BUDDLE FINDLAY

Legal update on regulatory and investigations - September 2015

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This is the first in what is to become a regular series of updates covering recent events in the increasingly active area of regulatory investigations and enforcement. Our objective is to provide you with a concise overview of the most significant current trends and developments both in New Zealand and overseas.

FMA issues progress report

An *Investigations and Enforcement - Key Themes 1 July 2014 - 30 June 2015* report released by the Financial Markets Authority (FMA) has revealed that it is now using a wider range of regulatory tools across a broad range of issues.

Over the last year, the FMA was involved in 51 inquiries and investigations and 28 litigation matters. The key outcomes of those matters were:

- $51.14 million was secured to compensate investors, from:
  - Strategic Finance - $22 million
  - Hanover finance companies - $18 million
  - Dominion Finance / North South Finance - $10 million
  - Pacific Edge - $500,000
  - SPI Property Fund - $640,000
- $1.71 million was awarded in penalties and fines
- Seven directors were prosecuted for failing to file financial statements resulting in fines totalling $210,625
- Undertakings not to participate in aspects of the financial markets for agreed periods of time were obtained from eight directors
- 28 companies were removed from the Financial Service Providers Register
- 77% of completed investigations resulted in sanctions that did not involve court proceedings. The remainder involved FMA-imposed sanctions. Of those that resulted in litigation:
  - 39% were prosecutions for non-filing of financial statements and civil proceedings on secondary market matters
  - 21% resulted in court judgments.

The remaining work on finance companies has now come to a close and amounted to only 2% of investigations and 28% of litigation matters for the past year. 63% of the FMA's inquiries over this period involved primary and secondary markets, including disclosure obligations, insider trading and market manipulation.

The report stated that the key issues encountered remain governance, culture and conflicted conduct. Some cases involved a lack of robust systems and controls and ineffective implementation of internal policies. Lack of awareness of basic regulatory requirements was also an issue. Supervising and monitoring of these issues will remain a focus of the FMA. The FMA expects that its focus on these areas and harms-based regulations is likely to increase.

FMA cases demonstrate breadth of its powers

A number of recent cases involving the FMA illustrate the wide variety of options available to the FMA to perform its regulatory functions. Two of the most notable are discussed below.

FMA issues first ever 'stop order'

Pursuant to the Financial Markets Conduct Act 2013 (FMCA), the FMA has the power to make 'stop orders' that prohibit certain specified conduct. Failure to comply with a stop order may result in conviction and a fine of up to $300,000.

The FMA recently issued its first stop order. The subject was Green Gardens Finance Trust Limited (GGFT) which is now prohibited from offering, issuing, accepting applications for or distributing restricted communications relating to the offer of debt securities. It is also banned from accepting further contributions, investments or deposits for debt securities. The order followed the FMA's conclusion that the site breaches the FMCA in a variety of ways, including the inclusion of an advertisement for an offer of debt securities that does not comply with sections 91 or 92 of the FMCA and by amounting to a restricted communication which is likely to mislead or confuse in a material particular. GGFT has since taken down the website.

The use of the stop order procedure, which enables quick enforcement action to be taken, without the need to obtain a court order, exemplifies this strategy and the willingness of the FMA to make full use of the new tools placed at its disposal by the FMCA.

FMA secures enforceable undertakings following action by Australian authorities

The FMA places considerable importance on co-operating with other regulators and, where possible, harmonising its enforcement action with that taken in other jurisdictions.

It has numerous tools at its disposal for achieving this objective. These include asking the High Court for a 'banning order' against a person who has been prohibited from carrying on specified activities in an overseas jurisdiction.

The FMA recently used the availability of this procedure as a negotiating tool in order to secure enforceable undertakings from a New Zealand couple, David and Jacqueline Hobbs. The Hobbs had received banning orders in Australia, after being found liable for serious financial misconduct in that country.

Following the Australian orders, the FMA negotiated a settlement with the Hobbs pursuant to which they provided undertakings that:

- Mr Hobbs will not act as a director or promoter of a company in New Zealand permanently and will not provide financial adviser or broking services in New Zealand
- Mrs Hobbs will not act as a director or promoter of a company in New Zealand for four years and will not provide financial adviser or broking services in New Zealand.

The case illustrates not only that the FMA takes a close interest in overseas regulatory action against New Zealanders but also that it is willing to use its powers to ensure that consistent sanctions are imposed here.

FMA: open to settlements

Recent figures released by the FMA show it only uses settlements sparingly - only 7% of litigation matters were settled between July 2014 and July 2015.

However, the settlement of two high profile enforcement actions, does illustrate a willingness by the FMA to reach a negotiated outcome in the appropriate circumstances.

On 18 June 2015, it announced that it had reached an agreement with Milford Asset Management Limited (Milford) in respect of conduct by a Milford trader that the FMA alleged breached the prohibitions against market manipulation in the Securities Markets Act 1988. On 31 July 2015, the FMA announced that it had filed civil proceedings against the trader.

While Milford denies liability for the trader's conduct (which has yet to be examined by the courts), it has agreed to pay a total of $1.5 million in settlement of the matter. According to a statement by the FMA, it has also accepted responsibility for the inadequate oversight and control of the trading conduct which was under investigation, and the failure to identify and monitor this activity, or to assess whether the activity was appropriate.

The case illustrates the dangers posed by so-called "rogue traders", not just to markets as a whole but also to their employers, who may incur legal liability as a result of their actions. It highlights the need for businesses subject to regulation by the FMA to operate according to carefully designed, implemented and continually monitored compliance policies.

The second highly publicised settlement relates to the long-running and high-profile "Hanover" litigation, which has concluded following an $18 million deal. The case centred around the (hotly contested) allegation that certain prospectuses and advertisements were misleading as to the financial position of the Hanover companies.

The settlement will reportedly result in eligible investors receiving returns of between 5c to 20c in the dollar. Significantly, it did not require the directors to make any admission of liability nor did it prevent them from publically expressing their views on the merits of the case, namely that they did not believe that the FMA would have succeeded at trial.

According to media reports, the FMA spent over 10,000 hours of staff time and $3.5 million pursuing the Hanover litigation. In future, where there is scope for a settlement, its preference may well be to resolve matters before such time and expense is incurred. This confirms the importance for defendants of the early adoption of a well-planned, strategic approach to any FMA investigation.

Judicial review in the regulatory sphere

The New Zealand courts have recently considered the scope of judicial review of government agencies in *Problem Gambling Foundation of New Zealand v Attorney-General*, and it has also been a topic for the English courts. In particular, the two English cases discussed below illustrate that judicial review is an available avenue by which to challenge action taken by not only regulators but also private entities performing regulatory functions.

UK Financial Conducts Authority as interested party in KPMG judicial review

In a novel development, a UK nursing home provider (Holmcroft) has been granted permission by the English Courts to bring judicial review proceedings against the accounting firm KPMG. The UK Financial Conducts Authority (FCA) (the equivalent to New Zealand's Financial Markets Authority) is participating in the proceeding as an interested party.

In 2012, the FCA identified failings in the way that some banks sold interest rate hedging products. The banks agreed to undertake a review of their practices and so far, £2 billion has been paid in redress. One of the banks was Barclays, which appointed KPMG to act as an independent reviewer of its compensation process. Barclays awarded Holmcroft £500,000 under this process. Holmcroft's dissatisfaction with the result has led to the current action against KPMG, Barclays and the FCA. KPMG challenged the validity of the action at an early stage, arguing that the matter was not suitable for judicial review (a procedure traditionally used as a tool to challenge decisions made by governmental bodies), as it concerned a matter of private contract. However, the English High Court has granted permission for the matter to proceed to a trial, as the role played by KPMG had enough of a public function to make it vulnerable to judicial review.

The case is likely to go to trial in 2016 and will be watched with considerable interest, as it seems likely to result in interesting and significant developments in the law of judicial review.

UK SFO has paid millions following botched investigation

The recently published annual report of the UK's Serious Fraud Office (SFO) has disclosed that the agency faces costs of at least £11.5 million as a result of the settlement of a civil claim brought against it by high-profile businessmen Robert and Vincent Tchenguiz.

The claim followed a successful judicial review application challenging the legality of search warrants used by the SFO in raids on Tchenguiz homes and business premises, on the basis that the evidence placed before the judge who issued them was inaccurate. As a result, the Tchenguiz brothers sued the SFO for £300 million. Following the settlement, the SFO's director stated that the SFO deeply regretted the errors for which it had been criticised by the High Court and took the unusual step of issuing a public apology.

The Tchenguiz saga emphasises that regulators' powers of search and seizure are not unbridled and that procedural errors may invalidate warrants, with catastrophic consequences for investigations. The message for business is that in any case involving a search by a government agency, it is important to carefully analyse the warrant and the circumstances in which it was obtained.

See articles:

- The Serious Fraud Office and Vincent Tchenguiz announce settlement of civil claims
- The Serious Fraud Office and Robert Tchenguiz announce settlement of civil claims

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FMA releases market misconduct guidance

The FMA has recently released an information sheet entitled *Market misconduct risks: a guide for MIS managers*. The sheet sets out the FMA's expectations of licensed managers of managed investment schemes, noting that they must comply with minimum standards in the Managed Investment Scheme (MIS) manager licensing application guide as well as all relevant legislation and regulations. The FMS emphasises that directors and management are responsible for their internal governance arrangements and are accountable for all trading transacted in the firm's name, including the conduct of employees and that they need to be comfortable that, where possible, they have mitigated the risk of market misconduct and eliminated potential problems such as:

- Lack of sufficient checks and balances in the risk and compliance reporting structure
- Assuming that staff experience, without ongoing training or formal compliance policies.

The information sheet sets out some examples of risk and compliance methods used worldwide by fund managers, noting that managers with higher-risk trading activities such as active trading strategies, proprietary trading or those with Direct Market Access systems will need more robust controls than managers with lower-risk trading strategies. The list is extensive but selected examples include:

- Segregating activity, so that front and back office roles are in different reporting lines
- Implementing a clear conflict of interest policy, addressing matters such as personal holdings, trading by close relatives, the impact on trading activity of incentive-based conflicts such as performance fees and extensive trading around performance reporting dates
- Controlling access to inside information and putting in place guidelines for reporting the receipt of any inside information, maintaining its confidentiality and implementing appropriate trading restrictions
- Developing guidelines for post-trade monitoring, detection and assessment of potentially compliant trades. Such trades could include trading occurring close to a performance reporting period end that may have the intent of setting the market price and trading that represents a significant proportion of activity in a particular stock or sector.

The information sheet is accessible here.

Bribery and corruption news

CAANZ Corruption Report: corruption is on the rise

New Zealand and Australia have long been perceived as trading partners with honesty and integrity. However, the Chartered Accountants of Australia and New Zealand (CAANZ) report on corruption released last week held no punches stating that "*relying on our historic reputations as 'fair dinkum' countries is no longer enough*" and both countries are at risk of losing this status.

Both New Zealand's and Australia's rankings have slipped on the Transparency International corruption index and both countries have been criticised for "*what is perceived to be a lackadaisical approach in addressing corruption*". The statistics are also not in our favour. In particular:

- There has been an 82% increase in fraud, bribery and corruption over $1 million
- 33% of New Zealand and 57% of Australian respondents experienced economic crime in 2014
- Between 1997 and 2012, there was a 300% increase in losses due to economic crime in Australia and New Zealand.

CAANZ says that one issue is that our top trading partners have relatively high levels of corruption and, indeed, it is third parties that are seen as creating the highest compliance risks for local businesses. In any event, the report was clear that Australia and New Zealand need to be more proactive in fighting corruption and it recommends ten steps that should be taken:

- Increase transparency in awarding public sector contracts
- No public sector contracts for those with past convictions
- No public sector contracts for companies without corruption policies
- Increase use of asset confiscation
- Encourage anti-bribery and corruption (AB&C) policies and practices in the private sector
- Rewards for whistle-blowers
- Better cross-border cooperation on bribery
- Harsher sanctions, applied more broadly
- Limit tax deductibility of “facilitation payments”
- Require AB&C policies in NZX and ASX listing rulings.

Read the full report here.

New anti-corruption legislation likely

On 4 May 2015, Parliament's Law and Order Committee reported back to the House on the Organised Crime and Anti-corruption Legislation Bill (Bill).

The purpose of the Bill is to strengthen the law to combat organised crime and corruption and to implement proposals aiming to improve New Zealand’s ability to collaborate with international efforts to disrupt and respond to organised crime.

The measures that the Bill proposes to introduce include, amongst others:

- A requirement that international transfers of $1,000 or more and cash transactions of $10,000 or more are reported by banks to the Police's Financial Intelligence Unit
- The creation of new "identity crime" offences
- Increasing penalties for private sector bribery and corruption offences so that they align with those for offences in the public sector
- Clarifying the circumstances in which a corporation will be liable for foreign bribery

In its current form, the Bill does not amend the exception of "facilitation payments" from foreign bribery offences. Such payments are not covered by the offence if they are made for the sole or primary purpose of ensuring or expediting the performance by a foreign public official of a routine government action, conferring a "small" benefit. Facilitation payments are illegal in many jurisdictions, including the United Kingdom and the Green Party has expressed concern that the Bill does not propose to outlaw them in this country. However, the Ministry of Justice has expressed the view that the payments do not yield an “undue advantage”, and that measures in the Bill to ensure the recording of these payments mitigate any concerns that the exception may be abused.

The Bill now awaits Committee of the whole House stage. If and when it is passed into law, it will be necessary for businesses to review their policies and procedures in order to ensure compliance. We will continue to report on progress, in order to ensure that our clients remain up to date with developments.

A$1 kick-backs lead to home detention

On 10 July 2015, the High Court sentenced an Auckland businessman to eight months home detention following a guilty verdict in a case involving 17 charges laid by the Serious Fraud Office (SFO). The case demonstrates that the SFO will not be deterred from pursuing prosecutions on the basis that the financial gain involved is relatively small.

The Court was satisfied that Peter Scutts, a former consultant to, then CEO of, the NZ Wine Company (NZWC), received volume-based "kick-backs" from an Australian wholesale customer (LMG) at the rate of A$1 per case of wine. Mr Scutts received the payments by submitting invoices totalling A$53,574.21 to LMG, on the letterhead of an associated company. The funds were paid into a bank account in Sydney.

The Court held that Mr Scutts' conduct amounted to receiving a secret reward for procuring a contract under the Secret Commissions Act 1910 and to dishonestly using a document under the Crimes Act 1961. In doing so, it rejected the argument that the "fees" were paid pursuant to an agreement whereby Mr Scutts' company would provide "marketing assistance" to NZWC's customer. A key finding relevant to this conclusion was that at the time of many of the payments, the alleged assistance had not been provided.

The SFO press release on the decision quotes director Julie Reid as stating: "Protecting New Zealand's reputation as a safe place to invest and do business is why the SFO targets both public and private sector corruption even at modest levels."

Toshiba begins facing consequences for overstating profit by US$2 billion

Toshiba Corporation (Toshiba) annual report was finally released (after two delays) on 7 September 2015. It confirms that the Japanese conglomerate has, for the last seven years, not only been overstating their profits by 230 billion yen (US$1.91 billion), but that the net losses for last year alone was 37.8 billion yen (US$313 million).

The company's improper accounting practices first came to light when an internal investigation found glaring bookkeeping irregularities. Toshiba then appointed a panel of independent experts to investigate.

The independent panel revealed that the problems arose following a fall in demand for Toshiba's products during the global financial crisis. The internal pressure that followed led many to resort to improper accounting practices. The panel found that this was exacerbated by a culture where top executives insisted on managers meeting unrealistic profit goals.

Toshiaki Oguchi, a Japanese governance expert, says that Toshiba's corporate governance had prioritised increasing profitability over preventing malfeasance. A contributing issue was the culture of large Japanese companies to tolerate low profits in order to avoid difficult and unpopular decisions such as selling or closing down unprofitable divisions.

Damningly, the independent panel found widespread and "*systematic involvement, including by top management, with the goal of intentionally inflating the appearance of net profits.*" It also found that Toshiba financial officials had "*deliberately provided insufficient explanations to auditors, with the intention of carrying out a systematic cover-up*."

As a result, half of Toshiba's 16 member board has resigned, along with the chief executive, vice chairman, and a senior adviser. Toshiba finally (after twice delaying) closed its book for the prior financial year on 7 September 2015.

Toshiba is now looking at how to rebuild its tarnished reputation. The panel had noted that Toshiba's audit committee had been led by long time Toshiba insiders and that this may have contributed to the accounting problems. Accordingly, one of the structural reforms includes appointing at least half of its directors from outside the company and changing corporate culture to avoid pressuring managers to meet unrealistic profit targets.

While no charges have, at this date, been filed against Toshiba or its executives, the matter is far from closed. Japan's Chief Cabinet Secretary Yoshihide Suga has weighed in stating that investigations into Toshiba's accounting irregularities will continue. There has also been suggestion that the company could be investigated by the US Securities and Exchange Commission (SEC) and the US Department of Justice (DoJ) despite the fact it is not listed on the US stock exchange.

Toshiba is already facing a class action, launched by its own shareholder Mark Stoyas, in the US over its accounting errors. Stoyas claims Toshiba has violated section 10(b) of the Securities Exchange Act of 1934 which prohibits any act or omission resulting in fraud or deceit in connection with the purchase or sale of any security.

Toshiba has asked its investors for forgiveness but this is unlikely to save the company from the legal wrangles that will inevitably follow.

See articles:

- Scandal upends Toshiba's lauded reputation
- Toshiba faces potential US probe after more accounting errors revealed
- Toshiba vows revamp after loss in push to regain trust

News from the Commerce Commission

Changes to consumer credit law now in effect

The Credit Contracts and Consumer Finance Amendment Act 2014 came into force on 6 June 2015. It made major changes to existing consumer credit laws, including the following:

- It introduced "lender responsibility principles", applying not only to loans but also to credit-related insurance contracts, guarantees and buy-back transactions. Lenders must comply with a number of specific responsibilities including helping borrowers and guarantors to make informed decisions about loans, acting reasonably and ethically and making certain reasonable enquiries before entering into loans.
- The rules relating to repossession of consumer goods have been updated. For example, only registered lenders may take steps to repossess consumer goods and repossession agents must be licenced or hold certificates of approval. Furthermore, lenders may not take security over certain "essential" consumer goods.

For the most part, consumer credit contracts entered into before 6 June 2015 will continue to be governed by the old law but all those involved in the consumer credit industry must ensure that they are familiar with the new regime. Failure to comply may result in enforcement action by the Commerce Commission and the imposition of heavy fines, as the maximum penalty per breach by a company has increased to $600,000.

The strengthening of New Zealand's consumer finance laws brings it into line with other jurisdictions where borrower protection is a priority for regulators and the financial consequences of breaches can be catastrophic. For example, the UK Financial Conduct Authority (FCA) recently announced that payday lender, Cash Genie, had voluntarily notified the FCA that it had engaged in unfair practices and, after working with the FCA, had agreed to write off over £10.3m of fees and interest and to provide £10 million in redress.

Commission gives insight into its consumer law priorities

The Commerce Commission recently held its second "Competition Matters" conference in Wellington. The opening address was given by the Commission's chair, Dr Mark Berry. Dr Berry took the opportunity to provide a preview of the Commission's 2015 assessment on consumer law issues. The matters highlighted by Dr Berry included the following:

- While the Commission received a large increase in Commerce Act complaints over the last year, a large number related to three cases – the merger of IAG and Lumley Insurance, allegations of anti-competitive conduct by Progressive Enterprises to its suppliers and the trademarking of the "Radler" style of beer by Dominion Breweries. Once those complaints were removed, numbers were static on the previous year.

- Just 24 traders represented 25% of complaints in the Fair Trading area. 33% of complaints in that area related to online-trading.
- As a result of the report, the Commission has prioritised certain areas for action. These include product safety, construction (in particular the Canterbury rebuild), telecommunications, motor vehicles and unlawful credit practices. Major areas of concern in relation to vulnerable consumers are credit contracts, unreasonable fees and truck shops.

Dr Berry emphasised that the Commission's assessment work was not "about finding matters to investigate and prosecute; it is about taking a holistic approach to resolving a problem." He stated that in addition to using existing tools, the Commission may be required to design "new interventions" but stopped short of describing the form that these may take.

The full report will be publicly released by the Commission in the near future.

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