BELL GULLY

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Ministry of Business, Innovation and Employment

FROM **Blair Keown / Zavara Farquhar**
Privacy of natural persons

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Submissions in response to Conduct of Financial Institutions discussion documents

1. This submission has been prepared by Bell Gully in response to the discussion documents on regulations to support the new regime for the conduct of financial institutions and the treatment of intermediaries under the new regime for the conduct of financial institutions that were released by MBIE in April 2021 (the **Discussion Documents**).

2. We have significant expertise and experience in the law relating to the regulation of financial markets. We welcome the opportunity to make submissions on the Discussion Documents (having already made submissions on MBIE's April 2019 Conduct of Financial Institutions Options Paper as well as the initial draft of the Financial Markets (Conduct of Institutions) Amendment Bill that was introduced to Parliament.)

3. The Discussion Documents contain a welcome acknowledgment of the need for greater clarity on aspects of the conduct regulation regime. However, as we explain in our response, clarity may be more effectively delivered by non-binding regulatory guidance once the regime has had an opportunity to operate in practice, rather than prescriptive and inflexible regulations that cannot adequately address the variety of practical issues that aspects of conduct regulation (e.g. remediation and vulnerable customers) may present.

4. Against that background, we set out our views on selected questions posed in the Discussion Documents in the **attached** schedule.

5. We do not propose to comment on all of the specific questions identified in the Discussion Documents. Our focus has been on legal questions or matters that relate to our practical experience of advising clients on conduct regulation: remediation; vulnerable customers; incentive regulation; publication of fair conduct programmes; and the treatment of intermediaries, employees and agents.

6. Many of the questions raise issues of operational detail and practical impact on which we expect banks, insurers and non-bank deposit takers to have developed insights. We encourage MBIE to give careful consideration to their feedback.

7. The views expressed in these submissions are those of members of our firm involved in the review of the Discussion Documents: David Friar, Blair Keown, Glenn Joblin and Zavara Farquhar. They do not necessarily represent the views of our clients.

8. We look forward to continued opportunities to comment on the detail of the proposed options and regulations as MBIE's thinking develops.

Yours faithfully
Bell Gully

David Friar/ Blair Keown / Glenn Joblin / Zavara Farquhar
Partner / Partner / Partner / Lawyer

Discussion document on regulations to support the new regime for the conduct of financial institutions

Question 1
Do you have any comments on the status quo i.e. no further regulations to support the minimum requirements for fair conduct programmes in the Bill?

We submit that clarity on the requirements of a fair conduct programme may be more effectively delivered by non-binding regulatory guidance rather than further prescriptive regulation. Extensive prescription risks depriving the regime of its necessary flexibility and may prevent financial institutions from adapting controls to their particular organisational settings and effectively dealing with the variety of practical issues that aspects of conduct regulation present. Prescribing requirements now, before the regime has any opportunity to operate in practice, also carries a risk of entrenching legal requirements that may prove to be unworkable or ineffective in practice.

Question 2
Do you have any comments on MBIE’s position that no regulations are needed at this time to support section 446M(1)(a)?

For the reasons set out in our response to Question 1 above, we agree that no regulations are needed to support the requirement that the fair conduct programme must enable financial institutions to meet all of its legal obligations to consumers under legislation and that non-binding regulatory guidance is a better option for delivering any additional clarity.

Question 4
Do you have any comments on MBIE’s position that no regulations are needed at this time to support section 446M(1)(ac)?

For the reasons set out in our response to Question 1 above, we agree that no regulations are needed to support the requirement for fair conduct programmes in relation to conduct risk management and that non-binding regulatory guidance is a better option for delivering any additional clarity.

Question 5
Do you have any comments on MBIE’s position that no regulations are needed at this time to support section 446M(1)(bb) to (bd)?

For the reasons set out in our response to Question 1 above, we agree that no regulations are needed to support the requirements that conduct programmes must include in relation to employees, agents and intermediaries and that non-binding regulatory guidance is a better option for delivering any additional clarity. Please also see our responses to the discussion document on the treatment of intermediaries under the new regime for the conduct of financial institutions below.

Question 6
Do you have any comments on the proposal to specify further minimum requirements regarding remediation of issues? Are there any further specific remediation principles that should be specified in regulations?

We do not consider that remediation is a matter than can be properly or usefully reduced into a discrete set of prescriptive requirements or principles. As MBIE will appreciate, the remediation of conduct issues involves a complex combination of considerations that apply differently according to the particular circumstances of any given case. Indeed, remediation guidance issued by the Australian Securities and Investments Commission – comprising a regulatory guide and a subsequent consultation paper – runs to 100 pages.

The additional minimum standards or regulations that MBIE has proposed at paragraphs 66(a) to (g) are generic statements of principle that will not materially assist financial institutions when undertaking remediation and, contrary to MBIE's suggestion in the discussion document, do not provide "further certainty … on what 'reasonable steps' are with respect to remediating conduct".

Fundamentally, the additional standards/regulations proposed by MBIE do not address any of the key practical issues that financial institutions grapple with when determining how remediation can ensure the fair treatment of customers in any given case. For example, they do not say anything about: (i) when to initiate remediation; (ii) how to identify and determine 'affected customers'; (iii) how far back to review and remediate; (iv) the adoption of assumptions; (v) the calculation of remediation payments; (vi) communicating with affected customers; (vi) the adoption of de minimis remediation thresholds; and (vii) documenting remediation with customers.

These are the matters where further detailed clarity is necessary in order to ensure that remediation delivers good customer outcomes. This clarity should take the form of non-binding guidance from the regulator rather than prescriptive regulations (consistent with the approach that MBIE proposes to adopt in relation to vulnerable customers). We understand that the FMA has already done much of this work in developing an internal remediation guide. We submit that this guide should be publicly available.

Question 7
Do you have any comments on MBIE's position that no regulations are needed at this time to support section 446M(1)(be)?

For the reasons set out in our response to Question 1 above, we agree that no regulations are needed to support the requirement for fair conduct programmes in relation to the design and management of incentives and that non-binding regulatory guidance is a better option for delivering any additional clarity. See also our comments in relation to incentives regulation in our response to Question 31 below.

Question 8
Do you have any comments on MBIE's position that no regulations are needed at this time to support section 446M(1)(bf)?

For the reasons set out in our response to Question 1 above, we agree that no regulations are needed to support the requirement that fair conduct programmes make provision for communication with customers and that non-binding regulatory guidance is a better option for delivering any additional clarity.

Question 9
Do you have any comments on MBIE's position that no regulations are needed at this time to support section 446M(1)(d)?

For the reasons set out in our response to Question 1 above, we agree that no regulations are needed to support the requirement that a fair conduct programme make provision for review and maintenance of the programme itself and that non-binding regulatory guidance is a better option for delivering any additional clarity.

Question 13
Do you have any comments regarding customer vulnerability?

We agree that it is not necessary to make specific provision for vulnerable customers in the Bill.

The basis of the proposed conduct regime is the fair conduct principle and the requirement to "treat consumers fairly". That principle does not distinguish between vulnerable or any other type of consumer.

It is implicit in the fair conduct principle and the additional factors that are relevant to the concept of fairness (see s 446B(1) and (2) of the Bill as proposed by the Finance and Expenditure Select Committee) that the interests and requirements of consumers in any given circumstance will depend on a number of factors, including but not limited to vulnerability.

Introducing prescriptive requirements that only apply to "vulnerable customers" risks unintentionally giving "vulnerability" and "vulnerable customers" a special regulatory status to the exclusion of other relevant factors and at the expense of consumers as a whole. This risks undermining the overall focus of the fair conduct principle (being the protection of all consumers).

It could also give rise to a two-track regulatory system which imposes different prescriptive requirements on institutions depending on whether the consumer is vulnerable or not vulnerable. This would place considerable significance (and invite intensive debate) on the definition of a "vulnerable customer" – a term that is not currently defined in the Bill or elsewhere.

Against that background, we agree that existing initiatives relating to vulnerable customers, particularly the upcoming release of further guidance by the FMA, make adequate provision for the specific position of vulnerable customers within the overall framework of the Bill and the fair conduct regime.

Question 14
Do you have comments regarding the option of including vulnerable consumers in section 446M(1A)?

See our response to Question 13 above.

Question 20
Do you have any feedback on a more principle-based approach to prohibiting some incentives?

We consider that a cohesive approach to incentives needs to be taken that takes into account both the nature of the incentive restrictions and the class to whom they will apply. In our view, a principles-based approach to incentive regulation may be more appropriate if regulation is to apply broadly across a variety of personnel and activities. However, a more prescriptive approach may be better suited where the intended class is narrow and covers similar personnel and activities.

Question 21
How could a principles-based approach to prohibiting some incentives be made workable?

See our response to Question 20 above and Question 31 below.

Question 22
If a more principles-based option was chosen, should there be some incentives specifically excluded?

See our response to Question 20 above and Question 31 below.

Question 23
Do you think there are any other viable options that what has been put forward by this discussion document? Please explain in detail.

See our response to Question 20 above and Question 31 below.

Question 27
Do you agree/disagree that within financial institutions and intermediaries sales incentives regulations should apply to all staff? Why/why not?

In our view, whether incentives regulations apply to all staff depends on the content of the regulations. As we explain in our response to Question 31 below, we consider a cohesive approach to incentives requires that the nature of the incentive restrictions and the class to whom they will apply are considered together.

Question 28
Do you agree/disagree that within financial institutions and intermediaries sales incentives regulations should only apply to frontline staff and their managers? Why/why not?

See our response to Question 27 above.

Question 31
Do you have any other comments on the discussion related to incentives?

<u>Uneven playing field</u>

Incentive regulations will apply only to financial institutions and their intermediaries but will not apply to non-financial institutions and their intermediaries who are providing the same relevant services and/or associated products. This necessarily creates an uneven playing field in how financial services and associated products are distributed to consumers. Financial institutions will be severely limited in how they can incentivise sales (if at all) while non-financial institutions will be subject to no such restrictions.

This imbalance in incentives could see a shift in the market in favour of non-financial institutions who are not subject to any form of conduct regulation. Employees and agents within financial institutions may leave in order to work in institutions that can freely offer incentives. Intermediaries who previously distributed the products of financial institutions and non-financial institutions, may find themselves favouring non-financial institutions. Contrary to the intention of the Bill, more financial services and associated products (and consumers) may be shifted to unregulated parts of the financial sector where conflicted remuneration has not at all been addressed. These risks should be considered as part of the process of making the incentive regulations that will apply to financial institutions and their intermediaries.

The Finance and Expenditure Select Committee has helpfully recommended that the Minister have regard to various considerations before making a recommendation for regulations relating to the prohibition or regulation of incentives (see proposed new s 546(5) of the FMCA). We consider that this list could be expanded by amending proposed new s 546(5)(c) as follows:

> … has had regard to the likely effect of the regulations –
>
> (i) on the availability of financial advice and the availability of financial services and financial advice products ; and
>
> (ii) on the financial services industry generally (<u>including the availability and quality of financial advice, financial services and financial advice products and the interests of consumers within the industry generally</u>).

<u>The content and application of incentive regulations should be considered together</u>

The MBIE discussion document (and the questions it has posed about incentives) treats the content of incentive regulations and the persons to whom they should apply as separate matters. In our view, a cohesive approach to incentives requires that the nature of the incentive restrictions and the class to whom they will apply are considered together.

Applying this approach, we consider that a purely principle-based approach to incentive regulation (i.e. a general obligation to ensure incentives are consistent with good customer outcomes without any prescriptive requirements). A principles-based approach would provide the institution with the flexibility necessary to calibrate its incentives more closely to the different roles that are performed within the institution and the different risks that each role presents to good customer outcomes. It would also be consistent with the commitments that banks and life insurers have already given to the FMA and RBNZ in relation to incentives across their organisations. That is, revising sales incentives through all layers of management to manage any conflicts or potential mis-selling.

By contrast, the imposition of prescriptive incentive prohibitions (e.g. a prohibition on target based sales incentives) across all employees, agents and intermediaries of a financial institution (not just frontline staff and their managers) could be an overly blunt instrument. Given the broad definition of “incentives”, it appears that a number of compensation arrangements would be automatically prohibited, including measures that have been adopted in direct response to the FMA and RBNZ’s thematic work into conduct and culture, regardless of the risk that they present to consumers. In effect, the prohibition would ban arrangements that financial institutions have already assessed as being consistent with good customer outcomes.

In principle, any compensation within a financial institution that is linked in any way to a sales value or volume targets would be prohibited. This would appear to include compensation gateways or KPIs in balanced scorecards for executives and management that reference sales targets and (potentially) profit or market share targets regardless of whether other good customer outcome focused KPIs or metrics offset the risks of conflicted conduct or adverse customer outcomes.

For these reasons, we submit that MBIE should carefully review the interaction between the nature of the incentive regulations and the population to whom they will apply. In our view, prescriptive

prohibitions on incentives are unlikely to be workable outside front line staff and their immediate managers.

Question 32
Is more detail needed to outline what information should be published regarding financial institutions' fair conduct programmes to assist financial institutions to meet this requirement, or to assist consumers in their interactions with financial institutions?

We continue to question the necessity and utility of a duty to publish the content of a fair conduct programme (whether in complete or summary form).

The Finance and Expenditure Select Committee has rightly recognised the impracticality of publishing the full content of a fair conduct programme, and has instead recommended that financial institutions only be obliged to publish summary information about the fair conduct programme. However, we do not believe that the publication of information about the programme in summary or truncated form will be helpful to consumers, particularly when financial institutions are already required to share their fair conduct programmes with the regulator who will oversee the regime (see further below on the need for clarity regarding the provision of this information to the FMA).

In particular, it is not clear what useful purpose will be served by publishing a "description of how the financial institutions will adhere to the fair conduct principle in practice" or "a description of what customers can expect from a dealing or interaction with the financial institution". In order to be meaningful (rather than a generic pro forma statement), this information would require financial institutions to provide some detail or description of policies, processes, systems, and controls. However, these matters are not designed for customers and are unlikely to be understood by them. There is also likely to be significant variation in the information published across financial institutions which may limit a consumer's ability to draw meaningful comparisons between service and product providers. To our knowledge, no comparable financial regulatory regime in any other jurisdiction requires such material to be publicly available.

We expect customers will be more interested in the complaints process and the steps that are available to them in the event that they do not consider they have been treated fairly. We therefore see the merit in MBIE's option 2 proposal for financial institutions to publish a summary of the process for making a complaint or, at a minimum, the contact details to make a complaint. In our view, that should be the full extent of the duty to publish information about a fair conduct programme. This would be consistent with the Financial Service Providers (Registration and Dispute Resolution) Act 2008 which already requires financial service providers to be a member of an approved dispute resolutions scheme and for the rules of the scheme must be publicly available.

<u>Provision of fair conduct programme to the FMA</u>

Section 446H of the Bill imposes a duty on financial institutions to provide a copy of their fair conduct programme and of any material change to the programme to the FMA. This duty is not limited to the provision of information in summary or descriptive form.

By definition, a fair conduct programme is a set of "policies, processes, systems, and controls that are designed to ensure the financial institution's compliance with the fair conduct principle". It would be unworkable for financial institutions to provide all of this information to their regulator (and we do not understand the FMA to be expecting this level of information).

Further clarity is required on how a financial institution is expected to comply with this requirement (noting that the discussion document does not address this topic).

Question 33
Do you have any comments on the options outlined above? What do you think the costs and benefits would be to financial institutions and consumers of the two options?

See our response to Question 32 above.

Question 34
This discussion document outlines two options regarding the requirement to publish information about the fair conduct programmes. Do you have any other viable options?

See our response to Question 32 above.

Question 35
Do you have any comments on the proposal to declare contracts of insurance as financial products under Part 2?

We support the proposal to call in contracts of insurance as financial products under Part 2 of the Financial Markets Conduct Act 2013 (**FMCA**). Given the existing application of insurance as a "financial service" under the fair dealing provisions, it is appropriate that misleading conduct in relation to insurance products is a FMCA matter and subject to enforcement by the FMA.

Question 36
Do you think it would be appropriate to exclude people who are subject to professional regulation from the definition of an intermediary (e.g. lawyers, accountants, engineers)?

We consider it would be appropriate to exclude people who are already subject to professional regulation from the definition of an intermediary. In our view, there is questionable utility in additional regulatory obligations being imposed in relation to the conduct of these professionals given they are already subject to regulation and codes of conduct specific to their professions. For further detail, see our separate response to the "Conduct of financial institutions treatment of intermediaries" discussion document.

Question 37
Do you think that any other occupations or activities should be excluded from the new proposed definition of an "intermediary"? If so, why?

See our response to Question 36 above and our separate response to the "Conduct of financial institutions treatment of intermediaries" discussion document.

Discussion document on the treatment of intermediaries under the new regime for the conduct of financial institutions

Question 1
Do you have any comments on Option 1: "Amend definition of intermediary to focus on sales and distribution"?

We agree that regulatory responsibility for the activities of third parties should be closely calibrated to those activities that are most likely to impact the achievement of the fair conduct principle. Amending the definition of "intermediary" to focus only on the performance of sales and distribution activities (thereby excluding involvement in preparatory and subsequent administrative services) appears to be consistent with that principle.

Question 2
Do you think the scope of the proposed definition of an intermediary is comprehensive enough to capture the variety of sales and distribution methods and to avoid gaps and risks of arbitrage?

See our response to Question 1 above.

Question 3
Do you have any comments on Option 2?

The definition of "agent" and the related concepts of actual and apparent authority are well known to the law. However, it does not follow that a financial institution should have prescriptive regulatory responsibilities for every such person who acts with their actual or apparent authority regardless of the activity or function that person is performing.

In our view, imposing regulatory obligations on financial institutions for the activities of all employees and agents regardless of their involvement in the provision of relevant services or associated products would be unnecessarily burdensome. We therefore agree with the suggestion that the definition of "agent" should be linked to those agents who have a direct or specific involvement in the provision of a financial institutions relevant services or associated products to individual consumers.

Question 4
Do you think Option 2 would adequately exclude advisory services (e.g. lawyers, accountants) and other service providers to the financial institution who are not involved, directly or indirectly, in providing any part of the financial institution's relevant service or associated products to consumers?

We agree that the definition of "agent" could be further refined to definitively exclude those who provide external advisory services pursuant to their own regulatory and professional obligations (e.g. practising lawyers and chartered accountants). In our view, there is questionable utility in additional regulatory obligations being imposed in relation to the conduct of these professionals given they are already subject to regulation and codes of conduct specific to their professions (see further below at Question 6).

This exclusion could take the form of an express exclusion of practising lawyers and chartered accountants from the definition of "intermediary". For the avoidance of all doubt, the obligations

relating to intermediaries could also be modified so they do not apply in respect of practising lawyers or chartered accountants.

Question 6
Do you have any comments on the objectives regarding the treatment of intermediaries?

In our view, the treatment of intermediaries should seek to encourage intermediaries to take responsibility for their fair treatment of consumers (and should not be framed in terms of the financial institution's responsibility for the fair treatment of customers in all circumstances).

Any responsibility on the financial institution should be limited to those circumstances where the intermediary's activities have the capacity to impact on fair treatment of customers. In determining "appropriate responsibility", specific regard should be had to the financial institution's capacity to exercise control over the intermediary. A financial institution cannot be responsible for outcomes it had no ability to control or prevent.

We also agree that the regulation of intermediaries should seek to minimise uncertainty and unnecessary duplication of existing regulatory and professional obligations. This should avoid imposing additional (and potentially inconsistent) regulatory obligations on populations such as lawyers and accountants who are already subject to codes of conduct and regulation by their professional body. It should also avoid imposing additional regulatory obligations on those who are already subject to financial conduct regulation (i.e. FSLAA).

Question 7
Do you have any comments on Option 3: 'Minimal changes to intermediaries obligations'?

In our view, further changes are required to the obligations of intermediaries (and the definition of "intermediary") in order to avoid imposing unduly onerous obligations on financial institutions without securing corresponding levels of intermediary compliance. For further detail see our response to Question 9 below.

Question 8
If Option 3 were pursued, do you think any other obligations in section 46M(1)(bb), (bc), (bd) or (bf) would need clarifying or amending? Why/why not?

See our response to Question 7 above.

Question 9
Do you have any comments on Option 4: 'More significant changes to intermediaries obligations'?

In our view, the content of obligations must be set by reference to the persons to whom they should apply (and vice versa). Applying this approach, we agree there is a case for financial institutions to have much less regulatory responsibility for the activities of intermediaries who are not agents or employees.

Many "intermediaries" will not be agents of the financial institution. They will be commercial entities acting on their own behalf. They will not owe fiduciary obligations to the financial institution. The

financial institution may have limited ability to influence their activities or ensure their compliance with the institution's fair conduct programme. Without sensible qualifications, attributing liability for the conduct of such independent "intermediaries" to the financial institution may be unduly onerous without securing corresponding levels of intermediary compliance (because it is not practically possible to achieve). It would also represent a departure from the ordinary agency basis on which the law typically attributes legal responsibility to a principal.

In these circumstances, we agree that regulatory responsibility should focus on those aspects of an intermediary relationship that financial institutions can control (i.e. the communication of its expectations of good conduct to the intermediary and the subsequent monitoring of compliance). Financial institutions should not have prescriptive regulatory responsibility for the "management and supervision" of intermediaries.

We consider that the level of responsibility can be appropriately framed in terms of exercising due skill care and diligence to inform intermediaries of their conduct responsibilities and monitor their resulting compliance.

Question 10
What do you think the level of responsibility should be for financial institutions' oversight of intermediaries? For example, "*managing or supervising* the intermediary to ensure they support the financial institutions compliance with the fair conduct principle", or "*monitoring* whether the intermediary is supporting the financial institution's compliance with the fair conduct principle", or something else?

See our response to Question 9 above.

Question 11
What standard do you think financial institutions should have to oversee their intermediaries to?

See our response to Question 9 above.

Question 12
Do you have any comments on Option 5: 'Distinguish between FSLAA and non-FSLAA intermediaries'?

In our view, there is a material difference between intermediaries who are subject to FSLAA and those who are not.

We agree that this difference warrants more limited regulation in respect of intermediaries who are already subject to FSLAA. However, we do not agree with the difference that MBIE has articulated. In our view, financial institutions could have <u>no</u> regulatory responsibility for intermediaries insofar as those intermediaries are subject to FSLAA. That is, financial institutions will not have obligations under the Bill when those intermediaries are providing regulated financial advice. However, they would have obligations insofar as the intermediaries are involved in the provision of other relevant services or associated products.

Intermediaries who are subject to FSLAA (i.e. licensed financial advice providers and nominated representatives) have statutory duties to (i) meet standards of competence, knowledge and skill; (ii) ensure a client understands the nature and scope of advice; (iii) give priority to the client's interests; (iv) exercise care, diligence and skill; and (v) comply with a conduct of conduct. These duties (which are consistent with the fair conduct principle) are broader and more exacting than the

duties in the Bill. They also apply directly to intermediaries when giving regulated financial advice (whereas the Bill does not impose any direct duties on intermediaries). Given this direct regulation, there is a much weaker case for financial institutions to have additional regulatory responsibility for intermediaries under the Bill when those intermediaries are giving regulated financial advice.

The imposition of additional (albeit more limited) obligations on these types of intermediaries would be unnecessarily duplicative. It would be contrary to the objectives of intermediary obligations that MBIE has articulated (i.e. the minimisation of compliance costs and duplication of regulation). It could also give rise to confusion as to the intended scope of obligations under the Bill and obligations under FSLAA. For example, it would be unclear whether an intermediary's compliance with FSLAA in a given scenario would amount to compliance by the financial institution with the "fair conduct principle" and its constituent statutory duties, or whether more would be required.

Question 13
How far do you think financial institutions' oversight of FSLAA intermediaries under Option 5 should extend? For example, should it cover the general conduct of the intermediaries, or more narrowly on product performance and related consumer outcomes (or something else)?

See our response to Question 12 above.

Question 14
Do you have any comments on the proposals regarding obligations in relation to employees and agents?

In our view, imposing regulatory obligations on financial institutions for the activities of all employees and agents regardless of their involvement in the provision of relevant services or associated products would be unnecessarily burdensome. We therefore agree that obligations should only apply to employees and agents who have a direct or specific involvement in the provision of a financial institutions relevant services or associated products to individual consumers.

We agree that the definition of "agent" could be further refined to definitively exclude those who provide external advisory services pursuant to their own regulatory and professional obligations (e.g. practising lawyers and chartered accountants). In our view, there is questionable utility in additional regulatory obligations being imposed in relation to the conduct of these professionals given they are already subject to regulation and codes of conduct specific to their professions. For further detail, see our response to Question 3 and Question 9 above.