OFFICE OF THE MINISTER
OF COMMERCE AND CONSUMER AFFAIRS

Chair
Cabinet Economic Growth and Infrastructure Committee

Improving Access to Quality Financial Advice: Recommendations to Amend the Financial Advisers Act 2008 and Financial Service Providers Act 2008

Proposal

1 This paper seeks Cabinet approval to a comprehensive package of changes to the Financial Advisers Act 2008 (**FA Act**) and the Financial Service Providers (Registration and Dispute Resolution) Act 2008 (**FSP Act**) to improve access to quality financial advice.

2 This paper also seeks Cabinet approval to changes to address misuse of the Financial Service Providers Register (**FSPR**).

Executive Summary

3 The FA Act and FSP Act (**the Acts**) which regulate financial advisers were passed in 2008 and aim to promote the sound and efficient delivery of financial adviser services and to encourage public confidence in the professionalism and integrity of financial advisers. They seek to do this by imposing regulatory requirements on advisers which vary depending on how complex the product is, how personalised the advice is, and whether the client is a retail or wholesale client.

4 Prior to 2008, financial advisers were largely unregulated and investor confidence in financial advice was low. The regime that followed the introduction of the Acts has succeeded in lifting professional standards by introducing conduct and competency standards. It has also improved consumer access to redress by requiring those who provide advice to retail consumers to belong to a dispute resolution scheme.

5 Despite these positive changes, the regime has also been subject to some criticism, including that some types of advice aren't being provided, the quality of advice may be suboptimal, it is unnecessarily complex and compliance costs are unbalanced. Over the past 16 months the Ministry of Business, Innovation and Employment (**MBIE)** has comprehensively assessed the performance of the Acts and consulted widely with industry and consumers to identify any problems with the regime and opportunities for improvement. This paper sets out my proposals to amend the regime.

6 One of the Government's key priorities is to build a more competitive and productive economy. A financial advice regime that encourages confidence and further investment in financial markets is central to this. I propose an amended regime which ensures consumers can access quality advice and which doesn't impose any undue compliance costs on industry or become a barrier to innovation.

7 I propose a comprehensive package of changes to create quality financial advice regime (see **Annex 1** for a summary of the current problems and proposed changes to the regime). The key elements are to:

7.1 Remove the regulatory boundaries which are preventing the provision of some types of advice. In particular, ensuring there are no barriers to the provision of robo (or online) advice or advice that takes into account the consumer's particular situation or goals.

7.2 Establish a level playing field of conduct and competency requirements. In particular, requiring all providers of financial advice to put the interests of the consumer first and be held to a Code of Conduct that establishes appropriate client care, competence, knowledge and skill standards.

7.3 Require anyone (or any robo-advice platform) providing financial advice to be subject to active regulatory oversight, and requiring this to be done through licensing at a firm level so it does not impose undue costs on industry or Government.

7.4 Create three types of advisers – 'financial advisers' who would be individually accountable for complying with the legislative and code obligations, while 'agents' who would be the responsibility of 'financial advice firms' which could also provide advice.

7.5 Remove unclear terminology and introduce simplified and common disclosure requirements to ensure consumers can access the right information in the right ways to make informed financial decisions.

8 I also propose to address the issue of offshore entities misusing the Financial Service Providers Register (**FSPR**) by giving consumers the impression that they are licensed and/or monitored in New Zealand, by requiring businesses to have a stronger connection to New Zealand by being registered on the FSPR.

Next steps

9 I intend to progress these changes through the Financial Services Legislation Amendment Bill (**the Bill**) and this paper seeks agreement to enable the Parliamentary Counsel Office (**PCO**) to begin drafting.

10 I propose that officials work with PCO and advise me further on whether an exposure draft of the Bill is needed to test the workability of the draft legislation before it is introduced. I will report back to Cabinet by September 2016 with a timeline for the legislative process, including for any possible exposure draft Bill.

11 I will also report back to Cabinet by September 2016 with recommendations regarding the remaining aspects of the proposed regime, including membership and proceedings of the Code Committee, compliance and enforcement tools and transitional arrangements.

Part I: Financial advice regime

Background

The importance of a quality financial advice regime

12 Building a more productive and competitive economy that creates more business opportunities and jobs, and raises wages and living standards is a key priority for Government. To achieve this it is important that we have a regulatory regime that enables access to quality financial advice and has the protections needed to give New Zealanders the confidence to invest and make informed financial decisions.

13 The nature of financial products means that many consumers need to rely considerably on financial advice before purchasing them. This is because financial products are often complex with risks which can be difficult to assess. And because consumers infrequently purchase financial products like life insurance and superannuation, the ability to learn over time is reduced. Meanwhile, the impact of a financial product that is not 'right' for the consumer can be significant. For example, a consumer being switched to a replacement life insurance product which fails to cover them for a pre-existing medical condition can be devastating to their financial position.

14 In essence, buying a financial product is not like buying other products such as televisions. It is crucial that consumers can access quality financial advice and can trust that advice when making decisions.

About the review of the FA Act and FSP Act

15 Prior to the introduction of the FA Act and the FSP Act (**the Acts**), financial advisers were largely unregulated and investor confidence in financial advice was low. In 2008 the Acts were passed, bringing in some positive changes. The regime has lifted professional standards by requiring financial advisers to be accountable for their advice and to meet minimum conduct obligations. It has also improved access to redress by requiring those who provide advice to retail consumers to belong to a dispute resolution scheme. Despite these positive changes, the regime has also been subject to some criticism, including that some types of advice aren't being provided, the quality of advice may be suboptimal, it is unnecessarily complex and compliance costs are unbalanced.

16 The Ministry of Business, Innovation and Employment (**MBIE**) is required by statute to review the operation of the Acts within five years of the commencement of the relevant sections. A changed regulatory landscape due to introduction of the Financial Markets Conduct Act 2013 (**FMC Act**), combined with ongoing criticism of the Acts, meant that a review of the financial adviser regime was timely.

17 I asked MBIE to comprehensively assess the performance of the Acts and in February 2015 Cabinet approved the publication of the terms of reference for the review [EGI Min (15) 3/9 refers]. The terms of reference established the objectives, approach and timelines for the review, including an indication that I would release both an Issues Paper and Options Paper for public consultation.

18 Over the last 16 months MBIE has undertaken its review, overseen by a steering group of senior officials from MBIE, the Treasury, the Financial Markets Authority (**FMA**) and the Commission for Financial Capability.

19 In May 2015 I released the Issues Paper and sought feedback on the key issues with the regime and opportunities for change [EGI Min (15) 10/8 refers]. Feedback indicated there

were a number of problems impeding the functioning of the Acts and in November 2015 I released an Options Paper that outlined opportunities for addressing those problems [EGI Min (15) 0154 refers]. Industry and consumers have engaged constructively throughout the review, providing evidence of the problems being experienced and suggestions for improvement.

20 I have received MBIE's report with its findings from the review and recommendations for amendments to the regime. MBIE's report is attached (see **Annex 2**) and is required to be tabled in the House of Representatives as soon as practicable. The comprehensive changes to the regime sought in this paper are consistent with MBIE's recommendations in its report.

The current regime

Features of the current regime

21 The FA Act regulates providers of financial advice in the investment, insurance, mortgage and banking industries. It aims to promote the sound and efficient delivery of financial adviser and broking services, and to encourage public confidence in the professionalism and integrity of financial advisers. It seeks to do this by imposing regulatory requirements on advisers which vary, depending on how complex the product is, how personalised the advice is, and whether the client is a retail or wholesale client.

22 The FSP Act requires financial service providers to be registered and, if they provide advice to retail clients, to belong to a dispute resolution scheme. These requirements seek to promote confident and informed participation in and development of fair, efficient and transparent financial markets.

23 The key elements of the regime (see **Annex 3** for a visual illustration of the current regime) are:

23.1 *Definition of financial adviser services* – the FA Act defines three key types of financial adviser services:

23.1.1 Financial advice is defined as when a person makes a recommendation or gives an opinion in relation to acquiring or disposing of a financial product. There are a number of exclusions from this definition, including providing information about a financial product.

23.1.2 An investment planning service is defined as the design of a plan for an individual based on an analysis of their current and future overall financial situation, and identification of their investment goals, including a recommendation or opinion on how to realise them.

23.1.3 A discretionary investment management service (**DIMS**) is defined as any service in which the provider decides which financial products to acquire or dispose of on behalf of, and authorised by, their client.

23.2 *Types of financial advice* – financial adviser services can be more or less tailored to the client. Personalised advice takes into account a client's particular situation or goals and class advice is more generic advice about what is usually suitable for people with similar circumstances (or in the same class).

23.3 *Categories of financial products* – financial products are categorised by complexity. Category 1 products are generally more complex and include securities (including

bonds, shares and KiwiSaver) and futures contracts. Category 2 products are generally simpler and include loans, term deposits and insurance policies.

23.4 *Types of advisers* – there are four types of advisers which have different regulatory requirements and restrictions on the advice they can provide:

23.4.1 Registered financial advisers (**RFAs**) are typically mortgage and insurance brokers and can only provide personalised advice on Category 2 products – there are currently approximately 6,400 RFAs.

23.4.2 Qualifying financial entity (**QFE**) advisers are representatives of QFEs (mostly large banks and insurance companies) and can provide personalised advice on Category 2 products and Category 1 products issued by the QFE – there are currently approximately 23,000 QFE advisers and 56 QFEs.

23.4.3 Registered financial adviser entities can only provide wholesale or class services (or both) – there are currently approximately 950 entities (including QFEs) which are registered as providing financial adviser services.

23.4.4 Authorised financial advisers (**AFAs**) are mainly investment advisers and financial planners (who may also provide mortgage or insurance advice). They can provide personalised advice on all products as well as investment planning services and personalised DIMS – there are currently approximately 1,860 AFAs.

23.5 *Types of clients* – clients are either deemed to be retail or wholesale clients. There are a number of factors which determine whether a client is a wholesale client and these are intended to capture more experienced investors who need lesser protections.

23.6 *Conduct and competency* – different advisers have different conduct and competency requirements but all financial advisers are required to exercise care, diligence and skill and not engage in misleading or deceptive conduct. There are no additional requirements for RFAs but there are for QFE advisers, QFEs and AFAs. QFE advisers are held to a higher ethical obligation in respect to personalised advice on Category 1 products, and QFEs are required to ensure that QFE advisers are supported to achieve and maintain the right level of knowledge, skill and competence. AFAs are subject to a Code of Professional Conduct which imposes further ethical, client care and competence standards and includes a requirement to attain the relevant Level 5 New Zealand Certificate in Financial Services unit standards in order to provide advice.

23.7 *Registration, authorisation and approval* – different advisers have different registration, authorisation and approval requirements. RFAs need to be registered on the FSPR while AFAs need to be registered on the FSPR and authorised by the FMA. To be authorised, AFAs must meet additional entry requirements and comply with a number of ongoing reporting obligations. QFE advisers do not need to be individually registered or authorised, but like AFAs, the QFE must be registered and to be approved as a QFE meet additional entry requirements and ongoing reporting obligations.

23.8 *Disclosure* – different advisers have different disclosure requirements. All financial advisers are required to disclose certain information about the nature of

services they provide prior to providing personalised advice to a retail client. In addition, AFAs are required to disclose more detailed information on the nature of the services they provide, the number of providers' products they can consider and any conflicts of interest.

23.9 *Dispute resolution* – unless an exemption applies, all those providing advice to retail clients must belong to a dispute resolution scheme.

Comparison with international best practice

24 The FA Act brought New Zealand's approach to regulating investment advice more in line with international best practice, including by setting conduct standards and authorisation requirements for AFAs.

25 However, New Zealand's approach to regulating RFAs (who are not actively regulated) remains out of step with international best practice. For example, the Insurance Core Principles (which New Zealand is currently being assessed against by the International Monetary Fund as part of its Financial System Assessment of New Zealand) state that insurance intermediaries should:

25.1 Be licensed and subject to ongoing supervisory review.

25.2 Possess appropriate levels of professional knowledge and experience, integrity and competence.

25.3 Be required to disclose to customers the relationship they have with the insurers and information on the basis on which they are remunerated where a potential conflict of interest exists.

26 Since the Global Financial Crisis (**GFC**) and several financial product mis-selling scandals (such as the mis-selling of income protection insurance in the United Kingdom) international regulatory practice has continued to evolve. Regulation is becoming increasingly cognisant of the role of behavioural biases in relation to financial products, with regulatory design increasingly taking account of the fact that consumers mostly trust those selling or giving advice to be acting in their interests and do not make optimal trade-offs between the present and the future. As a result, there is increased international focus on the conduct of those selling or advising on financial products and ensuring the consumer is at the centre of marketing practices.

Strengths of the current regime

27 While the current regime has a number of shortcomings, there are elements which are working well and I want to ensure that we retain and build on these:

27.1 *AFA conduct and competency standards* – AFAs (and in some situations, QFE advisers) are subject to a Code of Conduct which requires them to 'place the interests of the client first'. This makes very good sense and similar fiduciary type obligations are common internationally. While the current competence, knowledge, skill and continuing professional development standards for AFAs may need some refinement, they are broadly appropriate.

27.2 *The Code of Professional Conduct for AFAs* – A Code of Conduct which establishes minimum standards of competence, behaviour and client care is good practice for any profession. The Code Committee for Financial Advisers and the process it

follows in preparing and reviewing the Code of Professional Conduct is transparent, collaborative and working well.

27.3 *The QFE model* – The current approval and self-regulation model for QFEs has proven to be efficient and effective. It provides the regulatory oversight and supervision necessary of larger entities by holding businesses to account whilst also providing them with flexibility to establish their own training programmes and governance frameworks to ensure that advisers are competent and performance managed.

27.4 *Regulation of brokers and custodians* – The requirements imposed on brokers and custodians (those who hold, transfer or make payments with client money on behalf of clients) are adequate and effective in protecting clients and promoting consumer confidence.

27.5 *The dispute resolution schemes* – There are currently four dispute resolution schemes and all RFAs, QFEs and AFAs providing advice to retail clients must belong to one of them. While the four scheme model may not be common practice and some improvements could be made, there is no evidence to show that it is not working as intended or not delivering the right consumer outcomes.

28 There are a number of current legislative settings relating to Parts 1-3A of the FA Act that remain appropriate and should be retained. These include: the provisions that deal with the distinction between advice to retail and wholesale clients, the provisions exempting people from the definition of financial adviser service, and the provisions applying to brokers' disclosure and conduct obligations.

Problems with the current regime

29 There are a number of issues with the current regime which are hindering investor confidence, participation in financial markets and informed decision-making.

Some types of financial advice aren't being provided

30 Very few consumers are getting advice that takes into account their particular situation or goals. This is backed by the FMA's 2015 review of Sales and advice which found that for every 1000 KiwiSaver sales or transfers, only three were recorded as being sold with personalised advice.

31 Advisers almost unanimously agree that the boundary between personalised and class advice is inhibiting access to advice and that higher regulatory requirements and unclear documentation standards for personalised advice are incentivising this behaviour. This means that most advisers are operating at extreme ends of the advice spectrum, providing either very comprehensive personalised advice or generic class advice, where regulation and guidance is clearest.

32 The legislative requirement for personalised advice to be provided by a natural person is a barrier to the provision of robo (or online) advice. Internationally robo-advice has a rapidly growing market share and is increasingly used by technologically savvy investors who may otherwise struggle to get advice due to the smaller size of their investments and the cost of person to person advice. This is a missed opportunity for both consumers and businesses in New Zealand.

<u>The quality of financial advice may be suboptimal</u>

Accountability of advisers

33 Currently RFAs and AFAs are individually accountable (with no responsibility on their firm) while QFE advisers are not individually accountable (with all responsibility on the QFE).This split of accountabilities does not always ensure responsibility sits with the right people. In particular, there are concerns about the lack of individual accountability and ability to incentivise good adviser conduct within a QFE, that the current regime does not reflect a business's ability to influence consumer outcomes, and that consumers' may not be aware who is accountable.

Conduct of advisers

34 Commissions and remuneration structures are incentivising advisers to push particular products which may not be appropriate for the consumer. The FMA's 2015 review of Sales and advice found that KiwiSaver providers are paying direct sales incentives or setting sales targets in staff performance plans but were unable to show how they recognised and managed those incentives (or conflicts) against consumers' interests.

35 Another review by the FMA into life insurance replacement business (where a consumer moves their policy from one provider to another following financial advice) found:

35.1 The quality of a policy was only a minor factor in whether a policy was replaced, suggesting that some advisers are acting in their own interest, rather than the consumers' interest.

35.2 Correlations between replacement business and incentives. For example, advisers not subject to a clawback period[1] are 2.2 times more likely to replace policies when offered overseas trips (to destinations like Rome and New York) compared to advisers offered no trips.

35.3 Evidence that high replacement business is more prevalent amongst RFAs than AFAs. About two thirds of the high-volume advisers[2], and 85 per cent of the high-replacement advisers[3], were RFAs.

36 Although not widespread (and indeed there are many advisers doing an excellent job), this strongly suggests that some advisers' practices may be resulting in poor advice and consumer outcomes.

Competence of advisers

37 RFAs are not held to any competence standards, while QFE advisers and AFAs are held to standards which may not be fit for purpose. I am concerned this might be driving the provision of suboptimal financial advice and damaging consumer confidence and investment.

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[1] A clawback period is the period within which a financial adviser must repay a portion of the commission they received from an insurance provider if the policy is cancelled.

[2] High-volume advisers are AFAs and RFAs with more than 100 active life insurance policies on their books.

[3] High-replacement advisers are AFAs and RFAs with more than 100 active life policies on their books, who also have a high estimated rate of replacement business.

Oversight of advisers

38 RFAs are not subject to any active regulatory oversight despite providing some of the exact same services as QFE advisers and AFAs. This is confusing to consumers, nonsensical and means that unless the FMA receives a complaint about the activities of an RFA and investigates, they are not monitored or supervised.

Activities that are regulated

39 The 'reach' of the FA Act is determined by the definition of financial adviser service. I have two concerns about the current definition:

39.1 It may be unintentionally capturing activities that are not intended to be regulated. An example is execution or transaction-only services (where a consumer requests to buy or sell a specific financial product and does not want advice).

39.2 It may be allowing some activities which are intended to be captured to go unregulated by providers using the strict 'letter of the law'. An example from the FMA's 2015 review of Sales and advice is the cross-selling of financial products, where consumers who intended to purchase one financial product, such as a credit card or home loan, were sold additional products, such as life insurance or KiwiSaver and this was not treated as advice.

<u>Compliance costs are unbalanced and there are inefficiencies</u>

40 The current regime is designed in a way which misses opportunities for efficient compliance. QFEs are approved at a firm level with an upfront fee of $4886 while AFAs are required to be individually authorised with an upfront fee of $1145 per adviser. This means that a small-medium sized advisory firm with ten advisers is required to spend almost $11,500 in direct fees compared to $4886 for a large QFE with potentially hundreds of QFE advisers.

41 The scale of this disparity means that AFAs are imposed with significantly greater direct compliance costs. Many advisers claim this is preventing them from remaining viable and competitive, and forcing them to be selective about the type of clients they take on.

<u>Unnecessary complexity is preventing adequate consumer confidence and understanding</u>

42 The current distinction between Category 1 (complex) and Category 2 (simple) products, with different regulatory requirements (competency, conduct and disclosure) applying to each, does not necessarily reflect the true risk or complexity they can carry. For example, advice on some Category 2 products (like life insurance) can be complex and have a significant impact on consumers' financial outcomes.

43 Feedback from consumers is that terminology is causing confusion and can often be misleading. For example, adviser designations do not provide an indication of the kind of advice consumers can expect to receive or the quality of the adviser. In particular the term 'registered' suggests some level of qualification, oversight or monitoring (as it does with other professions like nursing) and superiority over 'authorised' financial advisers. The legislation has introduced other definitions which are difficult for advisers to communicate and consumers to understand. For example, consumers do not often understand the limitations of class advice and expect and assume all advice to be personalised.

44 Disclosure documents are long and unwieldy and are not providing consumers with the key information they need to make good financial decisions. Anecdotal evidence suggests they are rarely read and when read the differing disclosure requirements might mean that

consumers make incorrect assumptions about the advice they have received. An MBIE survey of consumers found that the information most useful to consumers (including remuneration and disciplinary details) is not required to be disclosed by all advisers.

The proposed regime

Objectives of the proposed regime

45 One of our key priorities is to build a more competitive and productive economy. A financial advice regime that encourages confidence and further investment in financial markets is central to this. I propose a new regime which is driven by the following four objectives:

45.1 To ensure that consumers can access the advice they need.

45.2 To improve the quality of advice.

45.3 To be enabling and not impose any undue compliance costs, complexity or barriers to innovation.

45.4 To ensure access to redress.

Proposed regime

Overall description

46 Investor and consumer outcomes are at the centre of the proposed regime. To ensure this translates into the legislative framework I propose that the objectives of the proposed regime, including access to quality financial advice, are appropriately reflected in the purposes of the relevant legislation.

47 I propose a comprehensive package of changes to improve access to quality advice for all New Zealanders (see **Annex 4** for a visual illustration of the proposed regime). The key elements are:

47.1 *Simplifying the regime by stripping out unnecessary complexity and arbitrary regulatory boundaries.* I want to remove the requirement for personalised advice to be provided by a natural person, remove the definitions of class and personalised advice, and do away with the categorisation of products. These changes will enable the provision of robo-advice and make it much easier for advisers to provide consumers with the advice they want and need.

47.2 *Establishing an even playing field with more proportionate entry and ongoing regulatory requirements.* I want to introduce uniform legislative conduct and competence obligations as all providers of financial advice should be required to place the interests of the consumer first and only provide advice where competent to do so. I also propose that an amended Code of Conduct (which all advice is held to) include standards of conduct and competence to ensure compliance with the legislative obligations. Recognising the breadth of advice services, some standards in the Code would vary for particular parts of the industry or products or services. For example, competency standards may be different for advisers who wish to advise on general insurance versus those who want to give investment advice.

47.3 *Enabling lower cost and more meaningful licensing.* I want all advice services to be licensed. To ensure this does not impose undue costs on businesses or Government, licensing would be required at the firm level. This approach replicates

the efficiencies of the existing QFE model and applies it to currently compliance burdened AFAs and unlicensed RFAs. I also recognise that a one size fits all approach to licensing and reporting would not work. To ensure that requirements are proportionate there would be flexibility, depending on the size and nature of the firm, in how prospective licensees would be expected to meet those requirements.

47.4 *Creating three types of advisers.* I want to dispense with the four existing types of advisers and introduce three new types – ‘financial advisers’, ‘agents’ and ‘financial advice firms’. Financial advisers would be individually accountable for complying with the legislative and code obligations whereas financial advice firms would be accountable for their agents. There would be no legislative difference in the services financial advisers or agents could provide. But in practice agents would be limited to types of advice where the financial advice firm could demonstrate it as appropriate for the firm to hold accountability, for example advice that is subject to clear processes and controls. The advice that could be provided by agents, and the controls around this, would be made explicit in the firm’s licensing documentation and licensing conditions (refer paragraph 60.2.2).

47.5 *Improving consumer understanding with better terminology and disclosure.* As well as removing unclear categorisations I propose to improve financial adviser designations to make it clear that agents are not individually accountable. For example, agents working for ANZ bank would need to disclose that they are agents for ANZ and could not call themselves financial advisers. I also propose to introduce more meaningful disclosure requirements for all types of advice. Disclosure would be simplified and shortened to include core information about the scope of service, remuneration (including commissions) and competence, and would be available in more user-friendly formats.

48 These changes represent a shift away from the current regime which sought to professionalise a subset of advisers (AFAs), towards a regime which seeks to more broadly regulate the conduct of all market participants. This brings it more in line with the approach undertaken in the FMC Act. The proposed changes will also enable a more principles-based approach to the redesign of the regime. This will enable the removal of some of the technical detail in the FA Act to regulations, which will ensure the proposed regime is flexible and durable. I intend to instruct officials to work with the Parliamentary Counsel Office (**PCO**) to identify which provisions of the FA Act are more suited to subordinate legislation.

Increased provision of financial advice

49 There are too many boundaries and restrictions which are forcing advisers to limit their services and spend more time figuring out what they can and can’t do instead of providing advice. Therefore I propose that:

49.1 The definitions of personalised advice and class advice are removed to enable simple and sensible advice conversations. This does not mean that all advice would have to be fully comprehensive or follow a full client needs analysis, rather that the scope of services could be tailored based on factors such as the consumer’s wishes and the areas of competence of the adviser.

49.2 The provision of robo-advice and other financial technology solutions are fully enabled. Robo-advice platforms would be licensed and required to meet the same standards as a natural person providing advice, however the means of meeting these standards will differ. For example, while a financial adviser or agent may be required to demonstrate competence through having passed a qualification, a robo-advice

platform may have to demonstrate equivalent quality through algorithm and scenario testing.

50 These changes would remove the legislative barriers and perverse incentives restricting provision of some advice services. They would also reduce the cost of providing more tailored advice and have the potential to create a different online advice market with new providers and new customers.

Higher quality financial advice

Accountabilities of individuals and firms

51 A feature of the current regime is that RFAs and AFAs are individually accountable (with no responsibility on their firm) while QFE advisers are not individually accountable (with all responsibility on the QFE). I propose to change this model by replacing existing types of advisers with three new types – financial adviser, agent and financial advice firm – and ensuring accountability rests with those able to influence consumer outcomes.

51.1 Financial advisers would:

51.1.1 Be registered on the FSPR.

51.1.2 Be engaged as a financial adviser by a licensed financial advice firm.

51.1.3 Be accountable for their financial adviser legislative and regulatory obligations.

51.1.4 Hold a restricted ‘financial adviser’ title.

51.2 Agents would:

51.2.1 Be engaged as an agent by a licensed financial advice firm.

51.2.2 Be titled using the descriptor ‘agent’.

51.3 Financial advice firms would:

51.3.1 Be registered on the FSPR.

51.3.2 Be licensed by the FMA to provide financial advice services (including robo-advice or other financial technology solutions), consistent with the licencing regime under Part 6 of FMC Act.

51.3.3 Be able to be a sole trader.

51.3.4 Be able to engage financial advisers and / or agents.

51.3.5 Be accountable for the financial advice firm’s legislative and regulatory obligations.

51.3.6 Be accountable for their agents. This is similar to the current QFE model and makes sense in a large organisation, like a bank, where representatives are required to follow the firm’s processes with limited individual discretion. In this instance, it is the firm which manages risk through the setting of advice processes and incentives.

51.3.7 Be required to put in place processes and provide resources to enable their financial advisers to meet their obligations. That is, while the individual financial adviser would be accountable for their advice, the firm would be accountable for supporting the individual to comply.

51.3.8 Be required to ensure they do not incentivise their agents to sell products without regard to consumer's interests. This would require firms to recognise potential conflicts of interest – such as the role of incentives in sales and advice – and develop plans to effectively manage such conflicts of interest.

Broad legislative obligations

52 I propose that two new obligations are built into the FA Act and applied to all financial advice services:

52.1 A conduct obligation to place the interests of the consumer first. This would be consistent with the current obligation on AFAs under the existing Code of Professional Conduct. What would be required to place the interest of the consumer first would be determined by what is reasonable in the circumstances, but should be founded on what is suitable for the customer regardless of the incentives for the adviser or agent. This recognises that all advisers and agents have limitations on the services they can provide. For example, some only provide advice on one or two providers' products. In putting the interests of the consumer first they would not be expected to consider the full range of products from across the market, but would be required to recommend the best product for the consumer from their suite and, if no product from those providers is genuinely suitable, to advise the consumer on that basis. In all cases, advisers and agents must put the consumers' interests ahead of their own regardless of the differing financial incentives offered by providers.

52.2 A competence obligation to only provide financial advice where competent to do so. This would be consistent with the current obligation on AFAs under the Code of Professional Conduct and would mean that advisers and agents would be expected to demonstrate that they have a reasonable basis for believing they have the level of competence, knowledge and skills required to provide that advice.

A universal Code of Conduct

53 I propose that all advice is held to a Code of Conduct which is developed by a Code Committee and prescribes in more detail how to comply with the legislative conduct and competence obligations.

54 In developing the Code of Conduct and to ensure it applied appropriately to all parts of the industry, the Code Committee would be required to identify sub-specialisations within the financial advice industry consult with the financial advice industry on what those sub-specialisations might be.

55 The Code of Conduct would be required to include:

55.1 Standards of conduct and client care that apply to all providers of advice. These standards would provide greater specificity on the behaviours, processes and practices expected when providing financial advice. For example, relevant standards might include how to effectively manage conflicts of interest and ensure there is an appropriate internal process in place for resolving consumer complaints.

55.2 Standards of competence, knowledge and skill that apply to all providers of advice. These standards would be relevant to all, irrespective of industry. For example, relevant common standards might include knowledge of New Zealand's financial advice and consumer laws, and skills required to assess a consumer's financial situation.

55.3 Standards of competence, knowledge and skill specific to particular parts of the industry or products or services, consistent with identified industry sub-specialisations. For example, life insurance advisers or agents could be required to demonstrate knowledge of life insurance products and skill in managing replacement business.

55.4 Prescribed methods[4], such as courses, which are deemed to comply with the standards of competence, knowledge and skill.

55.5 Continuing professional development (**CPD**) requirements. This would include requirements to maintain a CPD plan for each CPD period, and undertake sufficient professional development activities to maintain competence at a level appropriate for the services the adviser or agent provides or intends to provide. It is expected that the standards would not be prescriptive and would recognise that competency means more than technical knowledge and activities may come in many forms.

56 These changes, with core obligations set in statute and detailed requirements outlined in regulations and a Code of Conduct, would establish a flexible and nimble framework and ensure that the regulation could quickly respond to industry changes.

Increased oversight of those providing financial advice services

57 RFAs are not subject to any active regulatory oversight and have few regulatory obligations. This is inhibiting effective monitoring and enforcement and may be resulting in consumer harm. Therefore I propose that:

57.1 Anyone (or any robo-advice platform) providing financial advice services is required to do so under the authority of a financial advice licence, granted by the FMA.

57.2 Before being granted a licence, prospective licensees are required to show how they, their agents and / or financial technology solutions meet the relevant legislative and regulatory requirements (for example, the Code of Conduct).

57.3 All licensed financial advice firms must notify the FMA of all financial advisers (including their full name, address, FSPR identification and areas of competence) operating under their licence.

57.4 To retain a licence, all licensed financial advice firms are required to comply with any licence conditions imposed by the FMA. For example, this could include ongoing reporting, accounting and notification requirements.

Ensuring the regime regulates the right activities

58 To ensure that the right activities are captured I propose to clarify that the following does not constitute financial advice:

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[4] As having a qualification does not necessarily prove competence I expect the Code of Conduct to include alternative methods for demonstrating competence where appropriate. For example, this may include online assessments perhaps based on case studies or genuine work experiences.

58.1 Execution-only or transaction-only services (whereby a consumer has requested a specific product and does not wish to receive advice). For example, a consumer which says *I would like to purchase 5,000 Mighty River Power shares.*

58.2 The provision of factual information about a financial product (such as the cost or rate of return of a financial product), whether or not it is in response to a request by a consumer. For example, a consumer which asks for information about basic car insurance like *how much would the premium be? And what would the excess be?*

59 I also propose that officials consider whether additional mechanisms to ensure the legislation is in practice capturing the activities that should be regulated. For example, one option could be to enable the FMA to designate activities as advice, subject to a set of guiding principles. MBIE will develop and analyse options with the FMA and PCO and I will report back to Cabinet by September 2016 with my recommendations.

Improved compliance regime

60 The cost of registration, authorisation and reporting is imposing undue costs on AFAs. To ensure that the new regulatory oversight measures are reasonable and proportionate, I propose that:

60.1 Financial advice licences are issued to financial advice firms rather than individual financial advisers or agents.

60.2 What prospective licensees would need to provide to the FMA to meet the licensing requirements would be set in regulations and / or prescribed by the FMA, and be flexible. Expectations would vary, depending on the size and nature of the firm and the services it provides and whether it engages financial advisers and / or agents. For example:

60.2.1 Arrangements for overseeing compliance in smaller organisations may be more limited, whereas a larger organisation might require oversight by a committee of senior managers from across the firm with a number of operating procedures.

60.2.2 The requirements for firms with agents will be higher to ensure it is appropriate for the firm to take on the responsibility of the agents. However, firms with financial advisers will also need to show how they support their financial advisers to comply.

60.3 Financial advice firms are given flexibility in how they are required to demonstrate compliance with the relevant competence, knowledge and skill standards. In particular, while the Code Committee will establish prescribed methods which will be deemed to comply with the competence, knowledge and skill standards, firms could develop their own internal training programmes. This may be preferred by larger firms which want to design courses tailored to their services and train staff for potentially less cost. If firms chose to develop their own programmes, they would need to satisfy the FMA that their alternative methods met the relevant competence, knowledge and skill standards.

61 These changes will ensure that the compliance regime does not impose undue costs on business or Government.

<u>Simplified regime with improved consumer understanding</u>

Boundaries and terminology

62 There are a number of boundaries and definitions in the regime which are unnecessarily complex and causing consumer confusion. Therefore I propose the following changes:

62.1 The definitions of Category 1 and Category 2 products are removed. This would mean that all financial advice products would be regulated in the same way.

62.2 Types of financial advisers– 'registered financial adviser', 'QFE adviser', 'registered financial adviser entity', and 'authorised financial adviser'– are removed and replaced with 'financial adviser', 'agent' and 'financial advice firm' as described in paragraphs 51.1, 51.2 and 51.3.

62.3 I also think it would help consumers if financial advisers could identify themselves with sub-specialisations. For example, 'financial adviser – insurance' and 'financial adviser – investments' in accordance with the sub-specialisations that will be set in the Code.

Disclosure and client care

63 Disclosure documents are not providing consumers with the information they need to make informed financial decisions. Therefore I propose that:

63.1 Prescribed information is required to be disclosed by all providers of financial advice. The content, format and timing of disclosure would be detailed in regulations. Important information such as remuneration, the nature of the service they can provide, an indication of how many and which product providers they can consider and other information regarding relevant competency and conduct issues would be required to be disclosed in a clear and concise way.

63.2 All providers of financial advice are required to disclose information regarding conflicts of interest and conflicted remuneration in a prescribed format. This could require disclosure of how they are remunerated and the amount of conflicted remuneration (including details of soft commissions) they could expect to receive if the consumer took their recommendation.

63.3 All financial advisers and agents are subject to a broad legislative obligation to ensure that consumers are aware of the limitations of their advice when making a recommendation. This would include confirming how many types of financial products and providers have been considered, the elements of the consumers' circumstances that have been taken into account by the financial adviser or agent, and if they are an agent, to disclose which firm they are an agent for.

64 I also propose that MBIE explore options to require financial product providers to publish an annual register of soft-commissions[5] (beyond a minimum level) provided to financial advisers or agents. This would include, for example, disclosure of the number of individuals taken on a trip to Prague for having met a certain sales target. This approach – alongside disclosure by financial advisers and agents as set out above – recognises that soft commissions may be more difficult to disclose in a meaningful way by an individual adviser or agent. While I would not expect all consumers to look up such a register, this proposal

[5] Non-monetary incentives attached to the sale of a certain product.

aims to shine a light on industry practices and lead some consumers to ask questions of their financial advisers and agents.

65 These changes will improve consumer accessibility and ensure that regulatory design is not a barrier to consumer understanding.

<u>Other matters which require further consideration</u>

Membership and proceedings of the Code Committee

66 I think that the current functions of the Code Committee – to produce, review and recommend changes to the Code of Professional Conduct – will be fit for purpose under the proposed regime. However, as I am proposing that a Code of Conduct is applied universally to those who provide financial advice, it is appropriate to reconsider the membership and proceedings of the Code Committee. Therefore I propose that:

66.1 MBIE reconsider the membership and proceedings of the Code Committee and I will report back to Cabinet by September 2016 with my recommendations.

Compliance and enforcement tools

67 There are a number of compliance and enforcement tools which have not been used, while others require a lot of FMA resource or aren't fit for purpose. For example, the FMA has to prove criminal liability under the FSP Act rather than civil liability as under the FMC Act.

68 It is important that the FMA and Financial Advisers Disciplinary Committee (**FADC**) have the necessary tools to encourage compliance and respond to non-compliance. Therefore I propose that:

68.1 MBIE assess the effectiveness and efficiency of the current range of compliance and enforcement tools available under the Acts and I will report back to Cabinet by September 2016 with my findings and recommendations.

Dispute resolution

69 The dispute resolution regime appears to be functioning well, however I think there may be opportunities to further promote access to fair and effective redress. In particular, I could use my existing regulation-making powers to standardise scheme rules to improve consumer protection and ensure consumers are informed about how to make a complaint. Therefore I propose that:

69.1 MBIE work with the dispute resolution schemes to identify what improvements may be appropriate and report back with its recommendations later this year.

Transitional arrangements

70 Many of the changes proposed in this paper will have an impact on existing financial advisers and so it is important that appropriate transitional arrangements are considered. Transitional arrangements should ensure that new requirements are not introduced without regard to practicalities such as the need to undertake further training to meet higher competency standards. Therefore I propose that:

70.1 MBIE work with industry to consider what transitional arrangements might be appropriate and I will report back to Cabinet by September 2016 with my recommendations.

Finding an adviser

71 I am concerned that New Zealanders find it difficult to know where to go to find and choose a financial adviser. There seems to be sufficient information available to help consumers but it is not being drawn on by consumers. It is unclear whether this is caused by the underlying complexity of the current regime, low consumer awareness of existing tools, or the fact that this information is not held centrally in one user-friendly place. It is also possible that there may be other influencing factors such as consumer apathy and low levels of financial capability.

72 Given that it is not possible to identify the exact root cause/s of the problem or what Government's role is in remedying the problem, I want to defer recommending a proposed course of action until MBIE has engaged with industry and consumer representatives to determine what impact the changes proposed in this paper are likely to have on helping people find advice more easily. MBIE will also discuss with industry whether 'brokers' could be renamed to make it clearer to consumers what services they offer.

Other options considered but discounted

A "buyer-beware" carve-out for some activities

73 Distinguishing salespeople from advisers has been a key theme throughout the review and one that I have given much consideration to.

74 I considered whether it was appropriate to apply fewer regulatory obligations to some activities so long as the consumer was clearly made aware the provider was not required to put the consumer's interests first (e.g. by labelling them salespeople and providing a notification to the consumer). However, I am concerned that a lower set of standards for certain providers would perpetuate consumer confusion and further limit access to quality financial advice. This is a significant risk that would likely lead to poorer outcomes for consumers and damage confidence in the industry.

75 I have instead proposed a package of reforms which is focused on lifting conduct and improving disclosure of conflicts for all market participants who make a recommendation or give an opinion in relation to acquiring or disposing of a financial product. Moreover, my proposal to clearly distinguish between 'financial advisers' (who are individually accountable for their advice), and 'agents' (who are not), aims to ensure consumers understand where it is the firm and not the individual who is standing behind the advice.

Banning or restricting commissions

76 I recognise banning commissions is a more direct way to ensure consumer protection from the risks presented by conflicted remuneration. However, I don't favour this option in the first instance because:

76.1 There is a significant risk that banning commissions in New Zealand (where people are already reluctant to pay for financial advice) will further limit access to advice.

76.2 It is unlikely to address conflicts of interest where financial products are sold through in-house distribution channels, such as bonuses (and may increase the prevalence of such conflicts of interest since there would likely be a significant increase in advice provided through in-house distribution models).

76.3 My proposals will tackle the same 'conflict of interest' issues that banning commissions would seek to address. In particular, they include:

76.3.1 Introducing clear conduct obligations on all financial advisers and agents.

76.3.2 Improving the ability for the FMA to monitor and take enforcement action for breaches of those conduct obligations – like insurance churn.

76.3.3 Requiring conflicts to be disclosed clearly and consistently by all financial advisers and agents.

77 There is a clear trend internationally toward more direct interventions including bans on commissions on investment products. This comes in the wake of the GFC and as behavioural economics increasingly points to the limitations of disclosure *by itself* to address conflicts of interest.

78 Given the risk of harming access to advice, I think my proposals represent a more prudent approach in the first instance. This is underpinned by a judgement that the benefits of this access to advice, together with the measures to ensure good conduct, exceed the remaining risk of advice being motivated by conflicted means. However, I would like MBIE and the FMA to closely monitor conduct and the impact of the proposals to ensure they are sufficient.

PART II: Misuse of the Financial Service Providers Register

The FSPR is being misused

79 Some (predominantly offshore-controlled) entities have been misusing the FSPR to take advantage of New Zealand's reputation as a well-regulated jurisdiction.

80 Registration on the FSPR does not require pre-vetting by a regulator (although many registered entities are also required to obtain a licence). The qualification requirements for registration are similar to those for a director of a company, including not being an undischarged bankrupt.

81 Despite not providing services to New Zealanders or, in some cases from New Zealand, some firms register on the FSPR to create the impression to customers that they are licensed or otherwise actively monitored in New Zealand. An underlying issue is that the public often interprets "registered" on the FSPR to mean that an entity is actively regulated in New Zealand.

82 Some of these registered firms have allegedly been involved in fraudulent activities offshore. This poses a risk to New Zealand's reputation as a well-regulated jurisdiction and to the reputation of legitimate New Zealand financial service providers. Allowing such firms to register on the FSPR is imprudent and potentially harmful to consumers.

83 The FMA has powers to direct the Registrar of Financial Service Providers to decline a registration or deregister an entity in some circumstances, including if it considers that registration creates a misleading impression about the extent to which a provider is regulated in New Zealand. However, dealing with misuse issues in this manner has required considerable resources.

Proposal: Require a stronger connection to New Zealand

84 Currently a business can register on the FSPR if it has a "place of business" in New Zealand, regardless of where the financial service is provided. Businesses misusing the FSPR have often set up a superficial operation in New Zealand by leasing an office and employing a person to provide back-office services.

85 My proposal above to license all financial adviser firms will ameliorate this issue partly as more businesses will be subject to pre-vetting before they register on the FSPR. However, this is unlikely to be sufficient to address the issue as there remain other categories of financial services which require registration on the FSPR but not a licence. For example, those operating a money or value transfer service, or being a creditor under a credit contract.

86 Therefore I propose to address this by providing that entities can only register if they are (or will be):

86.1 In the business of providing financial services, not just back-office administrative services, from a place of business in New Zealand, or

86.2 In the business of providing financial services to New Zealanders, or

86.3 Otherwise required to be licensed under any other New Zealand legislation.

87 This change will make it more difficult for offshore-controlled entities without a genuine connection to New Zealand from registering, making it more difficult for those entities to misuse the FSPR.

88 There is a risk that changes to the entities required to register could lead to unintended consequences or uncertainty. Officials will continue to engage with the FMA, other interested government agencies and industry to refine and test the details of the new requirements in order to mitigate that risk.

Other measures to address misuse which require further consideration

89 In addition to the proposed changes to FSPR registration requirements I think there may be other complementary measures which could help address misuse of the FSPR and misunderstanding of what it means to be "registered". For example, including more stringent registration criteria with respect to an entity's compliance with financial services laws in its home jurisdiction and other jurisdictions in which it is operating. Therefore I propose that:

89.1 MBIE consider complementary measures which could help address misuse of the FSPR and I will report back to Cabinet by September 2016 with my recommendations.

Next steps

90 I intend to table a copy of MBIE's report in the House of Representatives alongside the announcement of Cabinet's decisions.

91 I intend to progress these changes through the Financial Services Legislation Amendment Bill (**the Bill**), an omnibus bill amending legislation regulating the financial services industry. I propose that officials work with PCO and advise me further on whether an exposure draft of the Bill is needed to test the workability of the draft legislation before it is introduced. I will report back to Cabinet by September 2016 with a timeline for the legislative process, including for any possible exposure draft Bill.

92 I will also report back to Cabinet by September 2016 with recommendations regarding the other matters that require further consideration. Any legislative changes that arise from that report back would be included in the exposure draft of the Bill. This may also include changes to the FMC Act to tidy up any technical issues that have arisen since its

implementation. Given the size of those reforms it can be expected that issues would emerge as the regime beds-in.

Consultation

93 This review was run in an open and transparent manner. Over the past 16 months, I have actively sought input from stakeholders through: two rounds of public consultation with formal submissions processes, online consumer surveys, public workshops and focus groups. Officials also met with various stakeholders upon request to further discuss their submissions. More recently, the proposals in this paper were tested in confidence with a cross section of trusted industry and consumer representatives.

94 Below is a summary of feedback received through consultation and stakeholder engagement:

General agreement	***Divergent views***
Some types of advice aren't being provided	
• Compliance costs and regulatory provisions are impacting the accessibility of advice. • Support for removing the class/personalised advice distinction. • Support for removing barriers to innovation e.g. robo-advice.	
The quality of financial advice may be suboptimal	
• Anyone providing a financial advice service should be required to place the interests of the consumer first. • Competency requirements should be increased and apply to all advisers. • There should not be different standards depending on product complexity as this would perpetuate confusion. • AFA standards (for conduct and competency) as set out in the Code of Professional Conduct are appropriate and there is scope for similar standards to be applied to all advisers. • There should be no ban on commissions due to concerns that this would create an advice gap.	• Distinguishing between salespeople and advisers. • Whether increasing competency standards would create a barrier to entry. • The best way to measure or demonstrate competency (prescriptive or principles based). • What the minimum requirement should be and whether there should be a common standard for all. • Whether all conflicted remuneration should be disclosed and how so – some suggested this could be difficult in practice due to the complexity of many remuneration structures.
Compliance costs are unbalanced and there are inefficiencies	
• There are areas where compliance costs could be reduced, such as simplifying or eliminating adviser business statements and altering disclosure provisions.	• Whether licensing should be managed on an individual or entity basis.
Unnecessary complexity is preventing adequate consumer confidence and understanding	
• Current terminology is complex and may be misleading to consumers. • Disclosure needs to be simplified,	

standardised and have flexibility around delivery. • There is not a huge information gap for consumers looking for an adviser but there may be issues around consumers accessing and utilising existing information.	

95 The following government agencies have been consulted: The FMA, the Treasury, the Commission for Financial Capability, the Reserve Bank of New Zealand, the Department of Internal Affairs and the Ministry of Justice. The Department of Prime Minister and Cabinet has been informed.

Risks and mitigation

96 While there has been broad support for the proposals, there may be some negative reaction from parts of the advice sector, for example:

96.1 There may be negative reaction from some RFAs (typically mortgage and insurance brokers) who will face increased compliance costs. However, many RFAs have indicated they are keen to lift their professional image and be treated as a profession. The risk of negative reaction can be partly mitigated through clear communication that transitional arrangements will aim to allow sufficient time for these advisers to demonstrate competence.

96.2 Some AFAs may be concerned that the proposals water down their status as a profession by lifting the standards that apply to all financial advice and, in doing so, removing the exclusive 'AFA' designation. This risk of negative reaction is acceptable in order to ensure consumers receive quality financial advice, whether from a bank, online, or from an individual financial adviser or agent.

97 There may be some criticism from consumer groups who argued that commission payments should be banned. I believe the risk of criticism can be mitigated through communications which will explain how the proposals address the risk of harm from commissions. MBIE will continue to monitor this area.

Financial Implications

98 The proposals involve increasing the population of advisers who are actively regulated by the FMA (since RFAs are not currently subject to any active regulatory oversight and have few regulatory obligations) and making all advice subject to a 'consumer first' conduct standard which will require active monitoring. These changes will have implications for the FMA's funding requirements that are separate to the funding proposals outlined in the Cabinet paper titled *Release of Consultation Paper for Reviews of the FMA's funding and levy, the XRB levy and Companies Office fees*. In particular:

98.1 The costs to the FMA to license financial advice firms will be recovered through licence application fees (as is the current situation). A separate policy process will follow (likely after the legislation is passed) for adjustments to the fees to reflect the proposals to reclassify advisers and to license at the firm level.

98.2 Additional funding, and associated adjustments to the FMA levy, may be required to meet the costs of FMA's ongoing monitoring of financial advisers and financial advice

firms. A separate policy and consultation process will follow (likely after the legislation is passed) for adjustments to the levy.

99 The proposals will require consequential amendments to the Companies Office FSP Register (for example, to include new fields for financial advisers and financial advice firms, rather than the current AFAs, RFAs, QFE). These are estimated to cost up to $300,000 and will be undertaken within existing baselines.

Human Rights

100 There are no inconsistencies between the proposals in this paper and the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993. There are no gender or disability perspective implications from the proposals in this paper.

Legislative Implications

101 The proposals in this paper will require amendments to the FA Act, FSP Act and FMC Act. This paper seeks agreement to enable PCO to begin drafting the Financial Services Legislation Amendment Bill, an omnibus bill, which has a category 6 priority on the 2016 Legislation Programme.

102 Officials will work with PCO and the Legislative Design and Advisory Committee to determine the most appropriate legislative design approach. This could involve amendments to the existing Acts, replacing the FA Act with a new Act, and / or moving some FA Act provisions into the FMC Act.

Regulatory Impact Analysis

103 The Regulatory Impact Analysis (**RIA**) requirements apply to the proposals in this paper. Two Regulatory Impact Statements (**RISs**) have been prepared by Ministry of Business, Innovation & Employment and are attached.

104 The Regulatory Impact Analysis Team (**RIAT**) has reviewed:

104.1 The RIS entitled *“Review of the Financial Advisers Act”*

104.2 The RIS entitled *“Amendments to the Financial Service Providers (Registration and Dispute Resolution) Act 2008 and Regulations”*.

105 RIAT considers that the information and analysis summarised in the *“Review of the Financial Advisers Act”* RIS **meets** the quality assurance criteria.

106 The RIS covers a range of issues and follows a significant review process, including multiple rounds of consultation and active engagement from the sector participants. The RIS acknowledges the difficulties in being certain about the impacts of the preferred options. The impacts identified rely on subjective and generally qualitative submissions from stakeholders, assumptions about behaviour (for example, the likelihood that consumers will seek quality advice), and judgments about the reasonableness of compliance costs. Consequently, there is limited quantitative information about the likely impacts.

107 RIAT notes that advice about preferred options relies on officials balancing these impacts. Close monitoring by the FMA and further work on compliance, enforcement, and transitional implementation arrangements by the Ministry will be used for assessing the ongoing effectiveness of the regulatory regime.

108 RIAT considers that the information and analysis summarised in the “Amendments to the Financial Service Providers (Registration and Dispute Resolution) Act 2008 and Regulations” RIS **meets** the quality assurance criteria.

109 The proposals in this RIS will entail some costs for the FMA, for overseas entities required to register, and for financial service providers needing to provide consumer information (particularly for smaller providers). There is a lack of certainty about the extent of misuse of the Financial Service Providers Register, so net benefits are uncertain. The RIS states further analysis will be carried out on how the preferred option will work in practice which should mitigate any risk of unintended consequences.

Publicity

110 Subject to Cabinet’s agreement to the recommendations in this paper, I intend to issue a press release announcing Cabinet’s decisions. MBIE will also publish a copy of this paper on its website.

111 Ahead of issuing the press release announcing Cabinet’s decisions I propose that MBIE share an in-confidence copy of this paper with the chair of the current Code Committee for Financial Advisers.

112 The review of the Acts has received a moderate level of media interest and I expect this to increase with the release of this Cabinet’s decisions. I intend to release a series of media statements and opinion editorials over the coming months to encourage further engagement in the Review.

113 On 29 June the FMA released its findings on the review of life insurance replacement business. The report found correlations between advisers recommending policy replacement and incentives (for example, overseas trips) and this is likely to attract significant media attention. Many of the concerns raised in the FMA report will be addressed through the proposals in this Cabinet paper (for example, through lifting conduct standards and requiring disclosure of commissions). The FMA and MBIE are working together to align communications messages.

Recommendations

The Minister of Commerce and Consumer Affairs recommends that the Committee:

General

1 **Note** that the Ministry of Business, Innovation and Employment (**MBIE**) is required by statute to review the operation of the Financial Advisers Act 2008 (**FA Act**) and Financial Service Providers (Registration and Dispute Resolution) Act 2008 (**FSP Act**) within five years of the commencement of the relevant sections.

2 **Note** that in February 2015 Cabinet approved the publication of the terms of reference for the review [EGI Min (15) 3/9 refers].

3 **Note** that I released an Issues Paper in May 2015 [EGI Min (15) 10/8 refers] and an Options Paper in November 2015 [EGI Min (15) 0154 refers] and received industry and consumer feedback on the key issues with the FA Act and FSP Act and options for change.

4 **Note** that I have received MBIE's report (**see Annex 2**) with its findings from the review and recommendations for amendments to the regime.

5 **Note** that I am statutorily required to table MBIE's report in the House of Representatives as soon as practicable and I intend to do this alongside the announcement of Cabinet's decisions.

6 **Note** that this paper seeks agreement to a comprehensive package of changes, consistent with MBIE's recommendations, which will create an improved financial advice regime.

7 **Note** that where legislative change is required this paper seeks agreement to enable the Parliamentary Counsel Office (**PCO**) to begin drafting the Financial Services Legislation Amendment Bill.

8 **Note** that a number of the current legislative settings, including those relating to retail and wholesale clients, exemptions and brokers' obligations remain appropriate and should be retained.

Objectives

9 **Note** that while the current regime has succeeded in lifting professional standards and consumer protection more can be done to build investor confidence and participation in financial markets.

10 **Agree** that an improved financial advice regime is driven by the following objectives:

10.1 To ensure that consumers can access the advice they need.

10.2 To improve the quality of advice.

10.3 To be enabling and not impose any undue compliance costs, complexity or barriers to innovation.

10.4 To ensure access to redress.

11 **Direct** officials to work with PCO to make any necessary amendments to the purposes of the relevant legislation to ensure they reflect the objectives in recommendation 9 above.

Roles

12 **Note** the roles and responsibilities of the Financial Markets Authority (**FMA**), the Financial Advisers Disciplinary Committee and the Code Committee are broadly appropriate and should be retained.

Types of adviser services

13 **Note** that the FA Act defines three types of financial adviser services:

13.1 Financial advice – when a person makes a recommendation or gives an opinion in relation to acquiring or disposing of a financial product.

13.2 Investment planning service – the design of a plan for an individual based on an analysis of their current and future overall financial situation, and identification of their investment goals, including a recommendation or opinion on how to realise them.

13.3 Discretionary investment management service (**DIMS**) – any service in which the provider decides which financial products to acquire or dispose of on behalf of and authorised by their client.

14 **Note** that the definitions of financial adviser services may be unintentionally capturing or excluding some services from being regulated.

15 **Agree** to amend provisions relating to financial adviser services to ensure the right financial activities are captured by the regime or excluded.

16 **Direct** officials to consider additional mechanisms to ensure the legislation captures the activities that should be regulated.

17 **Invite** the Minister of Commerce and Consumer Affairs to report back to Cabinet with recommendations for any additional mechanisms by September 2016.

Types of advice

18 **Note** that there are a number of regulatory boundaries and restrictions which are limiting the provision of some types of financial advice:

18.1 Personalised advice (which takes into account a client's particular situation or goals) has higher regulatory requirements than class advice and unclear documentation standards which is dis-incentivising the provision of some types of personalised advice.

18.2 Robo (or online) advice which has a rapidly growing market share internationally cannot be provided in a personalised way which is limiting access to advice for technologically savvy investors.

19 **Agree** to amend the legislation to enable more simple and sensible advice conversations by:

19.1 Removing the 'personalised' and 'class' distinctions.

19.2 Allowing the scope of advice services to be provided to a consumer to be less or more comprehensive in scope and for this variance to be based on a number of factors, including the areas of competence of the adviser and the needs of the consumer.

19.3 Making the legislation technology neutral to enable the provision of robo-advice and other financial technology solutions and future innovations.

20 **Note** that the current distinction between Category 1 (complex) and Category 2 (simple) financial products, with different regulatory requirements applying to both, does not necessarily reflect the true risk or complexity they can carry.

21 **Agree** that the definitions of ‘Category 1’ and ‘Category 2’ products are removed.

Types of financial adviser

22 **Note** that there are four types of financial adviser (registered financial adviser, qualifying financial entity adviser, registered financial adviser entity (including qualifying financial entity) and authorised financial adviser) which have different requirements, accountabilities and services they can provide.

23 **Note** that these differences are enabling some advisers to provide suboptimal advice, imposing undue costs on industry and are confusing to consumers.

24 **Note** that to increase the quality of financial advice and ensure a more efficient compliance model, a suite of changes are required.

25 **Agree** that the four types of financial adviser (‘registered financial adviser’, ‘qualifying financial entity adviser’, ‘registered financial adviser entity’ (including ‘qualifying financial entity’) and ‘authorised financial adviser’) and the accompanying requirements, accountabilities and services they can provide are removed.

26 **Agree** that the following new types of financial adviser are introduced:

26.1 Financial adviser.

26.2 Agent.

26.3 Financial advice firm.

27 **Agree** that financial advisers:

27.1 Must be registered on the Financial Service Providers Register (**FSPR**).

27.2 Must be engaged as a financial adviser by a licensed financial advice firm.

27.3 Are accountable for their financial adviser legislative and regulatory obligations.

27.4 Hold a restricted title as a ‘financial adviser’.

28 **Agree** that agents:

28.1 Must be engaged by a licensed financial advice firm.

28.2 Must be titled using the descriptor ‘agent’.

29 **Agree** that financial advice firms:

29.1 Must be registered on the FSPR.

29.2 Must be licensed by the FMA to provide financial advice services, consistent with the licencing regime under Part 6 of the Financial Markets Conduct Act 2013 (**FMC Act**).

29.3 May be a sole trader.

29.4 Can engage financial advisers and / or agents.

29.5 Are accountable for the financial advice firm's legislative and regulatory obligations

29.6 Are accountable for their agents.

29.7 Are required to put in place processes and provide resources to assist their financial advisers to meet their obligations.

29.8 Are required to ensure they do not incentivise their agents to sell products without regard to the consumer's interests.

30 **Note** that agents will only be able to provide advice services that have sufficient processes and controls in place such that the FMA is satisfied it is appropriate for the firm (and not the individual) to hold accountability.

Broad legislative requirements

31 **Agree** that all financial advice be subject to the following broad legislative requirements:

31.1 A conduct obligation to place the interests of the consumer first.

31.2 A competence obligation to only provide financial advice where competent to do so.

31.3 A disclosure obligation to disclose prescribed information.

31.4 A client care obligation to ensure that consumers are aware of the limitations of their advice at the point of making a recommendation.

Code of Conduct

32 **Agree** that all financial advice is held to a Code of Conduct which prescribes in more detail how to comply with the legislative conduct and competence obligations.

33 **Agree** that the Code of Conduct be developed by a Code Committee.

34 **Agree** that in developing the Code of Conduct the Code Committee be required to:

34.1 Identify sub-specialisations within the financial advice industry.

34.2 Consult with the financial advice industry on what those sub-specialisations might be.

35 **Agree** that the Code of Conduct must include:

35.1 Standards of conduct and client care that apply to all providers of advice.

35.2 Standards of competence, knowledge and skill that apply to all providers of advice.

35.3 Standards of competence, knowledge and skill specific to particular parts of the industry or products or services, consistent with identified industry sub-specialisations.

35.4 Prescribed methods which are deemed to comply with the standards of competence, knowledge and skill.

35.5 Continuing professional development requirements.

Licensing

36 **Agree** that before being granted a licence all prospective licensees must show how they, their agents and / or financial technology solutions meet the relevant legislative and regulatory requirements.

37 **Agree** that prospective licensees can develop their own methods for meeting the Code of Conduct standards of competence, knowledge and skill and must satisfy the FMA that their own methods meet those standards.

38 **Agree** that what prospective licensees will need to provide the FMA to meet the licensing requirements will be set in regulations and / or prescribed by the FMA, and will be flexible, depending on:

38.1 The size and nature of the firm and the services it provides.

38.2 Whether the firm engages financial advisers and / or agents.

39 **Agree** that all licensed financial advice firms must notify the FMA of all financial advisers (including their full name, address, FSPR identification and areas of competence) operating under their licence.

40 **Agree** that to retain a licence all licensed financial advice firms will be required to comply with licence conditions imposed by the FMA.

Disclosure

41 **Agree** that the content, format and timing of disclosure will be detailed in regulations.

42 **Agree** that disclosure regulations will require all providers of financial advice to disclose information regarding conflicts of interest and conflicted remuneration.

43 **Direct** officials to work with industry and consumer groups to develop the draft content, format and timing of disclosure.

44 **Direct** officials to explore options to require financial product providers to publish an annual register of soft-commissions paid to financial advisers and agents.

Dispute resolution

45 **Note** that there may be opportunities to further promote access to fair and effective redress through alignment of scheme rules.

46 **Direct** officials work with the dispute resolution schemes to identify what improvements may be appropriate.

47 **Invite** the Minister of Commerce and Consumer Affairs to report back to Cabinet with recommendations on those remaining aspects by the end of 2016.

Other matters

48 **Note** that officials are continuing to analyse remaining aspects of the proposed financial advice regime, including:

48.1 Membership and proceedings of the Code Committee.

48.2 Compliance and enforcement tools.

48.3 Transitional arrangements.

49 **Invite** the Minister of Commerce and Consumer Affairs to report back to Cabinet with recommendations on those remaining aspects by September 2016.

FSPR registration requirements

50 **Note** that some predominantly offshore-controlled entities allegedly involved in fraudulent activities have been registering on the FSPR to create the impression to customers that they are licensed or actively monitored in New Zealand.

51 **Agree** to amend the FSP Act so that entities will only be able register if they are, or will be:

51.1 In the business of providing financial services, not just back-office administrative services, from a place of business in New Zealand, or

51.2 In the business of providing financial services to New Zealanders, or

51.3 Otherwise required to be registered or licensed under any other New Zealand legislation.

52 **Note** that there may be other complementary measures which could help address misuse of the FSPR and misunderstanding of what it means to be 'registered'.

53 **Direct** officials to consider complementary measures which could help address misuse of the FSPR.

54 **Invite** the Minister of Commerce and Consumer Affairs to report back to Cabinet with recommendations for any complementary measures by September 2016.

Financial implications

55 **Note** that the costs to the FMA to license financial advice firms will be recovered through licence application fees and a separate policy process will follow (likely after the legislation is passed) for adjustments to the fees to reflect the recommendations in this paper.

56 **Note** that additional funding and associated adjustments to the FMA levy may be required to meet the costs of ongoing monitoring and a separate policy and consultation process will follow (likely after the legislation is passed) for adjustments to the levy.

57 **Note** that the recommendations in this paper will require consequential amendments to the FSPR and will be undertaken within existing Companies Office baselines.

Legislation

58 **Authorise** the Minister of Commerce and Consumer Affairs to issue drafting instructions to PCO to give effect to the above recommendations through the Financial Services Legislation Amendment Bill (**the Bill**).

59 **Authorise** the Minister of Commerce and Consumer Affairs to make minor and technical changes, consistent with the policy framework in this paper, on any issues that arise during the drafting process.

60 **Note** that the Financial Services Legislation Amendment Bill will be an omnibus bill which makes changes to the FA Act, FSP Act and FMC Act, and may include repeal and / or replacement of the FA Act.

61 **Direct** officials to work with PCO and the Legislative Design and Advisory Committee to determine the most appropriate approach to legislative design and to identify which provisions are more suited to subordinate legislation.

62 **Note** that officials are considering whether an exposure draft of the Bill is needed to test the workability of the draft legislation before it is introduced.

63 **Invite** the Minister of Commerce and Consumer Affairs to report back to Cabinet by September 2016 with a timeline for the legislative process, including for any possible exposure draft Bill.

Publicity

64 **Note** that the Minister of Commerce and Consumer Affairs will issue a press release on Cabinet's decisions on the matters covered by the above recommendations.

65 **Agree** that MBIE will publish a copy of this paper on its website.

66 **Agree** that officials will confidentially share a copy of this paper with the chair of the current Code Committee for Financial Advisers ahead of a press release on Cabinet's decisions.

Authorised for lodgement
Hon Paul Goldsmith
Minister of Commerce and Consumer Affairs

Annex 1 – Summary of the current problems and proposed changes to the regime

OBJECTIVES

- To ensure that consumers can **access** the advice they need.
- To improve the quality of advice.
- To be enabling and not impose any undue compliance costs, complexity, or barriers to innovation.
- To ensure access to redress.

Key: Current types of financial advisers
Authorised financial advisers (AFAs) e.g. investment advisers and financial planners – approx. 1,860
Qualifying financial entities (QFEs) e.g. banks and insurance companies – currently 56 QFEs and approx. 23,000 QFE advisers
Registered financial advisers (RFAs) e.g. mortgage and insurance brokers – approx. 6,400

CURRENT PROBLEMS AND PROPOSED CHANGES

Access to advice

Current problems

✗ The Act states personalised advice can only be provided by a natural person
→ Robo (or online) advice is prevented

✗ There is a regulatory boundary between personalised and class advice, with fewer compliance obligations on class advice
→ Dis-incentivising simple personalised advice (e.g. what KiwiSaver fund is right for me?) which is the kind of advice most New Zealanders want

Example:
The FMA found that in 1,000 KiwiSaver sales only three were recorded as involving advice that was tailored to the individual's personal circumstances

Proposed changes

✓ Enable provision of robo-advice and ensure flexibility to future proof for innovation and an evolving market
→ Increase access to advice particularly for those with simpler needs, lower sums to invest and the technologically savvy

✓ Remove the personalised / class advice distinction and clarify that scope of service should be determined by factors including the consumer's needs and adviser's competence
→ Enable sensible advice conversations which are tailored to consumers' needs

Anyone providing financial advice could provide advice tailored to their consumer's personal circumstances as long as they were competent to do so and it is what the consumer wanted

Quality of advice

Current problems

✗ Advisers are held to different conduct and competence standards which are not proportionate to the services they provide

✗ Only 1860 advisers (AFAs) are held to consumer first conduct obligations
→ Evidence shows insurance churn conduct issues are more prevalent among RFAs

✗ Inconsistent with the IMF's principles for insurance advisers (for example to be licensed and manage conflicts of interest)

Example:
FMA's review into life insurance replacement business found correlations between replacement business and incentives

Proposed changes

✓ Anyone providing financial advice would need to put the consumer's interests first
→ Better outcomes for consumers and increased confidence in advisers

✓ Anyone providing financial advice would need to be competent to do so
→ Competence requirements would vary and be proportionate to the skill / knowledge required

✓ Everyone providing advice would be licensed either directly or indirectly by the FMA

✓ Increased compliance with IMF principles

All advisers would be required to manage conflicts and prioritise the interests of consumers, minimising the risk of harm

Consumer understanding

Current problems

✗ Financial adviser designations (AFA, RFA, and QFE) are other distinctions (e.g. personalised / class and Category 1 / Category 2) are not well understood
→ This terminology and the differing standards confuse and mislead consumers

✗ Disclosure documents are unwieldy and do not contain the information consumers need to make informed decisions

Example:
The term 'registered' gives the impression that RFAs have proven competence and are actively monitored

Proposed changes

✓ Remove unclear categorisations and misleading terminology

✓ Simplify and improve disclosure requirements to include core information about the scope of service, remuneration (including commissions) and competence, and provide them in more user friendly formats

All financial advisers would simply be called 'financial advisers' while those who are not individually accountable could not hold themselves out as advisers (e.g. I am an agent of ANZ)

Cost of compliance

Current problems

✗ Some compliance activities have limited benefit to consumers and/or businesses (for example, current disclosure requirements)

✗ AFAs working for a QFE are effectively regulated twice – by the FMA and the QFE

✗ Missed opportunities for efficiencies (for example, limited ability for advisers working in the same firm to consolidate their compliance activities)

Example:
A firm with 10 AFAs (who are individually authorised) faces a direct cost of $11,450 in application fees

Proposed changes

✓ All providers of financial advice would be licensed at the firm level

✓ AFAs who work for QFEs would not be regulated twice

✗ Increased compliance for RFAs who are currently only required to be registered – the impact would be minimised with transitional arrangements

A firm with, say, 10 financial advisers and / or agents could hold one licence covering all at significantly less cost (for example, QFE applications currently cost approximately $4886)

Annex 2 MBIE Report

Please refer www.mbie.govt.nz/faareview for a copy of MBIE's Final Report on the Review of the operation of the Financial Advisers Act 2008 and the Financial Service Providers (Registration and Dispute Resolution) Act 2008.

Annex 3 – Status Quo

Legislative obligations which apply to anyone providing a financial advice service

Must not engage in misleading or deceptive conduct; and must exercise care, diligence, and skill.

Minister responsible

- Responsible for legislation and FMA.
- Appoints FADC members.
- Approves dispute resolution schemes.
- Approves final Code of Professional Conduct.

Financial Markets Authority

- Approves QFEs and authorises AFAs.
- Monitors QFEs and AFAs.
- Approves the draft Code of Professional Conduct.

Appoints members

Code Committee for Financial Advisers

Members must be knowledgeable, experienced and competent in relation to consumer affairs and the financial adviser industry.

Develops, reviews and recommends changes to

Code of Professional Conduct

- Minimum standards of ethical behaviour.
- Minimum standards of client care.
- Minimum standards of competence, knowledge and skills.
- Minimum standards of continuing professional training.
- Competence alternatives.

Financial Advisers Disciplinary Committee

Hear conduct proceedings brought by FMA against AFAs.

Required to apply similar standards to those in the Code of Professional Conduct in respect of Category 1 products

Subject to

Authorised financial advisers
(Can provide personalised advice on Category 1 and Category 2 products)
Approx. 1,860

- Must be authorised to provide financial advice services.
- Must satisfy additional entry requirements including a good character test.
- Must meet standards in the Code of Professional Conduct.
- Must comply with any conditions the FMA sets in granting authorisation.
- Required to provide two disclosure statements to consumers.

Qualifying financial entities
(Can provide personalised advice on Category 2 products and on own Category 1 products)
Currently 56
Approx. 23,000 QFE advisers

- Must be approved to provide financial advice services.
- Must comply with any conditions the FMA sets in granting QFE status.
- Must apply for renewal every 3-5 years.
- Required to disclose some information to consumers.

Registered financial advisers
(Can provide personalised advice on Category 2 products only)
Approx. 6,400

- Limited disclosure obligations.

- Must be registered as a financial service provider.

Member of

Member of

Member of

Dispute resolution schemes
Resolve disputes and award compensation

Annex 4 – Proposed Regime

Legislative obligations which apply to anyone providing a financial advice service

- Must not engage in misleading or deceptive conduct; and must exercise care, diligence, and skill.
- Must place the interests of the consumer first (conduct obligation). (***NEW***)
- Must only provide advice where competent to do so (competence obligation). (***NEW***)
- Improved disclosure requirements (disclosure obligation). (***NEW***)
- Must ensure that consumers are aware of the limitations of their advice. ***(NEW)***

Minister responsible

- Responsible for legislation and FMA.
- Appoints FADC members.
- Approves dispute resolution schemes.
- Approves final Code of Conduct.

Financial Markets Authority

- Licenses financial advice firms.
- Monitors licensed financial advice firms.
- Approves the draft Code of Conduct.

Appoints members

Code Committee

Members must be knowledgeable, experienced and competent in relation to consumer affairs and the financial adviser industry.

The membership and proceedings of the Code Committee are to be reconsidered in a subsequent Cabinet paper (Sept 2016)

Develops, reviews and recommends changes to

Code of Conduct

- Prescribes in more detail how to comply with the legislative conduct and competence obligations
- Will include standards of conduct, client care, competence, knowledge and skill and continuing professional development requirements.
- Will detail prescribed courses which are deemed to comply with the standards of competence, knowledge and skill.

Financial Advisers Disciplinary Committee

Hear conduct proceedings brought by FMA against financial advisers.

Detail regarding FADC and the range of compliance and enforcement tools are to be considered in subsequent Cabinet paper (Sept 2016)

Subject to

Financial advice firms *(NEW)*

Unknown

- Must be registered as a financial service provider.
- Must be licensed to provide financial advice services (including robo-advice).
- May be a sole trader.
- Can engage financial advisers and / or agents.
- Accountable for its obligations under the legislation and code and the agents under its licence.
- Must ensure they do not incentivise their agents to sell products without regard to the consumer's interests.
- Must put in place processes and provide resources to assist their financial advisers to meet their obligations.

Financial advisers (restricted title) ***(NEW)*** Est. 3,000-8,000	**Agents *(NEW)*** Est. 20,000-25,000
• Must be registered as a financial service provider. • Accountable for complying with the legislative and code obligations.	• Must be titled using the descriptor 'agent'
• Must be engaged by a financial advice firm	

Member of

Dispute Resolution Schemes

Resolve disputes and awards compensation.

Options for improvements to scheme rules to be reported back to Cabinet (late 2016)