INVESTMENT SAVINGS & INSURANCE ASSOCIATION OF NZ INC

SUBMISSION

TO THE

MINISTRY OF ECONOMIC DEVELOPMENT

ON THE

REVIEW OF FINANCIAL PRODUCTS AND PROVIDERS

Review of Platforms and Portfolio Management Services

13 December 2006

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Introduction

The Investment Savings and Insurance Association ("ISI") welcomes the opportunity to comment on the Discussion Document *Platforms and Portfolio Management Services* issued as part of the Review of Financial Products and Providers ("RFPP"). Our comments are made on behalf of our members who are the issuers and managers of life insurance, superannuation and managed funds listed at the end of this paper. Our members are keenly interested in the proposals put forward for regulation of the financial services industry and we have appreciated the extensive consultation on these issues with officials and advisory groups.

ISI generally supports the overall framework for regulation of the financial services industry and the registration proposal. This submission comments on the specific proposals that will impact on platforms and portfolio management services.

General Comments

ISI commends the Ministry of Economic Development for the process followed in the RFPP and the opportunity it presents for the regulation of financial services to be considered in a comprehensive manner. The discussion documents produced by MED together provide a very useful overview of the application of different pieces of legislation to the various products and services available within the industry.

We endorse the approach to financial services regulation from the point of view that comparable products and services should be regulated on a comparable and consistent basis in order to increase the protection and understanding of consumers and reduce the cost of compliance for providers. One of the key outcomes to be hoped for must be an improvement in the environment for saving in New Zealand in order to raise the level of personal saving and increase the pool of local savings available for investment.

As noted above, ISI members are the companies issuing and managing life insurance, superannuation and managed funds in New Zealand. That involves various ISI members in most of the activities reviewed as part of the RFPP: insurance, superannuation, collective investment schemes, platforms and portfolio management services, the offering of securities and consumer dispute resolution and redress.

All ISI members have an interest in New Zealand maintaining a robust and efficient financial services system which has the confidence and respect of the New Zealand public and local and international institutions. ISI has taken a leading role for the industry in commenting on law reform issues. Key issues in recent years have been the recommendations for review of the Life Insurance Act 1908 and the review of the Securities Act and Regulations.

We are aware of the need for financial services regulation in New Zealand to take account of responsibilities towards the security of international financial markets and ISI has provided submissions to recent Ministry of Justice discussion documents on

anti-money laundering and countering the financing of terrorism (FATF Recommendations). As most ISI members are trans-Tasman companies, we are also acutely aware of the issues around trans-Tasman mutual recognition.

A holistic approach to regulation of the financial services industry should ensure that all of these factors are taken into account in the design of a new regime.

Many observers believe that platform providers and the associated parties (Custodian and Administrator) operate in an environment free from regulation. There are in fact a number of statutes which impose various obligations on such parties. These statutes include but are not limited to The Fair Trading Act, Consumer Guarantees Act, Trustee Act and Securities Act. That said, it is fair to say many consumers are unaware they have some protection under such Statutes.

Platforms and Portfolio Management Services

Definitions

Platform Providers should be defined as that entity which actually owns/controls the Wrap and provides all the supporting documentation. The platform provider may either own all the operative aspects of the platform or alternatively outsource or contract out to a third party some or all aspects of its operation.

Portfolio Service Provider – the definition contained within is appropriate.

Custodian - the definition contained within is appropriate. As additional information, the custodian is appointed by the platform provider and can be one and the same. Alternatively, a platform provider can delegate the administration and/or custody to a third party.

Registration

ISI supports registration of platform providers to a degree. The proviso is that there needs to be very clear definitions and criteria against which capability, capacity and independence will be assessed. For example, platforms may have different functions and facilities however as long as they meet the minimum criteria for entry, then they should not be disadvantaged.

Entry Criteria

ISI supports the entry requirements for platform providers and custodians detailed in paragraphs 5.1.3.1 and 5.1.3.2. We do not consider that any further requirements are necessary.

We agree that custodians should be a Body Corporate for the reasons outlined in the document around perpetual succession.

In the event that an applicant is declined approval, ISI recommends that the applicant should be given the opportunity to present further information or have the opportunity to amend the deficiencies that have been identified and then re-present. This is based on the assumption that the entry criteria are very clear and there is little room for ambiguity. It is recommended that the Commission liaise with the existing platform providers when building the fit and proper entry requirements.

Independence
For practical reasons it makes sense to have an element of independence but not total independence as this will possibly impose additional costs on the investor without actually adding additional protection.

ISI considers that the platform provider and the custodian can be one and the same (and most in the NZ market currently operate like this) as long as there is a clear process to ensure monies are not intermingled as required by the Trustee Act. A requirement for complete separation is likely to incur additional costs without providing additional protection for investors.

The alternative is point 59 where companies create complex structures which add cost and confusion to the investor.

ISI considers that a requirement to appoint an independent director would introduce unnecessary complexity. We would, however, prefer that option to a requirement for complete separation between platform provider and custodian.

Monitoring 'Fit and Proper' Requirements
ISI generally supports the proposal for reporting to the Commission on an annual basis, the exception being that the provider and custodian must report any material change as soon as it is identified or intended which may lead the Commission to determine that entity no longer meets the minimum criteria.

We consider that more detail is required before full endorsement can be given to the reporting requirements. In addition, any direction by the Commission must contain the timeframe in which the issue must be rectified, clear actions as to what must be done, and what the consequences are if the appropriate course of action is not taken.

Also, on the basis that the "fit and proper" methodology is adopted, thought should be given to a transitional period allowing those currently in the marketplace to implement any necessary changes without the fear of repercussion.

Consideration needs to be given to what happens if one entity no longer meets the minimum criteria.

- What message is communicated to existing investors?
- What happens to the existing investors who wish to transact?
- Who takes responsibility for the platform while the issues are being sorted?

There needs to be sufficient flexibility to ensure where possible that the platform can keep operating while any issues are being resolved. Anything that affects an investor's ability to transact will seriously undermine confidence in the system and potentially cause a run on funds which has wider implications for not only the provider/custodian but the entire financial services industry.

Intuitively it makes sense that the Commission's first role should be to assist the offending party to become compliant. It needs to be very clear what the consequences are between the breach and the required action along with realistic timeframes to

correct the breach. The proposed options listed are appropriate, however point (d) being the revocation of an entity's approval, needs to be seen as a last resort for the reason outlined in the answer to question 9.

The provider/custodian should have the ability to appeal to the High Court but in reality if it is very clear as to why the revocation order has been issued then very few would take their case higher. This is the last stop after all other avenues have been explored and again comes down to there being very clear definitions as to what is required to be "fit and proper".

Governance Requirements
ISI supports the proposals. We believe there should be a minimum standard to ensure there is consistency across portfolio service providers and platform providers. In both cases the integrity of the solution and the provider of that solution are paramount to ensuring investor confidence. Minimum capital requirements should be included. A potential issue to consider is whether having the Commission standing behind its minimum standards would enable a platform and/or custodian meeting those standards to advertise that they are approved by the Commission. Assuming this is so, we would like clarification of the liability that the Commission would face if a "Securities Commission approved platform/custodian" failed.

Functions and Duties of Platform Providers
ISI generally agrees with the function outlined but considers it does not go far enough. In practice, many of the functions of platform providers are aimed at advisors rather than investors.

We recommend that where the platform provider is also the marketer of that product then they should be responsible for all marketing and disclosure obligations unless they are simply appointed by a third party to provide an administration solution only. In the latter situation, the party seeking this solution may elect to provide all marketing and disclosure information.

ISI considers the duties outlined in 5.2.2 are appropriate, with the proviso that additional clarity should be given to the statistical data that is required and the purposes for which that data will be used and disseminated. We would also appreciate confirmation that statistical data will not be required to be reported to more than one agency.

Reporting Statistical Data
ISI considers that there is some information which may be provided to the Commission but should remain confidential while other information that could be made available to the Commission without incurring any significant cost i.e. funds under management, number of users, dollars invested by product. By their very nature, platforms should be able to accommodate any type of report.

Data that should be included and made public:

- Funds under management
- Number of users
- Number of products
- Fees charged by the platform

Data that should be provided but kept confidential to the Commission:

- Users (by way of company and adviser name) of the platform and funds under management – this will allow the Commission to cross check against the proposed register of financial advisers if necessary.
- Any issues that are material and have been corrected by the provider as part of their self audit process.

Portfolio Service Providers
ISI supports what is proposed and additionally directs the reader to the answer for Question 14. This includes the additional duty to act in the best interest of clients and to act with due care and skill. The reason for this is that many advisers utilizing such a system take over the decision making process on behalf of their clients by way of power of attorney.

Powers
ISI considers the powers set out in the contract between the platform provider and the investor should be sufficient. Any other powers have potential to contravene the Bare Trust arrangement. All power should stem from the authority given by the investor.

Remedies for Breaches
ISI considers the proposed remedies for breaches are acceptable however again there must be very clear guidelines regarding what is expected from a platform. It is reasonable to expect the Commission to have the ability to step in and take appropriate action where a "substantial issue" has occurred that is a direct result of the Platform being unable to deliver what it is contracted to deliver. It is also expected that the Commission will have the right to prohibit the platform provider promoting or providing a platform if the breach warrants it.

We suggest remedy first, compensation second and penalties third. Depending on the nature of the breach, the Court may elect to remove the authority for the platform to continue and may instruct a transfer of assets across to another approved platform. We would like to see a facility for alternative dispute resolution options to be used before Court proceedings are instigated.

It is worth pointing out that there may be situations where a client is provided with incorrect data but it is not actually due to a failure on the part of the platforms. Many platform providers take external data feeds from product providers which include items such as pricing, fee rebates, and distributions etc. Inaccurate data-feeds will compromise the integrity of the reports the platform can generate. Additionally, issues may arise around the way various product providers account for tax which may be incorrect (ARMIS as a case in point). Responsibility for these issues clearly lies with the product providers as opposed to the platform provider that happens to report on that particular product.

Finally, there may be situations where there is product failure and that product is on the platform. Inclusion of a product on a platform should not constitute a product recommendation unless specifically stated.

Enforcing Platform Provider Compliance
ISI supports the imposition of compensation to ensure platform provider compliance with proposed legislation, provided it is limited to restoring the investors concerned to the position they would have been in if the breach had not occurred.

Financial Advice
ISI considers that, in order to ensure consistency and to avoid ambiguity, platform providers and advisers should be regulated separately.

We agree that a person can be both a platform provider and a financial adviser, as long as they are meeting the legal requirements of both and fully disclose this relationship.

Custodians
ISI considers that the duties described are sufficient. It is worth noting that point (g) relating to investors being promptly paid will also be determined by the nature of the underlying product. For example the custodian cannot make a direct payment if the fund they are withdrawing from has a 90 day notice period or the assets are illiquid such as selected debentures. More clarity is needed on this point.

With regard to statistical reporting we recommend that it should be limited to data identifying the size of the custodial services market and care should be taken to ensure there is no unnecessary duplication of data collected from the platform provider. As noted above, we would appreciate confirmation that statistical data will not need to be provided to more than one agency.

Auditing
ISI considers that a financial audit once a year by an independent auditor is necessary. The audit report should be provided to the Commission. The custodian is the integral component of a Wrap and without it performing correctly the whole integrity of the platform is destroyed. We question whether the cost of a financial audit would be significant as this is part and parcel of their current operating costs and can be part of the wider audit of the company.

With respect to a systems audit we believe that it is reasonable to conduct these every 2 to 3 years on a rolling basis. Doing such audits on an annual basis is simply not practical.

Powers of the Custodian
ISI considers the powers listed and proposed in paragraph 97 are sufficient.

Remedies for Breach by Custodian
ISI considers the proposed powers are appropriate and would add that the Commission should have the power to prohibit the custodian from providing custodial services if the breach warrants it. In the event that it was determined that a custodian should be removed, the Commission needs to consider how practically this could be accomplished as, under a wrap platform structure, the legal relationship is between the custodian and the investor. If the custodian is removed then the relationship would dissolve.

We recommend that all of the powers in paragraph 99 should be subject to a requirement for 'reasonableness'.

We agree that compensation is appropriate provided it is limited to restoring the investors concerned to the position they would have been in if the breach had not occurred.

Functions, Duties

We agree that the proposed functions, duties and powers of the custodian of a platform should extend to a portfolio management service for the reasons outlined in paragraph 101.

Whistle-blowing

ISI agrees that each platform should have a published complaints process plus a whistleblower process for product providers on the platform. We also agree that the whistle-blowing provisions should extend to portfolio management services.

Disclosure

ISI agrees that there should be a PSDS with respect to platforms which should include what is detailed in Section 9.2. It is crucial that investors receive the necessary information prior to making any decision. Transparency is paramount with respect to the way such platforms operate. We also concur with the MED view that disclosure may be made to an individual holding a power of attorney as opposed to the investor where this situation occurs.

In the situation where an investor has delegated power of attorney to an adviser or another person then all disclosure should be made to that adviser or attorney. From there, what is disclosed to the investor should be covered in the adviser's contract of engagement or, if an attorney, via that agreement.

We assume the definition of Service Level agreement is where the adviser has full discretion to act on the investor's behalf with respect to the platform. Such an agreement should clearly spell out what is expected from both parties and be signed by both parties.

We agree that the platform provider should be required to ensure the information contained in the PSDS is correct as ultimately they are the entity promoting the vehicle.

In the vast majority of cases investors can only get access to a wrap platform via an adviser and this is where the face to face communication occurs. We know of no platform with a bare trustee that accepts investors directly without the introduction of an adviser.

ISI considers that the responsibilities of advisers should be consistent with the recent amendments to the Securities Markets Act and the MED proposals for regulation of financial intermediaries and our following comments are given with that proviso.

We believe the adviser should be responsible for making disclosure on their fees/expenses and providing information which discloses platform and investment

fees. Material terms in the Service Level Agreement should also be disclosed. Clarity needs to be given as to what is deemed to be material.

Fees should be based on the current fee structure at the time of investing with a note to say that these fees will change over time, subject to volume, rebates, new negotiated pricing, new managers etc. The investor needs to be aware of what triggers can cause changes to their fees whether that change be advantages or disadvantageous.

All “adviser” and “wrap fees” in a Wrap are deducted from the clients cash account and there is no way to disguise these fees. As a result of this, advisers should be given the option to either disclose in dollar terms or percentage terms. The important factor is the investors’ understanding of what they are paying and what they are receiving for this payment. Illustrative MERs will in our opinion simply cloud the issue and create additional confusion.

We believe that such disclosure should extend to portfolio management services as we believe there should be no differentiation in this regard.

Breaches

We question the suggestion that a platform provider can commit an offence if it has information in the PSDS that is confusing. While providers should undertake to use best endeavours to make the wording as simple as possible, by their very nature such platforms are complex and are difficult for some investors to understand. This in itself can cause confusion from the investor’s perspective. We fully agree that the platform provider will commit an offence where the information enclosed in the PSDS is deceptive or misleading. An offer is misleading as per the definition contained within the Fair Trading Act.

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