OFFICE OF THE MINISTER
OF COMMERCE

The Chair
CABINET ECONOMIC DEVELOPMENT COMMITTEE

REGULATION OF FINANCIAL INTERMEDIARIES

PROPOSAL

1 This paper outlines the final report of the Financial Intermediaries Task Force (Task Force) on the regulation of financial intermediaries in New Zealand (attached), provides a response to the Task Force report, and seeks agreement on a number of Task Force recommendations so that the Ministry of Economic Development (the Ministry) can undertake further design work, in consultation with stakeholders, on the exact details of the Task Force proposals.

EXECUTIVE SUMMARY

2 The Task Force carried out an independent review into financial intermediary regulation in New Zealand and concluded that consumers, industry and financial markets would benefit from financial intermediary specific legislation. Rather than endorsing the status quo of the current voluntary self regulatory system, or direct government supervision, the Task Force recommended the introduction of a legislative framework for financial intermediaries, whereby a government regulator, Minister and industry-based approved professional bodies would create and approve standards for individuals and businesses who provide financial advice or who market financial products to members of the public.

3 This paper provides a response to the Task Force report and recommends that the Ministry carry out further design work on the co-regulatory model recommended for financial intermediaries by the Task Force, and, as a basis for this design work, that the Securities Commission undertake the role of government regulator.

4 There is still considerable design work to be done on the proposed co-regulatory legislative framework, including work on the definitions and obligations of financial intermediaries and the roles and responsibilities of the government regulator, Minister and the industry-based approved professional bodies. However, I am seeking Cabinet agreement in principle at this stage to the co-regulatory model and regulator to allow Ministry officials to work with industry and the Securities Commission to leverage off existing industry practice and expertise in designing the regime.

BACKGROUND

5 In October 2004, under Cabinet Appointments and Honours Committee decision APH (04) 164, the Minister of Commerce appointed the Task Force to consider and report on the regulation of financial intermediaries. A "financial intermediary" is generally described as an individual or a business who markets financial products or provides financial advice (that is, advice about financial products or investments or savings decisions and choices) to members of the public. This description is likely to include a large number of individuals and businesses (including financial institutions), mortgage brokers, investment advisers and bank and insurance company employees operating in New Zealand's financial sector. The Terms of Reference of the Task Force required it to consider options for reform that would ensure quality financial information and advice is provided to the public and would assist New Zealanders to make the most of their savings. These options for reform included introducing general legal standards; a general registration scheme; restricting occupation designation to those financial intermediaries who complied with certain requirements; or introducing a licensing regime.

6 The Task Force's final report "Confidence, Change and Opportunity" was publicly released in August 2005. In summary, the Task Force recommended that government and industry work together to introduce a co-regulatory framework under which financial intermediaries would be subject to enhanced standards, sanctions, disclosure, dispute resolution and enforcement procedures. A full copy of the Task Force report is attached.

Task Force recommendations

7 The Task Force recommended a co-regulatory model over the status quo (voluntary self regulation), enhanced self regulation or reliance on the state.[1] This was on the basis that:

- there was a high consensus across industry participants, consumers and regulatory bodies (including self regulatory bodies) that change was required, and that it was unlikely to occur in the existing voluntary self-regulatory environment;[2]

- enhanced self-regulation[3] may not be the most effective mechanism for ensuring that the interests of all parties (including consumers) are reflected in the operation of the regulatory system as this model still relies on sufficient cohesion within different sectors of the industry to ensure widespread voluntary inclusion within the system;[4]

[1] Task Force report "*Confidence, Change and Opportunity*" (29 July 2005) pages 35 and 44
[2] Task Force report "*Confidence, Change and Opportunity*", page 35. See also paragraph 19 below.
[3] This refers to a voluntary system where industry develops its own standards and dispute resolution and enforcement mechanisms, but these are backed by legislation (for instance, legislative name protection for a brand developed by the industry).
[4] Task Force "*Consultation Paper: Options for Change*" (23 May 2005), page 38

- while direct government supervision is usually appropriate where there is sufficient similarity across an industry and/or where state responsibility is needed to give greater assurance that industry standards and administration will actually take account of the interests of all parties (including consumers). However, in relation to financial intermediaries, different sectors of the financial intermediary industry have already developed their own standards, dispute resolution and enforcement mechanisms that are appropriate to, and recognised by, different sectors, and it would make sense to utilise these in the regulation of financial intermediaries, with government involvement required only in relation to these industry bodies.

8 Particularly, the Task Force recommended that:

- Financial intermediaries should be split into different classes, with different obligations attaching to each class so that those financial intermediaries who provide personal financial advice to the public would be subject to more obligations than those intermediaries who provide factual advice, or market products to the public.[5] These additional obligations would include:

  - (for those who provide personal financial advice) membership of an industry–based approved professional body and listing on a register; increased disclosure obligations in relation to remuneration, potential conflicts of interest and relationships with product generators, in some cases, in addition to the disclosure obligations being considered for investment advisers and brokers under the Securities Legislation Bill (currently awaiting its second reading); and increased standards of practice to be developed by approved professional bodies in relation to skill, education, experience, and, for businesses who act as financial intermediaries, set processes and policies.

  - (for all financial intermediaries) dispute resolution procedures, under which they may be liable to pay compensation, and disciplinary procedures, which may extend to appeals to the District Court.

- A statutory regulator and a Minister to provide government oversight of the industry-based approved professional bodies and their rules, with both industry and government contributing to funding the co-regulatory framework.

9 The Task Force recommendations are generally at a high level and, as the Task Force itself recognised, there is still a lot of detailed design work to be done. Importantly, the Task Force recommended that a regulatory impact analysis be undertaken after the Ministry has carried out further development work on the recommendations, as many of the specific costs will reflect the detailed design of the proposed regime (the Ministry would seek to minimise design costs where possible).[6] This design work would involve Ministry consultation with potential approved professional bodies, the regulator and other stakeholders.

[5] Refer paragraph 30 below.
[6] Refer to the regulatory impact statement.

This design phase would result in clearer policy proposals on the application of the regime, exact roles and responsibilities of financial intermediaries, approved professional bodies and the regulator, and matters such as dispute resolution, discipline and standards of practice and would set the exact parameters of the implementing legislation.

Why regulate financial intermediaries?

10 New Zealand has resolved to promote high standards of regulation to maintain sound, just, efficient and sound markets under the "IOSCO Objectives and Principles of Securities Regulation" in relation to how we regulate financial intermediaries.[7] In 2004, New Zealand's compliance with these "best practice" principles was assessed by the International Monetary Fund (IMF) Financial Sector Assessment Program. The resulting IMF report[8] recommended more comprehensive regulatory oversight of [financial] intermediaries in New Zealand, through either a licensing regime, or, as a less costly option, the imposition of standards, with monitoring by the regulator. This was on the basis that not all financial intermediaries in New Zealand are subject to comprehensive standards for internal organisation and operational conduct. Regulation of financial intermediaries would help New Zealand fully implement these best practice principles.

11 Financial intermediaries also play a key role in addressing information asymmetry in the financial sector. The market will only operate efficiently if investors can make informed choices about which products or providers best suit their needs and risk levels. Investors often do not have sufficient expertise, time or information to make these choices unaided, and as information is costly to gather and share, and once released the value dissipates, markets may under-produce information. Similarly, as the benefits of developing skills to evaluate firms and products are likely to be spent once the investment is made, consumers and investors may under-invest in financial expertise. Some of the problems with information asymmetries may be resolved through the use of intermediaries which give investors reasonable assurance that the provider is being truthful and that an investment is suitable for their needs. Intermediaries should have the expertise, time and information to break down the knowledge gap between the provider and the consumer to assist in the efficient allocation of resources by matching consumers with products that best meet their needs and risk appetite.

[7] IOSCO Objectives and Principles of Securities Regulation, Principle 23: "[Financial] intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters. "A "financial intermediary" is generally described as an individual or a business who markets financial products or provides financial advice (that is, advice about financial products or investments or savings decisions and choices) to members of the public. This description includes a large number of individuals and businesses (including financial institutions), insurance companies and agents operating in New Zealand's financial sector including mortgage brokers, investment advisers and bank and insurance company employees.

[8] Available as a country specific publication on the IMF website at http://www.imf.org/external/pubs/ft/scr/2004/cr04417.pdf

12 Intermediaries currently have informal incentives placed on them to credibly vouch for the quality of information because their business is based on giving accurate information and they will suffer reputational and therefore economic loss if they provide misleading information or allow a provider to falsify or exaggerate information.

13 However, consumers have limited information and a limited ability to evaluate their financial intermediaries. In addition, consumers may not verify the information provided by financial intermediaries so there may only be incentives on intermediaries to do the minimum necessary to keep their client satisfied. Low entry requirements may also allow intermediaries to operate off the reputations of other intermediaries. Further, as many of the failures in the last decades have shown there may not be sufficient incentives for intermediaries to act ethically or to manage conflicts of interests appropriately (e.g. auditors may act in the directors' best interest rather than that of shareholders, and financial intermediaries may recommend products based on the level of their commission rather than investor or consumer need).

14 The Review of Financial Intermediaries, including the Task Force report and anticipated upcoming work by the Ministry, is intended to result in:

- adequate disclosure of intermediaries' conflicts of interests, fees and competency so that investors/consumers can make informed decisions about whether to use an intermediary and whether to take their advice;
- investors having intermediaries available that have the experience and expertise to effectively match an investor or consumer with products that best meet their needs and risk profile;
- intermediaries being held accountable for any advice given and that there are incentives for intermediaries to manage appropriately conflicts of interest; and
- the promotion of a sound and efficient financial sector in which the public have confidence in the professionalism and integrity of intermediaries.

COMMENT

15 I am seeking in-principle Cabinet approval to the following general recommendations of the Task Force on the regulation of financial intermediaries to allow the Ministry to start design work on the details:

- that there should be a co-regulatory framework for the regulation of financial intermediaries consisting of industry-led approved professional bodies and a government regulator which would work together to regulate financial intermediaries;
- the statutory regulator be the Securities Commission;
- financial intermediaries would be subject to enhanced disclosure obligations when providing financial advice with obligations dependent upon the class of financial intermediary;

- legislation would set a number of conduct standards for financial intermediaries;

- financial intermediaries would be subject to dispute resolution and disciplinary procedures.

16 This design work would be done through consultation with potential approved professional bodies, the Securities Commission and consumer groups. As part of this design work, the Ministry would consider links with other reviews in the non bank financial sector including work on the Review of Financial Products and Providers, Domestic Institutional Arrangements and the Financial Action Task Force 40 Recommendations on Anti-Terrorism and Money Laundering.

CO-REGULATORY MODEL

17 The Task Force recommended an industry and government co-regulatory model which would allow different sectors of the financial intermediary industry to develop their own standards, dispute resolution and disciplinary procedures by forming approved professional bodies (APBs), to which certain classes of financial intermediaries ("personal financial advisers") would have to belong. The Task Force proposed that APBs would be overseen by a government regulator (see paragraph 23 below). An example of a current co-regulatory system in New Zealand is the regulation of engineers managed by an industry body (the Institute of Professional Engineers of New Zealand Incorporated) and a Crown entity (the Chartered Professional Engineers Council).

18 Each APB would represent a number of individuals and businesses undertaking a "personal financial adviser" role. While the exact definition of a "personal financial adviser" is one of the upcoming design tasks for the Ministry (see paragraph 44 below), the Task Force suggested that this role would include those intermediaries who give financial advice or advice on products to members of the public, while taking into account the suitability of the advice/product in light of the consumer's personal circumstances. The Task Force also suggested that lower level financial intermediaries (e.g. those intermediaries who market or promote financial products, or who only provide factual information to the public) would not have to belong to APBs, but would still be subject to dispute resolution and disciplinary functions as well as some disclosure requirements (see paragraphs 28, 40 and 43 below).

Why did the Task Force recommend a co-regulatory model?

19 The Task Force noted that there was strong support from industry stakeholders for enhanced self and/or co-regulation on the basis that the knowledge and practices of existing industry bodies could be leveraged to help address the current limitations of the existing self regulatory organisations. Currently, industry relies on voluntary compliance with codes of ethics and disciplinary procedures, but it is difficult for industry bodies to effectively sanction poor behaviour (e.g. members can simply leave the industry body but still continue to practise) and existing industry bodies are not well set up to deal with all disciplinary matters.

In addition, there was a high level of consensus across industry participants, consumer and regulatory bodies (including self regulatory bodies) that change was required and that it was unlikely to occur in the existing environment.

20 The co-regulatory model depends on sufficient willingness from the financial intermediary industry to form APBs. As part of the upcoming design work, the Ministry plans to consult with a number of stakeholders (who may potentially form APBs) on the exact roles of APBs, which may extend to:

- making rules for financial intermediary members (in addition to any statutory standards placed on financial intermediaries) on matters such as ongoing competency, training, professional indemnity insurance and fidelity fund contributions (etc);
- monitoring compliance by financial intermediary members with both statutory standards and APB rules;
- resolving low level disciplinary and consumer dispute matters;
- providing funds for higher level dispute resolution and disciplinary functions;
- reporting material breaches of standards and bringing disciplinary proceedings against members when there has been a material breach; and
- promoting to consumers their rights and also providing education on the role of the APB (which should not extend to a lobbying role according to the Task Force).

21 The Ministry would also consider whether APBs could include individual firms, such as banks or insurance companies.

Cabinet approval sought for co-regulatory framework

22 I ask Cabinet to approve a co-regulatory framework, broadly as recommended by the Task Force. This decision would allow the Ministry to carry out detailed design work with key stakeholders on the following matters (raised by the Task Force, Ministry officials and agencies consulted in the preparation of this paper):

- the role of APBs: how to deal with the extent of the roles of an APB (refer paragraph 20 above) to ensure that financial intermediaries and consumers are not disadvantaged by the potential increase in costs and complexities in the operation of the regulatory regime.
- the number of APBs: there are potential costs and interface complexities for consumers, industry participants and government if there are a significant number of industry bodies involved in a regulatory role.

- industry capture risks: there is a risk of industry regulatory bodies (especially in those sectors where there is already a strong industry representative) acting as "closed shops" deterring innovation and competition, preventing entry into the industry by creating excessive barriers or not taking into account the interests of all relevant stakeholders (for example consumers) when APBs carry out their regulatory functions.

- lack of APBs in a certain industry: officials need to consider back-up options under the co-regulatory model as it is not clear how the co-regulatory model would work in less developed segments of the market, where either there is no established industry body coverage or else the industry body has little expertise and or experience in carrying out the functions of a regulator (for example, in a reasonably new market segment).

- the role of the regulator and the Minister in relation to rules approval or disapproval, powers of intervention in relation to intermediaries or APBs (regarding conduct, disclosure, or rules), and any need for regulatory backstop provisions in the event of absence or failure of an APB.

- tension in the co-regulatory model: there is a need for clear distinction between the role of the industry bodies and government oversight (through the regulator and the Minister) to balance the risks of government "second guessing" industry body administrative decisions, or placing overly high standards on APBs, against the risk that government oversight may be limited to "rubber stamping", with the structure implying a higher level of government assurance than is actually delivered. This would also include consideration of whether an APB should have prime responsibility for its rules, or whether the regulator and the Minister should have power to propose changes.

- legislation: how legislation would define the required functions of APBs and deal with the potential conflict of existing legislation on financial intermediaries.[9]

- clear consumer information and representation: how to balance the shared responsibilities of APBs and the regulator to ensure effective and consistent delivery of information to consumers (including through the possible use of a register of financial intermediaries), and whether or not there should be consumer representation on boards of APBs.

[9] For example, investment advisers and financial planners are subject to the *Investment Advisers (Disclosure) Act 1996* and the *Securities Legislation Bill*; share-brokers require a share-broker's licence issued by the District Court under the *Sharebrokers Act 1908*; and contributory mortgage brokers must be registered at the Companies Office under the *Securities Act (Contributory Mortgages) Regulations 1988.*

STATUTORY REGULATOR

23 The Task Force recommended that the statutory regulator in the co-regulatory framework should have a market overview role including:

- providing advice to the Minister on the approval/disapproval of APBs and APB rules;
- providing advice to the Minister on the rules of the disciplinary and disputes resolution body;
- the power to impose temporary orders (for example stop order or temporary banning orders) in relation to businesses and individuals; and
- to have stop, banning and rectification powers in relation to the new financial intermediary statutory disclosure requirements recommended by the Task Force (similar to the powers provided to the Securities Commission under the Securities Legislation Bill).

Why is a regulator needed?

24 A regulator is required to balance the enhanced role of the industry-based APBs by monitoring industry activity, approving industry-developed rules, and stepping in where it considers that the industry has not effectively regulated itself.

Cabinet approval sought for Securities Commission to be the regulator

25 I suggest that the Securities Commission is best placed to be the statutory regulator in the co-regulatory model proposed by the Task Force on the basis that:

- the Securities Commission is already carrying out most of the suggested regulatory functions for investment advisers and brokers, both of which groups are included in the broader class of financial intermediaries.
- there is a low risk of conflict between the existing roles of the Securities Commission (already being the "main regulator of investments"[10]) and the role of the statutory regulator envisaged by the Task Force.
- related work on the Review of Financial Products and Providers and Domestic Institutional Arrangements (see paragraphs 48 and 51 below) suggests that the Securities Commission is best placed to be the regulator for market conduct ("market conduct" includes work on financial intermediaries, as well as financial product and providers) while the Reserve Bank is likely to be best placed to take on the role of the prudential regulator.

[10] Refer Securities Commission website: http://www.sec-com.govt.nz/about/

26 I ask Cabinet to recognise the Securities Commission as the statutory regulator under the co-regulatory framework. This decision would create greater certainty for industry stakeholders and would enable more design work on the relationship between the regulator, APBs, the Minister, financial intermediaries and consumers, as well as the exact role and powers of the regulator, and whether this could extend to carrying out high level disciplinary functions (see paragraph 40 below).

27 The Task Force recommended that a Minister have the power to approve or disapprove APBs and their rules. This would be the Minister of Commerce, who would carry out these functions under the co-regulatory model to help balance potential tension between the industry-based approved professional bodies and the Securities Commission. For example, both industry and the Securities Commission would have input on the content of the rules for approved professional bodies, prior to the Minister making the final decision.

DISCLOSURE

28 The Task Force recommended that disclosure of information by financial intermediaries should be clear, concise and effective; enable comparisons across intermediaries; and be standardised where possible. Importantly, the Task Force recommended that there should be research into what consumers would consider useful information and in what form, before the final content and form of disclosure is set.

Why is enhanced disclosure needed?

29 Increasing the quality of consumer information through enhanced disclosure obligations on financial intermediaries will, according to the Task Force:

- enable an individual consumer to make better decisions about an intermediary or a financial product (for example, whether to deal with that intermediary, whether the intermediary's fees are negotiable etc);
- enable a consumer to make comparisons across intermediaries and financial products;
- encourage greater competition between intermediaries and between product generators (for example, competition on fee structures and fee amounts);
- contribute to poor performing intermediaries and/or product generators exiting the market, and good quality intermediaries and/or product generators increasing their business, with the overall effect of increasing levels of performance; and
- address the problem of information asymmetry (see paragraphs 11 -14 above).

30 The Task Force also recommended that different disclosure standards (and also other standards, such as registration requirements) apply to the different classes of financial intermediaries, described in the Task Force report as those financial

intermediaries who undertake information only or execution only roles; those financial intermediaries who are product marketers; and those financial intermediaries who are "personal financial advisers". The exact definition of these different classes would impact on the responsibilities for each class with the result that some intermediaries would be subject to higher levels of regulation than others, with the divisions to be based, broadly, on the regulatory risk posed by each function (further work would be done on where lines should be drawn between the classes).

Cabinet approval on disclosure

31 The form and content of disclosure requirements to be placed on investment advisers and brokers are already contained in the Securities Legislation Bill, which has been reported back by the Commerce Select Committee and is awaiting its second reading. Many of the Task Force's recommendations either reflect requirements contained in this Bill, or it is anticipated that regulations under the Bill, which are currently being designed, would incorporate any remaining recommendations. The disclosure requirements for investment advisers and brokers are proceeding ahead of the rest of the Task Force recommendations, as it was thought important not to put these important disclosure requirements on hold until 2007/2008, when the rest of the regime is anticipated to be completed. In addition, as part of the Review of Financial Products and Providers, the Ministry is assessing the effectiveness of product disclosure, prudential regulation and supervision, including disclosure on institutional soundness, and merit regulation in protecting consumers and promoting the efficient functioning of financial markets.

32 I ask Cabinet to approve that all financial intermediaries will be subject to enhanced disclosure obligations when providing financial advice. This would allow the Ministry to undertake further design work into the most effective content and form of disclosure for different classes of financial intermediaries, financial providers and financial product generators.

LEGISLATION WOULD SET A NUMBER OF THE STANDARDS FOR FINANCIAL INTERMEDIARIES

33 The Task Force recommended that core minimum standards should be set out in legislation. These legislative standards would prohibit particularly egregious conduct requiring harsher penalties (e.g. misleading and deceptive conduct).[11] In addition, industry specific standards developed by APBs would also be given legislative backing/approval. This second class of standards would generally require financial intermediaries to meet certain levels of conduct, skill, care, diligence, qualifications and experience. For those personal financial advisers who are also businesses, APBs may require minimum set standards, processes and policies for dealing with employees.[12]

[11] The Task Force recommended that this standards require financial intermediaries "not to engage in conduct that is misleading or deceptive or is likely to mislead or deceive including as to the nature, characteristics or suitability for purpose of the information, advice or financial product " (Recommendation 12, at Task Force report "*Confidence, Change and Opportunity*" page 60.

[12] Recommendations 13 and 14 at Task Force report "*Confidence, Change and Opportunity*" page 60.

Why is the lack of standards a problem?

34 Existing legal obligations on financial intermediaries have been criticised for being unclear, not easily enforced and sector based.[13] Information gathered by the Task Force also suggests that inconsistent (or non-existent) industry standards on skill levels, qualifications (etc) are linked to lower quality advice, lower quality processes / formal records of advice and lower profitability / productivity for intermediaries. Low standards were linked to low consumer confidence, resulting in "an unwillingness to remunerate financial intermediaries for their services at a profitable level."[14]

35 The current lack of clear standards for financial intermediaries (both in relation to legislative standards and industry specific standards) is a problem as:

- there are no barriers to entry to the general profession (assuming that this leads to unscrupulous / less qualified intermediaries);
- it is harder for consumers to understand and distinguish between quality standards, and it is hard for financial intermediaries to judge themselves, or to be guided in their activities;
- there is less transparency around fees, commissions, and intermediary history, and more potential for conflicts of interest arising (assuming that mandatory standards as suggested by the Task Force would result in changed behaviour by the financial intermediaries, and would require more information to be provided to consumers).

Cabinet approval sought for legislative standards

36 I ask Cabinet to give in-principle approval that legislation would set standards for financial intermediaries. This would allow the Ministry to undertake design work on the appropriate form of the standards to be implemented by legislation and the appropriate form of the standards to be set by the APBs with legislative backing. A large part of this work would involve:

- consultation with consumers, industry and government to identify those areas which should have the certainty of clear rules set in statute, and which areas would benefit more from allowing variation across sectors of the industry (that is, where APBs could set the standards);
- consideration of the statutory standards recommended by the Task Force (some of which are already in the Securities Legislation Bill, for example, the standards relating to misleading and deceptive behaviour); and
- consideration of the different classes of "financial intermediary" to work out the appropriate skill set for each sector (refer paragraph 30 above).

[13] Task Force "*Consultation Paper: Options for Change*" page 23.
[14] Task Force "*Consultation Paper: Options for Change*" page 23.

37 Inserting standards in legislation, and also allowing APBs to set standards, would mean that financial intermediaries and consumers would have clear standards against which to measure the services provided by financial intermediaries. Standard setting will not necessarily guard against dishonesty, but the other functions of the co-regulatory framework (including dispute resolution and disciplinary processes) will help to reduce this risk.

DISCIPLINE

38 The Task Force recommended that all financial intermediaries (both individuals and businesses) would be subject to the jurisdiction of a single disciplinary body established by statute. The disciplinary body (from which there could be appeal to the District Court) would have a number of sanctions available, including temporary and permanent banning orders; orders for supervision or management of practice; orders for correction of information; orders for reimbursement of fees to consumers; and fines.

Why should financial intermediaries be subject to disciplinary procedures?

39 The Task Force recommended that financial intermediaries be subject to disciplinary procedures, on the basis that this would address the current inability of the voluntary industry bodies to stop inappropriate participants from practising as financial intermediaries.

Cabinet approval sought for disciplinary processes

40 I am seeking in-principle Cabinet approval that financial intermediaries would be subject to disciplinary procedures. This would allow the Ministry to undertake design work on the disciplinary functions and processes to which financial intermediaries would be subject. This would include work on sanctions, appeals and enforcement (including how to effectively enforce orders against any financial intermediary who is not required to be a member of an APB (see paragraph 44 below)). The Ministry would also consider how the functions of the disciplinary body suggested by the Task Force could be carried out by APBs and the Securities Commission, rather than a separate disciplinary body being created by statute. This is on the basis that:

- the reality is that the large percentage of disciplinary matters would be heard first through internal procedures carried out by a financial intermediary business, then through initial disciplinary function in the APBs. Appeals or any matters considered by the disciplinary body/regulator would be rare, which would raise questions as to whether it would be necessary to set up a separate body to hear such appeals or whether the Securities Commission could hear the appeals. Another potential option may be setting up a particular panel within the Commission to hear disciplinary actions for intermediaries;

- once the Securities Legislation Bill is passed, the Securities Commission will have the ability to take a range of actions against intermediaries for misleading and deceptive conduct, and breaches of the disclosure provisions (including imposing temporary bans or seeking permanent bans on intermediaries). This would mean that the Securities Commission would already have the experience of carrying out many of the functions of the disciplinary body; and

- the use of the Securities Commission would have the benefit of reducing the number of potential bodies in this area. This would result in reduced set-up costs, reduced potential for overlap in the roles undertaken by various bodies and a reduced need for information sharing across entities.

DISPUTE RESOLUTION

41 The Task Force recommended that there should be a disputes resolution body which is independent of industry and with jurisdiction over all financial intermediaries, to consider complaints about breaches of statutory standards or APB rules relating to that standard. The disputes resolution body would be able to award compensation to consumers up to a certain level, with failure to pay compensation being grounds for removal from an APB.

Why should financial intermediaries be subject to dispute resolution?

42 Dispute resolution processes are required as part of the co-regulatory framework to help address the following limits of the existing self regulatory organisations:

- generally, consumers do not have access to dispute resolution if the financial intermediary is not a voluntary member of an industry body (although consumers have access to the courts, including the Disputes Tribunal, the Task Force suggested that these processes may not sufficient to ensure universal access to timely, cost efficient and effective resolution of disputes);[15]

- there are a number of dispute resolution processes operating in the industry and multiple membership by some intermediaries so that consumers have difficulty determining where and how to lay a complaint;

- compensation is not always available under the rules of dispute resolution schemes, or is limited to a certain level; and

- there may be procedural barriers to consumers accessing dispute resolution

Cabinet approval sought dispute resolution process

43 I am seeking in-principle Cabinet approval that financial intermediaries would be subject to dispute resolution procedures. This would allow the Ministry to undertake design work on dispute resolution functions and processes to which financial intermediaries would be subject (this work would include consideration

[15] Task Force report "*Confidence, Change and Opportunity*" page 24.

about the form and nature of possible compensation). The Ministry can synchronise this design work on dispute resolution processes for financial intermediaries with the existing Ministry work on dispute resolution processes in the non bank financial sector under the Review of Financial Products and Providers that the Ministry is already carrying out in conjunction with the Ministry of Consumer Affairs. By combining the work in these two reviews, the Ministries should produce a comprehensive dispute resolution scheme to govern financial intermediaries, financial product providers and financial product generators.

APPLICATION OF THE CO-REGULATORY FRAMEWORK

44 In addition to the matters addressed in this paper, there are other areas which the Ministry would consider as part of the design phase for the co-regulatory framework. I ask Cabinet to note that there would be further design work on the co-regulatory framework (including consideration of links with other reviews in the non bank financial sector) and that this would include:

- whether there should be set processes for handling client moneys which would attach to those financial intermediaries carrying out a brokering role;
- how dispute resolution and disciplinary functions would apply to those financial intermediaries who are product marketers, as the Task Force suggested that they were not required to belong to an APB;
- whether fidelity funds, professional indemnity or other insurance, or other investor compensation schemes should form part of the regulatory model, and risks of and options for implementing these;
- clearer policy proposals on the application of the regime, exact roles and responsibilities of financial intermediaries (including the types of financial intermediaries who would be subject to legislation, for example, lawyers, accountants, journalists etc, and the types of financial products about which financial intermediaries provide advice, such as term deposits); and
- whether certain financial transactions should be considered as part of the Review of Financial Products and Providers or the Review of Financial Intermediaries, including futures dealings. Currently master trusts and wrap arrangements are being considered as part of Review of Financial Products and Providers. The Ministry proposes to consider the links between this work and the work on financial intermediaries.

TIMEFRAMES

45 Should Cabinet agree, I anticipate my officials carrying out the detailed design work on the Task Force proposals through to mid-late 2006. This design work would likely involve Ministry consultation with potential approved professional bodies, the regulator and other stakeholders. A discussion paper proposed for release in the first half of 2006 would also seek public comment on the detail of the regime.

46 I anticipate returning to Cabinet in mid/late 2006 to seek approval to incorporate the policy proposals resulting from this design work into implementing legislation, with introduction of any legislation in the first half of 2007 and the legislation being passed in 2007/2008.

LINKS TO OTHER REVIEWS

47 I am aware that the upcoming design work on the regulation of financial intermediaries would need to be considered against the context of three existing projects: the Review of Financial Products and Providers, Domestic Institutional Arrangements and the Financial Action Task Force 40 Recommendations on Anti-Terrorism and Money Laundering. The Ministry Financial Sector team is either leading or participating in these projects, so would be best placed to efficiently make the necessary links and share information.

REVIEW OF FINANCIAL PRODUCTS AND PROVIDERS

48 The RFPP will consider the regulation of insurance (health, life and general), superannuation, collective investment schemes (unit trusts, participatory securities, group managed investment schemes, contributory mortgages) non-bank financial institutions (friendly societies, credit unions, building societies, finance companies, industrial and provident societies), futures and derivatives and offerings of securities.

49 There are close links between the work on financial intermediaries and the RFPP as both deal with financial sector market conduct, and because financial intermediaries (which also includes financial institutions) provide advice on financial products, including advice from product providers.

50 The financial intermediary work is proceeding separately to that of the RFPP on the basis that the research and consultation undertaken by the Task Force, and the resulting Task Force recommendations for a co-regulatory model, mean that the work on financial intermediaries is more advanced than the work on each of the areas of the RFPP. There are similar time frames planned for both reviews however, as it is anticipated that policy decisions would be made in mid/late 2006 with the intention of legislation being introduced in 2007/2008.

Domestic Institutional Arrangements

51 I note that there is a separate Cabinet paper on Domestic Institutional Arrangements that accompanies this paper and that recommends that the Securities Commission be the regulator of market conduct. The recommendations in this report are consistent with that paper.

Financial Action Task Force 40 Recommendations on Anti-Terrorism and Money Laundering

52 The Ministry of Justice is leading a government review to ensure that New Zealand is complying with its obligations under the Financial Action Task Force 40 Recommendations on Anti-Terrorism and Money Laundering on preventing anti-money laundering and countering the financing of terrorism. To comply with

the recommendations, it is likely that some additional requirements would be placed upon some financial intermediaries. The Ministry is working closely with the Ministry of Justice on this work to ensure that these requirements are aligned as much as possible with the work on financial intermediaries work to minimise compliance costs. The Ministry of Justice also notes that financial intermediaries who handle client moneys could also fall under the Financial Transactions Reporting Act 1996.

53 The Task Force recommended a review of the Secret Commissions Act 1910 (which seeks to prohibit secret rewards and inducements in agency, principal and third party relationships). The Ministry of Justice has noted that Cabinet agreed on 8 June 2005 (ERD Min 05 4/4) to an increase of penalty levels under the Secret Commissions Act to bring it in line with the Crimes Act, and also directed that Ministry to review the necessity of having a separate Secret Commissions Act during 2006.

Trans-Tasman implications

54 The Memorandum of Understanding on Business Law coordination between Australia and New Zealand (MOU) and the Trans-Tasman Mutual Recognition Arrangement (TTMRA) are both relevant to this work. The MOU signed in 2000 between the two governments is based on the presumption that we should coordinate our business laws with Australia unless there is a good reason for the law to be different. The TTMRA, which came into effect in 1998, is an arrangement between New Zealand and Australia, whose strategic objective is to remove regulatory barriers to trans-Tasman trade in goods and the movement of registered professionals either through mutual recognition of our respective regulatory regimes or through harmonisation. It is implemented by way of overarching legislation which provides that mutual recognition in relation to the sale of goods and registration of occupations will apply between all participating jurisdictions, unless specifically excluded.

55 The Task Force in developing its recommendations, paid careful consideration to the Australian regime in this area, and consulted with Australian agencies and intermediaries. In this case it was determined that because of New Zealand conditions, and some concerns raised with the Australian regime, that the laws between Australia and New Zealand should be different and the co-regulatory model proposed does not adopt the Australian regime. However, in thinking about the detail of the regime, we will need to continue to consider aspects of the Australian regime and to ensure that equivalent objectives and outcomes to the Australian regime are obtained so that there is the potential to utilise (at least for some intermediaries) the TTMRA. This would enable intermediaries to operate in both jurisdictions, remove impediments to cross border activity and move us further towards a single economic market.

FINANCIAL IMPLICATIONS

56 I am seeking Cabinet approval for design work on a co-regulatory framework for financial intermediaries. This may have some costs for government (please refer to the attached work-in-progress regulatory impact statement), but some costs may also be borne by APBs and consumers. Ministry officials would work through the various costing options and I anticipate returning to Cabinet with details of these costs in mid to late 2006 when I come back with the proposed regulatory changes.

LEGISLATIVE IMPLICATIONS

57 There are no legislative implications to the design work.

REGULATORY IMPACT STATEMENT AND BUSINESS COMPLIANCE COST STATEMENT

58 A Regulatory Impact Statement and Business Compliance Cost Statement are attached that comply with the requirements for Regulatory Impacts Statements and Business Compliance Cost Statements as set out in Cabinet Office Circular CO (04) 4.

59 Based on the information provided in the attached RIS/BCCS, the Regulatory Impact Analysis Unit considers that the disclosure of information is adequate, and the level of analysis is appropriate given the likely impacts of the proposal.

60 While the exact costs are unable to be quantified at this time, the Business Compliance Costs Statement provides general information on expected compliance costs relating to disclosure, education and other mandatory standards.

TREATY IMPLICATIONS

61 There appear to be no Treaty implications.

HUMAN RIGHTS ACT AND BILL OF RIGHTS ACT

62 There appear to be no Human Rights or Bill of Rights Act implications.

PUBLICITY

63 I am seeking agreement to the release of this paper on the Ministry website. Following the release of this paper, officials would talk to potential APBs, the Securities Commission and other members of the industry and consumer representatives in order to design the regime. Information on the review and progress is proposed to be made available on the Ministry website and through regular email updates.

CONSULTATION

64 In preparing this report I have consulted Treasury, Reserve Bank of New Zealand, the Ministry of Justice, Securities Commission, State Services Commission and Ministry of Consumer Affairs.

RECOMMENDATIONS

65 It is recommended that the Committee:

1 **Note** that the Financial Intermediaries Task Force was appointed on 19 October 2004 (Cabinet Appointments and Honours Committee decision APH (04) 164).

2 **Note** that the Financial Intermediaries Task Force reported back on 29 July 2005.

3 **Agree** in principle with the Financial Intermediaries Task Force recommendation that there should be a co-regulatory framework for the regulation of financial intermediaries.

4 **Agree** in principle that the co-regulatory framework should have the following features:

- that there would be industry-led approved professional bodies and a government regulator which would work together to regulate financial intermediaries;
- the government regulator would be the Securities Commission;
- financial intermediaries would be subject to enhanced disclosure obligations when providing financial advice with obligations dependent upon the class of financial intermediary;
- legislation would set a number of conduct standards for financial intermediaries;
- financial intermediaries would be subject to dispute resolution and disciplinary procedures.

5 **Note** that this further design work on the co-regulatory framework would be done through consultation with potential approved professional bodies, the Securities Commission and consumer groups.

6 **Note** that as part of this design work, the Ministry would consider links with other reviews in the non bank financial sector including work on the Review of Financial Products and Providers, Domestic Institutional Arrangements and the Financial Action Task Force 40 Recommendations on Anti-Terrorism and Money Laundering.

7 **Direct** the Ministry of Economic Development to undertake detailed design work with stakeholders on the Financial Intermediaries Task Force recommendations and to report back with options, recommendations and final policy decisions regarding arrangements for financial intermediary regulation in mid/late 2006, with the intention of introducing legislation in 2007.

8 **Direct** the Ministry of Consumer Affairs to consider dispute resolution processes for financial intermediaries in conjunction with other dispute resolution processes in the financial sector.

9 **Agree** to the release of this paper on the Ministry of Economic Development website.

Hon Lianne Dalziel
Minister of Commerce

REGULATORY IMPACT STATEMENT

1 This regulatory impact statement accompanies the Cabinet Paper “Regulation of Financial Intermediaries”. It is a work in progress due to the high level of detailed design work yet to be carried out (refer paragraph 4 below).

BACKGROUND

2 In October 2004, the Minister of Commerce appointed an independent Task Force to consider and report on New Zealand’s regulation of financial intermediaries. A “financial intermediary” is generally described as an individual or a business who markets financial products or provides financial advice (that is, advice about financial products or investments or savings decisions and choices) to members of the public. This description is likely to include a large number of individuals and businesses (including financial institutions), insurance companies and agents operating in New Zealand’s financial sector including mortgage brokers, investment advisers and bank and insurance company employees operating in New Zealand’s financial sector.

3 The Terms of Reference of the Task Force required it to consider options for reform that would ensure quality financial information and advice is provided to the public and assist New Zealanders to make the most of their savings. The Task Force’s final report “Confidence, Change and Opportunity” was publicly released in August 2005. In summary, the Task Force recommended that government and industry work together to introduce a co-regulatory framework under which financial intermediaries would be subject to enhanced standards, sanctions, disclosure, dispute resolution and enforcement procedures.

4 The Task Force recommended that a regulatory impact analysis be undertaken after further development work on the recommendations as many of the specific costs will reflect the detailed design of the proposed regime.

STATEMENT OF THE NATURE AND MAGNITUDE OF THE PROBLEM AND THE NEED FOR GOVERNMENT ACTION

Problem - Voluntary and inconsistent standards for the financial intermediaries

5 Currently financial intermediaries in New Zealand are not subject to comprehensive standards relating to matters such as competence, disclosure of relevant information, "business conduct", ethics, quality of information and disciplinary/ dispute resolution processes.

- Without such comprehensive mandatory standards, financial intermediaries lack standards to work against or be judged against and consumers lack sufficient information or basis on which to compare intermediaries, or have sufficient mechanisms to seek redress or deal with conflicts.

- As well, it can be difficult to stop negligent or unethical financial intermediaries practising in an industry, or to ensure ongoing active monitoring of compliance with such voluntary standards.

6 It is increasingly hard for consumers to know which products or providers best suit their needs and risk levels:

- While intermediaries should have the expertise, time and information to break down the knowledge gap by matching consumers with products that best meet their needs and risk appetite, consumers have limited information and a limited ability to evaluate their financial intermediaries.

- In addition, consumers may not verify the information provided by financial intermediaries so there may only be incentives on intermediaries to do the minimum necessary to keep their client satisfied. Low entry requirements may also allow intermediaries to operate off the reputations of other intermediaries.

- Further, there may not be sufficient incentives for intermediaries to act ethically or to manage conflicts of interests appropriately as intermediaries only have informal incentives placed on them to credibly vouch for the quality of information because otherwise they may suffer reputational and therefore economic loss if they provide misleading information or allow a provider to falsify or exaggerate information.

7 Consumers have noted their dissatisfaction with the current services being provided by financial intermediaries:

- Responses to the Task Force noted concern about services received from financial intermediaries. These concerns were based on personal experiences with the behaviour of advisers, hidden commissions, difficulty in determining whether an intermediary has a conflict of interest, intermediaries influencing clients to invest in high risk products, unqualified / inexperienced / incompetent intermediaries, excessive fees, undisclosed fees and complicated fee structures. As well, consumers noted their inability to get proper redress, either because they did not know to whom they could complain, or else because they did not think that a complaint would make a difference.

- Consumers who had made complaints, had complained about false information, exorbitant fees, bad customer service, inadequate disclosure of risks. The noted effect of this unsatisfactory behaviour was that in some cases, the consumer simply stopped using the intermediary.

8 New Zealand has also been assessed against the best practice principles in the “IOSCO Objectives and Principles of Securities Regulation” in relation to how we regulate financial intermediaries. The report recommended more comprehensive regulatory oversight of financial intermediaries in New Zealand, through either a licensing regime, or, as a less costly option, the imposition of standards, with monitoring by the regulator.

Magnitude of the Problem

9 The Task Force noted that in New Zealand in 2001, approximately 7,836 people described themselves as “financial intermediaries” (up from 2,529 in 1996); approximately 2,817 as "financial dealers or brokers" (up from 2,478 in 1996) and approximately 3,840 as "insurance representatives" (down from 5,691 in 1996). All these people are “financial intermediaries” under the definition used for this review. There are also a large number of businesses who are treated as financial intermediaries.

10 It is noted that some financial intermediaries are already regulated, for example, those financial intermediaries who wish to be NZX Advisers under the NZX regime, or who wish to practise as lawyers, are subject to mandatory requirements. In addition, a number of financial intermediaries voluntarily belong to self regulatory organisations some of which have codes of conducts, and disciplinary procedures to which members are accountable, while they choose to be members of that organisation.

11 However, responses from industry and consumer groups indicate that inconsistent and voluntary standards are linked to lower quality advice, lower quality processes and formal records of advice, lower profitability/productivity for intermediaries and low consumer confidence.

12 These responses suggest that the current mixture of inconsistent and voluntary standards is a large problem for both industry and consumers. At this stage, there is no information on any quantifiable cost suffered by consumers by not having mandatory standards. The detailed design work to be undertaken by the Ministry of Economic Development (the Ministry) will assist in determining the magnitude of the problem.

13 At an international level, it is better for New Zealand to fully implement the best practice guidelines under the IOSCO Principles. By joining IOSCO, New Zealand resolved to cooperate to promote high standards of regulation in order to maintain just, efficient and sound markets and to promote the integrity of the markets by a rigorous application of the standards. As well, it could be embarrassing if New Zealand did not make every attempt to fully implement best practice as Jane Diplock, AO, Chairman of the Securities Commission chairs the IOSCO Executive Committee. It is also possible that international investors may consider best practice when exercising investment decisions.

STATEMENT OF THE PUBLIC POLICY OBJECTIVE(S)

14 The public policy objective is to ensure the regime for financial intermediaries is cost effective in achieving the following objectives:

- adequate disclosure of intermediaries’ conflicts of interests, fees and competency so that investors/consumers can make informed decisions about whether to use an intermediary and whether to take their advice;

- consumers having intermediaries available that have the experience and expertise to effectively match a consumer with products that best meet their needs and risk profile;

- intermediaries being held accountable for any advice given (including effective mechanisms for addressing poor quality information or advice and unethical or fraudulent behaviour) and incentives for intermediaries to manage appropriately conflicts of interest; and

- promoting a sound and efficient financial sector in which the public have confidence in the professionalism and integrity of intermediaries

STATEMENT OF FEASIBLE OPTIONS (REGULATORY AND/OR NON-REGULATORY) THAT MAY CONSTITUTE VIABLE MEANS FOR ACHIEVING THE DESIRED OBJECTIVE(S)

Status Quo

15 In the current environment, financial intermediaries are subject to:

- generic law relating to financial intermediaries, including relevant generic legislation and common law;

- relevant legislation with a consumer protection focus;

- sector-specific legislation; and

- generally voluntary sector specific self-regulating organisations and initiatives.

16 Currently, financial intermediaries are subject to generic law including the Investment Advisers (Disclosure) Act 1996 (which applies to intermediaries who give investment advice to, or receive investment money or investment property from, members of the public in relation to the buying or selling of securities and requires mandatory disclosure of certain convictions, bankruptcies and prohibitions as well as disclosure (on request) of qualifications, experience, remuneration and money handling processes) and the Financial Transactions Reporting Act 1996 which aims to prevent money laundering and dealing with crime proceeds (this applies to financial institutions who administer or manage funds on behalf of other persons, or provide financial services by requiring financial institutions to verify transactions, report suspicious transactions and keep certain records).

17 In addition, financial intermediaries will usually have obligations under common law including implied obligations under contract law (in addition to express contractual obligations to clients); obligations under tort law not to cause harm, as well as fiduciary obligations between intermediary and client as part of a relationship of trust and confidence. The law of agency (which overlaps with equity, tort and contract) also imposes obligations on a financial intermediary where the parties have agreed (or can be taken to have agreed) to an agency relationship.

18 Sector specific law includes Institute of Chartered Accountants of New Zealand Act 1996 (which applies to accountants) and the Law Practitioners Act 1982 (which applies to financial intermediaries who are lawyers). There are also laws applying to insurance intermediaries, real estate agents and share brokers.

19 There are a number of voluntary self regulatory organisations (e.g. New Zealand Mortgage Brokers Association or Financial Planners and Insurance Advisers Association Inc). Generally these organisations have set standards in relation to advice giving, qualifications and dispute resolution (etc) with which members must comply.

20 There is no current general obligation on financial intermediaries to disclose information on their remuneration (including commissions, bonuses or management fees), potential conflicts of interest or relationships with issuers of financial products (refer problem section above).

21 Although financial intermediaries in New Zealand are currently subject to the obligations listed above, there was a high level of consensus across industry participants, consumer and regulatory bodies (including self-regulating organisations) that change was required and that it was unlikely to occur in the current environment.

22 The status quo is not preferred as it does not meet the policy objectives.

Alternate options

23 In addition to the preferred option, there were the alternate options of either enhanced self-regulation or government supervision:

- Enhanced self-regulation refers to a voluntary system where industry develops its own standards and dispute resolution and enforcement mechanisms, but these are backed by legislation (for instance, legislative name protection for a brand developed by the industry). This was decided not to be the most effective mechanism for ensuring that the interests of all parties (including consumers) are reflected in the operation of the regulatory system as it still relies on sufficient cohesion within different sectors of the industry to ensure widespread voluntary inclusion within the system.

- Direct government supervision is where government would be the entity that approves whether or not a person/business could be a financial intermediary, with regulation by way of licensing or registration, without industry involvement. This is usually appropriate where there is sufficient similarity across an industry and/or where state responsibility is needed to give greater assurance that industry standards and administration will actually take account of the interests of all parties (including consumers). Here, in relation to financial intermediaries, different sectors of the financial intermediary industry have already developed their own standards, dispute resolution and enforcement mechanisms that are appropriate to, and recognised by, different sectors, and it would make sense to utilise these in the regulation of financial intermediaries, with government involvement required only in

relation to these industry bodies, and not in relation to each and every financial intermediary.

Preferred Option – Co-regulatory Model

24 The preferred option of the proposal to address the problems is for government to introduce a co-regulatory model. The key features of this co-regulatory model are:

- Industry-led approved professional bodies and a government regulator (the Securities Commission) which will work together to regulate financial intermediaries, with both industry and government contributing to funding the co-regulatory framework;

- The Securities Commission and the Minister to provide government oversight of the industry-based approved professional bodies and their rules, including any need for regulatory backstop provisions in the event of absence or failure of an approved professional body. The Securities Commission functions would include providing advice to the Minister on the approval/disapproval of approved professional bodies and approved professional body rules; the rules of the disciplinary and disputes resolution body/processes as well as the power to impose temporary orders and to have stop, banning and rectification powers;

- Legislation setting a number of conduct standards for financial intermediaries;

- All financial intermediaries being subject to dispute resolution procedures, under which they may be liable to pay compensation, and disciplinary procedures, which may extend to appeals to the District Court.

- Financial intermediaries being split into different classes, with different obligations (including those relating to disclosure) and standards of practice attaching to each class so that those financial intermediaries who provide personal financial advice to the public would be subject to more obligations than those intermediaries who provide factual advice, or advice on products to the public. These standards, to be developed by approved professional bodies, relate to financial intermediary skill, education, experience, and, for businesses who act as financial intermediaries, set processes and policies. Further design work is needed on the definitions and classes of financial intermediaries to determine which financial intermediaries would be subject to the respective standards.

Timing and Implementation

25 In terms of timing, pending Cabinet approval, Ministries of Economic Development and Consumer Affairs will undertake detailed design work with stakeholders on the Financial Intermediaries Task Force recommendations and to report back to Cabinet with options, recommendations and final policy decisions regarding arrangements for financial intermediary regulation in mid/late 2006, with the intention of the introducing legislation in 2007.

STATEMENT OF THE NET BENEFIT OF THE PROPOSAL, INCLUDING THE TOTAL REGULATORY COSTS (ADMINISTRATIVE, COMPLIANCE AND ECONOMIC COSTS) AND BENEFITS (INCLUDING NON-QUANTIFIABLE BENEFITS) OF THE PROPOSAL, AND OTHER FEASIBLE OPTIONS

26 There is still a lot of detailed design work to be done on the co-regulatory model. Many of the specific costs will reflect the detailed design of the proposed regime, although the Ministry will seek to minimise design costs where possible. This design work would involve Ministry consultation with potential approved professional bodies, the regulator and other stakeholders. This design phase would result in clearer policy proposals on the application of the regime, exact roles and responsibilities of financial intermediaries, approved professional bodies and the regulator, and mandatory standards such as dispute resolution, discipline and standards of practice and would set the exact parameters of the implementing legislation.

Government

27 There is an overall net benefit to the government endorsing the co-regulatory model to ensure mandatory standards for financial intermediaries. While the costs are unable to be quantified at this time (due to required design work), the following costs are likely to result:

- The Securities Commission is likely to require additional funding to carry out increased functions. These increased functions include making recommendations in relation to approved professional body rules, considering disciplinary matters; monitoring industry activity, and stepping in where the industry has not effectively regulated itself.

- Initial discussions within the Ministry indicate that the capital costs associated with government involvement in any public register with details of financial intermediaries may range from less than half a million dollars if the register only provides searchable material to the public, up to over one and a half million dollars if the register involved full online registration facilities. There would also be ongoing operating costs including communications with stakeholders, training and advertising and other implementation costs.

- There are likely to be costs associated with educating consumers about new standards in addition to the register.

28 As part of the design work, the Ministry will seek to minimise these costs.

29 The benefit of the preferred option is that it will create consistent mandatory standards for financial intermediaries which would address the concerns at the current inconsistent and voluntary standards, as well as information asymmetries and the lack of disclosure.

30 As well, having the Securities Commission as the regulator would result in minimised set-up costs, reduced potential for overlap in the roles undertaken by various bodies, and a reduced need for information sharing across entities. This is because the Securities Commission is already carrying out most of the

suggested regulatory functions for investment advisers and brokers, both of which groups are included in the broader class of financial intermediaries; there is a low risk of conflict between the existing roles of the Securities Commission (already being the "main regulator of investments") and the role of the statutory regulator envisaged by the Task Force; and related work on the Review of Financial Products and Providers and Domestic Institutional Arrangements which suggests that the Securities Commission is best placed to be the regulator for market conduct (this includes work on financial intermediaries, as well as financial product and providers).

31 New Zealand would also better comply with international best practice.

Financial Intermediaries and self regulatory organisations

32 There is an overall net benefit to financial intermediaries if the government endorses the co-regulatory model. While the exact costs are unable to be quantified at this time (due to required design work), the following costs are expected:

- Self regulatory organisations are likely to incur costs to set up approved professional bodies to carry out increased functions (including preparing new rules, separating lobbying functions, liaising with the Securities Commission and any other approved professional bodies)

- There will likely be costs associated with increasing the functions that industry bodies carry out if those functions are not already available (for example, while some self regulatory organisations have rules allowing for restitutionary compensation, others will have to create this function, or investigate outsourcing arrangements for dispute resolution functions).

- Some financial intermediaries may choose to leave the industry rather than paying or taking time to obtain qualifications on the basis that they view qualifications as a barrier to entry, because they see experience as sufficient qualifications, or because they are close to retirement.

- Financial intermediaries will likely incur increased compliance costs due to increased obligations (such as increased and ongoing education requirements and funding disciplinary procedures).

- There is a risk that some financial intermediaries may choose to meet higher than necessary standards (depending on the nature of enforcement, the statutory wording, and the design of the system) if expected to do so by consumers.

- There will be additional compliance costs to business arising from the proposal, which are detailed in the Business Compliance Cost Statement.

33 The Ministry will seek to minimise these costs, in part by consulting with industry on how their existing practises can best fit with the suggested regulation.

34 The benefit of the preferred option is that industry will be able to increase consumer and industry confidence, with set standards and reliability, while still leveraging existing industry features such as codes of conduct etc. This is likely to encourage a higher consistent standard of advice across financial intermediaries, due to set mandatory standards (on skill and procedure levels) to assist in greater profitability/productivity for intermediaries. This will hopefully contribute to poor performing intermediaries and/or product generators exiting the market, and good quality intermediaries and/or product generators increasing their business, with the overall effect of increasing levels of performance. By working with industry to set appropriate standards for financial intermediaries, costs are likely to be minimal.

Society

35 There is an overall net benefit to society (that is, consumers of financial services) if the government endorses the co-regulatory model. While the exact costs are unable to be quantified at this time (due to required design work), the following costs are expected:

- There will likely be increased costs in obtaining some types of advice as intermediaries look to recover some costs from consumers (however, higher quality advice may be seen to justify a higher premium).

- Consumers may spend more time to review the increased information about intermediaries.

36 The benefit of the preferred option is that consumers will receive more information about their intermediaries, and be able to rely on standards set by industry, to ensure that their intermediary is suitably qualified and has appropriate procedures under which to provide advice. These standards will include appropriate dispute resolution and disciplinary procures to allow for appropriate redress, sanctions and enforcement. This will likely result in increased consumer confidence to enable an individual consumer to:

- make better decisions about an intermediary or a financial product (for example, whether to deal with that intermediary, whether the intermediary's fees are negotiable etc);

- encourage greater competition between intermediaries and between product generators (for example, competition on fee structures and fee amounts);

- receive better advice; and

- a lower risk of possible exploitation, hopefully to encourage greater use of intermediaries, and perhaps greater investment and savings in New Zealand.

STATEMENT OF CONSULTATION UNDERTAKEN

Stakeholder Consultation

37 The Task Force circulated publicly a consumer questionnaire (which resulted in 274 responses), an issues paper (which resulted in 79 submissions) and an options consultation paper (which resulted in 97 submissions) before publishing its final report, which was then subject to media and industry comment. As part of the detailed design work yet to be undertaken, the Ministry proposes comprehensive consultation with industry and consumer representatives as well as the Securities Commission on the following significant issues raised with the Task Force , to ensure that costs are minimised:

- The potential costs and interface complexities for consumers, industry participants and the state itself if there are a significant number of industry bodies involved in a regulatory role;

- Industry capture risks, for example the risk of the industry regulatory bodies acting as "closed shops" deterring innovation/competition and creating barriers to entry, and/or that the interests of all relevant stakeholders (for example consumers) would not be taken into account when carrying out their regulatory functions;

- How the model would work in less developed segments of the market, where either there was no established industry body coverage or the industry body, reflecting the fact that it represented a reasonably new market segment, had little expertise and or experience in carrying out the functions of a regulator; and

- The need for clear distinctions between the role of the industry bodies and any state oversight so that on the one hand the industry bodies can function without the static and dynamic efficiency costs that can arise where there is state "second guessing" of industry body administrative decisions, while conversely such state oversight is not limited to "rubber stamping" with the structure implying a higher level of state assurance than is actually delivered.

38 The Task Force took these concerns into account when design and recommending the co-regulatory model and the Minister would also consider these concerns when undertaking the detailed design work to minimise costs.

Government Departments/Agencies Consultation

39 In preparing the Cabinet paper and this RIS, the Ministry for Economic Development consulted with Treasury, Reserve Bank of New Zealand, the Ministry of Justice, Securities Commission, State Services Commission and Ministry of Consumer Affairs. No significant concerns were raised.

BUSINESS COMPLIANCE COST STATEMENT

40 There will be business compliance costs if the government endorses the co-regulatory model.

41 At this stage the costs are described generally as further design work would be required on the types of financial intermediaries, and the definitions attaching to each class. Until this is done, it is not possible to state how compliance costs will apply to financial intermediaries (for example, while all financial intermediaries may be subject to dispute resolution processes and the jurisdiction of the Securities Commission in relation to this function, it is possible that the register may list only those financial intermediaries who offer advice at a product marketer level and at a personal financial intermediary level).

42 While the exact costs are unable to be quantified at this time (due to required design work), the following general business compliance costs are expected:

- Financial intermediaries will likely incur costs to ensure that they understand, and have appropriate systems to comply with, increased obligations set by the approved professional body. This may include one off compliance costs (e.g. drafting appropriate disclosure documents), and ongoing compliance costs (e.g. staff/system costs to monitor the content of the disclosure documents to ensure accurate disclosure in the event of changes of (e.g.) commissions.)

- There is a risk that some financial intermediaries may find the changes cause stress as not all financial intermediaries have been used to operating under mandatory standards.

- Those financial intermediaries with smaller businesses and a smaller client base may find it harder to comply with, and absorb the increased costs of, meeting educational and disclosure requirements. This is because they will still have to meet the same requirements as financial intermediaries in larger businesses, but will not have the large client bases across which to recover cost, or the ability to increase client levels beyond a certain level.

- Some financial intermediaries may have the option of selecting the most appropriate approved professional body to join which may involve research, time and investigation into the option which provides them with the most benefit and least cost.

43 The Ministry would work with industry and the Securities Commission to leverage existing procedures and practices to minimise compliance costs. The Ministry is also working with industry to provide regular public updates by email and through internet, and to adopt an open and consultative process of design. This will help reduce the risk of stress, and also help financial intermediaries prepare for any increased compliance obligations. In addition, a number of industry bodies are already reviewing their internal structures, so the timing of the review is likely to fit in with existing work, and changes to which intermediaries would have been subject in any event.