

**Internet Newsletter -
New Zealand Clients**

**THE NEW INVESTMENT
ADVISER REGULATIONS**

**Objectives of this
Newsletter**

The purpose of this Newsletter is to review the Securities Markets (Investment Advisors and Brokers) regulations 2007 ("the Regulations") which are to come into force 29th February 2008.

We also wish to examine the effectiveness of the investment adviser regime in New Zealand and contrast it with countries which have licensing of investment advisers, particularly Hong Kong, and show generally that the whole investment climate regime in New Zealand, even with the new Regulations, offers little protection to the public and is almost of banana republic status as compared with jurisdictions such as Hong Kong and Australia.

We also wish to make some suggestions of legislative changes that could be made immediately pending establishment of licensing of investment advisers.

**Background to the New
Legislation**

The collapse of a large number of finance companies in New Zealand over the last twelve months and the apparent involvement of some investment advisers in the debacle has prompted the Government (which, like a startled rabbit caught in the headlights, shamefully sat on its hands while the crisis unfolded) to promulgate the new Regulations under the Securities Markets Amendment Act 2006. It will be the view in this Newsletter that the Regulations will do little or nothing to assist the investment public and that it is a combination of a licensing regime, tighter securities laws, and a better educated public that is required to avoid a repeat of the huge loss of capital experienced by many investors.

The chaos that has occurred is not surprising. In any other Western jurisdiction it would be very unlikely that it could occur. In New Zealand finance companies, while having to issue a prospectus to attract funds, and appoint

trustees to protect investors, do not otherwise have to have any form of securities approval or licensing. This may be contrasted with other jurisdictions, such as Hong Kong, where similar institutions would be classed as deposit takers and need to go through a rigorous licensing procedure to ensure certain criteria was met. Added to that, we have a situation where investment advisers, unlicensed and many unqualified, were able to give investment advice, and take commission, without making any disclosures relative to the quality of the actual investment itself.

We do not propose to comment in detail on the existing regime. Suffice to say that under the Investment Advisers (Disclosure) act 1996 and its amendments initial disclosure covers only certain issues concerning the personal circumstances of the investment adviser or broker, and after that, request disclosure relative to possible conflicts of interest and remuneration. Exemptions existed for disclosures made in writing later rather than at the time of giving investment advice. In short, unlicensed and unqualified persons could (and still can) operate without so much as single word of advice about the

nature and quality of the investment, and without the need for the investor to sign any agreement or receive any warning about the risks associated with the investment. Clients of the writer's who are licensed investment advisers in Hong Kong have said that such a regime defies credulity.

Yet there seems to be a reluctance to consider licensing. As evidence of the low priority or reluctance to countenance changes, it was reported recently that the Chief Executive of the Institute of Financial Advisers, although mentioning the possibility of membership of a professional body and an upgrade of qualifications for the industry, said that any new regime, taking into account this new criteria, (whatever that might be) would not be enacted for up to four years. Such a statement seems incredible, given the fact that if there is lead in time for persons to become qualified, then new legislation and licensing criteria needs to be put in place now.

Later on in this Newsletter we will summarise some of the salient points of the Hong Kong licensing regime to show what might possibly be expected if the Government and associated bodies such as the SFC

decide to institute a licensing system rather than the completely ineffective (and dangerous) regime we have at the moment.

The New Regulations

The Regulations have been promulgated pursuant to Sec 49C (1) of the Securities Markets Act 1988 and its amendments.

In general, as mentioned above, they do little or nothing to improve the lot of the investing public. As a response to protect the investing public from similar situations to the finance company collapse they are a huge disappointment. We will examine the more important sections in the regulations under the following headings:

(A) Exemption for telephone investment advice

Section 4 of the Regulations basically provides that an investment adviser is exempt from making disclosure over the telephone (as well as when previous disclosure is out of date), so long as the investment adviser, before giving the telephone advice, verbally discloses the various matters that must be disclosed under section 41 B -41 F of the Act (including any changes under section 41 M) and

provided that disclosure is made not more than 5 working days after giving the telephone advice.

In our view, section four is absurd and unrealistic. It means an investment adviser must give a fair amount of detail under 41B regarding his qualifications, a description of how he has kept up to date, the knowledge gained in relation to any qualifications he has, his experience as an investment adviser, whether he has criminal convictions, disclosure of fees, disclosure of any relationship that may prejudice his advice, and details of remuneration that he may gain from other parties other than the investor to whom he is speaking.

We would seriously question whether any investment adviser is able to do that adequately on the telephone, or will do it at all. Granted written disclosure must be made within 5 working days after the conversation, but we would suggest that the investor is very unlikely to read this disclosure statement and would probably have formulated a decision to invest before receiving the statement.

This procedure may be contrasted, for example, with the Hong Kong regime

where first of all, no investment adviser is allowed to call anyone by telephone without a request and, as mentioned later in this Newsletter, cannot give any investment advice unless a client agreement is first signed with the adviser. Again, nothing in the Regulations requires the investment adviser to give any detailed information about the nature of the investment or the risks that might be attached to it. This is absolutely bizarre and if this part of the Regulations forms part of the Government's attempt to remedy the defaults by advisers which may have caused huge losses to investors, then, in our view, it is an abject failure.

B - Exemption for disclosure under section 41 D and 41 E

This regulation exempts an investment adviser from disclosing the nature and level of fees that he may charge to the investor or the nature of any relationship that might be likely to influence the adviser in giving investment advice. The latter obligation includes disclosure of any remuneration resulting from the advice.

The reason for this exemption appears to be that advice may be given in a general way not

relating to a specific investment, where the investment adviser reasonably believes that the disclosure under 41 D and E is not material in light of the general advice. Again, this seems very vague and open to abuse. An investment adviser may well discuss a number of investment opportunities but possibly recommend one only, and although subsection 3 refers to subsequent specific investment advice, there seems to be a possibility that the investment could proceed without subsequent advice, which may very well be overlooked or ignored by the investor. Again we see there is no requirement for the investor to be advised of the nature of the investment, how much he may have agreed to invest, whether it is a risky investment and whether it fits the investors risk profile.

C - Exemption from disclosure of associated persons interest or relationship

This regulation, broadly speaking, absolves the employee of a brokerage or investment firm from disclosing a relationship under section 41 E (1) if the employer has in place an internal information barrier and other procedures necessary to prevent the employee from knowing of the interest or

relationship of his employer and at the time when the employee gives the advice, he did not in fact know of the interest or relationship.

It is hard to imagine a more ill conceived regulation which signally fails to protect the investing public. This would allow a brokerage firm or investment adviser to take care and make sure that its employees were unaware that it had interests in the very firms that its employees were promoting. Indeed, the firm may very well be receiving remuneration as a result of its employees' activities. Granted the investment adviser involved in the transaction obtains some exemption from liability, but if the purpose of the legislation is to protect the public, then, again, it is an abject failure.

This may be contrasted with the Investment Advisers Code in Hong Kong, which specifically provides for declaration of any conflicts of interest, whether it be a principal or employee of the firm, and a prohibition of both the employee and the firm dealing in any transaction where a conflict of interest arises or it has not been disclosed. Taking commission from both sides without consent may also, in some circumstances, be

a criminal offence in Hong Kong. It is a firm responsibility to make sure that all conflicts are revealed, not hide them.

D - How information disclosed- form of disclosure

Section 10 of the Regulations requires changes to the format of a disclosure statement, and the provision of headings relative to important disclosures. There is an exemption for advice in relation to a term life insurance policy, although quite why a term life insurance policy should be exempt is beyond our comprehension. Surely it is an investment product involving specific returns in payment for specific premiums.

Again, our view is that the upgraded disclosure statement will be of little assistance. It will say nothing about the nature of the investment or the risks associated with it. It will largely be ignored by the investor, and may be contrasted with a situation where the investor is required to sign such a statement summarising the investment agreed to, have it explained to him, and to then sign and acknowledgement that he has read and understood the statement. This is

required in the Hong Kong legislation.

E. Details of Remuneration.

The new requirement to reveal a dollar amount or percentage value of remuneration scarcely adds anything to the existing legislation, and although it must now be revealed on the telephone, may be fleetingly referred to and then fully disclosed in writing later. We believe that it should be incumbent on an investment adviser to reveal the remuneration in an agreement signed before any advice is given.

Comparison with the Code of Conduct for Persons licensed or registered with Securities and Futures Commission in Hong Kong as investment advisers and suggestions for future reform of New Zealand legislation.

We do not propose to go into great detail about the licensing regime in Hong Kong except to summarise the main features of the regime, and highlight some of the advantages and protections for the general public which we hope the NZ government and Commerce Department will bring into the New Zealand legislation as quickly as possible.

We have already in this Newsletter referred to a number of matters covered by the Hong Kong legislation, that are not covered under the New Zealand regime. We propose to briefly summarise the Hong Kong regime, and then list the parts of the Hong Kong legislation that we think should be adopted immediately. While we realise that the legislation in Hong Kong may be of little or no interest to any investment advisers or the government in New Zealand, it is to be hoped that investment advisers at least will more readily appreciate the much greater degree of scrutiny that their actions will have under any amended legislation that is similar to Australia or Hong Kong, and the severity of punishments that might well come into effect if a licensing regime is adopted.

BRIEF SUMMARY OF THE HONG KONG LICENSING REGIME.

Salient features of the legislation and licensing regime that applies to investment advisers in Hong Kong are as follows:

- 1)** There is a licensing system. No investment adviser or broker can give advice or operate a brokerage service without being licensed under the provisions of the

Securities Ordinance which is supervised by the Securities and Futures Commission in Hong Kong.

2) Any investment adviser is required to have the requisite training and qualifications before he is registered with the SFC as an investment advisor. These competency tests relate to advisers simply giving investment advice, or those who are full brokers, or those dealing with specialist areas such as Futures or Leverage Exchange contracts etc. The activities of investment advisers are regulated by the Code of Conduct (The Code).

This Code, details of which are mentioned below, although not having the force of law, is regarded in the same light as legislation, and defaults under it can lead to striking off or severe penalties for those investment advisers who breach its provisions.

3) Breaches of The Code or Securities Ordinance are regarded very seriously in Hong Kong, and penalties can be substantial. Striking off, financial penalties or suspension are common. There is wide ranging power at any time for the SFC to conduct investigations into individuals or firms who they suspect are not properly conducting business in accordance

with The Code or Securities Ordinance.

4) As alluded to above, the foundation of any activities of investment advisers in Hong Kong is not only compliance with The Code, but the execution by the client of the appropriate client agreement which contains a number of matters dealing with the nature of the securities to be invested in, the actual securities to be purchased or advised on, the background of the client, the degree of risk that the client can tolerate, and warnings about the nature of the security in general. No advice or transaction can proceed until the client has signed the Client Agreement.

- Client Agreement.

Matters covered by the client agreement include:

A) Description of services - full names, addresses and contact details of the investment advisor and the investor. Full details of any remuneration that is to be obtained and the basis on which it is assessed. If the account or advice is to relate to investment in unit trusts and the administration of them, then details of whether any purchase can be

undertaken without the consent of the client, or whether the advice or trading is discretionary.

B) Most importantly, there is a need for prominent and detailed risk disclosure statements, which must be included in any client agreement. Failure to include them is a breach of The Code and the Securities Ordinance. These disclosure statements are to the effect that investing in the type of security is risky, and may lead to a complete loss of capital.

An example from the Code is as follows:

The prices of securities and funds fluctuate, sometimes dramatically. The price of a security or fund may move up or down and may become valueless. It is as likely that losses will be incurred rather than profit made as a result of buying and selling securities or funds"

C) There are also schedules which detail the investments that the client wishes to invest in. Included is a risk tolerance statement, which indicates whether the investor wishes to invest in high risk security, or whether it must be confined to low risk investments. The onus is

on the investment adviser to give advice over this.

D) The Securities Ordinance and The Code place great emphasis on the investment advisor only authorising investments into shares or unit trusts and securities that have been licensed in Hong Kong. The promotion of products that are not licensed is generally not authorised.

E) Unsolicited calls to clients about investment advice are strictly prohibited. This covers circulation of material and also unsolicited telephone calls.

F) There is emphasis on the investment adviser knowing the clients financial circumstances and a general requirement that the investment adviser become fully aware of the financial circumstances of the investor and the investor's risk tolerance. Promoting a high risk investment to a person who has indicated low risk investments would be a breach of The Code.

G) There is a distinction between retail investors and professional investors. If it is a professional investor then the need for a client agreement

or other advice may be waived.

- H)** There are prohibitions on analysts' reports where the firm may have a conflict of interest.

SUGGESTIONS ON CHANGES TO THE EXISTING NEW ZEALAND INVESTMENT ADVISER REGIME.

If the problems with finance companies in New Zealand is to be avoided, or at least the problems where investment advisers were involved, then there is a need for licensing. If it is not to be licensing, then it must be membership of an appropriate body, supervised by the Securities Commission and in our view there should be a modicum of qualifications for any investment adviser.

Hong Kong and many other Asian countries treat investment as a very serious matter, and this is not surprising; there could be a persons' life savings at stake and in the hands of advice from an unqualified person, this situation is not tolerated. We also believe that certain elements of the Hong Kong regime could be adopted without any difficulty in advance of a licensing regime.

These measures would include:

1) The signature of an appropriate client agreement between the investment adviser or broker and the client before any investment advice or investment is undertaken. There is no good reason why the agreement should not cover, as it does in Hong Kong, the nature of the securities to be invested in, the risks associated with them and the risk tolerance of the investor.

2) The investment adviser should also declare whether the product being promoted is an approved investment. For instance, in relation to finance companies, if there had been a prominent statement that the finance company did not have any rating, that an investment in it was illiquid, and could not be traded, as with a bond, and that generally investment in finance companies was very high risk, then it is not too much to say that many investors would have been deterred from making such an investment.

3) There needs to be a much stricter regime. If an investment adviser breaches the obligations of disclosure and does not comply with the provisions of the client agreement, then there should be provisions to strike him off the register or impose penalties. Not to have

these provisions seems to us to be completely unacceptable.

4) There needs to be something like a Code of Compliance such as Hong Kong has. Although we have not covered every aspect of what is in The Code, it generally sets out specific obligations that the client adviser must comply with, such as conflicts of interest, declaration of related income or soft dollar rebates from companies in which the investor may be investing and most importantly, risk disclosure statements which leave the investor in little doubt about the nature of the investment.

SUMMARY

We trust this Newsletter has demonstrated that the existing regime in New Zealand, even under the amended Regulations, is quite unacceptable. It gives no additional protection to investors and leaves investment advisers and brokers still in a position where they are unlicensed, unqualified, and have no obligation to give any details of the investment or the nature of risk attached to it.

If the Government agrees with statements that it could take up to four years to come up with a more comprehensive and

stricter regime than that is alarming. Amendment of the existing Regulations to provide at least for a proper client agreement containing particulars of the investment, risk disclosure statements etc, and requiring signature by the client before any investment was made or advice offered would be simple to introduce. In that signature of this agreement requires an acknowledgment by the investment adviser that he explained the contents to the investor, a much tighter regime would be in effect immediately.

It is not readily apparent why New Zealand, unlike places like Australia and Hong Kong, cannot take investment more seriously. There is a need for a complete change of mindset philosophically about investment. The Government needs to take action now, as there is certainly no incentive for investment advisers to do so.

New Investment Statement.

We have made submissions to the Securities Commission on the new Investment Statement they have suggested. Our letter is set out below.

Government to institute licensing and even before then, consider adding to the regulations so as to make it compulsory for the IA's to sign client agreements, with risk disclosure statements, and otherwise comply with a Code of conduct as is the situation in HK.

The new regulations are a huge disappointment for the reasons mentioned in my Newsletter.

**Letter to Securities Commission
on new form of investment
Statement**

Submissions were invited on the format of the new investment statement. Despite holding the view that the whole regime, even with the new Regulations, is a disgrace by international standards, I have the following comments on the form you have suggested:

(a) there is a spelling mistake in the first line- "her" , not hear;

(b) in the last bullet point, surely the words " from the institution or company you will invest in or other third party" must be added after " commission". The words otherwise do not convey the essential point that commission could come from the very body that the investor will invest in.

(c) I comment further below, and although the legislation does not require it, please add after "is" in the second to last paragraph " Ask about the quality of the investment and whether it is high risk and capital might be lost"

(d) I cannot see the logic in the first line of the last paragraph. By that time the investor will have had contact with the adviser and may have even committed to an investment. Surely " and not make an investment decision before reading the statement and deciding if the investment is high risk or otherwise" should be inserted after " adviser".

I have mentioned that the whole investment adviser regime is a disgrace. I practise in both HK and NZ. I have investment adviser clients in HK who I advise over HK law. I am attaching a draft Newsletter which, when finalised, will go to clients in NZ and some securities firms. I would sincerely hope that your Commission will prevail upon the

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