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Corporate Law, Labour and Commercial Environment Group
Ministry of Business, Innovation & Employment
PO Box 3705
WELLINGTON

Review of the Financial Advisers Act 2008 and the Financial Service Providers (Registration and Dispute Resolution) Act 2008

1. Introduction

1.1 This submission is made on behalf of Minter Ellison Rudd Watts, a national law firm with one of New Zealand's leading financial services law practices. Lloyd Kavanagh, who heads the firm's financial services law practice, is also a Fellow of INFINZ and a former member of the Securities Commission. The submission reflects our own views, and not necessarily those of any of our firm's clients.

1.2 We have focussed this submission on the aspects of the Issues Paper that relate to registration under the Financial Service Providers (Registration and Dispute Resolution) Act 2008 (**FSP Act**), and do not comment on the other matters raised by the Issue Paper, in particular in relation to the Financial Advisers Act 2008 (**FA Act**).

1.3 We have had extensive experience with the FSP Act in dealings with clients since the Act came into force. In particular we have focussed on what we consider to be the fundamental issues of the FSP Act's applicability and the perceived misuse of the register maintained under the FSP Act (the **FSP Register**).

1.4 Below we set out a summary of our submission, and further analysis on each of the points follows. We have not completed the template submission form because only questions 78 and 79 are relevant to the matters on which we wish to make submissions and our submissions do not easily fit within that form.

2. Summary

2.1 The FSP Act and the Anti-Money Laundering and Countering Financing of Terrorism Act (**AML/CFT Act**) both have purposes of assisting New Zealand's compliance with the FATF Recommendations and of building confidence in New Zealand's financial sector.

2.2 However, the applicability of the FSP Act has lost alignment with the applicability of the AML/CFT Act, and we consider that a key function of the FSP Act – assisting New Zealand meet its obligations under the Financial Action Taskforce (**FATF**) Recommendations – has been obscured.

2.3 The misalignment and uncertain applicability of the two statutes has caused significant confusion. In addition, in some cases it has allowed financial service providers to arbitrage the registration regime under the FSP Act and the regulatory regime of the AML/CFT Act, leading to potential misuse of the register and policy concerns about New Zealand's reputation.

2.4 We submit that the most appropriate solution for the apparent deficiencies of the FSP Act is to re-align the applicability of the FSP Act and the AML/CFT Act so that all registered financial service providers are required to comply as AML/CFT reporting entities (unless exempted). This would have the effect of addressing the legitimacy of financial service providers' customers and their transactions. The two core components of this remedy are:

(a) aligning the definition of "financial service provider" and "financial institution" in the FSP Act and the AML/CFT Act respectively; and

(b) aligning the territorial applicability of those two Acts so as to close the loophole which currently allows for the regulatory arbitrage described above.

2.5 We do not consider that providing greater discretionary powers to the FMA or other executive bodies under the FSP Act is the appropriate response. Similarly, we do not consider a comprehensive licensing regime is either necessary or desirable to achieve the correct regulatory setting.

2.6 We explain the above summary points in further detail below.

3. The FSP Act and the AML/CFT Act both have purposes of assisting New Zealand's compliance with the FATF Recommendations and of building confidence in New Zealand's financial sector.

3.1 The FSP Act contains several purpose sections.[1] One of the purposes of Part 2 of the FSP Act, which relates to the requirement for certain financial service providers to register on the FSP Register, is to "conform with New Zealand's obligations under the FATF Recommendations".[2]

3.2 The AML/CFT Act similarly has a purpose of "maintain[ing] and enhanc[ing] New Zealand's international reputation by adopting, where appropriate in the New Zealand context, recommendations issued by the Financial Action Task Force".[3]

3.3 FATF is the Financial Action Task Force on Money Laundering established in Paris in 1989, and the "FATF Recommendations" is defined in the FSP Act as:

(a) the 40 Recommendations adopted by FATF at its plenary meeting on 20 June 2003;

(b) the Special Recommendations on Terrorist Financing adopted by FATF at its extraordinary plenary meeting on 31 October 2001; and

(c) Special Recommendation IX on Terrorist Financing adopted by FATF at its plenary meeting between 20 and 22 October 2004.

3.4 Recommendations 26 of the FATF Recommendations states that "financial institutions" which are not subject to prudential supervision under the Core Principles for Effective Banking Supervision should be otherwise "licensed or registered and adequately regulated, and subject to supervision or monitoring for AML/CFT purposes".

3.5 It is for this reason that the supervisors under the AML/CFT Act use the FSP Register as an indicative (but not comprehensive) list of reporting entities under the FSP Act.

[1] See sections 2A, 9 and 26, FSP Act.
[2] Section 9(c), FSP Act.
[3] Section 3(b), AML/CFT Act.

3.6 In broad terms, the FSP Act applies to persons who provide a "financial service" and the AML/CFT Act applies to "financial institutions", casinos and other entities included by registration. The definitions of "financial service" and "financial institution" are both derived from the definition of "financial institution" in the FATF Recommendations.

4. **However, the applicability of the FSP Act has lost alignment with the applicability of the AML/CFT Act, and we consider that a key function of the FSP Act – assisting New Zealand meet its obligations under the FATF Recommendations – has been obscured.**

4.1 Paragraph 226 of the Issues Paper states that the FSP Register "satisfies New Zealand's obligations under the FATF Recommendations by allowing AML/CFT supervisors to identify financial institutions with obligations under the AML/CFT Act". Unfortunately, this statement oversimplifies the relationship between the two Acts. They do not have the clear relationship that the statement in the Issues Paper suggests.

4.2 The separate legislative and policy processes resulted in two critical differences between the two Acts.

4.3 First, the definitions of "financial service" and "financial institution" were drafted differently, although they were both based on the FATF definition. Examples of the divergence, drawn from the same categories of activity in the FATF Recommendations, include:

(a) the AML/CFT Act applies to a person who carries on a business of "*accepting deposits or other repayable funds from the public*", whereas the FSP Act applies to a person in the business of "*being a licensed NBDT, as defined in the Non-bank Deposit Takers Act 2013*"; and

(b) the AML/CFT Act applies to a person who carries on "*lending to or for a customer, including consumer credit, mortgage credit, factoring (with or without recourse), and financing of commercial transactions (including forfeiting)*", whereas the FSP Act applies to a person in the business of "*being a creditor under a credit contract*".

It is not clear from Cabinet papers or other background papers why the two ministries decided to draft these core definitions of "financial service" and "financial institution" differently.

4.4 The second significant difference between the two Acts relates to territorial applicability. The Acts are not aligned in this regard because:

(a) the FSP Act applies to a person who "is ordinarily resident in New Zealand...or has a place of business in New Zealand, regardless of where the financial service is provided"; whereas

(b) the AML/CFT Act contains no provision setting out its territorial applicability. The AML/CFT supervisors have issued guidance[4] which refers to the test for registration as an overseas company under the Companies Act 1993. The guidance contains the statement "an entity incorporated or formed in New Zealand which carries on financial activities wholly outside New Zealand will not be a 'reporting entity' under the AML/CFT Act". We understand that is interpreted in practice as meaning that if all customers are outside New Zealand, compliance with the AML/CFT Act is not required.

[4] *Territorial scope of the Anti-Money Laundering and Countering Financing of Terrorism Act 2009,* December 2012.

4.5 The consequence of the divergent approaches to drafting the statutes is that there is significant ambiguity as to when one, both, or neither of the Acts applies.

5. **The misalignment and uncertain applicability of the two statutes has caused significant confusion. In addition, in some cases it has allowed financial service providers to arbitrage the registration regime under the FSP Act and the regulatory regime of the AML/CFT Act, leading to potential misuse of the register and policy concerns about New Zealand's reputation.**

5.1 The Issues Paper and various media commentators have raised the prospect of the FSP Register being abused. The criticism generally relates to attempts by non-New Zealand entities registering on the FSP Register for the purpose of giving the impression that they are regulated in New Zealand when this is not necessarily the case.

5.2 The 2014 amendments to the FSP Act[5] sought to address such potential misuse of the FSP Register by allowing the FMA to direct the Registrar to de-register a financial service provider on the ground that:

(a) a person's registration on the Register creates a false or misleading appearance that the person was providing a financial service in New Zealand or was regulated under New Zealand law; or

(b) the person's registration is damaging to the integrity of New Zealand's financial markets or regulation of those markets.

5.3 This is a broad provision of executive discretion which in our view does not deal with the root problem, which is the ambiguity in the applicability of the FSP Act and the misalignment of the AML/CFT requirements. If anything, the powers introduced by the amendment Act have added to the uncertainty, and therefore serve to increase compliance costs for persons seeking to fully understand their obligations in relation to the Act.

5.4 If, for instance, a person supplies financial services solely to wholesale clients who are outside New Zealand from a place of business in New Zealand, then:

(a) the FSP Act is clear that they must be registered on the FSP Register, because section 8A of the Act is explicit that the FSP Act applies "regardless of where the financial service is provided"; but

(b) the AML/CFT Act does not appear to apply, due to its lack of an explicit extraterritorial application and the guidance issued by the AML/CFT supervisors, which states that a person does not need to perform customer due diligence on non-New Zealand clients (as referred to above).

5.5 The Registrar and the FMA have sought to achieve adequate consistency between the FSP Act and the AML/CFT Act by interpreting the FSP Act as applying to persons who carry on substantive business in New Zealand. But in our view this is a confusing approach because the FSP Act was drafted to apply to entities with a "place of business" in New Zealand. The FMA interpretation appears to align more closely to the Companies Act 1993, which requires overseas companies to be registered when they "carry on business in New Zealand". This test was available to the drafters of the FSP Act and is widely known. Lawyers are therefore invited to draw the inference that having a "place of business in New Zealand" is not the same as "carrying on business in New Zealand".

[5] See sections 18 to 18C, FSP Act.

5.6 To make matters more confusing, the AML/CFT supervisors' guidance states that for the AML/CFT Act to apply, the relevant financial activities must be carried on in New Zealand in the ordinary course of business. The guidance goes on to state that:

This implies a place of business in New Zealand from where the activity is directed. This is likely to include New Zealand staff and/or infrastructure that provide the means to carry on the activity. A financial activity may also be carried on in New Zealand by an overseas entity where the entity is actively and directly advertising or soliciting business from persons in New Zealand to such an extent that requires it to be registered under the Companies Act 1993.

5.7 The supervisors' guidance therefore conflates the distinct tests of "carrying on business" and having a "place of business".

5.8 The result is that entities incorporated in New Zealand carrying on financial services business for overseas customers are apparently not required to undertake the due diligence on, and monitor of, those overseas customers which would give confidence as to the integrity of those customers and the business being undertaken. This has created a significant arbitrage opportunity for unscrupulous operators, which will arise whether or not they are registered on the FSP Register but is certainly made more evident by the requirement to so register without complying with the AML/CFT regime.

5.9 We are aware of numerous persons who simply want to understand their obligations under the regime and have sought at great expense to achieve certainty in this regard. Unfortunately, the inherent inconsistencies between the AML/CFT Act and the FSP Act make this a very difficult task. The added threat of receiving a letter from the FMA seeking removal from the FSP Register on very broad policy grounds has only added to the uncertainty and cost to market participants.

6. **We submit that the most appropriate solution for the apparent deficiencies of the FSP Act is to re-align the applicability of the FSP Act and the AML/CFT Act so that all registered financial service providers are required to comply as AML/CFT reporting entities (unless exempted). This would have the effect of addressing the legitimacy of financial service providers' customers and their transactions. The two core components of this remedy are: (a) aligning the definition of "financial service provider" and "financial institution" in the FSP Act and the AML/CFT Act respectively; and (b) aligning the territorial applicability of those two Acts so as to close the loophole which currently allows for the regulatory arbitrage described above.**

6.1 A key concern identified by the Issues Paper is that registration on the FSP register may give a misleading impression as to the extent of a person's regulation under New Zealand law.

6.2 Our submission is that, in large part, this problem could be solved by re-linking the FSP Act with the AML/CFT Act and creating a rule under the AML/CFT regime that every person on the Register is also a reporting entity under the AML/CFT Act and required to comply in full (i.e. including in relation to overseas customers) unless an applicable exemption applies.

6.3 Among other things, this would require registered financial service providers to perform customer due diligence, put compliance programmes in place, provide annual reports, and be audited. That would operate as a significant deterrent to such entities engaging in transactions with undesirable counterparties or transactions of dubious status. It would also allow the existing machinery of the AML/CFT Regime (which includes supervisors' oversight, annual reporting and biennial independent audits) to be used.

6.4 This would go a long way in addressing the policy concerns that have led to the ad hoc powers recently being introduced into the FSP Act, and would also ensure that the FSP

Register was, as it supposed to be, a means by which the AML/CFT supervisors identify reporting entities and thereby effect compliance with the FATF Recommendations. In our view being required to comply with the AML/CFT Regime will be a significant disincentive to disreputable operators and their customers.

6.5 We believe the two pieces of legislation could be aligned relatively simply. As discussed above, the two main components to this exercise would be:

(a) aligning the definitions of "financial service" (in the FSP Act) and "financial institution" (in the AML/CFT Act) by reference to the FATF Recommendations from which the two definitions were initially derived; and

(b) revising the territorial application of the two Acts is both consistent and clear, so that the opportunity for arbitraging the application of the Acts is closed. This could be achieved in part by having the AML/CFT supervisors revise their territoriality guidance ahead of legislation being passed.

7. We do not consider that providing greater discretionary powers to the FMA or other executive bodies under the FSP Act is the appropriate response. Similarly, we do not consider a comprehensive licensing regime is either necessary or desirable to achieve the correct regulatory setting.

7.1 The solution we have proposed above in the section is designed to promote greater legislative certainty instead of greater executive discretion and the compliance costs associated with that.

7.2 We do not consider a licensing regime to be the appropriate response to the shortcomings associated with the financial service providers regime in New Zealand.

7.3 The Issues Paper notes that jurisdictions similar to New Zealand have countered the problem of financial service providers taking advantage of their regulatory regimes by licensing all types of financial service providers. The Issues Paper notes also that New Zealand opted largely for a registration regime because licensing can impose significant costs on financial service providers, thereby creating a barrier to entry and reducing competition.[6]

7.4 We do not consider that a licensing regime, such as the Australian financial services licensing regime of the Corporations Act 2001 (Cth), is the correct approach. In addition to the significant compliance costs associated with licensing, we do not consider that a licensing regime would in fact address the underlying policy concern of maintaining the integrity of New Zealand's financial services sector.

7.5 Licensing regimes tend to focus on the capability of the service provider instead of the transactions and customers of those providers. It is the latter issue which we believe to be the acute concern, and one which could be addressed by ensuring that a financial service provider registered under the FSP Act must also have in place a customer due diligence process both at the on-boarding stage and on an ongoing basis.

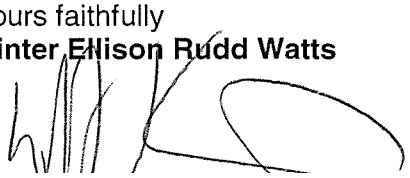
8. Conclusion

8.1 We have presented our submission at a high level at this stage of the legislative review process. We will be happy to discuss technical solutions and drafting issues in more detail in due course if this will be of assistance.

[6] Paragraphs 271 to 274 of the Issues Paper.

8.2 Thank you for taking the time to consider this submission. Please contact me (details below) if you wish to discuss any of the matters raised above further.

Yours faithfully
Minter Ellison Rudd Watts



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