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Financial Markets Policy
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SUBMISSION ON DISCUSSION DOCUMENT: EXPOSURE DRAFT: FINANCIAL MARKETS CONDUCT (REGULATED FINANCIAL ADVICE DISCLOSURE) AMENDMENT REGULATIONS 2019

Thank you for the opportunity to provide submissions on the exposure draft of the Financial Markets Conduct (Regulated Financial Advice Disclosure) Amendment Regulations 2019 (**Draft Regulations**). In these submissions I also refer to the following documents:

- Financial Services Legislation Amendment Act 2019 (**FSLAA**)
- Financial Markets Conduct Act 2013 (**FMC Act**)
- *Disclosure: Why it shouldn't be the default* report (October 2019), Australian Securities and Investments Commission and the Dutch Authority for Financial Markets (**Disclosure Report**)
- *Conflicts of interest and disclosure research paper*, Professor Sunita Sah, Cornell University for Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, 1 November 2018 (**Conflicts Paper**)
- *Financial Advice Provider Transitional Licence guide* (v4), Financial Markets Authority (**Transition Guide**)

1. REGULATION MAKING POWER

1.1 It appears (though is not stated) that the Draft Regulations are being made pursuant to section 546(1)(mc) of the FMC Act, which empowers the making of regulations for the purpose of "prescribing the information that must be made available under section 431O of the FSLAA, and when and the manner in which it must be made available". The duty in section 431O requires "A person who gives regulated financial advice to a client must make the prescribed information available in the prescribed manner when required to do so by the regulations."

1.2 While a financial advice provider (**FAP**) can, in some cases, be the person who gives the regulated financial advice, in the large majority of cases the person who gives the advice will be an individual engaged by the FAP, not the FAP. Unless there is another power that's being relied upon, it doesn't appear possible for section 546(1)(mc) to authorise regulations that apply to a FAP except when the FAP itself is giving the advice. Accordingly (in the absence of another power) regulation 229C is not permitted. If there is no alternative regulation making power then an option available is to impose the regulation 229C obligation as a condition, which is the approach used to impose record keeping obligations on FAPs.

1.3 It follows from the focus of section 431O on those who <u>give</u> the advice, that regulation 229B(1) should be in two parts, for example:

- “Regulation 229C applies to financial advice providers.”
- “Regulations 229D to 229H apply to a person who gives regulated financial advice to retail clients.”

1.4 Consequential amendments should also be made to section 229A(1) to make clear that regulation 229C applies only to FAPs.

1.5 If there is no regulation making power with respect to regulation 229C then it’s likely that regulation 229H (permitting the FAP to give information directly on the adviser’s behalf) is also not authorised. In that case regulation 229H(2) could be amended to focus on the obligations of the person who gives the advice “A~~P~~ does not have to give the information to the extent P ~~may~~gives the information to C directly on A’s behalf”.

2. DISCLOSURE OF CONFLICTS

2.1 The Draft Regulations require that conflicts of interest be disclosed, both in relation to commissions & other incentives, and other types of conflict. The Disclosure Report and Conflicts Paper highlight that disclosure of conflicts is likely to not only be ineffective but can have the opposite effect to that intended. The Conflicts Paper noted that in some situations disclosing conflicts can increase the bias of advisers. It also notes that financial advisers may think it is less morally reprehensible to give biased advice intentionally once a conflict of interest has been disclosed (caveat emptor), and they may accordingly strategically increase the bias in their advice to counteract anticipated discounting of their advice by their audience. However, the Conflicts Paper also noted that disclosure can have positive effects on advisers in some situations:

> *“Expert advisers, financial and medical advisers (i.e., investment advisers and physicians) alike, all decreased bias in their advice with conflict of interest disclosure versus without. Thus, disclosure can have the beneficial effect of decreasing bias in advice for expert professional advisers whose norms emphasize placing advisees’ interests first.”*

2.2 However, the position for clients was different, with the Conflicts Paper identifying significant downsides to conflict disclosure, with few upsides:

> *“In fact, not only is disclosure likely to fail as a discounting cue for biased advice, it may even make matters worse. Disclosure can often have the opposite of its intended effect on advisees.*
>
> *Although conflict of interest disclosure can decrease trust in advice (ostensibly the intended effect of the disclosure), it can also unwittingly pressure advisees to comply with that advice. The first, termed “**insinuation anxiety**” (Sah, Loewenstein and Cain, 2018) shows that disclosure can lead advisees to distrust advice yet feel pressured to take the advice for fear of signalling that distrust to the adviser.…*
>
> *The second, termed the “**panhandler effect**” (Sah, Loewenstein and Cain, 2013) is the tendency for advisees to feel pressured to satisfy their advisers’ personal interests.*
>
> *Another unintended consequence of disclosure I have uncovered is that in certain contexts, disclosure can lead to increased trust and persuasion. This effect occurs when disclosure acts as a cue to infer greater trust in the adviser’s expertise and consequently greater persuasion.…*
>
> *Given the mixed response of advisees to conflict of interest disclosures, it is apparent that we cannot rely on consumers to respond as anticipated by policy-makers. Other policy measures are needed to protect consumers from their advisers’ conflicts of interest.”*

2.3 The findings in the Conflicts Paper seem intuitively correct. Disclosure clearly has a role in areas such as investments, where investors are considering products that come with inherent risk. It's more difficult to see how conflicts disclosure can be effective in relation to services, where there is an expectation (from clients and at law) that services will always be performed to applicable standards. That's especially the case when there may be few alternatives beyond not seeking advice.

2.4 In my experience it's likely to be difficult to effectively identify and articulate conflicts (other than those that arise from remuneration). It's likely in practice that conflicts disclosure will be poor and will be unlikely to assist clients in their decision making. As the Disclosure Paper highlights, conflicts disclosure will quite possibly make matters worse.

2.5 Financial advisers will be subject to significant regulation and oversight under the new regime, which I consider should be the tool used to address issues arising from conflicts. Any benefit the financial advisers may gain from conflicts disclosure would appear to be significantly outweighed by the potentially detrimental effects it has on their clients.

2.6 It follows that I don't support conflicts disclosure. I submit that the obligation to disclose conflicts should be removed completely. If disclosure of remuneration is retained then I submit that it should not be labelled as a "conflict", to try to avoid some of the issues that the Conflicts Paper highlights with conflicts disclosure.

3. WRITTEN DISCLOSURE

3.1 The Draft Regulations don't require that any disclosure is in writing, except disclosure required on a FAP's website. An electronic or hard copy is only required to be provided if requested (regulation 229G(2)).

3.2 In many cases where FMA and the Financial Advisers Disciplinary Committee (**FADC**) have considered the conduct of advisers, poor record keeping is a very common theme. This has made it difficult for FMA and FADC to determine what actually happened. In the absence of a requirement to provide written disclosure it may be difficult to evidence what was (or was not) disclosed.

3.3 Also, it is less likely that clients will be able to effectively assimilate verbal disclosure. When it is legitimately used it is not often effective because it is perfunctory and happens quickly.

3.4 I submit that the regulations be changed in the following two respects:

a. Verbal disclosure should only be permitted when advice (or the steps preparatory to that) is not given face-to-face or via a visual medium (whether by an individual or online when a digital advice service is used).

b. Where disclosure is verbal there should be a default right for clients to receive a copy of the disclosure, which only doesn't apply if the client expressly declines to receive written disclosure (so amending regulation 229G(2)).

4. DISCLOSURE OF RELIABILITY EVENTS

4.1 The Draft Regulations will require disclosure of "reliability events". Where a person was a subject of disciplinary action by the FADC the reliability event is only required to be disclosed where the person was "publicly disciplined", that is when the FADC publicly disclosed the name of the person subject to the action (clause 3(2)(b) of Schedule 21A).

4.2 FMA has taken a significant number of actions against RFAs that have resulted in FMA using its power to issue both public and private warnings. Presumably this is a "regulatory action" that will be captured under clause 3(1)(b). However, there is no carve-out for advisers who were

not publicly named. In practice FMA has run a parallel disciplinary regime for RFAs, in the absence of the FADC process for RFAs. This has been subject to fewer procedural and substantive checks and balances, compared to the FADC process. However, given it had a similar process overall, I submit that a regulatory action that does not involve publicly naming the subject of the action should be subject to the equivalent "publicly disciplined" exception. Otherwise, the regulations would create an inequity as between AFAs and RFAs under the current regime who are subject to functionally similar disciplinary proceedings.

5. ADVICE SERVICE DESCRIPTION

5.1 Clauses 4(1)(b) and 5(1)(b) require disclosure of "a brief summary of the effect of each condition of the licence that limits or restricts the advice that may be given". I don't see how that assists with client understanding and, in any case, clauses 4(1)(f) and 5(1)(f) require disclosure of limitation and restrictions on the nature and scope of advice. I submit that clauses 4(1)(b) and 5(1)(b) be removed.

5.2 Clauses 4(1)(c) and 5(1)(c) require disclosure of the "types of advice that" P gives or the client will be given. Clauses 4(1)(g) and 5(1)(g) require disclosure of "the effect that the information set out in paragraphs (c) to (f) will help clients understand what type of advice" can or will be provided by the FAP. In practice, FMA has only specified three types of financial advice in the Transition Guide that must be specified by FAPs, being:

a Investment planning services

b Financial advice on financial products

c Switching funds within a Management Investment Scheme (including KiwiSaver)

The concept of "type of advice" is not further explained in law. Accordingly, specifying the type of advice given, and referring to "type of advice", will do very little to aid client understanding since "type of advice" only had very limited explanatory force. It would be better to simply require disclosure of the nature and scope of advice. This is consistent with the duty at section 431J to take "reasonable steps to ensure that the client understands the nature and scope of the advice being given…" and clauses 4(1)(f) and 5(1)(f) (which require disclosure of the limitations or restrictions on the nature or scope of advice, consistent with the section 431J duty except in relation to "restrictions").

6. DISCLOSURE OF COMPLAINTS & DISPUTES PROCESSES

6.1 Clauses 4(1)(k) to (m) and 6(1)(g) to (i) require disclosure of internal complaints processes as well as the availability of the dispute resolution scheme. However, it doesn't specifically require disclosure of when a client may complain to a DRS. This might be covered in the requirement to provide an overview of the internal complaints process but that is not clear. In practice a DRS often requires that a complaint must first be made to, and considered by, the provider before it can be lodged with the DRS. I submit that the Draft Regulations require disclosure of that detail.

Yours sincerely
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