

QFE Standard Conditions: Explanatory Notes

Introduction

The following explanatory notes are intended to assist QFEs in interpreting and complying with the Standard Conditions in practice in their financial adviser services.

The Commission has taken a principles-based approach to drafting the conditions. This is intended to assist QFEs in seeing the substance of the requirement. The Commission expects a QFE to take into account the objectives of the Act in interpreting the requirements in the context of its business.

The Commission may refer to these explanatory notes in discussing matters with QFEs.

1. Capacity

1.1 to 1.3 of the conditions reflect that the arrangements and procedures that are required to satisfy the Commission at licensing (s65(3) and s66) must be maintained.

1.4 reflects that the Commission's satisfaction with an entity's capacity starts from the Adviser Business Statement (ABS) document in which the QFE sets out its business and its governance and compliance arrangements. This condition requires a QFE to maintain procedures taken into account at licensing, but also allows flexibility for these procedures to be improved.

1.5 reflects that having and maintaining an ABS is a core requirement of grant of status. It provides the Commission with important information about the QFE's business and its capacity to comply with its obligations under the Act in relation to its financial adviser services business. The Reporting and Notifications Standard Conditions for QFEs requires a QFE to submit a copy of its ABS as part of its annual report to the Commission.

See the QFE ABS Guide at www.seccom.govt.nz/qfe. QFEs should develop and submit their ABS based on the current guide. The Commission reserves the right to change the QFE ABS Guide from time to time, following consultation.

1.6 to 1.9 require the QFE to notify the Commission of material changes to the QFE's business and governance and compliance arrangements set out in the QFE's ABS. The Commission will then consider whether it remains satisfied that the QFE will maintain capacity during, and after, any change and, therefore, whether the QFE remains eligible for QFE status.

In 1.8:

- the Commission expects the introduction of new product types will generally be a material change to the financial adviser services, as there will be implications for capacity, including training and suitability processes. (Examples of new product types might include adding health insurance where only motor insurance has been sold or adding KiwiSaver where this has not previously been sold. If a QFE already provides unit trusts, adding a new unit trust is unlikely to require notification.)
- a QFE is not required to notify the Commission if it is merely at the early stages of considering the feasibility of a change or potential changes.

2. Reporting and Notifications

Reporting and Notifications Standard Conditions are covered in a separate document but the relevant explanatory notes are included below under QFE Reporting and Notifications Standard Conditions: Explanatory Notes.

3. Records

In 3.1, generally the Commission will give a QFE notice when requesting records for inspection, and will visit premises within business hours. Typically, the Commission will require records to be made available within a few days.

3.2 imposes record keeping requirements on QFEs. Records are necessary to demonstrate the QFE's compliance with the Act, regulations and the terms and conditions, to enable the Commission to perform its regulatory duties and functions and for consumers in the event of a dispute. (QFEs must set out their approach to record keeping in their ABS in accordance with the compliance principle in the ABS Guide.)

The Commission expects the seven year period to commence on the last date that a financial adviser service was provided to the client. However, for information relating to a financial product transaction entered into by the client, the seven year minimum period for that information commences on the date that all benefits potentially available to the client from the financial product have been realised, or that all obligations owed by the client have been discharged, if that date is earlier than would otherwise apply.

In 3.1 and 3.2, relevant records are those records that can evidence a QFE's compliance with its obligations under the Act, regulations and terms and conditions.

For disclosures, it may not be necessary to keep a record on each client file of the actual disclosure information provided, if the information is the same for all clients in a service and the QFE can demonstrate compliance through records of its approach. Records to demonstrate compliance are likely to include the wording and form of the QFE's disclosure, its procedures and controls and the results from the operation of its monitoring.

3.3 places a requirement on the QFE to keep historic records of nominated representatives, supplementing the requirement to keep an up to date list as required by s76(1)(f).

4. Disclosure

Overview

The Financial Advisers 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.

The disclosure obligations for QFEs are set out in sections 25-29 of the Act, Regulation 8 of the Financial Advisers (Disclosure) Regulations 2010 and a QFE's terms and conditions set by the Securities Commission in accordance with Regulation 8(2)(f). These standard conditions contain the matters referred to in Regulation 8(2)(f). (Regulations will provide some exemptions for services provided over the telephone in respect of category 2 products.)

The Act puts disclosure obligations on the QFE for services carried out by 'QFE advisers', rather than directly on the individual advisers. Disclosure obligations therefore apply to the entity. Disclosure obligations apply when a personalised service is provided to a retail client (s25 of the Act).

An AFA in a QFE is not a 'QFE adviser' and will only make an individual disclosure in accordance with the requirements for AFAs in the regulations.

4.1 Information to be disclosed

The Act's objectives for disclosure are to assist clients in choosing an adviser and in deciding whether to follow any advice provided. Information on the nature of the service, products available and any potential conflicts is therefore important. To achieve the objectives, information should be:

- provided early enough to assist in the choice of adviser
- specific enough to evaluate the influences acting on the personalised service being provided.

QFEs are expected to consider both of these elements in designing their disclosures.

In practice, specific information (for example the amount of commission) may not become available until later in the service process, or may be overwhelming or confusing if provided before the specific service is known. The conditions therefore allow for generic information to be provided, with the expectation that QFEs will provide this information at an earlier stage. Matters to be disclosed are therefore set out in two tables:

- Table 1 'About the business' (the QFE's financial adviser services 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.
- Table 2 'About the service'. They are specific to the actual personalised service being provided and are affected by information being gathered during the process. They are therefore likely to be given at a later stage in the service. Table 2 currently relates to services for category 1 products.

The information in Table 1 and Table 2 can, however, be provided in different forms, at different times or at the same time, in order to provide relevant information for the client.

In considering whether it is practicable to provide information, the QFE should consider both the availability of information and whether information specific to the personalised service can be identified, so that information is not confusing (s27).

4.2 Documentation of disclosure approach

The Financial Advisers Act, the Regulations and the standard conditions allow flexibility for QFEs in how disclosures are made, so long as the approach taken is consistent with the purpose of the Act (s3(2)(b)(i)), that is, to ensure clients can make informed decisions about whether to use the financial adviser and whether to follow a financial adviser's advice. The Act provides that:

- disclosure must be provided before, or as soon as reasonably practicable after, providing the financial adviser service (s25)
- previous disclosure given to the client may be relied upon if it is not out of date (s29)
- disclosure can be combined with additional information, provided that disclosures are not misleading, deceptive or confusing (s27 and 28)
- matters to be disclosed can be dealt with together or at different times (so long as the s25 obligation is fulfilled).

The Commission expects a QFE to consider the needs of the client (and the objective of disclosures) when deciding how to use this flexibility and to be able to explain the reasons for its approach to disclosure in a particular service or channel. The QFE is encouraged to take into account where consumer protection needs may differ between services and the related products. In addition, a large QFE may make Table 1 disclosures more relevant to the client by making 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.

Whether disclosure is appropriate for the service provided is likely to depend on the form, timing, clarity and level of detail of the disclosures through the service process and the controls over operation. For example, QFEs might consider questions such as:

- When is the information most relevant to the client (from the client'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 clients in this channel?
- What type of language is most appropriate for clients in this target market?
- Will the importance of the disclosure be clear to clients?
- Are clients likely to be able to understand the disclosure?
- What type of disclosure can be successfully delivered by this adviser group?
- Does the approach allow sufficient monitoring of provision of disclosures?

It will not be necessary to document consideration of all of these suggestions for each service provided. The documentation necessary will depend on the nature of the service and its clients. A QFE can adopt a risk-based common sense, rather than a prescriptive, approach. For example, in determining whether a disclosure is easy for a client to understand, a QFE has a range of options: no additional evidence; asking some non-adviser staff; using adviser or client feedback; carrying out some specific consumer testing.

A QFE is not required to document the reasons why disclosures are provided in writing in the form set out in the Regulations (dated, with a clear heading including 'disclosure statement', easily readable and set out clearly and concisely in a manner likely to bring the information to the client's attention). A QFE is, however, encouraged to consider other aspects of the written disclosure taking into account the Act's objectives, such as the type of language chosen, the timing and the rationale where additional material is provided as part of the disclosure. In considering the format of written disclosures, we suggest that QFEs consider the approach taken in the Regulations for AFA and registered financial adviser (RFA) disclosure, so that clients can recognise disclosure statements and compare advisers.

Disclosure arrangements form part of a QFE's governance and compliance arrangements (condition 1.1). These should include the approach to making disclosure and to documenting decisions on the approach for the products and services, including the factors that have been taken into account in reaching those decisions. For example, a QFE might set out its framework for the approach in a disclosure policy, supplemented by an explanation of how it has applied its policy in each case.

Disclosure procedures form part of the procedures required for ensuring that retail clients of the QFE receive adequate consumer protection under standard condition 1.2. A QFE should maintain appropriate procedures for making and for monitoring disclosures as part of its governance and compliance arrangements.

Table 1 - About the business

Table 1, parts 2 and 3

Table 1 Part 2 assists a client in understanding the service being provided and any limitations or conflicts relating to the products available through the service. Table 1 Part 3 assists a client in understanding the potential conflicts, particularly those arising from remuneration.

The general descriptions can relate to the services through the particular channel or group of QFE advisers, rather than the QFE as a whole, so that disclosures are meaningful to the client.

Table 1, 2a - category 1 products and services

QFE advisers can provide services for category 1 products if the QFE Group provides or 'promotes' the product. The client needs to be informed of this limitation on a QFE adviser's choice of products and the QFE's general description should disclose that it, or a member of the QFE Group, is the provider or promoter of the product. ('Promoter' is defined in the Securities Act and may need to be explained to the client) This is particularly important where the relationship of the QFE to the product is not clear due to branding or the use of unrelated entity names. It should be clear to the client that the QFE Group is responsible for both the advice and the product.

The Table 2 Part 1 information about types of financial adviser service and financial products should be meaningful to the client in the context of the personalised service provided. Where this information cannot practically be provided with the general description in a level of detail that will assist the client, a QFE can provide this information later (see Table 2 Part 1 explanatory note).

Table 1, 2b - category 2 products and services

The general description of classes or products is expected to be clear, concise and meaningful for clients.

For services in relation to category 2 products, regulations do not currently require registered financial advisers (RFAs) to disclose their fees and remuneration (including commission) or potential conflicts from material interests, relationships or associations. 2b reflects the current position so that QFE disclosures are comparable. If changes are made to the regulations for RFAs, the Commission is likely to amend the conditions.

As part of the general description, the Commission suggests that a QFE might like to address:

- the relationship between the QFE and the product
- the range of products available

While any description should be brief, this would assist clients in choosing an adviser and whether to follow the advice, in accordance with the objectives in s3 of the Act.

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

Table 1, 3 - remuneration for the service

The general description given in Table 1 is expected to be high level, but sufficient to alert the client to the fact that a potential conflict of interest exists. More detailed information is required by the condition in Table 2 Part 3. It can be provided with other Table 1 information, if specific information can be given without overloading the client, or at a later stage in the process (see Table 2 Part 3 explanatory note).

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

Table 1, 4 - regulation by the Commission

In making disclosure about regulation by the Commission, QFEs should provide factual information and comply with standard condition 5 ('no endorsement').

Table 2 - About the service

Table 2, 1 - category 1 products and services

The information disclosed should relate to the financial products on which the personalised financial adviser service is being provided. The information provided is expected to be meaningful to the client in the context of that service.

The QFE should consider whether the level of detail is specific enough to enable the client to make an informed decision about whether or not to use the QFE's services.

Table 2, 2 - fees

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

In some situations a QFE may be able to provide the specific information in a single disclosure at an early stage, without overloading the client with information that is not relevant. However, in other situations, the Commission expects that more detail will be disclosed as the nature of the personalised service being provided becomes clearer. For example, in balancing early provision of information with the need for specific information, a QFE might determine that it can best fulfil the Act's disclosure objectives 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.

Table 2, 3 - interests, incentives, remuneration and relationships

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

A QFE with investment advisers that are currently subject to the disclosure requirements of the Securities Markets Act is likely to already have disclosure templates and procedures addressing 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 the objectives for disclosure in the Act.

Influences on the QFE

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, details disclosed 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 incentives external to the QFE Group, for example from the issuers of promoted products.

Clients may be aware there is a potential conflict of interest in receiving financial adviser services from a product provider. It is not intended that the QFE should disclose potential influences arising from the profitability of or margin on its products (as opposed to incentives and remuneration) - such disclosure is likely to lead to artificial cost allocations and therefore to be of limited value to clients.

Influences on the QFE Adviser

Influences on the QFE adviser will not be clear to the client 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).

Matters relating to influence in Table 1 and 2

QFEs should consider how best to fulfil the Act's disclosure objectives and requirements for matters relating to influence. For example, disclosure of all of the incentive and remuneration structures across a range of products at the start of the relationship might overload or confuse the client, while waiting until the actual personalised financial adviser service required has been identified might allow shorter disclosures and enable the client to focus on relevant information.

Definitions

The wording of the definitions reflects that in the Financial Advisers (Disclosure) Regulations 2010.

The Commission will view fixed benefits that form part of an employee's wage or salary package and that are not performance-related as 'salary or wages of a fixed amount' and therefore not within the definition of 'remuneration'. For example, health insurance, superannuation or a company car are likely to be fixed benefits.

5. No Endorsement

A QFE is able to refer factually to its QFE status. For example, in its financial adviser services disclosures it must refer to its status, the fact that it is regulated by the Securities Commission and that it takes responsibility for its QFE advisers.

This condition reflects that QFE status is a mechanism for efficient compliance for large businesses. Financial adviser businesses may choose whether or not to apply for QFE status, based on an assessment of the benefits and responsibilities. Grant of QFE status indicates that the Commission is satisfied an entity has the capacity to discharge its financial adviser compliance obligations; QFE status does not imply that an entity, its systems or its governance arrangements are in any way 'better' or 'worse' than a non-QFE. Therefore, an entity should not make claims about the implications of its QFE status or refer to its QFE status in a way that may mislead clients. For clients, the key relevance of QFE status is that advice can legally be provided by a QFE adviser.

A QFE should not imply that QFE status means that the Commission endorses the financial advice or the financial products provided.

QFE Reporting and Notifications Standard Conditions: Explanatory Notes

The Reporting and Notifications Standard Conditions and the QFE ABS Guide set out reporting and notifications conditions, referred to in standard condition 2.1. The Act allows the Commission to change these from time to time during the period of QFE status, subject to appropriate consultation (s147A and B). QFEs must provide information to the Commission in accordance with the latest versions of the conditions and Guide, published on the Securities Commission's website.

These explanatory notes supplement the QFE Reporting and Notifications Standard Conditions published by the Securities Commission on 22 December 2010.

Confidentiality of information provided to the Commission

Information held by the Commission is subject to the Official Information Act 1982 and the Privacy Act 1993. These Acts provide for proper access to information held by public organisations and also protect information to the extent consistent with the public interest and preservation of personal privacy. Any request for information we hold will be considered in accordance with the requirements of these Acts. We consider there are a number of grounds likely to provide good reason to withhold sensitive information submitted by a QFE, such as where its release would disclose a trade secret, prejudice the commercial position of the financial adviser business, or breach an obligation of confidence where release of the information would be likely to prejudice future supply of similar information, or information from the same source. While we understand that reporting and notifications will generally be submitted on a confidential basis, we suggest QFEs state if they consider the information provided is confidential.

Notifications

A QFE takes front-line compliance responsibility for the compliance of its advisers. The Commission expects to have an open and constructive relationship with entities that have opted to take on this responsibility. Notifications allow the Commission to engage in a dialogue with the QFE to

understand how it will continue to fulfil its responsibilities as its business and processes change, and as any issues arise and are dealt with.

The Commission may, in future, issue requirements relating to the form of notifications. The Commission may issue further guidance on matters that are expected to be notified and reported.

When considering whether a matter is material, a QFE is expected to consider the objectives of the Act and the implications for its clients, rather than materiality to the QFE or QFE Group, such as the financial impact on its business.

Notifications contained in Capacity section 1

Standard conditions 1.6 to 1.9 relate to capacity, but are also important notifications to the Commission. These are repeated in the Reporting and Notifications Standard Conditions for ease of reference. They require the QFE to notify the Commission of material changes to the QFE's business and governance and compliance arrangements set out in the QFE's ABS. The Commission will then consider whether it remains satisfied that the QFE will maintain capacity during, and after, any change and, therefore, whether the QFE remains eligible for QFE status.

1. Other notifications

N1.1

b and c - When making a notification under b and c, it will assist the Commission if the QFE provides such information as is available on its planned actions to maintain its capacity and its compliance with its obligations under the Act.

d to g - When making a notification under d to g, it will assist the Commission if the QFE provides such information as is available to explain the matter, including the QFE's approach to remedying the matter. The Commission understands that a complete plan of action will not be practicable within 5 days in all cases. For example, when a QFE becomes aware of a matter, it may take longer than 5 days to determine all of the client typologies affected, before the approach to remedying the matter can be determined. Notification within 5 days enables the Commission to engage in a dialogue with the QFE, with further details provided as they become available, if necessary in the circumstances.

The Commission will decide the extent of its own enquiries or actions based on the information provided with the notification, including the QFE's timetable for any proposed action.

g refers to matters relating to the QFE's financial adviser services. It does not, for example, require reporting of market price movements.

2. Reporting

R2.1

All QFEs must provide an Annual Report to the Commission including the information required by s77 of the Act and information in accordance with the requirements in the Reporting and Notifications Standard Conditions for QFEs.

The Commission intends to consult separately on regulatory reporting requirements (in addition to condition R2.1). Any obligations will not take effect before 1 July 2011 and time for consultation and implementation will be allowed.

The information will be used to focus the Commission's monitoring on QFEs at higher risk of damaging public confidence and serious non-compliance with the Act. Information requested is likely to be high level and of the type used by QFEs to monitor their own business and compliance, for example, information on business volumes for major product groups and service types, number of customers and advisers, and complaints information.