August 2011

QFE feedback summary:

How do you know?

Introduction

Qualifying Financial Entities (QFEs) take responsibility for their advisers.

It is up to a QFE to ensure its advisers are providing customers with suitable advice and services. The capacity to monitor advisers and ensure adequate consumer protection is key to an entity's eligibility for QFE status, at application and on an ongoing basis.

All entities granted QFE status demonstrated capacity. However in a number of cases application information was provided during 2010, before QFEs had fully implemented their compliance arrangements. And information in QFE Adviser Business Statements (ABS) was sometimes unclear, lacked concrete examples, or included detail that didn't relate to financial adviser services.

This feedback report summarises the common areas where, in future, FMA will expect greater clarity and focus when QFEs explain their capacity to us. This might be in:

- discussions with us during monitoring activities
- notifications to us (about changes in business or processes)
- the ABS (which must be submitted with your QFE Annual Report).

We also expect QFEs to demonstrate that compliance arrangements have now been implemented

This summary is addressed to QFEs. The summary may also be of interest to those who assist QFEs with their compliance responsibilities, and those in other financial adviser businesses in considering their compliance arrangements.

Using this feedback

You should use this feedback in conjunction with the compliance principles in the QFE ABS guide to review your compliance arrangements – and improve them where necessary. We have also provided your QFE with individual feedback on the most important areas for you. Your approach to using all these sources of feedback will shape your ongoing relationship with FMA.

Discussions with FMA

FMA's initial monitoring of QFEs is likely to include a focus on the four key areas described in this document. We recognise that when ABSs were written in 2010, many QFEs were still developing their compliance processes. We now expect these to be in place.

As we continue our discussions with you, we will be looking for evidence you have taken on board the feedback you've received. We will expect you to be able to answer two key questions about your financial adviser services: 'what do you do?' and 'how do you know it works?'.

Notifications to FMA

In feedback meetings, we have reminded QFEs of the notification requirements (under the standard conditions, and explained in the related Explanatory Notes). These cover a range of compliance matters, such as breaches and complaints. But they also require you to engage with FMA at an early stage if you are proposing changes to your business or processes.

We will expect you to explain how capacity will be maintained. In framing your notifications, you will find it useful to think about the four key focus areas outlined in this document.

QFE Annual Report

We have also reminded QFEs of the need to provide an Annual Report to FMA (under section 77).

In writing your Annual Report, you will need to consider whether your QFE and its advisers have complied with the requirements.

Your supervision and compliance assurance arrangements should help to provide evidence to support your principal officer’s approval of the report. We may ask about the basis for that approval.

Keep it clear – and make sure you know it works

A QFE must demonstrate on an ongoing basis that it can ensure compliance and provide adequate consumer protection. So a QFE must have robust compliance arrangements in place and be open in its dealings with FMA.

But FMA also expects QFEs to be more than technical compliers doing the minimum necessary. QFEs are encouraged to adopt high standards and to demonstrate engagement beyond the letter of the law. Remember, the objective is to encourage public confidence – so it’s about taking appropriate care in providing financial adviser services to your customers.

Make sure you and everyone in your organisation is clear about what they should do to achieve the objectives. And make sure you know that what you’re doing really works.

We will tailor our regulatory approach to your QFE accordingly.

What do you do and how do you know it works?

The compliance processes QFEs use are summarised in the Adviser Business Statement (ABS). In your ABS, in notifications to us, or in discussions with us, you should be able to show:

- **What you do** to ensure your customers are getting suitable advice or services
- **How you know** whether the compliance arrangements you've invested in are working.

What do you do?

'What do you do' is about processes. Getting the right outcome for customers from your advice or service process depends on:

- getting the design right
- people operating the process as designed.

How do you know?

'How do you know' is about your management information and controls. It is about making sure processes are working and delivering the right outcomes for customers. It is also about independent testing of the design and operation to ensure the controls are right, and that management information is accurate and measuring the right things.

Specific information about the processes for your financial adviser services

You should answer 'what you do?' and 'how you know?' at a day to day, operational, level with specific information rather than with generic statements.

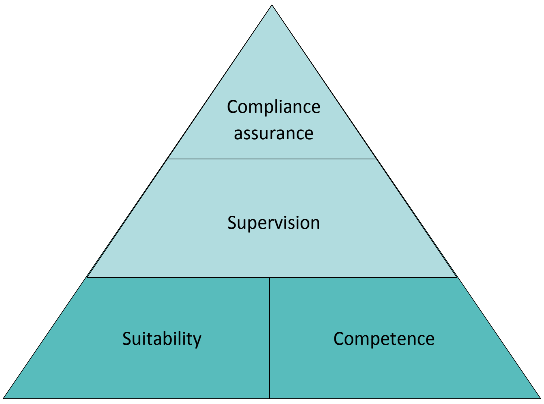
You should focus on the processes for financial adviser services. The key controls or management information used should be described for each activity (or in each section of the ABS).

It should be clear which senior management role is responsible for each area.

Four key focus areas

To demonstrate ongoing capacity and eligibility for QFE status, we expect you to have robust compliance arrangements in place, particularly in four key focus areas. We expect you to be clear about what you do and how you know it works in these areas:

Diagram: Key focus areas



Suitability (the advice or service processes) and competence are the foundations on which good financial adviser services are built - a robust process to match customers to suitable products, coupled with people with appropriate skills and knowledge.

There is often a balance between these two areas. For example, if your advice process is highly prescriptive, such as in a call centre, you might apply lower competence standards; but if your service is more principles based, for example designing an investment plan, then you will need higher levels of competence. Your ABS should reflect this balance.

Supervision and compliance assurance are key to your role as a QFE of ensuring compliance by your advisers. They explain how your QFE checks and tests that its systems and processes are appropriate and operating properly.

'Supervision' covers advice or service checking activities which are undertaken frequently within the business, often by a line manager or team supervisor or a quality assurance unit.

'Compliance assurance' covers checking and testing activities over all the systems and controls. Such activities are often carried out on a less frequent basis by a compliance monitoring unit, which is independent of responsible manager.

In practice, there may be a spectrum of testing activities, for example, including a quality assurance function. But they all help senior management to answer 'how do you know it works?' So they are a key part of FMA's interaction with your QFE.

We expand on these key areas later in the document. Information highlighted in boxes illustrates some of the better descriptions of processes and controls provided to us by QFEs.

Other areas

While this feedback summary concentrates on four key focus areas, there were two more where you should ensure you are clear about what you do and how you know it works.

Entity level conflicts

QFEs were very aware of the potential conflicts of interest that might arise from the way their advisers are remunerated. In asking about entity level conflicts, we were looking for matters which might influence senior management in an entity, which in turn might influence the culture and put other pressures on adviser behaviour.

Some QFEs did identify the receipt of commissions by the entity as a potential conflict, which might influence senior management. Few product providers identified their product role as a potential conflict, of which they needed to be aware. And few QFEs commented on remuneration for senior management, particularly those in sales roles.

You should be able to identify potential entity level conflicts of interest, as the first step to ensuring they are appropriately managed or taken into account.

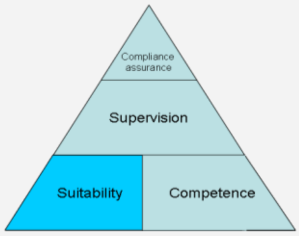
Disclosure

Now that disclosure regulations are in place, FMA is likely to ask for updated information about your approach to disclosure.

In addition to how you meet the requirements, we will focus on how your disclosure assists retail clients in making informed decisions about whether to use your services and whether to follow the advice received (section 3 of the Act). We will be looking for disclosure which is easy to understand and provided at a time when it is relevant to the customer.

Suitability

How do you know your advisers are consistently providing suitable opinions or services?



What do you do?

We expected you to provide a description of the advice processes in place for advisers, focusing on the elements that ensure any opinions have an appropriate basis and the customer is matched to a suitable product.

The processes and systems you have in place might vary by product type or adviser group. But for each key type, we were looking for:

- The opinions that are given. Some QFEs felt they might not always be asked for an overall product recommendation, but might be asked for opinions on particular aspects of a product. It was helpful when this was clearly described.
- The information advisers must collect from clients, and any standard forms and templates to help make this consistent. The key information is likely to reflect risks or benefits of a product type or option.
- How the advisers use this information to provide the right opinions and identify the right products. For example, are there specific tools, scripts or software packages that aid the adviser? Clear, concise examples were provided by some, but not all QFEs.

Some descriptions of processes seemed focused on how the entity manages its own risk, rather than on the elements which ensure the opinion given is right for the customer. So a lender explained how it decided whether to lend, rather than whether the client should borrow. While there is a strong correlation, a QFE should bear in mind its consumer protection obligations.

Focusing on the key information

One QFE provided a list of the information advisers had to collect from the client. This included mandatory risk profiling and identification of the client's liquidity requirements in any investment advice discussion.

They had clear processes for how reports were to be presented and for what happened in situations where the client sought a variation to the report. Clients had to sign key documents to show the key information gathered was correct, before investment plans could be implemented.

But this QFE could also have improved the information on how risk profiles were matched to particular investments and its research approach.

Facilitating advice through automation

One QFE described how they used a highly automated process to reduce the risk of unsuitable insurance advice.

At an initial consultation meeting, the adviser uses an automated tool to analyse the client's financial exposure. The results of the analysis became a written report that included 'reasonableness' checks – prompts to remind the adviser to check whether the recommendations in the report made sense for the client. This was then used to guide a discussion with the client on the risks and how best to manage those.

The risk tool assisted, but did not replace, the adviser.

While most QFEs provided descriptions of their suitability advice processes, few provided a description of their Discretionary Investment Management Service or Investment Planning Service processes.

How do you know?

We also wanted to know how you ensure that the process is followed – the key controls over your advice process and any management information that you use. QFEs gave less information in this area, although some controls relating to supervision were described in that section.

Key controls might include:

- checks that the prescribed forms and templates have been used in all cases
- confirmation that quality reviews have been undertaken when required
- analysis of management information on adviser recommendations
- post sale calls to customers confirming that the process was followed and their understanding of the reasons for the advice.

For example, management information on products sold might show one adviser thinks one product is the most suitable for all their customers. Management information might also highlight cases where asset allocation does not appear appropriate to the customer's risk profile.

Reducing risk through automated controls

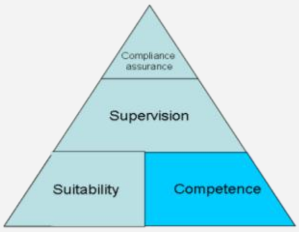
One QFE's system forced advisers to collect the information required. The system did not allow the process to proceed until all questions had been answered.

The system also restricted the changes that could be made to the customer information. This prevented advisers from encouraging customers to change their answers to generate a certain outcome – such as the sale of a loan. Where changes were made which put a customer outside the affordability criteria, an exception report was generated and investigated.

But this QFE also needed to focus more on advice, rather than credit controls.

Knowledge, skills and competence

How do you know your advisers are competent to provide financial adviser services?



What do you do?

Most entities understand that with new regulations, there is a greater emphasis on demonstrating competence.

Most QFEs gave a high level description of the training in place. But in some cases it was not clear how the training actually addressed provision of appropriate advice, or advice processes. For example, some ABSs stated only that advisers undertake a three day induction course or attend courses provided by product providers.

Attendance at training does not ensure a person is competent. Your training should have clear learning objectives and a documented approach to ensuring those have been met. So one thing we particularly looked for was that training was assessed.

Focusing on key elements of training

One QFE set out an overview of the five modules of their adviser induction programme, with a brief description of each. Two modules clearly included the advice processes, another products, and another compliance obligations. Some modules indicated additional CPD to be completed in the first 12 months.

The overview showed four assessment points during the induction.

QFEs are expected to set competence standards. These are usually expressed in terms of objectives or activities that a competent adviser will be capable of. So a person might be assessed against the objectives and be competent although no recent training has been undertaken.

Competence standard for Category 1 products

If your advisers sell category 1 products, you must be able to show how your QFE's competence standard compares to that of the Code of Professional Conduct for AFAs – the 'if not, why not' analysis.

One QFE provided a simple table showing which training objectives in its internal programmes mapped to the unit standards in the National Certificate in Financial Services (Financial Advice) Level 5. In some cases, the QFE believed the unit standard wasn't relevant because of the very limited nature of its category 1 product ('non-bank' term deposits). So it explained the internal standard and why this standard was more appropriate.

This QFE also compared other training to external standards set by the New Zealand Qualifications Authority. The QFE could clearly show the competence standard expected.

QFEs often focused on induction training. But once advisers have met your standards, how do you monitor and assess competence on an ongoing basis? How do you ensure that they keep up to date with both external changes, for example, products or regulatory requirements and internal ones, for example, processes? These areas need to be described as well.

How do you know?

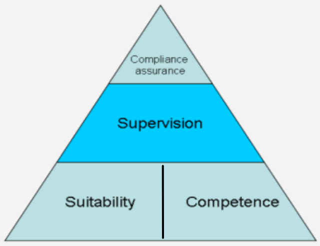
Generally QFEs provided less description of the management information and controls they had in place to ensure advisers were competent. You will be expected to answer questions such as:

- Can you extract a report that shows the standard each individual adviser has currently achieved?
- Do you know how many advisers have missed training and whether they are being followed up?
- Do you know who doesn't meet your competence standard and the controls that have been put in place to ensure that they give suitable advice?
- What do complaints tell you about adviser competence?
- What information do you rely on to know that your training is effective?

You also need to describe how you use information from controls to ensure your competence standard is consistently achieved. So analysis of management information should be used to revisit training needs for the adviser force, improve training design and delivery and adapt assessment.

Supervision

Supervision is the test of how you know whether advisers are doing what they should be.



What do you do?

We expected you to describe your supervision processes. In this area there was some confusion about who a supervisor was. The 'supervisor' we refer to is the person, or team, in your organisation who is specifically monitoring and supervising that the adviser is following the processes and delivering the right outcomes for customers. This might not be the adviser's direct supervisor, manager or team leader.

In general we needed to follow-up with QFEs to better understand how their supervisory processes worked. So we were looking for answers to questions such as:

- What do you require your supervisors to do and check? This is not about describing all the day to day duties of a front line supervisor or team leader – just those relevant to checking the financial adviser services.
- What tools do you provide? For example checklists, sample client files showing good practice?
- How often are supervisors required to make the checks? If there is a risk based approach, what do you see as the key risks?
- What management information do you provide to allow supervisors to target relevant areas?

Several QFEs described how working in an open plan office is conducive to the pro-active supervision of advisers. But in those situations it was not clear whether the supervisor was taking an active, planned approach – or whether the supervisor's activities checked the opinions given or financial adviser service provided.

Risk based approach

One QFE explained a risk based approach. All advisers are assessed at least once a year, with more frequent reviews based on volume and type of business and for advisers with lower quality scores from previous reviews.

But this QFE could have improved the file selection approach for lower risk advisers. Files selected were always those above a certain investment value. Advice to clients with less to invest was never checked.

Outside the process, the competence requirements for supervisors were often not explained. For example, was supervisory status a reward for sales performance? Did supervisors have to pass training courses on supervisory processes? Was their performance in their supervisory role assessed?

How do you know?

The management information on, and the controls over supervisors were not always clear. So we were looking for answers to questions such as:

- What are supervisors required to do with the results of their checking?
- How does this feed into your management reporting? And who does this go to?
- How do the results feed into training, advice processes and product development?
- If customers have not been provided with suitable advice, how is this put right for the customer?

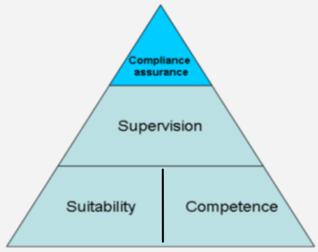
Results of supervision

One QFE provided management information on the number and percent of files and number of advisers who had been subject to quality assurance over a year. A chart was provided showing reasons why advisers had failed quality assurance and the number for each reason.

Results were collated and discussed monthly at compliance and business risk meetings. Because the vetting was against standard criteria, the organisation could see the specific areas advisers were slipping up on – for example, risk profile analysis incomplete. They could then put in place targeted training and communication initiatives to address the issues with all advisers, as well as the individual advisers concerned.

Compliance

At the compliance assurance level, you should be able to show how you check and test that all of the controls relied on are robust.



FMA expects your senior management to provide a clear description of the processes that give them assurance that your QFE complies across all its responsibilities – and that everything described in your ABS actually delivers compliance in practice.

What do you do?

Most entities were already aware of the benefits of compliance controls and monitoring. Many could describe the tools they use, such as self-certification, compliance monitoring and mystery shopping. They could generally describe who would take on this role. Examples ranged from full time compliance teams or officers in large organisations, to a director (who is independent of sales) taking on this role in smaller organisations.

There are also some good practice guidelines or regulatory processes that some QFEs already follow – for example, the 'three lines of defence' model and the Reserve Bank's operational risk requirements.

But what was less clear was how QFEs were using their compliance controls to test financial adviser service processes.

QFEs often described a framework within which compliance operates, but concentrated on reporting on controls by management, rather than on independent testing, for example by a compliance monitoring team.

They tended to focus on operation of existing processes and controls, rather than ensuring that these were properly designed to monitor and control the outcomes.

For example, rather than just monitoring that supervisors sit in on client interviews (the operational process), your compliance assurance needs to consider what they are checking when they sit in on the interview and whether this includes the outcome of the advice process (ie whether the design is right).

Compliance framework and reporting description

One QFE explained a framework that included:

- A compliance plan for each business area, including documentation of obligations, risk profile, key controls and a monitoring program including testing. This plan was the responsibility of business management
- A central aggregated plan including testing of high risk controls by a central team
- Reporting by business management including self assessment, including the results of testing and breach reporting
- Approval of the central plan by a risk committee and escalation of significant testing results through reporting to the committee.

But this QFE also needed to explain the areas regarded as key risks and indicate frequency or approach to testing these.

Creating a work plan

When processes are brand new it can take time to identify the best way to challenge and test them.

One QFE had created a work plan that identified and categorised the types of advice risks. They had identified a person who would be reviewing the risks and mapped out a timeline for the work.

The work plan was submitted to the governing body for signoff along with a template for the findings of the initial compliance review.

How do you know?

QFEs were clear about the governance bodies that would approve the plan and the ABS, and who would receive compliance reporting. But the content and frequency of reporting, including the monitoring of remedial action was less clear, as was the responsibility for monitoring progress against the plan and deciding on any revision of monitoring priorities.

When preparing the ABS in mid 2010, many QFEs were in the early stages of planning their compliance monitoring. We now expect you to have implemented your compliance monitoring plans, so that you are carrying out your QFE role.

Over time, we expect many of our discussions with you to start with, or include, compliance monitoring and its results. Demonstrating robust compliance monitoring will allow FMA to reduce its own surveillance activities with your entity – so that you can maximise the efficiencies of being a QFE.

Published August 2011 - Doc ref number 178369

FINANCIAL MARKETS AUTHORITY

TE MANA TATAI HOKOHOKO - NEW ZEALAND