FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

19 December 2012

Hon. Craig Foss
Minister of Commerce
Private Bag 18041,
Parliament Buildings
Wellington

Dear Minister,

Ross Asset Management

I am writing in response to your letter of 6 December 2012 on behalf of the Chairman, who is aware of and supports the views expressed in this letter.

1) FMA's authorisation of AFA's

The Financial Advisers Act (FAA) was designed as a first step to regulating a previously unregulated adviser population, by requiring registration, entry level competence and professional standards on financial advisers. After reviewing the processes and procedures which FMA applies to the authorisation of Authorised Financial Advisers (AFA), I am satisfied that they are consistent with the context and philosophy of the current regulatory regime. However, as set out in section 2) below, FMA considers that improvements to the regulatory regime could significantly reduce the possibility of this type of case arising again, should the Government wish to consider further regulatory enhancements.

Under the FAA, FMA is able to authorise advisers for specified kinds of financial adviser services. These are: Financial Advice, Discretionary Management Services (DIMS) and Investment Planning Services (IPS). Authorisation can be subject to terms and conditions imposed by FMA relating to financial adviser services or broking services or both.

The Act sets out four 'pre-conditions' or eligibility criteria for authorising AFAs:

i) Registration on the Financial Services Providers Register (FSPR);
ii) No criminal convictions (of the type specified in the Act) or if there are any, that they would not affect fitness to act as an AFA;
iii) Levels of competence set out in the Code; and
iv) Good character.

If the applicant satisfies all of the above criteria then FMA must authorise them. It cannot refuse to do so. FMA's only discretions are in respect of good character requirements and relevance of criminal convictions. You will appreciate that the 'good character' requirement in the FAA is

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different to the 'fit and proper' test that applies to licensing of other licensed populations, such as Securities Trustees and Statutory Supervisors, with such we have had recent experence.

On application to become an AFA, FMA's process is to check the FSPR, conduct a criminal record check with the Ministry of Justice, obtain required confirmation from the Skills Organisation that a candidate has passed National Certificate in Financial Services Level five, and require industry, client and/or peer testimonials to satisfy good character criteria. We also require applicants to disclose a wide range of issues that might be relevant to our assessment of character, as specified in our published policy on Good Character and Criminal Convictions, and the AFA Authorisation Guide.

FMA's supervision of AFAs

There are now around 2000 AFAs. FMA undertakes monitoring of those advisers as described in our June 2012 Monitoring Report. Our risk-based framework for supervision of financial advisers recognises:

- FMA monitoring not only identifies non-compliant behaviour in the participants monitored, but also acts as a deterrent or compliance-encouragement to other participants.
- Our risk-based monitoring activity will prioritise those types of advice and services for which higher obligations are imposed by the FAA – that is; it focuses on personalised advice provided to retail clients in relation to category 1 products and on financial planning services.
- There is less emphasis on the provision of class and wholesale advice and on DIMS, on which the FAA places reduced emphasis from a policy perspective.
- As a regulator (as opposed to a simple enforcement agency) our principal focus is also on encouragement of professional levels of behaviour, not soley on identification of crime.
- The importance of visiting firms or individuals needs to address a range of regulatory obligations.
- FMA will undertake thematic work from time to time including both sector-specific (e.g. KiwiSaver sales) or on types of adviser activity (such as disclosure by AFAs).
- FMA will undertake monitoring or surveillance visits in response to information/complaints received, where the information receives is sufficiently detailed to identify the AFA and conduct, and it is deemed to be significant.

Broadly, our approach to monitoring this newly regulated population has been to focus our monitoring and supervisory framework initially on a geographical basis. In addition, FMA is adopting thematic approaches as we develop our knowledge of regulated populations and build risk assessment capability. Thirdly, our surveillance responds to market intelligence and information/complaints received.

We have requested Adviser Business Statements (ABS) from 157 AFAs in a number of locations including those where we considered there was a concentration of 'vulnerable' investors. Our framework and assessment of ABS's enables us to identify which of those AFAs we should then visit.

In light of the issues identified in relation to Ross Asset Management, we are reviewing these risk settings and are undertaking a targeted thematic monitoring programme in relation to DIMS providers.

However, we note that a significant change to those settings would carry significant additional cost, for which FMA is not funded. For example, if FMA were to recalibrate the priorities referred to above to apportion equal priority to wholesale clients and on crime prevention, we estimate

additional appropriations of $2-3m a year would be required to provide those services without reducing our focus on the building of professional competence in the adviser community to service the needs of the core constituency of retail investors.

FMA is also developing 'best practice' guidance for practitioners who provide DIMS services. We expect this to be published for consultation early in 2013.

2) Improvements to the regulatory regime

While our initial focus has been on dealing with the initial implications of the Ross matter, conducting an investigation and litigation and particularly identifying and preserving assets, we are now also carefully considering further opportunities to improve the regulatory regime, process and settings including:

- Further steps FMA could take under the current model to further enhance the licensing application process and the conditions that apply to AFAs once licensed.
- Other enhancements that could be made to further guard against risks of the types revealed by this matter. This may be limited when the characteristics are those of a 'Ponzi' scheme, as has been suggested.

FMA considers that the circumstances identified in the Ross Asset Management case have revealed a number of enhancements that could be taken to improve the operation of the FAA regime and address risks of the type exposed. While the regulatory model enacted introduced new requirements on financial advisers, it was purposefully designed not to be overly onerous due to the fact there were competing policy considerations to be balanced. Based on FMA's supervision experience and in light of the Ross matter, we believe that the following could help reduce the likelihood of another similar case.

Regulatory improvements could include:

- Change of licensing eligibility criteria to require applicants to satisfy a 'fit and proper' assessment or otherwise introduce further FMA discretion in the licensing process.
- Significantly higher entry requirement hurdles for applicants to satisfy the FAA authorisation process, including submission of detailed business records and client files.
- Various requirements in relation to providers of DIMS including: appointment of independent custodian, reporting, inspection, record keeping, audit and other trust accounting requirements.
- Removal of the ability of individual AFAs to provide DIMS under the FAA.
- Review of the 'wholesale client' definitions for purposes of the FAA and the equivalent settings in the Securities Act and Financial Markets Conduct Bill (FMCB) to ensure appropriate regulatory scheme coverage.
- Licensing of custodial service providers.

Again, I note that significant changes to some of these settings would carry significant additional costs for which FMA is not funded. FMA notes that a change of eligibility criteria to include a full 'fit & proper' assessment alone would significantly increase the hours involved in licensing an AFA. As the licenses of the initial cohort of almost 2000 AFAs authorised in 2011 are renewed in 2016, this would require an additional appropriation of at least $750,000- $1m to undertake fit and proper checks on every financial adviser, accompanied by verification surveillance work to support authorisation decisions.

3) FMA view on further opportunities and steps to enhance the regime

The FMA Board has recently reviewed this matter and requested a further executive management report early in the New Year, to enable it to determine FMA's strategic approach to these potential legislative and other changes outlined above. I will update you again when the Board has received and considered that report.

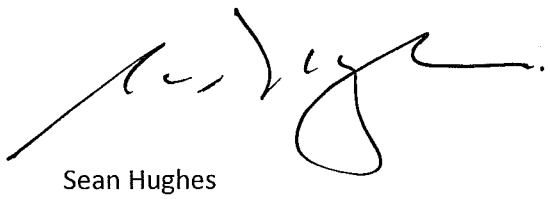
In the meantime, FMA staff will continue to work with MBIE in relation to these matters and the regulations being developed under the FMCB.

Ahead of the FMCB coming into effect we are reviewing the current licensing and on-going reporting requirements for AFAs who provide DIMS and are likely to propose some changes to both of these. For example, one of the initial changes we are considering is posting AFA applications on our website as they apply. This could allow members of the public to tell us if they have valid objections or information which could be useful in considering authorisation and good character assessments in particular. We will also signpost more clearly our channels for providing information, which could allow concerned investors to come forward earlier and drive greater awareness of our regulatory functions. Our experience here has been that investors and market participants are generally reluctant to report suspicions.

In summary, in the context of the existing FAA legislation, I am satisfied that FMA's processes for authorising Mr Ross were appropriate based on the information available at the time and the statutory powers and discretion presently available to FMA under the FAA. I am also confident once a complaint was made, that FMA responded in a prompt, proactive and effective way using new powers under the FAA. Given the circumstances in relation to the Ross case, FMA is committed to working with MBIE to improve the regulatory regime wherever possible.

Finally, the Ross case has highlighted a low level of investment awareness and competency among the New Zealand public. I note this is apparent even in relation to a sector of investors that are categorised as 'wholesale' under the current regulatory regime. I would welcome the opportunity to discuss this matter and indeed any of this response with you.

Yours sincerely



Sean Hughes
Chief Executive