To: Finance and Expenditure Committee

On: Financial Markets (Conduct of Institutions) Amendment Bill

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INTRODUCTION

This submission is from full service law firm Chapman Tripp. We have offices in Auckland, Wellington and Christchurch.

Our contacts for the purposes of this submission are:

TIM WILLIAMS – PARTNER
T: +64 9 358 9840
M: +64 27 243 1629
E: tim.williams@chapmantripp.com

PENNY SHEERIN – PARTNER
T: +64 9 358 9817
M: +64 27 556 6516
E: penny.sheerin@chapmantripp.com

BRADLEY KIDD – PARTNER
T: +64 4 498 6356
M: +64 27 224 1271
E: bradley.kidd@chapmantripp.com

JOHN KNIGHT – PARTNER
T: +64 4 498 4947
M: +64 27 224 9819
E: john.knight@chapmantripp.com

KARA DALY – CONSULTANT
T: +64 4 460 6913
E: kara.daly@chapmantripp.com

Introduction

1 Thank you for the opportunity to submit on the Financial Markets (Conduct of Institutions) Amendment Bill (***the Bill***). The Bill is of direct interest to us as legal practitioners and to our clients.

2 We have previously provided submissions on the Ministry of Business, Innovation and Employment (***MBIE***) April 2019 Conduct of Financial Institutions Options Paper.

3 Our submission does not purport to represent the views of our clients.

Summary

4 We make the following submissions on the Bill, which are explained in more detail below under the Detailed Submissions heading:

4.1 **The Bill was prepared before the impact from COVID-19. The Government may wish to reconsider its timing and approach post COVID-19, and should continue to consult with industry on its proposed reforms.** We welcome the month-long extension for submissions. The steps needed to submit on, prepare for, refine and implement procedures, policies and controls in response to, apply for licences under and comply with this proposed legislation will all place a further burden on banks, insurers, non-bank deposit-takers and intermediaries. These institutions range in size and scale, and so the effects of the new legislation would have a varied impact on them. The unprecedented disruption and economic implications caused by the Covid-19 lockdown raises a case for delaying this Bill's progression, which should be explored with institutions. We submit that consultation should continue on the proposed path of this legislation, and account should be taken of the current economic environment and its effects on the financial services sector when plotting the Bill's course.

4.2 **Clarity will be needed to support the fair conduct principle.** We agree that the principle of treating customers fairly should underpin financial institutions' general conduct obligations towards customers. Because, the fair conduct principle is undefined and subjective, clarity will need to be provided through guidance, ideally in regulations or in regulatory guidance, so financial institutions can identify and implement efficiently any adjustments to comply, so consumers know what to expect and, to the extent possible, so unnecessary disputes can be avoided.

4.3 **Fair treatment requirement needs to reflect the special circumstances of insurance industry.** Insurance policies are designed, offered and performed by classifying classes of risk on which premiums are set. Those classes have boundaries which are reflected in policy wording and conditions. This typically results in some insureds receiving different cover or paying different premiums based on their different circumstances, which inevitably creates fertile ground for customers to allege they have been treated unfairly. The Human Rights Act provides exceptions for policy wording allowing them to discriminate on the basis of age, disability or sex if the discrimination is based on actuarial models of the risks of the identified class. The Bill needs to reflect the practicalities of designing insurance policies, and clarify that it does not prohibit designing insurance policies on a basis which meets the Human Rights Act exception or otherwise in a manner which allows classes of risk, conditions on cover and exclusions to be established for the purpose of designing and offering insurance policies. Without these clarifications, insurance conditions and exclusions would lose their commercial efficacy, and premiums would need to reflect the increased uncertainty

arising from insurance policies no longer always being enforceable in accordance with their terms.

4.4 Fair treatment should be applied generically when designing or offering products or services. Designing and offering financial products is an activity which has to be objective and approach customers generally. It is not practical to require that these activities be conducted in a manner that treats customer's individual circumstances separately. The Bill indicates that financial institutions would be required to treat customers fairly on an individual basis. This would be clearly be impractical in the context of designing and offering products or services on any commercial scale, and changes are needed to ensure that this is not perpetuated.

4.5 Licensed financial advice providers (*FAPs*) are to be further regulated by FSLAA and should be excluded here for now. The definition of "intermediary" in section 446E should be amended to exclude licensed FAPs with respect to their FMCA regulated activities. Relief of the financial institution from its duty to ensure a FAP complies with the financial institution's fair conduct programme in section 446lL, does not assist in relieving the FAP's obligation to comply with the fair conduct programme in section 446I. There is no policy justification for licensed FAPs to be further regulated with respect to their FMCA regulated activities. The rationale for the new regime is to remedy the conduct regulation gap that the Financial Markets Authority (*FMA*) and the Reserve Bank identified following their conduct and culture review. There is no such conduct regulation gap with respect licensed FAPs undertaking FMCA regulated activities. When the new financial advice regime enacted by the Financial Services Legislation Amendment Act 2019 comes into force in early 2021, licensed FAPs will be, when providing regulated financial advice and financial advice services (ie, client money and property services) under various obligations and duties that seek to ensure that they act fairly towards clients and prioritise their clients' interests and their general conduct will be monitored by the FMA. If the fair conduct principle applies to licensed FAPs with respect to their FMCA regulated activities, they will be subject to an unnecessary duplication of regulation and, accordingly, incur unwarranted additional compliance costs.

4.6 Section 446E(2) should be amended to exclude from the "intermediary" definition persons who are "engaged" by a financial institution or intermediary. Section 446E applies only to employees of financial institutions or intermediaries. We submit that the exclusion should be broadened to apply to those contracted by financial institutions or intermediaries. As currently drafted, persons (ie, financial advisers and nominated representatives) who are engaged by licensed FAPs to provide advice on their behalf will be regarded as intermediaries and, accordingly, personally subject to the proposed regime.

4.7 The definition of "involved" in section 446E(3) should be narrowed in order to avoid unintended consequences. The definition of "involved" is overly broad as it may capture persons whose involvement is insignificant or passive and, accordingly, could result in the regime's scope being too broad with accompanying unintended consequences. Accordingly, we submit that further consideration should be given to section 446E(3) with a view to drafting it in a manner that delineates with sufficient precision the level of involvement necessary in order to for a person to be regarded as an intermediary.

4.8 **Section 446P (Meaning of incentive) should be changed to limit bans on incentives.** Section 446P does not contain a limitation that any ban on incentives would apply to volume or value based sales targets only. Section 446P appears to confer a general power to ban incentives, which does not reflect Cabinet's decision as set out in the Cabinet Paper and Minister's public statements that bans not apply to all incentives. Accordingly, we submit

that section 446P should be redrafted to limit incentive bans to value or volume based targeted commissions.

Detailed submissions

The Bill's pathway should be reconsidered in light of COVID-19.

1 We welcome the month-long extension for submissions. The impact of COVID-19 on the financial services sector has been significant, and we submit that consultation should continue on the proposed path of the Bill, and account should be taken of the current economic environment and its effects on the financial services sector when plotting the Bill's course.

2 The steps needed to submit on, prepare for, refine and implement procedures, policies and controls in response to, apply for licences under and comply with this proposed legislation will all place a further burden on banks, insurers, non-bank deposit-takers and intermediaries. These institutions range in size and scale, and so the effects of the new legislation would have a varied impact on them.

3 The unprecedented disruption and economic implications caused by the Covid-19 lockdown raises a case for delaying this Bill's progression, which should be explored with institutions. Financial institutions and intermediaries are currently focusing on working through the implications of the lockdown, and the Covid-19 pandemic generally, and it is expected that they will be preoccupied with the need to deal with these implications for a considerable time.

4 Risks arise if legislation is pushed through at times of crisis. Like other countries– Sarbanes Oxley legislation in the United States being one such example, New Zealand has had previous experience of enacting rushed financial services reforms at times of crisis. The Financial Advisers Act 2008 was pushed through immediately following the global financial crisis, with limited consultation and stakeholder objections. As a result, the Financial Advisers Act's implementation needed to be delayed at the last minute for two months after enactment so that parts of it could be rewritten.

Clarity will be needed to support the fair conduct principle.

5 We agree that the principle of treating customers fairly should underpin financial institutions' general conduct obligations towards customers.

6 Because, the fair conduct principle is undefined and subjective, clarity will need to be provided through guidance, ideally in regulations or in regulatory guidance, so financial institutions can identify and implement efficiently any additional steps to comply, so consumers know what to expect and, to the extent possible, so unnecessary disputes can be avoided.

7 A useful model for such guidance is contained in the United Kingdom Financial Conduct Authority's (*FCA*) *Responsibilities of Providers and Distributors for the Fair Treatment of Customers,* which sets out in detail the FCA's view on what the obligation in Principle 6 ("A firm must pay due regard to the interests of its customers and treat them fairly") requires in a range of circumstances.

8 Where similar concepts already apply in legislation, it would be desirable that any requirements are consistent with the conduct provisions contained in the adjoining regulatory regimes, for example:

8.1 Part 4, subpart 2, of the FMCA, in particular, sections 143 to 145 which impose various duties on managers, investment managers, and directors and senior manager of directors, of managed investment schemes, including acting honestly, acting in the best interests of scheme participants, treating scheme participants equitably and not using information acquired to gain improper advantage; and

8.2 Part 1, Standards 1 and 2, of the Code of Professional Conduct for Financial Advice Services (which will come into effect when FSLAA comes into force in early in 2021), which provides

commentary on what the standards to "treat clients fairly" and "act with integrity" require financial advisers to do when providing regulated financial advice.

9 We submit that it would be desirable for the words "in the prescribed manner" be added to section 446B, so that regulations can prescribe the specific standards intended, such as honesty, integrity, clear communication/not being misleading and not exploiting vulnerabilities. This approach would enable the fair treatment principle to be developed into cogent and balanced rules that identify and prohibit unacceptable behaviours in a manner which can get general acceptance and understanding.

Fair treatment requirement needs to reflect the special circumstances of insurance industry.

10 Insurance policies are designed, offered and performed by classifying classes of risk on which premiums are set. Those classes have boundaries which are reflected in policy wording and conditions. This typically results in some insureds receiving different cover or paying different premiums based on their different circumstances, which inevitably creates fertile ground for customers to allege they have been treated unfairly.

11 In the case of insurers, the Bill should not prevent insurers designing and offering policies which result in customers being treated differently according to their particular circumstances when those decisions are based on reasonable reliance on actuarial or statistical data, reputable medical or actuarial advice or opinion and other relevant factors, relating to life-expectancy, accidents or sickness.

12 The Human Rights Act provides exceptions for policy wording allowing them to discriminate on the basis of age and sex if the discrimination is based on actuarial models of the risks of the identified class. Section 48 of the Human Rights Act 1993 provides that section 44 (which makes it unlawful to discriminate with respect to the provision of goods or services on prohibited grounds of discrimination) is not breached where insurers:

> *offer or provide annuities, life insurance policies, accident insurance policies, or other policies of insurance, whether for individual persons or groups of persons, on different terms or conditions for each sex or for persons with a disability or for persons of different ages if the different treatment—*
>
> *(a) is based on—*
>
> *(i) actuarial or statistical data, upon which it is reasonable to rely, relating to life-expectancy, accidents, or sickness; or*
>
> *(ii) where no such data is available in respect of persons with a disability, reputable medical or actuarial advice or opinion, upon which it is reasonable to rely, whether or not contained in an underwriting manual; and*
>
> *(b) is reasonable having regard to the applicability of the data or advice or opinion, and of any other relevant factors, to the particular circumstances.*

13 The absence of any recognition in the Bill of the peculiarities of insurance creates the risk that customers will be able to contest decisions that are otherwise permitted under section 48.

The Bill needs to reflect the practicalities of designing insurance policies, and clarify that it does not prohibit designing insurance policies on a basis which meets the Human Rights Act exception or otherwise in a manner which allows classes of risk, conditions on cover and exclusions to be established for the purpose of designing and offering insurance policies. Without these clarifications, insurance conditions and exclusions would lose their commercial efficacy, and

premiums would need to increase to reflect the increased uncertainty arising from insurance policies no longer always being enforceable in accordance with their terms.

Fair treatment should be applied generically when designing or offering products or services.

14 Designing and offering financial products is an activity which has to be objective and approach customers generally. It is not practical to require that these activities be conducted in a manner that treats customer's individual circumstances separately. The Bill indicates that financial institutions would be required to treat customers fairly on an individual basis. This would be clearly be impractical in the context of designing and offering products or services on any commercial scale, and changes are needed to ensure that this is not perpetuated.

15 As currently drafted, it is unclear from section 446C whether the fair conduct standard applies generically or if it require each individual's particular circumstances be taken into account. The words "including by paying due regard to their interests" in section 446B appear to imply that each consumer's interests need to be ascertained and considered. That this is the intended interpretation is supported by section 446I(1)(3), which states that a contravention of the requirement to comply with a fair conduct programme that relates to only one consumer is a breach.

16 Financial institutions cannot design, offer and provide products and services on a bespoke basis. They must routinely engage in a complex balancing exercise between the particular customer's interests, other customers' interests and their need to operate as commercially viable businesses. Accordingly, it is submitted that section 446I(3) should be removed and it be made clear that institutions need not pay regard to individual interests when designing, offering or performing their activities, unless it the context it would be reasonably be expected the institution to do so.

Licensed FAPs are to be further regulated by FSLAA and should be excluded here for now.

17 The definition of "intermediary" in section 446E applies to licensed FAPs who provide regulated financial advice (and other financial advice services, ie, client money and property services) to their clients with respect to financial products of financial institutions covered by the Bill. Accordingly, as currently drafted, the Bill applies to licensed FAPs in respect of their activities that will (from early 2021 when the new financial advice regime enacted by the Financial Services Legislation Amendment Act 2019 comes into force) be regulated by the Financial Markets Conduct Act 2013.

18 There is no policy justification for licensed FAPs to be subject to the Bill with respect to their FMCA regulated activities. The rationale for the new regime is to remedy the conduct regulation gap that the FMA and RBNZ found during their conduct and culture review of registered banks and licensed life insurers.

19 There will be no such conduct regulation gap with respect licensed FAPs undertaking FMCA regulated activities. As a result of the new financial advice regime coming into effect, with respect to the regulated financial advice and other financial advice services they provide, licensed FAPs:

19.1 will be highly regulated as licensed providers of a financial advice service, supervised by the FMA;

19.2 must ensure that they, and the persons who provide regulated financial advice on their behalf, comply with the duties and obligations under Subpart 5A, Part 6 of the FMCA, which

relate to their conduct and are targeted at ensuring good customer outcomes, including (amongst other things):

(a) the duty to ensure that the client understands the nature and scope of advice when giving regulated financial advice to retail clients;

(b) the duty to give priority to client's interests; and

(c) the duty to comply with the Code when giving regulated financial advice to retail clients, which requires (amongst other things) that a person who gives financial advice must always treat clients fairly and must always act with integrity;

19.3 will have in place a range of policies, procedures and controls designed to support the giving of regulated financial advice, the provision of client money or property services (if applicable), and to ensure compliance the duties and obligations under the new financial advice regime; and

19.4 will be subject to the enforcement and liability regime under Part 8 of the FMCA (which includes civil liability for contraventions of duty provisions).

20 The new financial advice regime has been designed to ensure that customers achieve good outcomes and, integral to this, it seeks to ensure that customers are treated fairly and their interests prioritised. As the Minister of Commerce and Consumer Affairs, Hon. Kris Faafoi observed to the House of Representatives when speaking on the third reading of the Financial Services Legislation Amendment Bill: *"Financial advisers will be required to prioritise the customer interest, meaning their foremost consideration when recommending a product is how well it meets their customer's needs."*[1]

21 Therefore, requiring licensed FAPs to comply with the fair conduct principle with respect to their FMCA regulated activities would mean that licensed FAPs have to operate under two conduct regimes that effectively seek to achieve the same outcomes. In our view, this would result in licensed FAPs incurring unwarranted additional compliance costs; unnecessary because consumers will not obtain any apparent additional benefits from licensed FAPs being subject to the fair conduct principle with respect to their FMCA regulated activities.

22 The relief in the new section 446L for financial institutions from the requirement to ensure FAPs comply with their fair conduct programme was given in recognition that these FAPs would be under their license obligations. However, this relief does not go far enough: it does not exclude the fair conduct principle from applying to a licensed FAP's intermediary services under sections 446C or 446I, nor consolidate the requirements if a licensed FAP is also a financial institution.

23 While we think that the application of the fair conduct principle to licensed FAPs with respect to their FMCA regulated activities would be unnecessary regulatory duplication, we agree that:

23.1 the Bill's provisions with respect to the duties relating to incentives regulation should apply to licensed FAPs (subject to our submission below); and

23.2 licensed FAPs should be required to comply with a financial institution's fair conduct programme in respect of their non-licensed business activities (for example, claims handling, application processing, etc).

[1] https://www.goodreturns.co.nz/article/976514638/green-light-for-new-financial-advice-regime.html

24 Therefore, we submit that:

24.1 the fair conduct principle should not apply to licensed FAPs when they give regulated financial advice or providing client money or property services; and

24.2 the "intermediary" definition in section 446E should be amended to exclude licensed FAPs to the extent that they give regulated financial advice and provide client money or property services by:

(a) deleting section 446E(3)(c) of the Bill (which provides that "*a person is **involved** in the provision of a relevant service or an associated product if the person…gives regulated financial advice in relation to the product…*"); and/or

(b) amending section 446E(4) of the Bill to include a statutory exclusion for licensed FAPs in respect of the giving of regulated financial advice and the provision of client money or property services; and

24.3 in order for the duties relating to incentives regulation to apply to licensed FAPs, the term "financial advice provider" (as defined in the Financial Services Legislation Amendment Act 2019) should be used in the relevant sections applicable to incentives.

25 In the alternative, if the Select Committee does not wish to recommend the exclusion as we have suggested, we submit that it should consider inserting a provision that would allow for the fair conduct principle to apply to licensed FAPs by regulation after the two year transition period under the new financial advice regime has elapsed. Once this two year transition period has elapsed, and after experience of the financial advice reforms has been assessed, it will be possible to assess whether further conduct regulation should apply to licensed FAPs with respect to their FMCA regulated activities. The same delayed approach is being taken to other market service licensees under the FMCA who are not also registered banks, licensed insurers or NBDTs. This step would defer the regulatory burden of the introduction of two compliance regimes on the financial adviser sector at broadly the same time.

Section 446E(2) should be amended to exclude from the "intermediary" definition persons who are "engaged" by a financial institution or intermediary

26 The new section 446E(2) excludes a person from being regarded as an intermediary if the person is involved only as "an employee of a financial institution" or "an employee of an intermediary".

27 We understand that this exclusion is intended to ensure that "intermediaries" covers only entities, principals or sole traders.

28 However, section 446E(2) does not exclude persons who are contracted by the entities, principals or sole traders, but who are not employees. Under the new financial advice regime, a licensed FAP can engage persons directly as independent contractors to provide advice on their behalf or can engage such persons indirectly through one or more entities (referred to as "interposed persons" under the new financial advice regime). The new financial advice regime uses the concept of "engaged", which is defined in section 431E of the FMCA (as inserted by the Financial Services Legislation Amendment Act 2019).

29 As currently drafted, section 446E(2) could be read as meaning that such engaged persons will be regarded as intermediaries under the Act with all the obligations that attach to this status.

30 We submit therefore that section 446E(2) be amended to exclude persons who are directly or indirectly engaged by a financial institution, an intermediary or a licensed FAP. The meaning of "engaged" in section 431E of the FMCA could be used for this purpose.

31 Our suggested amendment:

31.1 will ensure the exclusion of financial advisers and nominated representatives from the "intermediary" definition, and

31.2 is consistent with our earlier submission that the "intermediary" definition should be amended to exclude licensed FAPs with respect to their FMCA regulated activities.

The definition of "involved" in section 446E(3) should be narrowed so in order to avoid unintended consequences

32 Section 446E(1)(a) provides that a person is an intermediary if the person is "involved in the provision of a relevant service or an associated product to a consumer". Section 446E(3) clarifies that a person is "involved in the provision of a relevant service or an associated product" if the person does any one or more of the following:

32.1 negotiates, solicits or procures a contract for the service or the acquisition of the product;

32.2 carries out other services that are preparatory to that contract being entered into;

32.3 gives regulated financial advice in relation to the product;

32.4 assists in administering or performing the service or the terms or conditions of the associated product.

33 Section 446E(3) shows that the meaning of term "involved" is very broad. That is confirmed by the example provided to illustrate the intended scope of section 446E(3):

> *A person (**W**) provides an Internet site that gives consumers information about 1 or more insurance contracts. Consumers are able to take steps towards entering into those contracts using the Internet site. W receives a fee from the insurer when a consumer enters into a contract using the Internet site.*
>
> *W is involved because W procured the contract. W is an intermediary.*

34 We do not think that a person detailed in the example should necessarily be regarded as being "involved". The example appears to cover a person who does nothing more than provide an online platform and the only "steps towards entering" the insurance contract involve the consumers clicking on the relevant page and being led to the insurers website to complete the insurance application. While we agree that the regime should be technologically neutral, so that it captures online distributors of financial products, we do not think that this is sufficient level of involvement that should bring the website provider within the conduct regime's scope.

35 This reinforces our concern that, as currently drafted, section 446E(3) may capture persons whose involvement is insignificant or passive and, accordingly, could result in the regime scope being too broad with accompanying unintended consequences. Accordingly, we submit that further consideration should be given to section 446E(3) with a view to drafting it in a manner that delineates with sufficient precision the level of involvement necessary in order to for a person to be regarded as an intermediary.

Section 446P (Meaning of incentive) should be changed to ensure policy decisions are appropriately reflected, and there are no unintended consequences

36 Section 446P defines the meaning of incentive and, in particular, it:

36.1 refers in section 446P(1) to "other incentive (whether monetary or non-monetary and whether direct or indirect)";

36.2 does not refer to "targets" in section 446P(1)(b); and

36.3 refers to "on a linear basis (that is, on a per service or per product basis) in section 446P(3).

37 As currently drafted, section 446P does not adequately give effect to the policy intention (a ban on volume or value based sales targets, as recorded in the Cabinet Paper (paragraphs 60 and 62), the Minister's public statements and the Bill's general policy statement).

38 The inclusion of words "on a linear basis", and the failure to refer to "targets", means that section 446P can be interpreted as meaning that commissions can no longer be calculated as a flat percentage of premiums, even if the criteria for being able to qualify to receive commissions is not itself based on targets for the volume/value of products sold.

39 This appears contrary to the Minister's unequivocal public statements to the effect that the restrictions would be limited to bonuses and other target-based incentives. It is also inconsistent with the clear indications in the Cabinet Paper, that the Cabinet was not authorising the drafting of a general power to regulate all commissions but rather a narrower power to ban target-based incentives and soft commissions:

39.1 The Minister states at [60] and [62] of his Cabinet paper, after referring principally to target based incentives at [59]:

> *"To address this problem, I propose to regulate incentives based on volume and value, and in particular, to prohibit incentives based on targets linked to sales value or volume, including soft commissions"…. [62] "The intention of this obligation is not to ban all commissions, but to remove particular incentive structures based on volume or value targets that create particularly perverse incentives to sell."*

39.2 In [63] of the Cabinet Paper, the Minister refers to a need to mitigate the risk of differing structures being used to avoid the target incentives restrictions and the ability to preserve the scope to regulate volume and value based incentives by banning some and regulating others.

40 The words "other incentive (whether monetary or non-monetary and whether direct or indirect)" can be interpreted as covering product training and systems assistance (financial or otherwise). We submit that the definition should be amended to exclude both of these from the scope of "other incentive", as they do not give rise to the mischief the incentive duties seek to address and their provision helps to support the new financial advice regime's broader purposes of ensuring customer receive quality financial advice services.

41 We submit that section 446P should be redrafted to better reflect that the Bill was intended only to ban target based incentives (including soft commissions) as outlined in the Cabinet Paper and was not intended to provide a generalised power to ban all incentives. We also submit that a transitional period is required so as to ensure that financial adviser businesses have sufficient opportunity to restructure their current commission structures to achieve compliance. Any

retrospective application of banning certain incentives arrangements without sufficient transition could result in financial adviser businesses becoming non-viable.