

The Chair
CABINET ECONOMIC DEVELOPMENT COMMITTEE

**REVIEW OF FINANCIAL INTERMEDIARIES: FINANCIAL ADVISERS – A
NEW REGULATORY FRAMEWORK**

PROPOSAL

- 1 This Cabinet paper seeks approval for the establishment of a regulatory framework for those who provide financial advice (including mortgage brokers, insurance brokers, investment advisers and financial planners) to members of the public. The purpose of the framework is to set clear standards of practice and competency to benefit these advisers and members of the public; to allow New Zealand to better meet international regulatory standards; and to provide a firm basis for trans-Tasman mutual recognition of financial advisers.

EXECUTIVE SUMMARY

- 2 New Zealand requires competent and reliable financial advisers to play a key role in addressing information asymmetry in the financial sector.
- 3 The current voluntary or sector specific industry self-regulation of advisers is failing to ensure that advisers are accountable to the public; that members of the public have sufficient information to make informed decisions about their advisers; and that advisers have the necessary experience and expertise. New Zealand has also been assessed as only partly implementing international regulatory standards for the monitoring of financial advisers, and there is insufficient information, monitoring and compliance to provide a basis for trans-Tasman mutual recognition of advisers under the trans-Tasman Mutual Recognition Arrangement (TTMRA).
- 4 To address these matters, I propose the establishment of a regulatory framework for financial advisers who provide advice to members of the public. Under the framework, the Securities Commission and industry-based “approved professional bodies” (entities approved by the Minister of Commerce) will work together as “co-regulators” to create and monitor standards for financial advisers – the industry-based approved professional bodies will be the front line day-to-day regulators, while the Securities Commission will be responsible for the oversight of approved professional bodies and ensuring the overall health of the sector.
- 5 The proposed regulatory framework requires Cabinet approval to replace the voluntary self-regulation and existing sector specific

legislation to ensure consistency across the financial advice giving sector.

BACKGROUND

- 6 In 2004, the Minister of Commerce (then the Hon Margaret Wilson) appointed an independent Task Force on the Regulation of Financial Intermediaries (“Task Force”) to consider and report on the regulation of financial advisers in New Zealand. The Task Force considered options for reform that would enhance the quality of financial advisers and advice being provided to the public, and assist New Zealanders to make the most of their savings.
- 7 The Task Force concluded that members of the public, industry and financial markets would benefit from financial adviser specific regulation. Rather than endorsing the status quo of the current voluntary self regulatory system (not supported by the International Monetary Fund) or advocating for direct government supervision, the Task Force recommended the introduction of a co-regulatory legislative framework.
- 8 In December 2005, Cabinet agreed (in principle) to the co-regulatory model recommended by the Task Force and instructed Ministry of Economic Development officials to carry out the detailed design work, with the intention of introducing legislation in 2007. [CAB Min (05) 41/1 referring to CBC Min (05) 18/30 refers]. As part of this design work, Ministry officials released a discussion document in July 2006, to which over 140 submitters responded. These submissions, together with wider public comment on the application and content of the proposed regulation, have been used by Ministry officials in preparing the required details for the proposed framework in this paper.

PROBLEM IDENTIFICATION

- 9 The government began the review of financial advisers in New Zealand on the basis that the voluntary or sector specific industry led self-regulation of advisers was failing to ensure that advisers were accountable to the public, that advisers had the experience and expertise to match the public with appropriate products; and that members of the public were able to make informed decisions about their advisers.
- 10 Financial advisers play a key role in addressing information asymmetry in the financial sector. The market will operate efficiently only if members of the public can make informed choices about which products or product providers best suit their needs and risk levels. Members of the public often do not have sufficient expertise, time or information to make these choices unaided. Advisers give the public reasonable assurance that a product provider is being truthful and that an investment is suitable for their needs. Advisers need to have the expertise, time and information to break down the knowledge gap

between the product provider and the member of the public to match the public with products that best meet their needs and risk appetite.

- 11 Advisers currently have informal incentives placed on them to credibly vouch for the quality of advice they give. This is because their business is based on giving accurate information and they run the risk of reputational and/or economic loss if they provide misleading information.
- 12 However, the public has limited information and a limited ability to evaluate their financial advisers. Low entry requirements may allow advisers to operate off the reputations of other advisers. As well, decisions by members of the public about financial investment and savings decisions (including protection of financial assets) are so important, that informal incentives on advisers do not provide a sufficient guarantee to mitigate the risk of inappropriate financial advice. This is especially important given the increased number of New Zealanders who will be encountering significant financial decisions following the introduction of the Kiwisaver regime (commencing 1 July 2007).
- 13 New Zealand has also resolved to promote high standards of regulation to maintain just, efficient and sound markets under the "*International Organisation of Securities Commissions Objectives and Principles of Securities Regulation*" in relation to how we regulate financial advisers. In 2004, New Zealand's compliance with these "best practice" principles was assessed by the International Monetary Fund (IMF) Financial Sector Assessment Program. The resulting IMF report recommended more comprehensive regulatory oversight of financial advisers in New Zealand, through either a licensing regime, or, as a less costly option, the imposition of standards through self regulatory organisations, with monitoring by the regulator. This was on the basis that not all financial advisers in New Zealand are subject to comprehensive standards for internal organisation and operational conduct. Regulation of financial advisers would help New Zealand fully implement these best practice principles.
- 14 Consultation through the Task Force and the July 2006 discussion document has demonstrated support for change. More than seventy per cent of those who responded to the Task Force options paper agreed that change was needed in this industry. When considering the proposed regulatory framework, the majority of submissions to the discussion document approved the change from status quo and welcomed the increased standards in the industry. There were still concerns expressed by some submitters at the potential complexity and cost of the proposed regulatory framework compared with the status quo; and whether or not there was a sufficient problem in individual sectors (e.g. advice on risk insurance) to justify regulation where that product was not perceived as a savings product.

- 15 To address these concerns, the regulatory framework proposed in this paper has been simplified, compared with the model recommended by the Task Force. It is now proposed to apply to all financial advice provided to the public in New Zealand, rather than the set of different classifications of adviser (and associated obligations) recommended by the Task Force. The application of the regime to all advisers was supported by a majority of submitters and will also reduce the risk of costs associated with over-compliance or attempts to avoid the ambit of the regulation. The majority of submitters also supported broad definitions of both “financial advice” and “financial products” so that the regulatory framework is proposed to apply to advice to the public about products as well as savings and investment decisions. Overall there is sufficient support for the introduction of a new regulatory framework for financial advisers to warrant further government action in this area.

Harmonisation with Australia

- 16 Instituting the proposed framework will also assist in deepening New Zealand’s relationship with Australia, as it will set the regulatory basis for mutual recognition of financial advisers. While the TTRMA is the usual starting point for harmonisation of laws with Australia, a more tailored solution is necessary in this case because of the different approaches to licensing in each country. Therefore, the basic principle that will guide harmonisation in this area is that regulated entities will only need to fulfil a particular requirement once. This will facilitate the ability of financial advisers to operate in both countries.
- 17 The concern expressed by submitters that New Zealand was going to replicate the Australian licensing regime (which sets the Australian Securities and Investments Commission (ASIC) as the key regulator, monitor and inspector) had to be balanced against the need to have a regulatory framework which meets the equivalent Australian objectives. The Securities Commission will not be replicating the ASIC role, it will instead focus on the health of the overall industry (and oversee approved professional bodies), while approved professional bodies are responsible for the day-to-day monitoring of advisers.
- 18 Australian officials are generally receptive towards the proposed co-regulatory model. In discussions between New Zealand and Australian officials, the main matters yet to be resolved relate to ongoing monitoring of financial advisers – at a preliminary level, Australian officials were comfortable with the proposed initial competency setting for financial advisers. MED officials will continue liaising with Australian counterparts and I will report back to Cabinet if further policy decisions are necessary in relation to the proposed framework.

THE PROPOSED CO-REGULATORY FRAMEWORK

- 19 The proposed co-regulatory framework will place responsibility on approved professional bodies and the Securities Commission to regulate those who provide financial advice (including mortgage

brokers, insurance brokers and financial planners). The co-regulatory model is proposed, rather than a direct licensing regime (as adopted in Australia), as it will:

- a Meet the IMF Financial Sector Assessment Program report recommendations, which require a more comprehensive regulatory oversight of financial advisers in New Zealand, through either a licensing regime, or, as a less costly option, the imposition of standards through self-regulatory organisations, with monitoring by the regulator;
- b Leverage the industry knowledge and experience of approved professional bodies so that they can act as front line supervisors, while allowing the Securities Commission to monitor the market and approved professional bodies to ensure public accountability, and to carry out set tasks such as risk management planning in the event of a market failure; and
- c Create a regulatory framework which can be used as the basis for trans-Tasman mutual recognition of financial advisers.

20 To address the issues identified by the Task Force and by submissions on the July 2006 discussion document, I propose that Cabinet agree to a new regulatory framework for financial advisers, in particular:

- a The objectives of the framework to ensure disclosure, competency and accountability, in addition to the general Review of Financial Products and Providers objectives as listed in the accompanying “Overview” paper (generally supported by submitters);
- b Definitions of “financial adviser”, “financial advice” and “financial products” – these proposed definitions have all been broadened to reflect submissions so that “financial advice” now includes opinions, recommendations and guidance on financial products as well as investment and savings decisions given to a member of the public by an adviser, in the course of the adviser’s business; “financial product” includes investment (real) property (generally supported by submitters);
- c Statutory conduct obligations of financial advisers – advisers will be required to belong to an approved professional body; to provide all required information to the approved professional body; to exercise reasonable care, diligence, skill; and to act with integrity (generally supported by submitters);
- d Statutory disclosure obligations of financial advisers – advisers will be required to disclose: their membership of an approved professional body; qualifications and experience; membership of a dispute resolution scheme; past criminal convictions; relevant remuneration/relationship; and the type of advice given

(generally supported by submitters, on the basis that it would better inform the public about potential conflicts of interest);

- e Set roles and responsibilities for the industry-based approved professional bodies, the Securities Commission and the Minister of Commerce under the co-regulatory model – this leverages the industry knowledge and experience of approved professional bodies so that they can act as front line supervisors, while allowing the Securities Commission to monitor the market and approved professional bodies to ensure public accountability (generally supported by submitters); and
- f The approval processes for “approved professional bodies” (generally supported by submitters).

The new regulatory framework: Objectives

21 I propose that Cabinet give approval to the following objectives of the regulatory framework. These objectives were set out in the discussion document and were generally endorsed by submissions.

- a **Disclosure:** ensuring adequate disclosure of advisers’ conflicts of interests, fees and competency so that members of the public can make informed decisions about whether to use an adviser and whether to take their advice;
- b **Competence:** members of the public having advisers available that have the experience, expertise and integrity to effectively match members of the public with products that best meet their needs and risk profile; and
- c **Accountability:** advisers being held accountable for any advice given and that there are incentives for advisers to manage appropriately conflicts of interest.

22 As well, similar to all financial sector work, the aim of the regulation is the promotion of a sound and efficient financial sector in which the public have confidence in the professionalism and integrity of advisers; regulation that is well targeted and does not impose unnecessary costs; and encouraging innovative and competitive markets.

23 I propose that these objectives be agreed to as the basis for the regulatory framework for financial advisers.

APPLICATION OF THE NEW REGULATORY FRAMEWORK – DEFINING “FINANCIAL ADVISER”, “FINANCIAL ADVICE” AND “FINANCIAL PRODUCT”

24 The regulatory framework for financial advisers requires Cabinet approval to the definitions of “financial adviser”, “financial advice” and “financial product”. Clear definitions are required to limit the potential application of the regulation and to reduce the risk of over-compliance.

Financial Advice

- 25 In the discussion document, officials proposed a definition of “financial advice” that relates to advice on the buying or selling of financial products. Submitters on that paper supported a broader application of the framework, so that “financial advice” would also extend to advice about investment and savings decisions or choices on the basis that a growing area of financial advice is not “product” restricted, and that members of the public would still make financial decisions on the basis of such advice. Officials endorse this broader definition, on the basis that members of the public are unlikely to differentiate between advice on products and general advice. I therefore propose that “financial advice” would include opinions, recommendations, and guidance on the buying, selling and holding of financial products or investment and savings decisions given to a member of the public in the course of the adviser’s business.
- 26 “Financial advice” is proposed to be broad enough to expressly cover some investment seminars, certain radio broadcasts paid for by financial advisers (which have been advertised as providing advice), published material of a financial adviser, and advice designed to sell third party financial products without regard to personal circumstances.
- 27 The regulatory regime will apply where the recipient of advice is a “member of the public”, an accepted term in New Zealand’s securities legislation (defined by exclusion), which includes natural persons as well as small businesses. This will meet submitters’ concerns that financial decisions about asset protection and insurance are just as important for small businesses as for natural persons. For consistency, the same exemptions as in the Securities Act 1978 will be adopted here.
- 28 I propose that there will be some limits on the application of the framework however:
- a The definition of “financial advice” will be restricted to advice provided in the course of an adviser’s business, to prevent social conversations being included. However, advice will not necessarily be required to be delivered for reward – on the basis that those who receive pro bono advice should still be entitled to expect quality advice;
 - b “Financial advice” will be required to be more than just information; advice must be an opinion, recommendation or guidance. This will exclude the acts of collecting information from members of the public (e.g. to complete an insurance policy) and placing promotional statements on display, both matters identified by submitters as matters which should be outside the extent of the framework;

- c The transmission of factual information given by an issuer or a product provider, or guidance about the procedure for buying/selling/holding financial products will be expressly exempted from the application of the framework as this conduct will be regulated under other financial services legislation (such as the Securities Act 1978); and
 - d “Financial advice” will not be intended to capture teachers talking about savings in classes; comments on Kiwisaver for example, by IRD, Ministers, commentators, journalists, employers, public servants; “Fair Go” commentary on bank products; advice by www.sorted.org on retirement savings and choices; or regulator commentary on financial products.
- 29 I propose that the definition of “financial advice” will generally include opinions, recommendations and guidance on financial products and investment and savings decisions, given to a member of the public by an adviser, in the course of the adviser’s business.

Financial Product

- 30 Officials proposed in the discussion document that the new framework be applied to advice about all categories of financial products including debt/equity, credit and risk products and investment (real) property. This was generally supported by submitters, on the basis that it would create an anomaly to cover advice about some, but not all products (e.g. insurance). There is little risk of duplication with the Credit Contracts and Consumer Finance Act 2003 (CCCFA) in relation to disclosure for credit products as the CCCFA expressly exempts contracts with an investment element, and the financial advisers’ framework focuses only on investment and savings decisions. The main cost of having a broad definition of “financial product” is likely to be borne by industries where there is no existing regulation of advisers, although submitters concluded that the benefits outweighed the costs.
- 31 There was express endorsement by submitters for adding investment (real) property as a category of financial product on the basis that real property makes up a large part of New Zealanders’ financial decisions and retirement savings. This would not make all real estate agents “financial advisers” as the regulation would only apply to those opinions, recommendations, guidance on investment property (not primary places of residence). Submitters also supported advice about other tangible products (e.g. gold bullion), being included in this regime, where there was an investment and savings element.
- 32 Submitters did not support an exemption for advice on “well-known” types of financial products (e.g. car insurance) on the basis that the point of any consumer-based legislation was to protect those members of the public who are not familiar with the products. Officials had raised this possibility in light of similar legislation in the Securities Markets Act 1988. The majority view was that even “simple” products have

complex elements which are not well understood (eg, how much house insurance is required); that conflicts of interest still exist in providing advice on such products; that any exemption would lead to uncertainty and mechanisms to avoid regulation; and that complaints to the Insurance and Savings Ombudsman focus on the less complex (but more common) products. Officials support this position for those reasons.

- 33 I therefore propose that the definition of “financial product” include debt/equity, credit and risk products, investment (real) property investment property and other tangible products where there is an investment and savings element.

Financial Adviser

- 34 Officials originally proposed different categories of financial advisers to ensure that costs were borne by appropriate parts of the financial sector, and on the basis of work done by the Task Force. A “financial adviser” is an entity who gives financial advice on financial products and investment and savings decisions to members of the public. However, there were high levels of submitter concern at the classification of “financial adviser” into “information only”, “product marketer” and “high level adviser”. This was on the basis that members of the public and advisers would not understand different levels of advice giving; that there would be unnecessary over-compliance or attempts at regulatory avoidance, and that the highest costs would be borne by the independent advisers who provide advice on a broad range of options for members of the public. Officials agree. I therefore propose there will be no separate categorisation of advisers, on the basis that it would be fairer to share the costs across the whole industry, rather than those costs being borne by those advisers who chose to advise on a range of products.
- 35 Given this, I also propose the term “intermediary” be dropped in favour of the term “adviser” as this more accurately reflects the focus of regime, the function of an adviser and is a term more commonly understood and recognised. I have used this phrase throughout this paper. I propose that officials highlight the change of term to stakeholders as part of the communication work following the release of the Cabinet paper.
- 36 Regardless of whether an adviser provides advice on one or more products, or whether or not an adviser only sells simple, or complex products, all financial advisers will be covered. I propose a publicly searchable register of financial advisers will be maintained, using information provided by approved professional bodies. This information will be available through the Companies Office as a searchable “notice board” of financial advisers. This is because it is important consumers are able to search and verify the professional status of a financial adviser as a member of an approved professional body.

- 37 In the discussion document, officials asked whether the framework should apply to either businesses or individuals or both. Submitters were mixed in their response – some large organisations were keen to maintain set standards for their employers themselves, without passing that obligation onto individual employees; some individuals were keen that the framework did not expect all advisers to meet business standards (on the basis that the Australian model did this, and resulted in individual advisers leaving the industry); others were concerned at the risk of regulatory duplication if both the employer and the employee have to meet set statutory requirements.
- 38 To address these matters, I propose that the framework will primarily apply to individual advisers. However, I also propose that financial advice-giving businesses will have the **choice** to join approved professional bodies as corporate members, and take over responsibility for their individual employees attaining the approved professional body standards. A requirement of this “corporate membership” will be that the corporate member satisfies the approved professional body that it has the necessary processes to ensure the competency and integrity of its employees. This will also help address the minority view that businesses should be treated as approved professional bodies for the purposes of the framework – while business are unlikely to be approved professional bodies (refer paragraph 52), they will still be able to retain responsibility for their competency setting and monitoring, provided that, at a minimum, they match the approved professional body standards.
- 39 Officials proposed that an express exemption be made for lawyers and chartered accountants where they are providing financial advice which is necessary and ancillary to legal advice or accounting advice. While this was generally supported by submitters, Ministry officials propose to work further with Ministry of Justice officials to assess the extent to which lawyers should be exempt from the regime or whether it would lead to dual regulation, and if additional regulation is desirable, to assess whether that additional regulation can be achieved through the vehicle of the Lawyers and Conveyancers Act 2006 or the proposed financial adviser legislation. I intend to report back to Cabinet by 31 July 2007 on this.
- 40 On the basis of the broad application of these definitions, I propose that the definition of “financial adviser” apply to those entities who give financial advice (see definition above) on financial products (see definition above) and investment and savings decisions to members of the public. I also propose that the Securities Commission be granted the power under regulation to make rules exempting classes of financial advice, financial product and financial advisers.

STATUTORY CONDUCT AND DISCLOSURE OBLIGATIONS

- 41 Officials proposed that financial advisers would be subject to statutory conduct and disclosure statutory requirements.

- 42 Submitters generally approved of the following proposed statutory conduct standards, which financial advisers would be required to meet prior to providing financial advice:
- a To belong to an approved professional body and to provide all required information to the approved professional body;
 - b To exercise reasonable care, diligence, skill and integrity.
- 43 Officials proposed that there would be a general restriction on conduct that is deceptive, misleading or confusing. Submitters did not support this, on the basis that the obligations already existed in the Fair Trading Act 1986. While I can appreciate that it may cause confusion as to whether this regulatory framework or the Fair Trading Act should apply, I propose that the Commerce Commission and the Securities Commission will work together to ensure that resources are not duplicated in investigating concerns raised by members of the public. A specific duty on financial advisers would be consistent with the approach taken under other securities legislation, which complements the general coverage of the Fair Trading Act. Officials had also proposed that there be a specific requirement that advisers comply with the Act but, in light of comments that this was an implied part of all legislation, this has been removed.
- 44 Officials proposed that advisers who gave advice across a range of financial sector roles (e.g. mortgage brokers, insurance,) would only be required to belong to one approved professional body, but that an adviser could belong to more than one if desired. This is similar to the status quo where advisers often choose to belong to more than one voluntary organisation. This was supported by a majority of submitters. I propose that the Securities Commission will develop guidelines to assist approved professional bodies in dealing with cross sector practice.
- 45 Disclosure is a tool to alert members of the public to potential conflicts of interest that may have an impact on the financial advice, and act accordingly. Disclosure also ensures that the member of the public is made aware of what services the adviser will perform and the type of advice that will be given. It is assumed that the recipient will deal reasonably with the information disclosed, hence, to be of most use, disclosure is required to be relevant, short and easy to understand.
- 46 Officials proposed that the following disclosure obligations would apply to all members of an approved professional body, to be made in writing prior to advice being given: membership of approved professional body, and which approved professional body; experience and qualifications; access to dispute resolution; past relevant criminal convictions; relevant remuneration / relationship; type of advice given. A small number of submitters considered that disclosure of commission was not required where the product provider paid the commission fee directly to the adviser for the sale of products. The majority of

submitters disagreed, on the basis that there was still potential for conflicts of interest to arise, even when the recipient of the advice is not the one directly rewarding the adviser. I therefore propose to retain the disclosure obligations originally suggested, which is consistent with the disclosure now required under the Securities Markets Act 1988.

- 47 Officials propose that corporate members of approved professional bodies be responsible for disclosure for some employees, to avoid call centre employees and bank tellers having to provide full disclosure in writing prior to giving advice. This is on the basis that the cost to organisations of providing this information would not be sufficient to justify the benefit to the consumer of knowing, for example, the exact qualifications of every bank teller. Instead, it is proposed that corporate members would take on responsibility for disclosing competency levels and remuneration levels where these are set by the entity or groups such as tellers or call centre staff. This would apply to a small group of disclosure obligations, and I propose that this exemption is addressed through regulation.
- 48 Officials also proposed that advisers could use a “health warning” in the event that any advice was based on incomplete or inaccurate information. While many practitioners liked this model, regulatory agencies did not, on the basis that advisers should not be able to contract out of providing a reasonable standard of service. I agree with this concern, and note that concerns at over-compliance can be addressed by the express conduct standards of only requiring a “reasonable standard” of care, skill and diligence from advisers, rather than the higher standard of acting in the “best” or “only” interests of the member of the public.

Handling money

- 49 In its initial assessment of the financial adviser roles carried out in New Zealand, the Task Force identified a role of “execution only” adviser – those advisers who execute instructions for their clients (the member of the public for whom they are acting). Officials proposed that those financial advisers, who handle money on behalf of clients, would be subject to the following conduct obligations, to:
- a Hold that money or property on trust for the client in a separate trust account with (e.g.) a registered bank;
 - b Describe that account as a trust account;
 - c Not use funds in the account as security for any entity other than the client;
 - d Account to the client for that money/property;
 - e Keep a record of the transactions on that account; and

- f Not use that account for the advisers' own funds.
- 50 In addition to the conduct obligations, those financial advisers who handle money on behalf of clients would be subject to disclosure obligations in relation to:
- a How payment or delivery of money or property should be made to the adviser;
 - b Whether or not the money or property received by the adviser will be held on trust for the client, and will be so held until it is disbursed or distributed in accordance with the client's instructions;
 - c What records will be kept by the adviser in relation to the money or property, whether the client has access to those records, and the terms of that access;
 - d Whether or not the receipt, holding, and disbursement of the money or property, by the client will be audited by an auditor and, if so, the name of the auditor; and
 - e The extent, if any, to which the adviser can use the money or property for the benefit of the adviser or any other person.
- 51 Submitters to the discussion document noted that lawyers, accountants, real estate agents, and insurance brokers all handled client money. Some but not all of these professions will be financial advisers. Rather than developing two sets of legislation to cover similar roles – one to place obligations on financial advisers, the other to place obligations on those who deal with client money, it was proposed that only those financial advisers who handle client money will be subject to additional conduct and disclosure obligations. Under these additional obligations officials proposed that the Securities Commission have the responsibility for monitoring advisers against these additional conduct requirements.
- 52 I propose that those financial advisers, who handle money on behalf of clients, would be subject to these statutory conduct and disclosure obligations, and that the Securities Commission will be responsible for monitoring against those obligations.

Enforcement of statutory conduct and disclosure obligations

- 53 Officials proposed that the regulatory framework would contain statutory penalties and enforcement mechanisms for breach of the above statutory duties. The Securities Commission would be the entity responsible for this enforcement, to avoid approved professional bodies taking on responsibility for prosecution. Submitters supported officials' views that both criminal and civil penalties would apply for breaches of the statutory duties. The Securities Commission is already empowered

to apply to the Court for criminal penalties for investment advisers, one of the subsets of financial advisers (refer Securities Markets Act 1988).

- 54 I propose that the Securities Commission be granted the power under the regulatory framework to enforce the penalties and enforcement mechanisms for breach of the above statutory duties, including the power to make rules exempting classes of advisers from conduct and disclosure statutory obligations.

Co-REGULATORY MODEL

Role of an approved professional body

- 55 Officials propose that the regulatory framework should set minimum standards for approved professional bodies. The majority of submitters agreed, wanting approved professional bodies to meet minimum corporate governance standards, particularly to ensure that product providers could not be approved professional bodies. I propose that, to be an approved professional body, an entity will be required to:

- a Have the capacity to carry out the purposes of governing laws, regulations and approved professional body rules;
- b Enforce compliance by its members and associated persons with those laws, regulations, and rules;
- c Treat all members of the approved professional body and applicants for membership in a fair and consistent manner (including accepting corporate memberships);
- d Develop rules that are designed to set standards of behaviour for its members and to promote public protection;
- e Submit to the Minister its rules for review and approval, and ensure that its rules are consistent with any public policy directives made by the Securities Commission;
- f Co-operate with the Securities Commission and other approved professional bodies to investigate and enforce applicable laws and regulations;
- g Enforce its own rules and impose appropriate sanctions for non-compliance;
- h Assure a fair representation of members in selection of its directors/administration of its affairs;
- i Avoid rules that may create uncompetitive situations; and
- j Avoid using the oversight role to allow any market participant unfairly to gain advantage in the market.

- 56 These minimum standards are adapted from those set by the International Organisation of Securities Commissions (IOSCO) for “self regulatory organisations” and will help set limits on any behaviour which is uncompetitive or not in the best interests of the regulatory framework. There will be no express restriction in the regulatory framework on lobbying, as restricting all lobbying would, in its broadest sense, restrict or limit an advocacy role for approved professional bodies.
- 57 I propose that the approved professional body will also have the responsibility to:
- a Maintain a register of its members and to pass this information to the proposed publicly searchable “notice board” of financial advisers run as part of the Companies Office register of financial service providers (refer to the accompanying paper “Registration of Financial Service Providers”);
 - b Set entry level competency standards;
 - c Set ongoing standards;
 - d Monitor members (on a risk based approach sufficient to enforce compliance);
 - e Carry out discipline for breaches of approved professional body rules (with sufficient powers to investigate possible breaches);
 - f Participate in a dispute resolution process (as set out in the accompanying paper entitled “Consumer Dispute Resolution and Redress”) and
 - g Report to the Securities Commission on its own corporate governance, as well as financial advisers’ behaviour.
- 58 In effect, the approved professional body will be applying a “fit and proper person” test for members by setting competency and conduct standards. This is similar to the standards imposed by ASIC prior to granting an Australian financial services licence. Submitters were generally comfortable with the responsibilities of the approved professional body and provided comments on how different approved professional bodies could structure themselves to carry out the separate tasks.

Role of the Securities Commission

- 59 Officials proposed that the Securities Commission would:
- a Pass recommendations to the Minister of Commerce on approved professional body applications;

- b Retain the authority to inquire into matters affecting members of the public and/or the market. This includes enforcing the statutory conduct and disclosure obligations through civil and criminal penalties (refer enforcement, at paragraph 53 above); evaluating the performance of an approved professional body, and have the necessary powers to obtain information from an approved professional body;
 - c Take over the responsibility for an inquiry from an approved professional body where the Securities Commission is satisfied that the powers of an approved professional body are inadequate for inquiring into or addressing particular misconduct or where a conflict of interest necessitates it;
 - d Direct the approved professional body to adhere to its rules; and
 - e Ensure the overall health of the sector.
- 60 Officials also proposed that the Securities Commission could have a role as a default frontline regulator (in the event that no approved professional body was operating in a particular area). The majority of submitters did not support this on the basis it would create too large a conflict for the Securities Commission, to be both the overall regulator of the market, and as well, to have a part in the day to day monitoring of advisers. To address this, in the event that there is no approved professional body for a particular sector of the market, I propose that officials work with industry to extend the existing capabilities of existing bodies, or to promote the establishment of an appropriate body in the transition period of this regulatory framework. The transition period for the regulatory framework may extend through to 2010 to allow for the introduction for all matters under the RFPP. This should guard against concerns that there will not be a suitable body to which an adviser can belong.

Anti-money laundering supervisory framework

- 61 The Ministry of Justice is leading the FATF-Compliance Review, which will recommend legislative and regulatory reforms to improve New Zealand's compliance with the Financial Action Task Force 40 Recommendations on Money Laundering and 9 Special Recommendations on Terrorist Financing.
- 62 The Ministry of Justice is proposing through its public discussion document (*Anti-Money Laundering and Countering the Financing Of Terrorism: Supervisory Framework, October 2006*) that the Securities Commission should be the anti-money laundering supervisor, and carry out the fit and proper character evaluations for directors and senior managers, for the parts of the financial sector that it regulates (this would include the regulation and supervision of any financial advisers covered by the new Anti-Money Laundering legislation). The registration regime proposed in the accompanying paper would also

apply to those financial advisers in relation to displaying a publicly searchable list of approved professional body members. Papers seeking policy approvals in relation to the anti-money laundering supervisory framework will be submitted to Cabinet later this year.

Role of the Minister of Commerce

- 63 The role of the Minister under this framework is proposed to be similar to the role of the Minister in approving securities exchanges under the Securities Markets Act 1988. Particularly, the Minister will have the set role of considering applications from entities who wish to be approved professional bodies; whether or not to direct approved professional bodies to change their rules; whether or not to de-register an approved professional body; all on the recommendation of the Securities Commission. The role of the Minister will help reduce the risk of conflict arising between the Securities Commission and approved professional bodies in the structure of the proposed co-regulatory model.
- 64 Both the Minister and the Securities Commission will focus on the market and approved professional bodies to ensure public accountability, so that approved professional bodies can leverage the industry knowledge and experience to act as front line supervisors. Ministry of Economic Development officials will provide support to the Minister of Commerce in this role.

Approval Process

- 65 Officials proposed that approved professional bodies be subject to an approval process. There was general support from submitters for the following proposed process:
- a A potential approved professional body will prepare its rules, governance structure and processes and consult with the Securities Commission on the proposed content of the rules;
 - b The potential approved professional body submits its rules to the Minister;
 - c The Minister refers the rules to the Securities Commission for a recommendation within a set time. The Securities Commission bases its recommendation on whether or not the approved professional body rules and processes would allow the approved professional body to meet the IOSCO criteria;
 - d The Minister will then, within a reasonable time period, consider whether or not to approve the application to be an approved professional body, taking into account the IOSCO criteria, the Securities Commission's recommendation, and public interest concerns. The Minister then advises the approved professional

body whether or not they will be registered as an approved professional body; and

- e If the application is unsuccessful, the applicant can choose to start the application process again through consultation with the Securities Commission on the content of the rules.

66 I propose that the above approval process for approved professional bodies be endorsed.

OTHER MATTERS

67 Introducing a new framework will not itself be sufficient to ensure that the framework objectives are met. A key part of this work relies on consumer education. Consumer education was supported by an overwhelming number of submissions, provided that approved professional bodies should not be solely responsible for this work, and provided that this was not an express role for the approved professional body. Further work is required on the best way for government-led work on public education on financial advisers and their role.

CONSULTATION

68 In preparing these policy recommendations, Ministry officials worked through more than 140 submissions on the discussion document proposal and met with self regulatory bodies, consumer representatives, industry representative groups, advisers, and large employers of advisers on a regular basis to discuss the issues in detail. In addition, Ministry officials have met with a number of stakeholders to talk further through their submissions and have kept submitters up to date on progress through email and web updates. Ministry officials propose meeting with key groups to discuss this paper following Cabinet decisions.

69 In some key areas, there have been split views from submitters. This reflects the large number of submitters and the broad range of financial advice giving that this framework will address. That means that it is likely that the proposed regulations will still be contentious for some parts of the advice-giving industry. Ministry officials have sought cost/benefit information from industry constantly throughout this process to ensure that compliance costs are minimised, but in some matters, the information provided has not been comprehensive.

70 The accompanying "Overview" paper outlines the agencies consulted in the development of these papers.

FISCAL IMPLICATIONS

- 71 The fiscal implications of the proposals are discussed in the accompanying paper “Reviews of Financial Products and Providers and Financial Intermediaries – Overview Paper”.

HUMAN RIGHTS AND BILL OF RIGHTS

- 72 The following issues arise in relation to Human Rights or Bill of Rights; disclosure of criminal convictions; and criminal penalties arising from breach of statute.
- 73 Officials from the Ministry of Economic Development and Ministry of Justice will work together to ensure that the regulatory framework is consistent with the Bill of Rights Act. A final view as to whether the proposals will be consistent with the Bill of Rights Act will be possible once the legislation has been drafted.

LEGISLATIVE IMPLICATIONS

- 74 The accompanying “Overview” paper outlines the legislative implications of these proposals.

REGULATORY IMPACT ANALYSIS

- 75 The Ministry of Economic Development (MED) confirms that the Code of Good Regulatory Practice and the regulatory impact analysis requirements, including the consultation RIA requirements, have been complied with. A RIS was prepared and MED considers the RIS and the RIA analysis undertaken to be adequate. A draft RIS was circulated with the Cabinet paper for departmental consultation purposes.

RECOMMENDATIONS

It is recommended that the Committee:

- 1 **Note** that the aim of the financial adviser regulatory framework is the promotion of a sound and efficient financial sector in which the public have confidence in the professionalism and integrity of advisers; regulation that is well targeted and does not impose unnecessary costs; and the encouragement of innovative and competitive markets.
- 2 **Note** that in December 2005 Cabinet agreed (in principle) to the introduction of a co-regulatory model for financial advisers, where financial advisers will be regulated by approved professional bodies (industry based groups approved by the Minister of Commerce) and the Securities Commission, and directed the Ministry of Economic Development to carry out the detailed design work [CAB Min (05) 41/1 referring to Cab Min (05)18/30].

- 3 **Note** that in July 2006 Cabinet agreed to the release of a discussion document [CAB Min (06) 24/4 refers] presenting detailed options under the co-regulatory model for public comment, namely:
 - 3.1 The application of the legislation
 - 3.2 The definitions of "financial intermediary", "financial advice" and "financial product"
 - 3.3 Different classes of financial intermediaries and how these different classifications could work in practice
 - 3.4 Legislative conduct standards for financial intermediaries
 - 3.5 Disclosure obligations on financial intermediaries
 - 3.6 The co-regulatory model
 - 3.6.1 The powers of the Securities Commission
 - 3.6.2 The powers of the Minister
 - 3.6.3 The powers and rules of the "approved professional bodies"
 - 3.6.4 Co-regulatory processes
- 4 **Confirm** Cabinet's previous in principle decision and agree to the introduction and establishment of a co-regulatory framework for financial advisers
- 5 **Agree** to the objectives of the regulatory framework:
 - 5.1 Disclosure – disclosure of advisers' conflicts of interests, fees and competency so that members of the public can make informed decisions about whether to use an adviser and whether to take their advice;
 - 5.2 Competency – members of the public have advisers available that have the experience, expertise and integrity to effectively match a members of the public with products that best meet their needs and risk profile; and
 - 5.3 Accountability – advisers are held accountable for any advice given and that there are incentives for advisers to manage appropriately conflicts of interest.
- 6 **Agree** to a definition of "financial advice" in the regulatory framework to include opinions, recommendations and guidance on financial products as well as investment and savings

decisions, given to a member of the public by an adviser, in the course of the adviser's business.

- 7 **Agree** to a definition of "financial product" in the regulatory framework to include debt, equity, credit, risk products as well as investment real property and other tangible products where there is an investment and savings element.
- 8 **Agree** to a definition of "financial adviser" in the regulatory framework to apply to those entities who give financial advice on financial products and investment and savings decisions to members of the public.
- 9 **Direct** Ministry of Economic Development and Ministry of Justice officials to work together:
 - 9.1 To assess the extent to which lawyers should be exempt from the regime and whether additional regulation of lawyers is desirable;
 - 9.2 If additional regulation is desirable, to assess whether that additional regulation can be achieved through the vehicle of the Lawyers and Conveyancers Act 2006 or the proposed financial advisers legislation; and
 - 9.3 To report back on this matter by 31 July 2007.
- 10 **Agree** to conduct and disclosure obligations for financial advisers in the regulatory framework.
- 11 **Agree** to set roles and responsibilities for approved professional bodies, in the regulatory framework, particularly for approved professional bodies to:
 - 11.1 Leverage the industry knowledge and experience to act as front line supervisor;
 - 11.2 Meet corporate governance standards adapted from the International Organisation of Securities Commissions (IOSCO) principles for self regulatory organisations; and
 - 11.3 Carry out the following functions: to maintain a register of its members and to pass this information to the proposed publicly searchable register of financial advisers; set entry level standards; set ongoing standards; monitor members (on a risk based approach sufficient to enforce compliance); carry out discipline for breaches of approved professional body rules (with sufficient powers to investigate possible breaches); participate in a dispute resolution process and report to the Securities Commission on its own corporate governance as well as financial advisers' behaviour.

- 12 **Agree** to set roles and responsibilities for Securities Commission in the regulatory framework, particularly for the Securities Commission to:
- 12.1 Monitor the market and approved professional bodies to ensure public accountability;
 - 12.2 Have the power under the regulatory framework to make rules exempting classes of advisers from the conduct and disclosure statutory obligations;
 - 12.3 Pass recommendations to the Minister on approved professional body applications;
 - 12.4 Retain the authority to inquire into matters affecting members of the public and/or the market (includes enforcing the statutory conduct and disclosure through civil and criminal penalties; evaluating the performance of an approved professional body, and having the necessary powers to obtain information from an approved professional body);
 - 12.5 Take over the responsibility for an inquiry from an approved professional body where the Securities Commission is satisfied that the powers of an approved professional body are inadequate for inquiring into or addressing particular misconduct or where a conflict of interest necessitates it;
 - 12.6 Direct the approved professional body to adhere to its rules; and
 - 12.7 Ensure the overall health of the sector.
- 13 **Agree** to set roles and responsibilities for Minister of Commerce in the regulatory framework, particularly for the Minister, on the recommendation of the Securities Commission, to consider:
- 13.1 Applications from entities who wish to be approved professional bodies;
 - 13.2 Whether or not to direct approved professional bodies to make change their rules; and
 - 13.3 Whether or not to de-register an approved professional body.
- 14 **Agree** to the approval processes for “approved professional bodies” under which the Minister will approve applications on the recommendations of the Securities Commission.

- 15 **Agree in principle** that the proposed regulatory framework should harmonise with Australia so as to facilitate the ability of financial advisers to operate in both New Zealand and Australia.
 - 15.1 **Direct** the Ministry of Economic Development to continue liaising with Australian officials and report back to Cabinet if further policy decisions are necessary.
- 16 **Invite** the Minister of Commerce to issue drafting instructions to Parliamentary Counsel Office to give effect to the above recommendations.
- 17 **Agree** to delegate to the Minister of Commerce the power to make decisions on minor issues that arise during the drafting process.

Hon Lianne Dalziel
Minister of Commerce

Regulatory Impact Statement

EXECUTIVE SUMMARY

Financial advisers play an important role in helping New Zealanders make good financial and investment decisions. New Zealand requires competent and reliable financial advisers to provide members of the public with information about the financial sector.

The current voluntary/sector specific regulation of advisers (the status quo) is failing to ensure that all advisers are accountable to the public; that members of the public are able to make informed decisions about their advisers; and that advisers have the necessary experience and expertise. New Zealand only partly meets international regulatory standards for the monitoring of financial advisers and there is insufficient information, monitoring and compliance to provide a basis for trans-Tasman mutual recognition.

As previously agreed by Cabinet (in principle), the preferred option to address these problems is to have the Securities Commission and industry-based “approved professional bodies” (APBs) as “co-regulators”, creating and monitoring mandatory standards for financial advisers who give advice to members of the public on financial products and investment and savings decisions. This paper discusses the preferred co-regulatory model as well as key detailed design issues relating to the coverage of the regulatory regime, specifically definitions of financial product, advice and adviser; conduct and disclosure requirements; and the powers of the Securities Commission, Minister of Commerce and the APBs.

ADEQUACY STATEMENT

The Regulatory Impact Analysis Unit has reviewed the RIS and considers the RIS is adequate according to the adequacy criteria.

STATUS QUO

Under the status quo, in New Zealand in 2001, approximately 7,836 people described themselves as “financial advisers”; 2,817 as “financial dealers or brokers” and 3,840 as “insurance representatives”. According to the New Zealand Law Society, there are 9,053 barristers and solicitors and according to Ministry of Justice officials, there just over 22,000 real estate sales people. All these people may be “financial advisers” under this review.

Financial advisers are currently subject to a regulatory environment which involves a mix of generic law relating to financial advisers (including relevant generic legislation and common law), relevant legislation with a consumer protection focus, sector-specific legislation, and voluntary sector-specific self-regulatory organisations. For example, financial advisers are subject to sector specific law or rules, such as the Securities Markets Act 1988 which applies to advisers who give investment advice, or the NZX Rules which apply to those financial advisers who wish to be NZX Advisers.

Some advisers choose to belong to voluntary self-regulatory organisations which have codes of conducts and disciplinary procedures. These include the Institute of Financial Advisers (1400 members); the Professional Advisers Association (530 members); the Insurance Brokers Association of New Zealand (180 member firms, employing about 2200 staff); and the New Zealand Mortgage Brokers Association (1000 members). Advisers can choose to belong to more than one organisation.

The problem with the status quo is that the voluntary or sector specific industry led self-regulation of advisers is failing to ensure that advisers are accountable to the public, that advisers have the experience and expertise to match the public with appropriate products; and that members of the public are able to make informed decisions about their advisers. Advisers currently have informal incentives placed on them to credibly vouch for the quality of advice

Consumers lack sufficient mechanisms to seek redress or deal with conflicts (for example, consumers are not aware of the voluntary dispute resolution methods or that there is a limit to the matters with which the Banking Ombudsman and Insurance Ombudsman can deal). It is difficult to stop negligent or unethical financial advisers practising or to rely on voluntary standards to ensure that advisers are acting ethically or managing conflicts of interests appropriately. Low entry requirements may allow advisers to operate off the reputations of other advisers. As well, decisions by members of the public about financial investment and savings decisions (including protection of financial assets) are so important, that informal incentives on advisers do not provide a sufficient guarantee to mitigate the risk of inappropriate financial advice. This is especially important given the increased number of New Zealanders who will be encountering significant financial decisions following the introduction of the Kiwisaver regime (commencing 1 July 2007).

New Zealand has also resolved to promote high standards of regulation to maintain just, efficient and sound markets under the "*International Organisation of Securities Commissions (IOSCO) Objectives and Principles of Securities Regulation*" in relation to how we regulate financial advisers. In 2004, New Zealand's compliance with these "best practice" principles was assessed as only "partial" by the International Monetary Fund (IMF) Financial Sector Assessment Program. The resulting IMF report recommended more comprehensive regulatory oversight of financial advisers in New Zealand, on the basis that not all financial advisers in New Zealand are subject to comprehensive standards for internal organisation and operational conduct. There is no current regulatory basis for mutual recognition of financial advisers with Australia as voluntary standards are not sufficient to allow a NZ adviser to practice in Australia.

OBJECTIVES

The objectives are:

- **Disclosure:** ensuring adequate disclosure of advisers' conflicts of interests, fees and competency so that members of the public can make

informed decisions about whether to use an adviser and whether to take their advice;

- **Competence:** members of the public having advisers available that have the experience, expertise and integrity to effectively match members of the public with products that best meet their needs and risk profile; and
- **Accountability:** advisers being held accountable for any advice given and that there are incentives for advisers to manage appropriately conflicts of interest.

As well, similar to all financial sector work, the aim of the regulation is the promotion of a sound and efficient financial sector in which the public have confidence in the professionalism and integrity of advisers; regulation that is well targeted and does not impose unnecessary costs; and encouraging innovative and competitive markets.

ALTERNATE OPTIONS

In October 2004, the Minister of Commerce appointed an independent Task Force to consider and report on New Zealand's regulation of financial advisers. The Task Force concluded that members of the public, industry and financial markets would benefit from financial adviser specific regulation. The Task Force recommended that government and industry work together to introduce a co-regulatory framework under which financial advisers would be subject to enhanced standards, sanctions, disclosure, dispute resolution and enforcement procedures.

In 2005, Cabinet considered the following alternate options (CAB Min (05) 41/1 referring to CBC Min (05) 18/30) refers):

- Enhanced self-regulation. This option refers to a voluntary system where industry develops its own standards and dispute resolution and enforcement mechanisms, but these are backed by legislation (for instance, legislative name protection for a brand developed by the industry). This option is not to be the most effective mechanism for ensuring that the interests of all parties (including consumers) are reflected in the operation of the regulatory system as it still relies on sufficient cohesion within different sectors of the industry to ensure widespread voluntary inclusion within the system. Without mandatory standards it can be difficult to stop negligent or unethical financial advisers practising in an industry, or to ensure ongoing active monitoring of compliance with such voluntary standards.
- Direct government supervision. Under this option, the government would be the entity that approves whether or not a person/business could be a financial adviser, with regulation by way of licensing or registration, without industry involvement. This option was not preferred as, in relation to financial advisers, different sectors of the financial advice industry have already developed their own standards, dispute resolution and enforcement mechanisms that are appropriate to, and recognised by,

different sectors, and it would make sense to utilise these in the regulation of financial advisers, with government involvement required only in relation to these industry bodies, and not in relation to each and every financial adviser.

Alternate options under the co-regulatory model

The co-regulatory model is the preferred overall option over enhanced self regulation or direct government supervision. Cabinet has provided in principle support for the co-regulatory model (CAB Min (05) 41/1 referring to CBC Min (05) 18/30 refers). Cabinet agreed in principle that, subject to some detailed design issues, the co-regulatory framework should have the following features:

- a That there would be industry-led approved professional bodies and a government regulator which would work together to regulate financial advisers;
- b The government regulator would be the Securities Commission;
- c Financial advisers would be subject to enhanced disclosure obligations when providing financial;
- d Legislation would set a number of conduct standards for financial advisers;
- e Financial advisers would be subject to dispute resolution and disciplinary procedures.

Cabinet directed the Ministry of Economic Development to undertake detailed design work on this co-regulatory model and report back with options, recommendations and final policy decisions for the co-regulatory model. This paper provides the analysis of the alternate and preferred options under the co-regulatory model relating to coverage and definitions of financial product, advice and adviser; conduct and disclosure requirements; governance of APBs and relationship with Securities Commission.

Alternate options - coverage and definitions of product, advice, adviser

Product: There are alternate ways to describe the coverage and definitions of financial product. The Task Force recommended that some 'simple' financial products be excluded from the regulatory regime (e.g. a short tail risk product like car insurance), and that advice and marketing in relation to tangible property (other than investment real property) be excluded. This is not preferred as it would involve increased time and effort of advisers and regulators to determine which advice and which products would be exempted, including ongoing work for government officials to ensure that the products described in legislation were still "simple" or had enough public knowledge.

Advice: There are alternate ways to define "financial advice". Advice could only be defined as advice relating to the financial products (and not broader investment and savings decisions making); or advice that takes into account

the personal circumstances of the consumer. This is not preferred because it would not include all investment and savings decisions made by members of the public, such as retirement planning, financial management, estate planning. Advice not related to products is a growing part of the financial advice giving industry. Restricting the regime to advice that takes into account the personal circumstances of the consumer would not include advice giving situations identified by the Securities Commission as of key concern where consumer protection is most needed (e.g. investment seminars).

Classes of advisers: The Task Force recommended that advisers be separated out into different classes to recognise the varying roles of a financial intermediary (i.e. high-level advisers, product marketers, and information/execution only advisers). Different obligations on different sectors were also considered. Different obligations would attach to each class. This is not preferred because of the difficulty in classifying the roles.

The costs and risks of these alternate options include: the possible distortion of the market to encourage advisers to only advise on exempt products, and not the longer term, less well known savings and investment choices; costs on consumers through mistaken assumptions that all advice, not just a subset of advice, is covered; it would be hard to separate out advice that is related to a product and advice which is not – leading to increased compliance costs and effort for general financial advisers; consumers are unlikely to spend the time and effort distinguishing between advice on this basis; considerable time and effort by government officials to research and classify the different roles; consumer and adviser education on the different roles and obligations; the risk of stifling future advice-giving roles by making them fit set categories.

The main benefit of these options would be lower compliance costs for advisers when advising on exempted products (however that it is unlikely that an adviser's business would consist solely of advice on exempted products). The adviser would therefore need to have compliance systems in place for the rest of their business anyway; compliance obligations could be tailored to the particular activities carried out by an adviser, however this would require additional supervision and monitoring costs to ensure that an adviser does not cross the line from one class into another.

Alternate options - conduct and disclosure standards:

There are alternate conduct obligations that could apply to advisers - whether there should be sector specific conduct in statute; or whether advisers should have to act in the best interests of clients. These alternate conduct obligations were not preferred as it is not appropriate for advisers to act in the best interest of the member of the public as some agents (e.g. insurance agents) have existing statutory obligations to act in the best interests of the product provider and have structured their business accordingly; and the co-regulatory model is flexible enough to allow a non regulatory approach to sector specific conduct by allowing APBs to set sector specific conduct requirements in their rules rather than in legislation.

There are alternate disclosure obligations that could apply to advisers - whether there should be sector specific disclosure in statute; whether advisers could use 'health warnings' to alert customers when they weren't providing high-level advice; whether there should be reduced disclosure of commissions; whether there should be disclosure of professional indemnity insurance (PII), and the details of the PII. These disclosure obligations are not preferred as, with only one category of adviser, there is reduced need to have different types of disclosure or a health warning; the establishment of the regulatory framework will reduce the risk that a financial adviser will provide negligent advice, and reduce the need for PII, as the framework sets competency and conduct standards for advisers to meet.

The cost of these alternate options include the costs of developing and testing sector specific conduct standards in statute and keeping them relevant and up to date; a lack of flexibility in developing new conduct standards for new financial advice giving roles; costs in changing procedures to act in the client's best interests, and a related cost in the service levels for consumers. The cost of the disclosure options would include consumers not receiving all relevant information; advisers having to prepare disclosure information for some but not all advice giving roles; consumers not being advised of the level of commission in some parts of the industry; initial compliance costs from having to arrange PII, and the ongoing premium and administrative costs.

The benefits would be that all conduct obligations on financial advisers would be in one set piece of legislation; reduced cost for advisers by being able to rely on a set health warning to reduce regulatory compliance costs and to maintain the status quo in terms of voluntary disclosure of commissions. Consumers would also be able to rely on PII as protection against low quality advice. The benefits of the alternate obligations do not outweigh the costs.

Alternate options - Governance of APBs / Relationship with Securities Commission

Under the co-regulatory model, there are alternate roles for the APBs and the Securities Commission, including whether the Securities Commission should have a role as a default regulator (in the event that there was no APB for a particular sector); whether an independent party should set competency levels, rather than the APB; and whether the APB monitoring requirements should be set in legislation. These options are not preferred as they would not reflect the objectives of the co-regulatory model, which aims to have well targeted regulation that does not impose unnecessary costs and to be sufficiently flexible to address innovation and future advice giving roles.

The costs of the alternate options would include set-up costs on the Securities Commission to create systems and procedures to "second-guess" the APB actions, or to take over responsibility for any set role; set-up and administrative costs on government to appoint an independent competency setter, determine the most appropriate monitoring across all industry and to apply that in legislation, ongoing costs to ensure that the monitoring levels are appropriate and compliance costs for advisers, APBs and the Securities Commission to fit within set statutory monitoring procedures. The benefit of

these alternate roles would be that the Securities Commission would have already developed appropriate skills and processes to take over from an APB in the event of a market failure by an APB.

PREFERRED OPTION

The co-regulatory model is preferred for the regulation of financial advisers, over enhanced self regulation or direct government supervision. Under the co-regulatory model, industry-led approved professional bodies (APBs) – approved by the Minister of Commerce – and the Securities Commission (as the government regulator) will work together to regulate financial advisers; financial advisers will be required to belong to an approved professional body; subject to disclosure and conduct obligations when providing financial advice and subject to dispute resolution and disciplinary procedures.

The co-regulatory model is preferred as it leverages off the existing industry bodies, knowledge and practices to enhance the overall effectiveness and efficiency of the regulatory regime; deals with the limitations of the existing self-regulatory approach, which arise out of the voluntary nature of the regime, the inability for industry bodies to effectively sanction poor behaviour and the fact that existing industry bodies are not well set up to deal with disciplinary matters; and the broad scope of the co-regulatory regime will include a wide variety of advisers (across the risk, investment and credit spectrum) with the inevitable need for flexibility as to operational requirements depending on the type of adviser, function and product type in question. The co-regulatory model also creates a framework to assist trans-Tasman mutual recognition of financial advisers and to ensure that New Zealand better complies with IOSCO requirements. There are preferred detailed options under the co-regulatory model (the costs and benefits for the co-regulatory regime are discussed below).

Preferred option - coverage and definitions of product, advice, adviser

The co-regulatory framework applies to all advisers who give recommendations, guidance and opinions on the buying/selling and holding of a broad range of products and investment and savings decisions to members of the public in the course of the adviser's business. This is preferred as members of the public and advisers do not have to differentiate between advice on products or general financial advice or levels of advice when determining the correct level of service to be provided, and a growing area of the financial advice sector is not "product" restricted. The definition of financial products will include debt/equity, credit and risk products, investment (real) property investment property and other tangible products where there is an investment and savings element; the definition of "financial advice" will generally include opinions, recommendations and guidance on financial products and investment and savings decisions, given to a member of the public by an adviser, in the course of the adviser's business; and the definition of "financial adviser" will apply to those entities who give financial advice (see definition above) on financial products (see definition above) and investment and savings decisions to members of the public.

There is a single category of “financial adviser”, which is tied to the broader definition of financial advice. This is preferred as it will reduce the potential for consumer confusion about the type of advice being given. Compliance costs will be minimised through the option of corporate membership of APBs for businesses. The set standards of businesses can be recognised by APBs, without passing that obligation onto individual employees and without individuals having to meet a business structure through corporate membership of APBs. The Securities Commission will also be able to grant exemptions from the regime for any class of financial advice, any person or classes of advisers from compliance with any adviser obligations, just as it currently does in relation to investment advisers under section 48 of the Securities Markets Act 1988 to ensure that the legislation allows room for innovation or for addressing unintended results. Ministry officials will work with the Securities Commission to determine whether or not any further direction or restriction is required on this general exemption power.

Preferred option - conduct and disclosure standards:

There are common statutory obligations which all financial advisers will be required to follow. All conduct obligations on financial advisers will be in one place. This option is preferred because it is consistent with the current approach taken under other securities legislation, which complements the general coverage of the Fair Trading Act 1986.

Financial advisers are required to act with integrity, as this recognises that advisers often have both an advising and selling role, and that a “best interests” duty may impose too high costs on advisers in carrying out both these roles. However, in order to protect consumers, advisers will still be subject to statutory obligations to provide reasonable standard of service and to act with integrity.

Financial advisers will be required to disclose qualifications, relevant convictions, dispute resolution, conflicts of interest (including remuneration and relationships – in formula or dollar where practicable) prior to giving advice. This is preferred as disclosure will ensure that the consumer is aware of all conflicts of interest; this reflects the current obligations on a subset of financial advisers under the Securities Market Act 1988; many advisers who handle client funds already meet the minimum statutory and disclosure conduct requirements. Financial advisers, who handle money on behalf of clients, would be subject to statutory conduct and disclosure obligations including the requirement to hold money or property on trust for the client in a separate trust account with (e.g.) a registered bank; describe and treat that account as a trust account; account for that money/property and disclose these matters, including record keeping to the member of the public.

Preferred option - governance of approved professional bodies/relationship with Securities Commission

The preferred option is for the Securities Commission and approved professional bodies (APBs) – entities approved by the Minister of Commerce – to work together as “co-regulators” to create and monitor standards for

financial advisers. The industry-based approved professional bodies will be the front line day-to-day regulators, while the Securities Commission will be responsible for the oversight of approved professional bodies and ensuring the overall health of the sector.

The preferred option is to establish governance requirements for APBs through the approval process for “approved professional bodies”. The governance standards are adapted from the IOSCO principles for self regulatory organisations. These will provide guidance on who can be an APB as it will be difficult for businesses to be APBs for their employees as they cannot enforce compliance by its members and associated persons with relevant laws, regulations, and rules when the business itself is likely to be vicariously liable for the actions of its employees and agents. This option is preferred because there is broad industry and regulator support for the co-regulatory model, and the IOSCO principles provide an internationally-recognised source of best-practice corporate governance requirements. This also provides support for the clear delineation of the roles between the front line APB regulators, and the Securities Commission, who will be responsible for the health of the overall market. The APB will also have set functions (including maintaining a register of its members and passing this information to the proposed publicly searchable register of financial advisers (dealt with in a separate paper); setting entry level and ongoing standards, monitoring members, carrying out discipline, participating in dispute resolution and reporting to the Securities Commission) to ensure that the objectives of the regime, in terms of disclosure, accountability and competence are met.

The co-regulatory model has sufficient safeguards to ensure that an APB will act according to the IOSCO principles through the approval processes (which is based on the approval process for securities exchanges); through directions from the Minister or de-registration in the event that an APB acts otherwise than in accordance with its approved rules.

Costs and benefits

The following costs are likely to result from the co-regulatory model:

- **Government:** The Securities Commission is likely to require additional funding to carry out increased functions (\$2.2-5.9M annually – note that this figure also includes additional funding for supervision of trustee functions, dealt with in a separate paper). This is addressed in the overview paper); there will also be an increased time costs for government officials to advise the Minister on the regime and comment on APB requests for approval, but this is likely to be part of the Ministry’s ongoing policy work. There will also be costs associated with the register, although the information provided by APBs is likely to be in electronic form and to be low cost – these costs are dealt with in the registration paper)
- **Industry:** Self regulatory organisations (SROs) are likely to incur costs to set up approved professional bodies to carry out increased functions (including preparing new rules, separating lobbying functions, liaising with the Securities Commission and any other approved professional bodies,

preparing templates; reporting procedures and registration; legal rule setting; identification and registration of members and passing this electronic information to the register; computerization; office set up; staff; registration with Securities Commission). SROs have indicated government assistance may be sought to cover this, especially prior to membership being mandatory (addressed in the overview paper). There will be disproportionate costs in parts of industry where the SRO does not already have a relationship with the Securities Commission. May also be additional compliance costs (time, effort and administration) to develop additional rules to cover a broader range of advice giving roles and to manage a more diverse membership, however it is not expected that SROs will substantially expand from their current activities.

- Financial Advisers:
 - Some may choose to leave the industry rather than paying to become members of APBs or taking time to obtain qualifications on the basis that they view qualifications as a barrier to entry, because they see experience as sufficient qualifications, or because they are close to retirement (one SRO estimated that 15% of members would not want to meet competency standards as they are near the end of their career);
 - Will have to join an APB. The costs of this have been estimated at \$1,000-\$5,000 depending on the extent of monitoring and reporting required by the APB. Some self regulatory organisations already carry out monitoring and inspections, while others will have to create this function. There will also be disproportionate costs borne by some parts for industry where there is no common practice of competency standards – the actual costs and benefits will depend on the rules APBs set.
 - Costs could include one off compliance costs (e.g. drafting appropriate disclosure documents), and ongoing compliance costs (e.g. staff/system costs to monitor the content of the disclosure documents to ensure accurate disclosure in the event of changes); reviewing procedures and staff training to ensure that they/their employees meet advice giving standards. Those financial advisers with smaller businesses and a smaller client base may find it harder to comply with, and absorb the increased costs of, meeting educational and disclosure requirements. Some financial advisers may have the option of selecting the most appropriate approved professional body to join which may involve research, time and investigation into the option which provides them with the most benefit and least cost.
- Members of the public: There will likely be increased costs in obtaining some types of advice as advisers look to recover some costs from consumers (however, higher quality advice may be seen to justify a higher premium); Consumers may spend more time to review the increased information about advisers.

The following benefits are likely to result from the co-regulatory model:

- **Government:** There will be increased knowledge about market size and practices - current statistical data is based on voluntary organisations, census data, self identification and sector specific groups. Information from APBs and the Register of Financial Service Providers will boost overall knowledge of market size and practices. There will also be increased compliance with international standards and obligations and a firmer basis for movement towards trans-Tasman recognition.
- **Industry:** increase in consumer and industry confidence, with set standards and reliability, while still leveraging existing industry features such as codes of conduct etc. This is likely to encourage a higher consistent standard of advice across financial advisers, due to set mandatory standards (on skill and procedure levels) to assist in greater profitability/productivity for advisers. This is likely to contribute to poor performing advisers and/or product generators improving their performance or exiting the industry. By working with industry to set appropriate standards for financial advisers, costs are likely to be minimal. It is hoped that the exit of poor performing advisers will increase consumer confidence in the competency and integrity of advice, and this will flow through to benefit advisers who remain in the market.
- **Society:** Consumers will receive more information about their advisers, and be able to rely on standards set by industry, to ensure that their intermediary is suitably qualified and has appropriate procedures under which to provide advice. These standards will include appropriate dispute resolution and disciplinary procedures to allow for appropriate redress, sanctions and enforcement. This will likely result in increased consumer confidence to enable an individual consumer to:
 - Make better decisions about an intermediary or a financial product (for example, whether to deal with that intermediary, whether the intermediary's fees are negotiable etc);
 - Encourage greater competition between advisers and between product generators (for example, competition on fee structures and fee amounts);
 - Receive better advice; and
 - A lower risk of possible exploitation, hopefully to encourage greater use of advisers, and perhaps greater investment and savings in New Zealand.

Following the further work on the design proposal, including an assessment of the costs and benefits, the co-regulatory model remains the preferred option.

STEPS TAKEN TO MINIMISE COMPLIANCE COSTS

In the design of the preferred option, the following risks were identified and steps taken to minimise compliance costs:

- That there is no APB for a particular sector of the market – to address this officials will work with industry to extend the existing capabilities of existing bodies, or to promote the set up of an appropriate body in the transition period of this regulatory framework. The transition period for the regulatory framework may extend through to 2010 to allow for the introduction for all matters under the RFPP. This should guard against concerns that there will not be a suitable body to which an adviser can belong.
- That the set-up costs for APB will be too high and the costs will be passed onto consumers and advisers – to reduce these costs, officials will encourage a close working relationship between Securities Commission and the APB in discussing APB rules. Officials will consider investigate establishing an advisory unit to assist APBs and the Securities Commission (as discussed in the “Overview” paper).
- The one-off compliance cost for businesses to learn about and meet their obligations under the legislation will be too high and people will leave the industry - this will be mitigated through the APBs leveraging off existing industry standards and Ministry officials holding meetings with those who provided submission on the content of the legislation, wider industry groups, and media releases.
- That the regulatory regime may unintentional cover individuals or groups who do not pose a significant risk to consumers – this has been managed by carefully crafting the definitions of financial product, financial advice and financial adviser have been crafted so as to avoid coverage of these individuals and groups.
- That the proposals are not sufficient for trans Tasman mutual recognition - MED officials will continue liaising with Australian counterparts and will report back to Cabinet if further policy decisions are necessary in relation to the proposed framework.

IMPACT ON THE STOCK OF REGULATION

The preferred option will impact on existing regulation as the proposal may overlap with the Fair Trading Act 1986 and the Consumer Guarantees Act 1993. The Securities Commission will work with the Commerce Commission to ensure that both Acts’ objectives are met. As well, The Securities Markets Act 1988 introduces disclosure obligations for investment advisers. Many of the obligations in the Act are replicated for financial advisers generally. Ministry officials will work with Securities Commission officials to ensure that enforcement is consistent. Finally, sector specific legislation (e.g. insurance brokers’ obligations and shareholder obligations) will be amended to avoid

duplication with the conduct and disclosure standards under the co-regulatory model for advisers to meet. Even though these issues are already dealt with in other legislation, the current proposals are preferred.

IMPLEMENTATION AND REVIEW

To implement the proposal, legislation will be required. The necessary provisions will be contained in the Financial Advisers Bill, intended to be passed by mid-2008. There will be a transition period to allow for APBs and all necessary parts of the regime linking the RFPP (registration and dispute resolution) to be in place by 2010 with the full regime in force by 2012.

The Ministry is already working with industry to provide regular public updates by email and through internet to those who submit, industry groups and to adopt an open and consultative process of design. This includes communications with journalists as required. This will help reduce the risk of stress, and also help financial advisers prepare for any increased compliance obligations. In addition, a number of industry bodies are already reviewing their internal structures, so the timing of the review is likely to fit in with existing work, and changes to which advisers would have been subject in any event. In addition to submitters, Ministry officials are identifying groups who may be affected to communicate the proposal to them and to leverage off existing practices.

To ensure that the regime meets the public policy objectives, the Ministry will rely on its ongoing work with key stakeholders (including the Securities Commission) during the development of the legislative scheme to highlight any deviation from the public policy objectives. As well, New Zealand is also subject to comment on its international compliance with IOSCO. In the event that the regime is not achieving the public policy objective, the Minister has the power to issue directions to an APB to encourage a 'whole of market' behaviour change. The Securities Commission can also consider exempting parts of the industry if required.

CONSULTATION

Stakeholder consultation

The Task Force circulated publicly a consumer questionnaire (274 responses), an issues paper (79 submissions) and an options consultation paper (which resulted in 97 submissions) before publishing its final report, which was then subject to media and industry comment. The Ministry officials undertook comprehensive consultation with industry and consumer representatives and released a public discussion document in July 2006 (140 submissions). These submissions, together with wider public comment on the application and content of the proposed regulation, have been used by Ministry officials to provide the required details for the proposed framework.

Ministry officials have consistently worked to develop policy to address submitter concerns. That means that Ministry addressed concerns on:

- The restrictive definition of “financial advice” – broadened to include advice on investment and savings decision as well as financial products
- The potential confusion caused by the classification of financial advisers – categorisation removed, so that the framework applies to all.
- Allowing businesses to act as an APB for their employees, on the basis that businesses could find it hard to act both as employer and as the front line regulator for their employees – corporate governance guidelines will set clear objectives for any prospective APB for businesses and SROs to assess whether or not they can be an APB.
- Fears that APB membership would duplicate corporate procedures with undue compliance costs – corporates will have the choice of either becoming corporate members of an APB, or else, allowing their staff to be members themselves.
- The potential costs, interface complexities and the risk of duplication of roles if there is a significant number of industry bodies; if APBs act as “closed shops” deterring innovation/competition and creating barriers to entry - addressed though the IOSCO set corporate governance principles. Officials also propose to work with existing industry groups to expand their services in less developed segments of the market.

To ensure that stakeholder feedback is considered throughout this process, the Ministry proposes to circulate the draft legislation, once drafted, through the Select Committee process, and also to those who submitted on the discussion document. This will ensure that those who are most interested in the legislation will have sufficient opportunity to feed into the policy process prior to the legislation taking effect.

Government Departments/Agencies consultation

In preparing the Cabinet paper and this RIS, the Ministry for Economic Development consulted with the Ministry of Consumer Affairs, the Reserve Bank, Treasury, the Ministry of Justice, Securities Commission, the Commerce Commission, the Retirement Commission and the Office of Senior Citizens, (as part of the Ministry of Social Development).

The Securities Commission raised concerns about whether financial advice should be restricted to advice that takes into account the personal circumstances of the member of the public, and the Ministry of Justice raised concerns about whether lawyers should be subject to regulations under this legislation as well as the Lawyers and Conveyances Act 2006. The preferred option addressed both issues – personal circumstances was removed as a restriction, and Ministry officials will report back on the application of the regime to lawyers by 31 July 2007.