Pathfinder
Asset Management

Submission: Consultation Paper – New Financial Advice Regime

To: Ministry of Business, Innovation and Employment

Below we provide our views on 4 selected questions:

3. Do you have any other feedback on the drafting of Part 1 of the Bill?

Our views: *(1) In Part One of the Bill the defined terms "Financial Adviser" and "Financial Advice Representative" are confusing and the term "Financial Advice Representative" should be changed (2) If FARs do not have personal liability then liability at Board level should be introduced (along the lines of the Health and Safety Work Act 2015).*

Page 7 of the Consultation Paper identifies an issue with the existing regime as "unnecessary complexity is preventing adequate consumer confidence and understanding." The current AFA and RFA designations fall into this category of creating complexity. Unfortunately, the new "financial adviser" and "financial advice representative" terms are also very confusing.

We recommend adopting two entirely distinct terms that cannot be confused. The terms need to clearly show that one category is very restricted in (1) work they can do for clients and (2) personal liability to those clients. Eliminating the words "advice" and "financial" from the "financial adviser representative" is imperative – as they are not a financial adviser. We support possible titles along the lines of "product specialist" or "provider representative".

The confusion is illustrated by wording within the Consultation Paper describing the two designations. For example, it is hard to make sense of the following statements:

- *Consultation Paper page 13*: "A financial advice representative means an individual who is engaged by a financial advice provider to give financial advice; and is not a financial adviser." This description is simply confusing.
- *Consultation Paper page 18*: "Financial Advice Representative: Individual engaged by a licensed financial adviser provider to give financial advice. Not a financial adviser. Financial adviser: Individual… engaged by a licensed financial advice

provider to give financial advice." The definitions are identical except a FAR is also described as "not a financial adviser" – this just adds to the confusion.

A key feature of an FAR is that, unlike an FA, they do not have personal responsibility to their clients. This is troubling as there must be accountability. If this approach is to proceed we believe that FAR liability should follow health and safety liability - the Board should be made responsible. Liability should go beyond the financial advice provider's corporate entity.

The Health and Safety Work Act 2015 has introduced a positive duty on Boards to exercise due diligence to ensure that the organisation complies with its health and safety obligations (which leads to personal responsibility for directors). It is described as follows "*Directorship in health and safety is not about responsibility for the day-to-day granular operations of the entity. It is about ensuring appropriate systems and processes are in place to support health and safety and, critically, that there is proper resourcing and verification of health and safety at the board table" (Institute of Directors and Worksafe NZ – Health and Safety Guide March 2016)*. If the controls and processes introduced for FARs are not clear, robust and effective then there must be clear accountability. If the accountability is not at the adviser (FAR) level then it should explicitly be imposed at the Board level. If Boards are uncomfortable with this, then they can employ FAs rather than FARs.

As the Health and Safety Work Act 2015 is dealing with human life and wellbeing, the maximum Director penalty for a serious breach of due diligence duty is very significant (imprisonment for up to 5 years and/or a fine of up to $600,000). D&O insurance cannot be used to pay fines. This recognises that there is no stronger way to grow a positive workplace culture than to focus Board attention through Director liability. (Note: we are not suggesting the Board are liable for investment losses of clients through changes in market prices or through asset allocation decisions - we are suggesting liability where the financial provider does not have "*clear and effective processes, controls, and limitations relating to the financial advice that may be given*" - wording here is from page 13 of the Consultation Paper).

5. Do you agree that the duty to put the client's interest first should apply both in giving the advice <u>and</u> doing anything in relation to the giving of advice? Does this make it clear that the duty does not only apply in the moment of giving advice?

Our views: *(1) yes this duty should apply at all times (2) the words in 431H achieve this (3) language around conflicts of interest need to be tidied up*

Yes, "client's interest first" should apply not only at the time of delivering advice, but also at all times through the preparation of that advice. How can advice be appropriately prepared if during the preparation there is no duty on the adviser to put client interests at the forefront? We believe that the words in 431H ("…in giving the advice or doing anything in relation to the giving of the advice…") achieve this result.

As an aside we note that the extent of possible conflicts (the advisers "own interests or the interests of any other person") are extraordinarily broad. This should be limited to the adviser and related parties – it is difficult to construct scenarios where the interests of unrelated third parties should be considered. An obvious third party to consider as captured by this drafting is product manufacturers who are not "related" to the adviser business but are "aligned" by contract as a preferred product provider – yet it is not clear why an adviser should be considering possible conflicts of the client and that aligned (but unrelated) product provider.

6. Do you have any comments on the proposed wording of the duty that a provider must not give a representative any kind of inappropriate payment or incentive? What impacts (both positive and negative) could this duty have?

Our view: *We support the prohibition on providers offering "inappropriate" incentives, however we suggest the language should be tightened.*

The need to add this requirement points to a failure of the current "client first" obligation. If the "client first" obligation was operating effectively, then there would be no concern around provider incentives influencing adviser behaviour. However, as the Consultation Paper notes (page 8), a concern with the current regime is "…remuneration structures are incentivising advisers to push particular products which may not be appropriate for the consumer…"

The issue with the suggested 431O wording is whether the threshold is set too high for catching "inappropriate" incentives. There are 2 limbs to the definition, being it is inappropriate if:

- *"it is intended to encourage"* – this requires proving actual intent by the provider firm and will be very difficult to establish
- *"likely to have the effect of encouraging"* – this hurdle is set too high. Given inappropriate payments are seen as an existing issue, the law must set the test at a relatively low threshold so this issue does not continue. We suggest that this limb is changed to "*may have the effect of encouraging*".

Not all incentives have to be a single event (i.e. not all have to be a single cash payment or promise of an overseas trip). For this reason we query whether it should be made clear that a series of small payments or incentives over time must be looked in totality rather than separately. What are seemingly small amounts individually may ultimately be a significant influence on behaviour (this is similar thinking to how a series of individually small and insignificant payments can together amount to a "bribe" as explained on the Ministry of Justice website).

8. Do you have any other feedback on the drafting in Part 3 of the Bill?

Our views: *(1) clients need to be actually aware of limitations on advice (rather than the adviser simply taking reasonable steps to make the client aware) (2) advisers should have some form of paramount obligation to promote client interests*

Page 9 of the consultation paper states that "a client-care obligation will be introduced, requiring advisers and representatives to ensure that consumers are aware of the limitations of their advice…" We support this objective – which appears to be drafted in this explanatory section as requiring each individual consumer to actually be aware of limitations.

However, this is slightly different to how Section 431G (Duty to agree on nature and scope of advice) is drafted. 431G provides that the adviser must have "taken reasonable steps to ensure that [the client] understands any limitations on the nature and scope of the advice". This does not require the adviser to ensure that the client in front of them is actually aware – they effectively just have to take steps that could reasonably be expected to make an average client aware (this implies that the adviser will only need to provide prescribed information under 431L and not discuss the disclosure and be sure their client actually understands).

All clients need to be aware of limitations for example around the product set advised on. In our view if an adviser is not required to ensure each client actually understands this, the process may “hinder … informed decision making” (which is identified on page 7 of the Consultation Paper as an issue with the current regime).

Our second point on Part 3 of the Bill is that the duty to put client’s interest first is something of a minefield. Under the current Code this is the first obligation and is described as being “paramount”. However, this has changed in the Bill – it is not expressed as a paramount obligation and is very specific to conflict situations. The Code needs an overarching obligation of client care – whether it is expressed as “client interests first”, “promoting the interests of the client”, “acting in the client’s best interests” or something else, there needs to be an overarching principle that sets the tone for all obligations.

Some form of paramount statutory obligation is common for professionals:

- *Real estate agents* “…must act in the best interests of a client…” (Real Estate Agents Authority website).
- *DIMs providers* have a “duty to act … in best interests of clients” (Financial Markets Conduct Act section 433(1)(b))
- *Fund managers* have a duty to “act in the best interests” of unitholders (Financial Markets Conduct Act section 143(1)).

Many in the industry regard this current “client first” obligation is “aspirational” – not going as far as acting in the client’s best interests but never-the-less an obligation to make client interests paramount. The drafting of 431H has eliminated this interpretation - reducing the “client interests first” obligation as applicable only where a conflict of interest arises. If there is no conflict, then 431H has no application – this is disappointing as a wider overarching duty should be adopted.

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