



CONSULTATION ON STANDARD CONDITIONS FOR QUALIFYING FINANCIAL ENTITIES (QFEs) – DISCLOSURE AND RELATED MATTERS

21 October 2010

Introduction

The Financial Advisers Act 2008 (the Act) provides that a grant of QFE status may be subject to terms and conditions and may also incorporate standard conditions. The proposed standard conditions in this paper relate to a QFE's disclosure obligations under the Act.

This paper supplements the consultation paper on standard conditions for QFEs that was published by the Securities Commission (the Commission) on 28 September. (See www.seccom.govt.nz/qfe). Together, the two papers present the proposed standard conditions for a QFE. The Commission intends use standard conditions for all QFEs, unless there are particular circumstances requiring modifications.

The Act requires that standard conditions must be consulted on before they are approved. This consultation paper is relevant for all QFE applicants and is likely to be of interest to consumer bodies.

Disclosure and consumer protection

The Act requires disclosure so that retail clients can make informed decisions about whether to use the adviser and whether to follow the advice received (section 3 of the Act). Disclosure is a key part of consumer protection.

Disclosure obligations for financial advisers are set out in sections 21 to 31 of the Act, and apply when a personalised service is provided to a retail client. Disclosure obligations for individual Authorised Financial Advisers (AFAs) and for registered financial advisers will be set by regulations. These will focus on:

- any limitations on the service or products available
- fees for advice
- remuneration, incentives or relationships which might influence the adviser – ie conflicts of interest.

The Act does not set out detailed disclosure requirements for QFEs (section 25). Regulations are expected to require a QFE to disclose matters prescribed in its terms and

conditions of QFE status. This consultation therefore sets out the proposed conditions. These have a similar focus to those for AFAs.

QFE status is intended to be an efficient way for businesses to comply with the Act. The Act puts disclosure obligations on the QFE for services carried out by QFE advisers, rather than directly on individual advisers. Standard conditions therefore apply to the entity. (Any AFAs in a QFE will make individual disclosures in accordance with requirements for AFAs.)

A wide range of entities can potentially become QFEs, including businesses providing services in relation to category 1 or category 2 products or both. To become a QFE, the Act requires that an entity must satisfy the Commission that it has the capacity to comply with the Act, including that it has procedures to ensure that retail clients receive adequate consumer protection (section 66). The Act, the regulations and the proposed conditions therefore allow flexibility for QFE disclosures. The conditions require a QFE to use this flexibility to meet its consumer protection obligation, while also allowing an approach which may be efficient for the QFE. The Commission expects a QFE to be able to explain the reasons for its approach to disclosure in a particular service or channel, including the form, timing, clarity and level of detail. It also expects QFEs to have appropriate governance and approval processes in place.

Advisers in a QFE do not have to be authorised to provide services for category 1 products if the QFE Group issues or 'promotes' the product. ('Promoter' is defined in the Securities Act.) In these cases there is a close link between the advisers and the product. The customer needs to be informed of this limitation on a QFE adviser's choice of products.

Customers may be aware there is a potential conflict of interest in dealing with an adviser who works for the product provider. However, conflicts arising from the way the QFE incentivises its advisers are less likely to be clear and must be clearly disclosed.

For services in relation to category 2 products, regulations do not currently require registered financial advisers to disclose limitations on the products that they can provide or conflicts of interest arising from commissions or other remuneration. Conditions for QFEs do not go further than the regulations. However, if changes are made to the regulations, the Commission will expect QFEs to amend their disclosures accordingly.

For all advisers, regardless of incentives or relationship to the product provider, the Commission expects that a professional adviser will ensure that the customer is aware of the initial and ongoing costs to the customer of any recommended product.

Disclosure obligations – other requirements

A QFE must comply with all of its disclosure obligations under the Act, the regulations and its terms and conditions. Disclosure regulations are currently being finalised. The regulations are likely to include some matters to be disclosed by a QFE, such as contact

details, information about its internal complaints handling arrangements and its external dispute resolution scheme. They may also provide for the form that the disclosure must take, but are not expected to always require written disclosure documents.

The Commission's powers

The Commission will work with industry to encourage high standards of professionalism, consumer protection and compliance when making disclosure. Guidance and illustrative examples are included in this paper to assist QFEs in designing their approach to disclosure.

The Commission will take a risk-based approach to monitoring QFEs and deal with issues through constructive dialogue, but will take action when standards fall below the required level. The Commission has a range of powers under the Act which it can use to address any default by a QFE, including any breach of the disclosure requirements in the Act, the regulations or the QFE's terms and conditions. The Commission's powers were outlined in the previous consultation on standard conditions.

Contents

The following sections of this paper contain:

- ***Proposed standard conditions for QFEs***

The standard conditions for disclosure are conditions which the Commission expects to be fixed during the period of QFE status. They include tables of disclosures in Table 1 and Table 2.

In addition, the QFE ABS Guide includes standard conditions on the reporting of information to the Commission. Amendments are proposed to bring the Guide into line with the disclosure conditions. The Act allows the Commission to vary reporting conditions, such as the QFE ABS Guide, from time to time during the period of QFE status, following consultation (s147A and B).

- ***Explanatory notes***

These provide explanations and guidance on how the Commission will interpret the condition. Additional guidance may be provided from time to time.

- ***Illustrations and examples***

These are intended to assist QFEs in considering how the conditions might be implemented in practice.

Request for comment

This paper can be downloaded from the Securities Commission website: www.seccom.govt.nz/qfe. Printed copies are also available from the Commission.

Please forward written submissions:

By post to:
The Securities Commission
PO Box 1179
Wellington 6140

By courier to:
The Securities Commission
8th Floor,
Unisys House
56 The Terrace
Wellington 6011

Or by email to:

QFEenquiries@seccom.govt.nz with “QFE disclosure standard conditions submission” as the subject.

Submissions close at 5.00pm on 12 November 2010.

Submissions will be subject to the Official Information Act 1982. The Commission may also make submissions available on its website or draw attention to submissions in internal or external reports. If you would like the Commission to withhold any commercially sensitive, confidential or proprietary information included in your submission, please say so in your submission. Any request to have information withheld will be considered in accordance with the Official Information Act.

Next steps

Once submissions have been considered, the Commission will finalise and approve the standard conditions by notice in the *Gazette*. These will be published on our website and will also be available in printed form. Any entity granted QFE status will be subject to the standard conditions unless there are modifications by the Commission.

Many QFE applicants will have submitted their ABS, or have substantially completed their ABS to meet the 1 December submission deadline. The Commission understands that these potential QFEs will not be able to address the specific requirements proposed in this consultation in their ABS. The Commission will consider disclosure as part of its ongoing monitoring of QFEs and may undertake monitoring work in this area after disclosure requirements are implemented on 1 July 2011. For investment business, QFEs should continue to comply with the requirements of Part 4 of the Securities Markets Act until that date.

Proposed Standard Conditions for Qualifying Financial Entities (QFEs) – Disclosure and Related Matters

These conditions are to be read alongside the Commission's earlier consultation paper on QFE standard conditions and are numbered accordingly.

4 DISCLOSURE

- 4.1 The QFE must have a written policy for approving and providing disclosure under the Financial Advisers Act (the Disclosure Policy). It must set out how the policy meets the QFE's consumer protection obligations.**
- 4.2 Where consumer protection needs differ between products or services, the QFE must document why the approach to disclosure is appropriate for each product or service.**
- 4.3 In making disclosure under s25 of the Financial Advisers Act the QFE must disclose*:**
- i) the information in Table 1 for all of its financial adviser services**
 - ii) the information in Table 2 for services in respect of Category 1 products.**
- Information disclosed should relate to the relevant service.**
- 4.4 Where the QFE's disclosure under s25 of the Financial Advisers Act is not in writing, the QFE must inform the client that written disclosure is available on request.**

Definitions

In the conditions, the following terms have the meanings set out below:

Material influence (in 4.3 Table 2)	An influence which a reasonable client would find reasonably likely to influence the adviser in providing the financial adviser service.
Relevant service	The particular financial adviser service (or services) that is likely to be provided to the client, or is being provided to the client (rather than necessarily all of the financial adviser services that a QFE offers across its client base).
Remuneration	Any commission, fee, or other benefit or advantage, whether a monetary benefit or otherwise, and whether direct or indirect; but does not include salary or wages of a fixed amount.

* Requirements in these conditions are additional to those set out in the Act and the Regulations.

TABLE 1 – All financial adviser services

This table forms part of condition 4.3

	Information to be disclosed	For services relating to:	
		Category 1 products	Category 2 products
1	That the QFE takes responsibility for the financial adviser service provided by its QFE advisers.	yes	yes
2	For the relevant service, a general description of: <ul style="list-style-type: none"> • whether the QFE or QFE Group is connected to the providers of the products or services, and a description of the connection • any limitations on the products and services provided • the range of products or product providers from which a selection will be made. 	yes	yes
3	A general description of how the QFE, members of the QFE Group and its QFE advisers are remunerated for the relevant service. A statement of whether there are other factors that could influence the QFE and its advisers. That the client will be provided with more detailed information as soon as practicable, and may request this at any stage.	yes	not required
4	That the QFE is licensed and regulated by the Securities Commission for its financial adviser services along with the contact details of the Commission. That the client can obtain information about financial advisers from the Commission and can report information about the QFE or its advisers to the Commission.	yes	yes
5	That the information provided is important and should help the client decide which financial adviser to choose.	yes	yes
6	That the client can check the status of the QFE and whether other entities are a member of the QFE Group on the register at www.fspr.govt.nz .	yes	yes

TABLE 2 – Services in respect of category 1 products

This table forms part of condition 4.3

	Information to be disclosed
1	Any fee(s) chargeable to the client for the relevant service, including the basis on which the fee will be charged, the amount or a reasonable estimate of the fee and when the client must pay the fee.
2	Details of any material influence on the QFE or the QFE adviser, including any interest, incentives, remuneration, relationships or associations. As far as is practicable, the QFE must disclose the amount (or rate) of the incentive or remuneration, together with the name of the person who provides the remuneration if that person is outside the QFE Group.

PROPOSED AMENDMENTS TO THE QFE ADVISER BUSINESS STATEMENT (ABS) GUIDE

The 'Information for Customers' section of the QFE ABS Guide will be amended to reflect the Disclosure Policy requirements.

The *compliance principle* will be amended to add (in bold):

The QFE should have governance and compliance arrangements that ensure:

- it **fulfils its disclosure obligations** and supports advisers in giving clear, timely information that helps customers make informed decisions

The *expected information* will be amended to add:

We expect your ABS to address these principles by covering, where relevant:

- **an overview of your approach to your Disclosure Policy and determining how the policy is applied**

Explanatory notes

4 Disclosure standard conditions

Disclosure under section 25 applies to personalised financial adviser services to retail clients. The obligations in a QFE's terms and conditions are in addition to the requirements in the Act and in the regulations (which contain additional content and deal with the form of disclosure).

The Commission has taken a principles-based approach to drafting these terms and conditions. This is intended to assist QFEs in seeing the substance of the requirement. Variations in terminology to the disclosure Regulations do not necessarily indicate that a different interpretation is intended. The Commission expects QFEs to take into account the objectives of the Act and their consumer protection obligations in interpreting the requirements.

4.1 and 4.2 – Policy and its application

A QFE has flexibility in how it interprets or combines elements of the disclosure requirements:

- disclosures must be provided before, or as soon as practicable after, providing the financial adviser service (section 25)
- previous disclosure given to the client may be relied upon if it is not out of date (section 29)
- disclosures can be combined with additional information (section 28)
- it is not currently proposed that the form of disclosure will be specified. (The Act does not require that disclosures must be made in a written statement, and this is not expected to be required by the Regulations.)
- matters to be disclosed might be dealt with together or at different times.

4.1 and 4.2 require a QFE to consider the needs of the consumer (and the objective of disclosures) when deciding how to use this flexibility. The QFE should have a governance framework around its disclosure approach, and to making and documenting its decisions on the approach for its products and services, including the factors which have been taken into account in reaching those decisions.

The design of the approach should consider the form, timing and content of the disclosures through a process and the controls over operation. For example, QFEs might consider questions such as:

- When is the information most relevant to the customer (from the customer's perspective)?
- At what stage in the process can an appropriate balance be struck between too much information (for example all the products that a QFE might be able to provide) or too little (for example insufficient information about the range from which the product was selected)?
- What format is most useful to customers in this channel?
- What language is most appropriate for customers in this target market?

- How can we ensure that the importance of the disclosure is clear?
- What type of disclosure can be successfully delivered by this adviser group?
- How can we monitor that our advisers provide the disclosures?
- Have we sought or received any customer feedback on our disclosures?

A large QFE may choose to provide relevant disclosures by making some part of its disclosure specific to each channel – for example, a different approach might be adopted in a call centre selling general insurance or credit products, to that taken for face to face investment advice. This would allow more specific relevant information to be given about the products and any limitations on products and on incentive schemes for advisers.

In considering the format of its disclosures, QFEs are encouraged to consider the approach taken in the AFA and Registered Financial Adviser disclosure regulations, so that customers can recognise required disclosures and compare advisers.

The Commission has particularly required a policy and documented reasons for the approach selected for disclosures. This reflects the focus of the legislative requirements on disclosures. Policy documents may also be a desirable approach to governance and compliance arrangements in other areas of a QFE's financial adviser services, even though not specifically required. The Commission may also ask QFEs about their reasons for adopting particular approaches to their consumer protection obligations in other areas.

4.3 – Matters to be disclosed

The Commission has taken a similar approach to that taken for AFAs. The Commission considers that some matters to be disclosed are 'about the business'. They tend to be generic in nature and are likely to be provided together at the start of, or at an early stage in, the process for the service. These matters are set out in Table 1.

Other matters to be disclosed are 'about the advice'. They are more specific to the actual service being provided and are likely to be affected by the more specific information being gathered during the process. They are therefore likely to be given at a later stage in the service. These matters are set out in Table 2.

The definitions of 'remuneration' and 'material' are derived from disclosure requirements in the Securities Markets Act and will be updated to take account of any definition in the disclosure regulations, if necessary.

Record keeping

Records of disclosures should be maintained in accordance with standard conditions 3.1 and 3.2. It may not be necessary to keep a record on each customer file of the actual disclosure information provided under Table 1, if the information is the same for all customers in a service and the QFE can demonstrate compliance through records of its approach. Such records are likely to include the wording and form of its disclosures, its procedures and the operation of its controls.

Table 1 – All financial adviser services

2 – Products and services

For services in respect of category 1 products, the QFE or a QFE Group member should disclose that it is the issuer or promoter (under the Securities Act) of the product. (The nature of the ‘promoter’ relationship may need to be explained.) It should be clear that the QFE Group is responsible for both the advice and the product.

For all services, the services or products may be limited by the QFE’s commercial arrangements or business structure – for example, dealing with one category 2 product provider, or a sales force which provides only certain types of product. This should be explained.

Where the relationship of the QFE to the product is not clear due to branding, this may also need to be explained. For example: if a product provider is a QFE Group member, but has a different name to the QFE Group; or if the QFE has branded a third party category 2 product.

The Commission expects that once disclosures are completed, the customer will understand whether any product recommended has been selected from a range of products of the same type available, or is the one product of that type which the adviser has available.

For services for category 2 products, the requirements may go beyond those for Registered Financial Advisers. Many QFEs are product providers, or have particular commercial relationships which may limit the products and services available to customers. The short disclosure envisaged balances the consumer protection obligations of QFEs and the efficiency advantages of the QFE model.

3 – Remuneration for the service

The general description given in the Table 1 disclosures is expected to be high level, but sufficient to alert the customer to the fact that a potential conflict of interest exists. More detailed information is required by the conditions in Table 2, but might be provided at a later stage in the process.

For services in relation to category 2 products, regulations do not require registered financial advisers to disclose conflicts of interest arising from interests, commissions or other remuneration. If changes are made to the regulations, the Commission will expect QFEs to amend their disclosures accordingly.

4 – Regulation by the Commission

In making disclosure about regulation by the Commission, QFEs should provide factual information and comply with standard condition 6 (‘no endorsement’).

Illustrations

Some illustrations of how Table 1 might look are provided in the Illustrations section.

Table 2 – Services in respect of Category 1 products

1 – Fees

The direct costs for the advice should be made transparent to the customer.

We expect that more detail can be disclosed as the nature of the service being provided becomes clearer. For example, in some situations a QFE may be able to provide the information in a single disclosure without overloading the customer with information that is not relevant. Where a QFE has a number of different services, it might determine that its consumer protection obligations are best satisfied by a number of disclosures of increasing detail:

- early in the advice relationship it is made clear that fees are payable and a basis of calculation is provided across the services, perhaps in percentage form
- once the nature of the service is established, a reasonable estimate might be provided, preferably in dollars
- at the time the advice is given, accurate fee information would be provided in dollars.

2 – Interests, incentives, remuneration and relationships

The customer should be made aware of any matter which may influence the service and which therefore represents a potential conflict of interest, so the customer can decide whether to follow the advice provided or use the service. QFEs should consider financial and other interests on the QFE itself and/or the QFE adviser.

A QFE currently subject to the disclosure requirements of the Securities Markets Act is likely to already disclose matters similar to those required by these conditions. The QFE should consider how to use the greater flexibility allowed under the Financial Advisers Act to disclose these matters in a way that meets its consumer protection obligations.

Influences on the QFE include remuneration or incentives received by members of the QFE Group or other related companies. Where the QFE or QFE Group is responsible for both the advice and product, this should include an explanation of the total remuneration to the QFE Group. For example for investments a composite charges ratio may be appropriate. Influences also include external incentives to the QFE Group, for example from the issuers of promoted products.

It is not intended that the QFE should disclose potential influences solely arising from the profitability of its products – such disclosure is likely to lead to artificial cost allocations and therefore to be of limited value to customers.

Influences on the QFE adviser will not be clear to the customer and should be disclosed. QFEs should also consider influences on nominated representative advisers, including incentives and remuneration received by the adviser from his/her employer (and amounts received by that employer if known).

When presenting incentive and remuneration disclosures, QFEs should consider how best to fulfil their consumer protection obligations within the timing requirements of the

Act. Potential complexities of incentives and remuneration should be balanced with the customer's need to understand influences relevant to their needs.

A QFE may consider that some influences are clear to the customer from high level disclosures (under Table 1) explaining that for investment services the QFE adviser can sell only the category 1 products issued or 'promoted' by the QFE Group. In these cases, a QFE might consider whether it can fulfil its consumer protection obligations by giving more detailed disclosures on influences later in the service. For example, disclosure of all of the incentive and remuneration structures across a range of products at the start of the relationship might overload the customer, while waiting until possible relevant products or services have been identified might allow shorter disclosures and enable the customer to focus on relevant information.

If the QFE decides that it is appropriate to leave detailed disclosures to later stages of the service or relationship, it should at least state (under Table 1, 3 of the conditions) whether there are matters which might influence the advice, and, if so, that further information can be provided now or at a later stage (and can be provided in writing).

The Commission expects that the QFE will take into account potential influences on the advice when designing its supervision and compliance monitoring approaches.

QFE ABS Guide

The QFE ABS Guide includes standard conditions for reporting by a QFE to the Commission in the form of an ABS. This includes information about its governance and compliance arrangements. QFEs must address the *compliance principles* and include the *expected information* in their ABS. For more information and a copy of the QFE ABS Guide see www.seccom.govt.nz/qfe For information about standard reporting conditions see the previous consultation on QFE standard conditions.

QFEs will be expected to address the amendments, once incorporated into the Guide, in future versions of their ABS. Most potential QFEs have already submitted or prepared their ABS for licensing. The deadline for submission is 1 December 2010.

The *suggested information* which provides guidelines for addressing the principle may also be amended to provide additional assistance to QFEs, if necessary.

Illustrations

TABLE 1 DISCLOSURE - CATEGORY 1 PRODUCTS

This example is for disclosure made through advisers working in MNO Limited, an approved associated entity of XYZ Limited, which is a QFE. The customer knows the MNO Limited brand. These advisers advise on category 1 products.

This example draws on the format of AFA disclosures under the Regulations.

	Table 1 reference
<p>It is important that you read this information It will help you to decide whether our services will suit your needs. We will provide you with more information later that will also be important for the financial decisions you make.</p>	5
<p>What sort of adviser are we? MNO Limited is part of a Qualifying Financial Entity (QFE) Group called XYZ Limited QFE Group. You can check this information on the Financial Service Providers Register at www.fspr.govt.nz.</p>	6
<p>XYZ Limited is the QFE licensed to take responsibility for the advisers in the QFE Group (the QFE advisers). This includes making sure that advisers exercise care, diligence and skill in providing financial advice to you. The QFE's licence means that QFE advisers do not have to be individually registered or authorised.</p>	1
<p>What services can we provide to you? Our QFE advisers can provide personalised advice about investment products which are provided or promoted by our QFE Group. ('Promoted' has a special definition.) This means that we take responsibility for the product as well as the advice. Our branch based advisers can provide advice on Unit Trusts and our Investment Funds**. Our QFE advisers cannot provide advice about other products or design a plan for dealing with all of your investment goals. If you need this service we can refer you to one of our Authorised Financial Advisers.</p>	2
<p>How do we get paid for the services that we provide to you? We do not charge a fee for our service, but when you buy something from us, our Group will benefit as we provide the products. Our advisers may also benefit as we provide a bonus scheme, which is based on a variety of factors, including the performance of our company and how much the adviser sells. We balance our bonus scheme by also requiring our advisers to consistently meet our suitable advice standards. Before you decide to act on our advice we will tell you more about how we and our advisers may benefit from your decision. You can also ask for more information.</p> <p style="text-align: right;"><i>contd over</i></p>	3

<p>Who licenses and regulates us? The Securities Commission. You can report information about us to the Securities Commission (but if you want to complain you should use our dispute resolution procedures*). Contact the Securities Commission for more information.</p>	4
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TABLE 1 DISCLOSURE – CATEGORY 2 PRODUCTS

This example is for disclosures made through the QFE's own advisers.

This example draws on the format of regulated financial adviser disclosures under the Regulations.

	Table 1 reference
<p>It is important that you read this information It is general information which will help you to compare financial advisers and choose the one that best suits your needs.</p>	5
<p>What sort of adviser are we? XYZ Limited is a Qualifying Financial Entity (QFE). You can check this information on the Financial Service Providers Register at www.fspr.govt.nz.</p>	6
<p>What does that mean? A QFE is licensed to take responsibility for its advisers. This includes making sure that advisers exercise care, diligence and skill in providing financial advice to you. The QFE's licence means that QFE advisers do not have to be individually registered or authorised.</p>	1
<p>What services can we provide to you? Our QFE advisers can provide personalised advice about:</p> <ul style="list-style-type: none"> • XYZ motor insurance, which is insured by DEF Limited • travel insurance provided by GHI Limited • health insurance provided by GHI Limited or JKL Limited <p>We are not related to DEF Limited, GHI Limited or JKL Limited, but have contracts with them to enable us to sell their products.</p> <p>Our QFE advisers cannot provide you with advice about investment products.</p>	2
<p>Who licenses and regulates us? The Securities Commission. You can report information about us to the Securities Commission (but if you want to complain you should use our dispute resolution procedures*). Contact the Securities Commission for more information.</p>	4

* Contact details, complaints handling and dispute resolution matters could be added to comply with the Regulations

** Further information on the range of Unit Trusts and Investment Funds should be provided once more information on the client's needs have been established.