

Submission to the Ministry of Economic Development

**Financial Markets
Conduct Bill**



Kiwibank Limited
6 September 2011

PART 1

INTRODUCTION

1 Introduction

- 1.1 This submission has been prepared by Kiwibank Limited ("**Kiwibank**") in relation to the Financial Markets Conduct Bill (the "**Bill**"). Kiwibank welcomes the opportunity to make a submission to the Ministry of Economic Development ("**MED**") on the Bill.
- 1.2 This Bill is a highly ambitious project and Kiwibank commends MED's efforts in producing the Bill. Kiwibank also strongly endorses the use of pre-introduction exposure drafts of proposed legislation, particularly when the proposed legislation is the length and complexity of the Bill. Kiwibank would encourage you to continue this practice.

2. About Kiwibank

- 2.1 The Government, as the shareholder of New Zealand Post Limited ("**NZ Post**"), granted approval for the establishment of a publicly-funded bank in 2001. Kiwibank was subsequently established and opened for business in early 2002. Kiwibank's ultimate parent company is NZ Post.
- 2.2 Kiwibank was established as a New Zealand-owned bank, for New Zealanders. At that time, it was intended that Kiwibank:
 - would have lower fees;
 - would benefit customers of other banks by keeping the other banks honest, producing lower fees and interest rates at all banks; and
 - would have more branches than any other bank.
- 2.3 Today, Kiwibank has the largest branch network in the country, with around 300 branches nationwide situated at PostShops around New Zealand. Through a shared cost and host business model, Kiwibank has branches in places that would not otherwise be economically viable. Kiwibank has made local banking accessible to people in areas that would otherwise miss out.
- 2.4 NZ Post is the agent of Kiwibank. Kiwibank pays NZ Post a transaction fee for every transaction undertaken at a PostShop. Where a Kiwibank transaction is undertaken at a franchise, the franchisee is paid by NZ Post. Approximately 150 PostShops are franchises; the remainder are owned and operated by NZ Post. Customer money is not directed through separate NZ Post or franchise accounts, but is deposited directly with Kiwibank. Kiwibank guarantees and retains responsibility at all times for the transactions and services provided by NZ Post and its franchisees on behalf of Kiwibank. In addition, the payment obligations of Kiwibank are guaranteed by NZ Post.

- 2.5 Kiwibank provides a full range of domestic banking services (retail and business), KiwiSaver and international banking services and investment management services to institutional clients. Kiwibank also provides investment products through AMP Capital Investors, and life insurance through Kiwi Insurance Limited and by way of contractual arrangements with CIGNA Life Insurance New Zealand Limited and TOWER Life respectively.
- 2.6 Kiwibank maintains a robust customer dispute resolution process for all disputes related to the Kiwibank brand irrespective of where they arise. Kiwibank is also a member of the Banking Ombudsman's Dispute Resolution Scheme which provides bank customers with an independent avenue of recourse should a dispute prove irresolvable through Kiwibank's internal dispute resolution process.

3. Contact details

If you would like to discuss any aspect of this submission, please contact:

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4. Confidentiality

- 4.1 We confirm that Kiwibank has no objection to the Ministry publishing this submission on the Ministry's website.

5. Structure of this submission

- 5.1 We set out below Kiwibank's comments on the Bill, under thematic headings. As Kiwibank's points are of a more general nature (and not of a technical/drafting nature), we thought this letter, instead of MED's suggested clause-by-clause template, would be more appropriate. We would be happy to provide further detail or more specific references on your request.

PART 2

SUBMISSIONS

1. Financial products

- 1.1 The four financial products are defined in section 8, but there is uncertainty around the distinctions between different financial products (for example, where a product looks like both debt and a managed investment product, which is it?). Kiwibank has pioneered a number of new and innovative products into the New Zealand market. In particular, Kiwibank launched one of New Zealand's first "cash PIEs". As you will be aware, cash PIEs essentially operate as a "wrapper" around existing debt securities; it seems to us that cash PIEs would likely fall within the definition of "debt" as customers have the right to be repaid their deposit plus interest. However cash PIEs are also undoubtedly managed investments (being units in a unit trust). We suggest this provision needs to be clarified and aligned with the relevant provisions of the PIE taxation.
- 1.2 Although the Financial Markets Authority ("**FMA**") does have the ability to designate a security to be a certain financial product, it would be preferable if the definitions could be made more certain now, an option being to list the products that definitely fall into certain definitions or, alternatively, by tightening up the definitions.

2. Misleading and deceptive conduct

- 2.1 Under part 2 of the Bill, the FMA appears to be taking responsibility for enforcing all "financial services" misleading or deceptive conduct rules (i.e. taken out of Fair Trading Act and Commerce Commission enforcement). "Financial services" includes financial advice, broking, banking, credit, money transfer, financial guarantees, foreign exchange as well as financial products.
- 2.2 Kiwibank supports this proposal as it makes sense to bring the provision of financial services under one regulator and this should also lead to greater clarity and consistency in regulation.

3. Product disclosure

- 3.1 Part 3 of the Bill proposes one offer document – a product disclosure statement ("**PDS**") - to replace the currently required offer documents of an investment statement and a prospectus.
- 3.2 Kiwibank is generally supportive of this proposal so long as the PDS is meaningful to potential investors and not simply a template of required statements that tell investors nothing about the individual product. Kiwibank also supports the proposal to exclude bank debt securities and category 2 products from this disclosure.

- 3.3 In relation to product disclosure and derivatives (see also our comments at paragraph 18 below), we suggest that the focus of the disclosure requirements should be aligned with the current disclosure requirements under the Securities Act (Registered Banks Futures Contracts) Exemption Notice 2007. In our view, these disclosure requirements (primarily focused on the risks of derivatives) work well.
- 3.4 Kiwibank would however suggest that, when the regulations are drafted, MED consider drafting in a regime that requires issuers to only update a PDS when there are material changes to the offer (instead of every 9 months as is required for prospectuses under the current regime). It seems to us that so long as a PDS is still accurate, then there should be no need to review and update it simply due to the passage of time. In particular, if detailed matters such as financial statements and lists of directors are included as part of the "register entry", then it seems to us that it is quite likely that at least some PDSs could remain accurate indefinitely.

4. Lodgement process

- 4.1 The newly-introduced "lodgement" process under the Securities Act 1978 (the "**Act**") is retained in part 3 of the Bill, however in practice, it appears that the FMA is continuing to use the pre-registration review process.
- 4.2 Kiwibank submits that the pre-registration review process should be retained as it is a useful process and gives clarity and comfort to providers, but it may be more transparent to have this review process formally recognised in the legislation.
- 4.3 Kiwibank also submits that while it supports the new online registration process and would like it to be retained; it would be useful if the timing around submitting online and actual registration could be clarified.

5. Consent of person to whom statement attributed

- 5.1 Clause 41 of part 3 of the Bill proposes removing the "expert statement" rules and the concept of "promoter", and replacing these with the general false/misleading prohibition and by requiring any statement attributed to a person to have the consent of that person.
- 5.2 Kiwibank submits that this should not apply to publicly available information as this would be too onerous on issuers, and there should also be an exemption for any "internal experts".

6. Continuously allotted securities

- 6.1 Clause 49 of part 3 of the Bill retains the Act's exemption for continuously allotted securities.
- 6.2 Kiwibank submits that this is working well in practice and should be retained.

6.3 Kiwibank also submits that, in relation to securities that Kiwibank offers that are not continuously allotted, the length of the no allotment period should be clarified (for example, how will the issuer know if the FMA chooses to exercise its discretion to extend the 5 working day period to 10 working days).

7. Defective disclosure

7.1 Clause 62 of part 3 of the Bill proposes adopting the Australian "cure period" approach. In the event that disclosure is defective (e.g. a PDS is misleading/deceptive), then the issuer may (a) repay the subscriptions; or (b) give a supplemental disclosure and a one-month cooling off period. After one month, the subscriber is deemed to have accepted the new disclosure.

7.2 Kiwibank supports this proposal on the basis that this approach appears to be reasonably well-liked in Australia and is at the very least an improvement on the void/voidable situation under the current legislation.

8. Unsolicited offers

8.1 Clause 69 of part 3 of the Bill proposes banning unsolicited offers of financial products in the course of physical meetings, telephone calls and electronic communications. This prohibition seems unnecessarily broad to us.

8.2 Kiwibank submits that:

- the electronic communication limb of clause 69(1)(b) seems inappropriate. This would appear to duplicate the subject matter of the Unsolicited Electronic Messages Act 2007. This regime allows customers to expressly opt-in to offers of new financial products and sets a clear standard for "consent", whereas the proposed regime in the Bill merely refers to "unsolicited";
- related to the previous point, we consider that electronic replacements of paper communications (e.g. electronic credit card statements) should be able to include the same information that the equivalent paper communication contains. It seems arbitrary that a paper credit card statement could include a brochure for a new financial product, but the electronic equivalent of the same statement could not;
- offers by a QFE of new financial products to its existing customers should be excluded from the prohibition. A QFE should also be able to make an offer directly, and not have to go through a QFE adviser per clause 69(3)(c); and
- offers of financial products to businesses should not be subject to the unsolicited financial products prohibition. This reflects the status quo under section 35 of the Act and ensures that Kiwibank's business banking representatives will be able to continue their current practices.

9. Advertising

- 9.1 The definition of "advertisement" in clause 6 contains several words that are not defined, for example "made to", "public/section of the public" and "promoting". This makes it difficult to work out what an advertisement is confined to and whether it is meant to be narrower or wider than the current definition.
- 9.2 In addition, the term "advertisement" is not used in section 71(1) and other parts of the Bill, but instead "advertise" and/or "publish a statement" are used. This makes the definition of "advertisement" more uncertain as it is unclear whether it should be confined/extended to these concepts or whether these concepts should be removed and there should only be references to "advertisement".
- 9.3 Clauses 71 – 76 use a range of phrases including "advertise", "publish a statement", "advertisement may be distributed" and "publication may be distributed". It is unclear whether all these phrases refer to the same thing, and if so, what is the one concept (distributing an advertisement, publishing an advertisement, making an advertisement), and if not, what is the distinction between "publish" and "distribute" and "advertise" and "statement" and how do they tie in with the definition of "advertisement"?
- 9.4 Kiwibank supports the test set out in clause 71(1)(b) however, and wonders whether just using this test (but replacing "statement" with "advertisement"), would clarify the concept of advertising. Kiwibank also thinks the factors set out in clause 72 are very helpful and think these limit advertising appropriately.
- 9.5 Kiwibank agrees that there should be some type of defence for publishers from the advertising obligations, and likes the test in clause 78 of "published in the ordinary course of business" and the publisher "did not know and had no reason to believe that the advertisement would contravene sections 71 or 77". Kiwibank however submits that the scope of publishers is too narrow and not clearly defined. For example, what is a "financial markets commentary internet site"? Any internet site that mentions financial markets in passing or something more?
- 9.6 Kiwibank is of the view that the definition of "advertisement" should be clarified (so either the words mentioned above would be defined or different words would be used), sections 71 -77 (and any other references to advertising) would all refer to "publishing an advertisement" (or something similar), the test in section 71(1)(b) and the factors in section 72 would be retained and there would be a sign off process like the current regulation 30 certificates.

10. Governance of debt securities

- 10.1 Part 4 of the Bill requires all regulated offers of debt securities to have a supervisor (formerly a "trustee").

10.2 It appears that registered banks are exempt from this requirement (as registered banks in relation to issues of debt securities and category 2 products are one of the exclusions in part 1 of Schedule 1), which Kiwibank supports. However we wondered if the intention was for something like a cash PIE unit trust to be captured, as potentially it could be (as we understand where a financial product looks like debt and a managed investment product, it will be classed as a debt security). This would mean there could be a cash PIE unit trust with no supervisor.

10.3 While Kiwibank of course supports limited or no disclosure by registered banks for offers of financial products, we would appreciate clarification as to whether our interpretation of the registered banks' obligations under the new regime is correct. We recognise that this may be dealt with in the regulations.

11. Managed investments

11.1 Kiwibank broadly supports the proposed regime around managed investment schemes. However, we reiterate our point discussed in paragraph 1.1, which asks for clarification around whether a cash PIE is intended to be a debt security or a managed investment scheme, and whether the intention is accurately portrayed in the Bill.

12. Senior manager obligations

12.1 Clause 126A in part 4 of the Bill introduces the concept of senior managers of fund managers being subject to "improper advantage" restrictions.

12.2 Kiwibank supports this new concept.

13. Limit break and pricing error reporting

13.1 Clauses 145 and 146 of part 4 of the Bill require the manager/supervisor to report a breach of a limit (for example in relation to the nature/type of the investment or the proportion of each type of assets that may be invested in) or a miscalculation of the value of the managed investment product, to the FMA.

13.2 Kiwibank supports remedying such a breach, but is not sure what the point of notifying the FMA is. If the manager takes the prescribed steps to remedy the breach, is this not sufficient?

14. Related party transactions, related party benefits

14.1 We are broadly supportive of the restrictions on related party benefits under clauses 150 to 152 of the Bill. In particular, we consider that supervisors should be able to approve "soft dollar" commissions in accordance with the fund's best execution policy (for example, soft dollar commissions may be accepted provided that the execution factors are otherwise identical). Soft dollar commissions such as market research are often of significant benefit to investors in a fund.

14.2 However we note that there are more onerous related party benefit restrictions for discretionary investment management services ("**DIMS**") licensees under clauses 422 to 424 of the Bill. We consider that DIMS licensees (as for funds) should be able to accept soft dollar commissions in accordance with a best execution policy that is disclosed to investors. We would anticipate that the FMA would review a DIMS licensee's best execution policy as part of the licensing process.

15. Exchange licensing

15.1 Clause 290 of the Bill provides that a "financial product market" is a facility by which offers to acquire or dispose of financial products are regularly made or accepted.

15.2 Kiwibank is concerned that this definition of "financial product market" is potentially broad enough to include an "open an account" facility on online banking. There is an exemption where it is the offeror's "own" financial products being acquired and disposed on the facility, but without the concept of "promoter" lots of financial institutions could be found to be acquiring/disposing of products that are not their "own", but issued by a subsidiary, etc.

15.3 Kiwibank submits that the exemptions should be clarified to ensure that this situation is not captured.

16. General market services licensing

16.1 Under part 6 of the Bill licenses are required for:

- fund managers;
- independent trustees;
- DIMS;
- derivatives issuers; and
- prescribed intermediary services,

but not for custodians, transfer agents, payment agents, registrars or administration managers.

16.2 Kiwibank submits that if the supervisor and manager need to be licenced, so should the custodian.

16.3 Kiwibank also notes MED's comment (in the explanatory information provided at the same time as the Bill) that it is intended that body corporates within QFE groups will have a straight forward route to licenses for other regulated services. This is very strongly supported by Kiwibank in order to avoid unnecessary duplication and to promote efficiency for both the FMA and regulated entities.

16.4 Kiwibank also submits that DIMs licensing overlaps with fund manager licensing and licensing under the Financial Advisers Act 2008 ("**FAA**").

17. DIMS

17.1 We welcome the opportunity to clarify DIMS. We are broadly supportive of the proposals in the Bill, however we would like to address how this works in with the status of DIMS under the FAA.

17.2 As the rules currently stand, it seems to us advice regarding an investment in a managed investment scheme (i.e. a category 1 product) would be subject to the full requirements of the FAA, however the same advice regarding an investment in a class DIMS (i.e. not a financial product at all) would not be subject to any FAA requirements. While a managed investment scheme and a class DIMS may invest in identical underlyings, the major difference is that an investor in a managed fund would have a credit risk against both the fund and the custodian of the fund's assets, whereas an investor in a class DIMS would only have a credit risk as against the custodian. We suggest that the FAA rules be clarified in this regard.

18. Derivatives

18.1 We support the Bill's intention to update New Zealand's regulatory regime for derivatives. The current futures contracts regime is outdated, inconsistent and does not accord with market practice.

18.2 We have concerns however that the Bill proposes grouping both exchange-traded and over-the-counter ("**OTC**") derivatives together. In our view, exchange-traded and OTC derivatives are so fundamentally different as to require different treatment.

18.3 The risks associated with exchange traded derivatives are essentially associated with the *derivatives broker*. Clause 10 of the Bill, paragraph 68 and the exposure draft commentary expressly identify that the broker would be treated as being the issuer of any derivative contracts. Futures exchanges already have strict rules relating to the terms of exchange-traded derivatives, and counterparty credit risk is managed through the use of central counterparties. In our view, the risks for a client dealing in exchange-traded derivatives are therefore the sorts of secondary market risks associated with dealing with brokers, including the credit risk as against the derivatives broker (which is in turn regulated by the relevant futures exchange), and the competence of the broker in executing transactions and (in some cases) advising about the exchange-traded derivatives.

18.4 On the other hand, the risks of OTC derivatives are far more related to the *product* itself (including the issuer of the product). These primary market risks include the inability to make informed decisions about a financial product with disclosure and the credit risk against the issuer.

- 18.5 It therefore seems to us that regulation of exchange traded derivatives should be focussed on futures exchanges and brokers. Futures exchanges are already regulated by Part 5 of the Bill. However we submit that futures brokers should be regulated under the FAA, rather than under derivatives issuer licensing. The broker sections of the FAA already deal with broker credit risk (via trust accounting), and the adviser sections of the FAA ensure competence in advising about particular exchange traded derivatives.
- 18.6 We do not believe it is necessary to have an additional layer of licensing in addition to such requirements. The product disclosure and derivatives issuer licensing regimes can therefore be restricted to OTC derivatives and OTC derivatives issuers. Correspondingly, there would be no need for the trust accounting requirements at clause 429 of the Bill.

19. Due diligence defence

- 19.1 Part 7 of the Bill incorporates new due diligence and reliance defences, which have been taken from the Australian Corporations Act 2001. These offer what seem to be reasonable and proper defences where the person has acted with due diligence, reasonably relied on another, withdrawn consent to a statement or have no knowledge of a new circumstance. However:
- the defences seem to relate only to compensatory orders, as opposed to, for example, pecuniary penalty orders or an offence. We wonder what the rationale for this is, noting that the Australian provision does relate to the offence?
 - the Bill does not incorporate the other defence in section 732 of the Australian Corporations Act 2001, which provides that a person does not commit an offence and is not liable to pay compensation because of (i) a misleading or deceptive statement if they prove that they did not know that the statement was misleading or deceptive, or (ii) an omission, if they prove that they did not know that there was an omission. Again, we query the rationale for this.
- 19.1 We also query whether clauses 466(4) and (5) in part 7 of the Bill should specify *when* consent needs to be withdrawn (presumably before the contravention) or the person needs to be unaware of the new circumstance.

PART 3

CONCLUSION

1. Concluding remarks

- 1.1 Thank you again for the opportunity to review the Bill at the exposure draft stage. We look forward to working with you further over the coming months to finalise and implement the securities law reforms.