A Discussion Document on the Main Issues Contained in the Financial Advisers Act Review Initiative

Presented by David Whyte
Managing Director
DCW Management Ltd
July 2015

Introduction

This is intended as a discussion document highlighting the main areas of concern, and not as a comprehensive anlaysis of the FAA review initiative.

Against a background of a tight timetable the FAA was introduced largely in response to the Secondary Finance sector collapse, and the emphasis was understandably placed on the area of investments which were of more immediate concern.

In retrospect, the reaction was perhaps execssive, particularly in light of subsequent analyais which showed that approximately 70% of funds in these organisation were invested without advice.

However, the Act became reality and a regulatory regime for the financial services induustry was at last in place.

Including a 5 year review period was prudent and there does need to be some modifications as there are areas where the objectives of the legislation – and the regulations – are not being achieved.

Examining the review document in detail there are a number of questions of some detail which will attract a range of responses, but there are also some primary areas of fundamaental principle in need of debate.

These can be summarised as follows:-

Education

Designation

Standards/Code of Conduct

Sales v Advice

Remuneration

FSPR

These tend to overlap and solutions will likely be inter-related as the discussion evolves. There may well be other items that will be raised, but from my perspective, addressing these issues would go a long way to making the regulations and the industry more effective.

This is the opportunity to address the issues which the original process could not consider – the opportunity should not be wasted.

Education

The relevance of education is not lost on the stakeholders in the current Financial Advisers Act review process, and while the discussions continue, let me state an adopted position after giving the issue considerable thought.

Anyone holding himself or herself out to be a financial adviser should be qualified to give financial advice in their chosen area(s) of practice.

In the contemporary world the definition of a profession has acquired certain specific characteristics, one of which is the need to be qualified by examination. Medicine, Law, Accountancy, etc., are vocations entered by tertiary level qualification, and while a degree level entry qualification may set the bar too high currently, I believe it is an aspiration all financial advisers should hold.

Of course, this doesn't guarantee universal excellence – REDACTED TEXT– but it does point to an industry seeking to improve practitioner knowledge and expertise.

After all, nobody would consult with a part-time or unqualified heart surgeon, so why would a consumer place their financial future in the hands of someone who cannot display at least a minimum level of competency?

Prior to the last minute changes to the legislation in 2011, when we expected all advisers to be qualified, the dealer group to which I was consulting, had taken every member through Standard Set 1 and all had acknowledged the need to qualify by examination.

For those unable or unwilling, I suggest that your experience will take you through the exams – even if a measure of studying is required to back up your track record in the industry.

But this approach is not taken in isolation.

The areas under review impact on each other, and the education issue is no different, with implications for designation, remuneration, and the "Sales v Advice" issue.

But more of this later – for the meantime, promoting confidence in the adviser industry will be significantly enhanced if all those claiming the title of financial adviser are able to display at least a minimum level of competence, education, and ability.

Designation

This is likely to be contentious, particularly given the responses to Barry Read's recent post on Good Returns – some souls concerned that others will be advantaged with the potential review of the designations being considered.

In the previous section, I suggested that all financial advisers should have a minimum level of qualification in their area(s) of operation.

I also mentioned the overlaps that would inevitably occur when suggesting alternatives to the status quo.

And so it is with the education/designation areas.

Financial adviser should be a designation available and applicable to Qualified Financial Advisers only, who, by definition, offer clients a range of solutions - some product based, others not.

It is clear that the current designations, RFA and AFA, are confusing, non-descriptive, and inappropriate.

All financial advisers, suitably qualified, are designated with the post-nominal – QFA.

The Qualifying Financial Entity structure is entirely appropriate in a free commercial market, and vertically integrated organisations (product providers with aligned distribution units) should be free to operate and offer their wares to the public as legitimate operators.

But the inherent underlying desire of product providers to see what we now refer to as "QFE advisers" recommend and sell those providers' products should be reflected in those entities' re-titled designation as Licensed Sales Organisations (LSOs).

Re-designated Qualifying Financial Advisers who elect to work with LSOs should be entitled to use the post-nominal QFA, but must in their disclosure statement explain the limitations placed on them by the LSO contract into which they have entered.

Organisations such as REDACTED TEXT, etc., are not product providers, are not vertically integrated, and cannot therefore be regarded as LSOs. Those who operate under the umbrella of such organisations should be qualified and entitled to use the post-nominal as QFAs

Disclosure statements from QFAs and LSO representatives should reflect the status and function of each, thus leaving the consumer in no doubt with whom they are engaging.

I believe that this is an elegant solution to the designation issue, with only two valid descriptive designations, clearly identifying for the consumer the scope, function, and status of the individual with whom they are dealing.

Qualified Financial Advisers retain a status reflecting their function, and LSOs that do not wish to incur the significant expense attaching to the education initiative, are free to train their distributors in their in-house products to an appropriate level of competency.

As always, there has to be a trade-off somewhere to adjust the focus and maintain consistency.

In this context, agency agreements are rendered obsolete, as a now designated QFA forfeits the vesting rights to renewal commissions, in favour of allowing the consumer to control the financial aspects of the relationship, where a product-based solution provides for this type of remuneration structure.

So while QFAs dispense with agency vesting rights, those within an LSO (currently QFE) stand up to be identified as distributors of their selected provider's products, and dispense with the confusing and non-descriptive tag of QFE Adviser.

I understand that no proposal will meet with universal approval, but with the aim of simplifying, identifying, and defining, I present the proposals on designation for consideration.

Standards and the Code of Conduct

The next issue under review in this series is the standards to which intermediaries and advisers should be held accountable.

Please forgive the language if it offends, but accountability is the appropriate term in this context, as the concept of standards is critical to perception and credibility.

The standards as laid out in the Code of Conduct should apply to those advisers currently subject to the measures articulated in the document, i.e. Authorised Financial Advisers.

Continuing the theme of 'overlapping issues', may I refer you back to the "Designation" and "Education" posts that outlined the need for exclusive use of the term "Financial Advisers" being available only to those suitably qualified by education.

The trade-off in this regard is that the Code of Conduct should now apply to all newly designated "Qualified Financial Advisers" – which includes those who are currently referred to as "RFAs" who will be required to qualify by examination.

However, there will be Qualified Financial Advisers from various areas of the industry and while some parts of the Code are common to all, other parts will need to be re-drafted to cover all QFAs relating to the area of the industry in they operate.

Therefore, all Qualified Financial Advisers (QFAs) will be subject to the same Code of Conduct and the same standards.

In this way, a broader accountability is created, the consumer is provided with a clearer understanding, and the industry achieves greater credibility by defining the responsibilities of the advisers involved.

The picture is building of an appropriately structured adviser industry, but in order to give the Code definition, and in order to add to the understanding of the consumer we need to look at what constitutes advice and what constitutes a sale.

Sales v Advice

Advice is defined as giving guidance or recommendation offered with regard to prudent action.

Guidance and recommendation implies that that there is a choice of alternatives to be considered and that an opinion is offered as to the most appropriate course of action.

A sale on the other hand, is defined as the exchange of a commodity for money, and does not imply that there is a range of alternatives from which a recommended selection is made.

In the context of the evolving financial services industry regulatory environment, a distinction needs to be made between the differing functions.

While a distinction is desirable, the validity of both functions is acknowledged.

There should be no regulatory barrier to vertically integrated organisations conducting both product manufacturing and distribution functions.

However, the distribution function within such organisations should be identified as "sales" and not "advice", as the former always includes a product transaction, the latter may not.

Even where a product solution is recommended in the advice process, the consideration is exchanged for the advice received as opposed to the product purchased.

It is important not to confuse the driver of the activity in each case.

The nature of the relationship and the allegiance of the intermediary involved are critical.

In the sales activity within the vertically integrated organisation, the intermediary's primary allegiance is to the product manufacturer.

In the advice activity, the intermediary's primary allegiance is to the client – irrespective of the source of remuneration.

This allegiance is endorsed by compliance with the Code of Conduct.

The disclosure regime should require both the Sales Intermediary – identified as an Appointed Representative – and the QFA to declare the means and quantum of remuneration – salary, bonuses, fees, brokerage, or a combination of both – as well as any 'soft dollar' incentives provided.

Consistent with the concept of providing the consumer with access to the necessary information to make an informed judgement, disclosure of status, obligatory or contractual relationships, and remuneration structure, quantum and source should be included.

Remuneration

This has received much publicity of late, and the measures adopted by Australia, in the light of flawed research methodology and blatant political manipulation, should be studiously avoided in NZ.

The emotive issue of remuneration masks the underlying issue of behaviour which is addressed in the "Standards and the Code of Conduct" section above. The presence of commission does not, in itself cause 'churn' to occur, it is rather the behaviour of the intermediary toward the remuneration that is the central issue, as it is possible to abuse any system of remuneration, fees, commission, brokerage, whatever.

The FMA investigation currently being conducted into the incidence of 'churn' in NZ needs to be well defined and the appropriate measurement of actual churn accurately calculated.

From the adviser's perspective, the arrival of a regulatory regime has added significant cost, and the prospect of reduced earnings could well drive some out of the industry.

There has already been some suggestions that there are not enough qualified advisers around to provide guidance to consumers – following the Australian experience will exacerbate the lack of choice further.

From the consumer's perspective, there seems to be little evidence of any particular concern with either the remuneration structure or the amounts involved. There are a considerable number of AFAs who write risk business, and there are no reports of client objections being raised on the disclosure of commission earnings.

From the product manufacturer's perspective, commission is an acquisition cost built into the retail premium-pricing model, and if impaired – as in the recent Australian measures – a reduction in expenses would occur.

However, attractive as this may be to some Life Offices, there is a danger that inefficient companies are being forgiven their expense over-run sins to the detriment of cost-efficient manufacturers that can allocate commission to stimulate ever increasing amounts of new business, invest in new products and systems, and still offer good shareholder value.

Regulating commissions disguises the inefficiencies and prevents a free competitive marketing operating effectively.

With all QFAs having to disclose earnings, the client and the QFA should be free to negotiate the funding of the cost of accessing advice.

This may be by payment of agreed and appropriate fees; or nil fees and the commission - where applicable - meets the cost of advice; or a negotiated combination of fees and commission to meet the agreed cost.

Financial Services Provider Register

A review of the function of the FSPR is necessary. Recently, the Register has ben used inappropriately by a series of so-called overseas currency traders inviting NZ citizens to pass their foreign currency exchange requirements via these organisations that claim registration as part of their credentials.

Appreciating that there have been measures undertaken recently to eliminate this, there is a suggestion that there needs to be a more informative role for the FSPR.

At the very least, the register should contain reference to status, area of expertise and advice offered, qualifications, and a brief description of the type of services provided.

The entries are not intended as promotional but should be descriptive and inform the consumer of the necessary information to decide which service provider meets their initial requirements.