FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

November 2015

Sales and advice

1 July 2014 – 30 June 2015

Who this report is about

This report covers thousands of advisers and salespeople who help New Zealanders invest billions of dollars in financial products each year.

KiwiSaver alone currently accounts for more than $28 billion of New Zealanders' savings. Other complex products that advisers and salespeople deal with (known as category 1 products) include bonds, shares, managed funds and derivatives. They also deal with less complex products (known as category 2 products) such as loans, transactional and savings accounts, term deposits, cash or term portfolio investment entities (PIEs), and some insurance policies.

Advisers and salespeople are classified according to the type of products they sell or advise on. As at 30 June 2015, the sector included:

- around 26,000 advisers who work for 57 large organisations such as banks and fund managers, known as qualifying financial entities (QFEs)
- 6,420 registered financial advisers (RFAs)
- 1,845 authorised financial advisers (AFAs).

They can all sell financial products without advice, or offer non-personalised advice (known as class advice). But there are limits on who can provide personalised advice.

- The only category 1 products that QFE advisers can give personalised advice on are those promoted or issued by their own QFE. They can also give personalised advice on category 2 products, but not as part of an investment planning service.
- RFAs can give personalised advice only on category 2 products.
- AFAs are individually authorised by the FMA to provide personalised advice on both category 1 and category 2 products. They can also be licensed to provide investment planning services.

We have included brokers and custodians as well, as they also perform important services, such as transferring, holding and safeguarding customers' assets.

www.fma.govt.nz

AUCKLAND OFFICE | Level 5, Ernst & Young Building | 2 Takutai Square, Britomart | PO Box 106 672 | Auckland 1143

WELLINGTON OFFICE | Level 2 | 1 Grey Street | PO Box 1179 | Wellington 6140

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Executive summary

Purpose of this report

Financial advisers and salespeople are regulated by various laws, including the *Financial Advisers Act 2008*. More recently, the *Financial Markets Conduct Act 2013* (FMC Act) brought in significant new conduct requirements. Many of the issues we have identified in this report are still relatively new for advisers and salespeople, and we are committed to working with the sector to help them meet the new standards and expectations.

This report reflects our supervision in the year to 30 June 2015. It is based on 47 site visits, as well as other monitoring such as desk-based reviews, and includes banks, insurers, fund managers, trustee companies, and individual adviser businesses.

We have also included our review of data from 10 KiwiSaver providers, covering 81% of KiwiSaver members. The review was prompted by issues raised in previous monitoring about KiwiSaver sales and transfers.

In our *Strategic Risk Outlook 2015*, we identified our seven main priorities for the next three years to promote and encourage the development of fair, efficient and transparent financial markets. This report focuses on four of those priorities: governance and culture, conflicted conduct, sales and advice practices, and investor decision-making.

It also includes specific observations for financial advisers, brokers and custodians, to help them understand exactly how our priorities apply to them.

Key themes

The key themes we have identified are:

- Putting customers' interests first – While we saw some excellent practices, there is still plenty of improvement required to reach the standards of conduct we expect. Many businesses were unable to show us how they explicitly balanced conflicts of interest, such as incentives for sales staff versus customers' interests. Many were also unable to demonstrate how they help their customers to make informed decisions based on a product's risk profile.
- Governance and culture – Many businesses were unable to demonstrate how the 'tone from the top' formed part of their culture. Good policies were not always reflected in good processes, and staff did not always have a good understanding of the value of such processes.
- Compliance – Many businesses lacked comprehensive systems to ensure compliance, and few were tested. We also noticed a lack of oversight of the suitability of decisions made by frontline staff.
- Supervision and reporting – Recording of information and reporting for management was inconsistent. For KiwiSaver, few providers collected and recorded useful data on sales, with reports to management mostly focused only on volume.

Our monitoring of AFAs shows the vast majority are committed to taking their obligations seriously, and we will continue to support these advisers.

While our review of the KiwiSaver data did not find any systemic issues, we are concerned that consumers are not always receiving the support they require or desire. We will be looking for improvements from providers to ensure they meet the new conduct obligations of the FMC Act.

While we have seen some improvements among brokers and custodians, many are still not meeting their obligations and we will continue to make this a priority area for our monitoring.

Action we have taken

Over the past year, our actions have included:

- publishing a report in April 2015 based on information AFAs were required to give us for the first time, giving a snapshot of the sector and outlining key issues
- senior staff giving presentations and speaking at several conferences, including the 2014 Workplace Savings Conference, the 2014 Institute of Financial Advisers conference, and the 2015 Institute of Finance Professionals (INFINZ) Conference
- holding a series of roadshows to help AFAs understand new licensing requirements, and working with AFAs and small financial adviser businesses to help them understand our expectations for licensing
- issuing an information sheet in October 2015 clarifying custodians' regulatory obligations
- publishing a consumer guide to bank capital notes, and to product disclosure statements
- issuing six warnings about specific firms and drawing consumers' attention to various scams
- warning consumers about UK pension transfers, where we believed the advertising gave a misleading impression of urgency
- following up with one KiwiSaver provider about improving their controls around transfers, and ensuring member consent
- providing feedback to firms from our monitoring, and following up on progress with recommended actions.

Future focus

We will be stepping up our engagement with the sector, and frontline supervisors, over the next two to three years. We will work collaboratively with them to help them improve their sales and advice systems, and ensure they are aligned with the intentions of the FMC Act. This will include:

- briefing the KiwiSaver providers who took part in our review of data, including two providers who had a high percentage of transfers which were subsequently stopped
- working with firms to help them improve how they construct, monitor and assess their sales and advice practices and their processes
- issuing guidance on disclosure of certain fees and returns for managed funds, including KiwiSaver, as well as further guidance on conduct and governance
- referring two AFAs to the Financial Advisers Disciplinary Committee due to issues we have identified
- continuing to be closely involved in the Government's review of the *Financial Advisers Act 2008* (FA Act) and the *Financial Service Providers (Registration and Dispute Resolution) Act 2008*
- continuing to monitor KiwiSaver switching and retention tactics to ensure members are being treated fairly, and continuing to work with them on any issues identified in our ongoing supervision.

We also accept that many providers have found our October 2012 guidance on the sale and distribution of KiwiSaver, and the use of personalised advice, impractical. We will review this guidance early in 2016 to ensure it reflects the reality of how customers are engaging with KiwiSaver and to ensure providers have a clear understanding of what we expect.

Sales and advice practices

What we expect:

- Processes designed for the sales and advice of financial products must place customers first.
- Customers must be given adequate information and help to make decisions, and referred to third-party sources (such as a financial adviser or tools such as Sorted), where that would help them.
- If advice is provided, it must be appropriate for the customer and products.
- Only those qualified to provide advice must do so.
- Supervision processes that allow management to understand the nature of the service provided (information only, class or personalised advice) and whether this was focused on the needs of the customer. They should also ensure the processes used are those approved by the provider.
- The same care and attention is given to sales practices as it is to financial adviser services, to minimise the risk of customers being mis-sold financial products.

What we found:

- Training and support for professional development of staff was well documented and consistently monitored across a range of organisations.
- Individual advisers were able to demonstrate their compliance with continuing professional development requirements and maintained professional development plans. However, some of these records were informal and would have benefitted from more detail.
- Informal approaches to supervision and few measures in place to detect unsuitable advice.
- Inconsistent recording of information and reporting for management, as well as a lack of oversight in some businesses.
- Absence of reviews of the supervision process.
- Incomplete file notes, and conflict between the scope of service and advice given.
- Lack of records supporting product replacement (such as insurance being replaced with a new policy, with no clear or documented benefit to the customer).
- Misuse of the client designation ‘eligible’ or ‘wholesale’.
- Some good use of mystery shopping, customer surveys and other methods of understanding the customer experience. These methods also helped to confirm that appropriate processes were followed.

Risks and benefits

Example: In some cases, the documentation in a customer file focused only on the benefits of the financial product being advised on.

Our view: You must provide a balanced view of the risks and benefits of products, rather than focusing solely on the benefits, which could be potentially misleading. This is particularly important when the advice is complex and could have a major impact on the customer’s finances. An example is the transfer of a UK defined benefits pension scheme to a New Zealand defined contribution superannuation scheme. In this situation, the risks may outweigh the benefits, depending on the customer. We would expect the customer to be told about the risk so they have a balanced view and, particularly for superannuation schemes, understand any loss of benefits.

Supervision of advisers by employers or large providers

Example: We saw some supervision of suitability recommendations by the immediate supervisor. However, this was not a formal process, and was not conducted in the 'line two' file reviews, so there was no independent check on the suitability and no oversight of the 'line one' supervision of suitability. We also noted that recommendations from adviser file reviews were required to be actioned by the advisers' administrative staff and not the advisers themselves.

Our view: We monitor financial advice providers on how suitable their supervision processes are, and how they report, aggregate and deal with their supervision requirements. We note organisations often have informal supervision processes. This makes it difficult for senior management to draw positive or negative conclusions about their staff and processes. We expect organisations to have formal processes designed to find systemic issues and deal with them. This should include staff training, to ensure consistent practice and understanding across the organisation. It may also include listening to calls, sampling calls, sampling files, and monitoring sales processes, as well as revising training to address any issues identified.

Suitability of advice

Example: In some cases where advice was provided, the needs analysis process was informal, with no documented evidence that a defined 'needs analysis' process was followed. Instead, there was a significant reliance on training to ensure staff members were aware of what they must cover in establishing the needs before making appropriate recommendations. It was acknowledged this is an area where issues could arise regarding suitability of advice. We also noted that a file note documenting the customer's needs was not required in all circumstances. Advisers appeared to focus on providing information and options for customers, rather than having the confidence to give an opinion or recommend the most suitable product.

Our view: We encourage financial service providers to consider whether their customers need advice, and provide this where required. Access to appropriate advice is important for more complex financial products such as derivatives, and where customers are making instant decisions that will have long-term significance for them. Where advice is provided, it is in the best interest of customers to be given a clear recommendation which they can consider when deciding to purchase a product. If there is more than one suitable product, then an outline of the risks and benefits of each option should be provided to enable them to make an informed decision.

Governance and culture

Having the right 'tone at the top' is vital to ensuring a business achieves good outcomes, both for itself and for its customers. We expect firms offering sales and advice to be able to show us they have strong oversight of their frontline sales and advice services, effective governance arrangements, and an embedded culture of compliance. Unfortunately many businesses struggled to demonstrate this. They often pointed to policies and procedures as evidence of meeting these expectations. However, they were unable to explain clearly how they continually tested their effectiveness, particularly for customers. When presenting their risks to us, businesses often only discussed the risk of non-compliance with regulatory obligations. Other risks, such as mis-selling and reputational risks, should also be considered.

We also noticed a lack of oversight of frontline staff. We often saw supervisors who did not consider suitability when conducting file reviews or observing interviews. We also noted a 'set and forget' attitude towards supervision and compliance arrangements. Many organisations reviewed the operation of these arrangements, but we did not often see a process to review the design of these arrangements to ensure they were effective.

What we expect:

- An effective culture that promotes customer outcomes.
- Boards and senior management taking clear responsibility for setting the tone and culture, ensuring adequate governance structures are in place for the sales and advice parts of their business, and regularly testing these.
- Boards and senior management fully informed on the performance of sales and advice teams, including oversight of complaints data, the nature and quality of advice provided to customers, and management of risks in sales and advice. Comprehensive management reporting should enable firms to identify and act on themes and systemic issues.
- Established risk management practices that address regulatory risk, and other risks that a business might be exposed to in sales and advice.
- Comprehensive compliance arrangements, including comprehensive management reporting, allowing the board and senior management to be reassured that the firm has adequate consumer protection measures and is consistently meeting its regulatory obligations.
- Willingness to engage with regulators, including actively providing information on potential and immediate regulatory issues, including where there has been actual harm to the interests of customers.

What we found:

- Organisations with a customer-centric focus were much more likely to have processes which led to good outcomes for customers, even if that outcome did not result in the sale of a product. We saw examples of firms spending considerable time with a customer, solely because it was believed to be in the customer's best interest. Mutual societies and co-operatives were much more likely to have this customer-centric focus.
- An uneven approach to risk management. Some firms had very good risk management, both of their corporate risks and risks in the services they provide. These firms understand that responsibility for risk management rests with the board and senior management, and they take action to ensure the board can manage risks properly. However, we also saw some firms with incomplete systems and practices.
- A lack of comprehensive compliance arrangements, with some regulatory obligations not covered by a compliance framework, under-resourced compliance and risk teams, a lack of coherent compliance frameworks, and reporting focused on non-compliance (effectively, reporting by exception). Some firms engaged easily with regulators, providing information on non-compliance; others were reluctant to do so.

Culture

Example: We noted several examples, particularly at mutual organisations, of a strong focus on placing the customer's interests first. We observed established processes, procedures and expectations to ensure customer engagement and satisfaction. This included a comprehensive process for recording breaches and resolving complaints, and advice processes focused on analysis of a customer's needs. Methods of quality assurance included both horizontal and vertical internal audits, as well as mystery shoppers and surveys.

Our view: It was encouraging to see a clear focus on customers' best interests, and a desire from boards to make further improvements. This was enhanced through having good supervision, and quality assurance processes that were undertaken on a regular and consistent basis.

Risk management

Example: On two recent monitoring visits, the businesses had not established risk frameworks or formally identified and assigned ownership of key risks relating to sales and advice. In both cases the businesses were able to explain the risks quite clearly, but had not documented them, or developed a formal process to manage them. As a starting point, we recommended the businesses develop a risk profile or risk register. We also recommended that senior management be regularly advised of the company's key risks. They should also discuss the adequacy of risk mitigation strategies, as well as any appropriate action that might be needed.

Our view: Directors and senior management should have a sound understanding of the key risks faced by the business, particularly those relating to sales and advice. The board should regularly verify that the business has appropriate processes that identify and manage potential and relevant risks.

Boards and internal governance structures

Example: During one visit we were provided with a presentation which described in detail the care the business had taken to ensure its board had an appropriate balance of skill, independence and experience. They mapped out clearly to us each board member's relevant executive experience, independence and ownership interests, experience within the industry, and particular strengths. This provided us with a clear view of how the board was able to adequately discharge its responsibilities and duties, including through its risk and compliance committee. It also showed how the board could be confident about the independence of its decision-making, and judgment on sales and advice issues.

Our view: To ensure effective governance and oversight within financial services firms, the board should have a balance of independence, skills, knowledge, experience and perspectives. Firms should also consider, depending on their size and nature, whether a separate risk and compliance committee or oversight body would help them manage sales and advice issues. In all of our monitoring and licensing activity we take an active interest in understanding the composition and effectiveness of such structures. We encourage firms to regularly test whether the right structures are in place, and their effectiveness.

Conflicted conduct

If they are not properly identified and managed, conflicts of interest can result in poor customer outcomes. Vertically integrated distribution models, where a business is the provider, manager and distributor of a product, can exacerbate conflicts of interest. Remuneration and incentive arrangements can also reinforce conflicts of interest, particularly when sales staff are remunerated on a volume basis or through certain bonus structures.

What we expect:

- Firms and professionals fully recognise conflicts of interest, and the results they might have, and actively manage them. This includes recognising that new or different conflicts arise as a business changes and as staff join and leave.
- Staff understand their obligations to identify and manage conflicts of interest.
- Sales and advice policies and practices recognise that the interests of customers must be prioritised and staff know how to ensure that happens.
- Boards and senior management are reassured that conflicts of interest are recognised and managed, and can take action to remedy shortcomings where necessary.

What we found:

- Conflicts of interest are recognised, but ongoing attention is sometimes inadequate.
- Firms often lack systematic approaches to conflicts of interest that allow them to reassure boards and senior management that conflicts are properly managed.

Example: In situations where an issuer works with brokers to distribute a product (such as a debt security), it is common for the broker to receive a fee for arranging the debt issuance and also receive a fee in relation to selling. In some cases they also provide advice on the securities to their retail customers.

Our view: In this scenario, the broker should clearly disclose to the customer the remuneration arrangement they have in place with both the issuer and the investor.

Example: We are aware of cases where customers have been sold a product such as life insurance or KiwiSaver, when their original intention had been to organise a different product, such as a credit card or home loan. In some cases there has been little, if any, awareness by the customer that the agreement to acquire the secondary product has been finalised.

Our view: The sale of products such as insurance and KiwiSaver can be problematic when the focus of the interaction with the customer has been another product. The secondary sale often has much less care or attention or time committed to it. The firm and their staff are conflicted when their performance is measured on volume and there is not a corresponding requirement to ensure all products meet suitability requirements, or are in the best interests of the customer. Advisers and salespeople should pay particular attention to this type of scenario to ensure customers' best interests are not compromised in the cross-selling process.

KiwiSaver

Our review of KiwiSaver sales and transfer practices was based on data received from five banks and five non-bank providers, covering 15 distribution businesses. Their selection was based on information we received, including complaints, which indicated possible concerns.

The data we collected covered 81% of KiwiSaver members, and 75% of funds under management. It included the period from 1 May 2014 to 31 October 2014.

Our aim was to identify whether:

- rules and guidance on KiwiSaver sales and advice were being adhered to
- systems and controls around sales were enabling effective management
- members were receiving appropriate information when joining or changing schemes.

While our review did not find any systemic issues, we are concerned that consumers are not always receiving the support they require or desire.

What we expect:

- Processes for sales and advice on KiwiSaver are designed with members' interests prioritised.
- Providers need to ensure that potential conflicts of interest, including the role of incentives in sales and advice, are effectively managed.
- Records need to clearly show the nature of the service provided, and whether a member has been provided with information or advice. If they have received advice, it needs to be recorded whether it was class or personalised advice. This applies to both initial sales and transfers.
- When determining whether an information-only, class or personalised service will be provided for a KiwiSaver sale or transfer, the best interest of the customer must drive this assessment.

What we found:

- Uneven approaches between providers in analysing issues and trends in complaints. Reporting to boards or senior management did not always enable these issues and trends to be effectively dealt with.
- Providers paying direct sales incentives to staff, or having KiwiSaver sales targets as part of staff performance plans. There was little evidence of supporting policies to ensure conflicts of interest in sales were recognised and managed.
- Most providers had minimal data on their sales processes, with little or no management information recorded on whether a sale or transfer was 'information-only' or with advice. If advice was provided, it was not recorded whether it was class or personalised advice. Most management reporting was by volume or was largely sales-focused.
- Around half of KiwiSaver sales were transfers between schemes (sometimes known as 'switching'). This was about 70,000 transfers in the six-month period. Transfers between schemes and between funds require careful consideration by members to ensure they understand the benefits and potential drawbacks of switching. Most providers did not have records of the type of service provided in transfer situations. We encourage providers to ensure their staff have adequate skills to make an assessment of client needs - from information only through to advice and to record the nature of the service provided.

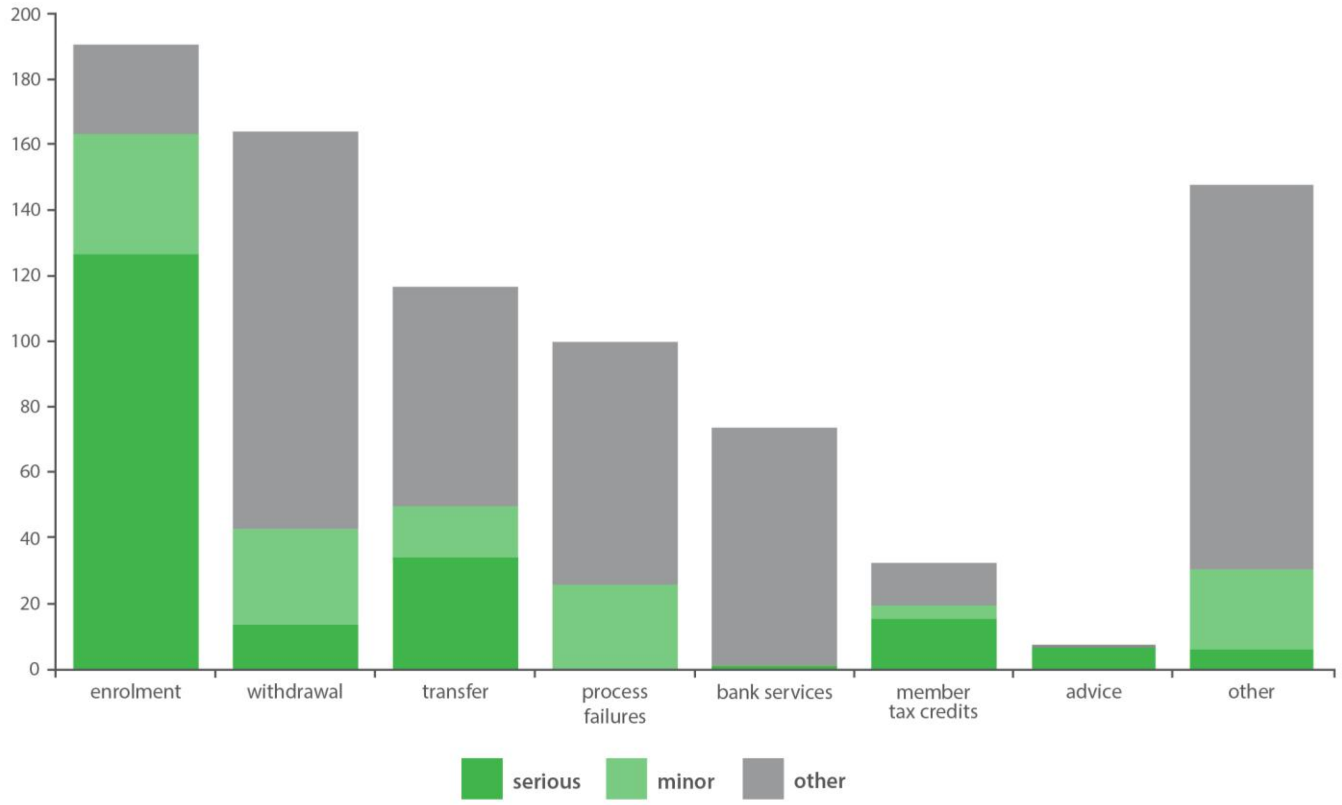
- KiwiSaver members may not be making decisions based solely on the merits of the scheme on offer. Other considerations, including incentives, may be influencing members to make decisions that are not necessarily in their long-term benefit.
- A reluctance to provide advice on KiwiSaver. KiwiSaver is sold by many advisers – including AFAs and QFE advisers – on an information-only basis. While advice (class or personalised) may not always be required, the full spectrum of service must be accessible and made available to clients based on their circumstances.

Complaints

There were 826 complaints recorded by providers during the six-month period we reviewed. We ranked them in the following order:

- Serious – sales and transfers made without consent, incorrect information given, advice asked for but not given
- Minor – misunderstandings, members did not receive forms or statements
- Other – processing mistakes

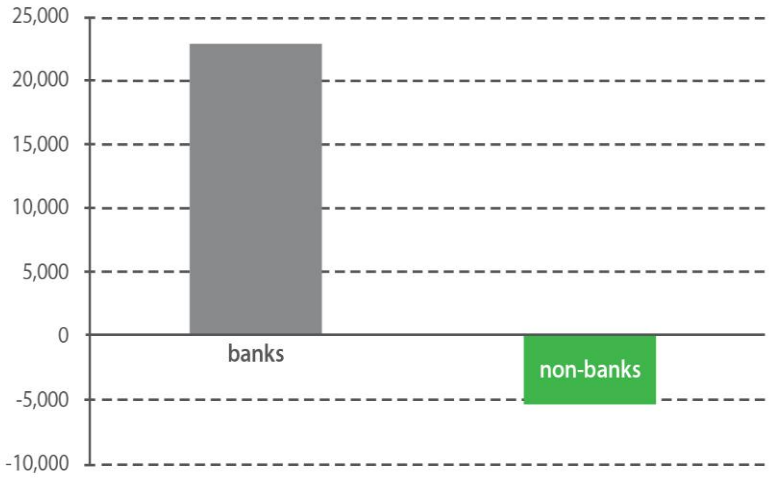
Most complaints were about new sales, and transfers. However, the overall percentage of complaints was small. There were 142,003 total sales during the period (of which 70,036 were transfers), which means the overall percentage of complaints to sales was 0.58%. Of these, just under a quarter were considered serious.



Advice

The data showed that for every 1000 sales or transfers, only three were recorded as having been sold with personalised advice. This shows most KiwiSaver providers are operating a sales model rather than an advice model.

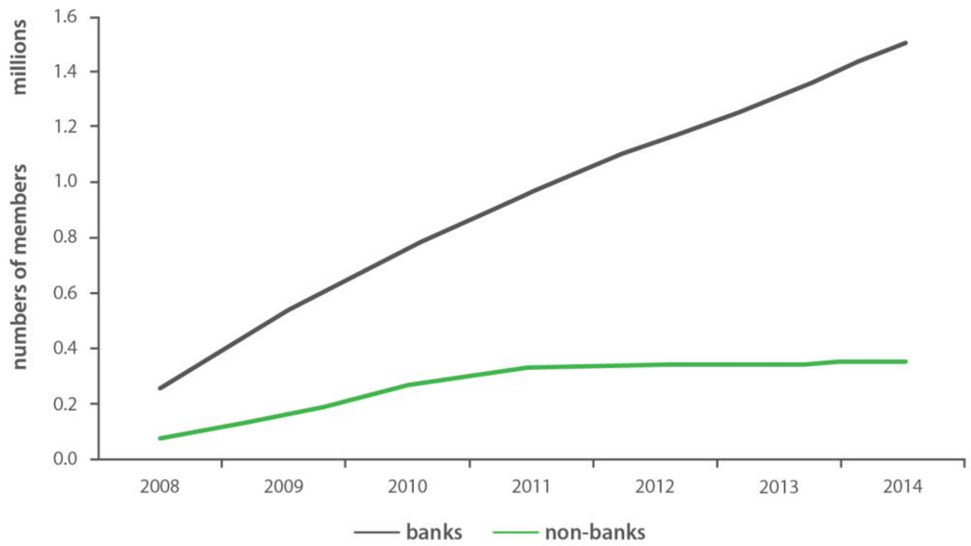
Transfers



The net effect of the 70,000 transfers during the six-month period was non-banks losing market share to banks. Our data indicated an isolated area of concern about members being transferred without their consent. We do not have evidence that this is widespread, but we have followed up with one provider in particular to improve their controls.

Two providers had a high percentage of member requests for transfers out that were subsequently stopped. We will follow up and monitor switching and retention tactics to ensure members are being treated fairly.

Membership



Since KiwiSaver launched in 2008, banks' penetration of the market has continued to grow, while non-bank numbers are now static. Banks tend to have more retail sales channels and better access to existing customers than non-banks.

Authorised financial advisers

The revised Code of Professional Conduct for AFAs came into effect in May 2014. Although RFAs and QFE advisers are not subject to the code, their QFE must demonstrate that it maintains procedures to ensure customers receive adequate protection. For category 1 products, the FMA must consider whether QFE customers receive protection of a similar standard to AFA customers, taking into account their scope of products.

Our observations below apply primarily to personalised advice and are ordered in relation to the relevant code standard. We note the vast majority of AFAs take their obligations seriously, and we are committed to supporting these advisers. In the small number of cases where we do not see a willingness to comply, we are taking this seriously. We are currently in the process of referring two AFAs to the Financial Advisers Disciplinary Committee.

6(c) – behaving professionally

When providing financial adviser services to a client, an AFA must make recommendations only in relation to financial products that have been assessed or reviewed by the AFA to a level that provides a reasonable basis for any such recommendation, or by another person if it is reasonable, in all the circumstances, for the AFA to rely upon that other person's assessment or review.

Example: An AFA associated with a product provider made recommendations to customers about the provider's products. The AFA used product analysis research provided by a research house that was part of the same vertically integrated business as the product provider. The AFA had a system in place to ensure dealings with the research provider covered key aspects of the engagement, including ongoing due diligence and an understanding of research methodologies. The AFA asked questions directly of the research provider to satisfy themselves that they could rely on the research when considering the recommendations they were making to customers.

Our view: In this example, the AFA acted professionally and was able to demonstrate that the customers' interests were placed first. An AFA must personally understand a financial product well enough to be able to form a reasonable basis for recommending it to a particular customer. They must also be able to articulate the nature, features and risks of the financial product to the customer in terms that the customer can understand. While AFAs can rely on a third party to perform the analysis of the financial product, they should not suspend their professional judgment when considering the integrity and appropriateness of that research. This applies whether the research is internally or externally generated. It is important to take into account factors such as the relationship between the person providing the analysis and the issuer of the financial product. If there is a perceived or potential conflict of interest, we would expect the AFA to review and assess whether the related-party research house has adequate policies and processes in place to effectively manage those conflicts. The AFA needs to be satisfied that it is reasonable to rely upon the analysis, despite the relationship the research house has with the financial product. AFAs may also want to consider other independent sources of research, if available. An AFA must, of course, also consider and comply with all other applicable code standards.

7 — ensuring clients can make informed decisions about using an AFA

An AFA must ensure each retail client has sufficient information to enable the client to make an informed decision about whether to use the AFA's financial adviser services and/or to follow any financial advice provided by the AFA.

Example: In some cases, the scope of service agreed with clients was either incorrectly documented or did not match the adviser services provided.

Our view: A client needs a correctly outlined scope of service to be able to make an informed decision on whether to use an adviser's services. Advisers must let their clients know what their obligations are. In some cases, clients also need to be clear about the services the adviser is not providing. For example, advice on life and trauma cover may not include advice on income protection.

9 — ensuring clients can make informed decisions about personalised services

Where an AFA provides a personalised service to a retail client that is an investment planning service or that relates to a category 1 product, the AFA must provide a written explanation to the client of the basis on which those services are provided. The AFA must also take reasonable steps to ensure the client is aware of the principal benefits and risks involved in following any financial advice provided as part of that service, having regard to the characteristics of the personalised service.

Example: AFAs did not always provide an outline of the principal benefits and risks of following their advice, and they didn't always provide personalised relevant information.

Our view: AFAs should provide a clear plan of what they are proposing for their clients, and how it will meet their financial objectives. Risks and benefits should be clearly communicated. We note AFAs with high quality documentation for code standards 6, 7, and 8 are able to provide better information to their clients. The opposite can also be said if the quality of the pre-advice process is incomplete, inconsistent, or inaccurate.

Example: A client had opted out of receiving recommendations on the suitability of products, but we did not see comprehensive documentation of this.

Our view: We have highlighted this issue in previous reports. We understand the challenge of providing written information to customers. However, we encourage advisers to test the effectiveness of their customer documentation to ensure the information is clear and accessible, and is focused on the customer and not just compliance. We know customers may opt out of receiving certain information. However, we expect this to be infrequent and appropriately documented with a signed and dated instruction from the client. This must include an acknowledgement that they understand the advantages of determining whether a product is suitable.

12 – keeping information about personalised services

An AFA must record in writing adequate information about any personalised services provided to a retail client. The information required to be recorded under this code standard in relation to each retail client must be sufficient to demonstrate compliance with code standards 5-9, and must include copies of all information and documents provided to, or received from, the client in writing, in connection with the AFA's personalised services.

Example: Some AFAs did not have sufficient records on the financial services provided to clients.

Our view: Relevant records should be retained in client files in a practical manner, as they help AFAs show they have met their obligations under the code. Failing to keep copies of key documents will make it difficult to prove the basis of recommendations in case of a dispute but is also good business practice. A reasonable person should be able to follow the rationale of recommendations. This will be easier where there is, at least, a clear scope of service, terms of engagement (if separate to scope), fact-find for the client, and statement-of-advice document.

Brokers and custodians

Many advisers are also brokers. Advisers sometimes provide custodial services, too, or at least use and supervise the services of third-party custodians. It is therefore important for everyone in the sales and advice industry to be aware of conduct obligations for brokers and custodians.

Since our guidance note on broker obligations in February 2014, there has been some improvement in the sector. Our monitoring showed most brokers met most of their obligations under the FA Act. However, further improvement is required. We have increased our focus on this sector over the past year, and that will continue. We also issued an information sheet on custodian obligations in October 2015.

What we found:

- Firms mistakenly believed that outsourcing broker services meant outsourcing their broker obligations.
- Insufficient oversight where broking services were outsourced to providers of broking and custodial services.
- Some brokers were still not classifying their clients under the definitions in the FA Act and the FMC Act, and were incorrectly treating retail customers as wholesale.
- Key regulatory and business risks were not being identified, assessed or managed, and no specific person was assigned to oversee them.
- Fees were not always clearly outlined in disclosure documents for customers, and were not prominent enough.
- Some brokers were not aware they had compliance obligations under Part 3A of the FA Act.
- Some brokers were aware of the broker obligations and had recognised that they need to comply but had not made sufficient effort to understand how the obligations applied to their business.
- Some brokers had no formal documented risk or compliance controls, and no testing of their controls.
- Documents provided to clients could be improved in almost all cases.

Oversight of outsourced providers

Example: A broker outsourced its broking service to a third party to provide cash handling, execution and custody services. It requested annual confirmation that a controls assurance review was being conducted. However:

- the confirmation was an email, and did not state clearly that the outsourced provider was meeting the relevant broker obligations
- the broker was not provided with the assurance report to review the results of the assurance reviews
- meetings with the outsourced provider were ad hoc and informal without an agenda covering the relevant areas of compliance reporting.

Our view: Under the FA Act, if broking services are outsourced, then the business or professional doing the outsourcing retains the obligations under the Act. They need to ensure these obligations are being met by the outsourced provider on their behalf. This will involve regular formal compliance reporting or certification from the service provider to the broker, and regular formal meetings. Outsourcing agreements should contemplate service level agreements relating to compliance and compliance reporting arrangements. The business or professional should conduct and record a reasonable level of due diligence on the service provider and the proposed arrangements. They should also get evidence from the service provider that they are aware of, understand and are meeting their compliance obligations. The business or professional needs to ensure the outsourcing risks are identified and assessed as acceptable and that risks to customers' assets are being appropriately managed. They should consider carrying out a suitability review of all their outsourcing providers on a regular basis.

Client classifications

Example: We visited two brokers who advised they had taken steps to revisit the classification of all wholesale clients under the FMC Act. Both were, however, unable to provide a current documented process explaining the process used to classify customers as either retail or wholesale as defined in the FMC Act schedule 1 part 3.

Our view: We recommend formally documenting the process and developing a flow chart to correctly classify customers under both the FA Act and the FMC Act categories in the appropriate policy and procedures document.

Managing risk

Example: Some services had no formal way of managing risk, and no-one with specific responsibility for risk management.

Our view: Brokers should have a risk register that formally identifies key business risks and assigns someone to oversee this. Risks should be identified and assessed by the business. Other methods of managing risk would depend on the size of the business, its appetite for risk, and board expectations. A risk management programme should include regular risk reporting and the programme should be regularly reviewed for effectiveness. This helps to safeguard customer assets and improves compliance with broker obligations, particularly the obligation to exercise care, diligence and skill when providing broker and custodial services.

Complying with the law

Example: We visited a broker who, from our conversations, clearly understood many of their conduct obligations for broking services. They had taken some actions to ensure compliance. However, they were not able to demonstrate how they got assurance that they were fully compliant with all of their obligations.

Our view: Brokers must ensure they meet their broker conduct obligations (as set out in Part 3A of the FA Act and the Custodian Regulations). As a matter of good practice, they should have documents showing a compliance plan, obligations register, policies, procedures, a risk register, compliance reporting and self-assessments of risk and controls. This should include testing to show they are safeguarding client assets and meeting their broker obligations.

Disclosure of fees

Example: On one visit, we noted that customer documents typically referred to charges as margins, rather than fees. We have also observed that brokers have different ways of describing fees for a cash management service.

Our view: A margin charged for a particular service, such as providing a cash account, is actually a fee. Brokers should review disclosure documents and customer forms to ensure it is clearly explained to customers that they will be charged fees for services such as a cash management service. These fees should be in the 'fee' section of customer documents. Brokers should regularly review all customer documents to ensure they are written in 'plain English', are not misleading or deceptive, clearly disclose fees, and link to other appropriate documents that customers might find useful.

Glossary

AFA	Authorised Financial Adviser – an individual financial adviser authorised by the FMA to provide certain services.
Category 1 product	These are generally more complex financial products and include securities (including bonds, shares, managed funds and KiwiSaver) and derivatives.
Category 2 product	These are generally less complex financial products. They include loans, transactional and savings accounts, term deposits, cash or term PIEs, and some insurance policies.
FA Act	Financial Advisers Act 2008
FMA	Financial Markets Authority
FMC Act	Financial Markets Conduct Act 2013
MIS	Managed Investment Schemes - these include superannuation schemes, KiwiSaver and workplace savings schemes.
QFE	Qualifying Financial Entity – a business registered on the Financial Service Providers Register and granted QFE status by the FMA. QFEs take frontline compliance responsibility for the conduct of their advisers.
RFA	Registered Financial Advisers - an individual adviser who is registered on the Financial Service Providers Register but who is not authorised by the FMA.
Sorted	A website run by the Commission for Financial Capability that provides financial tools and information for consumers.