Inquiry into finance company failures

Report of the Commerce Committee

Forty-ninth Parliament
(Lianne Dalziel, Chairperson)
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Presented to the House of Representatives

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The Commerce Committee makes the following recommendations to the Government.

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1 We recommend to the Government that financial literacy efforts include efforts to publicise the distinction between "independent" advisers and those who receive remuneration from the providers of investment products, to encourage the public to opt for independent advice (page 19).

2 We recommend to the Government that it investigate the possibility of banning conflicted remuneration structures in the provision of financial advice, including consultation with the Australian authorities on the model proposed in that country (page 20).

Disclosure

3 We recommend to the Government that the Financial Markets Authority be asked to investigate means of standardising the way information is publicly presented so the general public can readily understand financial information such as profitability (page 22).

Financial education

4 We recommend to the Government that it give priority to a coordinated effort to improve New Zealanders' understanding of financial matters, focused particularly on those at or nearing retirement age, on young people to build financial capability, and on those most at risk from scams and irresponsible lending practices (page 24).

5 We recommend to the Government that it review the adequacy of current funding of the Retirement Commissioner and schools for financial education and increase it as necessary (page 24).

Moratoria

6 We recommend to the Government that moratorium situations be referred to as "creditor compromise situations", as a small but important indication of the unlikelihood of a satisfactory outcome for investors (page 25).

Directors' duties

7 We recommend to the Government that the duties imposed on directors be stated clearly and forcefully in legislation, according to the principles set out in the February 2011 Cabinet paper which set out the policy intent of the draft Financial Markets Conduct Bill (page 27).

Trustees

8 We recommend to the Government that the term "supervisor" be used instead of the term "trustee", to describe those trustees who supervise peoples' investments (page 27).

Regulators

9 We recommend to the Government that it ensure that the Financial Markets Authority, as regulator of New Zealand's securities markets, be adequately resourced to fulfil its statutory functions (page 29).

10 We recommend to the Government that the wording of the Protected Disclosures Act 2000 be broadened to cover wrongdoing by board members and other senior officers besides the "head" of the company (page 29).

Redress

11 We recommend to the Government that priority be given to progressing legislation on class actions during the term of the 50th Parliament (page 33).

12 We recommend to the Government that such legislation include guidelines for the operation of commercial third-party funders of litigation (page 33).

Trusts

13 We recommend to the Government that it consider accelerating work on legislation to provide means for investors to gain redress from funds in trusts, including an examination of sham trusts and means of penetrating trusts to recover assets for creditors (page 36).

1 Introduction

Since May 2006, 45 finance companies in New Zealand have failed, either being placed into receivership or entering into moratorium arrangements with debt holders. These failures have put at risk about $6 billion of investors' deposits, much of which will not be recovered. It is estimated that between 150,000 and 200,000 deposit holders have been affected, and the losses to date have been estimated at over $3 billion. A table listing the failed finance companies is attached as Appendix D.

We are aware that the collapses have devastated many investors, and have had far-reaching consequences for their families. In wiping out people's savings, the failures have harmed not only their livelihoods but, as we heard from many submitters, their health as well. It is becoming clear that some of the failures involved criminal wrongdoing, not just inept management, inadequate supervision, or a bad business model. We hope to see those responsible for such transgressions held to account fully.

We initiated this inquiry because of our concern for investors. In doing so, we are aware that the Government has been reviewing legislation to improve the regulatory environment for securities markets. Our intention was not to duplicate this work (we have been in regular contact with the Minister of Commerce on progress) but rather to provide a form of back-stop, checking for problems that are not being addressed, and seeking to make useful suggestions for the benefit of future investors and the Government.

We have also been mindful that it is beyond our ability and our role to achieve recompense for the investors who lost their savings in the collapses. Nor have we intended to allow this inquiry to be a witch-hunt; we leave it to the courts to sort out issues of liability. We have shared investors' frustration at the length of time it has taken for investigations to be made and for cases to be heard in the courts—however necessary it is because of the complex documentation involved. We note that through the Serious Fraud Office, the Commerce Commission, and the newly-established Financial Markets Authority (which took over from the Securities Commission) some action is being taken to hold errant directors accountable for their actions. We are pleased to see some convictions finally resulting from the worst offending. Regrettably, we are aware that it is highly unlikely that investors will be compensated for their losses.

Outline of this report

In the rest of this section, we explain the process of this inquiry and our terms of reference. In Chapter 2, we summarise what went wrong in the finance company failures and explain how recent legislative changes address these failings. In Chapter 3, we set out the basic principles that have guided our assessment. In Chapters 4 to 7 we assess the corrective measures that have been taken so far against our terms of reference, and in Chapter 8 we sum up our assessment.

Inquiry process

Between 9 April and 20 August 2009 we conducted a briefing on the finance company collapses, led by the Ministry of Economic Development. We reported to the House on this briefing on 28 August 2009. From the briefing we identified four areas which did not appear to be addressed by Government work programmes, which we felt could benefit from select committee scrutiny:

- investors' information about investment proposals
- investors' understanding of the implications of moratorium proposals
- advance actions to reduce the chances of failure
- the adequacy of measures of redress.

On 20 August 2009 we initiated this inquiry, with the following terms of reference.

Terms of reference

Investor information

To examine the quality of information provided to investors when considering an investment decision, and investors' ability to understand financial matters.

- Whether the marketing and advertising of investment proposals play a disproportionate role in investors' decisions.
- Whether further rules are needed around the quality of advertisements for securities.
- Is the disclosure of advisers' commissions adequate? Should advisers' commissions be banned?
- What steps can be taken to improve the existing level of investor understanding of financial products and services?

Moratoria

To examine the quality of advice provided to investors in moratorium situations, including independent analysis of moratorium versus receivership, and the independence of the management of the moratorium.

Reducing chances of failure

To examine ways of minimising the chances of situations arising where the risk of failure is not adequately reflected in the risks identified to investors or the returns investors expect to receive for that level of risk.

- Should regulators have the power to "call in" particular products that may raise investor protection issues in order to scrutinise whether these products should be allowed to go to the market?
- Should the law provide for extended whistle-blowing protections?

- Does the law deal adequately with directors and managers who have been implicated in inappropriate activity in respect of finance companies and who go on to start up new firms? If not, what steps could be taken to improve how the law addresses this issue?

Redress and deterrence

To examine the measures in place that provide redress to investors where failure occurs and wrongdoing is established, particularly whether these measures act as a significant disincentive for wrongdoing to occur.

- Do directors and managers of finance companies hold the appropriate professional indemnity insurance? What is the state of the market for professional indemnity insurance for directors?
- To what extent could the law make it easier to trace funds following the recent finance company collapses? How can this be facilitated to make it easier for investors to get financial redress for their losses?
- Should the law make it easier to penetrate trusts that may protect the assets of culpable directors?

Petitions 2008/10 of Suzanne Edmonds and 2008/11 of Peter Smith

We received two petitions related to the subject-matter of this inquiry, and have considered them together:

- Petition 2008/10 of Suzanne Edmonds, referred to us on 11 March 2009
- Petition 2008/11 of Peter Smith, referred to us on 20 March 2009.

Both petitions request that the House of Representatives support the establishment of a Royal Commission of Inquiry to investigate the finance companies crisis.

We consider that the inquiry we have undertaken into the finance company failures, together with the legislative steps already taken or in progress, address the requests of these petitions. We do not believe significant value would be added by the establishment of a Royal Commission of Inquiry.

We have no further matters to bring to the attention of the House.

Delay in reporting

We had hoped to report back to the House sooner than we have been able to. The Chair's commitments in Christchurch since the Canterbury earthquakes meant extended leave from Parliament was required. This affected our ability to report in a more timely fashion, which is regretted.

2 Background

The role of finance companies

It is the nature of finance companies to lend in an environment with a higher tolerance for risk than the traditional banking sector. This has allowed them to form an important part of New Zealand's financial system by filling the gap when banks cannot or will not lend. Their customers have tended to be individuals and small to medium-sized enterprises who want more flexibility or more credit than banks will offer. Because finance companies are willing to lend for riskier ventures on the basis of lower credit security than banks, they charge a higher interest rate; in turn, they attract funding from depositors by offering higher interest rates on deposits.

In the decade or so of rapid growth in New Zealand's property sector up to 2007, finance company lending expanded rapidly. Many of the property developments of this period relied on finance companies for "mezzanine" funding to bridge the gap between what banks would lend with the security of a first mortgage, and the developer's own funding from equity or pre-sales. Because the finance company's security ranked below that of the bank, it carried a higher risk.

Another important trend over this period was the expansion of banks' own lending into the property sector. As banks expanded the credit they offered, this had the effect of shifting the gap that finance companies covered into riskier territory. In addition, finance companies were involved in an enormous expansion of credit, financing second-hand cars and other consumer purchases, with little oversight of capacity to repay loans. While the increased risk should have meant a corresponding increase in the returns finance companies offered, they did not always do so. Many companies did not disclose the level of risk adequately, and some sought to minimise the perceived risk difference between themselves and banks by offering only slightly higher interest rates to depositors. At the same time, they actively marketed themselves to retail investors. According to Reserve Bank of New Zealand data, between December 2004 and June 2007 the deposits invested by households in finance companies rose from $5.1 billion to $7.1 billion, an increase of 39 percent. Many of these investors, it seems, did not properly understand the role of finance companies in the marketplace, and the risks inherent in their lending.

Summary of what went wrong

Many factors clearly contributed to the collapses of finance companies. Some were related to the inherent riskiness of the finance company's role. Others stemmed from broad macroeconomic factors like the downturn in the property market and global credit crunch. Most of the reasons for the failures, however, fall into these main areas:

- **Poor governance and management:** the business model followed by finance companies led to poor governance by their managers and directors, and inadequate management of risk; risk was often concentrated by excessive lending to related parties, making the companies ill-equipped to ride out a downturn in market conditions.

- **Criminal misconduct:** in several cases the behaviour of directors and managers was not merely poor, but negligent and even unlawful. As the courts are now starting to confirm, there were instances of serious misconduct ranging from deliberate misrepresentation of risks and non-disclosure of significant lending to related parties, to outright fraud and Ponzi-scheme-style scams.
- **Deficiencies in disclosure, advice, and investors' understanding:** the information and advice provided to investors was frequently poor, with investors unaware of advisers' interest in promoting certain products and poorly informed of the associated risks. This was compounded by deficiencies in investors' own understanding of the nature of risk and reward; for example, their failure to grasp that a 1 percent increase in the return offered did not mean a mere 1 percent increase in the risk incurred. We are aware of instances in which investors' lack of understanding was exploited by finance companies. Rather than disclosing the risk entailed in an investment and increasing the return accordingly, they chose to drop their interest rates to a small margin above the term deposit rate, knowing this might be interpreted as representing a lesser risk.
- **Inadequate supervision:** the supervisory framework was fragmented and insufficiently rigorous. Trustees and auditors did not always do an adequate job. The several regulators operated under relatively narrow legislative mandates. Overlapping responsibilities and inadequate funding led to things slipping through the cracks. Confused rules about advertising and disclosure also left loopholes to be exploited.

Regulatory changes

It is a common misperception that there was no regulation of finance companies before the collapses. At the time of the first collapses in mid-2006, finance companies' conduct was already regulated by several pieces of legislation, principally the Securities Act 1978 and the Companies Act 1993. Several other pieces of legislation contained relevant law, including the Financial Reporting Act 1993, the Reserve Bank of New Zealand Act 1989, and the Securities Markets Act 1988. There were also duties imposed on statutory supervisors, trustees, and auditors by the Trustee Companies Act 1967 and the Corporations (Investigation and Management) Act 1989.

One of the difficulties with this regulatory framework was that it lacked a clear structure, and the various Acts, amended numerous times over the years, could be confusing. It was also difficult for investors to enforce the duties they were owed, as it lay with individual depositors to take action, at their own cost. Much has been done since 2006 to address such failings. For example, investors' previous inability to enforce duties they were owed has now been remedied with the power given to the Financial Markets Authority to take representative action on behalf of groups of depositors. (We discuss the issues of redress and penalties further in chapter 7.) The table below shows the main laws relevant to finance companies at the time of the first collapses in 2006, and the various pieces of legislation enacted since.

Main finance-sector legislation pre-2006	Enacted since 2006
• Companies Act 1993 • Financial Reporting Act 1993 • Reserve Bank of New Zealand Act 1989 • Securities Act 1978 • Securities Markets Act 1988 • Trustee Companies Act 1967 • Corporations (Investigation and Management) Act 1989	• Auditor Regulation Act 2011 • Financial Advisers Act 2008 • Financial Advisers Amendment Act 2010 • Financial Advisers Amendment Act 2011 • Finance Markets Authority Act 2011 • Financial Reporting Amendment Act 2011 • Financial Service Providers (Registration and Dispute Resolution) Act 2008 • Financial Service Providers (Registration and Dispute Resolution) Amendment Act 2010 • Reserve Bank of New Zealand Amendment Act 2008 • Securities Amendment Act 2011 • Securities Markets Amendment Act 2011 • Securities (Moratorium) Regulations 2009 • Securities Trustees and Statutory Supervisors Act 2011. • Crown guarantee over retail deposits (introduced under the Public Finance Act 1989)

It would be wrong to conclude that the measures in the right-hand column were initiated solely after the fact, and in response to the collapses; the process had begun well before the failures. The Review of Financial Products and Providers in 2005 provided a stocktake and an evaluation of current regulation. Nine discussion documents outlining options for reform were circulated in 2006. On the basis of submissions, legislation in 2008 introduced prudential regulation of non-bank deposit-takers by the Reserve Bank of New Zealand, and new licensing and dispute resolution regimes for financial advisers. These measures were followed in 2010 and 2011 by new licensing and supervision regimes for trustees and auditors, and the establishment of a new consolidated regulator, the Financial Markets Authority.

Concurrent with these changes, a wider review of the laws governing New Zealand's securities markets has been under way since 2008, and draft legislation has recently been released.

The Crown guarantee

In order to assure investors that their deposits were safe despite the global financial crisis, the Government introduced a retail deposit guarantee scheme in October 2008. Initially introduced for two years,[1] the scheme provided a Crown guarantee over all retail deposits in participating New Zealand banks, and retail deposits by New Zealanders in non-bank deposit-taking entities, including finance companies. The guarantee covered both principal and interest, protecting investors from the risk of default by financial institutions. In return for the guarantee, institutions were required to comply with certain prudential requirements. While providing investors with the reassurance they needed at the time that their deposits were safe, the guarantee also led finance companies to modify their behaviour, seeking more deposits from retail investors.

Wider reform of securities laws

Drawing on all the work described above and contributing to it, a longer-term, broader review of New Zealand's securities laws was undertaken. The Capital Market Development Taskforce, a private-sector-led group of experts charged with examining the context of New Zealand's securities laws, was established in 2008 and reported with recommendations in December 2009. Some of them were fast-tracked, to create the Financial Markets Authority and the new regulatory regime for trustees noted above. Others are still being developed, and the Government has added further proposals.

This process is finally nearing its conclusion. In March 2011, Cabinet agreed to a proposal that the Securities Act 1978 and the Securities Markets Act 1988 be repealed and re-enacted in a single piece of legislation, incorporating significant reforms. In August 2011 an exposure draft—named the Financial Markets Conduct Bill—was circulated for public comment, and the Minister of Commerce has stated that he hopes to have the bill introduced before Parliament dissolves in October.

On the next pages, a chart illustrates the problems that arose at each stage of the investment process, and the corrective measures that have been taken. Appendix C has more information about the legislative measures taken in response to each failure.

[11] To 12 October 2010; it was extended in more limited form to 31 December 2011.

Summary of corrective measures—pre-investment stage[2]

Stage of Investment Process	**Finance companies** Business model of taking deposits and lending to finance riskier activities banks avoid.	**Prospectuses** Company or fund issues investment statement and prospectuses to raise money from public.	**Financial advisers** Individual may seek financial advice before investment decision.	**Investors' understanding** Investor considers prospectus and advice in the light of existing financial knowledge.
Problem	Deposit taking model carries significant liquidity and other risks; poor corporate governance exacerbates risks.	Information investors need is not provided in accurate, concise form. Some offers structured to avoid prospectuses.	Many advisers not competent—individuals get poor advice about riskiness of investment.	Many investors have poor financial literacy and invest funds imprudently.
Steps taken or being taken to address problem	Non bank deposit takers regime establishes prudential requirements.	Securities Act Review will simplify disclosure documents and provide info on key risks. FMA established with strong powers.	Authorisation and supervision of advisers by FMA. Financial Advisers Act fully implemented from July 2011.	Minister of Commerce working with key agencies to improve financial literacy.
Responsible regulatory authority	Prudential regulation by Reserve Bank.	Consolidation of market conduct regulatory functions into Financial Markets Authority.		

[2] Source: Ministry of Economic Development.

Summary of corrective measures—post-investment stage

Stage of Investment Process	**Trustees** Trustee monitors company or funds activities on behalf of investors.	**Auditors** Auditors provide assurance re financial statements.	**Moratoria** Company gets in trouble and proposes moratorium to investors.	**Consumer redress** Investor seeks redress for misconduct, incorrect advice, failure in duties of care.
Problem	Trustees do not monitor effectively or establish inadequate monitoring powers.	Auditors undertake poor quality audits.	Investors do not receive clear information on pros and cons of moratoria versus receivership or liquidation.	Only some consumers have access to redress through Banking Ombudsman: others do not, other than through courts.
Steps taken or being taken to address problem	Supervision of trustees by FMA. Standardised performance reporting.	Independent supervision of auditor regulation.	Moratoria regulations developed to improve information for investors since 31 January 2010.	Financial service providers must belong to a consumer dispute resolution service since 1 Dec 2010.
Responsible regulatory authority	Consolidation of market conduct regulatory functions into Financial Markets Authority.			

3 Basic principles

We are aware that many New Zealanders are disillusioned with our financial markets. The losses resulting from recent finance company failures are just part of the problem. All too often over recent decades retail investors (so-called "mums and dads") have not been well served by our capital markets. Many investors were burned by the share market in the 1980s and 1990s, and retreated to fixed interest deposits as a more secure form of investment. Many moved from banks to finance companies because the extra 1 or 2 percent offered seemed to offer additional returns without additional risk. Many of the products were represented as equivalent to term deposits. The investors were let down by virtually every aspect of the system.

A lot has already been written about where the failings occurred: in the advice and information investors received, in the quality of the companies' governance by directors and managers, in the oversight by trustees and auditors, and in the scrutiny and enforcement by regulators. We look at how the framework of our laws can be improved each of these areas later in this report. But we believe it is also vital to look more broadly at the underlying culture of our financial markets and establish the overarching principles that should guide them.

We believe there is much truth in a comment made to us by our adviser, Tony Molloy QC:

> Meaningful consideration of investor protection legislation is impossible without first identifying the culture of the New Zealand market that has treated investors as prey, rather than as fellow citizens engaged in an enterprise from which all might profit to the benefit of the nation as a whole.

As well as our laws, therefore, we also consider how a culture change might be effected to shift the relationship between investors and other financial market agents to a more appropriate basis of mutually-beneficial partnership. As there will always be trust involved in handing over one's money to the care of another, the relationship should, we believe, be based on the overarching principle of fiduciary duty.

Fiduciary duty

The concept of fiduciary duty is often overlooked, but is fundamental to any financial relationship. From the Latin *fiducia*, meaning "trust", it refers to a person or business in which another has placed the utmost trust and confidence to manage and protect property or money. A fiduciary relationship is one in which one person has an obligation to act for another's benefit, under circumstances that require total trust, good faith, and honesty. It covers every possible case in which one side places confidence in the other and such confidence is accepted. Because the relationship entails dependence by one individual—the beneficiary or client—and influence by the other, it is critical.

The duty of a fiduciary to his or her client is one of absolute, altruistic loyalty. This can be expressed in terms of two fundamental precepts:

- The fiduciary may not take or gain any profit or advantage from the relationship other than that which is fully understood, and agreed to, by the client.
- The fiduciary may not act for the client where he, or any other person for whom he acts or with whom he is associated, has any interest in the matter which could be in conflict with the interests of the client.

It is clear to us that the principle of fiduciary duty was not upheld by a number of those charged with the care of investors' money. We also question whether it has been adequately understood and acknowledged by others. In particular, we note that a crucial corollary of the second point above is that the fiduciary relationship, once established, cannot be avoided by mere disclosure of a conflict; the duty is not to act. We believe this fundamental principle should be made more explicit in our securities laws, and in the training provided to financial advisers.

As we note later in this report, we believe there are promising signs that the proposed revisions to New Zealand's securities laws will place more emphasis on such basic principles, broadly and clearly framed. In many ways, we believe these principles can be more powerful than a series of rules spelled out in minute detail.

Limits to regulatory powers

Two other considerations have dominated in this inquiry. The first is a recognition, put simply, that "crooks will find a way". It is becoming clear as cases work their way through the courts that some behaviour by those in finance companies was simply dishonest.

There are limits to how well regulators can anticipate such conduct, however well mandated and funded they are. For this reason, harsh deterrents and punishment are needed. We look forward to the proposed changes to the Securities Act 1978 which will institute harsher penalties for fraud, and we particularly welcome the recent willingness shown by New Zealand's courts to impose criminal penalties, including imprisonment, for financial wrongdoing. We were pleased to note the assessment by the Serious Fraud Office that the first prison sentence imposed on a finance company director has had a "chilling" effect in corporate boardrooms.

Risk–return equation

Another essential principle—and one central to the idea of investment as a partnership—is the balance between risk and return. Regulators cannot, and should not, seek to guard investors against all risk, without which there could then be no return. What is essential, however, is that investors be adequately compensated for the level of risk inherent in the particular investment they are making. Here lay a key failing of the finance companies, as the true level of risk was not always disclosed to investors, nor were they adequately compensated for it.

4 Investor information

Key term of reference: To examine the quality of information provided to investors when considering an investment decision, and investors' ability to understand financial matters.

Financial advice

The new regime requiring financial advisers to be licensed and supervised by the Financial Markets Authority, and to adhere to a code of professional conduct, is a welcome step toward restoring investors' faith in those who offer advice on what they should do with their money. If investors' understanding of financial products is to be improved, we consider it crucial that they have confidence in such advisers as professionals with thorough training in this complex field. Much therefore depends on the stringency of the professional training and standards.

We consider it appropriate that the Code of Professional Conduct for Authorised Financial Advisers promulgated on 19 August 2010 sets out clear overarching principles for the competence and behaviour of advisers. In particular, Code Standard 1 specifies that "an authorised financial adviser must place the interests of the client first, and must act with integrity". We consider that this acknowledges more explicitly than previously the nature of the fiduciary relationship between an adviser and their client. We will expect the Financial Markets Authority to hold financial advisers to a high threshold in meeting the standards.

We have reviewed the requirements for the National Certificate in Financial Services,[3] which specify the minimum standards for qualifying as an authorised financial adviser. We understand that the length of the training for advisers varies, as it is "self-directed", depending on the amount of time an individual can devote to it each week, and on their previous experience. The average time needed to complete the five sets of unit standards is estimated at 200 hours (or over 600 hours for an adviser with no prior qualifications), meaning on average eight to 12 months is needed to qualify as an authorised financial adviser. The requirements appear to include a mix of academic and workplace-based evaluations. We consider it appropriate that the standards require a demonstrated understanding of ethical considerations, including "maintaining confidentiality, duty of care, non-discriminatory practices, full disclosure of remuneration or fees and other conflicts of interest that may influence any recommendation where required, good faith, remaining within candidate's field of competence."

It remains to be seen whether the new requirements produce better-trained and more professional financial advisers, who succeed in regaining the public's confidence. We expect the Financial Markets Authority to help this happen by monitoring the industry

[3] New Zealand Qualification Authority, Standard Set A: Core Knowledge, afacompetence.org.nz, accessed 20 September 2011

assiduously. As we discuss below, we consider the independence of advisers' remuneration an important factor in regaining public trust.

Advisers' commissions

It is an important step forward that advisers must now disclose their remuneration and relationships. However, we question whether mere disclosure provides adequate protection for consumers. We retain strong reservations about advisers' receiving any form of remuneration from those whose products they recommend.

Evidence we received was fairly evenly divided on this issue. On one hand, we have much sympathy for the view that commissions inevitably raise a conflict of interest, and that advice can be truly professional and independent only if it is not allied to any particular product. On the other hand, the point was made that investors are often reluctant to pay fees for advice, and fees would need to be higher in the absence of commissions. We believe this is one of the matters on which investors need to understand better the benefits to be gained from taking independent professional advice, so they are willing to seek, and pay appropriately, for it.

As a first step, we consider it appropriate that the Code of Professional Conduct for Authorised Financial Advisers specifies that an adviser must not state or imply that it is "independent" if it is under any contractual obligation to recommend particular financial products, or is related to a product provider. We will expect the Financial Markets Authority to enforce the code stringently, and to monitor compliance carefully. We agree with the Capital Market Development Taskforce that one means of doing so would be to conduct "mystery shopper" exercises.[4]

An important ancillary measure will be to work on educating the public to distinguish between advisers whose advice is unbiased and those conflicted by other relationships. We recommend that financial literacy initiatives include efforts to publicise this distinction. It could prove unnecessary to ban commissions if their use diminished as the public learned the value of paying for independent advice.

We would, nevertheless, like to see the option of banning commissions and other similar remuneration explored, as we believe this would be more in keeping with the fiduciary relationship between advisers and their clients. We note with interest that the Australian Government has announced a prospective ban on "conflicted remuneration structures", for which it is currently preparing legislation. The ban is intended to cover commissions and volume-based payments, and there would also be limits on "soft dollar benefits" from product providers to advisers.

Recommendation

1 We recommend to the Government that financial literacy efforts include efforts to publicise the distinction between "independent" advisers and those who receive remuneration from the providers of investment products, to encourage the public to opt for independent advice.

[4] Capital Market Development Taskforce, Summary report entitled *Capital Markets Matter*, December 2009, p 9.

2 We recommend to the Government that it investigate the possibility of banning conflicted remuneration structures in the provision of financial advice, including consultation with the Australian authorities on the model proposed in that country.

Credit ratings

We note that it is now easier for the public to determine which finance companies remain sound, as they are rated by the Reserve Bank in its prudential oversight role. It is, however, important for the public to understand how the rating system works, and to take the ratings as indicative only. Again, this is an area where efforts could focus on educating investors.

Advertising

Many submitters gave examples of investment products being marketed in misleading ways. Examples included advertisements by celebrities whose endorsements generated in consumers a false confidence, and finance companies implying misleadingly that they had unconditional insurance from a major overseas insurer. Several recent and proposed legislative measures will, we believe, significantly reduce the potential for misleading advertising of financial products.

We note that the draft Financial Markets Conduct Bill proposes to introduce a requirement based on the principle that an advertisement must not contain any matter likely to deceive, mislead, or confuse. We welcome this proposal.

We are aware that one of the failings brought to light by the finance company failures was an overlap between the Securities Act and the Fair Trading Act regarding liability for false, misleading, or untrue statements in an advertisement, prospectus, or investment statement. The resulting overlapping jurisdiction between the Securities Commission and the Commerce Commission meant that neither agency took ownership of the issue and acted decisively on breaches. We understand that the proposed Financial Markets Conduct Bill, while modelled on the Fair Trading Act, would make it clear that in areas of overlap, securities law would take precedence, and action would thus fall to the Financial Markets Authority. We consider the proposed approach a sensible one.

Celebrity endorsements

We note that the Government proposes that "no additional action be taken to regulate celebrity endorsements of financial products on the basis that the proposed liability regime for securities law adequately addresses this issue".[5] An additional reason given is the difficulty of defining what constitutes a "celebrity".

The liability provisions proposed in the draft Financial Markets Conduct Bill specify that anyone who makes misleading statements in a product disclosure statement or in an advertisement is liable for a civil pecuniary penalty of up to $1 million for an individual and $5 million for a company, plus compensation orders. This would include any celebrity who made a misleading statement. Most of us consider this a satisfactory approach. While it would not prevent celebrities from endorsing financial products, we believe it would make them considerably more cautious about what they said or implied in doing so.

[5] Minister of Commerce, Report to the Cabinet Business Committee, May 2011, MED1201904, p. 2.

The New Zealand Labour Party and Green Party, however, believe this approach will be ineffective, as people may be misled by seeing trusted faces endorsing products even if the words they use are not strictly misleading. We believe the advertising industry will find ways of couching statements so that they meet the letter of the law, while avoiding its intent.

Disclosure documents

We note that several improvements are proposed to the disclosure regime. Under the Non-bank Deposit Takers Bill recently introduced to the House, new disclosure requirements would be added to the Reserve Bank's prudential regime for non-bank deposit takers (NBDTs). The proposals include requiring NBDTs to disclose a standard set of prudential information, to be updated six-monthly. It is also proposed that the disclosures be subject to auditing, and NBDTs would be required to notify investors when disclosures were updated as a result of material changes in circumstances. The draft Financial Markets Conduct Bill would further refine the disclosure requirements for offers of financial products, basing them on a simplified "product disclosure statement" instead of the current requirement for both a prospectus and an investment statement. The content of the statement would be prescribed by regulations, and supplementary information would be included in an online register.

We consider it vital that investors be helped to compare investment options using a standardised set of information, which is audited and kept up-to-date. We therefore welcome the proposed changes. Care will, however, be needed in developing the regulations prescribing the content of the product disclosure statement to ensure that information is readily understandable and meshes appropriately with the requirements of the Reserve Bank's non-bank deposit takers regime. Care will also be needed in designing the online register so that its format is accessible to retail investors, while providing detailed information for those who want it.

Disclosure must be tailored

An important consideration in this respect is ensuring the level of disclosure required is appropriate to the level of risk entailed in an investment. While the finance company situation has shown that investors need protection so they are not misled into underestimating the risk entailed in a product, we believe that too high a compliance burden on issuers could stifle business development. We would not wish to see issuers incur high compliance costs to raise small amounts of money. Nor should a product that is clearly high risk, such as a start-up venture, be required to surmount major disclosure hurdles when fundraising from particular types of backers (such as angel investors), who understand the risks, as distinct from the public at large.

We note that the draft Financial Markets Conduct Bill recognises a need for balance, where it proposes various exemptions in Schedule 1, such as those for small offers or peer-to-peer lending. It also envisages different forms of product disclosure statement for different types of investment products. We endorse such tailoring of the disclosure requirements. The bill will provide an opportunity for people to submit on whether any extensions to the principle should be allowed.

Disclosure must be understood

While we believe the proposed combination of a product disclosure statement and searchable online register should be a good improvement, we remain concerned about a general lack of clarity in the financial information available to the public. A clear example is companies' increasing tendency to emphasise alternative measures of their profitability in media releases. While financial statements must, by statute, report a company's net profit after tax calculated according to International Financial Reporting Standards, there is a disturbing trend toward focusing in the accompanying commentary on alternative measures such as "underlying", "adjusted", or "normalised" profits, which can differ markedly from the official figure.

We are not surprised that people have trouble with investment decisions when even a simple assessment of whether a company's profit has gone up or down over the past year can require, as one commentator put it, "either the wisdom of Job, a degree in accounting, or a deep knowledge of the company.[6] As that writer also noted, a study by the accounting firm Deloitte New Zealand found "fully 214 different measures of profit in a review of 1000 New Zealand companies' annual reports, with 87 percent using alternative profit measures".

We are encouraged that Part 8 of the draft Financial Markets Conduct Bill proposes to give the Financial Markets Authority the power to issue "frameworks" and "methodologies" regarding the way information to be made publicly available is presented. We support this proposal, and consider that companies' presentation of their profitability results is an area crying out for a framework to be established by the Financial Markets Authority.

Recommendation

3 We recommend to the Government that the Financial Markets Authority be asked to investigate means of standardising the way information is publicly presented so the general public can readily understand financial information such as profitability.

We are aware that legislated requirements can only go so far. As we discuss below, the effectiveness of better disclosure will depend heavily on investors' own willingness to study the information presented, their ability to make sound decisions from it, and their willingness to seek, and pay for, financial advice as needed.

Improving investors' understanding

We believe this is probably the most important area where work is still needed.

Improvements in the information provided to investors—the quality of advice, and disclosure of the risks involved—were clearly needed, and to a large extent they have been effected. But their efficacy depends on the advice and information being understood. This crucial part of the equation is up to investors themselves.

In our view, work is clearly still needed to improve ordinary New Zealanders' understanding of the investment decisions they are required to make in the course of their

[6] Patrick Smellie, "Underlying profit—just what does it all mean", The Dominion Post, Wellington, 28 July 2011.

lives. While much commendable work has been done on this over the past few years across the public, private, and voluntary sectors, we believe more is needed.

Major steps taken so far to help improve financial understanding include the following:

- Since 2004, the Retirement Commissioner has been helping to integrate personal financial education programmes into the school curriculum; the Ministry of Education took over this project from 2009.
- The Retirement Commissioner established the financial literacy website sorted.org.nz to help publicise crucial information. The Securities Commission also issued warnings to the public about the risks involved in certain types of offerings.
- A National Strategy for Financial Literacy, coordinated by the Retirement Commissioner, was launched in June 2008 with a high-level advisory group that reports six-monthly to the Minister of Finance, stakeholders, and the public. It includes a five-year action plan for 2011 to 2016.
- A Centre for Personal Financial Education has recently opened (June 2011) in a joint project between Westpac and Massey University to train financial educators and undertake long-term research.

Coordination of such endeavours will be vital if efforts are to be efficient and effective. We understand that at present 15 Government departments and 12 private-sector organisations have a role in improving financial literacy, including the recently-established Financial Markets Authority. The Retirement Commissioner has been leading this work, and funding responsibility for that office has recently been moved from the Ministry of Social Development to the Ministry of Economic Development, to facilitate coordination.

While we commend such efforts, we have to question whether they are as yet efficient, or effective. A particular issue yet to be decided is which agency should coordinate financial education initiatives. So far, the Retirement Commissioner has taken on this role, and we note that it intends to change its name to "The Commission for Financial Literacy and Retirement Income". However, the Financial Markets Authority has also been given a statutory role in promoting investment literacy.

We consider that the Retirement Commissioner is best placed to coordinate the Government's work on financial education. It is the only Government-funded agency in New Zealand with financial literacy at the heart of its mandate. It is also active and well established, having coordinated the national strategy on financial literacy, and its Sorted website is widely known.

We believe that the Financial Markets Authority, with its dedicated market intelligence unit, will be well placed to monitor developments such as possible investment scams, and issue warnings about them. We would therefore like to see close coordination between the Financial Markets Authority and the Retirement Commissioner, ideally including links between their websites.

We acknowledge that there can be no short cut to lifting New Zealanders' understanding of financial matters. A multi-faceted approach is needed, addressing issues from basic budgeting to assessing and comparing investment products. We believe efforts should target three groups in particular:

- those at, or nearing, retirement age, who are likely to be considering major investment decisions
- young people, to build the financial capability of the next generation
- those most at risk from scams and irresponsible lending practices.

While we acknowledge the work that the Retirement Commissioner is already doing in the area of financial education, we believe more funding is needed to get her messages out more widely, and for specific initiatives such as providing more product comparison tables on its website to help investors assess alternatives.

We would also like to see resources increased to support financial education in schools.

Recommendations

4 We recommend to the Government that it give priority to a coordinated effort to improve New Zealanders' understanding of financial matters, focused particularly on those at or nearing retirement age, on young people to build financial capability, and on those most at risk from scams and irresponsible lending practices.

5 We recommend to the Government that it review the adequacy of resources for the Retirement Commissioner and schools for financial education, and increase them as necessary.

Loan sharks

We take a keen interest in proposals by the Government to address problems associated with loan sharks and others who operate in the "third-tier" lending market. While not strictly part of this inquiry, such lenders are certainly relevant to our third term of reference—minimising the chances of failure in the future—although, in this instance, the risks are more on the borrower's side than investor's.

We note that a financial summit was held on 11 August 2011, covering areas including responsible lending, credit advertising, social and community lending, responsible debt management, financial literacy, and dispute resolution. We understand that the summit will help to decide whether further legislative change is needed—in particular, to the Credit Contracts and Consumer Finance Act 2003—to provide more protection for consumers against irresponsible lending practices.

We hope to see plans for decisive action emerge from the summit.

5 Moratoria

Key term of reference: To examine the quality of advice provided to investors in moratorium situations, including independent analysis of moratorium versus receivership, and the independence of the management of the moratorium.

Usually, a company's collapse would result in its being placed in receivership. An external party would take control of the company and manage it in the interests of investors. Instead, several finance companies proposed moratorium arrangements to their investors as an alternative to receivership. By June 2009, 11 finance companies were in moratorium, involving an estimated 70,000 investors and about $2 billion in funds.

Some of the moratoria failed to meet investors' expectations. Many submitters expressed concern about the standard of the information on which investors were expected to vote for or against the companies' moratorium proposals. Concerns were also raised about the standard of governance and transparency of companies in moratorium, which were lower than those for a company in receivership.

We have considerable sympathy for investors regarding the complex decisions they were asked to make, often at short notice and in emotional circumstances, about which arrangements were more likely to recover their money. Investors were also understandably wary about entrusting the company's management to those they perceived to have got it into trouble in the first place. In many such situations, we believe the money was already lost and the process simply dragged out the pain for investors, who were no doubt reluctant to recognise this fact.

With effect from 31 January 2010, new regulations were introduced to impose more stringent rules on companies in moratorium. Companies proposing a moratorium must now provide investors with a clear and concise investment statement prepared by an independent expert, and companies in moratorium must report progress to investors every three months. Further, the regulations empower investors to direct a trustee to place the finance company in receivership if they are dissatisfied with the progress of the moratorium.

We believe these regulations do much to improve the situation. However, we consider that the term "moratorium" in itself can be misleading, as it does not help investors recognise that the situation has arisen because a company is on its knees, and most of their money is already lost.

Recommendation

6 We recommend to the Government that moratorium situations be referred to as "creditor compromise situations", as a small but important indication of the unlikelihood of a satisfactory outcome for investors.

6 Governance and supervision

Key term of reference: To examine ways of minimising the chances of situations arising where the risk of failure is not adequately reflected in the risks identified to investors or the returns investors expect to receive for that level of risk.

Finance company governance

The business model under which finance companies operated led to poor governance by their managers and directors, and inadequate management of risk, often involving a concentration of risks through excessive lending to related parties. As we have noted, there were also instances of fraud by directors and managers.

We believe that legislation in 2008 establishing the Reserve Bank as prudential regulator of non-bank deposit takers has set in place a much stronger regime for the governance and supervision of finance companies. Appendix C provides more detail on how the legislative measures will address each of the weaknesses in finance companies' governance.

Further tightening of the rules is proposed in the Non-bank Deposit Takers Bill. We see this as appropriate fine-tuning. We are particularly satisfied that it would give the Reserve Bank the power to remove directors in certain circumstances, or to issue directions to them.

It is also appropriate that the bill to be introduced as a result of the securities law review proposes a "fit and proper person" test for directors and managers. An important feature of the proposed Financial Markets Conduct Bill is that it would distil the duties of directors down to clear basic principles. According to the February 2011 Cabinet paper setting out the policy intent of the bill, it is intended that an offence be created for intentional contraventions of the following duties:

- To act in good faith and in what the director believes to be the best interests of the company.
- To avoid carrying on the business of the company in a manner likely to create a substantial risk of serious loss to the company's creditors.
- To not incur an obligation unless the director believes at that time on reasonable grounds that the company will be able to perform the obligation when it is required to do so.

We endorse these strong, clear statements of directors' duties. We discuss the levels of liability of directors and managers in the next chapter, under "Redress".

Recommendation

7 We recommend to the Government that the duties imposed on directors be stated clearly and forcefully in legislation, according to the principles set out in the February 2011 Cabinet paper which set out the policy intent of the draft Financial Markets Conduct Bill.

Supervision by trustees

Trustees of finance companies have been strongly criticised for failing to prevent, or even notice, the difficulties the companies were in. One submitter described them as "asleep at the wheel", not discovering breaches of trust deeds until it was too late.

According to the Registrar of Companies, a number of finance company trustees accepted circumscribed powers in relatively weak trust deeds. There are suggestions that some finance companies shopped around for trustees willing to accept this combination.

We believe the new regime set out in the Securities Trustees and Statutory Supervisors Act 2011 took a significant step forward. Trustees can now be held accountable by the Financial Markets Authority if they fail to meet expected standards of competence in performing their functions. Further tightening of the regime is proposed in the draft Financial Markets Conduct Bill. We consider three of the proposed changes to be of particular significance.

- The duties of trustees would be more fully and clearly spelled out. They would include the duty to act honestly and in the best interests of investors, the duty to carry out their functions diligently and to a professional standard of care, and the duty to seek to remedy any contravention of an issuer's obligations.
- It would be more difficult for trustees to exempt or indemnify themselves from liability in fulfilling their obligations, and any exemption would need to be disclosed. This should prevent trustees from accepting circumscribed powers in weak trust deeds.
- The civil remedies for any failure by trustees to perform their duties would be increased significantly. We discuss this further in Chapter 7.

We believe the proposed changes could do much to strengthen the framework under which trustees operate, and help to restore confidence in these important supervisors of people's investments. As a final point in this regard, we consider the term "trustee" to be a misnomer. It suggests that an investor's funds are being held in trust for them, which could give less sophisticated investors a false sense of security. We believe "supervisor" would be a more appropriate term than "trustee", and are therefore pleased to see this terminology adopted in the draft Financial Markets Conduct Bill.

Recommendation

8 We recommend to the Government that the term "supervisor" be used instead of the term "trustee", to describe those trustees who supervise people's investments.

Scrutiny by auditors

For investors, auditors form an important part of the supervisory framework. An auditor provides an independent assessment of whether a set of financial statements is free from material misstatements, resulting from either fraud or error. To do so, the auditor must consider whether the financial statements have been prepared in accordance with approved financial reporting standards. In the case of finance companies, it became evident that some misstatements and omissions were not picked up by auditors, and steps were taken to correct this by introducing independent oversight of the profession.

Previously, auditors were covered by a self-certification regime. They were subject to the professional standards of care and diligence set by the New Zealand Institute of Chartered Accountants, but required no independent certification to be licensed as auditors. Chartered accountants holding a certificate of public practice could carry out audits as long as they believed they were competent to do so and no specific restrictions had been placed on them.

The problems with finance companies have shown that it is not sufficient for auditors to be subject to the general professional standards set by the New Zealand Institute of Chartered Accountants. It is gratifying that the institute has taken steps to enforce its standards—albeit after the fact—with at least one successful action against a member. However, some of us have argued previously that there should also be some form of public-interest oversight of this profession, as there is in Australia and many other countries.

We are therefore pleased that the licensing regime introduced under the Auditor Regulation Act 2011 will entail independent supervision of auditors by the Financial Markets Authority, as well as by professional bodies.

We do, however, consider it important that investors understand the limits of the auditor's role. An auditor provides an independent assessment as to whether a set of financial statements is free from material misstatements. It is for investors and their professional advisers to interpret the financial statements, and in particular to evaluate the degree of risk entailed in any investment. We strongly suggest that efforts at improving investors' education should include information about the nature of, and limits to, auditors' scrutiny in this respect.

Regulators

We consider the Reserve Bank's prudential oversight of finance companies, along with other non-bank deposit-takers, to be a major and important improvement in the environment in which finance companies operate. We welcome the second wave of prudential measures proposed in the Non-bank Deposit Takers Bill, which would give the Reserve Bank a number of important additional powers, including "fit and proper person" requirements for directors and senior office-holders of non-bank deposit takers.

We believe the establishment of the Financial Markets Authority has also been a significant step forward. It has been given a broad mandate which should reduce the potential for problems falling through the cracks. It also has significantly wider powers than previous regulators, and more funding. It received a substantial injection of funds in the 2011/12 Estimates for Vote Economic Development, and its future funding is expected to represent an increase of $9.9 million per annum, on average, over that of the regulators it replaces. We also have confidence in the abilities of the personnel it is building up.

Our main concern is that a lot is being expected of it. Continued commitment to its funding will be needed for the authority to realise its full promise.

Recommendation

9 We recommend to the Government that it ensure that the Financial Markets Authority, as regulator of New Zealand's securities markets, be adequately resourced to fulfil its statutory functions.

Call-in power for regulators

Most of the submissions we received supported the idea of giving a regulator the power to call in a financial product for review. Recent experience showed that some investment schemes were designed in such a way that they did not meet the definition of a security, although they entailed high risk, and thus managed to bypass securities regulation. The Blue Chip incident was a prime example, and we are very aware of its investors' shock at finding out their money had slipped through the regulatory cracks. The main reservations expressed by some submitters were that the development of innovative new financial products could be stifled if the power were used inappropriately, and that it would be a significant departure from the disclosure-based principle of the current regime.

We note that it is intended to provide the Financial Markets Authority with a call-in power under the proposed Financial Markets Conduct Bill. We support this move, and expect that the Authority would use it effectively to protect investors.

Protection for whistle-blowers

We included in our terms of reference the question of whether the law should provide greater protection for whistle-blowers. We believe the risk of failure might be reduced if those associated with a company were encouraged to alert authorities to major non-compliance or wrongdoing. The submissions we received generally supported extending whistle-blowing protection.

We note that the Protected Disclosures Act 2000 (section18) already provides whistle-blowers with immunity from both civil and criminal liability. While not specifically directed at the financial sector, section 9(1) of that Act would apply to a situation in which an employee of a finance company believed the head of the company was involved in serious wrongdoing, and wished to make a protected disclosure to the "appropriate authority"—in this case, the Financial Markets Authority.

Recommendation

10 We recommend to the Government that the wording of the Protected Disclosures Act 2000 be broadened to cover wrongdoing by board members and other senior officers besides the "head" of the company.

Regarding the finance sector specifically, we note that the non-bank deposit takers regime introduced in 2008 requires trustees to inform the Reserve Bank if the trustee has reasonable grounds to believe that non-compliance with the deposit taker rules has occurred or is likely to occur.[7] This is accompanied by a provision that no civil, criminal, or disciplinary proceedings can be taken against a trustee for disclosure of such information in good faith. We believe this sort of protection is appropriate to encourage trustees to alert the authorities to concerns about issuers.

We understand that similar provisions applying to auditors and investment managers are proposed among changes to securities laws. Clauses 172 to 180 of the exposure draft of the Financial Markets Conduct Bill would place a duty on auditors to report relevant matters, with corresponding legal protection, and would empower the Financial Markets Authority to obtain relevant information about an issuer's compliance with its obligations.

We consider that such proposals are an appropriate means of extending the existing whistle-blowing protections in the Protected Disclosures Act.

[7] Section 1572F of the Reserve Bank of New Zealand Act 1989.

7 Redress and deterrence

Key term of reference: To examine the measures in place that provide redress to investors where failure occurs and wrongdoing is established, particularly whether these measures act as a significant disincentive for wrongdoing to occur.

The painfully slow process for investors seeking redress was one of the issues most commented on in submissions. We sympathise with their position. While we appreciate that it has been an exceptionally complex process to examine finance companies' books and establish the chains of facts, we believe it has been valuable as it has shown up several failings in the system of enforcement:

- too many regulators
- narrow mandates and limited enforcement powers
- under-resourcing
- limited, slow, and expensive avenues of redress.

We discuss below how these issues are being addressed.

Regulators

Important changes have been made to consolidate and strengthen financial market enforcement powers under the "twin peaks" of the Reserve Bank and the new Financial Markets Authority.

Reserve Bank

Significant powers have been granted to the Reserve Bank under the new prudential regime for non-bank deposit takers. Investors will no doubt be pleased to note that a second phase of the regime, for which legislation has just been introduced to the House, proposes to expand the Reserve Bank's enforcement powers. In particular, the Reserve Bank would have the power to remove directors in certain circumstances.

Financial Markets Authority

We also believe the establishment of the Financial Markets Authority has been a significant step forward. It consolidates functions previously undertaken by the Securities Commission, the Government Actuary, and NZX Limited in a broad mandate which should reduce the potential for problems falling through the cracks. It also has significantly wider powers than previous regulators—in particular, the ability to initiate actions on behalf of investors.

A common concern raised by submitters was that New Zealand's regulatory agencies lacked "teeth", because they lacked the mandate or the will to take action. We have been pleased to see that the FMA, soon after its establishment, moved decisively against the emerging problem of "low-ball" offers. We also note that it received a substantial injection of funds in the 2011/12 Estimates for Vote Economic Development, and its future funding is expected to represent an increase of $9.9 million per annum, on average, over the funding of the regulators it replaces. This also bodes well for its enforcement ability.

We observe that the investigations of the Serious Fraud Office continue to take precedence over the investigations of the regulators (something which has contributed to lengthy delays) and it may be time for the Government to consider rolling this aspect of its jurisdiction into the FMA as well.

Avenues of redress

Several steps are being taken in legislation enacted or proposed to provide more options for investors to have grievances heard and seek redress.

Dispute resolution

Under the Financial Service Providers (Registration and Dispute Resolution) Act 2008, every provider of a financial service to the public is now required to be a member of an approved dispute resolution scheme. Previously, banks and insurance companies were required to have an independent body to hear complaints, but no such requirement applied to non-bank deposit-takers. There are now four approved independent dispute resolution schemes, which provide a free service for consumers if they have failed to have problems resolved directly by their financial service provider.[8]

Group actions and litigation funding

In the submissions we received, a number of investors indicated that they wished to be able to initiate group actions.[9] There was also a common wish for Government help with funding, as the cost of litigation was seen as an insurmountable hurdle by investors whose resources had been devastated in the collapses. We believe the power given to the FMA to initiate actions on behalf of investors where it considers it in the public interest to do so goes some way to meeting this desire.

We note that in Australia, the difficulty of funding litigation is increasingly being overcome by means of professional litigation funders. Such third-party commercial funders take on the role of funding and managing a legal action in return for a negotiated percentage of a successful claim. The funder receives nothing if a claim is unsuccessful, but is still responsible for all the costs.

Commercial litigation funders are starting to emerge in New Zealand, and at least one representative action is being prepared against the trustees of finance companies. Historically, litigation funding arrangements were prohibited by the rules of the New Zealand Courts, but recent decisions appear to be taking a more liberal interpretation of them in the interests of access to justice.

8 Financial Services Complaints Limited, and the Government's backstop scheme, Financial Dispute Resolution, as well as the Insurance and Savings Ombudsman Scheme, and the Banking Ombudsman Scheme.

9 Although generally referred to as "class actions", these would be "representative actions", as class actions are not currently permitted in New Zealand under the rules of court.

If commercial funding of litigation became more widely available in New Zealand, it would probably be welcomed by aggrieved finance company investors. We believe, however, that safeguards would be needed to govern the operation of such third-party funders.

We understand that legislation has been drafted to introduce formal class action procedures to New Zealand courts, but the introduction of a bill has been delayed by other legislative priorities. We would like to see priority given to progressing this legislation during the term of the next Parliament, and believe the bill should also include guidelines for the operation of litigation funding.

Recommendations

11 We recommend to the Government that priority be given to progressing legislation on class actions during the term of the 50th Parliament.

12 We recommend to the Government that such legislation include guidelines for the operation of commercial third-party funders of litigation.

Further measures

Significant further measures are proposed among other changes resulting from the securities law review. They include a power for the FMA to seek a "declaration of contravention" from the courts, which would simplify the process for investors who then wished to apply for a compensatory order or other civil remedy. This means that an investor would not be required to prove that a company, director, or trustee had contravened its duties, but could simply point to the facts as established in the contravention order.

With these measures combined with increased penalties and clarification of the liability regime, which we discuss next, we consider that the options for redress would be considerably improved.

Penalties

We note that the Minister of Commerce has acknowledged failings in the current liability regime. In May 2011 he said in a report to Cabinet:

> There are a number of problems with the current liability regime for breaches of securities law. Most importantly, the regime lacks coherence and is difficult to understand for those who are subject to it or who wish to seek remedies. The overlap between criminal offences and civil pecuniary penalties in some circumstances is also a key issue that requires clarification. [10]

In response, he has proposed significant changes in the draft Financial Markets Conduct Bill to clarify—and, importantly, to strengthen—the liability framework for securities law, including criminal penalties for the most serious breaches. We understand that the aims will be to

- deter non-compliance and encourage voluntary compliance with the law

[10] Minister of Commerce, Report to the Cabinet Business Committee, May 2011, MED1201904, p 11.

- provide remedies for those harmed by undesirable conduct
- punish non-compliance.

The proposed regime would provide several tiers of penalties, on an escalating scale of liability, up to a 10-year prison term and/or a fine of up to $1 million for individuals or $5 million for businesses. We understand that it will be designed to make it easier for investors to obtain compensation, as the liability framework would focus on civil remedies and pecuniary penalties. However, the most egregious breaches would be subject to criminal liability, and would be publicly enforceable by the Financial Markets Authority and the Registrar of Companies.

The proposed categories of contravention would be on the following lines:

- **Infringement offences**, involving contraventions of basic compliance obligations that would not have serious consequences for investors, such as failure by an issuer to maintain a register of securities. The FMA could issue infringement notices in the nature of a speeding ticket. Penalties would involve a relatively minor fine, say, up to $50,000.
- **Civil liability** for more serious contraventions, such as insider trading, where the behaviour did not warrant the use of serious criminal offences, but a strong deterrent was wanted. This category would provide a means for harmed investors to seek compensation. Penalties would entail a considerable fine, likely to be up to $1 million for individuals and $5 million for businesses, plus compensation orders.
- **Criminal liability** for egregious contraventions of securities law involving reckless or intentional behaviour. Examples would be issuing a misleading or deceptive product disclosure statement or advertisement, or the knowing or reckless inclusion of a false statement in a product disclosure statement with the intent to induce a person to subscribe to a security or to deceive or cause loss. Conviction would entail up to a 10-year prison term and/or a fine of up to $1 million for individuals or $5 million for businesses.

Comment

We consider the proposed tiered approach to be a sensible one, and are pleased that it would provide considerably more scope for aggrieved investors to obtain compensation. The maximum penalties would be significantly increased—effectively doubled for some offences. However, this would be done in a rational way so that the consequences matched the level of wrongdoing, with thresholds set so that the harshest penalties were reserved for conduct involving knowing or reckless behaviour. Even more than the large fines proposed, we believe the threat of imprisonment would have a particularly strong deterrent effect on behaviour.

The FMA would have a stronger hand in monitoring market behaviour, with the ability to issue “speeding tickets” at a not-insignificant level, as well as the power to issue cease-and-desist orders, say, to stop a company from taking in further deposits if it was in breach of the rules. We are pleased that the FMA has been provided with funding for a market intelligence unit, so that it can monitor behaviour and exercise its powers before problems develop. As we have noted elsewhere, it will be important that it is funded adequately to carry out effective monitoring.

We are particularly pleased to note that the proposed regime would give the High Court the power to impose a permanent ban on managers or directors who have been convicted of a serious offence.[11] We firmly believe that some behaviour by directors and managers of finance companies warrants a lifetime ban on their ever again being entrusted with the public's funds.

Professional indemnity insurance

There is no requirement under either the Financial Advisers Act 2008 or the Code of Professional Conduct for Authorised Financial Advisers for financial advisers to hold professional indemnity insurance (or to disclose whether or not they hold such insurance).

We raised the desirability of such a requirement with the FMA and the Code Committee for Financial Advisers. The FMA expressed reservations about the usefulness of professional indemnity insurance to protect consumers.

The code committee's view was that the possession of professional indemnity insurance by authorised financial advisers would give clients a false sense of security about the protection available to them in the event of a claim of negligence. Its understanding was that professional indemnity insurance excluded cover if an adviser had been negligent. Also, professional indemnity insurance for financial advisers does not cover diminution of investment value for funds invested. Experience shows that very few claims are ever paid. The code committee was also concerned about the availability of such insurance: there is currently only one provider in New Zealand. It was aware of two financial adviser professional bodies which, in the past, had required members to hold professional indemnity insurance, but no longer did so because so few claims are paid.

The code committee was persuaded by the requirement for financial advisers to belong to dispute resolution schemes in accordance with the Financial Service Providers (Registration and Dispute Resolution) Act 2008. This was seen as a more practical way of obtaining a remedy from a financial adviser than initiating legal proceedings. However, without professional indemnity insurance, any compensation awarded under such schemes would depend on the depth of financial advisers' own pockets.

Remedies against trustees

New penalties have been introduced against trustees who fail to fulfil their duties, and proposed legislation would strengthen them. Under the Securities Trustees and Statutory Supervisors Act 2010 (sections 41–43), the FMA now has the power to seek pecuniary penalties and compensatory orders against trustees, statutory supervisors, and unit trustees who fail to comply with their obligations. Pecuniary penalties may be up to $200,000 when a breach has materially prejudiced investors' interests, and up to $100,000 in other cases. Compensatory orders would require the trustee, statutory supervisor, or unit trustee to pay compensation to security holders for any breach of its obligations.

[11] Draft Financial Markets Conduct Bill, Part 7, clauses 480–481.

The draft Financial Markets Conduct Bill proposes to extend the scope for redress against poorly-performing trustees. The maximum pecuniary penalty would be $600,000—three times the currently penalty. There would also be the option of further compensation being sought either by the FMA, or by private individuals on the basis of a "declaration of contravention" obtained by the FMA.

Trusts

After taking account of submissions, we believe it is beyond the scope of this inquiry to examine the complex issues involved in tracing funds and penetrating trusts in efforts to secure recompense for investors. However, we are strongly of the view that work should be carried out in this area.

We note that the Law Commission commenced a review of the law relating to trusts in 2009, and has released a series of issues papers for public discussion, with more to follow. We would like to see this review accelerated, and extended to include an examination of sham trusts and of means for investors to gain redress from funds in trusts.

Recommendation

13 We recommend to the Government that it consider accelerating work on legislation to provide means for investors to gain redress from funds in trusts, including an examination of sham trusts and means of penetrating trusts to recover assets for creditors.

8 Conclusion

We regret the long time it has taken us to complete our inquiry and present this report. The complex issues inevitably took time to review, and delays were also occasioned by the necessary absences of our committee Chair as a result of the Canterbury earthquakes.

Even more, we regret that we cannot reverse the losses investors have suffered from the finance company collapses. We hope that some comfort can be taken from the fact that those responsible are starting to be held to account, and some convictions for miscreant directors are being secured.

We have focused on the steps being taken to address the failings that allowed this disaster to happen, to ensure that such failures will not happen again on such a scale or in such numbers. A considerable amount of legislation has been enacted since the collapses, with more initiated since we started this inquiry. As we have indicated through this report, we believe these measures will do much to correct the underlying failings. In particular, we note the following achievements:

- Finance companies' governance rules have been strengthened. They must now have independent directors and minimum levels of capital and liquidity, and must limit their exposure to related parties.
- Financial advisers are now subject to stricter training, registration, and conduct standards, and must belong to approved dispute resolution schemes.
- Regulatory lines of responsibility have been clarified, and the Financial Markets Authority established as a new consolidated regulator with robust powers and funding.
- Trustees and auditors are now subject to stronger accountability requirements.
- Disclosure is being standardised and made subject to auditing.

We look forward to the further measures proposed in the Financial Markets Conduct Bill, particularly regarding financial disclosure, advertising standards, and means of redress, including allowing the Financial Markets Authority to undertake civil actions on behalf of investors when this is in the public interest.

As for what still needs to be done, we are recommending several further improvements, as set out in our summary of recommendations:

- investigating the possibility of banning conflicted remuneration structures for financial advisers
- standardising the way information is presented publicly so the general public can readily understand financial information such as profitability
- introducing legislation to allow class actions

- ensuring that resources are available to regulators to ensure that enforcement is both timely and effective
- accelerating work on means of penetrating trusts to recover assets for creditors.

Our strongest recommendation is that serious efforts be made to improve ordinary New Zealanders' understanding of financial issues. The Government can help with resources—we recommend that they be increased, and channelled through the Commission for Financial Literacy and Retirement Income—but there is a limit to what Government resources or regulation can achieve. There is also a need for effort by the public to improve their skills, and for it to be prepared to seek and pay for truly independent advice. Only then can the investment relationship be a partnership in which there are truly mutual benefits.

One submitter described the financial community leading up to the finance company collapses as "a culture in which anything that was not illegal was right", and where "professional integrity and responsibility were abrogated." We have tried to assess whether the corrective measures being taken will address not just each individual failing that led to the collapses, but also the cultural mind-set of the financial community. While the proof remains to be seen, we believe the signs are promising. There are now clearer rules to guide the conduct of advisers, trustees, managers, and directors, along with stronger regulators to police them, and stronger penalties for transgressions. If these are matched by a concerted effort at financial education, we believe investors should again have confidence in our capital markets.

Appendix A

Committee procedure

We initiated the inquiry on 20 August 2009. We called for public submissions, with a closing date of 15 October 2009. We received 48 submissions from the organisations and individuals listed in Appendix B. We heard 16 of the submissions orally. We met between 20 August 2009 and 4 October 2011 to consider the inquiry.

We received independent specialist advice from Anthony Molloy, QC. We received advice from the Ministry of Economic Development and the Securities Commission.

Committee members

Hon Lianne Dalziel (Chairperson)
Hilary Calvert
David Clendon
Clare Curran
Melissa Lee
Peseta Sam Lotu-Iiga
Hon David Parker
Katrina Shanks
Jonathan Young

Advice received

Anthony Molloy, QC, independent specialist adviser, Report to the Commerce Committee, dated 19 November 2010.

Code Committee for Financial Advisers, *Proposed minimum standards of ethical behaviour and client care for authorised financial advisers*, 17 November 2009.

Code Committee for Financial Advisers, *Minimum requirements of continuing professional training for authorised financial advisers*, 19 January 2010.

Ministry of Economic Development, Summary of current status of failed finance companies, 4 August 2011.

Office of the Clerk Legal Services, Inquiry into finance company failures: Legal analysis of submissions, July 2011.

Summary of submissions, prepared by committee staff, April 2010.

Tony Molloy, QC, "*Cuckoos in the nest in an otherwise promising jurisdiction*", in Offshore Investment.com, November 2009.

Tony Molloy, QC, speech to Tax Law Rewrite Conference, 29 October 2010.

Appendix B

List of submitters

Age Concern New Zealand
Anne Cook
Anne Lloyd
Anthony Molloy
Bell Gully
Brown Webb Richardson
Bruce Campbell
Bruce Wagg
Chapman Tripp
Chris Lee (on behalf of Chris Lee Sharebroking)
Claire Jonas
Code Committee for Financial Advisers
Geraldine Murphy
Glenys MacLellan
Graeme O'Neill
Grey Power Auckland, Finance Sub Committee
Institute of Directors in New Zealand
Investment Savings and Insurance Association of New Zealand
James Macfarlane
Jean Hodges
Jim and Lynda McSoriley
John Dunlop
John Eichelbaum
John McCarthy
John Patrik Wikstrom
Kathy Gordon
Laurette Robinson
Mark Fletcher
Mary Harris
Matthew Carran
Michael Warrington
Mike Walsh
Miles Agmen-Smith
Money Managers Action Group and Exposing Unacceptable Financial Activities New Zealand
Murray Lazelle (on behalf of Lazelle Forensic Accounting and Litigation Support)
Perpetual Trust
Peter and Vivia Whitlock
Peter Rodger
Philip and Jane Peters
PricewaterhouseCoopers
Professor Ray Adams

Roland Matley
Rowland and Marvyn Crone
Securities Commission
Stace Hammond
Stewart Financial Group
Trustee Corporations Association of New Zealand
Vicki Ammundsen (on behalf of Ayers Legal)

Appendix C

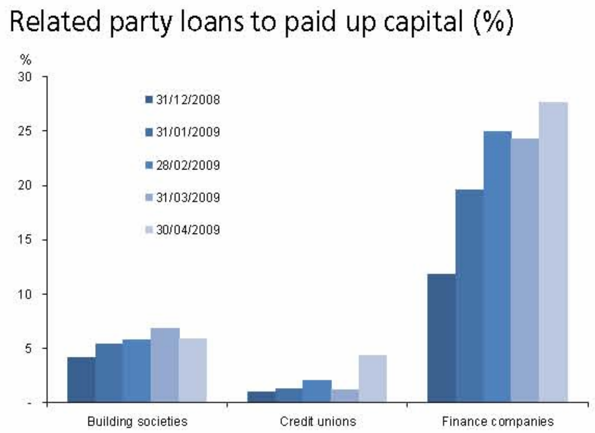
Outline of failures and measures taken:

Finance company governance

What went wrong	What has been done
Risk management practices Many of the finance companies that failed had poor risk management practices. For example, some had poorly diversified loan portfolios, or loans that were backed by inadequate security.	**Requirement for risk management plan** Since 1 September 2009, under the Reserve Bank prudential regime for non-bank deposit takers, finance companies have been required to develop and comply with risk management plans. (New Part 5D of the Reserve Bank of New Zealand Act 1989, introduced by the Reserve Bank of New Zealand Amendment Act 2008.)
Directors and managers The poor quality of corporate governance by directors and managers appears to have been a common factor in the failures. In several cases, the companies were dominated by the chief executive, with board members who lacked sufficient skills or independence to oversee the complex financing operations adequately.	**Requirement for independent directors** From 1 December 2010, under the Reserve Bank prudential regime for non-bank deposit takers, finance companies must have at least two independent directors and a chairperson who is not an employee of either the company or a related party. (Part 5D of the Reserve Bank of New Zealand Act 1989.)
Capital adequacy Many of the finance companies that failed were inadequately capitalised relative to the risks taken. This made them vulnerable to adverse economic conditions.	**Minimum capital ratios in trust deeds** From 1 December 2010 new regulations stipulate a minimum capital ratio to be included in the trust deeds of Non-bank Deposit Takers. Deposit Takers (Credit Ratings, Capital Ratios, and Related Party Exposures) Regulations 2010, provided for in the Reserve Bank of New Zealand Amendment Act 2008

Related party lending

A number of finance companies had high levels of related party exposure, as shown in the table below.[12]



Source RBNZ 2009

Restrictions on related-party exposure

From 1 December 2010, as part of the Reserve Bank's prudential regime for non-bank deposit takers, new regulations provide for a maximum limit on aggregate related party exposures (of no more than 15 percent of the capital of the NBDT). The regulations also extended the definition of a related party to cover key office holders, those with a substantial interest in the entity, and other entities with significant ownership or directorship crossover. The definition is similar to that applying to banks. Deposit Takers (Credit Ratings, Capital Ratios, and Related Party Exposures) Regulations 2010, provided for in the Reserve Bank of New Zealand Amendment Act 2008.)

Liquidity

Lack of liquidity—the ability to meet financial obligations as they fall due—was a major problem for finance companies. As investors' confidence diminished after the first failures, companies struggled to raise new funds. Finance companies in the property financing sector proved particularly vulnerable, as their loan book assets were highly illiquid in a stressed market.

Prudential liquidity requirements

From 1 December 2010 new regulations require that trustees and non-bank deposit takers set appropriate liquidity requirements which are to be included in trust deeds.
Deposit Takers (Liquidity Requirements) Regulations 2010, provided for in the Reserve Bank of New Zealand Amendment Act 2008

Work in progress

Further tightening of the rules for non-bank deposit takers is proposed, with the Non-Bank Deposit Takers Bill introduced to the House on 3 August 2011.

As the outcome of the securities law review, it is also proposed that a Financial Markets Conduct Bill will be introduced in 2011 to strengthen the public enforcement of directors' duties and the liability regime for breaches of securities law.

[12] Reserve Bank of New Zealand: *Bulletin*, Vol. 73, No. 4, December 2010, p.13.

Advice and information

What went wrong	What has been done
Financial advice Many investors were poorly served by the advice they received from financial advisers. Advisers often did not adequately inform clients about the risks involved, and did not recommend adequate diversification of investments to minimise the risks.	**New financial adviser regime** A new regime imposing higher standards on financial advisers was introduced through the Financial Advisers Act 2008 and the Financial Service Providers Act 2008. From July 2011 all financial service providers, including financial advisers, must be on a public register and, if they provide retail services, must belong to an approved dispute resolution scheme. To be authorised, advisers must undertake training and be confirmed by the Financial Markets Authority. A code of professional conduct sets minimum standards for ethical behaviour, client care, knowledge, skills and competence, and continuing professional development. (www.financialadvisercode.govt.nz, accessed 20 September 2011)
Advisers' commissions Investors were often unaware that advisers received commissions on sales of certain financial products, creating a potential conflict of interest.	**Disclosure of advisers' commissions and relationships** Financial advisers are now required to disclose their remuneration and material interests, along with their relationships and associations. Section 23 of the Financial Advisers Act 2008, introduced by the Financial Advisers Amendment Act 2010.
Advertising and marketing Numerous examples of misleading promotions, including those involving celebrity endorsements, and of incomplete information.	The Securities Amendment Act 2011 (sections 43C to 43M) empowered the Financial Markets Authority to deal with misleading prospectuses or investment statements.

<table>
<tr><td colspan="2">Work in progress
As the outcome of the securities law review, it is also proposed that a Financial Markets Conduct Bill would replace the highly prescriptive rules for advertisements with a simplified requirement based on the principle that an advertisement must not contain any matter likely to deceive, mislead, or confuse.</td></tr>
<tr><td>What went wrong</td><td>What has been done</td></tr>
<tr><td>Disclosure documents
Many prospectuses and investment statements were misleading.</td><td>The Securities Amendment Act 2011 (sections 43C to 43M) empowered the Financial Markets Authority to deal with prospectuses or investment statements that are that are non-compliant, false or misleading, incomplete, misdescribed, inconsistent, or illegible.</td></tr>
<tr><td colspan="2">Work in progress
Considerable work is still being undertaken in this area. We believe it is much needed. Further comment is provided in Chapter 4, above.</td></tr>
</table>

Supervision

What went wrong	What has been done
Trustees According to the Registrar of Companies, a number of finance company trustees accepted circumscribed powers in relatively weak trust deeds. There are suggestions that some finance companies shopped around for trustees willing to accept this combination. Lacked sufficiently experienced staff. Did not discover breaches of trust deeds.	**Licensing regime for trustees** A new regime requires trustees and statutory supervisors to be competent, perform their functions effectively, and be held accountable by the Financial Markets Authority if they fail to meet expected standards.
Auditors The Registrar of Companies said that audit failure was a contributing factor in the collapse of finance companies. He noted that the audits of many failed finance companies were conducted by second-tier audit firms, and lacked "the rigour and analytical depth one would expect."[13]	**Licensing regime for auditors** The Auditor Regulation Act 2011 introduced a licensing regime for auditors, with independent supervision by the Financial Markets Authority. The legislation did not make it an offence for auditors not to comply with auditing standards, which was deemed unnecessary: the Crimes Act 1961 applies to serious offending such as fraud and deception.
Regulators • Fragmented • Overlapping responsibilities, so things "fell through cracks" • Under-resourced • Lacked teeth.	**FMA established** From 1 May 2011 a new regulator, the Financial Markets Authority, consolidated functions previously fragmented among the Securities Commission, parts of the Ministry of Economic Development, and NZX Limited. The Financial Markets Authority was given extra functions, duties, powers, and funding compared with previous regulators.

13 Registrar of Companies, report to the committee, Finance Company Failures—Observations of the Registrar of Companies, para. 14, dated 23 February 2009.

Appendix D

List of failed finance companies[14]

Entity Name	Failed date	Deposit Liabilities ($m)	Estimated number of depositors
National Finance 2000	May 06	22	2,000
Provincial Finance	May 06	296	11,000
Western Bay Finance	August 06	48	
Bridgecorp	July 07	459	14,367
Bridgecorp Investments	July 07	30	1,334
Nathans Finance	August 07	174	7,082
Propertyfinance Securities	August 07	80	3,000
Five Star Consumer Finance	August 07	55	2,130
LDC Finance	September 07	20	1,200
Beneficial Finance	October 07	24	750
Clegg & Co Finance	October 07	15	496
Geneva Finance	November 07	140	3,000
Capital + Merchant Finance	November 07	167	7,500
Numeria Finance	December 07	4	500
Boston Finance	February 08	48	1,600
Capital + Merchant Business Investments	February 08	2	60
Lombard Finance & Investments	April 08	111	3,900
Kiwi Finance	April 08	2	42
OPI Pacific Finance	April 08	450	1,200
Fairview New Zealand	May 08	7	797
Belgrave Finance	May 08	20	1,000
North South Finance	June 08	78	6,925
Compass Capital	August 08	15	500
Dominion Finance Group	September 08	177	5,937
Chancery Finance	October 08	17	1,374
All Purpose Finance	November 08	5	336
St Laurence	December 08	250	9,431
Hanover Finance	December 08	464	13,000
Hanover Capital	December 08	24	
United Finance	December 08	67	
Dorchester Finance	December 08	197	7,800
Strategic Finance	December 08	350	15,000
Orange Finance	December 08	50	2,500
Mascot Finance	March 09	68	2,511
Structured Finance (NZ)	May 09	32	172
Strata Finance	September 09	1	
Vision Securities	March 10	29	953
Rockforte Finance	May 10	3	77
Viaduct Capital	May 10	8	110
Mutual Finance	July 10	9	340
South Canterbury Finance	August 10	1,580	35,000
Allied Nationwide Finance	September 10	128	4,500
Equitable Mortgages	December 10	192	
Finance and Leasing	January 11	17	227
NZF Money	July 11	19	1,007

[14] Source: Reserve Bank of New Zealand, accessed 24 August 2011.