FINANCIAL SERVICES COUNCIL OF NZ INC

Submission

to

COMMERCE SELECT COMMITTEE

on the

Financial Markets Conduct Bill

26 April 2012

Financial Services Council

Criteria for assessment of regulation

1. *Regulation should be used only to address an identified problem that cannot be solved by other means.*

2. *Regulation should be developed in consultation with those expected to benefit from it as well as those expected to be subject to it and the benefits of regulation should exceed its costs and provide the lowest cost solution from suitable options.*

3. *Regulation should be based on a reasonable assessment of the capability of consumers and providers to use and understand it. In other words, on what they are realistically likely to know and be able to do rather than what they might ideally know.*

4. *Regulation should not impede innovation or competition.*

5. *Regulation should be able to provide a predictable outcome and, where possible, should draw on other existing regimes (including those in other jurisdictions) that have been shown to be efficient and effective.*

6. *A regulatory impact statement should be prepared before the decision to enact the regulatory regime in order to avoid unintended adverse consequences.*

7. *Regulation should be the subject of both regular review and evaluation.*

Financial Services Council of NZ Inc.

1.0 Introduction

1.1 The Financial Services Council - ("FSC") (previously the Investment Savings and Insurance Association - "ISI") is the industry association for the companies that issue and manage life insurance, superannuation and managed funds in New Zealand. FSC members are responsible for approximately $67 billion funds under management. FSC members are also the leading providers of KiwiSaver funds and include the default providers.

A list of members is attached.

1.2 The rewrite of securities law is a significant event with major consequences for the strength and confidence of savers, investors and providers of securities and investment products. It is the remaining significant area of reform of the regulation of financial services, started in 2006, which has included regulation of financial advisers, prudential supervision, consumer dispute resolution, registration of financial service providers and the establishment of the FMA.

1.3 As we know, New Zealand households' poor savings record leaves the country uncomfortably exposed to the adverse outcomes of international financial imbalances. That household savers and investors' confidence in domestic financial markets has been severely dented by the collapse of the finance company sector due in significant part to the ineffective governance and lack of transparency of financial products illustrates the national importance of efficient and effective securities markets regulation.

1.4 We welcome the opportunity to comment on the Financial Markets Conduct Bill ("the Bill"). Last year the FSC and a number of FSC members took the opportunity to comment to the Ministry of Economic Development on the draft Bill released by MED. We appreciated the opportunity to comment on the draft Bill in such a significant and complex area of financial services regulation. We appreciate that a number of our comments have been reflected in the Bill.

2.0 General Comments

2.1 The FSC supports the rewriting of the securities legislation to create a coherent regulatory regime, replacing the sometimes confusing provisions of the Securities Act, Securities Markets Act, Unit Trusts Act, Superannuation Schemes Act, Securities Transfer Act and parts of the KiwiSaver Act.

2.2 The FSC supports the main purposes of:

- Promoting the confident and informed participation of businesses, investors and consumers in the financial markets; and
- Promoting and facilitating the development of fair, efficient and transparent financial markets.

2.3 The FSC supports the general policy direction of the Bill, in particular:

- the commitment to concise and clear product disclosure that supports consumer financial literacy through the product disclosure statement or PDS;
- the categorisation of financial products into debt, equity, managed investment schemes and derivatives; consistent regulation of managed investment schemes regardless of legal form;
- the duties and standards expected of managers and supervisors in Part 4; and
- the governance of financial product markets and behaviour in Part 5.

3. Summary of main concerns

3.1 We note that much of the detail of the new regime will be set out in regulations that will be drafted once the Bill is enacted and the content of these regulations will have a major impact on the workability of the legislation. Given the potential volume of regulations, we strongly recommend that regulation development is prioritised to those areas necessary for the operation of the Act and that consultation on the content of the regulations and the implementation plan is open and allows sufficient time for detailed input and implementation.

3.2 While we generally support effective intervention and enforcement powers of the FMA in Part 7 we have some concerns over the lack of restriction on those powers. While the FSC agrees that the FMA needs broad powers of intervention in financial markets to address exceptional market circumstances, there is a natural tension between these powers, their exercise and affected parties' right to be heard – it cannot be assumed that an FMA position on an issue will always be fully informed, proportional or inarguable. In particular, section 460 should be deleted and there needs to be a formal right of appeal against the FMA's designation powers under section 533.

3.3 We do not support separating the licensing of class Discretionary Investment Management Service (DIMS) providers from the regulation of other DIMS providers under the Financial Advisers Act. The same financial advisers will typically provide class and personalised DIMS and potentially require two licences. The proposals are complicated, will lead to complicated adviser disclosure and the two Acts will need to be coordinated as investment adviser disclosure evolves. All DIMS need to be regulated under the Financial Advisers Act.

3.4 We have a wider concern that the proliferation of licensing requirements that has arisen from the various parts of the overhaul of financial services regulation is leading to unnecessary compliance costs where the same entities provide a number of regulated services. While, throughout the Review of Financial Products and Providers and subsequent regulatory development, the FSC has supported the supervisory model for managed investment schemes and the twin peaks prudential supervision / market conduct approach, there needs to be greater recognition of the supervisory regime to mitigate the undeniable increases in costs that such a structure imposes.

3.5 Managed investment schemes are developed, after considerable initial and often ongoing investment by the scheme manager, to be offered to investors on a commercial fee basis. We are concerned that, without qualification, paragraphs 169(1)(a) and (b) could, for example, allow another manager to 'take over' an MIS by offering members a substantially lower fee because the new manager has not contributed the development costs. This could act as a powerful disincentive to

potential providers taking the financial risk in establishing managed investment schemes and limit financial product innovation.

The supervisor should also be required to consider the reasonable commercial interests of the present manager before making a direction under paragraph 169(1)(a) and a resolution under paragraph (b) should only be effective if supported by the supervisor having considered the reasonable commercial interests of the present manager.

3.6 Managed investment schemes operate in a changing commercial, regulatory and tax environment. A registered scheme's governing document requirements for coverage of fees under section 122 should clearly allow for their change with the basis of potential change disclosed to participants.

3.7 Our remaining submission points are more technical drafting ones.

Section Number	Section heading	Submission
Part 1	**Preliminary provisions**	
Section 8	Definition of debt security	To consistently refer to the 4 kinds of financial product in this clause, paragraph(1)(c)(iii) should simply refer to a managed investment product rather than a registered scheme. A managed investment product may not be a registered scheme which means that it may be debt security leading to ambiguity (e.g. if the scheme has to be registered at some point in the future).
Section 9	Definition of 'managed investment scheme'	The definition of managed investment scheme uses the undefined term 'scheme'. Given the importance of the scope of the term in the interpretation of the Bill it would be useful to define 'scheme' more clearly if only to establish its broad scope. For example, an insurance policy is part of a scheme (hence the exclusion under paragraphs 9(2)(c) and (d)). 'Scheme' is defined in the Financial Advisers (Definitions, Voluntary Authorisation, Prescribed Entities, and Exemptions) Regulations 2011 as 'any agreement, arrangement, or understanding (whether express or implied), whether or not legally enforceable, and irrespective of substance or form.'
Part 2	**Misleading or deceptive conduct**	
Section 23	Defence for reasonable reliance on information supplied by another person	Given the potential liabilities under the act, particularly for directors, it would be extremely helpful in due course for the FMA to provide guidance on what is 'reasonable reliance' under subsection 23(1). (Similarly with sections 479 and 486.)
Part 4	**Governance of financial products**	
Section 115	Additional initial and ongoing registration requirements for superannuation schemes	The scheme membership eligibility criteria, in particular the New Zealand criteria, are significantly more restrictive than those under the Superannuation Schemes Act. Section 115 should be clear in not preventing existing superannuation schemes from meeting the requirements of section 115 because existing members do not meet the eligibility criteria in that section (note that, by section 120, the requirements of section 115 are ongoing). The wording in paragraph 115(1)(c) has changed from the consultation draft of the Bill by changing 'restrict participation' to 'admit as members'. However, we submit that a prospective application only of this condition is still not completely clear. For complete clarity, sub-section 115(2) should have an additional paragraph that includes 'members of the superannuation scheme at the commencement of this section'.
Section 122	Contents of governing document for registered	Paragraph 122(1)(f) requires the governing document of a registered scheme to 'provide adequately for' the fees that can

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	scheme	be paid, including the fee basis. As a scheme manager cannot know for certain the future costs of administering a scheme or investing scheme assets (e.g. regulatory, tax or investment management fee changes), there needs to be ability for a manager to change fees. If the governing document is very prescriptive, then the FMA will need to approve fee increases as a fee increase will, prima facie, have a material adverse effect on scheme participants in terms of section 126. This outcome would represent a significant regulator intervention in a competitive commercial market (compare the KiwiSaver Act's coverage of unreasonable fees.) It is not clear in paragraph 122(1)(f) whether 'fee basis' would include the ability to change fees. The use of words 'can be paid' and 'determined' would suggest not. A perverse outcome would be for the fee basis in a governing document to provide a range within which fees could be charged to cater for contingencies. This would give the scheme participant less certainty. It would be preferable for the participant to have clarity of the present fee structure, whether those fees can be changed and, if they are, a requirement to be advised of the new fees. There needs to be greater clarity in subsection 122(1)(f) on what constitutes a fee basis. If the outcome is that the FMA has effective power to approve fee increases under section 126, then there would need to be much more guidance in the Bill for how the FMA would exercise that power and the ability to appeal or review the FMA's decision.
Section 155	Actuarial examination of a defined benefit scheme or a life benefit scheme	As a managed investment scheme may involve insurance-like schemes, the requirement for an actuarial examination of a life benefit scheme should not duplicate or overlap requirements under the Insurance (Prudential Supervision) Act on the basis that oversight by the Reserve Bank is sufficient. A life benefit scheme should therefore exclude a scheme that is subject to the Insurance (Prudential Supervision) Act.
Section 161	Additional restrictions on related party transactions of restricted schemes	Arms-length terms covered in sub-section 160(a) should be permitted in subsection 161(2)(a) (e.g. where a restricted scheme is provided by a financial services company).
Section 169	Removal of manager of registered scheme	Managed investment schemes are developed, after considerable initial and often ongoing investment by the scheme manager, to be offered to investors on a commercial fee basis. We are concerned that, without qualification, paragraphs 169(1)(a) and (b) could, for example, allow another manager to 'take over' an MIS by offering members a substantially lower fee because the new manager has not contributed the development costs. This could act as a powerful disincentive to potential providers taking

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		the financial risk in establishing managed investment schemes and limit financial product innovation. The supervisor should also be required to consider the reasonable commercial interests of the present manager before making a direction under paragraph 169(1)(a) and a resolution under paragraph (b) should only be effective if supported by the supervisor having considered the reasonable commercial interests of, and compensation to the present manager.
Section 193	Power of court to appoint a new manager, etc	There is no direction under this section as to what factors the court should take into account when considering whether to replace a manager. The court should be required to at least consider the interests of members, the reasonable commercial interests of the present manager, quality of scheme management, financial strength and character, experience and qualifications of key staff.
Part 6	**Licensing**	
		As noted in Section 3 of this submission, FSC is concerned that the proliferation of licensing requirements that has arisen from the various parts of the overhaul of financial services regulation is leading to unnecessary compliance costs where the same entities provide a number of regulated services As licensing requirements arise under a number of Acts and to avoid duplication and streamline processing (e.g. fit and proper person requirements for the same directors), the FMA and Reserve Bank should investigate the development of a licensing 'portal' from which all licensing requirements are maintained and coordinated.
Section 387	When provider of market services must be licensed	In the interests of consistency and simplicity of interpretation, the regulation of all discretionary investment management services (DIMS) should be covered in the Financial Advisers Act. The skills that the provider of a DIMS service would be expected to have are those of an investment adviser with the additional authority from the client to buy and sell investments within the client's mandate. The conduct and skill requirements for Authorised Financial Advisers are covered in the Financial Advisers Act and the Code of Professional Conduct for Authorised Financial Advisers. The broker requirements for handling client money that necessarily come with providing a DIMS service are also covered by the Financial Advisers Act. The same financial advisers will typically be providing personalised DIMS as well a class DIMS service where clients are offered standard, model portfolios as a less tailored and lower cost diversified investment option for those clients. Such a financial adviser would be required by the changes to section 19 of the FAA to have DIMS Licence under the FMCA as well as being an AFA under the FAA. The proposed structure also leads to

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		potential inconsistencies in who is giving the DIMS service. The FMCA allows for a corporate entity to be a class DIMS licensee, whereas a personalised DIMS for investment products can only be provided by an individual AFA (or a QFE). This is likely to further complicate customer disclosure – something that should be avoided in an inherently complicated financial services industry. We would expect that the Code of Professional Conduct under the FAA will develop with time with more specialised skill standards that are tailored to types of financial products. Of course changed skill demands would need to be coordinated between the two Acts – a further complication. Splitting the regulation of DIMS between the two acts also leads to cross referencing further complicating interpretation – e.g. sections 387, 424, 443.
Section 387(2)	Exemptions from licensing	An insurance company or registered bank may be a manager of a registered scheme. To avoid duplication of licensing requirements, the exemptions in clause 387(2) should extend to persons that are required either to have a licence under the Insurance (Prudential Supervision) Act or to be registered under the Reserve Bank of New Zealand Act.
Section 395	Procedural requirements	To reduce compliance costs arising from having to make multiple licence applications this section should also require the FMA to have regard to whether the applicant is an AFA or RFA under the Financial Advisers Act or is licensed under the Insurance (Prudential Supervision) Act. Subsection 395(1) should also require the FMA to have regard to whether the applicant is an exempt provider in terms of the Financial Advisers Act.
Part 7	**Enforcement, liability and appeals**	
Section 460	General provisions on FMA's orders	Subsection (1) gives the FMA apparently unrestricted powers to 'make an order under this Act on the terms and conditions that the FMA thinks fit'. It is not clear how these wide powers interact with the constrained terms or conditions in other sections of this subpart (e.g. sections 454, 456, 457). While the FSC agrees that the FMA needs broad powers of intervention in financial markets to address exceptional market circumstances, there is a natural tension between these powers, their exercise and affected parties' right to be heard – it cannot be assumed that an FMA position on an issue will always be fully informed, proportional or inarguable. Section 460 should be deleted with other empowering sections setting out more prescriptively the terms and conditions of the FMA's intervention, particularly affected parties' rights to be heard and right of appeal (e.g. section 457)

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Part 8	**Regulations and exemptions**	
Subpart 1	Regulations	As noted in section 3 of this submission, FSC is concerned that the substantive operational requirements of this legislation is from regulations to be enacted under the primary act, with no provisions to make draft regulations open to public consultation as there are for primary legislation. Given the potential volume of regulations, we strongly recommend that regulation development is prioritised to those areas necessary for the operation of the Act and that consultation on the content of the regulations is open and allows sufficient time for detailed input. We also strongly recommend that, following consultation on the prescribed matters, regulations are issued in a timely manner allowing providers sufficient time for implementation. Also, given the extensive use of regulation making powers throughout the Bill, we recommend that the scope of the regulation power in this Bill should be reviewed to determine whether the requirement may be better specified in the Act.
Section 533	FMA may designate financial products and offers	Given the potential impact of a designation change on the issuer, there needs to be provision for review or appeal of an FMA decision. The absence of rights of appeal against the potentially significant consequences of a designation decision by the FMA under section 533 is inconsistent with the rights of appeal on licence conditions decisions under section 507.
Part 9	**Repeals, amendments and transitional provisions**	
Section 574	Who is permitted to provide personalised service to retail clients	While we do not support the licensing of DIMS providers under this Bill, the new subsection (1A)(a) should have the words 'if the investment mandate is unlimited or' deleted. A 'limited' investment mandate is generally understood to be one where the DIMS provider has authority to trade within limits. This is the sense in which it is used in section 435 – i.e. limits within a class of investment. (Section 436 then provides for what actions need to be taken on the breach of a limit break.) The important point in section 574 is simply whether the investment mandate covers category 1 products and 'unlimited' appears to be being used in a different sense from the rest of the Bill. Reference to 'unlimited' should therefore be deleted.
Section 575	Who is permitted to provide class service to retail clients	The new subsection (2)(a) should have the words 'if the investment mandate is unlimited or' deleted. See the comments on Section 574 above.
Subpart 8	Transitional provisions for	We support the transitional framework in this subpart.

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	offers of financial products	We note that, for the transitional period to be effective, relevant regulations, particularly disclosure regulations, need to be finalised before the transition period commences and the commencement dates of relevant sections set accordingly.
Section 676	All offers and allotments under old law must cease	Section 676 appears to defeat the transitional provisions in sections 670 to 675. Section 676 prohibits offers or allotments under the former enactments once a scheme becomes a registered scheme. However, there is no relief in Part 4 from the registration requirement in the transition period. Subpart 9 of Part 9 provides for previous enactments to apply to offers including in the transitional period but this does not appear to overcome the lack of specific relief from registration in the transition period. Section 676 should be reworded to read as follows: (1) Despite the registration requirements of Subpart 3 of Part 4, a managed investment scheme is not required to register in the period under which former enactments apply under this subpart. (2) No offer or allotment of managed investment products may be made under the former enactments after the date on which the managed investment scheme to which the products relate becomes a registered scheme (or is treated as being a registered scheme under subpart 9).

List of FSC Members

FSC MEMBERS

Accident Compensation Corporation
AIA NZ
AMP Financial Services
Asteron Life Ltd
BNZ Investments and Insurance
CIGNA Life Insurance NZ Ltd
Dorchester Life
Fidelity Life Assurance Co Ltd
FNZ
Gen Re LifeHealth
Hannover Life Re of Australasia Ltd
Kiwibank Ltd
Mercer
Munich Reinsurance Co of Australasia Ltd
OnePath New Zealand Ltd
Pinnacle Life
Public Trust
RGA Reinsurance Co. of Australia Ltd
Sovereign Ltd
Swiss Re Life & Health Australia Ltd
TOWER New Zealand
Westpac/ BT Funds Management Ltd

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Davies Financial & Actuarial Ltd
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