

Our ref: 249

30 April 1993

The Hon D.A.M. Graham
Minister of Justice
Parliament Buildings
Wellington.

Dear Mr Graham,

REGULATION OF INVESTMENT ADVISERS

In September of last year the Commission published a discussion paper reviewing the business practices of investment advisers and financial planners. The Commission was concerned about reports of unsatisfactory business practices occurring in the investment advisory industry and was conscious of the lack of regulation of many of the persons offering investment advisory services to the public. Recent financial failures involving a financial planning company in Auckland, an Auckland accounting firm and a legal practice in Upper Hutt had highlighted the Commission's concerns. The purpose of the Commission's review was to undertake an analysis of the investment advisory industry and the business practices of its members and, following public consultation, to make recommendations to the Government or others for any changes considered necessary to the law or to present regulatory practices.

The Commission conducted its review in several parts:

- (a) a survey of financial institutions which use investment advisers to market their products in New Zealand, with particular reference to the selection, remuneration and monitoring of performance of investment advisers by the financial institutions;
- (b) a survey of those firms or companies which, either as their principal business activity or as an ancillary activity, provide investment advice to the public, with particular reference to mix of clientele, sources of income, procedures for handling of client moneys, levels of training and experience of staff and safeguards for investors;
- (c) a review of the relevant rules and practices of the existing professional or industry associations active in New Zealand, at least some of whose members offer investment advice to the public, in order to determine the extent of protection for the public provided by the entry restrictions, disciplinary procedures and codes of ethics and business practice;

- (d) a review of the law in New Zealand as it relates to the duties owed by investment advisers to their clients;
- (e) a review of the procedures in selected overseas countries to determine how other jurisdictions deal with the issues arising from the investment advisory industry;

As a result of its review, the Commission reached the following conclusions in respect of the investment advisory industry in New Zealand:

- (a) Many people giving investment advice to the public are members of existing professional bodies and are accordingly subject to the entry requirements, the ongoing educational and compliance obligations and the disciplines of those bodies. Many other advisers have voluntarily joined industry representative bodies. However, there is a very large number of investment advisers who do not belong to any professional industry association, have not attained any defined level of professional academic training, have had no need to demonstrate that they are of good character, have not agreed to uphold any industry standards or to subject themselves to any formal censure for non-compliance before offering their services to the public as investment advisers.
- (b) While legal and accounting firms and sharebrokers tend to be larger and much longer established than specialist advisory firms, this does not necessarily mean that they have more experience in the giving of investment advice than the specialist advisory firms.
- (c) Financial planning firms have staff of a mixed level of experience and qualifications. The experience and qualifications of persons giving investment advice to small investors would appear to be markedly lower than those of persons giving advice to substantial investors. The more established traditional providers of investment advice (law and accounting firms and sharebrokers) generally have more staff with professional qualifications than specialist advisory firms but these qualifications are not necessarily relevant to investment advisory work.
- (d) The independence of investment advice provided to the public appears to be compromised in many cases, despite the rules of equity about fiduciary duty owed to clients by professional advisers. Reliance is frequently placed on avoiding the duty, by some form of disclosure of conflicts and client consent thereto, rather than on avoiding the conflict. In several recent cases before the Courts, investment advisers have been criticized for failing to make appropriate disclosure.
- (e) There is evidence of widespread dissatisfaction with the services of investment advisers. It is widely believed that the disciplines of the free market are not adequate to instil high standards within the industry and that advice is seldom independent.

- (f) Procedures for handling client moneys differ widely. Although many advisers encourage clients to make their cheques payable to the financial institutions in which they propose to invest, this does not always occur. Where money is paid direct to the adviser many advisers do not routinely bank client cheques into separate trust accounts. Where there are said to be trust accounts, they are often not administered as trust accounts or regularly audited.
- (g) Investments made through advisers are sometimes registered in the names of the adviser or its nominee, and frequently at the adviser's address. This is most apparent with solicitors nominee companies. Investors do not routinely have the opportunity to verify that their investment instructions have been complied with.
- (h) Most financial planning firms do not disclose the state of their own financial affairs to clients and prospective clients and the investor cannot quantify either the risk of depositing funds through the adviser or the ability of the adviser to meet a claim in compensation in the event of default, negligence, breach of fiduciary duty or misappropriation.
- (i) A significant number of financial planning firms do not have professional indemnity insurance cover as a protection for clients.

On completion of its review, the Commission invited all interested persons to comment on its findings and on various possibilities for new rules of law relating to investment advisers. The Commission received submissions from thirty three persons/organisations. The majority of the respondents considered that there should be new rules of law in respect of the giving of investment advice to the public. They considered that these rules of law should apply in respect of all persons who offer investment advice/financial planning services to the public. The most preferred option was for the industry to be regulated by an industry body or industry or professional bodies authorised by the Commission or other equivalent organisation. Persons who wished to carry on the business of giving investment advice and financial planning would need to be members of such a body. The body would be responsible for establishing and administering an approved code of practice. This code would cover such matters as disclosure of interests, standards of conduct, handling of client moneys, character and educational qualifications of advisers and enforcement procedures.

In conducting its review the Commission has also had regard to the recommendations of the Todd Task Force on Private Provision for Retirement in its Final report - "The Way Forward" of December 1992. The Task Force states:

"We found that there was a lot of distrust and scepticism about the viability and effectiveness of private financial markets. Much of this distrust appeared to stem from situations where people felt they had not received the information required to make prudent savings decisions. It had also arisen where disclosure of fees and returns had been insufficient, where people were aware of cases of outright theft or fraud, or where inflation had seriously eroded the value of long term savings.

The availability of good information about the nature of savings products being offered (competent and unbiased advice about investment products and clear information about fees and performance) is necessary for savers to be able to make good decisions which will ensure them a good overall return on their savings." (page 27)

The Task Force also states:

"We think that much can be done to improve the returns which are available to savers in the current environment. This can most importantly be achieved through better regulation and better information to savers." (page 28)

The Commission agrees with these statements.

The Task Force does not consider it adequate to rely on voluntary codes for the regulation of investment advisers. It recommends that all persons holding themselves out as offering financial advice should be required by law to disclose:

- (a) their qualifications and experience,
- (b) their commissions and other financial interest in advice given or transactions concluded,
- (c) their procedures for the transfer of money to product providers.

Recommendations of the Commission

As a result of its review of the business practices of investment advisers and financial planners, the Commission considers that there is a need for new rules of law about the investment advisory industry. The Commission believes that the Government should very carefully consider the recommendations of the Todd Task Force concerning disclosure by all persons offering investment advice. The Commission notes, however, that there are difficult questions to be faced including:

- (a) a definition of the giving of investment advice to the public, including the persons, the activity and the products to which any new rules of law should apply;
- (b) the enforcement of any new rules of law; and
- (c) remedies for non-compliance.

While commending the proposals of the Todd Task Force, the Commission also notes the overwhelming preference of those persons who made submissions to the Commission that there should be some form of statutory encouragement for self regulation of the investment advisory industry. The Commission is of the view that the Government should not ignore this message from the financial marketplace. The Commission therefore recommends that the

Government also consider introducing legislation for this purpose. The Commission has had discussions with industry representatives and has developed a possible two tier model for this which is attached. On the lower tier there would be basic rules of law concerning disclosure and fair trading which would apply to all persons who offer investment advice to the public. On the upper tier there would be a system of self regulation to which those industry participants seeking higher standards can and will aspire. This will have the advantage of providing a minimum set of statutory obligations for all persons involved in the giving of investment advice at least in respect of the savings type products identified by the Todd Taskforce but with statutory encouragement given to those who voluntarily accept the discipline of a more exacting code administered by a self-regulatory body.

Industry representatives have, in their discussions with the Commission, affirmed their support for such an approach. It is designed to encourage, and not to intrude upon, effective self-regulation for example, the Code of Banking Practice of the New Zealand Bankers' Association and the Code of Business Practice of the Life Offices' Association.

In developing this model the Commission has been conscious of the very great difficulty of defining the giving of investment advice to the public. Ultimately, the model depends on voluntary membership of the self-regulatory organisation. However, Commission Members believe that if statutory backing and industry wide encouragement are available it will be possible to overcome most of the weaknesses of full self-regulation and will lead to a very wide-spread if not universal adherence to approved industry codes.

The Commission accordingly recommends that there should be a two tier system for the regulation of investment advisers in accordance with the terms of the attached model.

Yours sincerely,

P.D. McKenzie
Chairman

TIER I

ALL PERSONS OFFERING INVESTMENT ADVICE TO THE PUBLIC

A: EXISTING LAW

- Fair Trading Act 1986
- Law of Contract
- Law of Torts
- Rules pertaining to the duties of fiduciaries.

B: PROPOSALS OF TODD TASKFORCE

1. Legislation will define "the giving of investment advice".
2. Legislation will impose certain basic requirements in respect of disclosure and fair trading upon all persons who give investment advice to the public;
 - e.g. must disclose
 - their qualifications and experience,
 - their commissions and other financial interest in advice given or transactions concluded,
 - their procedures for the transfer of money to the product providers,
 - whether they are members of any professional organisation.
3. Failure to comply with these requirements will constitute an offence under the legislation.

TIER II

AUTHORISED INVESTMENT ADVISERS

EMPOWERING LEGISLATION

AUTHORISED INVESTMENT ADVISERS ACT 1993

to contain, inter alia, the following provisions: -

- Provision 1 - Commission empowered at its discretion and upon such terms and conditions as it thinks fit to declare bodies corporate or unincorporated bodies to be Authorised Investment Advisory Organisations (AIAO).
- Provision 2 - Every AIAO to register a trademark in accordance with provisions of the Trademarks Act 1953.
- Provision 3 - Restriction of the use of the name "Authorised Investment Adviser" to members of an AIAO.

Provision 4 - Use of the term "Authorised Investment Adviser" by non-members of an AIAO an offence.

Provision 5 - Every member of an AIAO to display the words "Authorised Investment Adviser" and trademark of AIAO on all written communications, advertising and at place of business.

SECURITIES COMMISSION

In exercising power to declare a body corporate/unincorporated body to be an AIAO the Commission could impose the following terms and conditions: -

1. That the AIAO require its members to comply with a code of practice approved by the Securities Commission:
2. That the AIAO provide the Commission with various undertakings.

AUTHORISED INVESTMENT ADVISORY ORGANISATION

To administer a code of practice dealing with such matters as:

- (a) membership criteria,
- (b) disclosure,
- (c) know thy client and know thy product rule,
- (d) information given to customers in order for customers to make an informed decision,
- (e) handling of client monies,
- (f) handling of client security documents,
- (g) professional indemnity insurance,
- (h) nature of customer agreements,
- (i) conduct of employees of members,
- (j) fair and clear communications with customers,
- (h) honesty and fairness,
- (i) enforcement procedures.