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[Clouds and Silver Linings



When something really spectacular happens, whether it's enjoyable or unpleasant, it can take a while to make sense of it, to gain perspective. Down the track, things that weren't clear at the time become apparent. Maybe we have more information so we gain understandings, insights, appreciation of what the event was all about and perhaps even reasons why it happened in the first place.

Sometimes, there's a "silver lining". A problem creates a solution that helps others. What's going on in the financial world at present may be like this. In many jurisdictions, our own included, information is coming to light about the circumstances that led to so much loss. Questions are being asked, analysis is being done and measures are being taken to protect investors in the future. Some would say it's too little, too late and that the law lacks teeth but the resolve to bring about change is strong and momentum is gathering.

This edition of Capital Eyes focuses on the changes going on in the financial sector at present, both here and overseas.

Continued overleaf

Heads to roll?

In New Zealand, criminal charges have been laid against the chairman of Bridgecorp Bruce Davidson, non-executive directors Gary Urwin and Peter Steigrad and executive directors, Rodney Petricevic and Robert Roest. Also charged under the Crimes Act are Directors of Lombard Finance & Investments Sir Douglas Graham, Michael Reeves, William Jeffries and Lawrence Bryant. The Securities Commission has laid criminal charges and issued civil proceedings against Capital + Merchant Finance directors Neal Nicholls, Owen Tallentire, Colin Ryan and Robert Sutherland. Criminal charges have also been laid against Wayne Douglas, who resigned as a director in February 2007. The Securities Commission has laid criminal charges and issued civil proceedings against Nathans Finance directors John Hotchin, Donald Young and Kenneth Moses. The case involving Feltex's failure is before the Court at present and it's unlikely the list will stop there.

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US case against Goldman Sachs

The Securities and Exchange Commission (SEC) is on the case in the US. In April they filed a twenty two page law suit charging Goldman Sachs with willfully mis-marketing some mortgage-related securities. Nine months after the investment was sold, 99% of the mortgages had had their credit worthiness downgraded and investors lost more than US\$1bn. The SEC alleges that another party stood to gain about the same amount of money as the investors lost because they were speculating on the fall and, even worse, had set up the fall of the fund by selecting the very mortgages that were to fail. Other parties were caught up in the affair: a Dusseldorf-based bank, IKB, which lost \$150m, and ABN Amro. News of the charges against the whole firm and one particular employee hit the market like a bomb shell with Goldman's shares falling 13% within minutes.

NZ's new Financial Markets Authority

Market regulation is being tackled on a broad front in New Zealand. The most recent announcement about a “super regulator”, to be called the Financial Markets Authority (FMA), was made by the Commerce Minister Simon Power late last month. The FMA will see a raft of regulatory functions currently carried out by a range of other bodies being consolidated. This includes some elements of the share market, securities issuers, auditors and others. The FMA announcement, and other regulatory activity, is designed to restore confidence in investment markets and those who operate within them. The role of auditors has been particularly significant. In a paper released by the Minister it stated “Audit quality is a core element of financial market confidence... The Registrar of Companies has noted that there were some finance company audit failures. It is essential that the practitioners who carry out financial sector audits have the necessary skills and experience to carry out the work to a high standard. In addition, New Zealand's self-regulation system is no longer acceptable internationally. We need to make these changes to allow New Zealand auditors to be recognised by overseas regulators, such as the Australian Securities and Investments Commission.

We look forward to seeing more details of the FMA as they are rolled out.

NZ Advisers to be regulated

Public confidence in Advisers has also been badly dented and regulation is about to impact on this group too. By June next year, it will be unlawful in New Zealand for any individual to give financial advice, make an investment decision on behalf of others or provide a financial planning service unless they are an Authorised Financial Advisers (AFA). AFAs must abide by the Code of Professional Conduct (the Code) and may be struck off or face financial penalties and other charges for breaches.

The Code, still in draft form, will be a very important document. Code Standard 1 states “When providing

financial adviser services, an AFA must place the interests of the client first and must act with integrity.”

Brilliant, we say! For us, “Client first” means being free to choose investments without any bias to one institution or another, having the ability to hire and fire at will, being totally transparent about what’s in portfolios and never taking commissions. The fiduciary role requires an adviser to do what’s best for the client even if that conflicts with the advisor’s financial interest. Loyalty must be undivided.

All advisers at Capital will easily be able to meet the requirements for registration and authorisation. We have already completed the tertiary study and just need to sit the NZQA standard test on Knowledge of the Code.

What’s so bad about commissions?

Commission is one way for an adviser to be paid. It’s the insurance company or the fund manager that pays the commission to the adviser and, of course, the money comes from the client. The problem is that commissions are very often not disclosed accurately in terms of either the amount or other related issues. There are up front commissions, trail commissions, bonus commissions and other non-monetary rewards (put x amount of business our way and we’ll take you to Fiji etc).

Commissions are here to stay in New Zealand for a while but are set to be banned in Australia in July 2012 and in the UK from the end of 2012. The Australian Minister for Financial Services says the new laws “are designed to tackle conflicts of interest... and the mis-selling of financial products...” The Financial Services Authority in the UK says “firms will not be able to accept commission in return for recommending specific products.... There is a need to reconnect the adviser and client, where one pays for the services of another, and without the distraction of commission. Only then can consumers have real confidence and trust in the advice they are receiving.”

There is widespread acceptance that commission-based advisers cannot help but be biased and that commissions

should be banned. The regulators in many jurisdictions agree. Ours don’t yet, though there are some noises.

The Investment Savings and Insurance Association (ISI) recently announced plans to implement a voluntary policy to discontinue the payment of commissions on investment products, including KiwiSaver. Our Government is hoping the new regulatory framework for financial advisers, requiring full disclosure of commissions, will suffice for now.

Capital Investment Planning Limited has never been involved in taking commissions. We’ve always either elected for it never to be paid or, where that can’t be done, we have rebated it to clients.

We agree that commissions pose real difficulties. The onus is on the client to try to work out the various relationships and remuneration arrangements an adviser might have – not an easy task. Why go there?

“Capital Investment Planning Limited has never been involved in taking commissions...”

The fiduciary principle – a much better model

We think the term “fiduciary” will be one that’s heard more and more in future and, in the end, will be the required approach. It fits the “Client First” Principle in Code Standard 1 for AFAs and it’s the standard used in many jurisdictions now.

Doctor Alpha and Doctor Beta – which one is the fiduciary?

When preparing this newsletter, we found an article written in the US that provides an easy way to understand some of the finer points of the fiduciary principle. In the US, a debate is raging about whether stock brokers should be required to join their adviser colleagues under the fiduciary “umbrella”. At present, a broker only needs to make sure an investment is “suitable” for a client before selling it to them.



Here's the example:

“Imagine this scenario: You go to see a doctor for a problem with your liver. Doctor Alpha only applies a suitability screen. He prescribes liver drug A made by a company that periodically hosts the good doctor on cruise trips. But drug A is meant to cure the liver ailment; therefore, it passes the suitability filter.

“ People from all over the world are getting on the band wagon. ”

Unsatisfied, you go to see Doctor Beta who goes beyond the simple suitability standard. This doctor evaluates the same drug A prescribed by Doctor Alpha as well as drug B and drug C. After reviewing your current prescriptions and your family medical history, Doctor Beta concludes you're best suited for liver drug B.

Can you tell who is the fiduciary...?”

People from all over the world are getting on the band wagon. The legendary John C Bogle, now aged 80, of

Vanguard fame (Vanguard offers index funds in the US and was the first to do so) thinks there's too much speculating and not enough investing being done these days. He says “If short-term speculation is folly and long-term investing is wisdom, we've moved down the road from wisdom to folly.” Bogle is an advocate of buying investments where the index dictates the stock selection, holding the investments long term and not trying to outwit markets.

Readers will know that our portfolios hold “Core” investments which have very widely diversified index-based mixes of shares / bonds. We also have some “Active” holdings too.

Note: Within a few weeks, all advisers at Capital Investment Planning Limited will be Accredited Investment Fiduciaries (AIFs). This is a professional designation awarded by the Centre for Fiduciary Studies, which is associated with the University of Pittsburgh's Centre for Executive Education. AIFs use a set of Prudent Practices designed to assist all investors and particularly those who act as Trustees/ Stewards/Guardians for others.

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For truly impartial advice about your investment needs, contact us to arrange a no-obligation consultation free of charge. One of our highly experienced and qualified investment advisers can help sort through the myriad of choices out there, so that you achieve your goals.

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