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## OH, OH, I THINK YOU MIGHT BE CONFLICTED

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Back in January this year in a story entitled “Poachers Turned Game Keepers” we looked at an article in the London Financial Times about regulatory capture which made the point that we are never likely to resolve the big problems of the finance sector – “old ways that ultimately benefit the big banks” because so many regulators previously worked for the people they are supposed to be regulating or aspire to work for them in the future. We put the FMA under the microscope through this lens and it didn’t score too highly with many of the directors currently working for companies active in the finance sector including banks and fund managers. A few years back we even had the Minister of Commerce, who was responsible for the FMA, leave politics and join Westpac. Furthermore various casualties from Sean Hughes’ cleanout of the Securities Commission have wound up working for the banks.

The Herald article highlighted the fact that comparable organizations overseas such as the SEC in the US and the Financial Conduct Authority in the UK rarely have board members who have ever worked in the financial services industry let alone people who currently work in the financial services sector. Instead board members are drawn from academia and people with law and regulatory experience. This is hugely significant. Sheila Blair, former head of the US Federal Deposit Insurance Corporation was quoted in the FT as saying that regulators should be banned for life from working for any bank they have overseen. Back in January I asked Craig Foss, Minister of Commerce responsible for the FMA and incidentally himself ex investment banking firm Credit Suisse, whether he saw this as an issue and if he intended to do anything about it.

In January he said in an email that board members of the FMA must have the appropriate knowledge, skills and experience to govern and some members will naturally be participating in financial markets in their private capacity and “as a result conflicts of interest may arise. To this end I am satisfied that the FMA has the appropriate processors in place to manage such conflicts”. Or perhaps not. Last month the Productivity Commission (PC), produced a huge 466 page report, entitled “Regulatory Institutions and Practices”. In the report the PC looked at the makeup of the FMA board and concluded “the risk of conflicts of interest due to having industry participants in governance roles on regulatory bodies was stark in the case of the FMA. The 12 board members were active participants in the business world”. The report recommended that this situation be reviewed by the government. Amen to that.

In the email Mr Foss further explained that the main reason they had conflicted people on the board was to give the FMA the background needed to consider specialist issues. Well that’s a “nice dream” but the reality according to the Productivity Commission (PC) is that the board members are so conflicted that sometimes it has been a struggle to even get a quorum of three non conflicted members to make decisions. It seems that the FMA has the experts but frequently none of them can participate in decision making because they are conflicted. Makes sense, not.

After reading the PC report I went back to Mr Foss and asked him what, in light of this damning report, having regard to best practice overseas, not to mention common sense, his next move would be and reminded him that one of the prime objectives of the FMA is to foster confidence in the finance markets.

Obviously any perception that the board might be conflicted and that the FMA may have been captured by big business is at variance with this objective. Mr Foss said “the government will consider the recommendations in the PC final report”.

I have been in this industry since 1984 and have always been concerned that whilst the participation of retail investors is encouraged it is not always clear that too many people are looking out for their interests. John Key has told Mum and Dad that they should get their share of the energy stocks which has meant quite a few new retail investors on the NZX. Looking at the list of FMA board members it is not clear “who is batting for Percy Punter” ie who on this board represents the interests of Mum and Dad retail investor? This is important because the government wants to encourage, in particular, savings outside the residential property sector. Obviously the perception that the board is compromised here, there and almost everywhere and that the FMA’s function may have at least, in part, been captured by big business is at variance with this objective.

Back to that list of FMA members - there is the mandatory gaggle of ex-stockbrokers on the board but given the standard stockbroking business model will they be in a hurry to initiate any action to split investment banking from commercial banking or risk upsetting their fund manager mates by advocating greater degrees of disclosure or, god forbid, reasonable fees? There is a fund manager on the Board. Any initiative by the FMA, like the Retail Distribution Review sponsored by the predecessor to the Financial Conduct Authority in the UK, to reduce management fees or the performance fees which are legal in NZ but illegal in the UK would reduce fund manager profits.

There is a sprinkling of bankers and corporate lawyers on the FMA board and, in respect of the latter, many of the firms for whom they work will have the major banks and fund managers as clients and probably friends. When/if they read a recent headline in the London Financial Times saying that the “SEC is to probe the way banks hand out debt in sought-after offerings” will they bring a copy of the article to the next FMA board meeting and say “maybe we should be looking at this?” Much easier to hassle some poor fool finance company director with only \$9m in funds under management who hasn’t filed his annual report on time. Last but not least there is a current FMA board member whose business has, according to a Sunday newspaper, promoted and sold more than \$100m worth of property syndicates to Mum and Dad investors. This is despite FMA Head of Primary Regulatory Operations, Sue Brown, saying in August 2012 “there are significant risks particular to Real Property Proportionate Ownership schemes”.

These are just a few of the potential conflicts of interest that can be dreamed up in five minutes. There are no doubt many more and so we come back to that article in the FT which makes the point that we are never likely to resolve the big problems of the finance sector when the sector effectively governs itself. By the way congratulations to Steven Bailey at the PC for raising this issue but don’t expect to get a job in the finance sector real soon!

Given these problems the question before the panel and the investing public has to be how on earth did NZ get into this embarrassing situation, ie who were the luminaries who picked the board members of the FMA? In an email Mr Foss said the board was “determined by Cabinet, in accordance with the advice of the FMA Establishment Board”. The Establishment Board was chosen by the then Commerce Minister, Simon Power. That Board too was, predictably, dominated by corporate lawyers whose client’s might include the banks to be regulated and stockbrokers and bankers all of whom presumably were to be regulated by the FMA. Were none of these bright sparks aware of best practice as evidenced by the makeup of the boards of regulatory bodies in the UK or the USA? The old saying about fox’s and hen houses springs to mind, again.

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