

The Ramifications of New Zealand Financial Adviser Regulation

BY LEONIE WALLWORK | BBus(HRM)

Director, Strategic Business Development | Adviserlink Learning Limited



Leonie Wallwork has 20 years' experience in the New Zealand Financial Services Industry. She has had a strong focus in the Learning and Professional Development area and in developing vocational education and competency frameworks to assist industry prepare for the pending regulatory environment.

Leonie has represented various industry sectors on the Financial Services Education Steering Groups over the past four years and is pro-actively involved with the Industry Training Organisation (ETITO) and industry representatives to help define unit standards and qualifications suitable for the financial advisory industry. She also provides consultancy and advisory services to financial services companies and professional associations with the aim of building industry skill and capability across a number of fronts. Leonie holds a Bachelor of Business Studies majoring in Human Resource Management.

For some years now the New Zealand Government has been steadily paving the way towards introducing a more rigorous regulatory regime covering financial advisers and those who provide financial advisory services. Although there are a number of pending regulatory changes affecting the financial services industry, the primary focus is on the recent changes to Securities Law introduced this year especially with regard to investment adviser disclosure requirements and the overarching Financial Advisers Bill.

The Financial Advisers Bill received its first reading on 19 February 2008 and was referred to the Finance and Expenditure Select committee with a closing date for submissions of 4 April 2008. The Select Committee has submitted an interim report of recommendations which in essence changes the regulatory model from a co-regulatory framework made up of Approved Professional Bodies (APBs) and governed by the Securities Commission to a sole regulatory model with the Securities Commission only. The Select Committee also recommends that the definition of 'financial adviser' be revised to capture only those whose primary business is the provision of financial advice or who regularly provide such advice in the course of their business.

The deadline for further submissions on a number of proposed changes is 16 May 2008 so timeframes are short for industry to react. Whatever the final outcome, it is envisaged the regulation will be principle-based with the International Organisation of Securities Commissions (IOSCO) principles forming the foundation for any regulatory framework. The principles are internationally accepted as key standards for sound, well-functioning financial systems. The International Monetary Fund (IMF) and World Bank use the IOSCO Principles in their Financial Sector Assessment Programmes. They set high level benchmarks for any country's regulatory system.

The legislation, introduced by the New Zealand Minister for Commerce Lianne Dalziel, aims to ensure financial advisers are "held to higher standards of competency, accountability and disclosure"¹.

COMMENT FROM THE HON. LIANNE DALZIEL, MINISTER OF COMMERCE (MARCH 2008)

1. *The initial main drivers behind the introduction of legislation were, as I understand it, New Zealand's non-compliance with international obligations with respect to the Financial Action Task Force (FATF) and the negative findings of the IMF report. Are we likely to come under their scrutiny again to check for compliance and if so, when?*

¹ New Laws for NZ planners by Mike Taylor, Money Management Today, 20 February 2008

“FATF compliance has always been one of the drivers behind the changes, but not the only one. Building confidence in our financial markets has been the most important driver of what has been the most substantial financial sector reform New Zealand has ever undertaken. The Review of Financial Products and Providers (RFPP) and Review of Financial Intermediaries have been only two aspects of that reform.

New Zealand’s next evaluation for compliance with the FATF Recommendations via a joint FATF/ APG Mutual Evaluation is due in April 2009.”

2. *In your view, has the necessity and urgency for financial adviser legislation escalated or decreased in recent times? What has caused this?*

“Recent events such as the collapse of a number of finance companies, and the introduction of KiwiSaver (which was premised on the assumption that individuals were able to access high quality financial advice), have shown the development of the financial adviser legislation to be timely, but it’s important to point out that policy development for financial advisers was already well under way before the finance company failures. Their collapse has focused everyone’s minds on the importance of the legislation, but it was not the reason for it.

However, the government is investigating ways of fast-tracking parts of the legislation and is reviewing the timetable for implementing the new regime.”

3. *Being an election year, are we going to see a ‘fast track’ approach to financial adviser legislation and is there Opposition support for the proposed legislation?*

“The fact that it is election year is irrelevant, other than my desire to see legislation enacted before the election so that the Parliamentary ‘down time’ can be used by the regulators to get the frameworks in place. The industry is already gearing up for the new rules, so I think everyone wants to see this work completed as soon as possible.”

4. *Is the legislation expected to prescribe ‘acceptable standards of competency and accountability’ or is this for the Regulator(s) to determine?*

“The aim of the standards is to set out a framework that provides a balance between certainty on the one hand, to ensure standards

are met, and flexibility on the other, to ensure that compliance costs are kept to a minimum.

This means that the legislation will prescribe some standards of competency and accountability. However, the regulator will be given a degree of discretion in this regard.

The balance between the legislation and the regulator in this area is an issue which is currently being worked through with relevant bodies in a concerted effort to develop the most suitable framework.”

Further general comments from the Minister:

“The aim of the Financial Advisers Bill is to ensure that people providing investment advice are appropriately qualified and meet certain disclosure obligations about their professional standing, qualifications, experience, fees, indemnity insurance, money handling procedures, and the like. As I said in the first reading speech for this Bill, I am open to, and indeed anticipate, there being changes through the Select Committee process to best reflect this intention. I am encouraging stakeholders to remain actively involved in the development of the Bill through the Select Committee process. This will ensure that we have legislation that is workable, and effective in achieving its objectives.

The government’s role is to create an environment that both supports investment and protects consumers to the extent possible where risk is the name of the game. Governments cannot eliminate risk, and that is why educating unsophisticated investors is vital, as is ensuring competent financial advisers are available. Our job is to ensure there is transparency and accountability so that investors know and understand the level of risk they’re taking, but can also have reassurance that incompetent or illegal behaviour won’t be tolerated.”

THE ROLE OF THE SECURITIES COMMISSION

According to Jane Diplock, Chairman, NZ Securities Commission,² “Our role is to promote the efficiency and integrity of our securities markets, and regulation that is cost effective. Ultimately, our purpose is to strengthen market confidence and foster capital

² Jane Diplock AO, Chairman of New Zealand Securities Commission speech Developments in New Zealand Securities Regulation 13 March 2007. <http://seccom.govt.nz/speeches/2007>

investment in New Zealand. The Commission is contributing to the process [Regulation] although, of course, we are not the architects of the regulatory proposals that eventually emerge.”

The Commission’s view is that ³ “New Zealand’s earlier approach to securities market regulation was relatively light-handed compared with some of our major economic partners. This was seen as appropriate given the small New Zealand market and the high burdens that can be imposed by compliance costs. As we entered the 21st century, New Zealand’s light-handed regulation was no longer appropriate as technology made traditional national boundaries irrelevant and securities markets became global. To attract investment, and to be accepted into the international financial community, New Zealand needed to have regulation that aligned with similar jurisdictions overseas.”

The report from the Finance and Expenditure Select Committee proposes a shift to a single regulatory regime as opposed to a co-regulatory regime originally being considered. If this is introduced it will mean the Securities Commission will oversee the new regime and be responsible for oversight, ongoing monitoring, discipline and enforcement, licensing, registration, education and acting as an interface between consumers and Financial Adviser.⁴

THE IMPACT ON ADVISORY SERVICES

Changes to NZ’s regulatory framework seem to have been ‘pending’ for quite some time. However, it is the open consultative process and the rigors of debate and lobbying that have helped shape the framework in recent years and given the industry some ownership for outcomes. Throughout the process, the overall aim or objective has been consistent – financial advisers will be held to higher standards of competency, accountability and disclosure.

With this in mind, it will be a mammoth task to try and get some understanding of the existing skill and competence levels and ascertain industry capability to assess this. This of course is aside from any other compliance requirements financial advisers are going to have to meet.

Colin James runs Adviserlink’s practice review and compliance service that is derived from the Australian compliance audit process delivered by Paragem. He is currently working with a number of financial advisory groups to review the advice process and practices of their advisers.

“All advisers believe they are doing their best work. However, in light of the old adage ‘you don’t know what you don’t know’, it is healthy practice to seek an independent review. With the knowledge that the full impact of regulation may come into effect

quicker than was expected, advisers and business owners are wanting early warning of problems so they can address them in an orderly fashion and then review again in 12 or 18 months, looking for ‘full marks’ at that stage.”

Reviews completed so far, coupled with Adviserlink competency assessments, show similar issues and trends emerging re levels of skill and competence, and the quality of the advice process and systems used. For example, in investment cases, lack of a written strategy could constitute prima facie evidence of imprudence if it comes to a dispute.

Section 26 of the Financial Advisers Bill specifies that in performing a financial adviser service, an adviser must exercise the *care, diligence and skill* that a reasonable financial adviser would exercise in the same circumstances.

Advisers who are the subject of a complaint will not necessarily be able to rely on the defense that they adhered to the standards of their professional body, or the rules of their dealer group. Professional body rules and standards need to be acceptable to the Securities Commission and also meet the needs of all the members who will not want them to be more onerous than is reasonable or necessary.

The professional bodies will need to continually monitor their internal practice standards not just for Securities Commission approval, but also to reassure members that adherence to the professional body’s standards may help provide some protection in the event of a dispute or complaint.

THE RESPONSE FROM INDUSTRY GROUPS

There has been an enormous amount of activity and lobbying amongst a number of industry professional associations and institutions as they prepare for the ramifications of the pending regulatory environment and the impacts on their members and representatives.

According to David Hutton, CEO of the Institute of Financial Advisers (IFA), there was general agreement that the proposed Bills are broadly in line with what was expected, most of which is acceptable to the IFA and they support the intention of the Bill to improve regulation for financial advisers. However in their submission to the Finance and Expenditure Select committee they feel the following principles should be retained in the legislation and in the companion Bill on registration and disputes resolution:⁵

- The purpose of the regulation of financial advisers is to protect consumers through ensuring that there are appropriate, uniform, minimum standards for all those

³ Neville Todd, Member of the Securities Commission speech New Securities Law-About to Come into Place 9 November 2007. <http://seccom.govt.nz/speeches/2007>

⁴ Proposal from Finance and Expenditure select committee - <http://www.parliament.nz/en-NZ/SC>

⁵ Institute of Financial Advisers Submission to the Finance and Expenditure Select Committee used with permission from David Hutton, CEO, IFA.

involved in giving financial advice. Any proposals to create 'exemptions' or 'exclusions' detract from this aim. The key elements that need to be retained are:

- inclusion of all aspects of financial advice and all products – so there are no gaps in consumer protection;
- uniformity in standards for advisers giving advice on the same/similar products/services – so consumers receive the same protection irrespective of who employs the adviser and there is a level playing field; and
- a single register of financial advisers – so consumers have only one source to check.

According to the IFA, these principles, as presently drafted, are not consistently reflected in the Bills. For example:

- there is no single register as Accountants and Lawyers are excluded;
- lawyers are fully exempt and Accountants partially exempt;
- anyone with property worth \$500,000 or more is excluded; and
- the definition of 'security' excludes important categories such as real estate.

The IFA submission further asserts: "Our view is that financial advisers that should be covered by regulation are those providing advice on borrowing, budgeting, credit, estate planning, financial planning, insurance, investments (including real estate), mortgages, saving, superannuation, giving security, a guarantee or indemnity".

The proposed changes to the Financial Advisers Bill include a revised definition of 'financial adviser'. They [the Select Committee] propose that the definition of financial adviser refer to those whose primary business is the provision of such advice, or who regularly provide such advice in the course of their business. Further submissions have been called regarding the definition of 'financial adviser' and 'financial advice'.

The Institute of Chartered Accountants (NZICA) has released a draft standard covering 'Financial Advisory Engagements undertaken by Professional Accountants'. This standard is aimed at all chartered accountants, not just those in public practice, who give personal financial advice. The draft sets out principles such as the need to act in the best interests of the client, objectivity and independence, conflict of interest (including an interesting discussion about fee-only versus commission-based remuneration) and handling client money – suggesting they should avoid doing so.

The issue from IFA's perspective – and Adviserlink concurs with its view - is that it doesn't go far enough. The educational requirements for a chartered accountant do not include personal financial advice subjects such as investment diversification and personal risk insurance, though some accountants may have studied these as additions to their core studies.

Under the current disclosure regime, chartered accountants are exempt from the need to have a disclosure statement if the advice they are giving is a 'necessary incident' to professional advice. This is carried forward into the Financial Adviser Bill, but would apply to all aspects of a 'financial adviser service'.

Other professional associations have elaborated on the impact of the reform from their respective viewpoints.

Vance Arkinstall, CEO, Investment Savings and Insurance Association (ISI):

"The effect of these changes all occurring within a short timeframe are fully taxing the available resources of the industry. Virtually all aspects of the life insurance and fund management industry will be subject to regulatory change – most of which will reflect a much more rigorous regime.

Whilst the industry may be challenged by these changes, the objective of 'increased confidence and trust in the industry' will provide many benefits and a further boost in success."

The ISI is in favour of regulation of the industry, but would want the solutions to be in line with the level of problems in the industry (in terms of competent advice).

Dr Dave McMillan, CEO of PAA:

"New Zealand has not had the consumer issues that drove regulation in the UK and Australia so we can see no reason for creating 'boiler plated' solutions for the NZ market.

We think there will be three main impacts on regulation:

1. Change in shape of remuneration -the weight of compensation could move from mainly upfront to a slightly lower upfront with increased servicing commission to compensate advisers for the increased ongoing cost of compliance.
2. Increase in salaried advisers - suppliers (particularly life insurers) will take advantage of the lower disclosure requirements for advisers who are paid a salary. We expect to see an increase of advisers working as employees for suppliers.
3. Despite all of the costs and compliance requirements, the consumer experience will remain broadly similar to today. The difference will be an increase in disclosure of conflicts of interest (which we think is positive) but beyond this we don't think consumers will see much of an upside to the changes."

TRANS TASMAN RECOGNITION

Although New Zealand will be developing a slightly different regime to that implemented in Australia, the principles will be the same and there will be a requirement for fit with the Trans Tasman Mutual Agreement Act.

The effectiveness of arrangements (based on mutual agreements being reached) will depend on the level of trust in the capacity and willingness of the other regulator to enforce and cooperate.

Like a number of other professions, it is reasonable to expect Trans Tasman mutual recognition of approved qualifications by the two authorities. Areas of obvious difference in both jurisdictions include legislation, taxation and superannuation, which will require extra study before licensing or registration can take effect. Fortunately, both the New Zealand and Australian industry and educators have worked in close alignment in the current development of the pending New Zealand qualifications. This will make the Recognition of Prior Learning (RPL) process much more streamlined and seamless and therefore less costly.

John Godfrey has been a director of financial planning companies on both sides of the Tasman, as well as having interests in a financial services recruitment business in Australia and NZ's Adviserlink:

"As an experienced observer on both sides of the Tasman I am watching the Kiwi way of financial services regulation unfold with interest. NZ has had the benefit of seeing many other jurisdictions implement full regulatory and co-regulatory arrangements. In the end result, however it is managed, the outcomes have to look approximately the same. That is: investors have a right to be protected against intentional fraud and must be able to expect advisory and product delivery systems to be sufficiently transparent to enable the 'customer' to make a series of reasonably informed decisions.

So the first idea that the sector has to understand is that, irrespective of the 'lightness' of the initial (and current) regime, the long term one will need to be reasonably heavy handed to achieve the Government's objectives. Once things go wrong, the government and regulators have no choice but to tighten the rules and compliance requirements. There is no long term benefit to the market, the consumers or the industry in starting light and ending heavy.

The second is that a co-regulatory regime, while it sounds good in practice to the co-regulators (APBs), has every likelihood of ending up under a much stronger surveillance

regime than if not. If indeed any form of co-regulatory regime is introduced, the APBs will have to demonstrate that they have the capacity to regulate, and they will find themselves being required to demonstrate their capacity in a range of areas that are not required under a single regulator environment. I compare it with the superannuation trustee operations under the Australian Prudential Regulation Authority (APRA) in Australia. APRA seeks to ensure that best practice in governance, resource capacity management and risk management is implemented and maintained. There is a grading system for watching the market participants where they appear to be falling behind.

In Australia, there was a quick recognition that this change was not going away. It has a serious international momentum as more countries facilitate their domestic financial sectors to develop the protection of wealth, its accumulation, its management, administration and distribution. Governments have recognised that retirement is a self funded objective and government is there only to provide a safety net to those who cannot do otherwise.

My message to the NZ financial sector is to enthusiastically embrace the change rather than downplaying its importance. Become a leader, gain the competencies, get compliance structures underway to find the shortcoming and protect the brand and your PI, and ensure that your local practices enhance your business's ability to deliver to your clients with higher productivity and better risk management outcomes.

In 5-10 years' time you will not recognise your industry as old practices die out, 'non practice' is taken over by improved processes ... and new practices ensure competency and compliance for your and your clients' protection. No system is fool proof, but the industry embarrassments can be minimised by a positive acceptance of the changes."