



Submission on Review of Financial Products and Providers

**Submission to
Ministry of Economic Development
1 December 2006
by Institute of Financial Advisers**

Privacy

The Institute of Financial Advisers (the Institute) does not seek to have any part of our submission withheld for privacy reasons. We are happy to have our submission available on the Ministry of Economic Development (MED) and other websites.

Advocacy

The Institute is keen to support our submission by participating in any further discussion forums.

The Institute appreciates the opportunity to be able to provide input into this review process, and is thankful for the opportunity to be invited to nominate appropriate people, including our members, to participate on the working parties.

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The Professional Body for Needs-Based Financial Advisers

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1. Institute Background

The Institute of Financial Advisers is the professional body for over 1,400 members, representing needs-based financial advisers in New Zealand. All these members are personal members, not corporate members.

Our members provide advice to their clients in the areas of insurance, investments, financial planning, and financial services generally.

Their professional practices reflect the broad spectrum of New Zealand businesses – they operate as local SME's, are part of large regional or national dealer groups, are associated with strong financial organisations, services companies in banking, funds management, or insurance, work in employee benefits organisations, or sometimes practice as lawyers, accountants and other professional advisers.

The Institute reinforces compliance with codes of ethics and practice standards, runs Dispute Resolution and Disciplinary Committees that are independently chaired, offers education pathways that can lead to tertiary qualifications and the attainment of internationally recognised adviser marks, maintains and ensures compliance with a continuing professional development programme, and provides networking, education, development, and business practice forums at a national and regional level for members. It represents its members with Government, government agencies, and other stakeholders.

2. Co-Regulation of Financial Intermediaries

On 29 September 2006, our Institute lodged a submission with the Ministry of Economic Development on the proposed co-regulatory regime for financial intermediaries.

In the introduction to that submission, we outlined the outcomes we were seeking for consumers and financial intermediaries from any reform or initiatives that would relate to the co-regulation of financial intermediaries. We now repeat those outcomes because we believe that most of them should have as much application in the Review of Products and Product Providers.

The result of any review of financial intermediaries must be that consumers have greater confidence in the quality of information and advice they receive. Such an environment will facilitate wealth accumulation and risk management, and will encourage participation by consumers, financial intermediaries, and market participants.

The Institute seeks to achieve these outcomes from any reform:

Consumers

- *Consumers have a better understanding of the role of financial intermediaries.*
- *Consumers have a better understanding of the co-regulatory regime that is developed to look after them, including:*
 - *Baseline competency and ethical standards of intermediaries*
 - *Disclosure of consumer relevant information about intermediaries, products, and product providers*
 - *Access to dispute resolution schemes, and confidence that there are mechanisms in place to discipline market participants who substantially fail to meet standards*

- Consumers have reasonable grounds to use financial intermediaries with confidence
- Consumers increase their usage of competent intermediaries where it is suitable and cost effective to do so
- Consumers have a better level of financial literacy so that they have a better understanding of financial markets, products, product providers, intermediaries, and the appropriateness of information and advice
- Consumers have access to choice, competition, and innovation
- As a consequence, consumers accumulate wealth, and manage their risks
- The benefits for consumers outweigh the costs of the co-regulatory regime.

Financial Intermediaries

- Intermediaries have confidence to participate in the sector, so that they can invest in themselves and their businesses
- Intermediaries have certainty, and can operate in a co-regulated business environment that is consistent, fair, and reasonable
- Succession planning. New entrants are encouraged to join the adviser sector
- Intermediaries, who chose to do so, can operate in Australia and New Zealand effectively and efficiently, within their area(s) of expertise and competency.

- Submission on Financial Intermediaries Discussion Document by
Institute of Financial Advisers, 29 September 2006

The Institute seeks to reinforce that the Ministry of Economic Development and other Government Agencies should ensure that any proposed outcomes of Co-Regulation, this Review of Products and Product Providers, the Securities legislation and other Government initiatives must be consistent and fair in their application.

3. General Comments

The Institute has identified four of the nine discussion documents as having special relevance to many of our members:

- Insurance
- Review of Securities Offerings
- Consumer Dispute Resolution and Redress
- Platforms and Portfolio Management Services

Specific submissions from the Institute have been made on these four documents. We have made more general submissions on the other five papers.

We support the general thrust of the Review as outlined in the Discussion Papers.

“The aim of the review of the framework is to promote confidence and participation in financial markets by investors and institutions, which results in a sound and efficient non-bank financial sector.”

We would seek to include “... ***and those seeking to manage their risks***, ...” after “investors”.

4. Registration of Financial Institutions

Use of Companies Office

The Institute supports the use of the existing Companies Office structure to record and permit access to information about registered entities. Access to the register should be free – any cost, even \$2, is a barrier for consumers.

AML/CFT Requirements

The Institute submits that any proposal for the Reserve Bank and Securities Commission to separately undertake AML/CFT duties may not be an effective or efficient system – any company that offers different products or services, or subsidiary companies within the same financial services conglomerate may be required to satisfy both regulations.

We further submit that market conduct activities should fall within the ambit of the Securities Commission.

Trusts

The proposals outlined should only relate to trusts that are providers of financial services and products. They should not impact on family and other trusts.

5. Insurance

Introduction

Members of the Institute are involved in providing advice to New Zealanders on life, disability and health insurance matters and the Institute submissions consequently concentrate on the latter part of the discussion document with direct day to day application to our membership in the giving of insurance advice.

However, the Institute states support for the outcomes and reasons for regulatory intervention outlined in the discussion document relating to licensing, prudential requirements, monitoring and supervision, as a means to reduce risks and provide greater certainty that valid insurance outcomes taken under advice from Institute members and for which premiums have been paid will be able to be honoured when valid claims are made.

Duty of Disclosure and Remedies for Non-Disclosure and Mis-Statements

The proposals for change as outlined are supported.

Registration of Life Policy Assignments and Mortgages

The proposals for change to a notice procedure as outlined are supported.

Insurance Intermediaries and Agency

The Institute submits that the proposal outlined creates significant risk, such that two consumers buying the same product, one via agency, one not, who suffer the same adverse event, will potentially get different redress outcomes.

It is the view of the Institute that it is unlikely that disclosure will be sufficient to enable consumers to appreciate the very significant differences and risks between utilising the services of a financial intermediary in an agency or non-agency role. If this view is accepted, then implementing such a proposal will fail to deliver an adequate level of consumer protection.

We must be more innovative in devising a solution that delivers benefit and real protection to consumers, particularly noting the focus of the financial intermediary, products and providers' reviews are about trying to address concerns over consumer ability to understand the complexities of financial advisory services and financial products.

The Institute submits that the regulatory objective should be focused on ensuring that the redress outcome for the consumer is appropriate, the same and will be fulfilled, irrespective of whether the product or service is delivered via an agency or non-agency arrangement.

A possible answer lies in the consumer being able to obtain redress jointly or severally from the product provider and the intermediary, irrespective of delivery via agency or non-agency arrangements, leaving the intermediary and the product provider to determine between them where the liability lies. This would have an advantage of imposing significant discipline on product providers to carefully vet the agents and intermediaries promoting their products and taking applications on their behalf, and would assist in reducing the potential for rogue advisers or agents to move from one product supplier to another.

Product Disclosure

Noting in the discussion document that further detailed work and consultation is yet to be completed, the Institute expresses support in general terms for the disclosure framework as set out.

6. Supervision of Issuers

The Institute supports the objectives and proposals outlined, including those proposed for supervisory trustees.

7. Consumer Dispute Resolution and Redress

Introduction

The Institute lodged a submission on 14 October 2006 with the Ministry of Consumer Affairs, as part of the process of MCA's inquiry into Industry-Led Regulation. Our submission can be found on the News page (<http://www.ifa.org.nz/news/index.htm>) of our website.

As noted by the Task Force reviewing the co-regulation of financial intermediaries, the financial services industry is not in crisis. However, the Task Force did note a range of issues relating to access to consumer dispute resolution and redress processes, including:

- Membership of industry bodies is voluntary
- Limitations of jurisdiction
- Compensation is not always available, the focus being on discipline
- Ability of an adviser or provider to withdraw from the process
- Difficulty determining where and how to lay a complaint
- Procedural barriers
- Costs
- Difficulties in establishing or quantifying losses
- Specialised areas of knowledge involved
- Time limitation issues – how long before a problem appears

We consider that the Task Force work in this area is sufficiently comprehensive, as it relates to our membership, that we chosen not to answer the detailed questions in the discussion document seeking further information about consumer problems.

Consumer Dispute Resolution and Redress

The Institute supports the establishment of a single consumer dispute resolution and redress process covering all financial service provision, with costs to be funded by government.

Support for such a single body complaints process was also evidenced in submissions to the Task Force reviewing the regulation of financial intermediaries. The Task Force itself recommended a single point of access as the best way of delivering effective outcomes to consumers.

The delivery of financial services can involve many parties including a financial intermediary or adviser, a financial product provider, legal and accounting services, and portfolio management, platform or custodial services. When a complaint arises, it is not always immediately apparent to a consumer where the complaint should be directed for resolution. In this circumstance, we consider that an independent complaints body can first deliver value by helping ensure that the complaint is correctly directed. Initially, this must be to the relevant product or service providers or adviser. Our experience has been that many disputes or complaints are often settled to the satisfaction of parties, at this primary level. When an appropriate resolution or outcome is not obtained at that level, the complaints body can look to redirect or take over the complaint process, as appropriate.

The Institute already has its own complaints and disciplinary processes but these processes are restricted to breaches of Institute rules and codes and do not extend to provide for restitution to consumers. We would therefore welcome an independent solution that delivers financial recompense to consumers, where appropriate, while at the same time being integrated with the Institute complaints process.

We consider that the Institute is well placed to assist such a centralised complaints body with expert advice on the ethical or conduct standards that should be met in respect of the services covered by the Institute rules and codes.

In those instances where the complaint does not readily fit within the Institute framework, we perceive a financial services sector complaints body having responsibility and authority to involve other, and potentially more than one, professional body, the ombudsmen or Approved Professional Bodies to assist with resolution of the complaint.

To be effective, such a complaints body will also require authority to impose restitution itself or confirm restitution recommended or imposed by another body, seek court backing for recovery, if necessary, and to refer delinquent providers to the Securities Commission, police or other government bodies as appropriate.

Such a structure would leverage off the detailed industry knowledge already in place in many existing bodies.

Size of Claim Permitted

Subject to an appropriate appeal structure, including a right of court review, the Institute submits that there should be no limit to the size of claim able to be assessed by a central complaints body.

8. Non-Bank Deposit Takers

We have concerns with the two tier proposal and point out that New Zealand consumers already face a two tier structure – banks and non-banks.

Prudential Supervision

The Institute submits that all non-bank deposit takers should be prudentially supervised, and also that the use of terms like “... approved ...” suggests that the institution is guaranteed.

Credit Ratings

As mentioned above, our preference is that all non-bank deposit taking institutions be prudentially supervised. However, if there are to be two tiers of non-bank deposit takers, the distinction should be between those that are required to obtain a credit rating, and those that are not.

9. Collective Investments

The Institute supports the objectives and proposals outlined.

We wish to emphasise that we have confidence in the operation and regulation of the existing structures.

10. Mutual's Governance

The Institute supports the objectives and proposals outlined.

11. Securities Offerings

Introduction

The Institute supports the proposals to review aspects of the Securities Act 1978 as outlined, particularly Sections 3 and 5. Many of the current provisions are difficult to follow, confusing, uncertain or impractical.

This is best demonstrated by the reluctance of Institute members to utilise these provisions to advise on such securities offerings or to act in the capacity of a third party certifier where required under the current provisions of Sections 5(2CB) – 5(2CF) of the Securities Act. Detailed comments follow.

Minimum Protections for Offers of Securities to Private Investors

The Institute supports the introduction of additional protections in relation to private offers of securities. Additional protections, as outlined in paragraph 44 of the document, such as introducing Securities Commission powers to prohibit distribution of advertisements, seek enforceable undertakings and seek court orders as well as introducing criminal liability for misstatements in an advertisement or prospectus are examples that are supported.

Distinction between Sections 3 and 5

The Institute supports the removal of the distinction between offers made under Sections 3 and 5. The current structure is confusing and difficult to follow.

Relatives and Close Business Associates

The Institute supports focusing on principle of the exclusion as outlined in section 52.

Re-definition, Certification and Registration of Sophisticated Investors

The Institute supports using a list of criteria to define a sophisticated investor. The four criteria listed are appropriate, but, for example, size of portfolio on its own is not a sufficient criterion to determine sophistication. A combination of criteria may often be required to be satisfied.

Where third party certification is required, the Institute submits that the current provisions of Sections 5(2CB) – 5(2CF) of the Securities Act be amended to restrict the provision of such a certificate such that it can only be given by those independent financial service providers registered with an Approved Professional Body and who are determined to have the competencies (yet to be defined) necessary to complete the assessment prior to providing the written statement required under this Act.

Minimum Subscription Price of \$500,000

The Institute supports removal of the exclusion based on a minimum subscription price at any level, on the grounds that the provisions of the professional or sophisticated investor tests should be met before the other protection of the Securities Act is removed.

Any Other Person

The Institute supports removal of the “Any Other Person” exclusion.

Wealthy Investors

The Institute supports removal of the “Wealthy Person” exclusion. Level of wealth is not sufficient in itself to justify removal of the protections of the Securities Act. The ability to pay for advice because of wealth does not mean such advice will necessarily be sought, leaving an inexperienced or naïve wealthy investor more exposed to inappropriate outcomes.

Small Offers Exemption

The Institute does not support the introduction of a small offers exemption. The introduction of a professional and sophisticated investor regime should satisfy such a funding requirement.

Listed Securities

The Institute supports the general objectives and intent of permitting issuers who are subject to the continuous disclosure regime being permitted to use a transaction-specific offer document as outlined.

Contributory Mortgages

The Institute supports the removal of the exemption for contributory mortgages but makes no submission in respect of the disclosure regime as it relates to solicitors.

Previously Allotted Securities

The Institute supports the extension of Section 6(7) of the Act as proposed.

Disclosure (Section 4 in the Discussion Document)

The Institute supports the objectives and general outline of the intended disclosure regime.

Detailed submission is made only in respect to the proposal outlined in Section 4.2.4 (paragraphs numbered 212 – 225) regarding the inclusion of certain educational information.

The Institute does not support such educational information being provided with every offer document as a separate document unless the cost can be contained such that the required information can be printed in legible form on no more than both sides of one A4 sized sheet. If this cannot be achieved, then the Institute instead proposes inclusion of a statement in every offer document as to how such educational material may be accessed, either via the Internet, or as a separate document, all costs of such provision to be met by government.

The Institute made a submission on the proposed Securities Legislation Bill. With respect to disclosure documents, we repeat our submission that they should be:

- short
- clear and easily understood
- useful for consumers to make informed decisions.

12. Platforms and Portfolio Management Services

Introduction

Many members of the Institute are significant users of platform and custodial services to assist in the delivery of advice, management, reporting, access to research, and custody for investments. Recognising the inherent risks associated with these services and with investments being held in a name other than that of the beneficial owner, the Institute supports this review to determine the need for appropriate regulation.

The Institute supports the focus of the review succinctly laid out in the two bullet points of paragraph 34 of the discussion document, repeated here for completeness.

- *“The governance arrangements for both platform providers and custodians, to ensure that platform providers and custodians are registered and comply with fit and proper entry and ongoing requirements, and*
- *Disclosure, such that investors have information about the service, charges and fees, and other information associated with investing through a platform, and are equipped to make informed decisions about their investments.”*

Definition of services

The nature and extent of contracts between members of the Institute, acting as investment advisers, their investor clients and platform and custodial service providers take many forms.

For example, the Institute member may negotiate the terms to apply to services to be provided to the Institute member’s clients by an independent platform and/or custodial provider, even where the investor client signs a contract establishing a direct service relationship with the platform and/or custodial provider. Alternatively, the investor client may arrange their own platform and/or custodial service independent of the investment adviser. In other circumstances, the platform and custodial services provider may be part of the same corporate group as the member of the Institute providing investment advisory services.

The resulting regulatory environment should not preclude and should support the continued diversity of service offering.

Potential Duplication of Regulation

Members of the Institute and/or their related corporate entities are expected to become subject to co-regulation under the Approved Professional Body structures currently being considered, as well as having to meet the requirements of the Institute.

To the extent that proposed regulatory changes relating to portfolio management, platform providers and custodial services might result in duplication of government regulation or supervisory oversight, the Institute submits that consideration be given to mitigating such an outcome. Wherever practical, the defined services should be regulated and supervised by one entity without duplication elsewhere.

Disclosure

Disclosure is about ensuring that the consumer is appropriately and adequately informed.

The Institute perceives a significant risk that, if the separate disclosure requirements relating to the investment adviser, the financial product and the portfolio management, platform and custodial service are not structured correctly, the consumer will become confused and will be unable to accurately determine who is providing what service at what price. The consumer may over or under estimate charges or fees, defeating the purpose of the disclosure requirement.

Recognising that the various services and financial products may be provided independently or as part of a packaged solution, the disclosure requirements will need to be sufficiently flexible to provide for either circumstance.

A simplistic solution would suggest that separate disclosure should be made for each service or by each service provider. However, this will not necessarily result in an optimum outcome for the consumer, as the disparate disclosure may make it difficult for the consumer to determine the total charges or fee impost.

Where the solutions or services are being provided or contracted for completely independent of one another at the decision of the investor, no one provider, such as the investment adviser, should be legally responsible for ensuring that disclosure has been completed by other providers.

However, the regulations should be clear as to when disclosure by a financial adviser may be consolidated with disclosure about a financial product or other portfolio management, platform or custodial service fees, where there is a clear advantage to the consumer in doing so.

Where the portfolio management, platform and custodial service are being provided together as one package promoted by a single financial intermediary, the Institute submits that the option of providing a composite disclosure should be permitted, disclosing, for example, individual and/or total costs across all of the services.

Breach by the Platform Provider of its Duties Owed to Investors

Noting the comments about possible court action and the proposal in paragraph 80 of the discussion document that the Commission have a range of powers to deal with a platform provider's breach of duty, the Institute submits that consideration be given to including consumer rights against platform providers within the context of the "Consumer Dispute Resolution and Redress" discussion document.

The opportunity for a consumer to have access through a dispute resolution and redress structure, independent of the courts and the Commission, covering the totality of the financial services being delivered is, in our view, more appropriate and more likely to deliver satisfactory outcomes to consumers.

Audit Requirements and Risk Mitigation

Section 6.2.1 in the discussion document includes questions about audit requirements.

The size of assets held by custodians implies significant financial risk to consumers if a platform or custodian fails, is negligent, or commits fraud or error. There are also indirect risks to the reputation of members of the Institute and the Institute itself arising from any such failure.

For these reasons, the Institute submits that a full system and financial audit be required.

These risks also dictate that the review include determination of the best method of mitigating an adverse outcome in such a circumstance. For example, assessment should be completed of whether service providers should be required to carry insurance cover appropriate to the type and level of business being conducted, or whether there are other solutions available for use alongside or in place of insurance to reduce risk of consumer losses arising from fraud, negligence, or error.