MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HIKINA WHAKATUTUKI

Final report

Review of the operation of the Financial Advisers Act 2008 and the Financial Service Providers (Registration and Dispute Resolution) Act 2008

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Ministry of Business, Innovation and Employment (MBIE)

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Contents

List of Acronyms

ABS	Adviser Business Statement
AFA	Authorised Financial Adviser
AML-CFT Act	Anti-Money Laundering and Countering Financing of Terrorism Act
BOS	Banking Ombudsman Scheme
CPD	Continuing Professional Development
DIMS	Discretionary Investment Management Service
FA Act	Financial Advisers Act 2008
FADC	Financial Advisers Disciplinary Committee
FATF	Financial Action Task Force
FCA	Financial Conduct Authority
FDRS	Financial Dispute Resolution Service
FMA	Financial Markets Authority
FMC Act	Financial Markets Conduct Act 2013
FSCL	Financial Services Complaints Limited
FSP Act	Financial Service Providers (Registration and Dispute Resolution) Act 2008
FSPR	Financial Service Providers Register
GFC	Global Financial Crisis
IMF	International Monetary Fund
IPS	Investment Planning Service
IFSO	Insurance and Financial Services Ombudsman
ISO	Insurance and Savings Ombudsman
MBIE	Ministry of Business, Innovation and Employment
PCO	Parliamentary Counsel Office
QFE	Qualifying Financial Entity
RFA	Registered Financial Adviser
RFPP	Review of Financial Products and Providers 2006

Executive summary

Background

The Financial Advisers Act (FA Act) and the Financial Service Providers Act (FSP Act) 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. Financial advice is regulated due to the nature of financial products and services, and the potential for harm to consumers as a result of poor service. When making a decision about a financial product, many consumers need to rely on the information given to them by the financial firm or adviser selling it, so it is important that consumers have access to high quality financial advice.

Prior to 2008, financial advisers were largely unregulated and investor confidence in financial advice was low. The regime 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 (DRS).

Despite these positive changes, the regime has been subject to some criticism, including that it is unnecessarily complex and has not adequately raised standards for all financial advice services. Over the past 18 months, the Ministry of Business, Innovation and Employment (MBIE) has comprehensively assessed the performance of the FA and FSP Acts. MBIE has consulted widely with industry and consumers to identify any problems with the regime and opportunities for improvement.

Purpose of this report

This report provides an overview of the current regime and financial advice market, the strengths and issues that have been identified with the current regime, and based on these findings, our recommendations for change.

Key themes and feedback from the review

It has been identified through consultation that some types of financial advice are not being provided. This review presents an opportunity to enable certain types of advice, such as online advice (known as robo-advice), and to ensure consumers can access simple personalised advice (*e.g. which KiwiSaver fund is right for me?)*.

We received strong feedback that unnecessary complexity within the regime is preventing adequate consumer protection and understanding. For example, terminology and the different tiers of financial advice can be confusing for consumers.

Other key findings were that conduct and competency standards should be applied more consistently across financial adviser services. We also found opportunities within the regime for increased efficiencies and reduced costs for licensing and compliance.

Key elements of the recommended regime

The long-term outcome we want the regime to achieve is more confident and informed participation of consumers in financial markets. We have recommended a comprehensive package of changes which ensure consumers can access quality advice, yet do not impose any undue compliance costs on industry or inhibit innovation.

The key elements of our recommended regime are to:

- Remove the regulatory boundaries which are preventing the provision of some types of advice. In particular, we are ensuring that there are no regulatory barriers to the provision of robo-advice, or simple advice that takes into account the consumers' particular situation or goals.

- Establish conduct and competency requirements for all financial advisers. In particular, we want all financial advice to be held to a clear requirement to put the consumers' interests first, and be subject to a Code of Conduct that establishes appropriate client-care, competence, knowledge, and skill standards.

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

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

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

This report also provides recommendations to address the issue of offshore entities misusing the Financial Service Providers Register (FSPR) and giving consumers the misleading impression that they are licensed or monitored in New Zealand. We recommend that firms be required to have a stronger connection to New Zealand to be registered on the FSPR.

About the review

The Ministry of Business, Innovation and Employment (MBIE) has reviewed the operation of the Financial Advisers Act 2008 (FA Act) and the Financial Service Providers (Registration and Dispute Resolution) Act 2008 (FSP Act).

This report summarises MBIE's findings after considerable consultation with a range of stakeholders. Based on these findings, the report provides recommendations for change to the FA and FSP Acts (the Acts), to be considered by the Minister of Commerce and Consumer Affairs.

Terms of reference

The terms of reference for the review are available online[1]. These set out the scope, objectives and key milestones of the review. They also provide context on the Acts and developments that have occurred since their implementation.

The objectives of the review as determined by the terms of reference are to:

- analyse the role of financial advice and financial service provider registration and dispute resolution in improving financial outcomes for New Zealanders, and to assess and update the objectives of, and rationale for, regulatory intervention in this area
- assess the performance of the FA Act and FSP Act against the updated objectives of, and rationale for, regulatory intervention in this area
- meet the statutory review requirements in section 161 of the FA Act by:
    - reviewing the operation of the FA Act since its commencement
    - preparing a report on the review for the Minister of Commerce and Consumer Affairs, including recommendations on whether any amendments to the FA Act are necessary or desirable, by July 2016
- meet the statutory review requirements in section 45 of the FSP Act by:
    - reviewing the operation of Part 2 of the FSP Act since its commencement
    - preparing a report on the review for the Minister of Commerce and Consumer Affairs, including recommendations on whether any amendments to Part 2 of the FSP Act are necessary or desirable, by August 2015.

[1] See *http://www.mbie.govt.nz/info-services/business/business-law/financial-advisers/review-of-financial-advisers-act-2008/pdf-document-library/faa-review-tor.pdf*.

This is the statutory report on the operation of the FA Act and recommendations for change. The statutory report for the operation of the registration part of the FSP Act has been completed separately. However, this report includes the recommendations for change to the FSP Act.

Objectives

Our aim is to promote more confident and informed consumers and investors

The long-term outcome we want the regime to achieve is more confident and informed participation of consumers in financial markets. This is aligned with the purpose of the Financial Markets Conduct Act 2013 (FMC Act).

To achieve this, we have set three primary objectives for the review of the FA Act:

- Consumers can access the advice they need.
- Advice makes consumers better off.
- Regulation is enabling with no undue compliance costs, complexity or barriers to innovation.

We have also set two primary objectives for the review of the FSP Act:

- Consumers have access to effective redress.
- Misuse of the Financial Services Providers Register (FSPR) is addressed.

Objective: Consumers can access the advice they need

All consumers should be able to access the right kind of advice to meet their needs and wants. For advice to be accessible to consumers it must be offered through different channels, easy to understand and available in a variety of ways (e.g. from simple targeted advice to more detailed comprehensive financial plans).

Measures to improve the accessibility of advice will be complemented by the Government's current financial capability programme. Both aim to improve consumer understanding of and engagement with their finances so they are better placed to make informed decisions.

Objective: Advice makes consumers better off

When consumers receive advice, it should be good quality. We want those providing financial advice to have the right skills, competencies and ethics to provide advice that enables consumers to make financial decisions that will make them better off. As a result, consumers are more likely to have high levels of satisfaction from their dealings with financial advisers and have confidence that anyone providing financial advice is held to certain standards. This requires consumers to be able to determine the interests and incentives, and the ethical and competency requirements, of the person providing them with financial advice, so that the consumer can place the right amount of trust in them. It also requires a regime that is easy to navigate so consumers are able to judge where to go for financial advice.

Objective: Regulation is enabling with no undue compliance costs, complexity or barriers to innovation

The regulatory regime should enable advice to be provided in a cost-effective way. This requires the removal of any undue barriers to innovation so advisers and firms can provide the advice that consumers want. This also requires regulatory provisions that are proportionate to the risks they are mitigating, so that regulation does not unduly limit the provision of advice.

Objective: Consumers have access to effective redress

If something does go wrong, there needs to be strong systems for internal and external dispute resolution, and workable consumer protection mechanisms. For redress to be effective, it needs to be easy for consumers to understand when and how to seek redress and to have sufficient information to judge the quality of advice they receive. It also requires transparent and fair dispute resolution processes so that both consumers and providers have confidence that there is an independent forum for dispute resolution.

Objective: Misuse of the FSPR is addressed

In order to protect the reputation of New Zealand's financial markets and of legitimate New Zealand-based financial service providers, we want to reduce instances of firms misusing the FSPR. We want to reduce misuse while still allowing regulators and the public access to information about financial service providers.

Timeline and approach

Background: Development of the FA Act

The FA Act had a lengthy development process, throughout which significant changes were made to the regulatory model and the scope of regulation. There have been substantial changes to the financial advice market and regulatory environment since it was passed in 2008.

The initial FA Act development process started from the recommendations of the Financial Intermediaries Taskforce (the Taskforce), appointed in 2004, following repeated calls to increase the professional standards of financial advisers. The International Monetary Fund (IMF) had also assessed New Zealand as only being partially compliant with the objectives and principles of the International Organisation of Securities Commissions.

Although the Taskforce emphasised that it did not consider the financial advice sector to be in crisis, it recommended a system of co-regulation between the then New Zealand Securities Commission (now the Financial Markets Authority) and professional bodies.

While the Government accepted the Taskforce's recommendations in principle, the regulatory model changed significantly throughout the policy development and legislative stages. This included abandoning the concept of co-regulation through approved professional bodies in favour of direct regulation by the Financial Markets Authority (FMA). The FA Act was passed in 2008, but did not commence until mid-2011 after two sets of amendments were made to the legislation.

The FA Act brought about a number of positive changes to the financial advice industry. The regime has lifted professional standards by requiring financial advisers to be accountable for their advice and to meet some 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 (DRS).

Process for the current review of the FA and FSP Acts

The review of the Acts is a statutory requirement, to be completed within the five years following commencement. Figure 1 gives an overview of the key milestones throughout our review process.

After initial research, stakeholder consultation and surveying, the Minister of Commerce and Consumer Affairs released an Issues Paper in May 2015 that sought feedback on key issues with the regime and opportunities for change. A simplified consumer brochure was released alongside the Issues Paper, with a link to an anonymous, online survey.

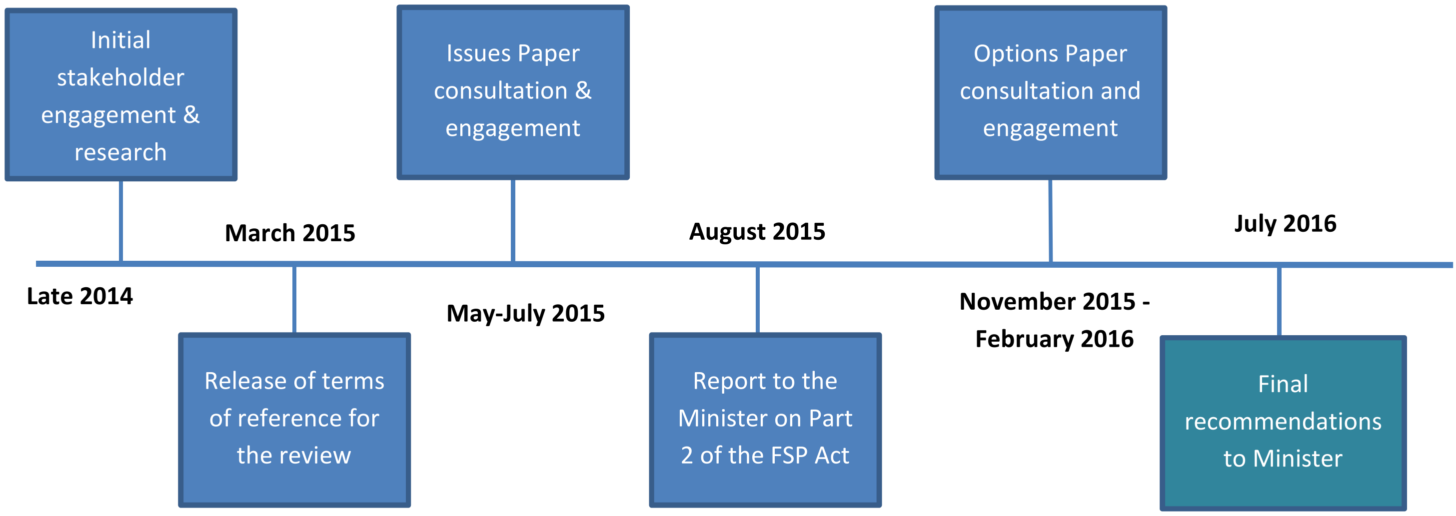
Submissions for the Issues Paper closed on 22 July 2015 and 166 submissions were received. The consumer survey received 248 responses.

In November 2015, the Minister of Commerce and Consumer Affairs released an Options Paper that sought feedback on potential options for changes to the regulatory regime. Submissions closed on 26 February 2016 and 149 submissions were received. Submissions on Part 3 of the Options Paper, regarding the misuse of the FSPR, closed earlier on 29 January. A simplified consumer brochure with an online survey was released alongside the Options Paper and received 545 responses.

Submissions received on both the Issues and Options Papers represented the views of a wide range of stakeholders, including businesses, consumer representatives, individual advisers and industry associations. MBIE officials analysed these submissions and the potential options for change to develop their policy recommendations for the new regime. Throughout this process, officials engaged closely with the FMA, held public workshop forums, and continued consultation with stakeholders to further discuss submissions and test thinking.

Testing of new ideas in the consumer facing areas of the regime, such as finding an adviser, took place through consumer focus groups. We propose to run further consumer focus groups, subject to Cabinet decisions, to test specific details of the recommended options bought forward.

Figure 1: Timeline of key milestones for the review of the FA and FSP Acts



FSP Act review requirements

The FSP Act is made up of three parts: preliminary provisions (Part 1), registration (Part 2) and dispute resolution (Part 3). It requires all financial service providers to be registered and, if they provide services to retail clients, to belong to a DRS. These requirements are aimed at promoting confident and informed participation of businesses, investors, and consumers in fair, efficient, and transparent financial markets.

The FSP Act required the dispute resolution part (Part 3) to be reviewed by September 2013 and the registration part (Part 2) to be reviewed by August 2015. Given the dispute resolution part of the FSP Act was reviewed only a short amount of time after it came into force (three years) and given the extensive inter-relationship between the FSP Act and the FA Act, it was decided that a joint review of the two Acts would be most effective.

In August 2015, MBIE reported to the Minister of Commerce and Consumer Affairs on the operation of the registration part of FSP Act[2]. The FSP report fed into the wider review of the two Acts, and final recommendations are included in Part 7 of this report.

[2] See http://www.mbie.govt.nz/info-services/business/business-law/financial-advisers/review-of-financial-advisers-act-2008/pdf-document-library/statutory_review_of_registration.pdf.

Structure of this report

This report gives an overview of the operation of the current FA Act and makes recommendations to change both the FA Act and FSP Act (as above, the August 2015 report provides an overview of the operation of the registration part of the FSP Act).

Part	Content
Part 1: Context	Outline of the value of financial advice and the rationale for regulation of financial advice.
Part 2: Current regulatory framework	Detailed overview of the FA Act and overview of the FSP Act. Outline of the current institutional settings of the regime.
Part 3: State of the market	Update on Authorised Financial Adviser, Registered Financial Adviser and Qualifying Financial Entity market.
Part 4: Strengths of the current financial advice regime	Authorised Financial Adviser regime. Code of Conduct and Code Committee. Qualifying Financial Entity model. Licensing at the firm level. Regulation of brokers and custodians. Dispute resolution regime.
Part 5: Issues with the current FA Act regime	Some types of financial advice are not being provided. The quality of financial advice may be suboptimal. Compliance costs are unbalanced. Unnecessary complexity is preventing consumer understanding.
Part 6: Issues with the FSP Act	Access to fair and effective redress could be improved. Misuse of the Financial Service Providers Register.
Part 7: Recommended changes to the FA and FSP Acts	The recommended regime.

Part 1 – Context

What is financial advice?

People make financial decisions every day throughout the course of their lives, ranging from relatively simple decisions, such as opening a bank account, through to more complex decisions such as how to save and invest for retirement.

At its broadest level, financial advice can be defined as any advice recommending a particular course of action in relation to spending, saving, borrowing, investing, choice of financial products, and similar activities. People get advice from family, friends, workmates, publications and the internet as well as from professional financial advisers.

The FA Act defines a financial adviser service as either giving an opinion or making a recommendation on whether to buy or sell a financial product, or providing an investment planning or personalised discretionary investment management service. Financial advice is much broader than just financial planning services – it includes advice on individual investments, on purchasing insurance, taking out a loan, or advice on what type of savings account to use. The FA Act has a broad impact across the economy and captures a range of service providers.

The value of financial advice

Good financial advice can help people make good saving, investment, and financial planning decisions to help them reach their financial goals. It is important for consumers to have access to high quality advice, particularly given the increased number of New Zealanders who are, or will be, making significant investment decisions following the introduction of the KiwiSaver regime in 2006.

Financial advice also has wider economic benefits and risks for New Zealand. Quality financial advice that assists people to participate in financial markets effectively can support economic growth and enhance financial stability. Conversely, poor investment decisions can increase systemic risks in the economy.

Financial advice can reduce search costs and asymmetric information

The market for financial products is very large, and many financial products and services can be complex. To make good financial decisions, people need to acquire and analyse a wide range of information, which can be time consuming, costly, and difficult. Financial advice can help people to get the information they need at a much lower cost than if they did not receive financial advice. Feedback from the consumer focus groups we held supports this rationale for seeking advice.

"You're basically buying their expertise. Some things change in the marketplace or where new products come along, or when law changes in relation to certain things, then they will tell you." – Insurance advice client, consumer group, April 2015

"It was originally time [when I chose to use an adviser], I didn't have time to track all that was happening in the stock market." – Investment advice client, consumer group, April 2015

Financial advice can help correct biases and poor judgements

Insights from behavioural economics suggest that people are subject to significant biases and cognitive errors that can lead to sub-optimal saving and investment decisions. Financial decisions require making trade-offs between the present and the future, and many financial decisions are emotional. Emotions such as stress, anxiety and fear of losses and regret can sometimes drive decisions rather than the costs and benefits. Good advice is important to help correct these biases. It can also help to reduce people's inertia, the behavioural economic bias which suggests people have a tendency to choose inaction, and stick with the status quo. This is particularly important to overcome for investment products, such as KiwiSaver.

Advice can improve decision making for consumers and investors. Without the necessary financial capability, investors may fail to consider all the factors that should affect their decisions.

Financial advice can promote confidence and participation

By providing coaching, mentoring and other similar benefits, financial advice may reassure consumers about participating in financial markets, increasing consumer confidence and participation. Consumers who obtain financial advice feel it gives them the confidence to make a wider range of investments than they would otherwise have done. Consumers who access what they perceive to be good quality financial advice feel they make informed decisions about investments and financial matters[3].

Rationale for regulation of financial advice

At a high level, the rationale for regulating financial advice is based on the nature of financial products and services, the potential for consumer harm as a result of poor service, and the evidence of harmful financial advice practices having occurred. These points are expanded on below.

Detailed rationale and supporting evidence are also included throughout this report, in regards to their specific areas of concern.

[3] As highlighted in the FA/FSP Act Review: Consumer Group report, prepared by Colmar Brunton. 2015. *http://www.mbie.govt.nz/info-services/business/business-law/financial-advisers/review-of-financial-advisers-act-2008/pdf-document-library/colmar-brunton-consumer-focus-group-report.pdf*.

The nature of financial products mean consumers may need to rely considerably on financial advice

When making a decision about financial products or financial planning, many consumers need to rely on the information given to them by the financial firm or adviser selling it. This is because the nature of financial products and financial decision making means there is information asymmetry between the consumer and the advice provider.

- Financial products are often complex and technical so consumers are not all equally equipped to assess the quality and suitability of products.
- The risks and benefits associated with financial products can be difficult to assess because of their long duration. Their value is not immediately clear at the point of purchase and it is usually difficult to detect misrepresentation at this time.
- Consumers infrequently purchase financial products and services and therefore often do not have good knowledge of them (e.g. life insurance or superannuation products). Infrequent decision making reduces the ability of consumers to learn over time and adjust their behaviour accordingly[4].
- Consumers also often have limited financial literacy skills and exhibit behavioural biases which may amplify the issues above.

The provision of 'bad' advice can be harmful to consumers

In the financial advice market there is potential for poor consumer outcomes if consumers are not able to attain the right source of financial advice to meet their needs. Given the variety of providers and consumer needs, and the difficulties in judging the quality of advice over time, consumers may find it difficult to assess the quality and suitability of advice. This information asymmetry could lead to an advice market of variable quality, where some consumers end up with 'bad' advice and corresponding financial outcomes.

The consequences of issues and problems arising from financial products and services are typically more drastic than for non-financial goods. The impact of a financial product that is not 'right' for the consumer can be very significant. For example, a consumer being switched to a replacement health or life insurance product, which fails to cover them for a pre-existing medical condition, can be devastating to a consumer's financial position. Further, poor advice practice can cause detriment to the wider economy if a large number of consumers are impacted.

A key trigger for occupational regulation is whether there is a possibility that incompetent, negligent or fraudulent service by members of the profession could result in harm to consumers or a third party[5]. In the case of financial advice, this potential was highlighted following the numerous finance

[4] Chater, Huck & Inderst. 2010. Consumer Decision-Making in Retail Investment Services: A Behavioral Economics Perspective. Final Report.

[5] CO (99) 6 – Policy Framework for Occupational Regulation https://www.dpmc.govt.nz/cabinet/circulars/co99/6.

company collapses in New Zealand over the last decade. Between May 2006 and October 2011, 45 finance companies in New Zealand failed, putting at risk around $6 billion of investors' deposits. The Commerce Committee's inquiry into finance company failures identified lack of adviser competence as one factor that contributed to the failures, which saw individuals receive poor advice about the riskiness of investment[6]. Advisers often did not recommend adequate diversification of investment to minimise these risks. Investors were also often unaware of advisers' interests in promoting certain products. The Commerce Committee stated that it was aware of instances in which finance companies exploited the lack of investor understanding[7]. At the time of the inquiry, it was estimated that between 150,000 and 200,000 deposit holders had been affected and losses sat at $3 billion.

Serious problems internationally following the Global Financial Crisis (GFC) demonstrated that this was not a New Zealand-specific problem and that regulatory interventions in other countries have not always successfully prevented such problems.

Reputation is frequently cited as a possible solution to this problem, on the basis that the experiences of other consumers can guide would-be clients of advisers to choose an appropriate adviser. However, as the recent GFC has shown, the effects of poor investment advice can take a long time to become apparent. In well-performing financial markets even poor investment decisions can be associated with strong performance in the short to medium term, with poor advice only being detectable following a significant market correction.

There is evidence that advice is motivated by factors other than consumer interests

The FMA have recently conducted a review of life insurance replacement business. The FMA's findings show a strong link between high upfront commissions and the likelihood of a life insurance policy being replaced[8]. The FMA review also found that the quality of a product was only a minor factor in whether a policy was replaced. This suggests that some advisers are not acting in the consumers' best interest.

Based on data from April 2011 to March 2015, the FMA's review found:

- There were high rates of replacement business[9]. For example, the overall number of life insurance policies grew by less than two per cent each year, while life insurers described 11 to 13 per cent of their policies each year as 'new'. This suggests that many 'new' policies were more likely to be replacement policies.

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[6] *Inquiry into finance company failures, Report of the Commerce Committee.* October 2011. *http://www.parliament.nz/resource/mi-nz/49DBSCH_SCR5335_1/0d9cfef1280ab5ba97f9569c8f965bfd7374305f*.

[7] For example, rather than disclosing the risk of an investment and increasing the return accordingly, finance companies would choose to drop their interest rates to a small margin above the term deposit rate, knowing this might be interpreted as representing a lesser risk.

[8] FMA, *Replacing life insurance – who benefits?* June 2016. *https://fma.govt.nz/assets/Reports/160322-Insurance-churn-2016.pdf*.

[9] 'Replacement business' is when a policyholder moves their policies from one provider to another following advice from their financial adviser.

- Of 1,100 high-volume advisers (those with over 100 active life insurance policies), 200 had high estimated replacement business[10]. Forty-five high-volume advisers replaced more than 20 per cent of their life insurance policies in a single year, while nine replaced more than 30 per cent of their policies.

- Policies sold through advisers were much more likely to be replaced after the end of the clawback period (the period in which an adviser must repay a portion of their upfront commission if the policy is cancelled).

- There were correlations between replacement business and incentives. For example, policies no longer subject to clawback were 2.2 times more likely to be replaced if overseas trips were offered as an incentive[11]. Even new policies subject to clawbacks were eight per cent more likely to be replaced if overseas trips were offered as incentives.

In an earlier review of industry sales and advice practices, the FMA has also found KiwiSaver providers paying direct sales incentives to staff, or having KiwiSaver sales targets as part of staff performance plans, with little evidence of supporting policies to ensure conflicts of interest were recognised and managed[12].

The regulatory environment is important to mitigate the risk of inappropriate financial advice

The nature of financial products and services are such that consumers place a considerable reliance on financial advice, and the impact of a misadvised or inappropriately sold product can be significant.

> *"This is not like when you go to a fast food restaurant and the server asks 'do you want fries with that?', or 'do you want to go large?'. We all know they ask these questions because they are encouraged to make the most of every sale, and when customers are standing at the counter, they are more likely to say yes. But then we also know what to expect – chiefly lots of salt, calories and a bigger waistline.*
>
> *But far fewer of us actually have such a clear understanding of financial services. We also mostly trust those selling or giving advice to be acting in our best interests. These are often complex and long-term products that turn into long-term problems if they go wrong.*

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[10] A high rate of replacement business was defined as when:
- at least 12 per cent of an adviser's policies lapsed, and the adviser writes at least 12 per cent of policies as new businesses within one year, or
- at least 40 of an advisers policies lapsed in a single month and an adviser writes at least 40 new policies in the same month.

[11] Insurance providers who sell through AFAs and RFAs offer overseas trips as sales incentives. Destinations during the FMA review period included Shanghai, Prague, Las Vegas, Hollywood, Rome and Rio de Janeiro.

[12] FMA, *Sales and advice: 1 July 2014 – 30 June 2015*. November 2015. https://fma.govt.nz/assets/Reports/151117-Sales-and-advice-report.pdf.

> *The cost of going large may cost us a few pence – the cost of buying the wrong mortgage could see you lose your home". – Speech by Martin Wheatley, Managing Director of the former UK Financial Services Authority, 5 September 2012*[13]

Prior to the implementation of the FA Act, there were no mandatory industry wide standards for competence, business conduct, ethics or quality of information and advice. Various Cabinet papers produced for the new regime noted that without such standards, it is difficult to stop negligent or unethical financial advisers practicing. It was also noted that it is difficult to rely on voluntary standards to ensure that those providing advice are acting ethically and managing conflicts of interest appropriately, as shown by the failures of the preceding decade.

Previously, advisers had only limited incentive to credibly vouch for the quality of advice they gave. As their business is based on giving accurate information, advisers and their firms run the risk of reputational and/or economic loss if they provide misleading information[14]. However, the public often has limited information and ability to evaluate financial advice they receive. As highlighted in the Cabinet papers preceding FA Act implementation, low entry requirements may allow advisers to operate off the reputations of other advisers, or jeopardise consumer confidence in the advice market as a whole.

When the new regulatory framework for financial advisers was developed and introduced in 2011, it was considered that decisions by the public about financial investment and savings were so important that reputational motivations were not a sufficient guarantee to mitigate the risk of inappropriate advice[15].

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[13] See *http://www.fsa.gov.uk/library/communication/speeches/2012/0905-mw.shtml*.

[14] Cabinet paper, Review of Financial Intermediaries: Financial Advisers – A New Regulatory Framework. *http://www.mbie.govt.nz/info-services/business/business-law/financial-advisers/cabinet-papers/documents-images/Review%20of%20financial%20intermediaries%20Financial%20Advisers%20-%20A%20new%20regulatory%20framework%20128%20kB%20PDF.pdf*.

[15] Cabinet paper, Review of Financial Intermediaries: Financial Advisers – A New Regulatory Framework.

Part 2 – Current regulatory framework

The Financial Advisers Act 2008

There are three financial adviser services

The three financial adviser services defined by the FA Act are:

- giving financial advice
- providing an investment planning service
- providing personalised discretionary investment management services.

Financial advice

Section 10 of the FA Act defines **financial advice** 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
- giving advice about a class of financial products or a process for acquiring or disposing of a financial product
- transmitting the advice of another person
- recommending a person consult a financial adviser.

Financial advice does not typically capture advice about purchasing physical property, such as land, as this is outside of the definition of a financial product. Property investment schemes that are captured by the FMC Act as managed investment schemes are included as financial products.

Investment planning services

An **investment planning service** (IPS) 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. Only AFAs can provide IPS to retail clients, regardless of whether it relates to Category 1 or Category 2 products. While IPS is a separate authorisation, there are no additional authorisation requirements for this service. As at April 2015, 1,490 advisers had IPS as part of their authorisation scope, but not all are believed to actually provide this service. In June 2014, the AFA return facilitated by FMA revealed that of the 1,490 AFAs who were authorised to provide an IPS, only 835 indicated they were offering this service.

Discretionary investment management services

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. As at April 2015, 902 AFAs have DIMS as part of their authorisation scope. Financial advice does not necessarily have to be provided in providing DIMS.

Since changes to the FA Act came into force on 1 December 2014, AFAs are only permitted to provide DIMS to retail clients if the investment strategy is personalised to their circumstances (personalised DIMS). Any other type of DIMS (class DIMS) requires a licence under the FMC Act, on the basis that it could be similar in practice to a managed fund (with the only significant difference being that clients hold a beneficial interest in the actual financial products rather than owning units in a fund which owned the products).

In response to feedback that a number of AFAs would need to obtain a DIMS licence in order to continue to offer their existing services, the Government adjusted the FMC DIMS licensing regime to make it more accommodating for small financial advice firms[16]. A key change was to provide an exemption from the FMC Act for AFAs exercising incidental discretion in some situations.

[16] See *http://www.med.govt.nz/business/business-law/current-business-law-work/dims-and-custody/cabinet-paper-dims.pdf*.

The requirements for providing financial advice depend on…

1: Who the consumer is

The majority of requirements in the FA Act only apply to financial adviser services provided to **retail clients**: defined as consumers who are not **wholesale clients** (*section 5C* of the FA Act). Wholesale clients are persons who, due to their assets, size or sophistication, are assumed to be able to effectively choose a financial adviser without much regulatory assistance. The wholesale client definition was recently amended to bring it closer to that in the FMC Act.

2: Whether the advice is personalised

The FA Act applies tighter restrictions on who can provide a personalised financial service i.e. personalised advice that takes into account a consumer's particular financial situation or goals. A class service is defined as advice that does not come under the definition of a personalised financial service. For the ease of the reader, this paper refers to these types of advice as 'personalised advice' and 'class advice' respectively.

The rationale behind placing higher restrictions on personalised advice is that someone receiving personalised advice has a reasonable expectation that their circumstances have been properly taken into account and that it usually takes a higher level of skill and competence to make this assessment.

3: The product being advised on

The FA Act divides financial products into Category 1 and Category 2 products. Category 1 products have been assessed as being higher risk or more complex and therefore advice on these products is subject to higher regulatory requirements. Category 1 includes investment products such as equity securities and KiwiSaver funds.

Category 2 includes products that have been assessed as being lower risk or less complex (such as most insurance products, credit contracts and many savings products) and are therefore subject to lower regulatory requirements.

Who can provide each type of financial advice?

	Authorised Financial Advisers (AFA) Individuals who are registered and authorised by the FMA	**Qualifying Financial Entity (QFE) advisers** Representatives of entities approved by the FMA as Qualifying Financial Entities	**Registered Financial Advisers (RFA)** Individuals registered to provide financial advice	**Registered financial adviser entities** Entities registered to provide financial advice
Wholesale adviser services	✓	✓	✓	✓
Class advice	✓	✓	✓	✓
Personalised advice on category 2 products	✓	✓	✓	×
Personalised advice on category 1 products	✓	✓ in respect of category 1 products issued by the QFE	×	×
Investment planning services	✓	×	×	×
Personalised Discretionary Investment Management Services[17]	✓ if they have been authorised for personalised DIMS	×	×	×

Regardless of which financial adviser service is being provided, personalised advice is currently restricted to provision by a natural person only.

[17] Note that DIMS licences can also be issued under the FMC Act.

Registered Financial Advisers (RFAs)

The FA Act and FSP Act require anyone in the business of providing a financial adviser service to be registered on the FSPR.

Becoming an RFA

Individuals who have registered on the FSPR to provide a financial adviser service, but have not been authorised by the FMA, are restricted to providing more limited financial advice. While the term is not used in the FA Act, these advisers are often referred to as Registered Financial Advisers (RFAs).

RFA conduct requirements

The FA Act sets out general conduct requirements that apply to all types of advisers, including RFAs providing a financial adviser service. These include:

- to exercise the care, diligence and skill that a reasonable financial adviser would exercise in the same circumstances
- to not engage in misleading or deceptive conduct or advertise in a way that is misleading, deceptive or confusing.

The requirement to exercise care, diligence and skill has provided the FMA, DRSs and, to an extent, professional bodies with a tool by which to encourage advisers to improve their standards.

RFA disclosure

RFAs are required to provide retail clients with a prescribed disclosure statement before providing personalised advice. This disclosure statement is required to set out:

- the adviser's name and contact details
- the types of services the adviser provides
- the adviser's dispute resolution processes and scheme membership.

RFAs are not obliged to actively disclose any qualifications or how they are remunerated, including whether they receive commissions or other incentives from financial product providers. This issue is discussed further in Part 6.

RFA firms

Firms (rather than individuals) that register to provide financial adviser services are only permitted to provide class advice. This allows a firm to take sole liability for published class advice (on a website, for example) and allows their employees to provide class advice directly to consumers. When the Issues Paper was released, around 900 firms were registered to provide financial advice, although many of these firms will also employ AFAs.

Authorised Financial Advisers (AFAs)

The FA Act permits AFAs to provide the widest range of financial adviser services and, in turn, applies a higher level of regulatory requirements to them.

Becoming an AFA

To become an AFA a person needs to be authorised by the FMA. To be eligible for authorisation in respect of financial advice and IPS, a financial adviser must:

- be registered on the FSPR or not be a disqualified person
- meet a good character test
- meet the level of competency, knowledge and skills specified in the Code of Professional Conduct for AFAs – currently the New Zealand Certificate in Financial Services (Level 5)[18]
- not have a criminal conviction for an offence punishable by imprisonment for a term of six months or more, unless the FMA is satisfied that the conviction does not reflect adversely on their fitness to act as an AFA
- comply with any terms and conditions the FMA sets in granting their authorisation.

All AFAs must have an adviser business statement (ABS) and keep it up to date. These statements are written documents that set out what type of adviser business they provide, and what compliance arrangements they have in place. They also explain the systems and procedures the adviser has in place to ensure he or she conducts business professionally.

In addition to financial advice, AFAs can be authorised to provide two other types of financial adviser services: IPS and DIMS.

AFA disclosure

AFAs are required to provide two disclosure statements to their clients before providing them with personalised advice, IPS or personalised DIMS. The first, known as the primary disclosure statement, is intended to be a relatively short description of the adviser's business which allows prospective clients to compare advisers. It is a largely prescribed document that outlines:

- the adviser's contact details
- the services they offer
- a general description of how they are paid
- their disciplinary history (if any)

[18] Following NZQA's Mandatory Review of Qualifications, the New Zealand Certificate in Financial Services (Level 5) has recently replaced the National Certificate in Financial Services (Financial Advice) (Level 5), to which it is still referred in the Code.

- their complaints procedure.

AFAs are also required to provide one or more secondary disclosure statements that describe the specific nature of the service that the adviser will provide to the client, what it will cost and how the adviser will be paid. This includes detail of any commission that the adviser will receive and any other conflicts of interest. Because this information could vary significantly between advisers there is no set format for secondary disclosures.

Code of Professional Conduct

The majority of obligations that apply to AFAs are set out in the Code of Professional Conduct for Authorised Financial Advisers (the Code). The Code sets out minimum standards of ethical behaviour, client-care, competence, knowledge and skills, and for continuing professional training[19].

The Code is set by a Code Committee, whose members are appointed by the FMA. Code Committee members are responsible for the development of the Code and for reviewing the Code to ensure that it remains fit for purpose. The Code must be subject to broad consultation and requires approval by both the FMA and the Minister of Commerce and Consumer Affairs.

The FMA monitors AFAs' compliance with the Code and with the general conduct provisions set out in the FA Act. The FMA can refer any perceived breaches of the Code to the Financial Advisers Disciplinary Committee (FADC).

Qualifying Financial Entities (QFEs)

Approval of Qualifying Financial Entities

The FA Act allows the FMA to confer QFE status on a firm if it is satisfied that the QFE will ensure that its advisers comply with their obligations under the FA Act and the terms and conditions of QFE status, and will maintain procedures to ensure that its retail clients receive adequate consumer protection. This standard requires the QFE to apply similar standards to those in the Code in respect of Category 1 products. Prospective QFEs apply for approval by providing an ABS that sets out how they will meet these requirements.

Approval as a QFE allows a firm's financial advisers to provide personalised advice in respect of any Category 2 products as well as Category 1 products issued by the QFE, without being individually registered and authorised. These financial advisers are generally referred to as 'QFE advisers'. The QFE is responsible for ensuring that its QFE advisers comply with their obligations, and is liable should a QFE adviser breach these obligations. QFEs can also employ AFAs, although AFAs working for a QFE retain individual accountability for their advice.

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[19] The current Code standards are available here: *http://www.financialadvisercode.govt.nz/assets/Code-of-Professional-Conduct-for-AFAs/Code-of-Professional-Conduct-for-AFAs-May-2014.pdf*.

QFE Conduct Obligations

The bulk of a QFE's obligations are set through the conditions that the FMA places on its approval. The standard conditions that apply to all QFEs are available on the FMA's website and include capacity, reporting and disclosure requirements. These standard conditions require the QFE to ensure that its governance and compliance arrangements and procedures meet the commitments made in the QFE's ABS.

QFE Disclosure

QFEs acting through a QFE adviser are required to disclose the following information to clients before providing them with personalised advice:

- the name and contact details of the QFE
- the QFE's dispute resolution procedures and the details of the DRS that it belongs to
- information about the QFE's business, including, in relation to Category 1 products, a general description of how the QFE and its advisers are remunerated for the advice
- information about the service being provided in relation to Category 1 products, including the fees charged for the advice, and any relevant commissions or other incentives.

Brokers and Custodians

In addition to financial adviser services, the FA Act also regulates the provision of broking services, defined in section 77B as *the receipt of client money or client property* (in relation to a financial product) *by a person and the holding, payment, or transfer of that client money or client property*.

A person can be providing broking services (and therefore be a broker) without being involved in the provision of financial advice. The broking section of the FA Act therefore has wide application across the financial sector, and is the primary way that the holding of client money and property is regulated.

As at February 2015, 1,187 persons were registered to provide a broking service. However, the FMA has advised MBIE officials that they believe most of these 1,187 will not be brokers as defined under the FA Act, but will be insurance and mortgage brokers who are incorrectly registered. The FMA estimates that there are around 15-20 brokers and 45 custodians. This is difficult to ascertain as there is confusion in the industry about what a broker is. This issue is discussed further on page 52.

Broker conduct requirements

All brokers are required to exercise care, diligence and skill and to not engage in misleading or deceptive conduct in relation to the broking service. Additional obligations apply to brokers handling assets for retail clients. Client assets are required to be held in a separate trust account, with clear records, and must not be used in any other way than is expressly directed by the client.

The FA Act also allows for upfront disclosure requirements for brokers to be prescribed in regulations, although no such regulations have been made.

Client money held by an insurance intermediary is excluded from a number of these requirements as this is regulated under the Insurance Intermediaries Act 1994. This legislation allows insurance intermediaries to benefit from investing client funds for a period before transferring the funds to the insurer.

Custodian obligations

A custodial service is a subset of broking service, where the client money or property is held by a person on behalf of its beneficial owner. Custodians typically hold client assets as part of a DIMS or as part of an investment platform service, and will often provide other services such as executing transactions and undertaking corporate actions.

The Financial Advisers (Custodians of FMCA Financial Products) Regulations 2014 apply additional requirements to custodians. This includes requiring custodians to regularly report on holdings directly to clients and to obtain an assurance engagement from an auditor examining the performance of their systems.

FA Act exemptions

The FA Act exempts some persons from its requirements. For example, lawyers and accountants are exempt from the application of the Act to the extent that they provide a financial adviser service or broking service in the ordinary course of their business. Non-profit organisations are also exempt in respect of free financial adviser services.

The basis for these exemptions was that these professions are already subject to regulatory oversight, and that the minimal additional benefits of requiring them to comply with the FA Act (in relation to financial advice that they might provide as part of their normal activities) were not justified.

The Financial Service Providers (Registration and Dispute Resolution) Act 2008

In 2005, the Taskforce identified widespread concern with shortcomings in complaints and dispute resolution mechanisms in the financial advice industry. The Taskforce considered that universal access to timely, efficient and cost-effective dispute resolution would engender greater consumer confidence in the industry, and recommended that all financial intermediaries be subject to the jurisdiction of a single dispute resolution body.

The 2006 Review of Financial Products and Providers (RFPP) recommended that all financial service providers join either a dispute resolution scheme (DRS) approved by the Minister of Commerce or the government-established reserve scheme. Given that it was anticipated that sector-specific DRSs would be created, a reserve scheme was needed for sectors that might not be covered.

The RFPP also recommended the introduction of a comprehensive register of financial service providers. This register would satisfy New Zealand's international obligations under the Financial Action Task Force (FATF) Recommendations. The FATF Recommendations include requiring the licensing or registration of all financial institutions to ensure effective monitoring is in place to confirm financial institutions are meeting their anti-money laundering obligations.

The resulting FSP Act introduced compulsory membership of an approved DRS for providers of financial services to retail clients and established the FSPR.

The Financial Service Providers Register (FSPR)

From 1 December 2010 anyone providing a financial service (such as insurers, banks, lenders and financial advisers) has been required to be registered on the FSPR, operated by the Companies Office. The qualification requirements for registration are similar to those for a director of a New Zealand company, including not being an undischarged bankrupt or convicted of a crime involving dishonesty in the previous five years.

The FSPR records the name, address and (if applicable) the DRS of the provider, along with the services it is registered to provide and any relevant licences it has under other legislation. There are currently around 13,000 financial service providers registered on the FSPR.

Financial service provider dispute resolution

Financial service providers were required to join an approved DRS from 1 December 2010 and financial advisers were required to do so from 1 April 2011. The Government approved three DRSs: the Banking Ombudsman Scheme (BOS), the Insurance and Savings Ombudsman (ISO)[20] and Financial Services Complaints Limited (FSCL). BOS accepted banks as members while ISO and FSCL both accepted all types of financial service providers. In addition, FairWay Limited operated the government-owned reserve scheme.

In 2014, amendments to the FSP Act were made through the Financial Service Providers (Registration and Dispute Resolution) Amendment Act 2014. These amendments removed the requirement for a government-run reserve DRS (which was no longer required following the approval of the schemes listed above). The amendments also provided that the Registrar of Financial Service Providers can refer an application for registration on the FSPR to the FMA where the application:

- could create a misleading appearance as to how the provider provides financial services in New Zealand or will be regulated by New Zealand law, or
- damages the integrity or reputation of New Zealand financial markets.

With the disestablishment of the reserve scheme, the Government approved FairWay Limited to run an approved DRS, called Financial Dispute Resolution Service (FDRS), which accepts all types of members.

[20] Note that ISO have since changed their name to the Insurance and Financial Services Ombudsman (IFSO).

Institutional settings

The following institutional settings support the FA and FSP Acts.

The Financial Markets Authority (FMA)

The FMA is responsible for the monitoring and enforcement of the FA Act. In addition to authorising AFAs and approving QFEs, it monitors all financial advisers' ongoing compliance with the FA Act's provisions and has both formal and informal tools through which to respond to non-compliance. The FMA has extensive enforcement powers under the FA Act, the FMC Act and the Financial Markets Authority Act 2011. The FMA's powers include the ability to require information, to direct a financial adviser to take steps to comply with the Act and ultimately, to withdraw the authorisation/approval of AFAs and QFEs.

The FMA's enforcement policy states that it focusses its enforcement resources on conduct that harms or presents the greatest likelihood of harm to the function of open, transparent and efficient capital markets. The FMA therefore targets its activities on a risk assessed basis, informed by its surveillance and intelligence activities.

The FMA also periodically releases guidance documents, outlining providers' regulatory responsibilities and how to comply with relevant legislation, and information and fact sheets on issues relevant to the industry.

Code Committee

The Code Committee (the Committee) was appointed in 2009 to prepare and periodically review the Code. Members of the Code Committee are appointed by the FMA. Under the FA Act, the Committee may be comprised of between seven to eleven members from industry and the consumer affairs sector as follows:

- one member with knowledge, experience and competence in consumer affairs, appointed for three years
- other persons who, in FMA's opinion, are qualified for appointment by virtue of their individual knowledge of, and experience and competency in relation to, the financial adviser industry.

Professional associations and industry bodies

There are a range of professional associations and industry bodies in New Zealand that specifically focus on representing, advocating for, and providing services to financial advisers. The largest of these are the Professional Advisers Association, the Institute of Financial Advisers and the Insurance Brokers Association of New Zealand, though a number of smaller associations exist which cater to different subsets of the adviser industry.

The associations do not hold a formal regulatory role under the current regime, though many provide assistance to their members and some set their own standards that members must meet (over and above those set in law). Membership of a professional body is voluntary.

Financial Advisers Disciplinary Committee (FADC)

The FADC is an independent body established under the FA Act. The FA Act sets out the functions of the FADC and authorises it to determine its own procedures in order to meet its responsibilities and obligations. The functions of the FADC are:

- to conduct disciplinary proceedings arising out of complaints about AFAs in relation to breaches of the Code of Professional Conduct which are referred by the FMA
- to consider and impose appropriate penalties that may range from recommending that the FMA cancel an AFA's authorisation, to imposing a fine of up to $10,000 as a result of disciplinary proceedings.

The jurisdiction of the FADC is significantly narrower than that originally proposed by the Taskforce, in that it cannot consider complaints against RFAs or QFE advisers. As of March 2015, the FADC had only considered cases against seven AFAs.

Dispute Resolution Schemes (DRSs)

Under the FSP Act, all financial service providers who provide services to retail clients are required to be a member of one of the four approved DRSs (refer to page 27). Originally, each of the schemes had different specialities, meaning that they were better equipped to deal with their particular members' issues. However, this is changing with the majority of schemes opening up their membership to a wider range of financial service providers.

The DRSs provide an avenue for consumers who have a dispute with their financial service provider to seek redress in a quick, efficient and cost-effective manner. Without dispute resolution, consumers' primary recourse for redress would be through the courts. The particular procedures and jurisdiction of each scheme are set out in their individual DRSs rules, which are approved by the Minister of Commerce and Consumer Affairs.

The Minister can also recommend that regulations be made that prescribe provisions to be implied into the DRS rules.

Part 3 – Snapshot of the market

As at February 2015, 8,000 individuals and 906 firms were registered to provide financial adviser services. In comparison, by the end of May 2011 (just prior to the implementation of the FA Act) there were over 5,000 registered financial service providers, with over 3,700 registered as individual financial advisers.

Authorised Financial Adviser (AFA) market

Throughout this review, MBIE has drawn on data from the FMA's AFA information returns for 1 July 2013 – 30 June 2014 (2014 AFA return) to gain an overview of the market[21].

As at June 2014, there were about 1,900 AFAs. The 2014 AFA return revealed that about 200 AFAs had chosen to retain their authorisation, but did not provide financial adviser services to clients. Reasons for this were varied, and included those taking leave from the industry, and those who had moved into compliance roles.

The number of newly authorised financial advisers dropped significantly after the initial registration period following the implementation of the Acts, with 108 gaining authorisation by the year ending June 2014. From 1 July 2014 to 31 March 2015, 52 new AFA registrations were processed by the FMA.

The number of AFAs has remained stable since, with 1, 845 as at 1 July 2014 and 1, 863 as at 16 February 2016.

AFAs operate in a range of different employment structures

The 2014 AFA return showed that AFAs operate in a range of different employment structures. For example:

- 27 per cent were employees of a QFE
- 23 per cent were employed by a firm that is not a QFE
- 22 per cent were a shareholder/director of an advisory firm (with more than one employee)
- 15 per cent were a sole adviser practice.

[21] See FMA, *Authorised Financial Advisers in NZ, A snapshot of the industry from AFA information returns 1 July 2013 – 30 June 2014*, April 2015. *https://fma.govt.nz/assets/Reports/150423-Authorised-Financial-Advisers-in-NZ.pdf*.

The level of AFA experience and the services they provide varies

The 2014 AFA return showed 15 per cent of AFAs had three years or less experience in providing financial adviser services on investment products in New Zealand. Fifty-four per cent had between three and twenty years of experience, and 31 per cent had more than twenty years of experience.

AFAs had provided the following financial services in the 2014 AFA return period:

- 41 per cent provided financial adviser services in relation to insurance
- 67 per cent provided advice in relation to KiwiSaver
- around 18 per cent provided advice in relation to private investment offers
- 14 per cent provided advice in relation to mortgages.

The 2014 AFA return showed that the average number of clients of an individual AFA was around 250. This figure was based on AFAs that reported managing their own set client base.

Ninety per cent of AFAs recorded no complaints in the 2014 AFA return period.

AFA remuneration methods also vary across industry

The 2014 AFA return showed that remuneration methods for AFAs vary. For example:

- 45 per cent of AFAs reported that their clients pay commissions for their services
- 36 per cent reported that their clients pay a fixed fee or an hourly rate
- 20 per cent reported receiving bonuses based on volume and set targets
- 40 per cent reported that they receive bonuses based on a mixture of measures, including compliance and quality.

Qualifying Financial Entity (QFE) market

There are currently 56 business groups with QFE status. The QFE market consists of:

- 31 per cent insurers
- 18 per cent banks
- 18 per cent non-bank deposit takers (e.g. credit unions)
- 15 per cent lenders
- 13 per cent fund managers
- 5 per cent other.

The 2014 AFA return showed that about 27 per cent of AFAs work within a QFE business group. Non-AFAs working within a QFE (as QFE advisers) are estimated at 23,000.

Registered Financial Adviser (RFA) market

As at 30 June 2015 there were estimated 6,420 RFAs. These individuals are registered to provide a financial adviser service, but are not authorised by the FMA.

Registration on its own only permits an adviser to provide limited types of advice, including personalised advice on Category 2 (lower risk or less complex) products, as well as class advice on any financial product. As a result, RFAs currently work in the following areas:

- **Life insurance advisers** work with their clients to assess risk, help their clients understand policy exclusions and ensure they possess the correct information about their policy. Such policies cover debts, funeral expenses, full mortgage repayment, and any living costs incurred by a client's family after death. Life insurance can also include income replacement insurance.

- **Fire and general insurance advisers** provide personalised advice on fire and general insurance. This includes a wide range of products such as home, contents, vehicle, commercial and rural cover. A large proportion of this market appears to be aimed at providing advice to small to medium sized firms.

- **Mortgage brokers** are intermediaries who facilitate mortgage loans on behalf of their clients. An individual or firm is able to utilise a mortgage broker to be matched with a bank or lender to secure their loan.

MBIE's March 2015 survey of financial advisers found that over half of the RFAs in the survey had been working as a financial adviser for over 20 years, with a further 25 per cent working in the role for 11-20 years. A majority of 62 per cent provided financial adviser services to over 100 clients a year.

There are a number of reasons why many RFAs do not seek AFA status. The most common reasons cited by respondents to MBIE's survey of financial advisers were that authorisation is not required to offer advice on the products that they deal with and a view that the qualifications required are not relevant to their current role. In addition, some noted their clients do not see sufficient value in AFA status.

Submissions on the Issues Paper highlighted the compliance obligations and costs associated with becoming an AFA as a barrier to seeking authorisation.

> *"The difference in compliance costs (direct and indirect) for AFAs and RFAs means that a number of advisers have preferred to define their advice model in such a way to remain an RFA. As long as there is a price/cost differential there will be an artificial limit placed on the Category 1 advice." – Kepa Financial Services Limited, submission on Issues Paper, July 2015*

"There is no doubt that there have been significant costs involved in being an AFA. One of the reasons many advisers decided to remain RFA and not become an AFA was the lower compliance costs that they would incur (along with other no-disclosure requirements).There have been numerous costs incurred but the main costs incurred have been: 1.) Annual FSP registration fee 2.) Two yearly AML audit fee 3.) Personal time in ensuring all compliance requirements are met." – John Wood, submissions on Issues Paper, July 2015

Part 4 – Strengths of the current financial advice regime

As previously mentioned, the FA Act has brought about a number of improvements to the financial advice industry. Some specific features of the current regime that are working well are discussed below.

AFA standards are generally seen as appropriate

AFAs are required to meet minimum standards of ethical behaviour and client-care, which are set out in the Code. This includes requirements to *place the interests of the client first* and to manage any conflicts of interest. AFAs must also disclose any commissions and conflicts of interest.

AFAs are required to meet minimum standards of competency and undertake continuing professional development (CPD). This includes a general obligation to have the competence, knowledge and skill to provide a financial adviser service, and a requirement to attain the New Zealand Certificate in Financial Services (Level 5) (which has applicable modules for different services). AFAs are also required to undertake CPD to maintain competence and keep up to date with relevant developments.

We found that the conduct and competency obligations that AFAs are held to are generally working well. Almost all submitters on the Issues Paper considered that the ethical standards for AFAs set out in the Code are appropriate. Many submitters also commented that anyone providing financial advice should be subject to the Code, not just AFAs.

The 'consumer first' standard is generally seen as the right ethical obligation for all providing financial advice

Most Options Paper submitters, who commented on what the 'right' ethical obligation for those providing advice is, supported the current AFA obligation to *place the interests of the client first*.

> *"We support an obligation to put the consumers' interests first. We consider this is an appropriate and suitable obligation for any person providing advice. To this end we would support extension of the Code of Conduct applicable to AFAs being extended across any person 'authorised/licensed' to provide advice (including extending ethical obligations to any robo-advice provider)." – AMP, submission on Options Paper, February 2016*

> *"We support an extension of the requirement to put the consumers' interests first to all advisers. This appropriately recognises and supports that the ultimate goal*

of the regime is to increase customers' confidence to act on the advice they receive. The obligation should be consistent with Code Standard 1 under the Authorised Financial Advisers Code of Professional Conduct. This would require all advisers to place the interests of the client first, and act with integrity in accordance with the overarching purpose of the Act. What is required in order to place a client's interests first should be determined according to what is reasonable in the circumstances of that advice, as is the case currently for AFAs." – ASB, submission on Options Paper, February 2016

Competency standards and the requirements for CPD are working well

Options Paper submitters tended to support competency requirements for everyone providing financial advice. The majority of submitters were also in support of mandatory CPD requirements, with many commenting that the current AFA requirements for CPD work well and could be applied to all.

"We agree that all advisers should be required to do a minimum number of CPD hours each year. This ensures they keep up to date with regulatory and industry changes, and the latest best practice standards in advice and portfolio management. We believe the current CPD requirements outlined in the Code of Conduct for AFAs works well and should be applied to all advisers." – Craigs Investment Partners, submission on Options Paper, February 2016

The AFA competency standards help to ensure that consumers receive competent advice and, in turn, reduce the likelihood of harm. The standards have also helped to increase public confidence in advisers, which supports increased demand for advice.

"All advisers, in my opinion, should have to complete the full range of entry requirements imposed on those wishing to be designated an AFA." – Mike Cole, submission on Options Paper, February 2016

The Code of Conduct and Code Committee process are working well

The Code standards are set and reviewed by the Code Committee. The Code provides specificity as to the behaviours, processes and practices that are expected when providing financial advice, and therefore provides certainty for advisers about how to comply with their legislative obligations.

"The current structure (regulator, Code Committee, Disciplinary Committee, dispute resolution providers) seems to be working well and should be given time to develop." – Perpetual Guardian, submission on Options Paper, February 2016

We received feedback that the Code and Code Committee process are working well. Respondents on the Issues Paper were positive about the process for developing and approving the Code, highlighting that industry and consumer representation provides appropriate viewpoints and balance in the development of industry standards. Setting the rules in the Code produced by a Code Committee helps to enhance industry buy-in, and this is an element working well at the moment.

> *"We support the process for the development and approval of the Code of Professional Conduct, believing that the involvement of industry and consumer representation helps ensure an appropriate balanced development of industry standards. But we strongly make the point that this Code should apply to all advisers." – Institute of Financial Advisers, submission on Issues Paper, July 2015*

The Code also allows for flexibility in the regime, as Code Standards are regularly reviewed and can be amended if circumstances change, making the Code no longer fit for purpose.

> *"The Code of Professional Conduct is the best feature of the Act. However, it only applies to a minority of those calling themselves 'financial advisers'. This is most unhelpful to the consumer - and to those advisers (AFAs) who do have to follow the Code." – Tony Walker, submission on Issues Paper, July 2015*

The QFE regime supports flexibility in compliance and operating models

Feedback received through submissions and consultation with industry indicates that the current licensing 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 firms to account, whilst also providing them with flexibility. This model allows the QFE to establish their own training programmes and governance frameworks, to ensure that advisers are competent and performance managed. Rather than favouring a certain business model, this approach caters to the range of business models that can be seen across QFEs.

The Issues and Options Papers highlighted some of the rationale for why the QFE model has potential to provide better outcomes for consumers:

- Because QFEs take responsibility for their advisers, and are typically well resourced organisations, staff have better access to ongoing training and development.
- The FMA sets minimum standards for QFEs and the ongoing monitoring of QFEs ensures their accountability.
- Since the QFE ultimately has responsibility to consumers, these organisations (which have strong brands) have a strong incentive to protect their reputation.

While the majority of Issues Paper submitters thought that the QFE model allows larger organisations employing many advisers to lower compliance costs, a number of submitters raised concerns about the lack of individual accountability under this model. Moreover, concerns have been raised about the conduct obligations applying to QFEs. This is discussed further on pages 48-49.

Licensing at the firm level enables efficiencies

Licensing at the firm level is an aspect of the QFE model that is seen to be working particularly well. By enabling a firm to apply for a single licence that covers all employees, the licensing costs are reduced and economies of scale can be enabled.

The option of extending licensing at the firm level to other financial advice firms was tested through the Options Paper. Submitters were split on whether the firm or the individual should be licensed, with slightly more expressing a preference for licensing at the firm level.

> *"We support entity licensing rather than individual licensing. Entity licensing appears to achieve the outcomes sought for less cost. Some of our members have invested large sums of money establishing QFEs and the regime appears to be working well for those QFEs." – Insurance Council of New Zealand, submission on Options Paper, February 2016*

> *"I believe that individual advisers (rather than their businesses) should be subject to annual licensing because it is they who provide the advice, not their limited company, and I say this as a sole trader. To become licensed and included on the public register an adviser would need to disclose relevant qualifications or accreditations, length of experience, any disciplinary black marks etc. so that consumers can make a fully informed decision when choosing an adviser. Tied or aligned salesmen would be shown as such along with the provider responsible for their conduct." – John Heritage, submission on Options Paper, February 2016*

The regulation of brokers and custodians is effective

The Issues Paper consulted on the effectiveness of the requirements for brokers and custodians. The majority of submitters saw these as being adequate and effective at protecting client interests.

Broker requirements were seen as necessary to ensure the client's assets are safeguarded and to promote consumer confidence. There was strong support for the use of trust accounts which minimise the possibility of fraud or other criminal activity. Almost all submitters thought the current requirements for custodian services are good protection against misappropriation and mismanagement of client assets.

> *"As with custodians these requirements ensure broker conduct maximises the best interests of their clients and safeguarding of client assets at all times. The promotion of a degree of separation when acting with client assets ensures client assets should always be handled correctly and the broker is answerable to this. The requirements set a formalised standard for competency and accountability for the benefit of the overall industry." – Financial Services Council, submission on Issues Paper, July 2015*

> *"We consider that the current requirements are proportionate in reducing the risk of client losses from a range of possible causes and we do not recommend any*

further changes." – Institute of Financial Advisers, submission on Issues Paper, July 2015

It was noted that it is probably too early to assess the effectiveness of the reporting requirements placed on custodians under the Financial Advisers (Custodians of FMCA Financial Products) Regulations 2014.

A minor issue that was raised by submitters is that the use of the term 'broker' in regulation differs from its common usage, leading to confusion among consumers and the industry. The misalignment of these definitions is discussed further on page 52 of the report.

The dispute resolution regime is functioning well overall

The dispute resolution regime appears to be functioning well. MBIE received largely positive feedback about the dispute resolution schemes (DRSs) and their role in improving consumer access to redress. Notwithstanding this, there are opportunities to further promote access to fair and effective redress, by dealing with concerns about some inconsistent rules and low levels of public awareness. This is covered in the dispute resolution issues section later in the report (page 57).

Throughout both the Issues and Options Paper consultations, MBIE sought feedback on the existence of multiple schemes.

> *"We have seen no evidence that the current model is not working as intended or delivering poor consumer outcomes, despite some minor inconsistencies across the various schemes. With no strong driver for change in this area, resources should be focussed elsewhere." – ASB, submissions on Options Paper, February 2016*

MBIE also consulted on whether the current $200,000 cap for disputes is a barrier to the resolution of some disputes. MBIE found insufficient evidence that the current cap is a barrier to effective dispute resolution. Moreover, an increase could result in DRSs being required to assess technical evidence beyond current expertise and resourcing levels (i.e. there is a reason why these matters are passed to the Courts).

Part 5 – Issues with the current FA Act regime

Some types of financial advice are not being provided

One of the measures we have identified as an indicator of a well-functioning financial advice market is that people are able to access the level of advice appropriate to them on reasonable terms. However, we have found that current regulatory provisions are limiting the types of advice provided, and advice gaps are developing in exactly the areas we expect more New Zealanders to want advice in.

The regime does not support technological innovation

Under the current regime, personalised financial advice can only be provided by a natural person, preventing the provision of automated advice through online channels. The requirement was intended to ensure that an individual is responsible for advice that meets the required standards. However, since the FA and FSP Acts came into force, there have been considerable advances in technology relevant to financial advice. Globally, technological developments in this area now see financial advice being produced by an algorithm that determines the client's needs through their inputting of data. This has been referred to as 'robo-advice' throughout the review.

Under the current FA Act, New Zealand financial service providers have been unable to fully develop online advice channels. This is reducing access to advice (especially for those consumers with lower sums to invest) and reducing firms' cross-border competitiveness.

Internationally, robo-advice has a rapidly growing market share and is increasing the accessibility of advice for young, internet-savvy investors. New technologies can help those providing advice to offer new services and reach new consumer segments, as well as making existing relationships more efficient to manage. Despite its intention, the prohibition in New Zealand is now an undue barrier to advice, and overseas experience demonstrates that controls can be put into place for robo-advice to ensure consumer protection.

The majority of submitters on the Options Paper supported enabling robo-advice. The key submission themes in this area were the inevitability of robo-advice/sales and the importance of consumer protection.

Submissions also emphasised the importance of:

- warnings, such as that there is no personal adviser sitting behind the advice

- disclosing the limitations of the advice, such as whether the advice is considering one product or a range of products.

The majority of submitters noted that the obligations for traditional and online advice should not differ.

> *"The provision of advice through online platforms is a developing area, and one that may provide advice to consumers that are unable to access advice through traditional means. We agree that there needs to be accountability for any advice provided through an online platform and support the options that require any entity providing online advice to be licensed and subject the same, or similar, obligations to other advisers." – nib nz limited, submission on Options Paper, February 2016*

Limited personalised advice is not being provided due to regulatory boundaries

The distinction between class and personalised advice in the FA Act is based on whether or not the advice takes into account a client's situation or goals. The original rationale for distinguishing between class and personalised advice was to allow firms to produce generic publications. However, in practice the distinction is relied upon for a much wider range of services than the intended 'generic publications and online planning services'. The lower level of regulation that applies when giving class advice has also created a perverse incentive for providers to limit their services to class advice.

Based on state of the market analysis and consultation feedback, it appears that the class/personalised distinction is constraining advice, and those providing advice tend to do so at either end of the spectrum. By setting higher requirements for personalised advice, the current regime has created the following perverse outcomes:

- It has provided an avenue for advisers to avoid compliance costs by limiting their services to class only, thereby contributing to the advice gap for personalised advice.
- It has led to risk aversion by those providing personalised advice (who believe they must take into account all elements of a client's financial situation and goals), thereby increasing the costs of personalised advice and contributing to the advice gap for limited advice or advice on a discrete issue.

> *"At present, many advisers are reluctant to offer advice of any type – choosing to remain in the information-only space – because of the challenges of identifying and complying with advice boundaries." – Mercer, submission on Options Paper, February 2016*

This means that those with more simple needs or smaller assets often cannot have the advice conversations they require.

> *"We believe removing the distinction between class and personalised advice would remove a significant barrier to accessibility. At present, the class/personalised advice boundary is blurred, as are the documentation standards for personalised*

advice. As a result we understand many advisers are operating only at the extreme ends of the advice spectrum; providing only generic class advice or comprehensive personalised advice, as this is where the regulation guidance is clearest. The result is that many consumers who want or need only a limited form of personalised advice cannot access this advice." – Craigs Investment Partners, submission on Options Paper and Securities Industry Association, submission on Options Paper, February 2016

"Financial advisers should be able to respond to the needs of their customers without being forced down artificial channels such as class or personalised advice."—Fidelity Life, submission on Options Paper, February 2016

Simple personalised advice (*e.g. which KiwiSaver fund is right for me?*) is the kind of advice that most New Zealanders want, and this is being disincentivised. In its report *Sales and advice*, the FMA found that there appears to be a reluctance to provide advice on KiwiSaver, seeing it is sold by many advisers – including AFAs and QFE advisers – on an information-only basis. FMA data for the period July 2014 to June 2015 found that for every 1,000 KiwiSaver sales or transfers, only three were recorded as having been sold with personalised advice[22].

"At present many consumers do not receive advice regarding provider and fund choices for KiwiSaver because RFAs are only allowed to provide class advice and AFAs usually wish to charge a fee that many consumers are unable or unwilling to pay. This either leaves them in a default fund or not in KiwiSaver at all." – John Heritage, submission on Options Paper, February 2016

We have also heard concerns that the requirements on AFAs when giving personalised advice mean that they are unwilling to do so unless it is part of a full financial plan. AFAs are required under Code Standard 8 to take reasonable steps to ensure that the personalised advice is suitable for the client. This includes making reasonable enquiries to ensure that they understand the client's situation, needs, goals and risk profile.

"The distinction between class and personalised advice is, in our view, the most problematic issue in the FA Act. There are many instances where a limited form of personalised advice is the most appropriate but advisers are reluctant to provide it given the uncertainty around their Code Standard 8 obligations." – Craigs Investment Partners, submission on Issues Paper, July 2015

The quality of financial advice may be suboptimal

The current regime has disproportionate conduct and competency requirements. Consumers may be receiving advice from people without adequate knowledge, skills and competence levels, and certain conflicts of interest may be leading to suboptimal outcomes for consumers. The different

[22] See FMA, *Sales and advice 1 July 2014 – 30 June 2015*. November 2015. https://fma.govt.nz/assets/Reports/151117-Sales-and-advice-report.pdf.

registration, licensing and reporting requirements across the types of adviser also create inconsistencies in regulation and oversight.

The Category 1 versus Category 2 product distinction is not reflective of risk or complexity

The current distinction between Category 1 (complex) and Category 2 (simple) products is not reflective of risk or complexity. Many submitters to the Options Paper noted that advice on life insurance or mortgages (currently Category 2 products), for example, can be complex and can have a significant impact on consumers' financial wellbeing. It was also raised that the complexity of a product is often contingent on the value of assets involved relative to the consumer's income or total assets, or depending on the consumer's financial capability.

Disproportionate competency requirements create a varied quality of advice

There is currently an imbalance between higher competency requirements for AFAs and low or non-existent competency requirements on other advisers (in particular RFAs). We have heard that these competency requirements are not always proportionate to the risk or complexity of the financial advice services being provided. There were concerns that RFAs do not have to meet a competency standard, despite advising on financial products which can have a significant impact on consumers' financial wellbeing (e.g. life insurance).

AFAs must meet the minimum standards of competence, knowledge and skills as specified in the Code of Professional Conduct for AFAs. This includes attaining the *Unit Standard Sets* within the New Zealand Certificate in Financial Services (Level 5) that are relevant to the financial adviser services provided by the particular AFA[23].

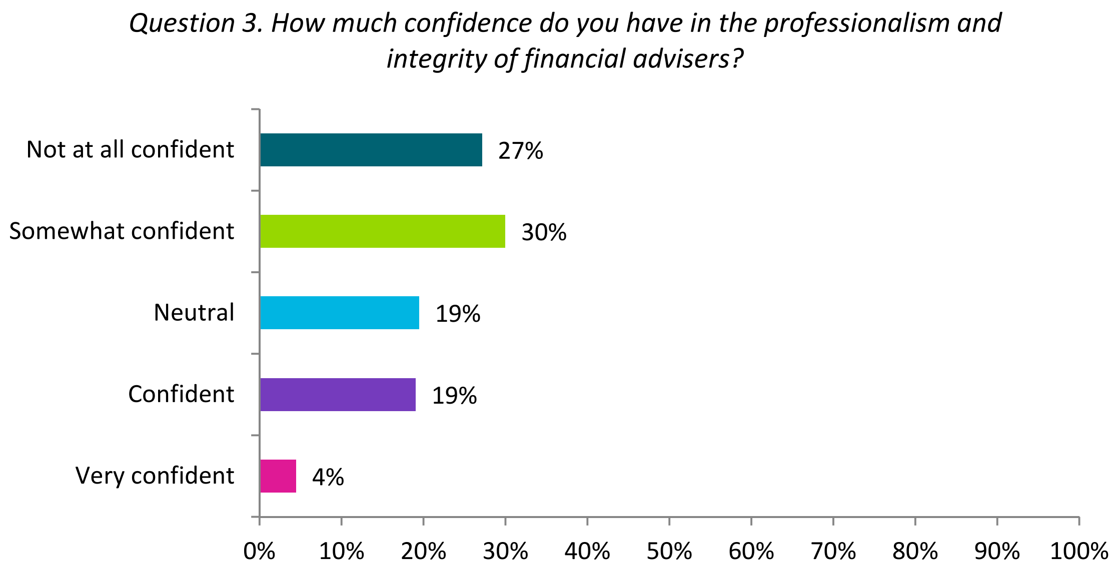
QFEs can set their own standards of competence for their QFE advisers. Guidance from the FMA is that QFEs should have governance and compliance arrangements in place to ensure individual advisers are supported to achieve and maintain the right level of knowledge, skill and competence.

RFAs are not subject to any competency requirements (beyond the broad obligation in the FA Act to exercise due care, skill and diligence). Without appropriate competency requirements there is a risk that some advisers may not have the capabilities required to provide a particular advice service, and this could cause significant, potentially irreversible harm to consumers.

A lack of competency standards may also be inhibiting public confidence in the professionalism and integrity of financial advice. The Issues Paper consumer survey asked about the confidence that people have in the professionalism and integrity of financial advisers, and 53 per cent said they have at least some confidence in the professionalism and integrity of advisers (see Figure 2). However, almost 50 per cent of respondents said their confidence in the professionalism and integrity of advisers has not changed since the FA Act came into effect in 2011.

[23] Following NZQA's Mandatory Review of Qualifications, the New Zealand Certificate in Financial Services (Level 5) has recently replaced the National Certificate in Financial Services (Financial Advice) (Level 5), to which it is still referred in the Code.

Figure 2: Results from Issues Paper consumer survey about consumer confidence in financial advisers



Issues Paper feedback supported lifting educational standards for financial advisers. Many submitters commented on the need for higher levels of education, especially for RFAs. The majority of submitters who commented on this were in favour of anyone providing financial advice being required to meet a minimum qualification standard and/or undertake CPD. Submitters on the Options Paper also tended to agree that competency requirements should be increased, but complemented with transitional provisions for advisers while any new changes are coming into effect.

The concept of introducing a stepped pathway, which would allow trainees to commence work under supervision while studying towards a qualification, was another common suggestion made through Options Paper feedback.

Many submitters commented that an increase in competency standards should not be perceived as a barrier to entry for an industry looking to professionalise. Some noted that it could have the opposite effect, and lift the credibility of providing financial advice as a career and attract new graduates.

> *"Introducing a stepped career path for new entrants to the industry would be likely to encourage interest in the industry amongst young people when choosing a career. Within this stepped process the RFA-type designation could be structured as a step towards becoming a fully licensed adviser." – Alan King, submission on Options Paper, February 2016*

Options Paper feedback also showed broad support for minimum entry requirements for all providing financial advice, however a few submitters opposed this view, commenting that minimum entry requirements are not needed and would impose unnecessary costs on advisers and thereby consumers.

> *"All advisers should be required to meet core minimum requirements (covering such things as demonstrating understanding of the advice process, understanding*

what amounts to a conflict and how these are to be managed, demonstrating understanding of legal/code/ethical requirements). The adviser would then need to have demonstrated competency relevant to the adviser's scope of service e.g. knowledge of risk products, insurance advice, wealth etc." – AMP, submission on Options Paper, February 2016

The majority of advisers are not required to put consumers' interests first

The current situation with different advisers facing different ethical requirements can be confusing to consumers, who may not understand that some advisers are not required to put their interests first. Without clarity to consumers on the different obligations, they may place undue trust in advice.

"Whether you are a financial adviser or a bank, the impact of the advice is the same for the consumer… all people providing that advice need to meet the same standards." – Issues Paper consumer survey respondent

All advisers are required to meet the conduct obligations in the FA Act to exercise care, diligence and skill, and must not engage in misleading or deceptive conduct. AFAs are also required to meet minimum standards of ethical behaviour and client-care, which are set out in the Code of Conduct. This includes requirements to place the interests of the client first and to manage any conflicts of interest to ensure that this obligation is not compromised. AFAs must also disclose commissions and any other conflicts of interest.

RFAs are not required to put consumers' interests first. QFE Advisers only have this obligation when giving personalised advice on Category 1 products. This means that only 1,900 advisers are held to consumer-first obligations.

Ninety-four percent of respondents to the Options Paper consumer survey thought that all advisers (including those in banks and mortgage and insurance brokers) should be required to put consumers' interests first.

"Advice should be independent and serve the best interest of clients/customers. It should be practical, clear and simple. Risks should be outlined, with examples for clarification. Advisers should be held to account (within reason). Advisers must be suitably qualified and trained and sign an oath to uphold specific ethical standards (like doctors)." – Options Paper consumer survey respondent

Most Options Paper submitters who commented on what the 'right' ethical obligation for those providing advice is supported the current AFA obligation to *place the interests of the client first*. Some submitters noted that there should be guidance to help advisers to know how they can comply with the obligation to put consumers' interests first in different situations. In contrast, some submitters thought that there should be a distinction between salespeople and advisers, and only those with the title 'adviser' should be required to put the consumers' interests first. The option of distinguishing between sales and advice is discussed on page 78.

"Sovereign supports the option to extend ethical requirements to all financial advice services. Every adviser should be obligated to put the consumer's interests before the adviser's own interests. Further guidance on 'putting the consumer

> *first' will help all advisers meet their obligations in this regard." – Sovereign, submission on Options Paper, February 2016*

Meanwhile there is evidence that conflicts of interests may be compromising advice and resulting in poor outcomes for consumers

There are currently no restrictions around conflicted remuneration or other conflicted incentives. The AFA and QFE (in regards to Category 1 products) consumer first obligations, as described above, and AFA disclosure requirements are the only mitigation for conflicts of interest.

The lack of conduct standards has seen rise to issues that are having a negative impact on consumers' financial wellbeing. Switching insurance policies, for example, can be a positive indication of a competitive market and can be driven by consumer expectations rather than advisers. However, it is important that advisers ensure that the new policy meets the consumer's needs and that the consumer understands any differences in policy coverage. Complaints to DRSs suggest that this does not always happen under the current obligations.

In its 2014/2015 annual report, the FSCL scheme noted that it investigated a number of complaints rising from consumers being sold replacement insurance – usually life, health or income protection – by an insurance adviser[24]. The complaints fell into two broad categories:

- where the consumer claims to have been given inappropriate or inadequate advice about the risks of changing insurers, particularly where they have a pre-existing medical condition
- where the consumer decides to cancel a new insurance policy within the first two years of cover and is then asked by the adviser to pay a fee.

> *"We generally see a failure to put consumers' interests first in respect of replacement insurance policies. In this situation, there is a significant risk consumers will find they have no cover (because they had pre-existing conditions or failed to disclose material information), often for minimal or no benefit to the consumer." – Insurance and Financial Services Ombudsman, submission on Options Paper, February 2016*

However, it is difficult to gauge the full extent of poor advice, as it is likely that some issues are not reported[25].

As mentioned on pages 15-16, the FMA's recent review of life insurance replacement business has found evidence that suggests there may be insurance churn happening within the life insurance industry[26]. The data found that high replacement business is slightly more prevalent amongst RFAs than AFAs. About 66 per cent of the high volume advisers and 85 per cent of the high-replacement advisers were RFAs.

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[24] See *https://www.fscl.org.nz/sites/all/files/FSCL_AR2015_Low_Res_final.pdf*.

[25] As stated in FMA, *Replacing life insurance – who benefits?* June 2016.

[26] Churn is where a consumer is moved from one financial product to another based on the commission and incentives payable to an adviser, rather than because it is in the consumers' best interest.

Replacing a consumer's life insurance policy where it is not in the best interest of the consumer can cause harm. For example:

- Differences in policy exclusions and cover mean that consumers miss out when making a claim under the new policy.
- A change in premium may result in a consumer paying for insurance they do not need, or paying lower premiums in the short term but higher premiums in the long term.

> *"In this case, a consumer does not have to have a bad experience to be harmed. They are buying the transfer of risk, and the harm is the difference in risk transferred because of poor financial advice." – FMA, Replacing life insurance – who benefits? June 2016*

In their report *Sales and advice,* the FMA found[27]:

- KiwiSaver providers paying direct sales incentives to staff, or having KiwiSaver sales targets as part of staff performance plans, with little evidence of supporting policies to ensure conflicts of interest were recognised and managed.
- Cases where customers had been sold a product, such as life insurance or KiwiSaver, when their original intention had been to organise a different product, such as a credit card or home loan. They note that the secondary sale often has much less care or attention or time committed to it.
- Around half of KiwiSaver sales in the *Sales and advice* review period were transfers between schemes (sometimes known as 'switching'). Most providers did not have records of the type of service provided in transfer situations.

> *"The firm and their staff are conflicted when their performance is measured on volume and there is not a corresponding requirement to ensure all products meet suitability requirements, or are in the best interests of the customer." – FMA, Sales and advice report, November 2015*

The lack of consistent competency and ethical standards may mean that conflicts of interests, such as commissions, are not being managed properly by some advisers. This has the potential to undermine consumer confidence in the financial advice they are given.

The current regime is also inconsistent with the IMF's principles for insurance advisers, for example, the requirement for insurance advisers to be licensed and manage conflicts of interest.

Current disclosure of conflicted remuneration is inadequate

The different disclosure requirements can result in consumers making incorrect assumptions about the advice they receive.

[27] See FMA, *Sales and advice 1 July 2014 – 30 June 2015.* November 2015. https://fma.govt.nz/assets/Reports/151117-Sales-and-advice-report.pdf.

As RFAs and QFEs are not required to disclose conflicts of interest or details of their remuneration or incentives, a consumer might conclude that there are no conflicts of interest in play and that the adviser does not receive commission payments. The information that consumers would find most useful to help them choose a financial adviser relate directly to adviser remuneration[28].

> *"Sovereign believes that one solution to the underinsurance and inappropriate churn issues is to level the playing field on disclosure of commissions. Currently, when they sell Category 2 products, AFAs and RFAs do not have the same commission disclosure requirements. Sovereign believes that this unevenness provides a mechanism that could encourage inappropriate churn. Anecdotally, we have heard of instances of AFAs becoming RFAs to take advantage of the reduced disclosure requirements." – Sovereign, submission on Issues paper, July 2015*

While a consumer receiving advice from a bank might reasonably expect that they will only be receiving advice on the bank's product, this is less apparent when a consumer meets an adviser not directly aligned to a product provider. RFAs are not required to disclose information on the number of manufacturers whose products they consider, which could result in consumers not being aware of restrictions in the product suite they are being offered by their adviser. Some advisers might be able to consider the products of multiple organisations but, in practice, place the majority of their clients with one or fewer organisations.

The non-disclosure of other forms of remuneration, such as soft-commissions[29], has also been raised as a concern. Similarly, there is concern that sales targets and other incentive arrangements within QFEs are leading to suboptimal outcomes for consumers.

Generally, submitters on both the Issues and Options Papers agreed that remuneration and other incentives should be disclosed by all providing financial advice. However, some suggested that the structure of incentives makes it difficult to disclose and for consumers to understand, and that some incentives are easily hidden. AMP suggested that any remuneration that cannot be calculated in dollar terms should be prohibited. Eighty-seven per cent of respondents to the Issues Paper consumer survey thought that disclosure of commission payments is useful (see Figure 3). Fifty-five per cent of respondents thought that they would know how to interpret disclosure of commission payments, while 28 per cent did not. Sixteen percent did not know whether they would be able to interpret disclosure of commission payments.

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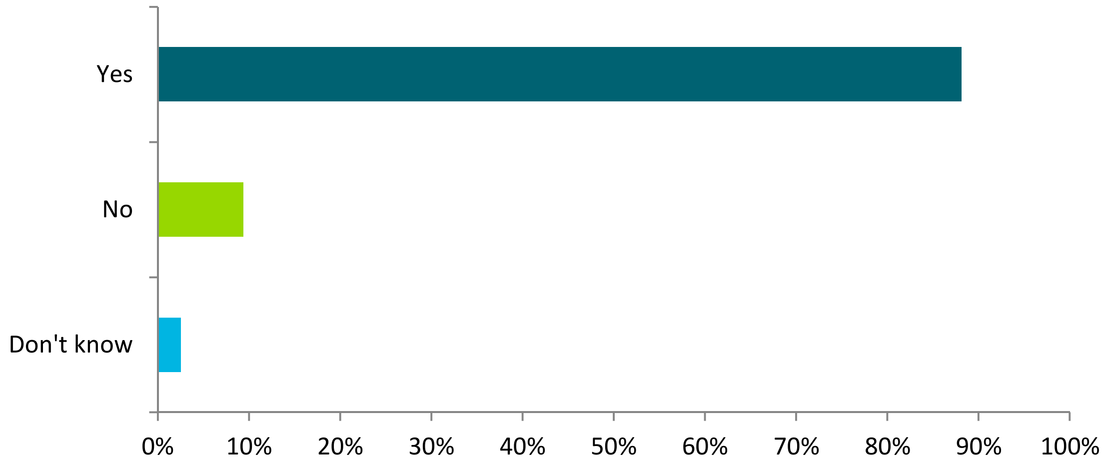
[28] Options Paper consumer survey, Question 5. *http://www.mbie.govt.nz/info-services/business/business-law/financial-advisers/review-of-financial-advisers-act-2008/pdf-document-library/Consumer-Questionnaire-Summary.pdf*.

[29] Non-monetary incentives attached to the sale of a certain product. Examples include overseas trips, tickets to sporting events, training, software subsidies, business development and marketing grants, event sponsorship, and paying registration fees.

Figure 3: Results from Issues Paper consumer survey on disclosure of commission payments

Question 8. Do you think disclosure of commission payments is useful?



> *"It would be meaningful for consumers to know if an adviser is being incentivised to promote a particular product. We believe independence is a key disclosure requirement." – AA Insurance, submission on Options Paper, February 2016*

> *"Disclosure should be any and all remuneration and/or other benefit that the adviser and their employer would receive from parties other than the customer." – SiFA, submission on Options Paper, February 2016*

> *"The disclosure regime should encourage and reward the clarity and transparency of remuneration structures." – Professional Advisers Association, submission on Options Paper, February 2016*

However, it is worth noting that some academic literature supports the view that people are naïve about how conflicts of interest affect the quality of advice[30]. In addition to recognising the behavioural biases described on page 13, this suggests that disclosure alone will not prevent the potential harm to consumers created by conflicts of interest and other incentives[31].

There are concerns about the ability to incentivise good conduct by advisers within a QFE

Through consultation, concerns were raised about the QFE model and in particular the lack of incentives for QFE advisers to adhere to conduct and client-care standards. We heard the issue arises

[30] Chater, Huck, and Inderst. 2010. Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective. Final Report.

[31] Charter, Huck, and Inderst (2010) conducted an online experiment with over 6,000 subjects across Europe on their willingness to pay and follow advice from financial advisers. They found that, even though the advisers compensation schemes are disclosed, subjects displayed the same willingness to pay and follow advice regardless of whether the adviser's compensation scheme presents a potential conflict of interest. Cain, Loewenstein and Moore (2005) also found that people generally do not discount advice from biased advisers as much as they should, even when conflicts of interest are disclosed.

because QFE advisers are not individually accountable to legislative standards combined with the fact that they may be incentivised by the QFE to sell products without due consideration as to whether it is in the consumer's interests.

> *"Our understanding is that the majority of complaints dealt with by the Disputes Resolution Schemes are products delivered via QFEs (e.g. credit card based travel insurance and consumer finance) and also that the FMA has expressed considerable concern around the practices adopted by banks in aggressively churning KiwiSaver funds. The high incidence of issues combined with a limited transparency for the public can be doing little to improve public confidence in this part of the regulatory scheme." – Kepa Financial Services Limited, submission on Issues Paper, July 2015*

> *"Given that the majority of QFE advisers are employed by banks and insurance companies, the employee performance/remuneration models are based on sales targets etc. This presents a massive conflict of interest. Disclosure of the sales etc. is not provided to consumers. Also QFE advisers have to provide the QFE solution to consumers; even if there is a better option in the market place they are unlikely to provide this information to the consumer." – Don Broad, submission on Issues Paper, July 2015*

There is evidence that these concerns may be valid. For example, the FMA's *Sales and advice* report found KiwiSaver providers paying direct sales incentives to staff, or having KiwiSaver sales targets as part of staff performance plans, with little evidence of supporting policies to ensure conflicts of interest were recognised and managed. It is unclear, however, whether the problem arises from the different accountability arrangements applying to QFEs (alternatively, it could arise because QFEs are not subject to the consumer-first obligation in most situations, in which case this problem would be addressed by extending the consumer-first obligation as discussed in the previous section).

Different registration, licensing and reporting requirements create inconsistencies in regulation

Different registration, licensing and reporting requirements mean that oversight is inconsistent across the financial advice industry. In particular:

- RFAs are reactively monitored following complaints, as there are few obligations on the service they provide and a lack of swift, low resource tools available to the regulator to deal with non-compliance. This is inhibiting effective monitoring and enforcement.
- QFE advisers are not directly regulated and therefore cannot be individually identified or subject to FMA enforcement.

> *"The FMA should be empowered to monitor, investigate and discipline the behaviour of all advisers (including RFAs). It is not appropriate for the public to be advised by any advisers who are not adequately regulated. In terms of RFAs, public trust and confidence in financial advice in New Zealand is significantly dependent on the behaviour and management of RFAs (i.e. they are a large category of*

advisers and therefore a large proportion of the public receive their advice). Despite this, RFAs are subject to a very low-level of regulation. We believe that the issue could be addressed by expanding the powers of the FMA." – Partners Life, submission on Issues Paper, July 2015

The definition of financial advice may not always be capturing the right activities

The 'reach' of the FA Act is determined by the definition of a financial adviser service. We have found two contrasting issues with the current definition:

- The current definition might be unintentionally capturing activities that are not intended to fall within regulatory scope. An example is execution or transaction-only services (where a consumer has requested to buy or sell a specific financial product and does not wish to receive advice).
- The current definition may be allowing some conduct – which is intended to be captured – to go unregulated by providers using the strict 'letter of the law' definition. An example from the FMA *Sales and advice* report is the cross-selling of financial products, where a consumer who intends to purchase a financial product, such as a credit card, is sold an additional product, such as life insurance or KiwiSaver.

"Since the implementation of this definition, I have noticed a number of situations where 'advisers' are arbitraging the definition. I have seen people 'give information' but then it transforms into advice, without any recognition from the 'adviser' that this has happened. Some of these people have not been registered on the FSPR - as they were 'giving information only'. That 'information only' has ended up providing them with income from the sale of a financial product. A number of these products are going to be with the client for a lifetime - but the person 'selling' the product can hide behind the fact that they are not covered by the Act." – Carey Church, submission on Issues Paper, July 2015

Compliance costs are unbalanced

Some compliance activities have limited benefit to consumers and/or firms

Financial advisers and financial adviser professional bodies have expressed concerns with the extent to which some regulatory requirements are imposing additional costs on their businesses.

Some compliance activities in the current regime have limited benefit to consumers and/or firms. For example, current disclosure requirements tend to produce long and legalistic documents and do not include the key information that consumers need to make informed decisions.

We have also heard that some AFA reporting requirements are of limited benefit. In particular, while AFAs are required to maintain an adviser business statement (ABS), these are only provided to the FMA on request and are thought to be imposing undue cost on industry, while providing little direct benefit to consumers. The ABS requirements will be reviewed in conjunction with regulatory reporting and licensing requirements.

There also appears to be missed opportunities for efficiencies. AFAs working for a QFE are effectively regulated twice – by the FMA via individual licensing and by the QFE through their ABS and licensing process. Further, there is limited ability for advisers working in the same firm to consolidate their compliance activities. For example, AFAs working in an adviser firm need to be individually authorised by the FMA and produce an individual ABS. There is limited ability for an adviser firm (whether comprising three advisers or one hundred) to leverage economies of scale in its compliance activities.

QFEs are approved at the firm level with an upfront fee of $4,886, while AFAs are required to be individually authorised, with an upfront fee of $1,145 per adviser. This means that a small-medium sized advisory firm with ten advisers is currently required to spend almost $11,500 in direct fees compared to large QFE firms with potentially hundreds of advisers. The scale of this disparity means that AFAs are imposed with disproportionate direct compliance costs.

A commonly cited issue by financial advisers in MBIE's March 2015 adviser survey was that compliance costs and regulatory requirements not only form barriers to entry, but also prevent more established advisers from remaining viable and competitive, and is forcing them to be selective about the type of clients they take on. There were a number of areas specified by submitters on the Issues Paper where they believed compliance requirements could be reduced. These included simplifying or eliminating the ABS, and eliminating any duplication of requirements between the regime and the Anti-Money Laundering and Countering Financing of Terrorism Act (AML/CFT).

> *"There is a lot of superfluous compliance and administration that could be simplified significantly and then applied across the industry… If some core requirements were simplified, it would make the rest of it a lot more bearable." – Carey Church, submission on Issues Paper, July 2015*

Unnecessary complexity is preventing adequate consumer protection and understanding

Some terminology is confusing and misleading to consumers making it difficult for them to understand and respond accordingly

The legislation sets terminology and advice distinctions that are unclear and confusing, and this prevents consumers from knowing where to seek advice from. Examples include:

- The differences between adviser types (e.g. 'authorised', 'registered' and 'qualifying financial entity') and the scope of the work they can provide can be difficult for consumers to understand.

- The term ‘registered’ is often seen as superior to ‘authorised’ and may be wrongly interpreted as being associated with particular competencies or active regulation, as is the case in other industries (e.g. registered nurse).
- The definition of ‘broker’ and ‘broking services’ in the FA Act differs from common use. Common examples cited were that those operating in the fire and general insurance and mortgage fields are typically called brokers. Therefore, consumers may be looking for someone to help with broking a mortgage or insurance, when under this regime that is not the role of the broker. The different interpretations of the term broker may perpetuate confusion among consumers when looking for a particular service.

> *“Concepts in the FA Act are often poorly understood, unclear, or are not used as intended. The current regime also expects the customer to engage with and understand the structure of the regime. NZBA and its members believe that some of these issues could be addressed by changes in the way that advisers are labelled or presented.” – New Zealand Bankers’ Association, submission on Options Paper, February 2016*

> *“The broker requirements in the FA Act are confusing. The term ‘broker’ has always been widely used in the industry to refer to a person who sells fire and general insurance (an insurance broker), or arranges mortgages (a mortgage broker). As a result, the different and specialised use of the term in the FA Act is confusing for both advisers and consumers; the use of the term ‘broker’ in the FA Act should be changed.” – Insurance and Financial Services Ombudsman, submission on Options Paper, February 2016*

Advisers and product providers have reported that they consider the current framework too complex and confusing for consumers. Respondents to MBIE’s March 2015 adviser survey reported that their clients tend to have a fairly poor understanding of the differences between types of advisers, the conceptual differences between class advice and personalised advice, and the purpose of disclosure and what is being disclosed to them.

> *“The current lack of consumer understanding about this distinction [between class and personalised advice] adds confusion as customers do not understand why we cannot explain elements in a way that is meaningful or ‘personal’ to the customer.” – Cigna Life Insurance, submission on Options Paper, February 2016*

Feedback stresses that the current adviser types and associated terminology cause confusion for consumers. The titles do little to suggest what type of advice (and on which products) a certain adviser can provide. Further, consumers are often unaware of the limitations of class advice when it is provided. This was seen in the Colmar Brunton focus groups and responses to the Issues Paper consumer survey. Some consumers said that the distinctions do not provide any indication of the type of advice they will receive.

> *“Terminology under the current regime ‘Registered Financial Adviser’, ‘Authorised Financial Adviser’, ‘QFE Adviser’ is not meaningful for consumers. The use of the term ‘registered’ is also confusing when compared to other industries which use*

the term 'registered' to denote attaining a minimum qualification or training standard, i.e. teachers or nurses." – Westpac, submission on Options Paper, February 2016

This lack of understanding is a concern because uncertainty about the different adviser designations runs counter to the rationale that regulating can reduce consumer information asymmetries (so that consumers are able to choose an adviser who best meets their needs). It may also contribute to a lack of confidence in the financial market, thereby reducing consumer participation. However, it should be noted that the terminology is not the fundamental problem; rather, it exacerbates the issues of complexity. Increasing consumer access to, and understanding of, financial advice is likely to require more than just fixing the terminology.

Current disclosure and client-care obligations are inconsistent and of limited use to consumers

Disclosure is an important tool for addressing the information asymmetry inherent in financial advice. Disclosure ensures that consumers have sufficient information about the person providing them with financial advice, before engaging their services.

The FA Act sets out disclosure obligations that relate to QFEs and financial advisers. All financial advisers and QFEs are required to disclose certain information about the nature of services they provide prior to providing a personalised service to a retail client.

AFAs are also required to disclose more detailed information on the nature of services they provide, signify how many organisations' products they can consider, and detail all other conflicts of interest. RFAs are not required to disclose details of any conflicts of interest or the number of organisations that they are able to consider prior to giving financial advice.

The consensus from submitters on the Options Paper was that disclosures are not useful for consumers. Common reasons cited were:

- Consumers see disclosure as a compliance requirement from their QFE and do not see it as being a valuable tool for them to make choices.
- Disclosure documents are too long, complex, and jargon-filled, so often end up not being read. Even if the statement is read by consumers, it is too complex and consumers lack understanding of other categories of advisers in the FA Act to make comparisons.

"For more sophisticated customers the disclosure has meaning. BNZ is concerned however that retail customers view this as just part of the process and it is not perceived as providing significant value. Customers see it as a compliance process that the banker must complete rather than a value tool for the customer." – BNZ, submission on Issues Paper, July 2015

Feedback from both the Issues and Options Papers highlighted that disclosure documents across the board need to be standardised, simplified (no jargon) and shortened. Standardisation would see that there is a degree of comparability between those providing financial adviser services, so consumers can make an informed choice.

Given the different ways in which people engage with financial advice providers, there needs to be flexibility in how these are delivered – but the content should be the same.

> *"We think anyone providing financial advice should have to provide standardised written disclosure … this would be provided before any advice was provided. The document should be short-form (no more than a side of A4) and, as well as matters such as fees and conflicts of interest, clearly and effectively set out any restrictions on the scope of the advice engagement offered." – Forsyth Barr, submission on Options Paper, February 2016*

> *"The current disclosure assumes retail customers have a level of financial knowledge that many simply do not. The disclosure should be in plain English that could be easily and quickly understood by the layperson." – BNZ, submission on Issues Paper, July 2015*

The FA Act differentiates between retail and wholesale investors. Wholesale investors are, due to their assets, size or sophistication, assumed to be able to engage with financial advisers without much regulatory protection. The lack of disclosure requirements for RFAs means that their wholesale clients may be unaware that they have less protection than retail clients.

Consumers continue to struggle to know where to find good quality financial advice

There is some information already in the public domain to help consumers find an adviser. The government administers the FSPR that enables the public to access basic information (e.g. name, business address, the DRS they belong to, the types of financial service they are registered to provide) about all financial service providers operating in New Zealand.

The FA Act also prescribes that advisers must make information (such as the type of adviser they are, the type of services that an adviser can provide, and the DRS they belong to) available via Primary Disclosure Statements to help consumers compare and choose an adviser.

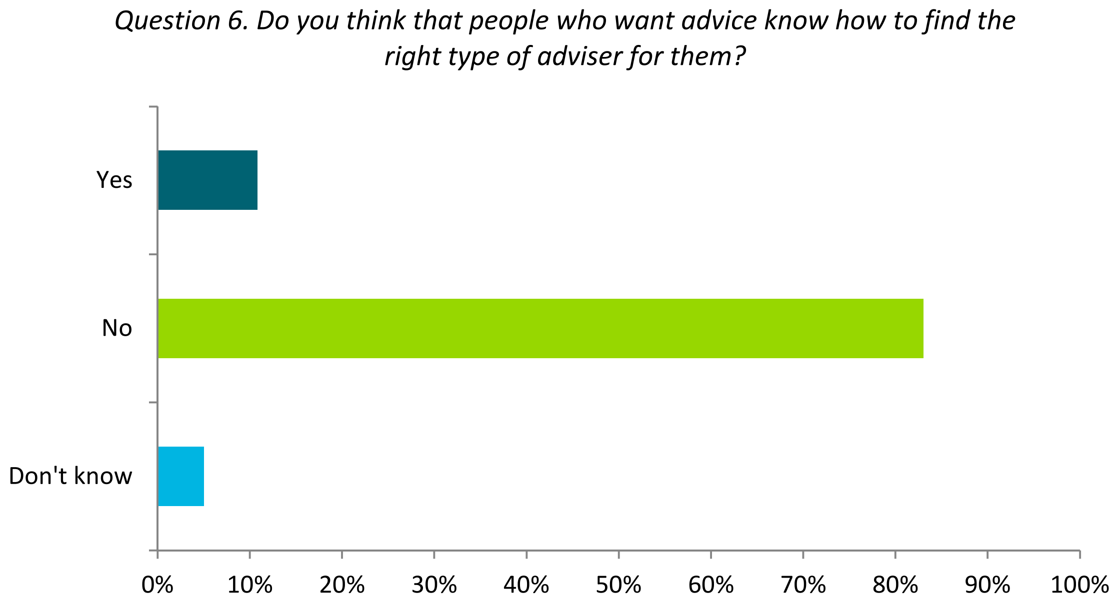
The *www.sorted.org.nz* website (run by the Commission for Financial Capability) provides plain English information on the different types of adviser and on what to look for when getting financial advice, along with tools to help determine investment appetite. The FMA provides a list of those advisers and QFEs approved by the FMA, and warnings about advisers to avoid. Industry associations (such as *www.ifa.org.nz*) provide information including 'find an adviser' search engines, where consumers can search for advisers who are members of that particular industry organisation. Consumer organisations provide basic information on things that consumers should know when looking for an adviser. Advisers and firms also provide their own marketing information.

Despite the information referred to above, New Zealand consumers still do not seem to know where to start when wanting to find and choose quality financial advice[32]. Eighty-three per cent of

[32] See examples: Commission for Financial Capability/FMA survey on New Zealanders' expectations and experiences of retirement, 2015. *http://www.cffc.org.nz/assets/Uploads/CFFC-FMA-Survey.pdf*
MBIE Issues Paper consumer survey 2015. *http://www.mbie.govt.nz/info-services/business/business-law/financial-advisers/review-of-financial-advisers-act-2008/pdf-document-library/Summary%20of%20Consumer%20Brochure%20responses.pdf*

respondents to the Issues Paper consumer survey did not know how to find the right type of adviser for their needs (see Figure 4).

Figure 4: Results from Issues Paper consumer survey on finding an adviser



It is unclear if the root cause of this is:

- insufficient information located in one place that consumers can easily access and understand and may help them filter a 'good' adviser from a potentially 'bad' one
- the complexity and parameters of the current regime (including a lack of consumer friendly disclosure, and confusing terminology and categorisation of advisers and advice) meaning consumers may not get the information that might help them find quality advice. Alternatively, they get it and either do not understand it or are misled by it (e.g. are misled that registration on the FSPR means an adviser has met prescribed competency standards and is actively monitored)
- low consumer awareness of existing publicly available tools and information to point them to quality advice
- a combination of the above.

Other, larger influencing factors could be consumer apathy, low levels of financial capability, high levels of trust in the opinions of friends and family, and continued mistrust of financial advisers.

Colmar Brunton, FA Act/FSP Act review: Consumer groups report, for MBIE 2015. *http://www.mbie.govt.nz/info-services/business/business-law/financial-advisers/review-of-financial-advisers-act-2008/pdf-document-library/colmar-brunton-consumer-focus-group-report.pdf*

Consumer NZ 2009 Financial Advisers Survey. *http://www.consumerprotection.govt.nz/legislation-policy/policy-reports-and-papers/research/consumersurvey-2009.pdf*.

However, we are not sure if pursuing options to address one or more of the above will drastically improve the ability of consumers to find the advice they need. If other proposals in our following recommendations to simplify the current regime are taken forward – such as the removal of numerous categories of advice, tiers of advisers, and improved disclosure – we would expect to see current consumer confusion reduce.

Most Options Paper submitters argued that there is a lot of good information already in the public domain and should continue to be optimised to provide consumer-focussed information. There was general agreement that a single, centralised source, such as the FSPR, is still of value to consumers. However, if a centralised register is kept, submitters thought it needed to provide more useful information and be more consumer-friendly than the current FSPR. Some submitters thought that there was a need for further information and research into where consumers currently look for financial advice.

> *"It is abundantly clear from the various consumer surveys that the public do have issues around finding and identifying advisers. What we have at present is not working and the Government should engage with advisers associations, other industry groups and consumer groups to improve on what is available at present and develop a better outcome." – Institute of Financial Advisers, submission on Options Paper, February 2016*

Part 6 – Issues with the FSP Act

Access to fair and effective redress could be improved

Jurisdictional differences between dispute resolution schemes (DRSs) may be limiting access to redress

Under the status quo, with DRSs setting their own (slightly different) rules, situations can arise where a consumer's access to redress is limited.

Firstly, differences in scheme rules could result in a consumer losing access to redress if the provider moves to a different scheme. For example, if a provider terminates their membership of a given scheme after the conduct in question, but before a complaint is made, the current rules are unclear as to whether the old or new scheme (or either) has jurisdiction to handle the consumer's complaint. Under this scenario, it will also be unclear to the consumer which scheme has jurisdiction of the complaint, and hence where to go for redress. This confusion and inconsistency is confirmed from reading the different DRS rules and through discussions with the DRSs.

Secondly, there is a risk that differences in rules between DRSs could create an incentive for a financial service provider to choose one scheme over another in their own interest, rather than in the interest of their customers. For example, the timeframe in which a complaint must be received by the DRS varies between them, and whether or not the DRS might consider a complaint outside these timeframes might also vary. Also, some DRS 'exclusions from jurisdiction' rules might mean they will not consider a complaint in certain circumstances. For example, FDR, BOS and FSCL's jurisdiction rules state that they do not take complaints that have already been considered in another forum, while IFSO's does not appear to have this limitation.

It is also important to ensure that the $200,000 cap on disputes is being applied consistently across DRSs.

> *"We've previously expressed concerns about the number of dispute resolution schemes, the variability of scheme rules and the fact the schemes are not required to publish their decisions." – Consumer NZ, submission on Options Paper, February 2016*

Consumers may not be sufficiently aware of DRSs and the complaint handling processes

For consumers to seek a low cost remedy if things go wrong and know that financial service providers will be held to account, they must be aware of the dispute resolution mechanisms available to them, and the general process through which they may progress a dispute with a financial service provider.

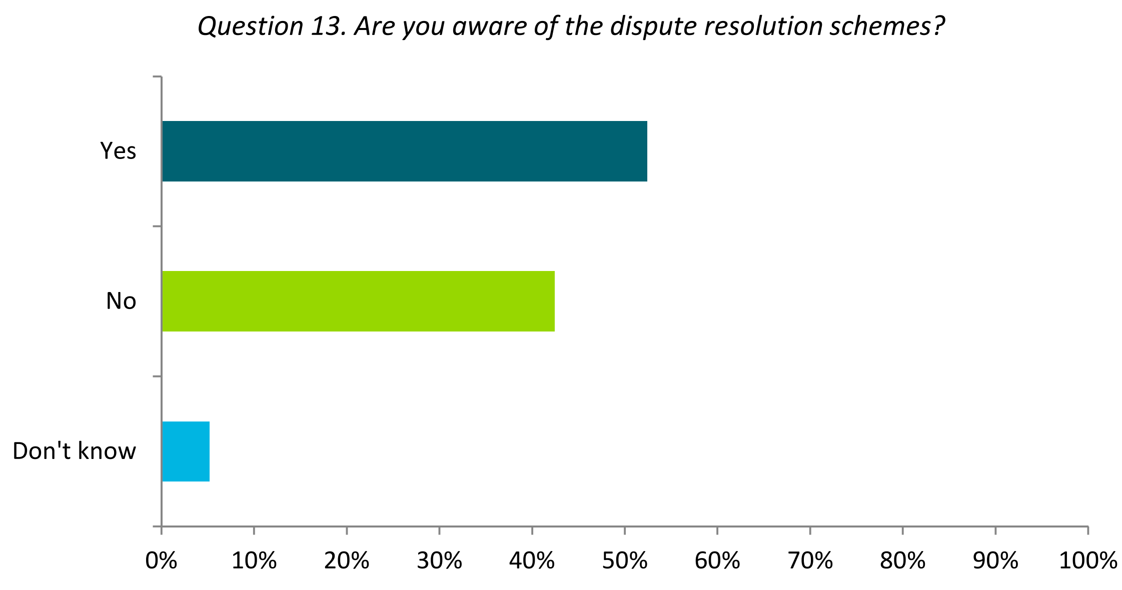
The Code of Banking Practice obliges banks to provide information about the Banking Ombudsman Scheme (BOS) to their customers, which includes providing information on the banks' website. Some DRSs have consumer awareness initiatives such as distributing information sheets and brochures, media interviews and website video clips.

Although details of what a consumer should do if something goes wrong is initially disclosed, the relevant details of the disclosure may be forgotten by the consumer should a problem arise down the track. Some financial advisers include details on how to make a complaint on their websites.

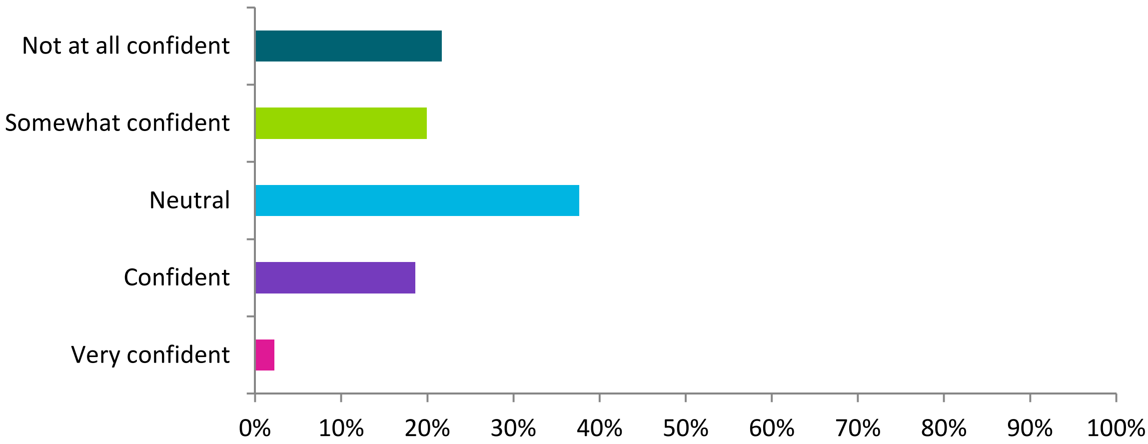
However, respondents to the Issues Paper consumer survey expressed the need for publicity around DRSs and that the financial service providers should be required to openly discuss them rather than simply disclose them. The FDRS' annual report (1 July 2014 – 30 June 2015) states that "consumer awareness of financial dispute resolution schemes and ability to make complaints to their provider remains very low".

Fifty-one per cent of respondents on the Issues Paper consumer survey are aware of DRSs, while 42 per cent are not. Forty-one per cent of respondents said the availability of DRSs make them at least somewhat more confident in participating in financial markets (see Figure 5).

Figure 5: Results from Issues Paper consumer survey on dispute resolution schemes



Question 15. Does the availability of dispute resolution schemes make you more confident in participating in financial markets?



Submitters on the Options Paper thought that more could be done to promote the schemes to increase consumer awareness. Suggestions were made that more information should be made available to consumers and that all financial service providers should be required to disclose their scheme up-front and on the FSPR.

The FSPR is being misused

The FSPR is being misused by some offshore-controlled firms to gain the appearance of being regulated in New Zealand

There have been instances of offshore-controlled firms registering on the FSPR to take advantage of New Zealand's reputation as a well-regulated jurisdiction.

Registration on the FSPR allows these firms to misrepresent to overseas customers that they are licensed or actively regulated in New Zealand, and enables them to enjoy a lesser degree of scrutiny overseas than might otherwise be the case.

The firms in question are setting up superficial New Zealand operations in order to fall within the relatively wide scope requiring registration. The requirement to register applies to a person who is ordinarily resident in New Zealand or has a place of business in New Zealand, regardless of where they are providing financial services. These firms generally do not make financial services available to New Zealand-based customers, and are therefore unlikely to be subject to regulation by New Zealand regulators.

These firms are registering for financial services which do not require licensing in New Zealand e.g. foreign exchange services – 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. Other similar jurisdictions typically license all types of financial service providers. For example, in Australia all entities that provide financial services are required to obtain an Australian Financial Service Licence. New Zealand does not license all financial service providers because licensing can impose significant costs, create a barrier to entry and reduce competition in the market.

An underlying issue is that the public often interprets 'registration' on the FSPR to mean that an entity is actively regulated in New Zealand.

The FMA receives large volumes of complaints from persons outside New Zealand, relating to offshore-controlled firms registered on the FSPR which have not paid out customer funds when required to.

Existing tools to overcome misuse require significant resources

The FMA was given the power in 2014 to direct the Registrar to decline a registration application or deregister an entity if it considers that registration of that entity is likely to:

- create a false or misleading impression as to the extent to which an entity provides (or will provide) financial services in or from New Zealand, or is regulated in New Zealand, or
- otherwise damage the integrity and reputation of New Zealand's financial markets or regulation of those markets.

However, addressing misuse through this FMA power has required a significant amount of resource.

The FMA's powers do not affect who is entitled to register on the FSPR. There is little financial or other detriment to an entity that attempts to apply and is unsuccessful. There is therefore little to deter entities from attempting to register on the FSPR to facilitate misuse.

Given the resources required to address misuse using the FMA's existing powers, it is likely that those powers are not sufficient to deal with all attempts to misuse the FSPR.

One reason for the decision to address misuse through the FMA's existing powers was the expectation that in time, suspect applications would reduce as prospective applicants became aware of higher standards being applied. However, this does not appear to have eventuated.

> *"Misuse of the FSPR by offshore financial service providers is a significant risk to New Zealand's reputation. We have already had complaints about offshore entities which have no bona fide complaints processes and we have had to terminate their membership of the ISO Scheme. A better means of assessment of the entities is required, prior to allowing them to register. Those which do not meet the required standard should not be allowed to register on the FSPR." – Insurance and Financial Services Ombudsman, submission on Issues Paper, July 2015*

Part 7 – Recommended changes to the FA and FSP Acts

This section sets out our recommendations for change to the FA and FSP Acts. These recommendations are based on consultation feedback, analysis of the market and evidence of harm in the financial advice space, and address the issues with the regime as described in Parts 5 and 6 of this report.

The Regulatory Impact Statement produced alongside this report contains the full analysis of each option considered throughout the review and justification for the preferred options, which form the basis of these recommendations.

The recommended regime

Objectives of the recommended regime

One of the key Government priorities is to build a more competitive and productive economy. A financial advice regime that encourages confidence and participation in financial markets is central to this, and is the long-term outcome of this review. As set out on pages 7-8, the new regime we are recommending is driven by the following five objectives:

- Consumers can access the advice they need.
- Advice makes consumers better off.
- Regulation is enabling with no undue compliance costs, complexity, or barriers to innovation.
- Consumers have access to effective redress.
- Misuse of the FSPR is addressed.

Overall description

Investor and consumer outcomes are at the centre of the regime we are recommending. To ensure that this translates into the legislative framework, we suggest that the objectives outlined above, including access to quality financial advice, are appropriately reflected in the purposes of the FA and FSP Acts.

We are recommending a comprehensive package of changes to improve access to quality advice for all New Zealanders. The key elements are as follows.

Simplify the regime by stripping out unnecessary complexity and arbitrary regulatory boundaries

We recommend that the requirement for personalised advice to be provided by a natural person be removed, along with the definitions of class and personalised advice and the categorisation of products. These changes will enable the provision of robo-advice and make it much easier to provide consumers with the advice they want and need.

Establishing an even playing field with more proportionate entry and ongoing regulatory requirements

We recommend introducing uniform legislative conduct and competence obligations, as all people or platforms providing financial advice should be required to place the interests of the consumer first and to only provide advice where competent to do so. We also recommend that an amended Code of Conduct be produced, in which all advice is subject to set standards consistent with those legislative obligations. Recognising the breadth of financial adviser services, we would expect the standards in the Code to vary for different types of advice. For example, competency standards would differ for general insurance and investment advice.

Enabling lower cost, fit for purpose licensing

We are recommending that anyone (or any robo-advice platform) providing financial advice services should be covered by a licence. To ensure this does not impose undue costs on firms or government, licensing would be required at the firm level (for the avoidance of doubt, a sole-trader is considered a firm). This approach replicates the success of the QFE model and applies it to currently compliance-burdened AFAs and unlicensed RFAs. In recognising that a one size fits all approach to licensing and reporting would not work, and 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.

Creating three types of advisers

We are recommending that the four types of advisers, AFAs, RFAs, QFEs, and QFE advisers, are removed. Instead, we recommend that three new types of adviser are introduced:

- financial advisers
- agents
- financial advice firms.

Financial advisers would be individually accountable in 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 the types of advice where the financial advice firm could demonstrate it is 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.

Improving consumer understanding with better terminology, disclosure and client-care

As well as removing unclear categorisations, we are recommending that financial adviser designations be improved 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 working for ANZ and could not call themselves financial advisers. We also recommend introducing 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.

We are also recommending that a client-care obligation be introduced. This would require advisers and agents to take steps (at the point of recommendation) to ensure that consumers are aware of the limitations of the advice they receive.

Require businesses to have a stronger connection to New Zealand to register on the FSPR

To address misuse of the FSPR, we recommend a requirement that entities can only register on the FSPR if they are (or will be) either:

- in the business of providing financial services (not just back-office administrative services) from a place of business in New Zealand, or
- in the business of providing financial services to New Zealanders.

MBIE will be undertaking further work to refine the details of this requirement.

The regime as a whole seeks to regulate the conduct of all who provide financial advice services

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 who are providing advice. Our recommended changes will also enable a more principles-based approach to the redesign of the regime. To ensure that the recommended regime is flexible and durable, we suggest that some of the technical detail be moved from legislation into regulations.

Figures 6 and 7 provide an overview of how our recommended changes achieve the five objectives of the review. Figures 8 and 9 illustrate the structure of the recommended regime compared to the existing regime. These tables are followed by a further break down of the recommended changes and explanations of how they will work in practice.

Figure 6: How recommendations achieve the review objectives for the FA Act

	Overall objective: Confident and informed participation of consumers in financial markets			
Objectives	***Consumers can access the advice they need***	***Advice makes consumers better off***		***Regulation is enabling with no undue compliance costs, complexity, or barriers to innovation***
		Improves consumer understanding of what they are receiving and how best to respond	**Improves the quality of advice, adviser conduct and competence**	
Recommendations	Enable robo-advice (with licensing and broadly the same controls that apply to traditional advice)	Improve the disclosure of conflicted remuneration by all providing advice	Universal conduct obligation to put the consumer's interest first	Provide greater clarity as to what is not financial advice
	Remove the class/ personalised advice distinction	Require product providers to disclose soft commissions	Code of Conduct to provide minimum standards of conduct and client-care for all financial advice	Ability to designate activities as advice on the basis of substance over form
	Remove the current distinction between Category 1 and 2 products – all financial products treated equally	Introduce simplified disclosure	Obligation for firms to ensure they do not incentivise their agents to sell a product in a way that does not put the consumer first	Ability for firms to take on all accountability for the advice of their agents
		Require all providing advice to take steps to ensure consumers are aware of the limitations of financial advice	Introduce a broad competency obligation for all providers of advice	Dual accountability between the firm and the adviser
		Re-label representatives of a firm as 'agents'	Require all providers of advice to meet common standards of competence, knowledge and skill	Enable flexibility in how those providing advice demonstrate compliance with the competence, knowledge and skill standards
			Introduce some competency, knowledge and skill standards specific to certain parts of the industry	Require all financial advice firms to be licensed
			Require all providers of advice to meet continuing professional development standards	

Figure 7: How recommendations achieve the review objectives for the FSP Act

	Overall objective: Confident and informed participation of consumers in financial markets	
Objectives	***Consumers have access to effective redress***	***Misuse of the FSPR is addressed***
Recommendations	Ensure dispute resolution scheme rules are aligned	Require entities to have a stronger connection to New Zealand for FSPR registration
	Require financial service providers to provide information about dispute resolution at the time of complaint	

Figure 8: 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.

Authors, 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.

Subject to

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

Authorised financial advisers (Can provide personalised advice on Category 1 and Category 2 products)

Approx. 1,860 AFAs

- 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 QFEs

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 RFAs

- 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

Figure 9: Recommended 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)

Authors, 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 for 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 award compensation.

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

Increased provision of financial advice

Based on feedback received through our consultation process, there appears to be too many restrictions and boundaries around providing advice. This is often forcing advisers to limit their services, and sees them spending more time figuring out what they can and cannot do, rather than providing advice. It also encourages them to only provide class advice, which has fewer requirements and obligations.

Addressing the 'advice gap' is important for achieving our objective of increasing access to advice. As explained on pages 40-41, simple personalised advice is often the type of advice that New Zealanders want, yet this is difficult to provide in a cost-effective way due to the current regulatory boundaries and their associated compliance costs. We are therefore recommending that:

- The definitions of class advice and personalised 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 consumer-needs analysis. To this end, the legislation would clarify that the scope of advice can be limited by factors such as the consumer's wishes and the adviser's or agent's competency requirements.

- The provision of robo-advice be fully enabled. In line with what we have heard throughout consultation, 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.

These changes would remove the legislative barriers and perverse incentives restricting the 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. This allows New Zealand financial advice firms to align with those in other jurisdictions where robo-advice models are already operating.

Higher quality financial advice

Broad legislative obligations

We are recommending that four new obligations are built into the FA Act and applied to all providing financial advice services:

- A conduct obligation to place the consumer's interests first. This would be consistent with the current obligation on AFAs under the Code of Professional Conduct and in accordance with the overarching purpose of the FA Act. What would be required to place the interests 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 differing 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. If no product that they can recommend is genuinely suitable, they would then be expected to advise the consumer on that basis. In all cases, advisers and agents must put the consumer's interests ahead of their own regardless of the differing incentives offered by providers.

- 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 client-care obligation to ensure that consumers are aware of the limitations of their advice at the point of making a recommendation.
- An obligation to disclose prescribed information (discussed further on page 72).

A universal Code of Conduct

We are recommending that all advice is held to a Code of Conduct which prescribes in more detail how to comply with the legislative conduct, competence and client-care obligations. The Code of Conduct must include:

- **Standards of conduct and client-care that apply to all 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.
- **Standards of competence, knowledge and skill that apply to all advisers and agents.** These standards would be relevant to all advice irrespective of industry. For example, relevant common standards might include knowledge of New Zealand's financial advice and consumer laws, and the skills required to assess a consumer's financial situation.
- **Standards of competence, knowledge and skill specific to particular parts of the industry or products or services.** These standards would only apply to advisers or agents who provide advice in those areas of the industry. For example, life insurance could be required to demonstrate knowledge of life insurance products and skill in managing insurance replacement business.
- **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 advice service provided. It is expected that the standards would not be prescriptive, and would recognise that competency means more than technical knowledge and activities might come in many forms.

- **Prescribed methods,** such as courses, which are deemed to comply with the standards of competence, knowledge and skill.

As having a qualification does not necessarily prove competence, we would 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.

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 regulation could quickly respond to industry changes. As mentioned throughout this report, the current Code of Conduct process for AFAs is seen as appropriate and a large number of submitters suggested that it could be further applied to all advice provision.

Increased oversight of those providing financial advice services

RFAs are not subject to any active regulatory oversight and have few regulatory obligations. This is inhibiting effective monitoring and enforcement, which may result in consumer harm. Therefore, we recommend that:

- Anyone (or any robo-advice platform) providing financial advice services is required to be covered by a financial advice licence, granted by the FMA.
- Before being granted a licence, prospective licensees are required to show how they meet the relevant legislative and regulatory requirements (for example, the Code of Conduct) and adhere to any terms or conditions imposed by the FMA.
- To retain a licence, firms are required to comply with any licence conditions imposed by the FMA. For example, this could include ongoing reporting, accounting and notification requirements.

Accountabilities of individuals and firms

A feature of the current regime is that AFAs are individually accountable for their advice and conduct (with no accountability on their firms) while QFE advisers are not individually accountable for their advice and conduct (with all accountability on the QFE). We suggest that this model be changed, by replacing the existing types of adviser with three new types – financial adviser, agent and financial advice firm – and ensuring accountability rests with those able to influence consumer outcomes.

Recommended type one: the financial adviser

We consider it is appropriate for individuals who are exercising discretion to remain individually accountable for their conduct. We therefore recommend that the title 'financial adviser' be restricted for use by these individuals who are individually accountable.

A financial adviser would also be a representative or employee of a financial advice firm.

Recommended type two: the agent

An agent would also be a representative or employee of a financial advice firm, but would not be individually accountable for their advice. They would need to disclose which firm they are an agent for.

Recommended type three: the financial advice firm

A financial advice firm would be able to have representatives or employees who are financial advisers and/or agents. They could also be a sole trader.

Financial advice firms would be accountable for their agents. This makes sense in a large organisation, like a bank, where its representatives are largely required to follow the firm's processes with limited individual discretion. In this instance, it is the firm who manages risk through the setting of advice processes and incentives.

However, we think there should be an additional obligation that would apply where a firm chooses to take on all accountability. The firm would be required to ensure it is not incentivising its agents to sell products without regard to the consumers' interests. This would require a firm 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.

We are also recommending that the firm should be accountable for putting in place processes and providing resources to enable their financial advisers to meet their accountabilities. That is, while the individual financial adviser would be accountable for their advice, the firm would be accountable for supporting the individual to comply.

Financial advice firms would have to hold a licence to provide financial advice services (including through robo-advice platforms and other financial technology solutions). This would be issued by the FMA.

Ensuring the regime captures the right activities

Due to issues with the way some activities are or are not covered under the current regime (as explained on page 50), we are recommending that some changes be made to the regulatory scope to ensure that the it captures the right activities.

We recommend clarifying that the following does not constitute financial advice:

- An execution-only or transaction-only service (where a consumer has requested a specific product and does not wish to receive advice) *e.g. I would like to purchase 5,000 Mighty River Power shares.*

- The provision of factual information about a financial product, whether or not it is in response to a request by a consumer (e.g. the cost or rate of return of a financial product) *e.g. Can you please give me information about your basic car insurance – how much would the premium be? What would the excess be?*

We also recommend that consideration be given to whether an additional mechanism should be introduced to ensure that the legislation, in practice, is capturing the activities that should be regulated. We will develop and analyse options with the FMA and Parliamentary Counsel Office (PCO), but one mechanism could be to enable the FMA to designate activities as advice, subject to a set of guiding principles.

Improved compliance regime

The cost of registration, authorisation and reporting is imposing costs on AFAs. For example, firms with multiple AFAs have no ability to exercise the registration, authorisation and reporting efficiencies as afforded to QFEs. To ensure that the new regulatory oversight measures are reasonable and proportionate, we are recommending that:

- Financial advice licences are issued to financial advice firms rather than individual agents or advisers.
- 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, the services it provides, and whether it engages financial advisers and/or agents. For example:
    - Arrangements for overseeing compliance in smaller organisations might be more limited, whereas a larger organisation might require oversight by a committee of senior managers from across the organisation with a number of operating procedures.
    - 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.
- 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 courses which will be ‘deemed to comply’ with the competence, knowledge and skill standards, some firms could develop their own internal training programmes. This may be preferred by larger firms that want to establish courses tailored to their services and agents at potentially less cost. Through the licensing process, firms could convince the FMA that their tailored programmes achieve the standards in the Code of Conduct.

These changes will ensure that the compliance regime does not impose undue costs on firms or government.

Simplified regime with improved consumer understanding

Boundaries and terminology

Throughout our consultation process we received overwhelming feedback that the terminology in the regime is unnecessarily complex and causing consumer confusion. It appears that the boundaries around advice are not fully understood by many consumers. Therefore, we recommend that:

- The categories of products – Category 1 and Category 2 – are removed. This would mean that all financial advice products would be regulated in the same way.
- Financial adviser designations – 'registered', 'authorised', 'QFE adviser', and 'QFE' – are removed and replaced with financial adviser, agent, and financial advice firm, as described on pages 69-70.
- In line with feedback received through consultation, we also think it would be helpful for consumers if financial advisers could identify themselves with sub-specialisations. For example, 'financial adviser – insurance' and 'financial adviser – investments'. We want to further consult with industry on what these vocational sub-specialisation terms could be.
- As all firms (including sole-traders) providing financial advice will need to be licensed, the term 'financial advice firm' will apply to all licensed firms.

Disclosure and client-care

Disclosure documents are not providing consumers with the information they need to make informed financial decisions. As discussed on page 53, the current disclosure requirements are creating disclosure documents that are too long and complicated to be of much use to consumers. To address this, we recommend that:

- 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 would be required to be disclosed in a clear and concise way, 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.
- All providers of financial advice are required to disclose the same information regarding conflicts of interest and conflicted remuneration in a prescribed format. This would require all financial advisers and agents to disclose how they are remunerated prior to providing financial advice to retail consumers. They would also be required to disclose the amount of conflicted remuneration (including details of soft commissions) they could expect to receive if the consumer took their recommendation.
- All financial advisers and agents are subject to a broad obligation to ensure that consumers are aware of the limitations of their advice when making a recommendation. This would include confirming how many classes of financial products and providers have been

considered, and the elements of the consumer's circumstances that have been taken into account by the financial adviser or agent.

We also recommend that financial product providers be required to publish an annual register of soft-commissions (beyond a minimum level) provided to financial advisers or agents[33]. 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 individual financial advisers as set out above – recognises that soft commissions may be more difficult to disclose in a meaningful way by an individual financial adviser or agent. While we would not expect all consumers to look up such a register, this recommendation aims to shine a light on industry practices and lead some consumers to ask questions of their financial advisers and agents.

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

Overall impact of recommended changes to the FA Act

Figure 10 below summarises the expected impact of our recommended changes to the FA Act on existing advisers, consumers and government.

[33] Non-monetary incentives attached to the sale of a certain product. Examples include overseas trips, tickets to sporting events, training, software subsidies, business development and marketing grants, event sponsorship, and paying registration fees.

Figure 10: Expected impacts of the recommended changes to the FA Act on key parties

Affected party	One off transitional impacts	Ongoing impacts
Authorised Financial Advisers (AFAs)	- Minor transitional costs associated with re-packaging compliance material (e.g. so that material covers the business's approach to compliance rather than the individual's approach – note that for small businesses and sole traders this will involve only very minor changes), updating disclosure documents, and applying for new licences. - Detailed transitional arrangements to be determined by September 2016.	- AFA could coordinate licensing activities at the business level with potentially significant savings e.g. lower direct licensing costs for a business of 10 financial advisers who currently apply for 10 individual licences. - AFAs who work for QFEs would no longer need to be regulated twice (e.g. AFAs would not need to separately apply to the FMA for authorisation, since they would be covered by the business's licence). - Savings associated with more efficient ongoing reporting and compliance activities through greater ability to utilise business-wide processes (and alignment with AML reporting requirements).
Qualifying Financial Entities (QFEs)	- Minor costs associated with updating compliance material to reflect conduct obligation and new disclosure material. - Minimal transitional impacts as proposal retains broad approach to regulating QFEs. - Detailed transitional arrangements to be determined by September 2016.	- Retains efficiencies of the QFE model (e.g. firms can take advantage of economies of scale and removes duplication). - Ensures firm processes are robust and are providing consumers with what they need. - Costs associated with meeting, and demonstrating compliance with, conduct obligations (e.g. identifying conflicts of interest and ensuring their sales and advice processes have sufficient regard to the consumer's interest).
Registered Financial Advisers (RFAs)	- Costs associated with meeting higher competency standards. - Costs associated with obtaining a licence to provide financial advice services and preparing new disclosure material. - Detailed transitional arrangements to be determined by September 2016.	- Costs associated with meeting the conduct obligations. - Costs associated with increased disclosure requirements. - Greater credibility and professionalism.
All advisers/consumers	- Costs associated with changing systems and processes to ensure ongoing compliance with new obligations. - During the transitional phase there could be confusion to consumers (as existing terminology is replaced and businesses change their operating models to meet new standards).	- Technological innovations/robo-advice enabled so advice provided in a wider number of formats at lower cost. - Confusion and 'boundaries' created by complexity of status quo are removed – access to sensible advice conversations across a more open advice spectrum. - Access to more accurate, useful information from advisers including details of conflicts of interest. - More flexible regime supports a range of business models, with more tailored conditions. - Enables the option of tailored competency requirements or the certainty of meeting a prescribed standard.
Government (e.g. MBIE, FMA)	- Costs associated with ensuring systems can operationalise the preferred options. - Costs associated with consequential changes to the FSPR. - Costs to the FMA to produce new licensing guidance, processes, terms and conditions etc. - Costs associated with producing a new Code of Conduct.	- Fully monitored adviser population held to the same standards. - Allows more flexible risk-based monitoring (rather than having to focus on limited areas where obligations currently apply) but holding a greater population of advisers to higher standards may be more resource intensive for the FMA. - Costs associated with producing guidance.

Improve access to redress for consumers

As mentioned on page 38, we have found opportunities to improve access to fair and effective redress for consumers.

- To ensure that there are not jurisdictional differences between DRSs that limit access to redress, we are recommending that regulations be made to align certain DRS rules.
- To increase consumer awareness of DRSs and the complaint handling process, we are recommending that financial service providers be required to provide information about dispute resolution when a consumer complains. This could include information about the providers' complaints handling process as well as how to raise a complaint with the appropriate DRS.

Amend FSPR registration requirements to require a stronger connection to New Zealand

Currently a firm can register on the FSPR if it has a 'place of business' in New Zealand, regardless of where the financial service is provided. Firms 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. These firms register to provide financial services which do not require licensing or pre-vetting by a regulator. They will then use their registration offshore to give the false impression that they are regulated in New Zealand.

The recommendation to license all financial advice firms will help to reduce this issue in part, as more firms will be subject to pre-vetting before they register on the FSPR. However, this is unlikely to be sufficient in itself 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 creditors under a credit contract.

To further address this, we are recommending that entities only be eligible to register if they are (or will be):

- in the business of providing financial services, not just back-office administrative services, from a place of business in New Zealand, or
- in the business of providing financial services to New Zealanders, or
- otherwise required to be licensed under any other New Zealand legislation.

This change will make registration more difficult for offshore-controlled entities without a genuine connection, therefore making it more difficult for those entities to misuse the FSPR.

MBIE officials will continue to engage with the FMA and other interested government agencies to refine the details of these requirements. There is a risk that changes to the entities required to register could lead to unintended consequences or uncertainty. This will be mitigated by testing the recommended scope with industry, including through the Exposure Draft Bill process.

Other matters which require further consideration

Membership and proceedings of the Code Committee

We believe 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 recommended regime. However, as we are recommending that a Code of Conduct is applied universally to all who provide financial advice, it is appropriate to reconsider the membership and proceedings of the Code Committee. Therefore, if the decision is made to apply the Code of Conduct to all providing financial advice, we suggest that:

- MBIE officials reconsider the membership and proceedings of the Code Committee, and report back to the Minister of Commerce and Consumer Affairs by September 2016 with recommendations.

Compliance and enforcement tools

There are a number of compliance and enforcement tools which have not been used under the current regime, while others require significant FMA resource or are not 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.

It is important that the FMA and Financial Advisers Disciplinary Committee (FADC) have the necessary tools to encourage compliance and respond to non-compliance. We therefore recommend that:

- MBIE officials should assess the effectiveness and efficiency of the current range of compliance and enforcement tools available under the FA and FSP Acts, and report back to the Minister of Commerce and Consumer Affairs by September 2016 with our findings and further recommendations.

Dispute resolution

The dispute resolution regime appears to be functioning well, however the review process has revealed that there may be opportunities to further promote access to fair and effective redress. In particular, there is potential for the existing regulatory making powers to standardise DRS rules to improve consumer protection and ensure consumers are informed about how to make a complaint (as recommended on page 75). We further recommend that:

- MBIE officials work with the DRSs to identify what improvements may be appropriate, and report back to the Minister of Commerce and Consumer Affairs with recommendations later this year.

Transitional arrangements

Many of the changes recommended in this report will have an impact on existing financial advisers, 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, we suggest that:

- MBIE officials work with industry to consider what transitional arrangements might be appropriate, and report back to the Minister of Commerce and Consumer Affairs by September 2016 with our recommendations.

Finding a financial adviser

The review process has suggested 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, yet it is not being drawn on by people looking to access financial advice. 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. There also might be other influencing factors such as consumer apathy and low levels of financial capability.

Given that it is not possible to identify the root cause/s of this problem, nor is it clear what the role of government is vis a vis industry, we want to defer a recommended course of action until we have had the opportunity to engage with industry and consumer representatives to determine what impact the changes that Government decides to bring forward are likely to have on helping people to find advice. We also intend to discuss with industry what 'brokers' might be more usefully known as to make it clearer to consumers the services that they offer.

Misuse of the FSPR

In addition to the recommended changes to FSPR registration requirements, we believe there may be other complementary measures which could help address misuse of the FSPR and the 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. We therefore recommend that:

- MBIE officials consider complementary measures which could help address misuse of the FSPR, and report back to the Minister of Commerce and Consumer Affairs by September 2016 with our recommendations.

Other options considered but discounted

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

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

It was considered whether it was appropriate to apply fewer regulatory obligations to some activities, so long as the consumer was clearly made aware that the provider was not required to put the consumer's interests first (e.g. by labelling them salespeople and notifying the consumer). However, we considered that a lower set of standards for certain providers could 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, in addition to undermining one of the key objectives of this review.

The package of reforms we have recommended is focused on lifting conduct and competency, 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, our recommendation 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. These changes will help to ensure that consumers can be confident when engaging with all aspects of the financial advice market.

> *"All advice contains a certain amount of 'sales' pitch – there is nothing wrong with 'sales' as such as long as a customer is made aware of any limitations of the advice (i.e. the adviser can only recommend certain providers products and that there may well be better options elsewhere that the customer may want to consider). This should be a mandatory statement that is made up front (i.e. very early in the advice process) and is acknowledged by the customer by way of separate sign off, not a sign off that's part of a long-winded disclosure that most customers don't read anyway." – Options Paper consumer survey respondent*

Banning or restricting commissions

We recognise that banning commissions is a more direct way to ensure consumer protection from the risks presented by conflicted remuneration. However, we are not recommending this option in the first instance because:

- 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.
- It would not 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).

- Our recommendations address the same 'conflict of interest' issues that banning commissions would seek to address. In particular, they include:
    - introducing clear conduct obligations on all providing advice
    - improving the ability for the FMA to monitor and take enforcement action for breaches of those conduct obligations – like insurance churn
    - requiring conflicts to be disclosed clearly and consistently by all financial advisers and agents.

There is a clear trend internationally toward more direct interventions, including bans on commissions. This comes in the wake of the global financial crisis (GFC) and several major mis-selling scandals (e.g. widespread mis-selling of income protection insurance in the United Kingdom), and as behavioural economics increasingly points to the limitations of disclosure by itself to address conflicts of interest.

Given the significant risk of harming access to advice, our recommendations represent a more prudent approach in the first instance. However, we suggest that MBIE officials and the FMA closely monitor conduct and the impact of the recommendations taken forward to ensure they are sufficient.

The FMA have also indicated in their report on life insurance replacement business that they will monitor advisers, and carry out site visits where particular issues have been identified. In particular, they will be visiting advisers with high rates of replacement businesses to review their practices and examine whether churn is occurring.

The vast majority of industry submitters on the Issues Paper thought that commissions should not be banned or restricted. They are widely viewed as a legitimate form of remuneration, and submitters raised concerns that such intervention could adversely impact the accessibility of advice. Many submitters were concerned that a ban on conflicted remuneration would create an advice gap for consumers who are unwilling to pay upfront for advice. This concern is supported by an evaluation of the ban of commissions that was implemented by the Financial Conduct Authority (FCA) in the United Kingdom[34].

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[34] The FCA banned commissions as part of the Retail Distribution Review in 2013. In the FCA Financial Markets Review Final Report 2016, the FCA noted that the move to fee-based advice on retail investment products has improved transparency and ended conflicts of interest caused by a mainly commission-driven model. However, the report also notes that advice is expensive and is not always cost-effective for consumers, particularly those seeking help in relation to smaller amounts of money or with simpler needs. Some respondents to FCA consultation suggested that despite the benefits of removing 'commission' bias, the move from paying for advice via commission to paying adviser fees contributed to many people not being able to get the advice they need at a level they are willing to pay. It is also worth noting that the ban only addresses conflicts where advice is through a third-party channel. It does not address conflicts through in-house distribution channels (such as bonuses and other incentives linked to sales targets – which the FMA identified as a concern in its 2015 review *Sales and advice*).

Most submitters instead suggested that:

- anyone providing financial advice should be required to put the interests of the consumer first
- all advisers should be required to clearly disclose any conflicts of interest.

> *"We do not believe that a ban on conflicted remuneration is necessary where the adviser is under an obligation to put the interests of the client first and their disclosure statement discloses the source of their income in relation to the particular advice." – Mercer, submission on Options Paper, February 2016*

Although a large number of respondents to the Issues Paper consumer survey said they would prefer to pay a fixed fee or hourly rate over a commission fee, it was noted that this could deter people with lower levels of funds or first home buyers from seeking advice. Most other respondents to the survey said that they think commissions are acceptable, but should be fully disclosed upfront.

> *"For advice to be truly independent, ideally advisers wouldn't be paid by commission. If advisers are paid commissions they should declare what the commissions are upfront. Transparency would help consumers to gain trust in advisers. Perhaps people should be given the choice to pay a fee and have a truly independent approach or pay no fee but accept that the adviser will have some bias because of commission." – Options Paper consumer survey respondent*

> *Yes [financial advisers should be required to put consumers interests first]. But I also realise that I can't afford these services; and they get a financial reward from product providers. So in a way commissions work. It ensures advice is accessible in the market place to those who need it the most. I believe emphasis has to be placed on the ensuring the processes for the adviser and within product providers are sound and compliant; and disclosure around which products can be sold is transparent through disclosure." – Options Paper consumer survey respondent*