

APRIL 2010

The Financial Advisers Act 2008 and the Financial Service Providers (Registration and Dispute Resolution) 2008 Act (Acts) was passed a year and a half ago and it is anticipated that these Acts will be fully enforced by December 2010.

In the last quarter of last year, advisers may have attended the various presentations run by the Securities Commission and the Code Committee on the registration requirements of financial advisers and the Committee's discussion papers on the standards in the code which authorised financial advisers (AFAs) must abide by.

These Acts are currently undergoing further amendments – there is a Bill with the Select Committee which proposes to overhaul certain parts of the Financial Advisers Act.

The draft code for AFAs was released at the end of March and is awaiting public submissions which are due early May. The code is expected to be finalised by the end of June.

This update will comment on the following five matters:

1. The objectives of the new adviser regulations and the three types of financial advisers to be regulated under the Act;
2. The Bill which proposes to make certain amendments to the Act, the term 'necessary incident', and the implications of being a trustee of family trusts;
3. The Securities Commission's recent guidance on what is considered to be a 'financial planning service';
4. The draft code and what this means for authorised financial advisers; and
5. Our submissions to the Select and Code Committees requesting a transitional period for financial advisers.

OBJECTIVES OF THE REGULATIONS

The three main objectives of the regulations are:

- To impose on anyone providing a financial adviser service an obligation to exercise care, diligence and skill.

- To provide a minimum level of competence and skill for financial advisers who are authorised financial advisers.
- To provide that financial providers be registered and belong to a dispute resolution scheme. The registry will be administered by the Companies Office and is available to be searched online by the public.

Overall, the legislation aims to promote good advice and encourage confidence in the professionalism of advisers.

The Financial Advisers Act defines three types of financial advisers.

The first two types of financial advisers depend on the kinds of products they can provide financial advice on.

The first type is a financial adviser that can only provide financial advice on Category 2 products. Category 2 products are defined under the Act (as amended by the Bill) to be bank term deposits, bonus bonds, consumer credit contracts, call building society shares, call debt security, insurance products including term life insurance policy and life insurance policies issued before 1 January 2009. All other products that are not in Category 2 are classed as Category 1 – typically what can be seen as complex-type products. NZ Funds Management's Global Investment Service Portfolios are Category 1 products, as are listed stocks, real estate and KiwiSaver schemes.

The second type is a financial adviser that can provide a financial planning service and financial advice on both Category 1 and 2 products.

All financial advisers must register with the Companies Office. Employers and principals of financial advisers must also register with the Companies Office as a financial services provider and be a member of an approved dispute resolution scheme. Employees of the registered employer or principal do not have to separately belong to an approved dispute resolution scheme.

In addition to becoming registered, a financial adviser that provides a financial planning service and financial advice on all products (that is, the second type of financial adviser mentioned above) must also become authorised. Authorisation and supervision of AFAs lies with the Securities Commission.

The third type of financial adviser is one that is called a qualifying financial entity financial adviser or a QFE financial adviser. A QFE is a cost-savings concept for organisations with large numbers of employees that would need to be registered under the Act. QFE status is suited for financial institutions like banks where the bulk of their front line employees may provide financial advice on Category 2 products and the organisation has the ability to regulate its own advisers via its internal monitoring and training processes. Only the QFE needs to register with the Companies Office and be regulated by the Securities Commission. However, the QFE financial adviser will be restricted to only providing financial advice on Category 2 products and only Category 1 products that are issued or promoted by the QFE. They cannot provide financial planning services to a client.

ACT AMENDMENTS

The Financial Adviser Act in its current form is not entirely free from issues. Some of these issues stem from the lack of clarity in the interpretation of wording (for example, the term 'necessary incident') and the difficulties in complying with certain sections like the performance of investment transactions. Currently, only individuals can provide investment transactions or 'broking-type' services. This is difficult considering entities or organisations, as opposed to individuals, are the ones that normally provide such services.

The Bill that is currently with the Select Committee is proposing to resolve this by removing 'investment transactions' as a financial adviser service and introducing a new section for 'broking services' to give entities, as well as individuals, the ability to provide these services,

'Investment transactions' will be replaced with a new term 'investment management decisions' to catch discretionary portfolio managers within the adviser regulations.

Lawyers and accountants are excluded from the legislation if they provide financial advice that is a 'necessary incident' of their legal/accounting practice. The extent of what 'necessary incident' could cover remains open for interpretation. The New Zealand Institute of Chartered Accountants, in their April issue of the Chartered Accountants Journal, states that the exclusion will "require consideration of the individual's practice and the circumstances of the particular transaction". No

formal time line has been put in place to resolve this issue although the Accountants Journal notes it will publish further discussion on this in its future issues.

Those accountants and lawyers who are acting as trustees of family trusts are probably wondering whether they are caught within the adviser regulations. Discussions with our legal advisers suggest that this will turn on the capacity in which they have been appointed as trustee. If the trustee is appointed as such to provide advice to the other trustees or for the benefit of the trust's beneficiaries, such that he/she is providing that advice in the course of their business, then they will be captured under the adviser regulations. If, on the other hand, the trustee is merely appointed as such having regard to their background, an argument could be made that any view that the trustee shares with his/her fellow trustees is not provided in the course of business, and as such, does not constitute the provision of a financial adviser service. This argument is not free from doubt and we understand officials are giving further consideration to this issue.

SECURITIES COMMISSION GUIDANCE ON 'FINANCIAL PLANNING SERVICE'

Only an AFA can provide a financial planning service. A financial planning service is a service that analyses an individual's current financial situation, identifies his or her financial goals and develops financial options for realising those goals. If someone inadvertently provides a financial planning service without being authorised, there is a penalty of up to \$10,000 for the individual and up to \$50,000 for the entity.

The Commission recently issued guidance on the boundary between a financial planning service and financial advice. This is available on the Commission's website.

The guidance, in our view, does not provide much clarity and can be interpreted to suggest that any financial advice provided on Category 1 products can also be a provision of a financial planning service. An excerpt from the guidance is as follows:

"The extent to which an adviser should consider their client's nature and requirements depends on the circumstances: it should be greater when the advice is more complex or comprehensive... The Commission will consider the significance of the advice to a client's

current financial situation and goals when assessing whether a financial planning service has, or should have been, provided. It will also consider the nature of the service being performed for the client. Where the advice is significant to a client's current financial situation, or where the performance of the service necessarily involves an analysis of the client's current financial situation, it is likely to result in the provision of a financial planning service as defined by the Act."

Practically this means that, when in doubt whether or not an adviser is providing financial advice or a financial planning service, then they should consider becoming an AFA.

THE CODE

AFA's will be required to comply with the code.

The Code Committee, established by the Commission, is responsible for developing a professional code of conduct for AFA's.

The draft code was published by the Committee in late March and the Committee is currently seeking public submissions on the draft code standards.

Four draft standards are worth noting:

The first is the restriction on the usage of the term 'independent' or any other terms that could imply the adviser is 'independent' if the adviser is a related person or receives a benefit from a person other than the client. This is notwithstanding the considerable amount of submissions made to the Committee on this issue late last year which supported disclosures to the client instead of a ban on the use of the word 'independent' to counter the perception of conflicts of interest.

The second is, except in limited circumstances, financial advice cannot be provided to a client in relation to a financial product if the adviser is a related person of the product provider. The restriction does not apply to NZ Funds Management's Global Investment Service Portfolios because of an exemption noted in the draft code standard for financial products offered for public subscription under the Securities Act 1978.

The third is a 'dob-in requirement' where the adviser has an obligation to report another adviser to the Securities Commission who has not complied with the code or the legislation. Lawyers and accountants have a similar obligation. The lawyers have a 'lawyers complaints service' with a dedicated 0800 number to receive potential complaints. The standards and complaints officer may try to resolve the matter informally first before the complainant makes a formal complaint. Lawyers also are bound not to use, or threaten to use, the complaints process for an improper purpose. At this stage, there isn't a similar obligation here for the financial adviser who makes spurious complaints.

The fourth is the requirement to keep adequate documented records of financial advice provided to clients for a minimum of seven years. Although possibly less of an issue for lawyers and accountants, some financial advisers will likely need to formalise and adopt client documentation and filing procedures within their practice.

With regards to minimum competency level, financial advisers will need to have attained the Level 5 National Certificate in Financial Services (Financial Advice) in order to qualify as an AFA. The Certificate contains four or five Standard Sets which the individual will need to complete. Those with certain recognised qualifications – like certified financial planners, chartered accountants, or has a Bachelor of Commerce – are exempted from having to complete some of the standard sets.

This information is available on the website under www.financialadvisercode.govt.nz

SUBMISSIONS TO THE SELECT COMMITTEE AND CODE COMMITTEE

We understand the Minister has continued to maintain that the financial adviser legislation will commence in December 2010. This is notwithstanding that the legislation and the code of conduct for authorised financial advisers is yet to be finalised.

NZ Funds Management has made a submission to the Select Committee to request that a transitional period be introduced for financial advisers who are genuinely committed to comply under the new regulations but are time-constrained to qualify as AFA's by December 2010.

We are also intending to make a submission to the Code Committee on practical issues regarding some of the code standards.

WHERE TO FROM HERE

The events and timing towards the December 2010 start date are as follows:

- Late May Select Committee report back on the Bill Submissions due on the draft code
- June The Code Committee expects to make a formal recommendation on the code to the Securities Commission
- June It is anticipated the Minister will have reviewed the code and if approved the code will be finalised and published
- July Financial adviser registrations open
- December Implementation

This gives financial advisers five months from July to get trained, registered and authorised before the new adviser regulations kick in.

Part of the application to be authorised is the requirement for a financial adviser to prepare their 'adviser business statement'. The Commission has yet to publish guidance on the content of the adviser business statement but has indicated that the statement will be similar to the QFE adviser business statement. The QFE ABS is in two parts. The first part is an explanation of the entity's adviser business including the entity's organisation structure, types of clients, types of products which financial advice is provided and types of financial advice provided. The second part is an outline of the entity's governance and compliance framework which supports its adviser business. The framework ranges from recruitment and training policies to client servicing and compliance procedures.

Some financial advisers may be of the view that being affiliated with a QFE (as a nominated representative) may solve their training and registration issues. This may be the case if the financial adviser is intending to provide financial

advice only on Category 2 products. But if the financial adviser wants to provide financial advice on Category 1 products, our discussions with the Commission confirm that the QFE training requirements are equivalent to an AFA's. If the financial adviser has to be trained to AFA level, the reasons for affiliating with a QFE become less compelling – note, a QFE financial adviser is restricted to only being able to provide financial advice on the QFE's products and cannot provide a financial planning service. Also, the Commission's 'not so clear' guidance on financial planning service does not help the argument for becoming a QFE financial adviser. Note, these restrictions do not exist for a fully fledged AFA.

Advisers who are intending to continue with their advisory practice beyond December 2010 will need to consider the requirements they need to undertake in order to comply with the regulations. ETITO, the organisation that is responsible for setting the National Certificate standard, has reported on Good Returns that it is confident there are sufficient accredited training organisations to provide training capacity for all advisers wishing to complete their training requirements in time for December 2010. In our view, notwithstanding our submission for a transitional period, at this stage it is looking like the Minister will continue to stick to his December 2010 start date. Because these regulations are new and have had a lot of publicity given recent financial crisis events, we expect the Commission will take an active enforcement approach over the course of 2011.

SUMMARY

So, what should advisers be doing now?

Understand the qualifications they need, and what steps they may need to take to be certified.

Review systems and processes – do they support the required level and quality of client documentation? If required, improve the adherence to those processes.

Where required, start writing plans now for clients that don't have a plan or have one that is out of date. We think the basis for documenting client data including the recording of the client's suitability analysis can be founded on the goals-based advice framework.

The next few months will disappear quickly so it will be important for advisers to move forward on these matters.

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