New Zealand Bankers' Association

Submission to the

Commerce Committee

on the

Financial Markets (Regulators and KiwiSaver) Bill

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SUBMISSION BY THE NEW ZEALAND BANKERS' ASSOCIATION TO THE COMMERCE COMMITTEE ON THE FINANCIAL MARKETS (REGULATORS AND KIWISAVER) BILL

1. Thank you for the opportunity to comment on the Financial Markets (Regulators and KiwiSaver) Bill (Bill).

2. Our written submission follows. We would also welcome the opportunity to make an oral submission to the Commerce Committee.

ABOUT NZBA

3. The New Zealand Bankers' Association (NZBA), established in 1891, is a forum for member banks to work together on a co-operative basis. It is a non-profit unincorporated association funded by member banks through subscriptions. Membership of the NZBA is open to any bank registered under the Reserve Bank of New Zealand Act 1989. Currently ten registered banks are members of the NZBA.

4. NZBA provides those services to members which may be most effectively undertaken on an industry basis. These services include:

- Collective submissions on public policy and regulation which affect banks, in relation to, for example, taxation, consumer credit, privacy, terrorism and money laundering
- Development of the self-regulatory Code of Banking Practice
- Development of co-operative inter-bank procedures and standards for retail payment methods such as direct debits and automatic payments
- Development of collective priority documents for securities over real and personal property.

5. Our members are:

- ANZ National Bank Limited
- ASB Bank Limited
- Bank of Tokyo-Mitsubishi, UFJ
- Bank of New Zealand
- Citibank, N.A.
- Hongkong and Shanghai Banking Corporation Limited
- Kiwibank Limited
- Rabobank New Zealand Limited
- TSB Bank Limited
- Westpac New Zealand Limited.

SUBMISSION

6. This submission forms the collective view of NZBA's member banks.

7. NZBA strongly supports the objectives of the Bill. We support the establishment of the Financial Markets Authority (FMA) as the financial markets' conduct regulator and the Bill's main objective or promoting fair, efficient, and transparent financial markets.

8. Our submission focuses on the following matters of concern:

- The consultation process
- FMA's information gathering powers
- FMA's civil action powers
- FMA's levy power
- Changes to securities law
- Changes to KiwiSaver law.

Support requested for establishment of joint industry-government working groups

9. We acknowledge the Government's desire to have the Bill passed and the FMA established as early as possible in 2011. We agree that it is in the interests of New Zealanders as a whole to encourage confidence and participation in financial markets. However, we are concerned that such rapid change has the potential to undermine the desired regulatory outcomes. To ensure the Bill achieves its intended objectives and does not create any unintended consequences, good regulatory practice should be followed to the greatest extent possible.

10. The Bill contains major legislative changes which need to be properly debated. There is also significant work in progress on other reforms which will impact the financial sector. These need to be properly co-ordinated.

11. As the timeframe for consultation is short, we seek the Committee's support to establish working groups among industry participants and officials. These groups would work through important technical detail in the Bill.

12. NZBA's member banks are strongly committed to making the legislation work well and are able to provide technical and practical information and resources to government to support these working groups. A similar approach worked extremely well during the latter stages of the financial adviser reform process. In that case, significant issues were able to be debated and resolved in very short timeframes.

13. NZBA suggests that separate groups be established in relation to:

    - **Part 2, Subpart 1 of the Bill:** Power to obtain information, documents and evidence

    - **Part 2, Subpart 3 of the Bill:** Power to exercise a person's right of action

- **Part 5 of the Bill:** Amendments to the Securities Act 1978[1]
- **Part 7 of the Bill:** Amendments to the KiwiSaver Act 2006.

Membership of board of FMA

14. The Minister can appoint associate members of the FMA, either generally of in relation to a specific matter or class of matters. NZBA submits the FMA would benefit from having an associate member with specialised experience in the banking industry in order to advise on issues affecting the banking sector and to help the FMA quickly understand and deal with new products and services. This would help the FMA understand and effectively regulate a sector that is one of the largest distributors of financial products in New Zealand. It could also help the FMA to work effectively with industry stakeholders such as the Reserve Bank of New Zealand and registered banks in New Zealand.

15. NZBA would be happy to recommend a banking industry expert for any such appointment.

Power to obtain information, documents and evidence

16. NZBA supports giving the FMA appropriate powers to obtain information and documents. However, the power to search another person's private property is fundamentally intrusive and must be properly balanced against privacy rights.

17. The Bill proposes the FMA will have comprehensive powers to enter and search premises and to seize documents and data. This is a fundamental change from the status quo. A more limited version of these powers has historically only been available to the Commerce Commission (Commission).[2] The Commission's

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[1] This working group could be further divided into subgroups dealing with, for example, disclosure, derivatives, and collective investment schemes. We consider this would be of great benefit to the securities review process as well as the consultation process on the Bill and would assist co-ordination between the reforms.

[2] As a drafting point we note that there is no obvious equivalent to section 98B of the Commerce Act, which expressly states that documents can be seized during a search. Without that, the power to search may be somewhat redundant.

powers were only available under the Commerce Act 1986 and traditionally used to investigate the serious offence of price fixing. The Commission has never had this power to investigate other arguably less serious matters such as breaches of the Fair Trading Act 1986.

18. By contrast, the proposed FMA search powers will extend to possible contraventions of all financial markets legislation. This legislation is listed in Schedule 1 of the Bill and includes the Companies Act 1993, the Financial Advisers Act 2008, the Unit Trusts Act 1960 as well as the Securities Act 1978.

19. The search powers are, for example, broad enough to allow the FMA to conduct a search to investigate an allegedly misleading advertisement. It is not clear why such powers are needed for all such legislation, or why such investigations cannot be conducted effectively through other conventional mechanisms, such as information requests and interviews.

20. The proposed powers are controversial and must be properly debated to ensure they are not over-reaching. For example, consideration could be given to establishing an appropriate threshold for the use of the proposed powers which would exclude their application to less serious offences.

21. The need for caution is reflected in the progress of the Search and Surveillance Bill, which has been referred back to Select Committee due to concerns over expanded search powers. Banks have confidentiality obligations to their clients which could be impacted if documents were searched or seized by the FMA. The Bill should provide some measure of protection in such circumstances. For example, a clause could be added providing that the search or seizure of documents by the FMA shall not breach any confidentiality obligations owed by financial market participants to their clients and shall not render such participants liable to their clients on this basis.

22. Of related importance to our member banks is the need to identify and protect privileged information during a search.

23. NZBA submits information obtained by the FMA should be presumed to be confidential information and, for the purposes of the Official Information Act 1982 (OIA), should be deemed by default to be information that, if disclosed, would be likely to unreasonably prejudice the commercial position of the supplier or subject of the information.

24. Furthermore, where, in the circumstances of the particular case, other considerations render it desirable, in the public interest, to make information available despite that information being commercially prejudicial for the purposes of the OIA, the entity from which the information was obtained should at a minimum be given advanced notice of an OIA application for the release of the information, so that entity would have sufficient opportunity to consider and if appropriate oppose the request.

25. It would also be appropriate for any information not directly relevant to the purpose of the request to be treated as confidential by the FMA and that such information would not be available for:

- public release (including pursuant to a request under the OIA)
- release to another law enforcement or regulatory agency under clause 30 of the Bill, or
- release to an overseas regulator under clause 31 of the Bill.

Civil actions

26. For on civil actions note that all member banks oppose the regime for FMA collective actions as drafted. The submission in paragraph 27 is made on behalf of nine of the NZBA's ten member banks. However the remainder of the submissions in this section are made on behalf of all member banks (paragraphs 28 to 37).

Majority submission

27. Nine of the ten member banks oppose clauses 34 to 37 on the basis that they impose a regime where people must act or forgo their rights. For instance:

- The right to bring proceedings is an individual's right and the FMA should not be able to bring an action without a person's consent.

- The provisions discourage potential claimants from considering whether they want to commence litigation themselves, and increases the likelihood that the taxpayer will bear the cost of private rights of action.

- The provisions preclude individuals from pursuing claims brought on their behalf by the FMA, even where they did not agree to the FMA doing so.

- If a person objects, the FMA should not be able to override that decision. The FMA should not be able to ignore that decision if a person chooses to bring their own proceedings or, for their own reasons, does not wish to bring proceedings. While there appear to be checks and balances on the FMA's power there are two main concerns:

    - The cost to the person not wanting to consent having to instruct lawyers and/or appear in the High Court to explain why, which are likely to be prohibitive to ordinary people.

    - The potential for breach of privacy, where the person does not want to be the "test" case that is used by the FMA in its Court proceedings. There are many people who go through the Banking Ombudsman service to avoid the publicity of legal proceedings or *Fair Go*. Has this been considered by the Privacy Commissioner?

Public interest test

28. NZBA submits consider the public interest test gives the FMA very broad discretion over what claims to take and whether to take those claims. Clause 34(1) allows the FMA alone to determine what is in the public interest.

29. While the Bill's Explanatory Note states that the expectation is that the power will be used infrequently, the public interest test in clause 34 gives the FMA very broad discretion over whether to take claims. Much will depend on the enforcement policy of the FMA, which cannot yet be predicted, and will be subject to change.

30. More restricted criteria are necessary to determine when such a power should properly be exercised, and the determination of when bringing an action is in the "public interest" should not be left solely to the body wishing to bring that action.

31. Clause 34(4) sets out the factors that the FMA must consider in determining whether exercising a person's right of action is in the public interest. The interests of the underlying claimant should be a mandatory consideration to be balanced, at the very least, with other factors considered by the FMA. At present, the Bill gives the FMA discretion over whether to consider their interests and ranks them below other considerations. Clause 34(3) simply says that in exercising this power the FMA "may" take into account their interests, giving the mandatory considerations in clause 34(4) greater priority.

32. NZBA submits that the FMA should be required to consider whether a person has the means and the capability to enforce the rights that have been breached, whether they have access to funding, could pursue representative proceedings or whether other alternative regulatory action could be brought.

Specified persons

33. NZBA considers the definition of "specified person" in clause 34(2) to be considerably wide. While senior management may exercise significant influence, they are not the ultimate decision makers. Given the nature of the financial services business, higher standards may be warranted. However, one negative

side effect may be to deter talented and capable people from directorships of financial service providers in favour of other industries. Those who do take up the challenge may act in an unduly cautious and risk-averse fashion, stifling growth and innovation in financial markets.

Recovery of costs

34. The Bill would allow the Court to order the recovery of reasonable costs incurred by the FMA from a person whose right is being exercised.

35. NZBA submits any costs should only be imposed where the FMA has been successful in its action, and it reimburses itself for its costs out of the proceeds of the action before distributing the remainder of the proceeds to the beneficiaries.

Powers of high court for proceedings exercising person's right of action

36. NZBA opposes the extent of powers proposed to be granted under clause 39 in that they do not require consultation with affected parties. The Bill would allow the FMA to control the exercise of a person's private rights of action and the proceedings without their input. The FMA should be required to consult with affected parties if it is to control the exercise of private rights of action.

Representative actions

37. NZBA opposes clause 40. Representative actions are currently currently provided for in the High Court Rules and there is no need for this provision.

Levy

38. We support a strong, adequately resourced FMA and, in principle, a levy on financial markets participants to help fund a portion of the FMA's costs. We appreciate that the existing Securities Commission is underfunded, and that

pooling the resources of the agencies that will form the FMA will not provide an adequate budget.

39. However, any potential levies should be applied to financial markets participants fairly and reasonably, and should not simply be targeted at those participants who are in a better position to afford a levy. In addition, we are strongly opposed to the retrospective application of any such levy.

40. While we appreciate that the shape of the levy will be prescribed by regulations, in our view the levy should be calculated on a 'user pays' basis according to the proportion of the FMA's time and resources for each class of market participant consumes. Higher risk market participants will be subject to closer monitoring and supervision, and as such should be subject to a higher levy than lower risk participants. Banks should be considered lower risk as they are subject to other regulators such as the Reserve Bank of New Zealand as well as the FMA.

Securities Law Changes

Are changes to the Securities Act necessary ahead of securities law review?

41. NZBA questions the need to fast-track aspects of the securities law review in advance of the completion of the Ministry of Economic Development's Review of Securities Law, which is only in its initial stages.

Consideration Period does not work for continuously issued products

42. NZBA is strongly of the view the clause 97, which prevents the allotment of securities for five days following registration of a prospectus (Consideration Period) will not work for and should not apply to prospectuses registered for continuously issued securities.

43. Clause 97 of the Bill proposes a new section 43D of the Securities Act which does not work for securities that are continuously issued, as is the case for most collective investment schemes including KiwiSaver and unit trusts.

The problem

44. Clause 97 requires the Registrar (upon receipt of a prospectus or instrument amending a prospectus) to immediately register that prospectus or instrument and prevents the allotment of securities during the Consideration Period. During the Consideration Period the FMA may consider whether the documents comply with the Securities Act and the regulations and whether they are false or misleading in a material particular. The FMA may extend the Consideration Period for a further five days.

45. The effect of this new section as it is currently drafted means continuously issued securities would need to be taken off the market each time a prospectus is renewed or an amendment to a prospectus is registered, as no allotments can be made or subscriptions received under that prospectus or amended prospectus during the Consideration Period.

46. We understand that the regime in Australia was considered and used as a basis for introducing the Consideration Period. However, we note that the regime governing disclosure for continuously issued securities in New Zealand is not analogous to that in Australia. In Australia, issuers are not required to register their offer document and simply file a notice advising the Australian Securities and Investment Commission that they have a current product disclosure statement in use. As such, a Consideration Period does not apply to collective investment schemes in Australia.

47. Under the Securities Act, issuers are required to register a new prospectus at least once a year and make amendments to the current registered prospectus in the event of material changes to the offer. Prohibiting issuers of continuously issued

securities from allotting securities during the proposed Consideration Period will be problematic and in some cases unworkable for the following reasons:

- The temporary suspension of a continuously issued security will have a significant negative impact upon the confidence of both investors in that product and investors generally, particularly as the duration of suspension cannot be certain.

- The suspension of allotments is administratively difficult and in some cases outside the control of the issuer. For example, KiwiSaver schemes would be unable to suspend the allotment of securities to new members who are automatically enrolled under the KiwiSaver Act.

- For some continuously issued securities that offer fixed term investments, many investors opt for their investment to be automatically reinvested upon maturity of the agreed term with units allotted accordingly. The proposed Consideration Period will mean that automatic reinvestment upon maturity will not be possible. This will be inconvenient and potentially confusing for investors.

- Many investors choose to make regular investments in a collective investment scheme by way of a direct debit or automatic payment initiated on an agreed regular frequency (for example fortnightly or monthly). Under the proposed regime, issuers would be unable to initiate any direct debit or receive any automatic payments during the Consideration Period. Issuers will be required to give advance notice to all affected regular investors and will require direction from such investors as to how to proceed with respect to the payment. In addition to being both confusing and inconvenient for investors such a process would impose a costly additional administrative burden on issuers.

- In practice the Consideration Period could effectively extend beyond five -10 days. For example, if there are changes required to a

prospectus as a result of the FMA's review, the issuer would be required to cancel and reregister the prospectus, or to file an amended document – presumably thereby restarting the Consideration Period. Such a scenario would give rise to significant complications in relation to the update, printing and distribution of the investment statement in light of the requirement to ensure consistency between offer documents.

Alternative approaches

48. If the FMA wishes to put in place a process under which prospectuses for collective investment schemes can be reviewed prior to allotment of securities under that prospectus, NZBA submits that the FMA consider retaining the ability for issuers opt to have a pre registration review of the prospectus (as per the process currently conducted by the Companies Office).

49. Alternatively, NZBA submits that a form of class exemption could be given for prospectus renewals and amendments for continuously issued securities so that the Consideration Period does not apply. This could be included in the legislation or be in the form of a class exemption notice. Including the exemption in the legislation is preferable as it gives issuers greater certainty.

50. Should neither of the above approaches be acceptable, NZBA submits that any change be deferred to align with the single product disclosure statement proposal that is being considered under the wider securities law review.

Additional matters

Related company website disclosure

51. Clause 97 of the Bill (in respect of the amendment to section 43B of the Securities Act), relating to the obligation of the issuer to give public notification of the fact of registration of a new prospectus or of an instrument amending a prospectus on its internet site, should permit issuers to make that disclosure on a related company's

website where that website is used by the issuer to market and distribute the collective investment scheme.

Disclosure of warnings

52. Clause 47 of the Bill gives the FMA the power to issue a warning in respect of a financial markets participant or another person who is dealing in securities. They can then require that the warning be disclosed on the relevant party's internet site or that any other documents be supplied to a third person. Whilst the power to issue a warning is not questioned, the power to require disclosure requires further clarification. Disclosure would not be appropriate in all circumstances. For example, where the conduct which warranted the warning has been rectified and/or remedied or where the damage to reputation or otherwise would be disproportionate to the conduct.

KiwiSaver

Potential areas of ambiguity requiring clarity

53. NZBA generally supports the proposal to align KiwiSaver schemes with unit trusts from a structural perspective. However, there are significant areas of ambiguity in the Bill which require addressing. Those identified by NZBA member banks are summarised below. However we consider the provisions still require a close check to make sure the provisions operate as intended and all consequential amendments required are set out clearly.

54. Clause 116D of the Bill states that the manager may appoint an administration manager and/or an investment manager to undertake some or all of the administration/investment functions of the scheme. NZBA presumes this express authority does not prevent the manager from delegating other functions if permitted by the trust deed, but we would like some clarity around this.

55. The Bill states that the functions and duties of the manager include that the manager must act in the best interests of members of the scheme (clause 206 of the Bill, which proposes new clause 1C(b) of the KiwiSaver scheme rules). We would like to receive confirmation from the MED that trust deed powers designed to operate for the benefit of the manager and the trustee need not be exercised in the best interests of members, given that not all powers vested in the manager will be held in a fiduciary capacity. Furthermore, it should be made clear that it is the best interests of investors as a whole, rather than each individual investor, that should be assessed.

56. Given that the trustee's role in relation to KiwiSaver has shifted towards more of a monitoring role, there is some uncertainty as to what that entails. For example, the audited accounts for a KiwiSaver scheme are required to be 'approved' by the trustee (clause 120(d) of the Bill), but it is not clear what this 'approval' entails. In addition, one of the broad functions of the trustee is to supervise the manager's performance of its functions. This has the potential to go beyond the pure monitoring role of the trustee and requires the trustee to consider whether the current activities of the manager are appropriate, and is not supported by NZBA. This could create an undue burden and cost on the trustee to review the manager's activities. We also consider it inappropriate for a trustee to be 'second guessing' a specialist fund manager's activities, where the trustee will generally not have this level of specialist knowledge.

57. The Bill does not expressly provide for the trustee under the new KiwiSaver structure to hold assets through a nominee. It is established practice in New Zealand (in legislation such as the Unit Trusts Act 1960) and internationally for trustees of collective investment schemes to delegate custody of assets to a nominee or custodian. Furthermore, offshore laws sometimes require the legal owner of assets (being the trustee) to be a registered entity in that foreign country, necessitating the use of a custodian or nominee. The Bill should be amended to clarify that the trustee is entitled to delegate custody.

58. There are a number of operational functions that should be transferred from the trustee to the manager to reflect their new roles. In particular these include:

- Key operational functions in relation to certain transfers between KiwiSaver schemes (section 177 of the Bill which proposes new sections 119D, 119F, 119H and 119I of the KiwiSaver Act).

- KiwiSaver scheme rules in relation to early withdrawal as well as applications for withdrawal or transfer to a foreign scheme in the case of permanent emigration or transfer to another KiwiSaver scheme (clauses 8, 9, 10, 12, 14 and 16 of Schedule 1 of the KiwiSaver Act).

- Reporting requirements such as the annual report (section 122, 123 and 124 of the KiwiSaver Act); annual return (section 125 of the KiwiSaver Act); and annual personalised statement (section 125A of the KiwiSaver Act).

59. Similarly, the requirement in proposed clause 1B (2)(b) of Schedule 1 to the KiwiSaver Act for the trustee to exercise care, diligence and skill required of a trustee under the Trustee Act does not align with the manager's obligation to manage the schemes property and investments rather than a trustee and the trustee being required to comply with the directions of the manager.

60. The number of misaligned functions suggests that a thorough audit is required to ensure that, moving forward, all functions are appropriately allocated to the new roles of trustee and manager under the new regime.

61. Sending updated investment statements to investors is a costly, inefficient and ineffective method of communicating changes made to an investment. In our view a better and more cost efficient way to communicate the key changes would be by way of a letter or flyer in the next annual report for the scheme. As such, the Bill should expressly provide that there is no requirement to send new investment statements to investors to notify them of the key changes brought about.

62. The Bill creates a new class of restricted KiwiSaver schemes. We understand that trustees of restricted KiwiSaver schemes will not be required to be licensed under

the Securities Trustees and Statutory Supervisors Bill. This could undermine the KiwiSaver 'brand' and create competitive distortions, especially in relation to larger restricted KiwiSaver schemes. In our view these schemes should be required to make additional disclosures, and a size requirement should apply to restricted KiwiSaver schemes in addition to the proximity requirements already prescribed.

Technical Issues

63. There are a number of issues that need clarification or re-drafting:

- Clause 177 of the Bill makes changes to the provisions of the KiwiSaver Act 2006 relating to compulsory transfers. The wording should be amended to clarify that compulsory transfers do not constitute offers of securities to the public.

- Clause 208 of the Bill provides for amendments to certain enactments listed in Schedule 6 of the Bill. NZBA submits that various additional amendments will need to be considered under the Securities Act 1978 in the light of the change of issuer. For example, Schedule 6 of the Securities Regulations 2009 sets out the prospectus requirements for superannuation schemes. Clarification that Schedule 6 applies to KiwiSaver schemes is required and consequential amendments to Schedule 6 (in recognition of the change in issuer for KiwiSaver schemes) will be necessary. In particular:

    - there should be a requirement to disclose the directors of the manager but not the trustee;

    - the disclosure required in respect of character (bankruptcy, dishonesty, solvency etc) should apply to the directors of the manager instead of the trustee;

    - the statement in respect of whether there have been any material or adverse changes during the period between the date of the latest

financial statements referred to in the prospectus and the specified date should be required from the manager instead of the trustee;

- there should be a requirement to disclose the name and address of the manager of the scheme; and
- the definition of "administration manager" and "investment manager" in the Securities Regulations 2009 in respect of superannuation schemes require amendment as they are imported from the Superannuation Schemes Act 1989 and are unlikely to be appropriate for KiwiSaver schemes given they recognise trustee appointments.

Transitional provisions

64. Given the substantial amount of work that the Bill engenders, we would like to see a transitional period of 12 months to implement these changes. That way changes to trust deeds and offer documents can be made to align with the scheme financial year end, a natural juncture to transfer issuer responsibility and liability from trustee to manager.

65. A number of transitional issues will need to be considered to ensure a robust and workable transition including:

- The new requirements will give rise to a variety of changes to the disclosure documents for KiwiSaver schemes, which will add significant cost to the fund. The Bill should expressly allow updates to investment statements to by way of a supplement or insert in an investment statement;

- Ensuring that there is no need to treat trustees as “promoters” on the basis that they were originally “instrumental” in the formulation of the relevant schemes. This is relevant to the extent of the trustee’s liability for advertisements of the KiwiSaver scheme – while the removal of the

trustee as issuer dispenses with the need for trustees to sign certificates in accordance with regulation 30 of the Securities Regulations 2009, this does not remove the level of administration for the approval of advertisements given that promoters are liable for advertisements under the Securities Act; and

- Ensuring that the requirements of the Financial Reporting Act 1993 in respect of KiwiSaver schemes are satisfactorily transferred from the trustee to the manager.

66. The transitional provisions, currently contained in clauses 209 to 216 of the Bill, should also cover the following issues to ensure a robust and workable transition:

- Amendments to section 129 of the KiwiSaver Act to change the obligations from trustee to manager, and

- The Bill proposes to amend clause 2 of schedule 1 of the KiwiSaver Act 2006 by inserting "the manager of the scheme" as paragraph (ab). We note that the schedule will retain the reference to administration manager and investment manager and the inclusion of these parties may need to be revisited depending on the revised definitions of administration manager and investment manager and the nature of any fee for services supplied by such parties (i.e. in some cases they will be paid out of the manager fee).