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CONDUCT OF FINANCIAL INSTITUTIONS BILL

4 December 2019 *8 min read*

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Following on the Financial Sector Regulation Act, 2017 ("**FSR Act**"), the Conduct of Financial Institutions Bill ("**COFI**") was published by the Minister of Finance in December 2018 for public comment until 1 April 2019. Since then, there has been no further communication from National Treasury on the bill.

COFI is intended to streamline the conduct requirements for financial institutions, which are currently regulated in a number of financial sector laws. In essence, COFI will replace the conduct provisions in various financial sector laws and will build on a strong, effective and consistent market conduct legislative framework for all institutions, which undertake financial activities.

As part of the Twin Peaks reform process underway in South Africa, the bill is aimed at strengthening the regulation of the financial sector with respect to the treatment of customers and general market conduct. The bill outlines what key industry players and customers may expect from financial institutions, with a move to focus on "*treating customers fairly*" and streamlining the conduct of financial institutions.

COFI is underpinned by a number of principles, which are:

1. **activity-based**: the proposed framework will shift away from a sectoral approach to the regulation of the financial sector and move towards an activity based approach. This approach will be the starting point for defining the activities, which may be undertaken in the financial sector. All similar financial sector activities will be regulated and supervised, irrespective of the institutions performing them, in a single law. The purpose of this approach is to narrow the gap in our law where conduct, which should qualify as a financial service, is overlooked since the entity engaged in such conduct does not fit into the current institutional definition;
2. **principles-based**: the intention is to follow a principles based approach and to set principles, which will specify the intention of the regulator rather than set rules detailing the specific requirements of a financial institution. This will see a shift towards actions and processes achieving a desired level of outcome and remove the focus from strict compliance with the law. It is the intention of the legislature to seek an effective balance between a principles based and rules based measure in order to achieve the desired outcome and not to impose a rigid focus on compliance with rules;
3. **outcomes-based**: the policy framework that will be introduced seeks to shift the focus to the achievement of desired outcomes. This will enable the regulators to monitor the extent to which the outcomes are being achieved thereby enabling appropriate preventative measures being taken to mitigate the risks accompanying circumstances, where intended outcomes are not being achieved. This will allow the regulators to implement appropriate remedies when undesired outcomes are produced; and
4. **risk-based and proportionate**: this is aimed at ensuring that the outcomes focused approach is appropriately applied to the different levels of risk that are expected from the different activities sought to be regulated. This will affect the regulator's supervisory approach, the standards it sets and the enforcement action it takes in respect of the different categories of financial institutions. Proportionality is important in levelling the playing field for the various institutions that bring different risks to customers and the financial sector.

These principles will play a critical role in how COFI will be applied and the changes it will bring to financial market conduct. Furthermore, the principles will inform the conduct of entities and individuals by expecting them to balance any intended conduct, service or product with these principles, further guaranteeing that they are aware of them.

IMPACT ON SPECIFIC FINANCIAL SUB-SECTORS

The intention is that COFI will replace the conduct provisions in existing financial sector laws, which will entail the repeal of various provisions in certain Acts or the outright repeal of others. This is necessary to ensure that all laws are mutually reinforcing and empower the Financial Sector Conduct Authority ("**FSCA**") to appropriately use financial sector legislation to meet its market conduct mandate. The Acts which will be affected include:

- The Pension Funds Act, 1956 ("**PFA**")
- The Long-term Insurance Act, 1998
- The Short-term Insurance Act, 1998
- The Financial Institutions Act, 2001
- The Financial Advisory and Intermediary Services Act, 2002
- The Collective Investments Schemes Control Act, 2002 ("**CISCA**")
- The Financial Sector Regulation Act, 2017
- The Insurance Act, 2017

The Twin Peaks framework reforms were intended to broaden the FSCA's jurisdiction over all financial institutions in South Africa and accordingly some financial institutions will have to obtain a direct conduct licence from the FSCA pursuant to the licensing processes in the bill, whilst others may be licensed and supervised by other laws, but will have to comply with the requirements in COFI.

COFI imposes additional requirements on persons performing critical functions in relation to financial institutions, this includes people identified as "*key persons*". It will also affect all financial market participants, both retail and non-retail. Financial institutions that do not service retail customers will still need to be licensed under COFI and all licensed institutions will have to comply with the bill's requirements on a risk-based and proportional basis.

IMPACT ON THE CREDIT SECTOR

The National Credit Regulator will continue to regulate credit providers and all credit agreements as defined in the National Credit Act, 2005. COFI will however focus on credit providers who bring the most conduct risk to the largest number of vulnerable customers in the market. Banks will be supervised to ensure that their governance arrangements are sound, their financial services meet customers' needs and that customers are not exposed to undue post sale barriers.

IMPACT ON THE NATIONAL PAYMENT SYSTEM

Steps have been taken to define the payment environment that the FSCA will regulate and the payment activities, which must be directly licensed by the FSCA. A conduct licence will be required for payment service providers who have a direct relationship with a financial customer (including retail and non retail) with conduct standards being set accordingly. The FSCA will be able to set conduct standards in relation to, amongst others, the disclosure of fees charged for payment services offered. This will be done in consultation with the South African Reserve Bank ("**SARB**") or issued as a joint standard between the SARB and the FSCA. The SARB will continue to oversee the payment system from an integrity, stability and efficiency perspective, whilst the mandate of the FSCA will require co operation with the SARB to ensure that conduct outcomes are considered across all components of the payment infrastructure.

IMPACT ON THE PENSION FUNDS ACT

It has been proposed that retirement funds will have to be licensed under both the PFA and the bill. These funds will be subject to the requirements of both laws to ensure consistency in the manner in which customers are treated. Retirement fund benefit administrators and other service providers, currently regulated under the PFA, will, in future, only be licensed and authorised under COFI. There will be a transitional period to ensure alignment between the provisions of the PFA and COFI.

IMPACT ON CISCA

COFI will regulate investment arrangements that bring together contributions from the public for purposes of investing such contributions in order to generate a return. Accordingly, traditional products such as collective investment schemes ("**CIS**") and private equity funds will now be licensed under the framework of the bill. The category of pooled investments currently contemplated under CISCA is retained under COFI, whilst provision has been made for another pooled investment product to be known as "*alternative investment products*". This will ensure that there is sufficient regulatory oversight, considering the risks that different products pose to different customers. The licensing requirements will, in turn, distinguish between the licensing for a pooled investment product contemplated under a CIS and pooled products classified as alternative investments. COFI will replace CISCA in its entirety.

LICENSING OF FINANCIAL INSTITUTIONS UNDER COFI

Currently, the licensing of financial institutions is done on an institutional basis, e.g. as a bank or an insurer, etc. This approach has been found to be lacking and a new licensing approach has been proposed. It envisages that a financial institution carrying out one or more identified activities will have to be authorised for each activity. Accordingly, a financial institution carrying out multiple activities will be required to obtain a single FSCA licence with multiple activity authorisations thereunder. This is a three tier approach, namely a financial institution will be authorised to carry out an activity that is linked to a specific financial product, which is associated with specific customers.

This means that licences will be issued in terms of the primary law and will specify activities, which a licensed institution is authorised to perform. Licencing conditions that accompany such licence will specify the products and customers to which the authorised activities apply. Licensees will have to make changes to their primary licences should they want to add or remove any activities. Any amendments to the products or customers, which an activity relates to would only require a change to the licensing conditions.

In terms of the Twin Peaks reforms, some financial institutions have to obtain approval from the Prudential Authority and the FSCA to operate. To ensure compliance with this, COFI has a concurrence provision by the relevant regulators.

CONCLUSION

COFI will have a significant impact on the financial sector. Whilst the principles it adopts seek to bring about needed change and extend greater protection to customers when it comes to how the financial sector conducts business with the public, it is unknown whether the FSCA has the capacity to handle the proposed administrative requirements or what the ultimate impact on the cost to doing business for financial institutions will be.



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