

Submission to the Productivity Commission Regulatory Institutions & Practices

Financial Markets Authority

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Note: As the regulator of the capital markets in NZ FMA is pleased to offer generic comments specifically related to the operation of regulation in our field.. FMA has not sought to respond to every question, as the Authority was only established in May 2011, although contributors to these responses have had relevant experience in predecessor regulators, other public authorities and at overseas regulators – so are able to offer comparative perspectives and parallel insights.

1. What sort of institutional arrangements and regulatory practices should the Commission review?
2. The Commission has been asked to produce guidelines to assist in the design of regulatory regimes. What type of guidelines would be helpful?

A framework that can be used for public engagement in deciding appropriate governance regimes for a given area or public risk / value, paying particular attention to how the balance of interests between regulator and the regulated population are managed.

3. Does New Zealand have (or need) a unique “regulatory style” as a result of our specific characteristics?

Yes. We are a small, distant economy with a unique culture. While we may not need to mimic all the same regulatory mechanisms observed overseas, we must take great care that our regulators’ incentives and objectives are aligned with long term interests of New Zealand.

4. What influence has New Zealand’s specific characteristics had on the way regulation is designed and operated in New Zealand?
5. What other ways of categorising New Zealand’s regulatory regimes and regulators would be helpful in analysing their similarities and differences? How would these categorisations be helpful?
6. Can you provide examples of regulatory regimes with particularly clear or (conversely) unclear objectives? What have been the consequences of unclear regulatory objectives?

The scale of NZ lends itself to monopoly, on occasion. In a number of areas, maintenance of a fully functional market conflicts with arguments based on economy of scale. Our desire for a free market appears sometimes to hamper our willingness to compensate for market failure and conflict of interest. An obvious example is the contrasting approach to regulation of the utility sector between New Zealand and, say, [The United States](#) or [United Kingdom](#).

7. Where regulators are allocated multiple objectives, are there clear and transparent frameworks for managing trade-offs? What evidence is there that these frameworks are working well/poorly?

The widespread adoption of [risk differentiation methods](#) in the last ten years or so has ostensibly been a response to resource challenges, and the difficulty of “doing the right thing” in the context of NZ’s unique output driven public funding model.

Most agencies are charged with promoting social good or managing harms, and try to translate public desires in these areas into measurable targets, captured in Statements of Intent.

Many government objectives are strategic, and play out over many years. Mechanisms to align a long-term view with the execution approach are important. A good example is retirement income and education policies. The outcomes of both arise many years after the public circumstances that created them. Governance arrangements need to be cognisant of the time-scale of the effects (such as how responsive a matter should be to public opinion, and therefore the level of independence from that opinion).

Perhaps it would assist to supply templates and guidance (such as use of the Treasury Living Standards Framework) that promote alignment between of the time-scale of agency objectives with its governance. In other words, an explicit mandate to consider long-term factors may require a greater level of independence and consensus political support (such as the Reserve Bank).

*For example, an agency with a simple tactical mandate **or** a strong element of decision making driven by societal norms needs a high degree of political oversight. One that operates in a more technical field, or one driven by international requirements needs to be less subject to short term domestic political effects.*

8. Can you provide examples of where assigning a regulator multiple functions has improved or undermined the ability of the regulator to achieve the objectives of regulation?

Without identifying specific examples, New Zealand has carried out some agency mergers. The risk is that focus and resourcing in the larger agency shifts, and smaller or less politically visible policy areas lose attention. On the other hand, FMA is itself a successor agency to smaller entities with converging regulatory functions and mandates. To date, we think the amalgamation of agencies operating in the same part of the market with similar or overlapping responsibilities, is not only more economically efficient but also more likely to generate consistent regulatory outcomes.

9. Can you provide examples of where a single agency is responsible for both industry promotion and the administration of regulations? What processes are in place to align the incentives of the regulator with the desired regulatory outcomes? What evidence is there of success or failure of these processes?

FMA is charged with promoting growth in capital markets through the finance sector, as well as regulating it, through its statutory mandate¹. Alignment is also achieved through the appointment of a non-executive Board selected largely from the regulated sector.

10. Are there examples of where regulators have clearly defined policy functions? Conversely, are there examples of where the policy functions of a regulator are not well defined? What have been the consequences?

¹ "The FMA's main objective is to promote and facilitate the development of fair, efficient, and transparent financial markets." Section 8, FMA Act 2011

One agency that designs and authors its own legislation is Inland Revenue. This is justified partly on the technical nature of the subject matter, and governed by the [Generic Tax Policy Process](#).

Overseas, there are examples of regulators being able to make their own regulations, but with Parliamentary oversight through disallowance mechanisms.²

A key area of focus for the review should be identifying ways to align pace of change with the government machine.

11. Can you provide examples where two or more regulators have been assigned conflicting or overlapping functions? How, and how well, is this managed?

Economic harms range from consumer to wholesale, and are managed by a range of agencies with differing governance structures. Various overlaps and gaps are managed through mechanisms often governed by Memoranda of Understanding. This is perhaps easier to achieve with a newly established agency, seeking to define its boundaries and touch-points from inception, as FMA has done with the RBNZ and SFO, as well as with relevant industry bodies performing front-line regulatory roles such as NZX.

It could be that responses to work by the Law Commission in the fields of [Privacy](#) and [Information](#) should be revisited, to ensure there are no areas causing practical barriers to the operation of agencies.

12. Are there examples of where regulators are explicitly empowered or required to cooperate with other agencies where this will assist in meeting their common objective?

We suggest this area be explored further in the context of reviews by the Law Commission into privacy and the Official Information Act, which offer many useful examples where agencies are empowered to share information.

In a nutshell, the reviews recommended that sharing be governed by point-to-point relationships between agencies, implying a dependency on Memoranda of Understanding. However these documents and processes prove time consuming to agree in many cases. Cross government support for the creation and operation of such mechanisms including sound public debate may assist in building robust links in which the public and servants of the public have confidence. This would go a long way to promoting more effective use of information and regulatory efficiency.

13. Can you provide examples of where two seemingly similar regulatory areas are regulated under different regulatory structures? What factors have contributed to differences in the regulatory structures?

New Zealand has adopted a peculiar model for the regulation of money-laundering and terrorist-financing risks. Unlike other countries which have adopted a single specialist uniform regulatory model³ New Zealand has 3 regulators (RBNZ, FMA and DIA) based on an industry sector model, coupled with a policy / rule-making body (Ministry of Justice) and a financial intelligence hub (NZ Police).

² For instance, the Australian Securities and Investments Commission.

³ For instance, the Australian Transaction Review and Analysis Centre (AUSTRAC)

14. Are the dimensions of regulator independence discussed in Figure 4.2 helpful in thinking about New Zealand regulators?

We support this model and note that it prompts a number of questions regarding governance arrangements. We also feel it is useful in considering the balance between promotion and regulation of markets.

15. Which of these dimensions of independence is most important to ensure a regulator is seen to be independent?

A concept that could be explored is an explicit a hierarchy of needs in government. This would also assist with prioritisation.

16. Can you provide examples of where a lack of independence or too much independence according to one of these dimensions undermines the effectiveness of a regulatory regime?

We can think of instances where there may be inadvertent competing outcomes between regulators or regulatory decisions from different bodies, but this may not be due to any issues of independence. Strictly speaking, we think there should be a principle of independence where the regulator is required to make decisions or carry out activities which have the potential to impact on livelihood or liberty.

17. What should be the limits of regulator independence? What sorts of regulatory decisions should be the preserve of Ministers rather than officials?

The boundaries of regulatory power are properly drawn by Parliament and the Judiciary – which we think to be preferable to that power being exercised by the Executive. In our experience, matters that are reserved to Ministerial decision-making are likely to be sensitive or in the national interest, and therefore may require a broader array of advisory inputs than purely that of the regulator. We would prefer that this type of decision-making be the exception rather than the rule, given that a Minister may be challenged over perceptions of independence.

18. Do you agree with the list of features in Figure 4.3 which indicate a need for more or less regulatory independence? What other criteria are missing?

We support the model, and would perhaps add more independence (but with retrospective review) where a decision must be taken with urgency in the public interest.

19. Is regulatory capture more or less likely in a small country? Can you provide examples of capture in New Zealand?

The short answer is no. There appears to be little difference in explicit capture, perhaps because a small market also implies a small base for lobbying.

However there is potential for a more subtle form of capture. This is simply a group-think risk. The pool of people from which decision makers may be drawn is perceived as being small given issues of available expertise and experience. Ultimately this is a skill and leadership issue to be identified and recognised and a risk to be mitigated.

20. Are there other institutional forms for government-established regulators?

21. Do particular types of institutional form lend themselves to more enduring regulatory regimes?

Broadly the oldest agencies in our democratic structure tend toward what could be described as the Statutory Office(r), or career public service. The issue of perceived subtle capture above is perhaps tackled by strong advisory boards (such as used by the Reserve Bank), objective performance assessment processes and the trend toward consultative policy development.

22. What are the key differences of institutional forms in terms of their regulation, operational, institutional or budgetary independence?

23. Are there aspects of regulatory independence that are more or less important in regulating state power or government-provided/funded services?

24. Are there other types of governance structure than the three listed above? How well do they work?

An alternative model for securities regulators such as FMA, is a Commission-style governance structure with a full time executive Board (of between 3 and 5 members). This is more or less the same model as the Commerce Commission, with the addition of non-executive specialist members, and one of our predecessors, the Securities Commission. It is also the approach adopted by each of the twin peaks regulators in Australia (ASIC and APRA).

25. What type of governance and decision-making structures are appropriate for different types of regulatory regime?

Regulators which oversee specialist or technical markets benefit from close engagement and alignment with their regulated populations, both to build trust and collaboration on common issues, as well as to have intellectual credibility.

26. How effective and consistent are the review and appeals processes provided for in New Zealand regulatory regimes?

27. Can you provide examples where the review and appeals processes provided for are well-matched or poorly suited to the nature of the regulatory regimes?

With the trend toward more administrative mechanisms (the regulatory equivalents of parking tickets), combined with the challenges of devolving discretion to the front line, simple methods of appeal to rapidly check fairness and redress regulatory mis-fires will become more important.

28. What are the advantages and disadvantages of a general merits review body like the Australian Administrative Appeals Tribunal?

This forms a half-way house between internal adjudication (where experts have a sound technical grasp) and a more generalist function that drives consistency across administrative

processes. It is attractive but perhaps best applied at a sector level, with an appeal to a general tribunal in event of scope conflict. It resonates with the NZ tribunal approach in other areas.

29. Can you provide examples of regimes where risks are borne by a regulator, regulated party, or the public/consumers, but they are not best-placed to manage those risks?

There are on-going issues regarding investor literacy and financial education in New Zealand, which would suggest that the financial risks of more complex products may not be well-understood by many consumers and may not be in their best interests. Disclosure-based regulatory models (at one extreme view) are an exercise in risk-transfer from vendor to purchaser on an uneven pitch.

30. Can you provide examples of where the mix of funding sources contributes to the effectiveness or ineffectiveness of a regulatory regime?

FMA has a mixture of appropriation and industry levy funding (with the levy quantum fixed by Government, not FMA). In the initial years of a new agency, we think this approach is sensible, although the quantum-setting process is necessarily one which requires skilful engagement and consultation, as well as a commitment to on-going reviews for effectiveness and appropriateness. The model is currently based on size of entity rather than actual risk to market integrity – which is a more advanced and logical approach. Some of the other models we have considered from overseas may be based on a percentage of regulated capital in the market (eg, the French levy based on a percentage of CAC turnover).

31. Is the mix of funding sources for individual regulators consistent with their stated funding principles?

32. Which New Zealand regulators (or regulatory regimes) provide good examples of open and transparent funding arrangements? Can you provide examples where the transparency of funding needs to be improved?

In many circumstances the link between funding and activity is not broadly understood by industry and the public. This is an age-old issue: there is no silver bullet. A key element is simply to ensure all stakeholders are involved in a regular review of mechanisms. Any move to levy-based funding of the regulated population necessarily broadens the base of those with an interest in the regulator's performance. How that interest then translates into performance criteria and assessment is worth considering.

33. Can you provide examples where a regulator's funding arrangements support or undermine its independence?

34. What approaches are there to identifying, building, and maintaining workforce capability? How effective have they been?

As a recently-established regulator, FMA has sought to attract talented professional staff from across the state sector, financial services sector and professional service firms. FMA has also deliberately established a visible presence in Auckland – with the result that it now hosts the majority of FMA's resources. This has been done deliberately to equalise the negotiating power on either side of the table, but also to create an alternative career pathway, especially in

Auckland. At a senior level, development programs have included a tailored leadership progression pathway at an individual and team-level, as well as individual coaching and mentoring.

35. What restrains or enables a regulator to develop the capability they need in the New Zealand context?

As a regulator of the financial markets, the most significant restraints FMA faces is salary parity and retention beyond the 2 – 4 year service mark. It has also been difficult to recruit foreign staff or NZ expatriates from overseas, given limitations on remuneration structures. The small size of regulators and long-serving senior staff also limit promotional opportunities.

36. Where are there gaps in regulator workforce capability? Can you provide examples?

37. What is the potential to improve capability through combining regulators with similar functions, compared with other alternative approaches?

In an information driven world, centralisation and amalgamation are becoming increasingly disaggregated from economy or effectiveness of scale. Fast and responsive is not generally correlated with big, and it is the former that is important in the twenty first century.

While there have been opportunities explored by FMA in the past 2 – 3 years to combine regulatory activities across agencies under one umbrella, none of these have been implemented either due to an absence of provable material economic benefit or diffuse levels of political support.

38. When do changes to institutional arrangements work best to improve capability, and when are other solutions preferable?

Any arrangement that supports innovation (with the associated risk-taking) supports better regulation. This does not align well with the 15 – 20 year life-cycle of many regulatory regimes. [see the discussion above regarding size and pace at 7 & 11].

39. Can you provide examples of strengths and challenges in the way regulators monitor and enforce regulations? What are the consequences?

Regulation is an inherently prospective approach to tomorrow's unforeseen problems, and therefore there is often an element of "right-sizing" the regulation to fit the issue. Necessarily, regulators in New Zealand prefer general principles and flexible tool-kits, which may not suit markets looking for certainty and predictability.

40. Do New Zealand regulators have access to a sufficient range of enforcement tools? If not, what evidence is there to suggest that a broader range of tools would promote better regulatory outcomes?

In the financial markets arena, recent and on-going reforms will address many of the shortcomings of the previous regulatory regime. By contrast with Australia, the only tools FMA lacks relate to electronic interception of communications in relation to secondary market activities. In addition, FMA is yet to establish a capacity to conduct real-time monitoring of trading on the securities exchanges.

41. What sort of regulatory regimes are suited to more (or less) discretionary enforcement?

Discretion is best aligned with matters that are subject less personal bias. This field is well researched in [front line policing](#) which may offer lessons as to how to establish appropriate boundaries and controls of discretion.

42. Can you provide examples of where a regulator has too much or too little discretion in enforcing regulations? What are the consequences?

While the exercise of discretion appears to generally work well, one aspect for consideration is where capacity, rather than regulatory purpose becomes the primary driver. We must remain vigilant for signs that a regulator is over- or under- utilising its powers imply because it has too much or too little capacity.

43. Can you provide examples of where risk-based approaches have been used well? What are the critical pre-conditions for effective implementation of risk-based approaches to compliance monitoring and enforcement in New Zealand?

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44. What are the challenges to adopting risk-based approaches in New Zealand?

See the Prime Ministers Science Advisory Committee: [The Role of Evidence in Policy Formation and Implementation](#).

45. Can you provide examples of where regulatory regimes require too much or too little consultation or engagement? What are the consequences?

It is difficult to conceive of an example of too much consultation. Too little consultation is likely to lead to industry disengagement, higher levels of non-compliance and a breakdown of trust.

46. What are the characteristics that make some regulations more suited to prescriptive consultation requirements than others?

47. What forms of engagement are appropriate for different types of regulatory regime? When do formal advisory boards work or not work well?

Advisory boards are useful in very technical circumstances, or where decisions must take into account strong cultural or moral factors. Balance is a challenge, as these areas may be subject to capture or domination. One mechanism to address this is to ensure a high degree of transparency, coupled with some level of technical or academic representation where appropriate.

48. What elements of a regulatory regime's design have the biggest influence on culture? Why?

49. How best can the challenges of working in partnership with Māori be met by regulatory agencies? What models, methods, and approaches are most successful?
50. How well do regulatory agencies ensure consistency of approach between or amongst regulatory staff, so that individual variations are minimised?

Considering the vast number of decisions made on a day to day basis, extraordinarily well. Many agencies have boiled decisions down to simple and clear guidelines. This is a question of quality management for which there is a well-established body of knowledge.

51. Can you provide examples where the culture or attitude of the regulator has contributed to good or poor regulatory outcomes? How?
52. Can you provide examples where the culture within a regulator supports or inhibits staff in making difficult decisions, particularly where those decisions may be unwelcome to government, regulated parties or the general public? How?
53. Can you provide examples where a regulator places too much value on managing risks to itself, relative to other priorities (such as the regulatory objective, or customer service)? What are the consequences?
54. Can you provide examples of regulators whose approach to their business is largely shaped by their reliance on a particular profession? How might that approach be different if it drew on a wider range of professions?

FMA is not alone in a heavy reliance on the legal profession, as exercising control requires a significant technical capability. The challenge remains to balance this with the needs of the industry being regulated: for example, injecting an understanding of how markets operate in an economic sense, rather than at a transactional level.

This is perhaps an area where governance mechanisms must be constructed to ensure suitable balance in the focus of operating strategies.

55. Can you provide examples of how accountability or transparency arrangements improve or undermine the effectiveness of a regulatory regime?
56. What types of accountability or transparency arrangements are appropriate for different types of regulatory regimes?
57. Are the problems that the Commission identified in the assessment of local government regulatory performance also evident in the assessment of central government regulatory performance? If not, how do the problems differ for central government?
58. Can you provide examples of where performance assessment of regulatory regimes is working well, or needs improvement?

59. When are feedback loops being used well to improve the performance of New Zealand regulatory regimes? When aren't they?

Pace is perhaps the biggest challenge to feedback mechanisms. The legislative and judicial process (including the way in which regulators decide on what action to take) mean that clarity can often take years to achieve. This means that poor practice can continue long after it is understood to be incorrect.

60. Can you give examples of indicators or proxies that are effective as early warning signs of regulatory noncompliance or failure?

An agency that is not demonstrating a healthy level of tension with its regulated population (perhaps by some public disagreement and a healthy prosecution loss rate) should expect greater scrutiny and questions of capture.

61. Can you provide examples of regulatory regimes with effective processes for formally or informally raising concerns about potential regulatory failures? What examples are there of regimes that handle this poorly? What are the consequences?

FMA has a specific function dedicated to looking for (systemic) regulatory failure, but this is unusual. The real challenge is not identifying the problem, but driving action.

The challenge is engagement. The finance company issues of the last decade were signalled in advance (including by the Securities Commission) however garnering public support to take action met with great resistance in some cases. The public sometimes choose, through their political representatives, to prefer to wait for disaster to prove the point rather than take early action.

Examples include the resistance to earthquake strengthening rules and responses to climate change.