

**REGULATION OF INVESTMENT ADVISERS -  
IMPLICATIONS FOR PROFESSIONALS GIVING  
INVESTMENT ADVICE**

Discussion - Paper

by

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## 1. INTRODUCTION

This document is a personal paper written by Brian Lenehan and any views expressed are those of the author and not his employer.

Unlike many jurisdictions world-wide, NZ is a very unregulated market in terms of legislative control of persons providing investment advice.

The key features of the NZ market are:

- there are no minimum standards in terms of experience and qualifications
- there is no licensing
- there are no self-regulatory bodies to which advisers automatically have to belong
- there is no investor compensation scheme.

This situation has recently been subject to comment within the financial services industry, debate at conferences and review by the Securities Commission.

This paper seeks to:

1. consider why investment advice is important to efficient financial markets
2. discuss what is investment advice
3. considers who provides investment advice
4. focuses on the role of professionals who provide investment advice incidental to their main core functions
5. debates the current lightly regulated regime in NZ
6. considers some changes proposed by the Securities Commission
7. discusses the role of professional bodies
8. considers arguments for and against tighter regulation

The NZ Securities Commission has recently highlighted the need for tighter law relating to persons who provide investment advice. The Commission has recommended changes to investment adviser law following extensive public discussion that included submissions by several professional bodies.

The purpose of this paper is to provide an update on recent developments, discuss some broad issues and outline some personal thoughts on the way ahead. There is very little written on this subject in NZ and this paper should also be useful as a reference document.

This is a very wide-ranging topic and by its nature this paper only touches on some significant issues.

## **2. WHY INVESTMENT ADVICE IS IMPORTANT**

Investment advice has the goal of enabling / facilitating consumers to achieve financial security for themselves and their families. Effective investment advice is important to the success of a free-market economy.

The welfare state is founded partly on the principle that people lack the resources, prudence and the discipline to look after their own financial affairs. Any gaps and strains from demographic change on social welfare (including state retirement provision) places increasing importance on the competence of people in securing for themselves adequate investment advice.

Despite the importance of investment advice to consumers and to the free-market economy there is a perception (reinforced in the submissions to the Securities Commission in their recent review) that there is little protection of unsophisticated consumers who require or seek advice.

The range of knowledge, education and expertise required to provide competent investment advice implies providers of such advice must be professionals. However part of the issue is that the legal / regulatory framework does not recognise them as such. Anyone can claim to be an investment adviser without meeting any particular educational standards or meeting licensing tests.

Although many persons who provide advice are members of professional bodies, there is a lack of clear recognition of the professional status of them. This makes it difficult for the public to easily differentiate service depth, scope and quality.

Within NZ there are private sector professional organisations, such as the Financial Planners and Insurance Advisers Association (FPIA), who have similar goals to other professional bodies, of setting high standards and looking after the public interest.

These organisations provide an important standard and guidance for the public to gauge what constitutes appropriate investment advice.

In 2000 Paul Thornton, the then President of the Institute of Actuaries (London), said:

“It is very important in the public interest that individuals have access to timely, accurate and understandable information and advice to enable them to manage their affairs”.

### **3. WHAT IS INVESTMENT ADVICE?**

There are inherent difficulties in defining what is meant by investment / financial advice.

Investment advice covers a wide range of areas, including accountants talking to small business owners, staff of product providers dealing with customer queries, actuaries talking to members of superannuation schemes, accountants commenting about master trusts to their tax clients and full service financial planners / investment advisers who see it as their core business.

#### **3.1 Definition in New Zealand**

Under the Investment Advisers (Disclosure) Act 1996 the definitions are detailed.

`Investment advice' and `advice' mean:

- a) A recommendation, opinion, or guidance given to a member of the public in relation to buying or selling (or not buying or selling) securities; and
- b) Without limiting paragraph (a) of this definition, include any such recommendation, opinion, or guidance, that is communicated by letter, newspaper, periodical, broadcasting, sound recording, television, cinematographic film, video, or any form of electronic or other means of communication; but
- c) Do not include:
  - (i) Any such recommendation, opinion, or guidance given by a person whose principal occupation is that of a journalist and that is given in that person's capacity as a journalist; or
  - (ii) Any such guidance about the procedure for buying or selling securities.

`Investment adviser' and `adviser' mean:

A person (whether or not the person is also an investment broker) who, in the course of the person's business or employment, gives investment advice; and,--- (a) Where a person is giving investment advice in the course of his or her employment, include both that person and his or her employer; but (b) Do not include the issuer or a promoter or a trustee (within the meaning of the Securities Act 1978 or the Unit Trusts Act 1960) or statutory supervisor (within the meaning of the Securities Act 1978), of the particular securities to which the advice relates; and (c) Do not include a person who only transmits investment advice relating to particular securities given by the issuer or a promoter or a trustee (within the meaning of the Securities Act 1978 or the Unit Trusts Act 1960) or statutory supervisor (within the meaning of the Securities Act 1978), of those securities.

### **3.2 Securities Commission recommended definition**

Following their review of the Investment Adviser (Disclosure) Act in 2001/2, the Securities Commission recommended that the definition of "investment adviser" be clarified by stating the exclusion of the issuer / promoter / trustee does not extend to employees, agents and persons associated with the issuer / promoter / trustee who give investment advice.

### **3.3 SEC definition in the US**

In the US there is legislation at both state and federal level. At federal level the SEC, under the Investment Advisers Act of 1940, defines an investment adviser as anyone who, for compensation, engages in the business of advising others about the value of securities or the advisability of investing in, purchasing or selling securities.

### **3.4 Australian definition**

Under the Financial Services Reform Act (FSRA) a person will be considered to provide a "financial service" if they deal in a financial product, provide financial product advice, make a market for a financial product, operate a registered managed investment scheme or provide custodial or depository services.

The FSRA defines financial product advice as:

"a recommendation or a statement of opinion, or a report of either of those things, that:

- (a) is intended to influence a person or persons in making a decision in relation to a particular financial product or class of financial products, or an interest in a particular financial product or class of financial products; or
- (b) could reasonably be regarded as being intended to have such an influence."

Insurance products will generally be within the definition of a financial product. So the majority of insurance advisers will have to either obtain an Australian Financial Services (AFS) licence or be a representative of one who has such a licence. Interestingly the term "insurance brokers" is only permitted to be applied to licence holders or their authorised representatives.

In Australia the law defines who can offer advice and sell investments. They must be licensed in Australia if they are:

- advising and selling you investments: the law calls them "**securities dealers**" or "futures brokers" because they buy and sell investments or futures contracts, and advise you as part of their dealing business; or
- advising only and not selling you investments: the law calls them "**investment advisers**" or "futures advisers". Only a small number of specialised people work this way but this is the category many professionals such as lawyers, accountants and actuaries may find themselves in.

The majority of people who sell investments, or give investment advice are "authorised representatives" of licensed dealers or investment advisers.

Under the AFS licensing system, people who provide financial services (for example, advising on, or dealing in, financial products) must be licensed by the regulator, ASIC.

One attractive feature of the Australian legislation is it tries to over-ride any wholesale and retail distinction. The identity of the recipient of the financial service is not a key issue here. That is, if a person provides advice in relation to a financial product, they will need a licence (or will need to be the representative of a licensee), regardless of whether the client receiving the service is a wholesale or retail client.

### **3.5 Importance of a stake**

One key issue is whether there is a stake involved. The US definition has the useful requirement for some form of compensation to be receivable by the adviser in order for the advice to be regulated as financial advice.

Persons with backgrounds in finance may often be asked to consider and comment on particular securities (whether individual stocks or investment vehicles such as unit trusts) to acquaintances.

The concept of no stake then no liability is certainly an appealing one. However it is important to take a broad definition of what compensation actually means. A stockbroker / researcher may receive no direct compensation from comments about a particular Initial Public Offering but his / her employer may have an affiliate investment banking unit which benefits greatly. As such the definition of stake must be all encompassing and include the individual, his / her employer and associate companies.

### **3.5 Personal definition**

Consumers are overwhelmed by information and personal opinion disguised as advice that is offered by everyone from investment consulting firms making predictions about asset classes to investment newsletters. Investors are becoming confused.

The word 'advice' is used indiscriminately and it is difficult for consumers to distinguish between information offered and personalised advice given by full-service professionals dedicated to individual service.

I think we should stress the essential human component of advice and develop the definition through the word 'advice'.

Personally, I prefer the wide definition of advice to cover the business of:

- providing information (with the exclusion of purely factual information) or
- recommending to others the value of securities or
- notifying or recommending the suitability of investing in, purchasing or selling securities (using the wide definition of securities to cover all investment classes).



In addition:

- I prefer a wide definition with incidental advice being deemed to be advice ;
- There should be no distinction according to whether the initial recipient is a consumer or a wholesale client. The wholesale client is often a proxy for the individual consumers and any advice on a wholesale basis will often impact on individuals ;
- Any recommendation or statement of opinion intended to influence a person (or persons whom the initial recipient represents) in making a financial decision should be deemed to be financial advice.

#### **4. WHO PROVIDES INVESTMENT ADVICE?**

Categories of people giving investment advice, include :

- persons whose primary function is investment advisers, they will usually be a member of one of the relevant bodies such as Financial Planners and Insurance Advisers Association (FPIA) whose members or the New Zealand Society of Investment Professionals (NZSIP)
- other persons who act primarily as finance-related professionals with other specialist areas but incidental to their main function also provide investment advice.

##### **4.1 Investment advisers who are members of core investment advice bodies**

###### **4.1.1 FPIA**

The FPIA is New Zealand's largest investment advisory professional body representing around 1300 financial advisers New Zealand-wide. The Association's primary focus is to improve and enhance the professional status of financial planners and insurance advisers, and to advance the interests of members and their clients.

The FPIA aims to:

- raise advisory standards in ethics and professional conduct
- provide education standards designed to inspire greater confidence and trust between advisers and the public
- identify and serve the needs and interests of members

The senior designation for FPIA financial planning members is Certified Financial Planner™ (CFP™), which is a financial planning designation internationally recognised .

All new CFP<sup>TM</sup> licensees have a minimum level of qualification and the CFP<sup>TM</sup> certification process also requires them to continue to pursue a broad based education programme.

There is an issue in New Zealand in that a number of the CFP<sup>TM</sup> licensees were “grand-fathered” the qualification based on experience. FPIA members are actively involved with the consumer market. Although members do act in the wholesale and asset consultancy markets this does not appear to be their primary focus.

#### **4.1.2 SIFP**

The New Zealand Society of Investment Professionals is the local NZ branch of the Association for Investment Management and Research (AIMR).

AIMR styles itself as “the leading, global, professional association in the investment industry, serving investment analysts, portfolio managers, and other investment decision makers.” The senior designation for AIMR is Chartered Financial Analyst (CFA). The attainment of the CFA qualification requirements a significant amount of study.

AIMR's members are employed as securities analysts, portfolio managers, strategists, consultants, educators, and other investment specialists. These professionals practice in a variety of fields, including investment advice and management, banking, insurance, and investment banking and brokerage firms.

#### **4.1.3 LBA**

The Life Brokers Association (LBA) is another body that represents insurance and investment advisers in New Zealand. The LBA registers members who attain certain standards and provides them with a current Annual Practice certificate. There is some overlap between the LBA and FPIA membership but I understand this is not significant. The LBA has around 200 members. The senior designation for the LBA is Fellow of the Life Brokers Association.

#### **4.1.4 SIFA**

The Society of Independent Financial Advisors, is a body set up in the 1990s. Some investment advisers are members of this body.

#### **4.2 Investment advisers who are members of finance-related professions**

There are a number of finance-related professions such as lawyers, chartered accountants and actuaries who have members actively involved in providing financial advice.

A recent survey showed that up to 5% of actuaries NZ do investment advice type work as a significant part of their work and a further 10% do some incidental work in this area. The Institute of Chartered Accountants of NZ and the Law Society do not hold figures. I suspect percentages are low but not insignificant.

#### **4.3 Incidental investment advisers who are members of finance-related professions**

The numbers of finance related professionals who provide investment advice as a core part of their work is not very significant. However, a significant number of these people do provide incidental investment advice as part of their work.

Legislation in NZ makes no distinction between those who provide advice as part of their core work and those who provide investment advice incidentally as part of other services such as capital budgeting or tax advice.

This group is an important one from a risk management viewpoint as investment advice is not their core work, they may not be up to date in their skills and the extent of their Professional Indemnity (PI) insurance cover may not include such incidental work.

#### **4.4 Investment advisers not members of any body**

In New Zealand there is no requirement of a person providing investment advice to be a member of a professional body. There are a significant number of persons who are not members of any of the bodies mentioned above. Some of these are employed by banks and other financial institutions and others are sole traders or members of distribution groupings.

There appears to be no formal census of the numbers involved in this work. Anecdotally discussions with Phillip Matthews, CEO of the FPIA, leads one to believe there may be up to 1,000 individuals who do not belong to any body. This number appears to be declining as member of the bodies such as the FPIA have seen significant growth in membership.

## **5. HOW ARE PROFESSIONALS INVOLVED IN THE PROVISION OF INVESTMENT ADVICE?**

Professionals often provide financial advice, and in many cases provide specific investment advice. Finance-related professional qualifications such as being an accountant, lawyer or actuary require evidence of competence in a range of disciplines including investment matters, and through professional codes and rules the individuals involved are required to ensure that they are adequately experienced in any particular area before providing advice.

### **5.1 No involvement in investment advice**

There are of course many finance-related professionals who have no involvement in providing investment advice. This would include actuaries who do work on financial services company reporting based on factual information.

### **5.2 Incidental advice**

A large group of finance-related professionals appear to only give advice incidental to their main function.

An example is actuaries who advise trustees and employer sponsors on superannuation funds. The role of the actuary is primarily focused on analysing the financial stability of the fund.

However, quoting from the Australian Institute of Actuaries (IAAust) Submission to ASIC on FSRA Policy Proposals the superannuation actuary's role includes advice on:

- Broad investment policy and matching of assets and liabilities
- Whether the fund is being invested in pooled trusts or direct portfolios
- Whether the investment management should be through "balanced" or "sector specialist"
- The selection of investment managers or investment products
- The insurance product for the insurance of the super fund
- Insurance or self-insurance and formula for sums to be insured

Aspects of the above clearly constitute investment advice and this was recognised by the IAAust.

Accountants providing general advice on taxation to clients may comment on the structure or set up of the client's personal investments. Many finance-related professionals who undertake investment consulting in particular are likely to face situations where they are deemed to provide investment advice whether on a retail or wholesale basis.

Some professionals argue they only provide advice to wholesale clients. Under the current NZ legislation they are only deemed to be an investment adviser if providing advice to a member of the public. The distinction between wholesale and retail (direct to the public) is increasingly blurred and using a liberal definition, much "wholesale investment work" could be deemed advice.

Although professionals may argue that wholesale advice, such as recommendations to superannuation trustees, is not consumer advice, they should recognise that the advice is ultimately used by or to benefit individual consumers and as such should in many cases be considered investment advice.

Interestingly my understanding of the position in Australia is a person who provides advice in relation to a financial product needs a licence regardless of whether the client receiving the service is a wholesale or retail client.

### **5.3 Future expected rates of return**

One area where finance professionals such as accountants and actuaries do regularly have a professional involvement is in setting future expected rates of return (single rates or through stochastic processes) on asset classes. This may be for use cashflow modelling, capital budgeting, valuation of defined superannuation scheme or other work.

Generally, setting future expected rates of return will not be investment advice, However, taking a wide view of the definition of advice in some cases the setting of expected rates of future return could be seen as investment advice. Even though the advice may be to the trustees of a super scheme, for example, it will impact on the benefit and contribution structure of the scheme and as such impact on members. By setting expected future rates of return the professional could be indirectly influencing the client / staff of the company / members of a scheme to take a particular investment route and in this way is giving advice to them. In my view she or he may be acting as an investment adviser.

In setting future expected rates of return the professional will often be giving an opinion as to expected returns on different asset classes. This could be construed as giving guidance to members of the public (for example scheme members) on likely returns of different asset classes.

## **6. RISK TO CONSUMERS AND THE NEED FOR REGULATION**

Many people see consumers as financially unsophisticated and exposed to a risk of some rip-off by the big bad world of advisers and product providers. This viewpoint seems somewhat extreme and in my experience the NZ public is reasonably astute when it comes to parting with or investing their hard-earned cash.

It would be wrong to classify the public as either financially illiterate or very financially astute as the reality is people generally sit at varying levels between these two extremes. The risk to consumers is the financial impact of fraud and bad investment advice.

There is an argument that different levels of advice are just a reflection of a functioning market (similar to company bankruptcy) rather than a symptom of a rotten system. The key point about regulation is will it help reduce the level of fraud and improve the standard of advice.

It is interesting that there seems, to the best of my knowledge, no evidence of a higher incidence of fraud and bad investment advice in jurisdictions like New Zealand (with limited regulation) compared to more tightly regulated markets. This would be an interesting area for some research. As such one has to be cautionary and not assume tighter regulation will fix the problem. Firstly there may not be a major problem and secondly regulation itself may not help it get better.

To quote Sir Geoffrey Palmer:

“ New Zealanders ..... seem to be addicted to passing legislation for the sake of it, and to believe that legislation can cure our innermost ills.

New Zealand suffers from hyperlexis – an overactive law making gland and the statute book is already enormous.”

Legislative change involves the state exercising coercive powers over citizens and business and it should not be entered into lightly.

There are moves afoot with various parties pushing for tighter regulation. Jane Diplock, Chairman of the Securities Commission has recently said the “need for tighter law relating to investment advisers is highlighted in a report of a Securities Commission inquiry ..”.

We need to be aware of conflicts of interest of people pushing for tighter or looser regulation of those providing investment advice.

When considering if legislative change is beneficial the two issues are whether the costs of the change (largely incurred by consumers) will be outweighed by the benefits and whether there are currently sufficient remedies available to consumers when advisers act inappropriately.

There are a surprising number of remedies open to consumers, including:

- Full legal action through the court system
- Small claims court – Disputes Tribunal
- Complaint to the Commerce Commission if the Fair Trading or Consumer Guarantees Act are breached – the Commerce Commission often act
- Complaint to Securities Commission for investment business
- Complaint to professional body e.g. FPIA if the adviser is a member
- Complaint to the product provider who will have internal systems to deal with complaints
- Complaint to the Insurance & Savings Ombudsman (ISO)
- Complaint to the product providers’ body, ISI, who may do something to encourage a product provider to do something

## **7. CURRENT SITUATION – INVESTMENT ADVISER (DISCLOSURE) ACT**

### **7.1 Characteristics**

The current NZ legislation has the following characteristics:

- There are no licensing requirements for those giving advice
- There are no minimum standards in terms of qualifications or training for those who give advice
- No recognition is given to any existing professional bodies in terms of advisers having to belong to authorised bodies
- No capital requirements on those providing advice
- No minimum professional indemnity insurance requirements
- No indemnity levy fund against which the public can claim losses from an adviser
- There is a two-tier disclosure approach. The first tier is mandatory disclosure of certain items when giving advice and the second tier is on request disclosure of fuller details when requested by a member of the public

### **7.2 First tier - Mandatory Disclosure**

#### **A. Character disclosure**

Before giving advice or receiving investment money or investment property the adviser (or in the case of an incorporated entity, any director) must disclose in writing to the investor if in the preceding five years the adviser has been:

- convicted of an offence of dishonesty or an offence against the Investment Advisers (Disclosure) Act,
- a director or principal officer of a company that committed an offence against the Act or an offence involving dishonesty,
- adjudicated bankrupt,
- prohibited by law, from taking part in the management of a company.

If none of the above apply to the adviser then no disclosure is required before giving advice.



## B. Money handling disclosure

Before receiving investment money (including cheques) or investment property an adviser must disclose in writing:

- how the payment or delivery of money should be made to the adviser,
- whether or not the money will be held in trust for the investor,
- what records will be kept by the adviser in relation to the money and whether the investor has access to those records,
- whether or not holding of the money will be audited and if so, the name of the auditor,
- the extent, if any, to which the adviser can use the money for his / her own benefit,
- any other information that may from time to time be required by regulation.  
(No other regulations have been introduced at this time)

Money handling disclosure applies to investment monies or investment property only.

### 7.3 Second tier - Request Disclosure

An investor is able to request additional information from an adviser within one month of being given advice. The adviser must respond within 5 working days. Once a request is made, the adviser must disclose all of the following items:

- the name of any relevant issuer or companies with which the adviser has a relationship and a description of that relationship,
- the types of securities about which the adviser gives advice and if advising only about securities for particular issuer companies, a statement to this effect and the name of each issuer (company) concerned,
- the qualifications of the adviser that are relevant to the advice given, where those qualifications were obtained, and a brief description of the extent to which the adviser has kept up to date the knowledge gained in obtaining those qualifications,
- a brief description of the adviser's experience as an investment adviser,
- if the adviser may receive any remuneration that is likely to influence the adviser in giving the advice, the nature and the amount of the remuneration, and the name of the person or company from whom it will be received.

Some advisers as a matter of practice decide to make “request disclosure” up front as a matter of course and also to comply with the requirements of their particular professional body. Request disclosure need not be given if the information has previously been given.

#### **7.4 Method of Disclosure**

All disclosures are to be made in writing. The disclosure must include the full name, address, and telephone number of the adviser, and if the advice was given by an employee of the adviser, the name of the employee. This must either be handed to the investor or sent to the investor’s last known address (which could be an email address).

#### **7.5 Definitions**

(refer 3.1 above for definitions of investment advice and investment adviser)

##### Member of the Public

A “member of the public” is defined as any person other than:

- a business partner or close associate,
- a relative,
- a professional investor, or
- investment institution.

##### Penalties

Penalties for contravention of the Investment Advisers (Disclosure) Act include:

- prohibiting the person from acting as an adviser or broker,
- enforcing the requirement to disclose,
- and / or fines of up to \$10,000 for an individual or \$30,000 in any other case.

Proceedings may commence at any time within three years after the contravention occurred. Criminal charges can also be brought against the adviser.

### **8. FIDUCIARY RESPONSIBILITY / NEGLIGENCE**

Any person giving advice has a duty of care to their client. If they breach this duty they are subject to a claim under the tort of negligence under common law. The law requires any adviser to act in good faith and not do anything that is likely to mislead or deceive the client or other party.

Under common law, any adviser is responsible to their client for any loss occasioned by their failure to exercise the proper care, skill, or diligence in the carrying out of their duties.

Although no absolute standard can be laid down as to what constitutes proper care, skill or diligence, each case is judged on its own circumstances.

An adviser receiving payment for his or her services is expected to have a higher standard than someone acting without payment.

## **9. SECURITIES COMMISSION RECOMMENDATIONS**

It is very encouraging that the Securities Commission takes its responsibilities in respect of adviser regulation seriously and has a proactive process to look at issues and areas of reform. In February 2002 the Securities Commission issued its formal recommendations in respect of the review of investment adviser law reform.

The main points were:

1. The Commission recommended that the term "*investor*" be deleted from the Act and be replaced, whenever it appears in the Act, with the term "*member of the public*".
2. They recommended that the definition of "*investment adviser*" be clarified so that the exclusion of the issuer or promoter or trustee does not extend to employees, agents and persons otherwise associated with issuers, promoters and trustees who give investment advice.
3. They recommended disestablishing the distinction between initial disclosure and request disclosure and to require every investment adviser to provide investment adviser disclosure to members of the public before giving them investment advice.
4. They recommended that persons who give investment advice to members of the public by way of broadcast, newspaper or periodical be excluded from the requirement to make investment adviser disclosure in respect of matters currently covered as request disclosure.
5. They recommended that the Act specify that where an investment adviser or investment broker has previously disclosed information to a member of the public in accordance with the Act and the disclosure no longer meets the requirements of the Act as a result of a change in circumstances, then if the non-compliance was not material the investment adviser or investment broker shall not be liable under the offence provisions of the Act;

6. They recommended that the Act specify that investment adviser disclosure must include all matters presently listed in both sections 3(1) and 4(1) of the Act.
7. They recommended that the Act also specify that investment adviser disclosure include:
  - a. The date on which the disclosure document was prepared.
  - b. The nature and level or rate of fees that will be charged for the service.
  - c. Whether the investment adviser is a member of a professional body.
  - d. What dispute resolution facilities are available to clients.

8. They recommended that it be mandatory for an investment adviser to refer to the availability of investment adviser disclosure information in any advice advertisement that is authorised or instigated by or on behalf of the investment adviser or prepared with the co-operation of, or by arrangement with, the investment adviser.
9. They recommended that it be enacted as an offence, in certain circumstances and subject to certain defences, for an investment adviser in the course of business or employment to advise a member of the public to acquire securities where the offer of those securities does not comply with the Securities Act or Regulations.
10. They recommended the Commission be given powers to suspend or prohibit an investment adviser or investment broker disclosure document/ advertisement.
11. They recommended that they have powers to suspend investment advisers or investment brokers and freeze investment broker accounts

## **10. INTERNATIONAL REPUTATION OF NZ**

The International Organisation of Securities Commissions (IOSCO) is a worldwide body of regulators with the focus on:

- co-operating together to promote high standards of regulation in order to maintain just, efficient and sound markets;
- exchanging information on respective experiences in order to promote the development of domestic markets;
- uniting efforts to establish standards and an effective surveillance of international securities transactions;
- providing mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offences.

The NZ government, through the Securities Commission, is a member of IOSCO and has agreed to adhere to IOSCO principles. One of the principles involves having a system of adviser regulation / registration.

The relevant IOCSO document is called “Objectives and Principles of Securities Regulation” and was updated in February 2002.

The part of the IOSCO document relating to the Protection of Investors states:

“Investors should be protected from misleading, manipulative or fraudulent practices, including insider trading, front running or trading ahead of customers and the misuse of client assets.



Full disclosure of information material to investors' decisions is the most important means for ensuring investor protection. Investors are, thereby, better able to assess the potential risks and rewards of their investments and, thus, to protect their own interests. As key components of disclosure requirements, accounting and auditing standards should be in place and they should be of a high and internationally acceptable quality.

Only duly licensed or authorised persons should be permitted to hold themselves out to the public as providing investment services, for example, as market intermediaries or the operators of exchanges. Initial and ongoing capital requirements imposed upon those license holders and authorised persons should be designed to achieve an environment in which a securities firm can meet the current demands of its counter parties and, if necessary, wind down its business without loss to its customers.”

As such the world-wide body has a standard recommending a system of licensing and minimum standards. The current environment in NZ does not comply with these international standards even though NZ is a full member of IOSCO.

There is an argument that by not adhering to the IOSCO principles the international reputation is tarnished.

IOSCO members express their commitment to the objectives and principles it sets out. Insofar as it is within their authority, they state they “intend to use their best endeavours within their jurisdiction to ensure adherence to those principles. To the extent that current legislation, policy or regulatory arrangements may impede adherence to these principles, they intend that changes should be sought”.

I am not sure about this argument and local practice must be also considered. Although international practices are an important consideration they are not necessarily suitable completely for NZ conditions.

The question is why should NZ have looser standards than a body of which we are a full member ?

## 11. ROLE OF PROFESSIONAL ORGANISATIONS

We should consider what distinguishes a profession from a trade body and what the essential features of a profession are:

- (a) A profession involves a skill based on theoretical knowledge
- (b) The skill requires training and education
- (c) The professional must demonstrate competence by passing a test
- (d) Integrity is maintained by adherence to a code of conduct
- (e) The service is for the public good
- (f) The profession is organised
- (g) Profession should undertake some research and add to intellectual capital

The essential feature which distinguish a profession are service for the public good, adherence to a code of conduct and requirements for standards of skill (initially and ongoing).

Any professional body whose members are involved in providing investment advice must act as advocates for the consumer and also set standards for its members.

With regard to the subject of adviser regulation and actions the role of the finance related professions should, in my view, be as:

- Public interest advocates – *promoting the interests of the public in relation to the provision of financial advice.*
- Public policy advocates – *making submissions and making valued comments to regulator and other bodies considering change in this area.*
- Conduct - *To promote and encourage proper conduct among the members of the profession. If profession accepts its members give investment advice then it must be involved in setting standards for members who act in this area.*
- Practice role - *To suppress improper and illegal practices by members of the profession, including in the area of financial advice.*



- Body of learning - *To promote opportunities for the acquisition of financial knowledge. This includes adding to the body of research on the subject of advice.*
- Arbitrator - *To provide means for the appropriate resolution of professional differences amongst members of the profession and possibly between members of the public and members of the profession.*

## 12. NEED FOR TIGHTER REGULATION

### 12.1 Arguments for tighter regulation

#### Sets minimum standards for those giving advice

This is a strong argument for a system of licensing, authorisation or minimum standards. In the current regime someone could be a paint sprayer all his or her life and suddenly change and call himself / herself an investment adviser and be giving investment advice to members of the public without any formal qualifications or experience.

#### Reduce fraud and inappropriate advice

Undoubtedly there are cases of both fraud and inappropriate advice and the Securities Commission has investigated some of these. There is an argument that tighter regulation will act to reduce the level of such events.

#### Mechanism to have some form of expulsion of inappropriate advisers

A system of licensing or authorisation will allow the public to make complaints about inappropriate advice, for these to be investigated and if necessary for the expulsion from the approved list of the individuals involved in performing inappropriately.

Without licensing or authorisation it is harder to have a system of expulsion.

#### High regulatory standards reduces systematic risk

This is an argument put out by IOSCO. Examples of systematic failure include the pension mis-selling issue in the UK.

A tight approach to regulation allows the regulator to identify the areas of macro concern and systematic failure and act accordingly.

### Investor protection

There is an argument the public will feel more comfortable knowing the adviser has a certain standard of training / experience and a framework behind him or her. This is the whole point of regulation of course.

### Improve market efficiencies

It is a fact there is a scarce amount of resources and capital available for investment is limited. Using this scarce capital to produce the best results is important and a high standard of advice may act to facilitate this.

### To allow New Zealanders to have better investment outcomes

By removing / reducing inappropriate advice.

## **12.2 Against regulation**

### Free market

There is an argument that the invisible hand of the free market will find ongoing optimum positions in terms of the balance between high levels of adviser and the cost of achieving those levels. Any moves to interfere with this will simply move one away from the optimum. This does have some appeal to my capitalist tendencies.

### Caveat Emptor

There are arguments for buyers beware and the view that trying to create artificial protection takes away personal accountability and responsibility.

### Regulatory costs

The main argument against any system of regulation, including authorisation and licensing, is that there are significant regulatory costs. If these costs outweigh any benefits then the regulation will be a negative sum game.

### Fraud / poor advice will happen anyway

Jurisdictions with strong regulation are still subject to fraud and poor advice. A clear example of this is the UK where advisers were authorised but there was still the pensions mis-selling scandal.

### Why are financial services different?

All services (not just financial services) have clear regulation in the form of the Consumer Guarantees Act and the Fair Trading Act. Sometimes we should question why we feel it necessary to have tougher regulation for financial services. The arguments are given that our industry involves uncertain futures and people's livelihoods but other services are also important.

### Moral hazard

There may be a moral hazard that a tight environment may create a moral hazard, as consumers let down their guard expecting the regulation will see them right. This is particularly important if the government is setting the regulation. Some members of the public may see this as some form of government guarantee that if they suffer from poor advice then they have recourse to government compensation on the basis the system was set up by the government.

### Anti-competitive

The market for investment advice is currently very competitive with freedom of movement of labour. Any system of licensing or authorisation will set up barriers to new entrants and be anti-competitive.

### Creation of lazy monopolies through authorised bodies

One possible approach of having self regulated bodies providing authorisation may lead to lazy monopolies. The self-regulated bodies will be a form of compulsory unionism. In the current environment they have to add value or their membership will reduce, as they are voluntary.

## **13. FUTURE OPTIONS**

### **13.1 Status quo**

I believe this will continue for the short-term but in the medium term the increasing demand for stronger regulation will make the current position unsustainable.

### **13.2 Minor changes to current structure**

In the medium term this appears to be the most likely scenario and this seems consistent with the approach being taken by the Securities Commission. The recommendations outlined by the Commission seem positive and I support them.

### **13.3 Full licensing by Government**

I believe this is not appropriate. It would create a moral hazard for the government and the high costs of such a regulatory regime would be hard to justify in New Zealand.

### **13.4 Capital requirements or compulsory PI or fidelity fund**

Setting minimum capital requirements for those who give advice would act to provide some security for consumers. The reality is the capital requirements needed to make a significant difference would be so large as to exclude very large numbers of advisers and act as very anti-competitive.

Compulsory PI cover would help in some ways but in my limited experience there are often issues as to what is actually covered and what is not. Unfortunately people are not always clear to the underwriters as to the nature and extent of the professional work they are carrying out.

A fidelity fund on the face of it has some attractions. The fundamental flaw is that the honest end up paying for the dishonest advisers. Also unlike other professional work such as the law it is not often clear who is involved in investment advice as much of it is incidental.

### **13.5 Encouragement of standards and qualifications**

One area where I believe we could build upon the existing regime is through the encouragement of standards and qualifications.

There are some excellent education programmes offered by bodies such as the FPIA and consumers should be encouraged to make queries of their adviser as to the nature of the training and education they have.

### **13.6 Self-regulatory bodies**

My belief is that rather than full-on regulation with licensing high costs (borne largely by consumers) and other requirements a better model is the encouragement of self-regulatory bodies (SRB) as a model (but not a compulsory option). A partial self-regulating regime would approve SRBs which have an established code of practice to regulate behaviour, guide advice, require appropriate disclosure, regulate membership criteria and provide appropriate discipline mechanisms.

The lack of a SRB may penalise the reputable investment advisers with compliance costs, while leaving the marginal operators largely unregulated and undifferentiated from reputable advice providers.

### **14. MINIMUM STANDARDS / QUALIFICATIONS FOR THOSE GIVING ADVICE**

In the current environment there are no minimum standards. Personally I believe consumers should be encouraged to seek out minimum standards and be educated as to their importance. I am not yet convinced of the benefits of having minimum standards set through some form of regulation.

### **15. PERSONAL THOUGHTS ON IMPLICATIONS FOR FINANCE PROFESSIONALS**

Finance professionals often provide investment advice, and in many cases provide specific investment advice. I believe this is more widespread than many professions are actually aware of. I advisers when making financial statements about arrangements of an investment nature (such as superannuation schemes), are often indirectly providing advice which impacts on the ultimate individual consumers of the arrangements and thereby giving advice.

This is an important issue in terms of how the profession deals with members who give advice (especially those who do so incidentally). An important consideration is how the coverage of any Professional Indemnity insurance works in terms of incidental investment advice. Given the duty of care requirements in this area it would be advisable for professionals who feel they may give advice to ensure that the coverage of their PI policies includes investment advice.

Finance professionals attempt to make financial sense of the future by reference to the past and models of the future. It is important for actuaries involved in providing advice to discourage consumers from making investment decisions on false assumptions.

Professions need to do more to understand the extent to which members are involved in the provision of advice. If it turns out there is a significant involvement (including incidental advice) then is beholden upon the profession to set standards for members acting in this area. Also the profession should consider taking a more active role in public policy advocacy.

The Economist magazine put it well in April 2002 when it said,

“Above all, investors should remember those old principles of commerce. Besides caveat emptor stands another: he who pays the piper calls the tune. Whatever the rules or the internal walls, the recommendations of any analyst who is paid a small fortune by his bank should always be regarded with suspicion. No amount of structural changes, lawsuits or compensation funds can beat this simple advice.”

## **17. CONCLUSIONS**

There is no clear definition of what is meant by financial advice. The best definition appears to revolve around the provision of information or analysis of a financial situation and formulation or advice on strategies to allow individual to achieve economic goals.

There have been significant changes in the financial services environment in recent years with a plethora of new products and consumers facing much confusing information.

The world-wide trend to tighter regulation of those providing advice has not been evident in NZ.

The most important question is whether the public would be better served by the current deregulated environment or whether a regulated model with minimum standards and possible licensing is appropriate. The answer from my limited efforts appears to be on the side of yes.

The professions should recognise this and move to proactively lobby for legislative change to create a more appropriate environment.

The finance-related professions should also do more to understand the extent of their members' involvement in this area and set standards in place for their members.

If tighter regulation is not forthcoming there is still a role for professions to develop standards amongst their members and create a mechanism that allows investors to differentiate between those who voluntarily adhere to high standards set by their profession and other advisers with no minimum level.

Clients must be protected and strict qualifications for people practising financial advice should be maintained along with mandatory continued professional development.

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### Notes on the author

Brian Lenehan is a part-time extra-mural student at Massey University and currently undertaking a course of post-graduate study in Finance. Brian graduated with an honours bachelor degree majoring in Econometrics from Manchester University in 1986.

Brian is a qualified actuary (Fellow of the UK Institute of Actuaries and the New Zealand Society of Actuaries – NZSOA) and member of the Council of the NZSOA and past chair of its Finance and Investment Committee.

Brian has taken an interest in securities regulation and in 1998 presented a paper to an actuarial conference of the amendments to the Securities Act. Brian was responsible for the submission of the NZSOA on the review of adviser regulation and also was asked to provide input to the Law Society's submission.

Brian works in Auckland for Royal & SunAlliance – one of NZ's largest financial services companies. Brian has been responsible for Royal & SunAlliance's retail investment business since 1999. In addition, since May 2002 Brian has been General Manager Marketing (Acting) for Royal & SunAlliance. Brian has been in management roles with investment and insurance companies for nearly 15 years.