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Submission on Consultation Papers – Conduct of financial institutions regulations and treatment of intermediaries

1 This is a submission by Dentons Kensington Swan on the following two consultation papers dated 24 May 2021 ('**Consultation Papers**') released by the Ministry of Business, Innovation, and Employment ('**MBIE**'):

a Regulations to support the new regime for the conduct of financial institutions ('**Regulations Paper**').

b Treatment of intermediaries under the new regime for the conduct of financial institutions ('**Intermediaries Paper**').

About Dentons Kensington Swan

2 Dentons Kensington Swan is one of New Zealand's premier law firms with a legal team comprising over 100 lawyers acting on government, commercial, and financial markets projects from our offices in Wellington and Auckland. We are part of Dentons, the world's largest law firm, with more than 12,000 lawyers in over 200 locations.

3 We have extensive experience advising a range of banks, insurers, non-bank deposit takers, fund managers, and financial advice providers, all of which will be affected by the proposals set out in the Consultation Papers.

General comments

4 We were very pleased to see the Consultation Papers released last month. The rushed nature of the introduction of the Financial Markets (Conduct of Institutions) Amendment Bill ('**Bill**') in December 2019 was unfortunate, as it resulted in a significant piece of regulatory reform being introduced to Parliament without the benefit of widespread stakeholder input. While the second reading of the Bill addressed many of the concerns raised in the Select Committee process, it is pleasing to see a more robust consultation process now being implemented. This will hopefully ensure that the final refinements to this major piece of reform are as well-informed as possible.

5 The Regulations Paper was expected, and touches on all the major implementation issues we have identified. There are some points of detail we have commented on, but by and large our view is that the housekeeping aspects of the new regime are headed in the right direction.

6 The Intermediaries Paper was less expected but absolutely critical to the workability of the new regime. Ensuring there is effective consultation in relation to the way the proposed financial institution conduct licensing regime will interact with the distributors of financial products is essential. The prospect of undue complexity, with multiple conduct programme obligations being imposed upon financial advice providers, and financial institutions facing the prospect of an unnecessary compliance burden in managing the conduct of a broad range of intermediaries, was one of our major reservations with the proposed reforms. We believe the new financial advice provider licensing regime must be given some breathing space to bed in before exposing the licensed financial advice provider cohort to an additional array of conduct duties.

Summary of our submission points

7 In brief:

7.1 We do not support the promulgation of further regulations to spell out the content requirements of fair conduct programmes. We believe the changes introduced to the Bill through the Select Committee process strike the right balance of prescription versus principle without needing anything further.

7.2 Notwithstanding the above, greater clarity would be beneficial in outlining what should be included in the publicly available summary of a financial institution's fair conduct programme. The approach taken for prescribing the requirements for the information licensed financial advice providers are required to make publicly available provides a useful precedent to follow in that regard.

7.3 To provide certainty, we support an express prohibition on problematic target-based sales incentives, provided the list of incentive arrangements excluded from that prohibition is expanded to ensure legitimate commercial practices are able to continue, and to permit the use of target-based sales incentives as a minor part of a balanced scorecard approach to adviser incentives.

7.4 For the Intermediaries Paper we support Option 1, proposing a tighter definition of those within scope. To be workable, only those directly involved in sales and distribution of relevant products and services should be caught. We strongly favour Option 5, in terms of reducing the extent of the obligations imposed in relation to intermediaries from managing or supervising to monitoring, although believe further work is required to define what is required to discharge the monitoring obligation. When dealing with a licensed financial advice provider, in particular, it is important that the tasks expected of a financial institution in monitoring an intermediary are not too invasive.

7.5 The distinction proposed at Option 5 between obligations when dealing with licensed financial advice providers and other forms of intermediary strikes the appropriate balance.

Specific response to the Regulations Paper

Requirement for fair conduct programmes

Questions 1 and 2

8 We agree with MBIE's expectation that passing the Bill without any further regulations for fair conduct programmes 'would have a material positive impact on improving the conduct of financial institutions' (paragraph 32). In our view, the added detail for fair conduct programmes provided in the second reading of the Bill provides sufficient guidance as to what is required, without needing the support of any further regulation. Avoiding further prescription would better support financial

institutions properly tailoring their fair conduct programmes to meet their particular dynamics, without being unduly constrained by prescribed requirements.

9 While the absence of additional regulation may result in some variation in the approach taken to operationalising the requirements, we do not see this as problematic. With the objectives and headline requirements of fair conduct programmes now clearly articulated in the Bill, we do not anticipate financial institutions will have undue difficulty in operationalising the requirements with respect to policies, processes, systems and controls. On the contrary, more difficulty is likely to be created through further prescribing what is required.

10 Without limiting the above, we specifically support MBIE's position that no regulations are needed at this time to support the headline requirements for fair conduct programmes set out in section 446M(1)(a).

11 The balance of our comments under this heading are limited to specific queries and proposals made around additional prescribed requirements, or the lack thereof. They are provided in case our preferred position as to no additional regulation being imposed is not adopted, and further prescription is provided or considered through regulation.

Question 3: Do you have any comments on the proposals regarding distribution of relevant services and associated products? We are particularly interested in how these proposals may be implemented.

12 Section 446M(1)(ab) requires the fair conduct programme to include effective policies, processes, systems and controls for designing, and managing the provision of, each financial institution's relevant services and associated products, including regularly reviewing:

a the relevant services or associated products that are provided to consumers on an ongoing basis to determine whether they are likely to continue to meet the requirements and objectives of those consumers (when viewed as a group); and

b whether enhancements or improvements in the financial institution's relevant services or associated products should be made available to those consumers (when viewed as a group).

13 In our view, the wording of the statutory provision is sufficient without requiring anything further. The requirements for what is required to be included in fair conduct programmes in relation to the management of the provision of financial products and services should remain broad, ensuring that financial institutions have the flexibility to determine what is appropriate to ensure fair treatment of their customers in this context.

14 Our concern is that by hard-coding further requirements for the content of fair conduct programmes, the flexibility that is needed for the purposes of a conduct regime will be compromised. That flexibility is a key aspect, ensuring that financial institutions are able to support all their customers, including any vulnerable customers.

15 The potential consequence of requiring financial institutions to identify customers and their likely requirements and objectives in respect of each relevant service and product (as set out at paragraph 52a and 52b) may mean that customers could be predetermined as 'appropriate' or 'inappropriate' for that product or service, without a proper analysis of the customer's financial situation and/or needs. We believe this would be a retrograde approach, and the case for adding this type of prescription is not made out.

Question 6: Do you have any comments on the proposal to specify further minimum requirements regarding remediation of issues?

16 We believe section 446M(1)(ad) provides a sufficient framework for remediation without requiring anything further. The proposed obligation is to take reasonable steps, and it should be left to the financial institution to determine what is reasonable in the circumstances without being constrained by further prescription.

Question 10: Do you have any comments on the proposal to specify further minimum requirements regarding consumer complaints handling?

17 Most financial institutions will already have an internal complaints handling process in place. They will also all be members of an external dispute resolution scheme. In our view, there is no value in introducing further prescription for complaints handling processes. Doing so risks further complicating the obligations that financial institutions already face under their existing licence conditions and/or their external dispute resolution scheme rules.

Question 11: Do you have any comments on the proposals to specify further minimum requirements regarding claims handling and settlement?

18 We are not convinced that imposing further obligations on financial institutions in relation to fair and timely claims handling (as set out in paragraph 99) will lead to better outcomes than simply relying on the fair conduct principle. What is 'fair and timely' will depend on the complexities of the particular claim. Adding prescription risks compromising the policy objectives in the absence of extensive exception relief, which would add undue complexity for uncertain gain.

19 Claims handling requirements should be determined on a principled basis to ensure providers are able to tailor their claims handling approach in a way that best supports the fair conduct principle in their particular circumstances.

Questions 13 and 14: Do you have any comments on the discussion regarding customer vulnerability? Do you have comments regarding the option of including vulnerable consumers in section 446M(1A)?

20 Our view is that the Bill should not further define vulnerable customers. This should be left open to financial institutions to interpret, ensuring flexibility to what may constitute a vulnerable customer in the particular circumstances. Leaving the specifics undefined allows greater flexibility for the Financial Markets Authority to issue guidance that is appropriately tailored to meet changing societal pressures, with the impact of Covid-19 and the creation of a new cohort of the newly vulnerable a topical example of the need for flexibility in determining who is vulnerable and what is required to address that vulnerability.

21 We do not believe it is necessary for the regulations to specify that financial institutions must have regard to the needs of vulnerable customers in determining what policies, processes, systems and controls are required. We believe that is inherent, and already incorporated under the reference to the types of customers.

Sales incentives

Questions 20 and 25: Do you have any feedback on a more principle-based approach to prohibiting some incentives? Do you think there are any other types of incentives that should be excluded from the regulations? Please provide reasons for your comments.

22 Any prohibition on sale incentives based on volume or volume targets should be tightly prescribed, and no wider than is absolutely necessary. We perceive significant risks of unintended consequences flowing from the way that market participants may respond to any prohibitions. We

believe it is important for financial institutions and intermediaries to have certainty in this space. This is one area where relying upon a principles-based approach would not provide sufficient certainty.

23 In light of the above, we recommend a defined set of exclusions from the prohibition to ensure that non-problematic or desirable incentive arrangements are clearly permitted, and only problematic volume-based incentive arrangements are prohibited:

a First, we recommend the inclusion of an express ability for providers to specify a minimum volume of business that a distribution intermediary must transact in order to retain a business relationship with the provider, or to qualify for particular levels of support. This is a straight matter of commercial common sense. Providers have finite resources, and should be free to devote those resources for the optimal benefit of the provider and the customers it serves. Providers should be entitled to sever relationships with intermediaries where the volume of business renders it uneconomic for the provider to sustain the relationship. Providers should also be able to cease the provision of support to the intermediary if it might preclude the provision of support to another intermediary who is servicing a greater number of the provider's customers and who is therefore likely to deliver greater benefit for the provider's customer base.

b Second, there should be an express carve-out to enable financial institutions to specify minimum threshold criteria for an adviser to qualify for training support. This recognises that providers need to manage their resources in as cost effective a fashion as possible. Allowing providers to restrict the training they provide to advisers that meet minimum volumes of business should be tolerated as a valid commercial response.

c Third, setting threshold levels of business that must be transacted before an adviser can move to a higher level of remuneration structure or seniority in a business should be expressly permitted. Allowing providers to determine the level of business that an individual must transact in order to 'earn their stripes' is a simple marker of increased seniority and experience. Excluding such gateways to progression would present some significant employment challenges for some organisations. Such measures are commonly employed in determining which advisers should be deployed to assist the more complex customer situations or supervise junior advisers. In our view, ensuring such career progression mechanisms can continue is likely to be beneficial for customer outcomes, and banning them may well be detrimental.

d Fourth, we support a carve-out for volume-based targets which form part of a balanced scorecard. What is permitted should be based on maximum percentages of such a scorecard being allocated to meeting sales targets, provided the majority of the bonus relates to other non-sales target-based aspects of the balanced scorecard – and provided the person receiving such an incentive is verified as focused on good customer outcomes.

e For the avoidance of doubt, we support the retention of the current set of defined carve-outs from the proposed prohibition, supplemented by the above.

24 Our concern with a solely principle-based approach to prohibiting incentives is the potential for uncertainty and inconsistency. While we disagree with the comment that sales target-based incentives cannot be adequately managed, given the Government's decisions made in this space and the importance of businesses having certainty, we believe the best outcome is the one we have proposed above. If a principle-based approach is adopted, we still recommend that an express set of permitted incentive arrangements is included to provide confidence to providers that the arrangements they put in place are lawful.

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?

25 We agree and support Option 2 as outlined at paragraphs 182 and 183, on the assumption that an express prohibition is included (as opposed to a principle-based approach) as per our submission above. Any prohibition regulations should focus on the point of interaction with customers, which is where the conflict of interest primarily operates.

26 Directors and senior managers do not tend to have a direct interaction with customers, so the ability to materially influence the volume of sales (and qualification for sales incentives) are reduced. The key concern is that there could be sales pressures that are projected down from directors and senior managers. However, directors and senior managers will be subject to their own good conduct and good customer outcome obligations, providing a basis for conflicts of interest to be managed.

Other comments

27 We recommend that consideration be given to only permitting trail commissions (or their equivalent) where evidence of service can be produced by the recipient, or at least evidence of actively offering to provide services to the customer. It is important to restrict commissions from being paid where no services are in fact provided. There is no consumer benefit from doing so, with fees for no service likely to increase the cost of providing services (and hence the likely cost to the consumer) for no apparent benefit.

Requirement to publish information about fair conduct programmes

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?

28 In our view, further guidance is desirable to clarify the information that must be made publicly available under section 446HA. As it stands, section 446HA(2)(a) requires 'a summary of key matters about the fair conduct programme that is in sufficient detail to assist consumers in respect of the matters referred to 446HA(2)(a)(i) and (ii)'. That section is widely cast, and may result in uncertainty as to what should be included in the summary and inconsistent practice in the industry (i.e. overcompliance and undercompliance), potentially causing customer confusion.

29 This is one area where we believe further direction in the form of regulations would be beneficial. That direction must strike the right balance, ensuring that key subject matters are covered off but without overprescribing the detailed information that must be disclosed. Our preferred approach is to follow the approach taken with respect to publicly available financial advice disclosure information under the Financial Markets Conduct (Regulated Financial Advice Disclosure) Amendment Regulations 2020. This provides for prescribed headings and the type of information that needs to be summarised, but leaves the actual content and required wording open for providers to tailor for their business.

Exclusions of certain occupations or activities from the definition of intermediaries

Questions 36 and 37: 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)? Do you think that any other occupations or activities should be excluded from the new proposed definition of an 'intermediary'?

30 We strongly support excluding from the definition of 'intermediaries' those who are already subject to professional regulation. In particular, we recommend that external medical practitioners be expressly excluded from the definition of 'intermediary', along with lawyers, accountants, and engineers. These

professions already have regulatory bodies overseeing their extensive conduct expectations. Financial institutions cannot realistically oversee professionals such as external medical practitioners. Additional requirements could lead to a duplication of regulation and be difficult to enforce. They may also compromise the independence that these external professionals are otherwise able to provide.

Specific responses to the Intermediaries Paper

The treatment of intermediaries

31 As the Bill is currently drafted, requirements are placed on financial institutions to oversee and train intermediaries distributing or managing their products, to ensure good outcomes for customers. This reflects the overall fair conduct principle at the core of the new regime. Our key concern with the current drafting is the extent of the requirement to oversee and manage intermediaries (which seems unworkable) and the extent of the overlap between the obligations that now apply to some intermediaries under the new financial advice regulatory regime introduced under the Financial Services Legislation Amendment Act 2019.

Part 1: Definitions

32 The current definition of 'intermediary' in the Bill is broad, generally covering any person who is 'involved' in the provision of a financial institution's relevant service, and is paid or provided commission for their involvement by the financial institution or another intermediary. The scope of this definition is too broad. It captures sale and distribution activities, as is appropriate. However, it also captures administrative and fulfilment services that support the provision of the financial institution's relevant services, which is not appropriate.

33 We agree with and support Option 1, as it will carve out from the definition persons in 'services that are preparatory to a contract being entered into', as well as those merely involved in administrative tasks. This is important, as it will exclude the likes of lawyers, plain English writers, claims management services, external medical, and claims fulfilment providers. Nothing is gained from a good conduct perspective by including this cohort of support actors within the intermediary net.

34 The application of the new regime to 'agents' is an important one, and we are pleased to see it discussed under Option 2. Conceptually, agents ought to be caught. However, the breadth of the concept creates uncertainty as to the appropriate scope. We support a tailored definition being included in the Bill to narrow the class of persons considered as agents for the purposes of the Bill. It should be expressly limited to those who have a direct involvement in the provision of a financial institution's relevant services or products, and exclude those whose involvement is limited to providing advisory services to the financial institution (such as lawyers and accountants). Classifying advisers as agents is likely to be unworkable in practice.

Part 2: Obligations in relation to intermediaries

35 Our key concern with the interaction between the conduct regime contemplated by the Bill and intermediaries is its overlap with the new requirements imposed on financial advice providers under the Financial Services Legislation Amendment Act 2019. Despite the changes made at the Select Committee stage, the obligations created are unduly onerous and create undue complexity.

35 We strongly support Option 5. This option contemplates refining the obligations imposed to make them more workable, and distinguishing between intermediaries that are licensed financial advice providers (that are already subject to conduct obligations) and intermediaries that are not.

36 In particular, the removal of the proposed requirement for financial institutions to manage or supervise intermediaries to ensure they are supporting compliance with the fair conduct principle is essential, regardless of the status of the intermediary. Financial institutions are not in a position to be able to do that in every situation.

37 Limiting the obligation to ‘monitoring’ strikes a good balance, and the additional obligations contemplated under Option 5 in relation to non-licensed financial advice providers is proportionate.

38 Our only material reservation is in relation to what is actually meant by ‘monitoring’ in this context. Paragraph 51b of the Intermediaries Paper contemplates monitoring whether the intermediary is communicating clearly, concisely, and effectively with consumers about the financial institution’s products. This is excessive, and would amount to an unreasonable intrusion in the intermediary’s business. In our view the obligation should be limited to simply requiring reporting from the intermediary, and monitoring at the entity level to verify that processes are in place, without requiring deep dives into individual advisers’ file records.

Further information

39 We are happy to discuss any aspect of our feedback on the Consultation Papers.

40 Thank you for the opportunity to submit.

Yours faithfully

Privacy of natural persons

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