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Submissions on the Regulatory Systems Amendment Bill Exposure Draft

Thank you for the opportunity to make submissions on the *Regulatory Systems Amendment Bill Exposure Draft* (**Bill**). These submissions are being made by Cygnus Law Ltd (**Cygnus Law**) and not on behalf of any client of Cygnus Law. These submissions relate to the proposed amendments to the *Building Societies Act 1965* (**Act**). I note that I previously worked for the Financial Markets Authority (**FMA**). All information provided in these submissions is based on publicly available information. I have not discussed these amendments with any building society and I acknowledge that their input will be important before any consideration is given to implementing any of the suggested amendments.

In these submissions I suggest additional amendments to that Act for inclusion in the Bill that I consider would meet the objective of the Bill, including by:

- addressing regulatory gaps and inconsistencies within and between different pieces of legislation; and
- keeping the regulatory system up to date and relevant.

I also consider that those amendments will provide for greater protection for investors and recipients of financial services in New Zealand and overseas, with very little or no impact or cost on the financial markets, the economy or individual businesses.

The key amendments I propose would seek to better regulate the activities of certain buildings societies incorporated under the Act and make it more difficult to incorporate building societies under the Act in some cases.

1. Background

1.1 I consider that most people in New Zealand and other countries would view the primary purpose (if not the only purpose) of building societies is to act as deposit taking and lending institutions within a particular area or within a particular country, with a focus on providing home loans as well as associated banking services. They are typically perceived in my view as conservatively operated, member owned, financial institutions.

1.2 In 1987 section 9A of the Act was amended to extend the "functions" of building societies. The effect was that, despite the name "building society", the new functions allowed building societies to provide services of any kind, not just financial services. I understand that in practice those amendments never had the intended benefit, as the liberalisation of the 1980s meant that banks

gained a comparative advantage, reducing the number and size of building societies, with a number choosing to become banks.

1.3 Following collapses of finance companies and the global financial crisis all building societies (regardless of where they conduct business or whether they make offers of securities to the public) are regulated as non-bank deposits takers subject to Reserve Bank oversight under the Part 5D of the *Reserve Bank of New Zealand Act 1989*. However, the Reserve Bank states on its website "that the Bank is not in a position to monitor transactions undertaken by New Zealand registered building societies that operate in overseas markets. Building societies in this category include Kiwi Deposit Building Society and General Equity Building Society." And in the *Deposit Takers (Persons Declared Not to be Deposit Takers) Regulations 2011* General Equity, Safe & Sound Building Society and Kiwi Deposit were declared not to be deposit takers for the purposes of Part 5D.

1.4 Those building societies have been subject to negative public comments regarding their activities. Except with respect to the FMA warning, I am not suggesting that any allegations regarding improper behaviour have any basis. Rather, I highlight these as an example of the types of concerns that could arise given the current state of regulation of building societies. With regard to General Equity, in September 2014 it was the subject of an FMA warning, which warned "any persons dealing with General Equity to exercise extreme caution before obtaining any financial services, or acquiring any financial products, from General Equity". Concerns included statements the FMA considered were misleading regarding how General Equity was regulated and that most of General Equity's business was conducted off-shore so FMA had limited ability to take action. Kiwi Deposit is currently in liquidation. According to the liquidator's report it is still not clear whether a full return will be made to creditors. Safe and Sound Building Society lists its administration as being in Queensland and all three of its directors are based in Australia. It appears that all three of those buildings societies conduct (or conducted) a significant amount of their business outside of New Zealand.

2. Issues with the Current Building Societies Act

2.1 I consider that there are a number of shortcomings with the current regulatory regime for building societies:

a. **Directors:** Like New Zealand companies, building societies can conduct a very wide range of activities- these do not need to be related to financial services. Also, some New Zealand building societies conduct much of their activity outside New Zealand and these have been a cause of concern. In response to similar concerns regarding the activities of New Zealand companies overseas, all companies are required to have at least one director who lives in New Zealand (or Australia in certain circumstances). There is no such requirement under the Act- the only specific requirement is that a building society have two directors.

b. **Scope:** In my view some activities that building societies can conduct are outside those that most people would consider are usual for a building society.

c. **Members:** A condition of incorporation is that building societies have at least 20 members. This presumably reflected the importance of having at least a minimal base to support initial activities. However, in two cases I'm aware of, General Equity and Kiwi Deposit, this requirement was met by incorporating a number of related companies that each acted as a member shareholder. In effect those building societies were closely-held body corporates with

effective ownership concentrated in the hands of very few people. The cost of doing that is relatively low.

d. **FSPR:** If a building society conducts any financial services that require it to register on the Financial Service Providers Register (**FSPR**) it must register. However, even if it is not required to register (e.g. because all activities are conducted outside New Zealand), the very name "Building Society" in my view carries a clear connotation that it is subject to a regulatory regime that would be expected for a bank-like entity, or at the very least carries connotations of registration.

3. Suggested Amendments to the Building Societies Act

3.1 Taking into account the background and the issues I noted above, I suggest that consideration is given to including one or more of the following amendments to the Act in the Bill:

a. **Resident Director:** Amend section 13 and/or section 83 of the Act to reflect the requirements of section 10(d) of the Companies Act 1993. I suggest going further and requiring that a majority of the directors should live in New Zealand.

b. **Function:** Replace subsection 9A(1) with the following (without amending the subsections 9A(1)(a) or (b)):

> to provide the services for its members or other persons, consisting of, or relating to the following services, and including such other incidental services as are necessary to support the provision of the following services-

The effect of this would be to largely restrict the activities of building societies to the provision of financial services. This better reflects in my view the proper purpose and function of building societies. Consideration could be given to only imposing those restrictions on new building societies or permitting other activities by way of exemption. To my knowledge this wouldn't place any significant impediment on business activity as a company can be incorporated at any time to carry out any of the activities of a building society. I consider that it would reduce the risk of customers and investors being misled (if unintentionally) about the nature of the business of a building society.

c. **Jurisdiction:** In addition to the amendments suggested to subsection 9A(1), make the following additional amendments to subsections 9A(1) (underlined):

> to provide the services for its members or other persons <u>in New Zealand (together with any incidental services outside New Zealand)</u>, consisting of, or relating to the following services, and including such other incidental services as are necessary to support the provision of the following services-

I appreciate that it is unusual to place restrictions on where activities can be provided. However, as I've noted, I consider that there are real risks in building societies operating outside of New Zealand, particularly if not subject to any significant regulatory oversight in New Zealand, given the impression that the name "building society" provides to people dealing with a building society. Again, this does not prevent anyone from using a company to provide

financial services outside New Zealand, including of the type that would be provided by a building society.

d. **Members:** New section 41A:

> 24A Every society shall at all times have at least 20 member shareholders, each of whom is not an associated person of any of the other member shareholders.
>
> This would be supported by a definition of "associated person" similar to that in section 12(1) of the *Financial Markets Conduct Act 2013*.

This better reflects my understanding of how a society should function, as a membership organisation with a relatively wide ownership base. I don't consider that this would make it difficult to establish a building society. A company in my view is a more appropriate corporate vehicle for the conduct of closely-held body business entity, including because the Companies Act 1993 includes many provisions that simplify decision making for closely-held companies e.g. the right for entitled persons to approve certain corporate actions by unanimous consent.

e. **Requirement for Regulation:** As noted the *Deposit Takers (Persons Declared Not to be Deposit Takers) Regulations 2011* provides that General Equity, Safe & Sound and Kiwi Deposit are not deposit takers (suggesting that Kiwi Deposit was somewhat misleadingly named). While this certainly resolved any need for the Reserve Bank to provide oversight it seems contrary to the very nature of building societies, which is as deposit taking institutions. This presents a clear, and I would have thought uncontroversial, way to address a number of concerns. The Act could be amended to provide that any building society that ceases to be subject to section 5D can either no longer provide services or must convert to a company within a stipulated timeframe (e.g. 3 months), or will otherwise be deregistered. Part 7A of the Act already provides a process for conversion to a company so little extra drafting would be required to effect those changes. This requirement has some similarities to the FMA's power to order deregistration of financial services providers from the FSPR pursuant to sections 18A and 18B of the *Financial Service Providers (Registration and Dispute Resolution) Act 2008*, by recognising that there are circumstances when a person should not be permitted provide financial services where to do creates or is likely to create a misleading impression as to the extent to which a person is, or will be, regulated by New Zealand law in relation to a financial service.

Yours faithfully
Cygnus Law Ltd

Simon Papa
Director