INVESTMENT SAVINGS & INSURANCE ASSOCIATION OF NZ INC

SUBMISSION

TO THE COMMERCE SELECT COMMITTEE

ON THE

FINANCIAL SERVICE PROVIDERS (PRE-IMPLEMENTATION ADJUSTMENTS) BILL

SUPPLEMENTARY ORDER PAPER

15 April 2010

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INVESTMENT SAVINGS AND INSURANCE ASSOCIATION OF N.Z. INC.

1.0 Introduction

1.1 The Investment Savings and Insurance Association ("ISI") has made a submission to the Select Committee on the Financial Service Providers (Pre-Implementation Adjustments) Bill ("the Bill") and this submission on the Supplementary Order Paper ("SOP") should be read in conjunction with that earlier submission.

1.2 This submission deals solely with concerns arising from the new concepts and definitions introduced by the SOP.

1.3 The SOP replaces all references to 'investment transactions' with the new concept of 'investment management decisions'. The definition of 'investment transactions' which is repealed by the SOP covered

> *the receipt, handling, payment or investment of money or other property by one person on behalf of another person in relation to acquiring or disposing of a financial product*

The definition of 'investment management decisions' covers the activities of a person acting under delegated authority to manage and make decisions about the acquisition and disposal of a client's holding of financial products.

1.4 Money handling aspects previously included as investment transactions are now covered (with some exceptions) under another new definition of 'broking services'.

2.0 Investment Management Decisions

2.1 In discussions with officials last October ISI pointed out the difficulties that arose with the Financial Advisers Act requirement that investment transactions could be carried out only by an individual and for category 1 products that individual must be an authorised financial adviser ("AFA").

That meant that any investment transactions involving category 1 products carried out within a company (such as the receipt of investment amounts for category 1 products) would have to be done in the name of an individual within the company who was an AFA. Similarly, the transfer of amounts from an investment company to a subsidiary that provides KiwiSaver (a category 1 product) would be an investment transaction and therefore would need to be done in the name of an AFA.

2.2 The introduction of the concept of a 'broking service' being able to be performed by either an entity or an individual addresses some of the issues with the previous

'investment transaction' definition. However, a problem remains in that only an individual can make an 'investment management decision'.

The concept of investment management decisions only being made by individuals is not feasible for investment managers. Clients of investment managers engage the investment manager as a corporate to provide services, not the individuals within the corporate. It is not practical to expect specific staff within an investment manager to take individual responsibility (and potential large corporate liability) for decisions that are made by the investment manager as a corporate.

At the very least the Act should allow entities to make investment management decisions if they ensure that the relevant employees comply with the conduct obligations in the Act. An adapted QFE model could mitigate some of the problems by allowing an entity to make investment management decisions (and be liable for them) if the entity takes responsibility for its employees who provide the service rather than the employees having individual responsibility.

Recommendation 1:
The SOP should be amended to allow investment management decisions to be provided by entities as well as individuals.

2.3 The new section 12 (i), which the SOP inserts into clause 8 of the Bill, is limited in the exceptions it provides. It does not apply if the investment management decision is made by the product provider itself, for example, a unit trust manager or trustee of a superannuation scheme making investment managements decisions. Nor does it apply to sub-delegates of an investment manager, for example where an investment manager for a product provider sub-delegates to a specialist asset class investment manager.

Section 12(i) also does not recognise that it is common practice for investment managers to be appointed by a person other than the issuer. For example, in the case of a superannuation product, the issuer is the trustee. The trustee may delegate the investment management responsibility to the manager and the manager (not the issuer) may appoint the investment manager.

The exception in section 12(i) should apply where an investment manager is appointed in relation to a financial product regardless of who makes the appointment. It can be assumed that whoever makes such an appointment would have the requisite authority to do so (from either the manager or the trustee of the financial product).

Recommendation 2:
The new section 12(i) as it appears in the SOP should be amended by:
(i) Deleting the words 'by a product provider' from line 3
(ii) Adding the words 'as a product provider or' at the end of line 1; and

(iii) Adding the words 'all or some of' at the end of line 3.

With these amendments, section 12(i) would be:

"*any person making an investment management decision as a product provider or in the course of an appointment (of that person or that person's employer) to undertake all or some of the investment management functions of the product provider in relation to the relevant financial product:*"

2.4 The SOP does not specifically address the provision of 'investment management decisions' for clients that have a high degree of financial knowledge and/or have expert advisers on investment matters. An example of such clients is those that engage the services of investment managers. Those clients are in a position to negotiate the terms of their investment management agreements (including appropriate recourse) and are able to ensure that their commercial interests are protected.

Such clients also engage investment managers as an entity rather than individuals within the investment manager (we refer to our comments above in paragraph 2.2). The Act will impose unnecessary compliance costs on the provision of investment management services to these clients without affording any further protection.

Recommendation 3:
The provisions relating to 'investment management decisions' in the SOP should not apply to the clients described in paragraph 2.4 above.

2.5 **Recommendation 4:**
The new section 11A is misnamed as it applies more broadly than to investment management. It should be headed 'When person makes financial product management decision' and 'investment' should be replaced by 'financial product' in the first line. Corresponding changes should be made to all other references to 'investment management decision' in the SOP.

3.0 Financial Advice

3.1 As noted above in paragraph 2.2 above, clients engage investment managers as a corporate to provide services, not the individuals within the corporate. As such, the new section 11A inserted by the SOP should be amended to allow investment management decisions to be provided by entities as well as individuals.

Clients also engage investment managers as a corporate to provide financial advice, at times in conjunction with making investment management decisions. It is common for an investment manager in making an investment management decision to also 'make a recommendation or give an opinion or guidance in

relation to acquiring or disposing of a financial product'. The SOP should recognise this.

Recommendation 5:
The SOP should be amended so that specific entities (such as investment managers) that make investment management decisions are able to provide financial advice to clients as an entity (and such financial advice should not be required to be given by a specific individual).

Individual ISI members may make their own submissions on particular issues and one member has indicated that it does not support recommendation 5.

4.0 Broking Services

4.1 The definition of broking services picks up most of what were previously classed as investment transactions.

(1) A broking service is the receipt, holding, or payment of client money or client property by a person acting on behalf of a client.

(2) The mere transmission of a non-negotiable instrument payable to another person is not a broking service.

The definition of 'broker' includes either an individual or an entity. Although 'client' excludes a product provider, the definition of broker could capture a corporate entity such as a custodian that receives client money from a wrap provider or a trustee of a unit trust (neither of which is a product provider as defined).

Recommendation 6:
The definitions of broker and broking service in the SOP should be amended to specifically exclude 'business to business' broking services, for example, a custodian providing services to a trustee or manager of a financial product or to a wrap service.

The SOP repealed the previous sections 12(i) and 12(j) of the Act and these are not replicated in the new section 77C. We recommend that provisions equivalent to the previous sections 12(i) and 12(j) be included in section 77C.

4.2 **New Section 77F(2)(c)**
Section 77F(2)(c) inserted into the Act by the SOP allows regulations to prescribe disclosure in relation to fees but does not mention other forms of remuneration the broker may receive.

Recommendation 7:
New section 77(F)(2)(c) as it appears in the SOP should be reworded to refer to 'any fees or direct or indirect remuneration'.

4.3 New Section 77P

An amendment to the effect that any client money or property held by the broker *is* held on trust would avoid the situation where the broker does not comply with the requirement to hold client money or property on trust under section 77P(1)(a) and there is a debate as to whether another party has a claim (e.g. an insolvency). It would also address the situation where problems arise as a result of non-compliance and a third party becomes a broker inadvertently – e.g. an employer who does not forward employee contributions promptly to a product provider.

Recommendation 8:

The SOP should be amended to include an additional clause to the effect that client money or property held by the broker will be deemed to be held on trust even where a trust has not been established under section 77P(1)(a).

4.4 There is currently no requirement in the legislation for AFAs to report breaches of the Act or the Code of Professional Conduct for Authorised Financial Advisers. Code Standard 7 of the draft Code requires AFAs to report breaches of the Code and Act by other AFAs to the Securities Commission. Whistle blowing provisions such as these typically have statutory protection for whistleblowers.

Recommendation 9:

The SOP should include an amendment to the Financial Advisers Act to provide protection for compliance with the whistle blowing requirements of the Code (similar to section 127 of the Insurance (Prudential Supervision) Bill).