BELL GULLY

By email FinancialConduct@mbie.govt.nz

Ministry of Business, Innovation and Employment

FROM **Glenn Joblin / David Friar**
DDI Privacy of natural persons
MOBILE
EMAIL
EMAIL

DATE 10 June 2019

Submission in response to Conduct of Financial Institutions Options Paper (April 2019)

This submission has been prepared by Bell Gully in response to MBIE's April 2019 Conduct of Financial Institutions Options Paper (the **Options Paper**).

We are a leading New Zealand law firm with significant expertise and experience in the law relating to financial markets, and we welcome the opportunity to make submissions on the Options Paper.

We acknowledge that the Options Paper proposes a principles-based system, comprising overarching conduct duties and detailed guidance for conveying and enforcing regulatory expectations for financial institutions. The adoption of such a model would represent a significant shift in the existing approach to conduct regulation in New Zealand. As such, in order for the changes to be effective and introduced in an efficient manner, it will be important that MBIE and relevant regulators provide detailed guidance on the parameters and substance of any proposed regime, meaningful opportunities to provide industry input, and sufficient time to adjust to any new requirements.

We set out our views on the specific questions posed in the Options Paper in the attached schedule.

The views expressed in this submission are those of members of our firm involved in the review of the Options Paper: Glenn Joblin, David Friar, Katie Dow, Blair Keown and Gabriella Garcia. They do not necessarily represent the views of our clients.

We look forward to continued opportunities to comment on the detail of the proposed reforms as MBIE's thinking develops.

Yours faithfully
Bell Gully

Bell Gully

Glenn Joblin / David Friar
Partner / Partner

Options for overarching duties

Question 1
Which overarching duties should and should not be included in the regime? Are there other duties that should be considered? In particular: Do you agree with the pros and cons of each duty? Do you have any estimates of the size of the costs and benefits of these options? Are there other impacts that are not identified?

Bell Gully's general comments

In our view, a principles-based approach, which comprises a clearly defined set of overarching duties that are complemented by specific prescriptive requirements and/or detailed regulatory guidance, can convey and enforce regulatory expectations of good conduct. A similar approach has been applied to the United Kingdom's financial sector for a number of years. Although it is not without limitations, it has provided a workable framework for regulators and regulated persons.

The adoption of a principles-based approach would be a significant change to the regulation of New Zealand's finance sector. As MBIE has itself acknowledged, such a change would not have the benefit of the extensive public inquiries that informed similar regulatory reform in the United Kingdom and Australia. This raises a degree of uncertainty as to the specific conduct risks that any regulatory reform (and specifically principles-based regulation) would seek to address. Principles-based regulation is inherently uncertain. It places the burden of complying with uncertain requirements on the regulated population. MBIE's suggestion that any overarching duties will apply to all aspects of a financial institution's activities may exacerbate this uncertainty (as employees who have been unfamiliar with any form of regulation endeavour to comply with new regulatory requirements).

In our view, these matters underline the importance of MBIE obtaining meaningful industry input into the contours and substance of any new regulatory regime before formulating policy.

One way of facilitating that input would be for staged consultation to take place over the remainder of this year, following MBIE's review of the initial submissions.

Information from those submissions could be used to develop the details of a conduct regulation regime, delivering clarity around principles, guidance and any other specific rules on what those subject to the regime can and cannot do. That could be published for consultation, delivering a second round of design-focused submissions to inform the formulation of a near final conduct regulation regime. The substance of this near final regime would provide a more reliable basis for assessing how any new regime could be introduced in light of existing regulations and laws.

The coherency of any principles-based regime also requires clarity on the parameters of each principle and the avoidance, as far as possible, of overlap between them. For example, company directors are already required to act in the best interests of the company. To the extent that any new overarching duties conflict or overlap with these existing obligations, this should be clearly acknowledged and a coherent mechanism or hierarchy developed to resolve any incompatibility.

In our view, a preferred starting point would be to identify a limited number of overarching duties that could form the initial basis of principles-based regulation in New Zealand. Those duties could be supplemented by detailed guidance to be published and consulted on alongside the overarching duties. We set out our proposals on the content of such guidance in response to Question 3. We consider that the six duties proposed in the Options Paper could be consolidated into three

overarching duties, with the remaining overarching duties being included in detailed guidance as specific applications of the three general duties.

Given the technical nature of these regulatory requirements and the likelihood that they will be unfamiliar to the regulated population, we consider that they should only be enforceable by a regulator and not, for example, actionable by private persons.

Proposed options

We consider that a duty in the spirit of **Option 1** could form the basis of an overarching duty for a principles-based framework. However, in our view, a duty to "prioritise the customer's interest" is likely to be unworkable in practice. Such a formulation suggests a duty that is fiduciary in substance as between the financial institution and the customer. If so, that would conflict with established and longstanding obligations that arise under existing areas of the law (including company law, directors' duties and prudential regulation). That could give rise to ongoing disputes as to what principles take precedence in any given situation. We submit that a more appropriate formulation would be "a duty to have regard for customers' interests". We do not consider the concept "to the extent reasonably practicable" is necessary if the duty is formulated in this way.

We submit that **Option 2** could also usefully form an overarching duty for a principles-based framework.

In addition, we submit that "a duty to act with integrity" could be a useful, appropriate and workable third overarching duty to complete the broad framework. Such a duty would mirror Principle 1 of the UK Financial Conduct Authority's principles for business. Acting with integrity is an essential obligation which carries with it numerous aspects of good conduct.

We consider that **Options 3 to 6** are much more specific than Options 1 and 2. They may give rise to inconsistency with and potentially undermine the benefits of an overarching, broad duties approach. The spirit of these duties can be accommodated within the three overarching duties we have proposed. We suggest that Options 3 to 6 would much more appropriately be included as specific instances of how the overarching duties could be complied with in accompanying detailed guidance.

Question 2
Do you think the overarching duty for managing conflicts of interest should be general (as it is currently worded) or focus on conflicts of interest that arise through remuneration? What are some examples of conflicts of interest that arise outside of conflicted remuneration and incentives?

Given our suggested approach set out above in response to Question 1, we consider that a duty relating to the management of conflicts of interest could be best characterised as a specific incident of one of the overarching duties and form part of the detailed guidance referred to in response to question 3 below. Addressing a duty to manage conflicts in this way would allow the regulators to address both general conflicts of interest, as well as conflicts in relation to remuneration, without overlap or potential inconsistency with any overarching duties.

If the legislation is to impose an overarching duty for managing conflicts of interest, it should be general in nature. It is not clear what is meant by "transparently" in this context. We agree with the comment in the Options Paper that this concept could create uncertainty.

Any guidance on remuneration conflicts of interest should be carefully considered against existing regulation and in particular the remuneration disclosure regimes under the Financial Services Legislation Amendment Act 2019 (**FSLAA**).

Question 3
Is a code of practice required to provide greater certainty about what each overarching duty means in practice?

Consistent with our general comments above, we consider that guidance is required to provide greater certainty about what each overarching duty means in practice. That guidance could take the form of policy statements issued by the responsible regulator, a code of practice and/or a detailed regulatory handbook.

In our view, it may not be constructive to develop any specific guidance in isolation from the principles themselves (and vice versa). We therefore suggest that the basic detail of any guidance is published, consulted on and developed alongside the principles.

Options to improve product design

Question 4
Which options for improving product design do you prefer and why? In particular: Do you agree with the pros and cons of the options? Are there other impacts that are not identified? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of the options?

In our view, while improving product design may prevent low-value policies from reaching the market, the best way to ensure that customers only purchase products or use services that are of value to them is to ensure that customers are receiving clear and useful disclosure and advice in relation to those products and services. In light of this, and the fact that these safeguards will only be strengthened by the proposals elsewhere in the Options Paper, we submit that it is not necessary to regulate product design directly by giving the regulator the power to ban or stop the distribution of products. This would be a blunt instrument and effectively mean that other controls (such as disclosure and advice regimes) have failed to adequately protect consumers in relation to the banned products. We also agree that it would be difficult to define exactly which products a ban covers, which would undermine the effectiveness of any power to ban products.

For the reasons set out above, we submit that Option 3 is also not necessary. In practical terms, it is difficult to see how the first limb of Option 3 (requirement for manufacturers to identify intended audience for products) could feasibly apply generically across all financial services products.

For example, there are many insurance products such as health insurance and travel insurance that do not typically have an "intended audience". These products are generally aimed at a broad range of consumers, with specificity created through exclusions or higher premiums for increased cover. In such situations, the intended audience identified by the manufacturer would be so broad as to provide no assistance to consumers whatsoever, at greater cost to the industry (and ultimately consumers).

We also consider that the second limb of Option 3 (requirement for distributors to have regard to the intended audience when placing the product) would be adequately addressed by the overarching duties framework proposed in response to Question 1 above, as well as current regulations including the duties of financial advisers under the FSLAA.

Question 5
If a design and distribution requirement like option 3 were chosen, are there particular products for which this is more necessary than others? If so, please explain what and why.

For the reasons set out above in response to Question 4, we do not consider that Option 3 would be appropriate for standard products such as health, travel or general insurance. We understand that Option 3 is likely intended to address so-called "junk" insurance products, as identified by the Australian Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. It is necessary to carefully consider whether Option 3 is the best way to address such products, given the potential unsuitability to apply such a policy generically (as outlined above).

Options to improve product distribution

Question 6
Which options to improve product distribution do you prefer and why? In particular: Do you agree with the pros and cons of the options? Are there other impacts that are not identified – such as unintended consequences or impacts on particular business models? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of the options?

We submit that a principles-based, overarching duties regime (as described in our response to Question 1 above) would adequately address regulation of product distribution. A duty such as that described in Option 1 would naturally fall under the proposed overarching duties, and could be developed and described in a supporting code of practice.

However, we submit that a standard of "likely to promote good customer outcomes" is unworkable in practice. We consider that it would be difficult to adequately determine the scope of such a standard without either being too vague and unclear or being overly prescriptive. The notion of "good customer outcomes" is too subjective when imposed in legalisation. It is also unclear what standard would be required to be achieved in order to be "likely to promote good customer outcomes". It is more effective to deal with this issue through a general overarching duty. In addition to being at odds with a principles-based regime, an overly prescriptive standard may lead to issues with maintaining competitiveness within the market, if all industry participants are restricted to adherence with prescriptive requirements in the same manner.

We submit that Options 2, 3 and 4 are unnecessary if a principles-based, overarching duties regime is imposed, and given the obligations and duties of financial advisers that exist under the FSLAA and the associated Code of Conduct.

We submit that Option 5 would be unnecessary if a duty similar to Option 1 is incorporated underneath an overarching duties regime. Additionally, we consider that an effective and appropriate duty along the lines of the proposed Option 5 would be difficult to apply in practice. We

consider there would be issues with both the interplay with existing duties that rest directly on advisers and what constitutes appropriate monitoring and feedback, which is relatively subjective. In our view, Option 5 is too vague – the phrase "ensure the sale of its products are likely to lead to good customer outcomes" is not a standard which financial services companies can implement with certainty.

Question 7
To assist us in comparing the pros and cons of various options, please provide information about remuneration and commission structures currently in use. In particular: What are common structures, average amounts of remuneration/commissions, qualifying criteria etc.?

We have no comments on question 7.

Options relating specifically to insurance claims

Question 8
What is your feedback on imposing a duty to ensure claims handling is fair, timely and transparent? In particular: Do you agree with the pros and cons? Are there other impacts that are not identified? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of this option?

As an initial step, we submit that it is important to carefully analyse whether there are material industry-wide issues in relations to claims handling. While we acknowledge the examples provided in the options paper in relation to the handling of property insurance claims arising from the Christchurch earthquakes, it is critical that MBIE seeks context from the insurers involved in the handling of those claims. The Christchurch earthquakes involved an extraordinary number of claims, involving complex issues and multiple organisations including EQC. We would also observe that a review of the Christchurch earthquake cases in the High Court shows that, out of many dozens of cases, there has only been one successful claim in respect of an insurer's claims handling (and even then the general damages awarded was low). This suggests that there may be no systemic issue. We submit that a detailed analysis of whether there are industry-wide issues is required before additional obligations or costs are imposed on insurers in relation to claims handling.

In any event, the most effective and appropriate way of addressing this question would be as part of the Insurance Contract Law Review, rather than as part of the Conduct Review.

Question 9
If a duty to ensure claims handling is fair, timely and transparent were to be adopted, should an attempt be made to clarify what fair, timely and transparent mean? In particular: Why? Why not? What are the benefits and costs of doing so?

As set out in our answer to Question 8 above, we submit that the options in relation to insurance claims are best considered in the context of the Insurance Contract Law Review, as any codification of such a duty will require careful consideration and analysis.

We understand that the terms "fair, timely and transparent" are likely to have been selected to mirror the decision in *Young v Tower* [2016] NZHC 2956, where Gendall J held that an implied duty of good faith in insurance contracts required insurers to "act reasonably, fairly and transparently" and to "process the claim in a reasonable time". The test in the *Young* decision has yet to be tested by the higher courts.

In our view, the terms "fair, timely and transparent" are vague and likely to create uncertainty. However, if these terms are developed further, there is a real risk that the regulations will become overly prescriptive and unsuited to the myriad of circumstances in which claims arise.

Question 10
What is your feedback on requiring the settlement of claims within a set time? In particular: Are there other impacts that are not identified? How do you think that exceptions should be designed? Should there be different time requirements for different types of insurance? Do you have any estimates of the size of the costs and benefits of this option?

In our view, it is important to carefully consider whether there is a material industry-wide issue which needs to be addressed, as discussed above in our response to Question 8.

In our view, it would not be appropriate to require the settlement of claims within an arbitrary set time, both because such a requirement is inconsistent with an otherwise principles-based approach to regulation, and because it is difficult to formulate an effective prescriptive approach to this issue.

As identified in the Options Paper, situations will arise where a claim is legitimately "complex and takes a long time to settle", even outside obvious contexts such as natural disaster responses. Accordingly, we submit it would be very difficult to design an appropriate and effective regime to prescriptively regulate the settlement of claims within a set time.

Further, although the Options Paper identifies that this option would dis-incentivise delays in claims handling by insurers (backed up with consequences for breaching the time limit), the corollary to this (not discussed in the Options Paper) is that insureds may be incentivised to delay the settlement of their claim initially, in order to leverage settlement as the claim approaches the time limit and the insurer is under pressure to avoid breaching the time-limit requirement.

Options for tools to ensure compliance

Question 11
Do you agree with the option to empower and resource the FMA to monitor and enforce compliance? In particular: Do you agree with the pros and cons? Are there other impacts that are not identified? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of the options?

We agree that the FMA would be the most appropriate regulator to supervise and enforce a conduct regime for financial institutions, and that it should be appropriately empowered and resourced to do so.

In our view, the FMA's role under a new principles-based regime should include the publication of policy statements or similar guidance that conveys the regulator's expectations in relation to specific principles or situations. The provision of this guidance will be particularly important in the early stages of any new regime as industry participants adjust to new requirements.

Question 12
What is your feedback on the option to require banks and insurers to obtain a conduct licence? In particular: Do you agree with the pros and cons? Are there other impacts that are not identified? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of the options?

In our view, requiring banks and insurers to obtain a conduct licence may be of limited benefit overall, and would come at a high cost (initial and ongoing) for both the industry and the regulator. These costs may ultimately flow through to consumers.

We submit that the resulting benefit may not reflect this significant additional cost. Banks and insurers are already subject to respective prudential Reserve Bank registration and licencing regimes. As identified in the Options Paper, a dual licencing regime is likely to result in duplication of effort for financial institutions and regulators. In our view, this effort would be significant.

Additionally, we submit that in the context of the recent FMA and RBNZ review of the life insurance industry, the FSLAA, the Financial Services Council's Code of Conduct and the Options Paper, the introduction of an entity licencing regime is not urgently warranted.

Finally, in respect of established financial institutions, most of the pros of this option as identified in the Options Paper would also be achieved by the introduction of any new conduct regime (such as a principles-based regime with overarching duties as proposed in our response to Question 1), along with engagement by the regulator with the industry at the time of introduction to ensure a smooth implementation.

Question 13
What is your feedback on the option which discusses a broad range of regulatory tools? In particular: Do you agree with the pros and cons? Are there other impacts that are not identified? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of the options?

In principle, it is appropriate for the regulator to have a broad range of regulatory tools to enforce a conduct regime. It is also important that the regulator provides clear guidance as to the circumstances in which a given tool will be used. If a principles-based conduct regime is implemented, the FMA's regulatory response criteria will need to be updated to address the expanded and varied circumstances in which regulatory breaches could arise and the FMA's regulatory tools could be deployed. It should also be made clear that any such regulatory breaches shall only be enforceable by a regulator and not, for example, actionable by private persons.

Question 14
Do you think that the maximum pecuniary penalties available for breaches of any conduct duties should be the same as the existing FMC Act penalties? In particular: Is there a case for making the penalties higher?

We do not see any reason why the maximum pecuniary penalties for breaches of a new principles-based regime should exceed those available under the FMC Act. The maximum penalties available under the FMC Act apply to contraventions that include market manipulation, insider dealing and other conduct that damages the integrity of New Zealand's financial markets. In our view, it would be anomalous if breaches of generally defined overarching conduct duties (which could encompass a wide range of conduct) attracted higher penalties.

There is likely to be a wide range of circumstances in which a breach of any given overarching duty could arise. In order to ensure consistency of penalties and that like cases are treated alike, the responsible regulator could develop penalty guidance which clearly sets out the approach that it will adopt to calculating the penalty whether in a settlement context or in submissions to the Court as to an appropriate pecuniary penalty. The UK Financial Conduct Authority's Decision Procedure and Penalty (**DEPP**) manual provides one example of what this guidance could look like. It contains a five-step framework within which the Financial Conduct Authority will determine an appropriate penalty. This involves:

- the removal of any financial benefit derived directly from the breach;
- the determination of a figure which reflects the seriousness of the breach;
- an adjustment made to take account of any aggravating and mitigating circumstances;
- an upwards adjustment made to the amount arrived at after steps 2 and 3, where appropriate, to ensure that the penalty has an appropriate deterrent effect; and
- the application of a settlement discount, if applicable.

Question 15
What is your feedback on the option of executive accountability? In particular: Do you agree with the pros and cons? Are there other impacts that are not identified? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of the options?

In our view, it would be premature to introduce an executive accountability regime before a new principles-based conduct regime has been formulated and/or has had time to be applied in practice. Doing so would subject executives (however that term might be defined) to personal liability for breaches of unfamiliar regulatory requirements. Those requirements may, depending on the specific principles adopted, differ materially from the legal obligations under which they have traditionally operated. It is also unclear, at this stage, whether and, if so, why executive accountability is required in New Zealand. As MBIE acknowledges, New Zealand has not had an extensive public inquiry that has identified systemic misconduct and a need for greater accountability of senior management beyond their existing duties.

Developing an appropriate executive accountability regime is a complicated process. We do not believe the liability regime for disclosure breaches of the Financial Markets Conduct Act 2013 is directly analogous to issues under consideration in the Options Paper. It will be important that any executive accountability regime reflects global thinking on the topic, rather than carry over an existing regime dealing with financial product disclosure.

In our view, any new conduct regime should be allowed to run its course for a reasonable period of time before proposals for executive accountability are published, consulted on and, if appropriate, adopted. A similar path has been followed overseas. For example, the UK Senior Managers Regime was implemented in March 2016. By that time, principles-based regulation had been operating under the oversight of the Financial Conduct Authority and/or its predecessor (the Financial Services Authority (**FSA**)) for approximately 15 years. Over 2,000 final disciplinary notices had been published by those regulators. These notices comprised a significant body of publically available material that informed industry participants of appropriate standards of conduct and expected enforcement responses.

Question 16
What is your feedback on the whistleblowing option? In particular: Do you agree with the pros and cons? Are there other impacts that are not identified? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of the options?

As noted in the Options Paper, similar procedures to that proposed under this option are already in place within the industry.

Question 17
What is your feedback on the option of regular reporting on the industry? In particular: Do you agree with the pros and cons? Are there other impacts that are not identified? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of the options?

We submit that further consideration of the need and likely benefits of additional reporting is required, particularly in light of existing reporting requirements within the industry.

We support a review of existing disclosure requirements, so that insurers are required to provide meaningful information only. Any additional reporting obligations must however provide a real benefit, given they will likely impose a cost on reporting entities.

For example, we do not agree with the benefit identified in the Options Paper that having information published about specific companies would help inform consumer decision making when choosing a financial institution, similar to the annual telecommunications market monitoring report under the Telecommunications Act 2001.

We submit that such reports are highly unlikely to benefit or influence consumers in this way. We consider that it is highly improbable that consumers access telecommunications market monitoring reports as part of their decision-making processes in relation to telecommunications products and services. This would also be the case in respect of financial institutions reporting.

Question 18
What is your feedback on the role of industry bodies? In particular: Do you agree with the pros and cons? Are there other impacts that are not identified? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of the options?

We submit that industry bodies have an important role to play, especially in the context of the proposed principles-based regime, as such a regime (including the overarching duties and accompanying guidance) would be most effectively developed in close consultation with the industry. However, this does not necessarily require an increased role for industry bodies – simply a strong partnership between the regulator and industry bodies.

Who should the conduct regulation apply to?

Question 19
What is your feedback on the options regarding who the conduct regime should apply to? In particular: Do you agree with the pros and cons of the options? Are there other impacts that are not identified e.g. do the proposed overarching duties conflict with existing regulation that applies to other financial institutions? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of these options? Which options do you prefer and why?

Application of options to banks, insurers and other financial institutions

From a consumer perspective, there is unlikely to be a distinct difference between obtaining a service from a bank or insurer and obtaining the same service from another financial services provider. In principle, we see merit in a proposal that involves institutions offering the same services being subject to the same obligations and regulation. This could contribute to consistency in customer outcomes and a level playing field within the industry. However, participants within the industry are likely to have understandably differing levels of preparedness for intensive regulation that may need to be factored into the date(s) for implementation and/or transitional arrangements.

Overlap with existing legislation

As identified in the Options Paper, changes to regulation of conduct for financial institutions creates extensive overlap with many other pieces of legislation and regulation. It is obviously important that regulation be straightforward to understand and apply in order to be effective, especially where the industry is already working to comply with multiple pieces of regulation.

Accordingly, we submit that the most effective approach would be to analyse any overlap with existing legislation once the proposed framework is in a near final form. This would allow the exact extent of overlap with existing laws and regulations and any issues of particular concern or conflict to be clearly identified. Those issues could be directly addressed in the final stages of developing the framework. We submit that this would provide the most clarity, consistency and efficiency for both the industry, the regulator and consumers.

It is essential that any new legislation is able to be readily interpreted and applied in order for it to be adopted effectively by financial services companies. In addition, it must be part of a

comprehensive and cohesive legislative framework governing all sectors of the financial services sector. A patchwork or rushed approach is unlikely to be effective in advancing the Government's goals.

Entity- vs. product-level regulation

In our view, a conduct regime does not necessarily present a binary choice between entity-level regulation and product-level regulation. We acknowledge that an entity-level approach maximises the likelihood of those who have some influence on customer outcomes being subject to regulatory oversight. However, further definition of the circumstances in which the regime will apply to those within an entity is necessarily required (whether by reference to products, activities or both). Otherwise, all employees would be subject to regulatory duties in every aspect of their daily role. That would be a significant overreach of regulation.

We note that the Options Paper does not seek to define the circumstances in which the overarching conduct duties will apply. One section of the Options Paper states that the duties would apply *"to all aspects of a financial institution's activities"*. A later section of the Options Paper indicates they will apply in respect of *"all products and services offered to retail customers"*. We therefore suggest that further detail of the proposed application of the regime is provided. That could be provided once the contours and substance of the proposed duties have been determined.