A high-level view of the second draft of the Conduct of Financial Institutions Bill

October 2020

Progress

The first draft of the Conduct of Financial Institutions Bill (COFI) was published for public comment in December 2018. The second draft was recently published on 29 September 2020. COFI will be submitted to Cabinet for approval and tabling early 2021 (not this year as originally planned). Thus, the provisions set out below are not yet effective, are in draft form and may still change.

What is COFI aimed at?

Twin Peaks – regulating conduct

COFI is a key pillar in government's Twin Peaks financial sector regulatory reform process that aims to entrench better financial customer outcomes in the South African financial sector. It is a financial institution-facing law that mostly sets conduct principles for financial institutions to meet (principle–based legislation). Financial institutions include, among others, insurers, retirement funds and administrators. The overall regulatory framework will be a combination of high-level principles and more granular rules.

High-level principles

The overall approach is the application of overarching principle-type requirements to categories of activities and financial institutions. However, it is acknowledged that more detailed requirements, delivered by way of conduct standards, are necessary to support the overarching principles in certain circumstances.

Rationalising law

COFI will significantly streamline the legal landscape (i.e. the laws that financial institutions are currently subject to) for conduct regulation of financial institutions and others.

Making Treating Customers Fairly law

One of the aims of COFI is to give legislative effect to the market conduct policy approach, including implementation of the Treating Customers Fairly (TCF) principles. COFI ensures that the TCF principles are legally binding and enforced on all financial institutions.

What are the main changes made between the first and second draft of COFI?

Rationalisation of provisions between COFI and the Financial Sector Regulation Act

To avoid confusion and duplication, what needs to be provided for in COFI and the Financial Sector Regulation Act respectively has been separated. The idea being that the Financial Sector Regulation Act will hold all the enabling provisions (for example that the regulators can issue conduct standards and what these may be issued about) whereas COFI is to include the high-level conduct principles as well as some granularity in requirements.

Conducts standards will provide more specific rules and requirements for the different types of financial institutions in relation to the COFI principles (as permitted by the Financial Sector Regulation Act).

There will be further amendment of the Financial Sector Regulation Act as well as consequential amendments to other legislation as a result of COFI.

Conduct standards
Conduct standards will be generally enabled under the Financial Sector Regulation Act and not specifically enabled in COFI chapters. These sections in COFI have been removed. The Financial Sector Conduct Authority (FSCA) will be empowered through the conduct standard making provisions in the Financial Sector Regulation Act to set conduct standards under COFI.

Refining the approach to licensing
The Financial Sector Regulation Act will contain the framework for licensing, but the license will be issued under COFI. The licensing chapter has, thus, been significantly shortened in COFI.

The documents issued by the FSCA refer to the fact that "the FSCA plays an important gatekeeper function through licensing". For example, to keep potentially rogue financial institutions out of the financial system in the first instance and to remove unfit institutions. Thus, during the licensing process the FSCA will be looking for "red-flags".

The licensing schedule is now Schedule 1 of COFI. The list of licensed activities has been refined.

Transformation – tangible targets and enforcement
The first draft of COFI proposed that a financial institution must design, publish and implement a transformation policy that should satisfy the requirements of the Broad-Based Black Economic Empowerment (BBBEE) Act and the Financial Sector Code.

The COFI requirements for a **transformation plan** are retained and have been reworded to require the plan to more *closely align to the achievement of tangible targets* informed by the targets in the Financial Sector Code.

Enhanced enforcement powers: COFI allows for the FSCA to issue **Directives** in relation to transformation policies and clarifies that the FSCA may use its supervisory and enforcement powers to ensure that a financial institution's governance frameworks – including in relation to transformation – are adequate *and adhered to*. Directives are a strong enforcement mechanism and non-compliance with a Directive is a criminal offence.

Medical schemes and their administrators are out of COFI for now
The first draft of COFI envisioned application of conduct requirements in relation to medical schemes and medical scheme administrators.

The FSCA's and Prudential Authority's full powers and duties under the Financial Sector Regulation Act apply to medical schemes. As we know, the Council for Medical Schemes must exercise these powers until 31 March 2021, but with the concurrence of the FSCA in relation to conduct matters and the Prudential Authority in relation to prudential matters.

A *task team* has been established between the National Treasury, the Council for Medical Schemes, the Prudential Authority and the FSCA to address the regulatory approach of the three regulators (Council for Medical Schemes, Prudential Authority and the FSCA).

The revised draft of COFI removes all reference to medical schemes and medical scheme administrators until the work of this task team has concluded. Thus, COFI does not currently apply to *medical schemes* and *medical scheme administrators.*

The current status quo remains regarding the FSCA's licensing and regulating of the activity of "financial advice" and "sales and distribution" activities in relation to health benefits (i.e. medical schemes brokers). Changes to this approach will be considered in future, once the work of the task team is concluded.

Making the culture and governance provision more high-level

The provisions concerning culture and governance of financial institutions in the first draft of COFI were not sufficiently high-level and there was duplication with the Prudential Authority's requirements.

COFI now makes reference to governance arrangements, instead of the previous wording which required a governance-related policy. The chapter now provides for high-level requirements. More detailed requirements for governance arrangements may be set through subordinate legislation, such as conduct standards.

Other adjustments to the culture and governance chapter include:

- the requirement for licensed financial institutions to conduct their business in a manner that enhances and supports the efficiency and integrity of financial markets;
- the definition of "control function" now includes the senior management function of financial institutions. This implies that governance requirements applicable to control functions in COFI are applicable to senior managers. It is envisaged that a full senior management regulatory regime will be implemented through conduct standards.

Small enterprises

The first draft of COFI proposed exempting licensed small enterprises from certain requirements of COFI. This included exemption from the previous governance policy requirements. Concern was raised that this would result in unequal playing fields and unintentionally result in poor customer outcomes.

It was decided by Treasury that exemptions for small enterprises are not needed because the nature of the COFI requirements are sufficiently high-level to not pose an undue burden on smaller enterprises. Proportionality would be ensured for small enterprises through tailored subordinate legislation (e.g. conduct standards) which can differentiate between institutions that pose differing levels of conduct risk.

Thus, references to small enterprises in COFI have been deleted.

Retail customers
The second draft strengthens the delineation between retail financial customers versus all financial customers (i.e. the identity of each). The idea is that the FSCA is able to use conduct standards to further tailor the regulatory framework for different categories of financial customers (which it would not be able to do if the different categories were not clearly delineated).

Asset consultants' services fall into COFI and they will have to be licensed
The services of asset consultants will be included in the definition of "advice" in COFI. Asset consultants will be required to be licensed for the "advice" activity. Treasury state that this is necessary to close the current loophole where some asset consultants argue that their services fall outside the ambit of FAIS because their recommendations do not necessarily relate to a "financial product" as defined (e.g. where they recommend general investment strategies, or where their services entail manager selection, rather than actual products).

Public sector retirement funds are in
Public sector retirement funds established in terms of legislation are included in the definition of retirement funds. This was still being debated at the time of the first release of COFI. This means that these funds will be subject to the conduct requirements under COFI. In addition, it is specifically mentioned by Treasury that the customers of public sector funds will be permitted to lodge complaints with the Pension Funds Adjudicator. There is no doubt that this will lead to an increase in complaints being dealt with by the Adjudicator and that Office will need to gear up for this.

The central unclaimed benefit fund is established
COFI contains provisions for the establishment and operations of the central unclaimed benefit fund, including the board of management. It is noteworthy that:

- The fund will appoint an administrator;
- If unclaimed benefits are still in the fund 30 years after they are received by the fund, the fund can utilise that money (the FSCA must set out the purposes for use in a gazette).

Further enforcement powers
The Regulators have been granted even more enforcement powers than they currently have under the Financial Sector Regulation Act. Under COFI, they will be empowered to issue 'take-down' notices where a person is conducting, advertising, soliciting or marketing a business on the internet in contravention of a financial sector law or in a manner that is likely to lead to prejudice to financial customers or harm the financial system.

Other
In addition to the above, the following amendments have been mentioned by Treasury:

- It is clarified that a person may also be debarred where the person no longer complies with the prescribed fitness and propriety requirements.
- Administrative penalties levied by regulators against financial institutions may also be applied to provide redress to prejudiced financial customers ("also" in that these amounts can be used to cover the costs of the regulator in relation to any investigative process before the amount is paid to the National Revenue Fund).

Changes to the Pension Funds Act

The second draft of COFI includes an amendment to the Pension Funds Act. We have set out the main changes below. This amendment is not yet effective and will be enacted with COFI.

Definitions of different types of funds
Instead of all regulated funds being called "pension funds" or "pension fund organisations" they will now be called "retirement funds".

"retirement fund" means any arrangement established with the primary objective of providing annuities or lump sum payments on retirement of a member or for payments of benefits to beneficiaries upon the death of a member';

The Pension Funds Act will be renamed the "Retirement Funds Act".

The definitions of the different types of "retirement funds", namely "pension fund", "pension preservation fund", "provident fund", "provident preservation fund", "umbrella fund", "retirement annuity fund" and "unclaimed benefit fund" have been updated to provide a description of what the funds do rather than referring to the Income Tax Act.

The long definition of pension fund has been done away with and the shorter definitions of the different types of funds have replaced it. The definitions of "pension fund" and "provident fund" may need further changes so that they recognise the compulsory annuitisation requirements which are to be implemented in March next year. The definitions currently read as follows:

"pension fund" means a [pension fund organisation] retirement fund where a member may elect to receive a lump sum payment up to one-third of the member's individual account of the member' benefit upon retirement';

"provident fund" means a retirement fund where a member may receive the member's full benefit upon retirement';

COFI has introduced the new definition of "occupational fund" – this refers to what many may currently call a free-standing or stand-alone fund, i.e. a fund that is established for an employer (including a group of companies).

"occupational fund" means a retirement fund established by a principal employer, or by the principal employer in a group of companies where two or more of the employers in the group participate in the fund, for the benefit of the employees of those employer(s)';

Treasury states that the idea behind adding all the definitions to describe the different types of funds is not because COFI treats them all differently but to ensure that different conduct standards can be published for different types of funds.

Umbrella funds
"Umbrella fund" has also been defined and seems to refer to Type A umbrella funds. In addition, a definition of "sub-fund" has been introduced to refer to the part of an umbrella fund that relates to a particular participating employer.

"umbrella fund" means a retirement fund which provides for the participation of more than one employer that are not associated with each other; and';

"sub-fund" means that section of an umbrella fund that is defined in terms of a set of special rules applicable to that employer that participates in the umbrella fund';

Umbrella funds can be commercially sponsored funds.

Specific requirements have been set out for registered umbrella funds and it appears as though existing umbrella funds will have 12 months to comply (once COFI is enacted and the section is made effective). These specific requirements are that:

- The rules provide for the assets, rights, liabilities and obligations in respect of each participating employer to be maintained separately in each sub-fund;
- Assets and liabilities corresponding to members employed by a participating employer, members and pensioners who were previously employed by that employer as well as their beneficiaries must be held separately in each sub-fund;
- Any provision in the Pension Funds Act that applies to any of the below must apply to each sub-fund separately:
    - The determination of minimum benefits, minimum individual reserves, minimum pension increases of members;
    - The determination, application, distribution and transfer of actuarial surplus;
    - The funding of any shortfall between the assets and liabilities; and
    - Member and employer surplus accounts; and
- An umbrella fund may maintain accounts at fund level.

Commercially sponsored funds
Definitions of "commercially sponsored fund" and "commercial sponsor" have been included in COFI. A commercially sponsored fund is not a type of fund. Any type of fund can be a commercially sponsored fund. For example, an umbrella fund, beneficiary fund, preservation fund, retirement annuity fund or unclaimed benefit fund could be a commercially sponsored fund.

The definitions are as follows:

"commercial sponsor" means a licensed financial institution that establishes a retirement fund, with the intention that the financial institution, or another financial institution within the same financial group, will provide products or financial services to the retirement fund, once established, or its members;

"commercially sponsored fund" means a retirement fund that is established by a commercial sponsor;

A “commercially sponsored fund” is any retirement fund established by a “commercial sponsor”, that establishes the retirement fund with the intent that the financial institution or other financial institutions in its group (associates) will provide financial products or financial services to the fund, once established, or to its members.

Only a licensed financial institution as defined in the Financial Sector Regulation Act may be a commercial sponsor, for example an insurer or an administrator. The term “sponsor” does not refer to employers, unions, or other entities that establish retirement funds, thus they cannot establish a commercially sponsored retirement fund.

For example, if an insurer sets up an umbrella fund and will be providing administration, consulting, actuarial and investment management services to the umbrella fund, that umbrella fund would then be a commercially sponsored fund.

From the definition, it appears (but is not clear) that in order to fall within the definition of a commercially sponsored fund there would have to be more than one product or service provided to the fund by the sponsor, but it would not have to be all products or services. Hopefully this uncertainty will be cleared up in the final version of COFI.

The discussion around these sections mentions that once sponsor-nominated board members are appointed they are subject to the Pension Funds Act (in future COFI) provisions regulating board conduct. This means that they are then not acting in the capacity of sponsor, but in the capacity of a board member. The activity of sponsoring a commercial fund will not require authorisation/ licensing under COFI and is not defined as a licensed activity.

However, Treasury goes on to state that the only situation in which COFI needs to directly refer to the commercial sponsor is to deal with activities in the period prior to the actual registration of the fund. Athough the sponsor will not need to be licensed, as a belt-and-braces approach, COFI will impose obligations on a financial institution in relation to a commercially sponsored fund. These obligations will be similar to those imposed by COFI where the financial institution is providing a product or service. For example, where the commercial sponsor designs financial products that will be held by that fund, the commercial sponsor will need to comply with COFI’s product design requirements, notwithstanding the fact that the financial customer concerned (the fund) has not yet come into existence.

Employers become supervised entities

Employers will be regarded as “supervised entities” for the Financial Sector Regulation Act and COFI purposes. However, this appears to be only in relation to their obligations as currently provided for in section 13A of the Pension Funds Act (e.g. contributions and contributions schedules). This is important as this allows the FSCA to exercise their extensive and formidable enforcement powers against employers in relation to contributions.

Levelling the playing field for administrators and self-administered funds

COFI now requires that a retirement fund that performs its own benefit administration must be authorised for the licensing activity of benefit administration in addition to the activity of providing a financial product. This applies equally to administrators, who would previously have been registered

as administrators under section 13B of the Pension Funds Act, and will now be "third-party retirement fund administrators" and licensed under COFI for certain activities.

This requirement has been added to close the current regulatory gap between self-administered funds and administrator registered under section 13B, as currently the Pension Funds Act only applies to third party administrators.

The regulation of retirement fund benefit administration is removed from the Pension Funds Act as it will be dealt with under COFI and section 13B will be repealed.

Principal officer duties are spelt out
The Pension Funds Act will be amended to state the following:

Principal officers must comply with the prescribed fit and proper requirements.

A principal officer has a fiduciary duty to the fund and its members and must:

(a) be independent and have the requisite knowledge of, or experience in, relevant laws;
(b) be appointed by the fund;
(c) oversee the proper execution of resolutions taken by the board of the fund;
(d) report to the board on matters requiring the board's attention and resolution;
(e) provide the board collectively and board member's individually with guidance as to their duties, responsibilities and powers;
(f) make the board aware of any law relevant to or affecting the fund;
(g) report to the board any failure on the part of the fund or a board member to comply with the registered rules of the fund or relevant laws;
(h) ensure that minutes of all board meetings and the meetings of any committees are properly recorded;
(i) be the official contact person for the FSCA with the fund unless the circumstances of the fund dictate otherwise;
(j) independently satisfy themselves as to the veracity of documents required to be submitted to the Authority by the fund in terms of the Pension Funds Act;
(k) be accountable to the FSCA.

The amendment specifically includes a provision to the effect that just because the principal officer has the above responsibilities does not mean that the board or a board member is divested or relieved of their responsibilities under the Pension Funds Act.

The definition of "key persons" in COFI is amended to include principal officers and deputy principal officers of retirement funds.

Section 37C (lump sum death benefits) and section 37D (deductions) of the Pension Funds Act
Fortunately, these sections have been re-written. It is anticipated that these sections will undergo several changes between this version and the final version of COFI and so the changes have not been detailed in this newsletter. It is hoped that the short-comings of these sections, from both a legal and practical perspective, will be resolved in the final version.

Auditors
Limiting an auditor's term: amendments to the Pension Funds Act allows for the FSCA to refuse an application for approval of the appointment of a fund auditor if the application seeks the re-appointment of an auditor who has already served as auditor of the particular retirement fund for the prescribed number of years.

Amendments to the Pension Funds Act allow the FSCA to withdraw its approval of the appointment of an auditor, after which their functions and responsibilities immediately cease, if the auditor:

(a) has been convicted of an offence of which dishonesty is an element;
(b) is under investigation by the Independent Regulatory Board for Auditors; or
(c) fails to disclose any direct or indirect interests which may constitute a conflict of interest in respect of the auditor's duties.

Other amendments
(a) An amendment provides that the **rules** of a retirement fund which applies to be licensed must be in the prescribed format and form and must comply with the prescribed requirements. This will allow the FSCA, in our view, to replace the existing Regulation with an updated conduct standard about rules requirements.

(b) The FSCA can **appoint independent persons** to a board in certain circumstances.

(c) The FSCA can assess or appoint an independent person to **assess remuneration, costs and fees** to determine if remuneration, costs and fees are reasonable.

(d) Section 26(2) persons appointed to funds can be paid by the fund **or the administrator**.

(e) The **statutory manager** appointment provisions that were under the Financial Institutions (Protection of Funds) Act have been imported in an amended format into the Pension Funds Act.

(f) Amended fund **liquidation** and **liquidator** requirements, including provisions for the FSCA or a court to remove a liquidator and for the FSCA to appoint someone to fill that vacancy (if required).

(g) The amendments allow the FSCA to:

- **prescribe standards** on any matter that is appropriate and necessary for achieving the purposes of the Pension Funds Act. These could apply generally or be limited to apply only to a category or type of fund; and
- to determine **administrative and penalty fees**, the person by whom the fee must be paid, the manner of payment of the fees, and, where necessary, the interest payable on overdue fees.

Leanne van Wyk
Director: ICTS Legal Services (Pty) Ltd