exposed to, especially during periods of market volatility.

Although the PDSs generally outline the risks associated with margin trading, we consider that there are residual risks where customers are getting poor outcomes from margin trading. We will be conducting further monitoring to ensure margin trading aligns with serving the needs of customers.

There is a risk that conflicts of interest are poorly managed for proprietary trading.

DIs must have clear and appropriate policies on speculative trading on proprietary accounts (Dealing Conduct – Minimum Standard 2). Our survey revealed the majority of DIs operate a straight through processing (STP) model where all client transactions are fully hedged with a market counterparty. However, we were told about isolated instances of speculating against clients, such as DIs hedging less than 50% of client trades or carrying a substantial level of unhedged positions. This presents a conflict of interest between the DI and their investors, as DIs can directly benefit from an investor's losses.

There is a risk that conflicts of interest caused by sales and distribution arrangements are inadequately managed.

13 DIs told us they had referral arrangements with third-party agencies. There is a conflict of interest between referrers who receive a commission or volume bonus, and customers. Referrers may behave in a way that influences a client to trade derivatives, even if it does not meet the client's investment needs.

Eight DIs provide inducements such as gifts, bonus credits or rebates to retail customers, which may be in exchange for making trades or providing names of prospective clients. This creates a risk of investors making trades that are not in their best interests, or recommending unsuitable services to other consumers.

DIs need to manage these conflicts of interest to ensure their customers get good outcomes.

There is a risk that DIs' business continuity plans (BCP) are not adequately tested to provide assurance of continuity of services in the event of business disruption.

DIs must maintain an appropriate (and tested) business continuity plan in accordance with Business Continuity Minimum Standard 3. The majority of DIs told us their BCP is tested at least annually and results of the test are recorded. However, five DIs told us that their BCP is tested less frequently than annually, or not at all. In addition, some DIs told us their BCP covers some key functions, but not all. There is risk that key functions required to service retail customers may not be covered during a crisis. COVID-19 has highlighted the importance of having a tested BCP; it can put DIs in a position of resilience and provides added confidence and stability for the DI and its clients.

The risk is heightened if those functions experience a cyber-security incident and cannot recover in a timely manner. The FMA provided guidance on cyber-resilience for regulated entities, and we expect DIs to have considered the expectations outlined in this guidance. Our future monitoring will focus on how DIs manage their cyber-resilience.

There is a risk that the oversight of outsourced functions may be inadequate.

We asked DIs to tell us what functions of their licensed service are outsourced. All DIs outsource at least one function. The most common functions outsourced are IT support and dealing operations. Some DIs outsource all of their key functions, including client on-boarding. In some cases, outsourced service providers are offshore and/or related parties.

DIs must ensure outsourced functions are adequate, effective and comply with their licence obligations as per the minimum standards. Outsourcing Minimum Standard 2 stipulates that DIs must have proper legal arrangements with providers, including provisions that enable effective monitoring of performance and taking appropriate action for non-performance.

In our survey we also asked about governance, systems and controls related to outsourcing, and found that DIs have legal agreements with some, but not all, outsourced service providers. Some of these agreements do not include powers to take action for non-performance. Some stated outsourced service providers are only monitored as needed, rather than on a regular basis; we question whether this is appropriate.

Our ongoing monitoring has revealed outsourcing risks linked to COVID-19, where an outsourced service provider's performance affects a firm's operational resilience and its ability to comply with obligations and serve customers.

Risk rating: Medium-Low

There is a risk that, due to a lack of independence on licensee boards, oversight may be focused primarily on the interests of the company rather than bringing a customer-centric perspective.

DIs viewed their oversight body as having extensive industry skills, knowledge, expertise, and prior governance experience. The majority also viewed their board as having adequate diversity.

15 DIs told us they do not have an independent chairperson, and 13 boards are solely comprised of executive directors. Executive directors may be more focused on growth and business performance, which may come at the expense of appropriate customer outcomes. Non-executive directors, who do not have other interests that could affect their judgment or decision-making, can bring an independent perspective to board decisions.

Our survey showed non-bank DIs are relatively small, measured by full-time equivalent employees, which presents challenges in obtaining non-executive directors. In smaller organisations, the oversight body will often be the board of directors. If a company has only one director, they might perform this duty on their own. In larger organisations with more diverse operations, the oversight body may be a committee composed of senior managers and representatives from legal, risk and compliance areas.

We encourage DIs to observe the principles outlined the FMA's Corporate Governance Handbook, specifically Principle 2 (Board Composition and Performance) for their oversight body.

There is a risk that DIs may be complacent about their conduct and culture, and may not be aware of their own inadequacies with respect to conduct risk management.

DIs viewed themselves as adequately managing conduct and culture. However, 11 DIs had not completed a gap analysis against our Guide to Good Conduct, some of which also told us they have a high level of conduct maturity. 10 DIs do not include conduct and culture risk as a standing agenda item for their oversight body. DIs should continuously examine how they think about good conduct, to ensure they consistently deliver good outcomes to their customers.

There is a risk that advertising does not comply with fair dealing provisions.

The most common forms of advertising used by DIs are digital, word of mouth, and publications such as magazines, newspapers and newsletters. Some DIs told us they use presentations, seminars, TV, radio, billboards, and third-party advertising agencies. Others told us they also sponsor events, such as sporting events. These channels are likely to reach the mass retail market. However, our view is that derivatives, including OTC leveraged products, are likely to be appropriate only for a relatively small number of sophisticated retail investors who understand the products and their risks, and are financially capable of absorbing the potential losses. We will conduct further monitoring to determine whether DI's advertising policies and controls are designed to ensure advertising materials are appropriate.

We asked about governance, systems and controls related to advertising. DIs viewed their controls as very strong. Most noted their review process for advertising is regular and ongoing. However, five DIs noted they only review advertising materials when required, such as when changes are made (rather than performing periodic reviews). Without a regular review, DIs may not detect whether their advertising complies with their obligations.

DIs must ensure their advertising complies with the fair dealing provisions in Part 2 of the FMC Act and advertising provisions in Subpart 3 of Part 3 of the FMC Act (Advertising and Disclosure Minimum Standard 1). This includes providing compliant product disclosure statements (PDS).

Risk rating: Low

Retail customers may not fully understand the fees and charges imposed on them.

We asked DIs about types of fees and costs they charge to earn revenue. Most told us they earn their revenues through spreads, which are the difference between the buy price and the sell price of a derivative. Some DIs also have other fees such as overnight funding costs, forex (FX) conversion fees and account inactivity fees. Inactivity fees are applied if there is no trading activity or open positions in an

account for a set period. We expect DIs to ensure their clients receive adequate information on the different fees and costs that may be applicable when trading derivatives.

Bank DIs

This SRA considers DIs that are registered banks (bank DIs) to be low risk due to prudential oversight and the generally limited scope of their derivative offerings to retail customers. None of the bank DIs told us they offer high-risk derivatives such as CFDs or exotic options to their retail customers. Bank DIs focus on offering forward contracts, swaps, and options for foreign currencies for risk management purposes and on an exception basis.

Most bank DIs told us they did not have an existing vulnerable customer policy in place. One bank DI did tell us it is implementing its vulnerable customer policy in 2020 across the entire business. Another bank DI does take some steps to identify vulnerable customers, but with no formal policy. It is our view that without a policy in place, there is a risk that bank DIs are unable to identify and treat vulnerable customers appropriately in their derivatives business.

A few bank DIs told us they do not currently publish any separate warnings regarding the risks associated with trading derivatives in their marketing and advertising materials. These bank DIs are relying on investors to read their PDS. Some bank DIs told us they have referral arrangements with third-party intermediaries such as advisers, affiliates, or introducing brokers. We expect bank DIs to ensure they manage these conflicts of interest to ensure they are serving the needs of customers, consistent with our messaging to them in the Bank Conduct and Culture and Bank Incentive Structures thematic reviews.

Future focus

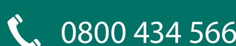
The FMA expects DIs to demonstrate that they are meeting their compliance obligations in accordance with the minimum standards, standard licence conditions, and other relevant financial markets legislation.

We expect DIs to review this report and be able to demonstrate that their governance, systems, culture and controls are in line with our expectations.

Based on what we have learned from this sector risk assessment, we believe the risk profile of this sector is high. We will continue to focus on monitoring DIs, using the risks summarised in the SRA to target monitoring activities. The survey responses will help us prioritise monitoring activities, for example, by focusing on instances where a DI's self-assessment was inconsistent with their compliance history, or where it appears the DI's systems, controls, and practices may not meet our expectations.

Our future monitoring of DIs will involve both desk-based and onsite inspections. Initially we will be following up with individual DIs to determine how they are addressing the risks identified in this SRA. Where DIs are not meeting key compliance obligations, we may take action on the DI's licence, or other enforcement action.

Based on what our monitoring finds in the risk areas noted in this report around governance, and conduct and culture, we will consider issuing additional guidance on our expectations, including best practice for DIs to serve the needs of customers.



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