

THE REGULATION OF ADVICE WITHIN THE FINANCIAL SERVICES SECTOR*

1 Introduction

The Financial Services Sector has undergone quite significant legislative changes in the last number of years. These changes were mainly facilitated through the Financial Advisory and Intermediary Services Act (37 of 2002, hereinafter “the FAIS Act” or “FAIS”) together with the Policyholder Protection Rules (Long-Term Insurance) 2001 (GN R165 in GG 22085 of 2001-02-23) and the Policyholder Protection Rules (Short-Term Insurance) 2001 (GN 164 in GG 22084 of 2001-02-23). These rules were promulgated in terms of section 62 of the Long-Term Insurance Act (52 of 1998). However, the content of these rules was to a large extent duplicated in the General Code of Conduct for Authorised Financial Services Providers and Representatives (BN 80 of 2003, hereinafter “the Code of Conduct”). One of the main purposes of this legislation is the regulation of advice in order to enable clients to make informed decisions with regard to financial products and to ensure that intermediaries (commonly referred to as “brokers”) and insurers conduct business honestly and fairly, and with due care and diligence. The Act is ultimately aimed at the protection of consumers. It can be regarded as market conduct legislation as it provides for the regulation of the conduct of specifically providers of financial services and their representatives. Although financial advisors are still playing the same game, the FAIS Act has effectively changed the rules of the game. Financial advisors are consequently faced with the following decision: Accept the new rule changes and adapt your business to be consistent with legislation, or decide that the rule changes are too drastic and stop playing altogether.

The FAIS Act, however, also created the need for a referee to ensure that all the players play according to the new rules. In this regard, Part IV of the Act made provision for the establishment of the Ombud for Financial Services Providers. The Office of the Ombud became operational in 2005 and has since received numerous complaints regarding the furnishing of advice and has made several determinations. (Determinations of the Ombud can be accessed www.faisombud.co.za.)

This note will examine the relevant sections in the legislation dealing with the regulation of advice. The position of the FAIS Ombud will be considered and recent determinations made by the Ombud on the subject of the furnishing of advice will be discussed.

* This note is based on a paper delivered on 6 July 2006 in Cape Town at the Annual Law Teachers' Conference of Southern Africa.

2 Financial advice defined

2.1 *The FAIS Act*

The main object of the FAIS Act is to regulate the rendering of financial advisory services to prospective clients. In order to have a clear understanding of what is meant by financial advisory services, it is important to define "advice". Section 1 of the Act defines advice as:

"[A]ny recommendation, guidance or proposal of a financial nature furnished, by any means or medium, to any client or group of clients."

The recommendation, guidance or proposal should be aimed at the purchase, variation or termination of a financial product or at the investment in a financial product or on the conclusion of any financial transaction relating to a financial product (s 1(1)). Financial products include benefits provided by pension fund organisations, medical schemes and short-term and long-term insurers (s 1(1)). Should a client receive advice regarding, for instance, a life insurance policy, the policy would be considered to be a financial product within the definition of the Act.

However, despite the provided definition of advice, the Act clearly states that advice does not include factual advice given on the *procedure* for entering into a transaction in respect of any financial product (s 1(3)). The description of a financial product or an answer to routine administrative queries, as well as the display or distribution of promotional material is also not considered to be advice (s 1(3)). Should a client thus have an inquiry about the procedure for the variation of a beneficiary on a life insurance policy, the answer supplied by the financial advisor will not constitute advice in terms of the Act. On the other hand, should a client ask the financial advisor whether or not he should change the beneficiary nominated on his policy, the answer supplied will, in terms of the definition, constitute advice being given. This is due to the fact that the *recommendation* is aimed at the *variation of a financial product*. This example stresses the fact that even persons who do not consider themselves to be financial advisors in the traditional sense of the word should take care that the advice that they are rendering to their clients might constitute advice within the definition of the Act and consequently requires adherence to the Act. Attorneys and estate planners come to mind in this regard. Should an attorney or estate planner who has done an estate duty calculation before drafting a will, recommend that his client take out a life policy in order to address the liquidity in his estate, such a recommendation would be considered to be advice since it is a recommendation of a financial nature.

As a result of the abovementioned the following question might be asked: Who may advise a client? According to the Act, financial advisors may only render advisory services to a client once the advisor has obtained authorisation (in the form of a licence) from the Financial Services Board (FSB) to do so (s 7(1)). However, it is important to bear in mind that any transaction concluded on or after 30 September 2004 (the date when Part II

of the Act came into force – the rest of the Act came into force on 15 November 2002) without the advisor being authorised would not be unenforceable between the advisor and the client merely by reason of such lack of authorisation (s 7(2)). Since all the current product suppliers (such as insurance companies) are prohibited from doing business with financial advisors who are not properly authorised, it is submitted that very few transactions would be concluded without the advisor having the required authorisation.

In order to obtain authorisation to act as a financial services provider (FSP), the financial advisor needs to indicate to the Registrar of Financial Services that he can be regarded as being fit and proper to act as an advisor (s 8(1)). To be regarded as being fit and proper the advisor needs to satisfy the Registrar that he has the personal character qualities of honesty and integrity (s 8(1)). The advisor is also required to indicate his competence and operational ability to comply with the responsibilities imposed by the Act (with reference to the operational ability, the Code of Conduct requires an advisor to have appropriate procedures and systems in place to store and retrieve documentation relating to transactions with the client). Once the Registrar has established that the advisor complies with the fit and proper requirements, the Registrar will issue a license authorising the advisor to act as a financial services provider (FSP). Upon receipt of the license the FSP must not only display a copy of the license in a prominent and durable manner, but also ensure that reference to the fact that such a license is held, is contained in all business documentation, advertisements and other promotional material (s 8(8)). It is due to this fact that all the advertisements of most financial institutions, not only insurance companies, contain a phrase referring to the fact that the business is an “authorised financial services provider”.

Despite the fact that the financial advisor (if he is conducting his business as a sole proprietor) or his business (if he conducts his business in, for example, a company, closed corporation or trust) has been authorised to provide financial services, it is important to note that only representatives and key individuals who comply with the fit and proper requirements are allowed to provide advice to clients (s 8(1) and 13(2)(a)). Persons rendering clerical, technical, administrative, legal, accounting or other services in a subsidiary or subordinate capacity, that does not require judgment on the part of the latter person or does not lead a client to any specific transaction in respect of a financial product in response to general enquiries, is not considered to be a representative (s 1(3)(a)).

As a result of this definition it is of utmost importance that a FSP determine beforehand who is to be regarded as a key individual or a representative and who will be rendering purely administrative services. Anyone rendering, for example, purely administrative services will not be regarded as a representative and will consequently not have to comply with the fit and proper requirements that have been laid down for representatives (BN 91 of 2003 Determination of fit and proper requirements for financial services providers, 2003). As is the case with a FSP, a key individual must

also have the personal character qualities of honesty and integrity (a key individual can be described as a person who manages or oversee the activities for which the FSP is licensed (Van Zyl *Financial Advisory and Intermediary Services Manual* (2004) 45), BN 91 of 2003)). These qualities are assessed through a standard questionnaire (Form FSP 4). This questionnaire requires the key individual to, for example, confirm whether or not in the preceding five years he has been found guilty in any civil or criminal proceedings by a court of law or other competent authority of having acted fraudulently, dishonestly or in breach of a fiduciary duty (Form FSP 4 par E).

In addition to these requirements a key individual must also attest to his competency and operational ability (Form FSP 4 par F, BN 91 of 2003). In determining whether or not a financial advisor is to be regarded as competent, he needs to indicate that he has the minimum required levels of experience and qualifications (Form FSP 4 par G-I, BN 91 of 2003). The required minimum standards will depend on the financial product that the advisor recommends to a client. For example, the requirements for an advisor providing advice on a short-term product are not the same as the requirements for providing advice on an investment product. Despite the minimum requirements relating to an advisor's qualifications, the Registrar of Financial Services has gone further and indicated that advisors who have only the minimum academic qualifications must, within a specified time, attain a qualification on a higher NQF level (BN 91 of 2003). It is submitted that this step would ensure that within the next three to five years all financial advisors would be suitably qualified to ensure that at least they have an acceptable level of theoretical knowledge.

A FSP is also under obligation to ensure that his representatives are at all times competent to provide advice and that such representatives comply with the fit and proper requirements (s 13(2)(a)). It is interesting to note that the FSP 5 form used to register representatives does not contain the same questions regarding, for instance, honesty and integrity, nor is any inquiry made regarding the representative's qualifications or work experience. The questionnaire focuses only on the type of financial product on which the representative would provide advice and/or intermediary services. As a result of this, the FSP must make sure that someone is employed to ensure compliance with these provisions.

After a FSP has established which of his employees meet the fit and proper criteria and are thus suitable to act as representatives, the FSP is obliged to maintain a register of representatives which must be regularly updated and be available to the Registrar for reference or inspection purposes (s 13(3)). This register should make reference to the categories of products that the representative is considered competent to render and should indicate whether the representative acts for the provider as employee or as mandatory (s 13(4)(a) and (b)). The issue whether or not the representative acts as an employee or as a mandatory will become an important one in, for instance, cases where vicarious liability is at stake.

The fact that the FAIS Act prescribes a minimum level of qualification and experience is an indication that there is a conscious move towards creating a proper profession within the financial services sector.

2.2 The Code of Conduct

Despite the FAIS Act, it is also important to examine subordinate legislation promulgated in terms of the Act. The most important development in this regard was the announcement of the General Code of Conduct for Authorised Financial Services Providers and their Representatives (BN 80 of 2003). This Code of Conduct was published by the Registrar of Financial Services in reaction to section 15 of the FAIS Act that placed the Registrar under an obligation to draft a code of conduct for authorised financial services providers.

The purpose of the Code of Conduct is to ensure that clients are able to make informed decisions regarding the financial service that is being rendered to them as well as ensuring that their reasonable financial needs regarding financial products will be appropriately and suitably satisfied (s 16(1)). The Code of Conduct requires financial advisors to render their services (especially the advisory services) honestly, fairly and with due skill, care and diligence (s 2 of BN 80 of 2003). The advisor should in all his dealings with his clients, have their best interests at heart in order to ensure that they are in a position to make well informed decisions.

Despite the abovementioned general duty that the Code of Conduct places on advisors, the Code also contains various specific duties. The Code requires advisors to make sure that the advice they are dispensing is factually correct and provided in plain language in order to avoid uncertainty or confusion (s 3(1)(a)(i) and (ii) of BN 80 of 2003). The advice rendered needs to address the financial needs of the client and take cognisance of the level of knowledge of such a client (s 3(1)(a)(iii) of BN 80 of 2003). In order to establish the financial needs and level of knowledge of the client, the advisor is required to seek appropriate information regarding the client's current financial situation, his financial product experience as well as his financial objectives in connection with the financial service required (s 8(1) of BN 80 of 2003). The advisor is, in other words, required to conduct a financial needs analysis based on the information gathered from the client in order to enable him to properly advise the client (s 8(1)(b) of BN 80 of 2003). After conducting the needs analysis, the advisor consequently identifies products that would address the client's needs, having regard to the client's risk profile and the established needs (s 8(1)(c) of BN 80 of 2003)). The Code requires an advisor to take reasonable steps to ensure that the client understands the advice rendered and that the client is ultimately in a situation where an informed decision can be made (s 8(2) of BN 80 of 2003).

From the abovementioned it is clear that the FAIS Act, together with the Code of Conduct, does not only regulate the actual advice being given to a client, but also prescribes the procedure for the rendering of such advice. These legislative changes are to be welcomed within the financial services

sector. The legislation goes a long way towards protecting clients and ensuring that they receive advice that is accurate and relevant to their financial needs. A further positive that can be taken from this legislation is that clients are becoming more aware of their rights and are more alert to malpractices of financial advisors. This is supported by the amount of complaints the Ombud for Financial Services Providers has received since it came into operation.

3 The FAIS Ombud

3.1 Introduction

As mentioned earlier the main object of the FAIS Act is the regulation of the rendering of financial advisory services. In order to ensure that the stated object of the Act is achieved, section 20 of the Act makes provision for the establishment of the Office of the Ombud for Financial Services Providers (hereinafter "the Ombud"). The object of the Ombud is to consider and dispose of complaints in a manner which is procedurally fair, informal, economical and expeditious and to provide a dispute resolution mechanism that is easily accessible to all potential users (s 20(3)). The aim of the Ombud is to provide complainants with an alternative to the often drawn-out and costly option of litigation. The procedures followed by the Ombud are similar to what is commonly referred to as alternative dispute resolution. When investigating and disposing of complaints the Ombud must at all times be impartial and act independently (s 20(4)).

In order to ensure that determinations by the Ombud are legally binding on all the parties to the dispute, section 28(5)(a) of the Act clearly states that a determination by the Ombud is to be regarded as a civil judgment of a court, had the matter been heard by a court.

3.2 Jurisdiction of the FAIS Ombud

With regard to the jurisdiction of the Ombud it is important to note that services rendered by the Ombud are not to be construed as being similar to those of a professional legal adviser and are confined to the investigation and determination of complaints in terms of the Act and the Ombud rules (s 2(c) of BN 100 of 2004). Before the Ombud can adjudicate a complaint, the complainant must prove that a FSP or his representative has contravened or failed to comply with a provision of the FAIS Act and as a result thereof the complainant has suffered or is likely to suffer financial prejudice or damage (s 2(c) of BN 100 of 2004). The fact that a FSP or his representative has willfully or negligently rendered a financial service (that includes the rendering of advice) to the complainant which has caused prejudice or damage to the complainant, or which is likely to result in such prejudice or damage, will also give rise to a claim that falls within the ambit of the Ombud's jurisdiction (s 1(1)).

Before a complaint is justiciable by the Ombud the respondent must have failed to address the complaint satisfactorily within six weeks of its receipt and the Act or omission complained of must have occurred at a time when the Ombud Rules were in force (Rule 4(iii) and 4(iv) of the Ombud Rules). The Ombud does not have jurisdiction in cases where a monetary claim exceeds R800 000, unless the respondent has agreed in writing to this limitation being exceeded, or the complainant has abandoned the amount in excess of R800 000 (Rule 4(c) of the Ombud Rules). The Ombud also does not have jurisdiction to adjudicate complaints relating to investment performance of a financial product which is the subject of the complaint, unless such performance was guaranteed expressly or implicitly or such performance appears to the Ombud to be so deficient as to raise a *prima facie* presumption of misrepresentation, negligence or maladministration on the part of the FSP or its representative (Rule 4(f) of the Ombud Rules).

In the *Le Vatte v Spendley* determination (FOC/600/05/IC) the question regarding the jurisdiction of the Ombud was raised for the first time. The Ombud was called upon to make a ruling on the question whether or not the Ombud is precluded from adjudicating a matter where a respondent has already instituted legal proceedings against the complainant. The respondent alleged that the Ombud did not have jurisdiction to adjudicate the matter and based its argument on section 27(3)(b)(i) of the FAIS Act which provides that

“[T]he Ombud must decline to investigate any complaint if, before the date of official receipt of the complaint, proceedings have been instituted by the complainant in any Court in respect of a matter which would constitute the subject of the investigation”.

The respondents' reliance on this section was, however, misplaced. It is clear from the wording of this section that the Ombud is only precluded from adjudicating a matter where proceedings have been instituted by the *complainant* and not by the respondent. It was accordingly found that the mere fact that proceedings have been instituted in a court does not necessarily preclude the Ombud from investigating and adjudicating the matter (par 22 of 38).

4 Recent determinations

Since its inception the Ombud has made numerous significant determinations of which the *Le Vatte* determination is but one. This section will briefly discuss some of the determinations that dealt with aspects regarding the furnishing of advice.

4.1 *Stephenson v Nedbank* (FOC/540/05/KZN)

One of the issues raised in this determination related to the appropriateness of advice rendered by the respondent in rendering financial services to the complainant.

4 1 1 The facts

Mr Stephenson was a long-standing client of Nedbank and held a substantial amount to his credit in the Nedbank Money Market Account. As a result of the advice furnished by Ms Rasool, an employee of the respondent, Mr Stephenson agreed to transfer his investment (R1.2-million) from the Nedbank Money Market Account to the Old Mutual Money Market Account. This was done under the impression that the investments were on all accounts the same except for the fact that the Old Mutual investment would yield a higher return and that the funds in the investment would only be available after a period of 72 hours. The transaction was brokered by Mr Maharaj, an employee of the respondent, acting within the scope of his employment with the respondent as an authorised representative. At no stage during the negotiations were any fees disclosed and no needs analysis was done (the complainant had agreed to waive his right to have the analysis done).

Upon a request by the complainant to provide him with proof of the investment he was informed that it would only be possible to provide him with the requested documentation if the funds were transferred back to the Nedbank account. At this stage Mr Stephenson became aware of the fact that fees to the amount of R13 465.68 were levied against his investment. After conversations with a Mr Hoyle, also an employee of the respondent, it became clear that there were significant differences between the Nedbank account and the Old Mutual account.

As a result of the abovementioned the complainant alleged that the advice rendered to him where not appropriate and that he was falsely advised.

4 1 2 The determination

The Ombud found that the investment was materially misrepresented to the complainant and that the respondent had failed to comply with the Code of Good Conduct. Statements made by the respondent were not factually correct and constituted a false representation of the financial product being recommended (par 65). Mr Maharaj should have known that there were material differences between the two products and either willfully or negligently withheld them from the complainant in order to conclude the transaction and receive the commission. The respondent accordingly did not act with the required skill, care and diligence expected of someone acting in a position of trust.

As a result it was found that the advice provided by the respondent was not appropriate given the circumstances and the respondent was ordered to repay the commission together with interest.

4 2 *Ramdass v Standard Bank* (FOC882/05/KZN/(1))

4 2 1 The facts

The issue of the appropriateness of advice was again raised in this determination. The Ombud again stressed the fact that, in order to properly advise a client, the advisor must gather relevant information from his client regarding the client's financial needs. In this matter the complainant had about R87 000 that she wanted to place in an investment where the invested funds would be immediately available upon request. Mr Maistry, an employee of Standard Bank, advised the complainant to invest the money in Liberty Life. Since the complainant was looking to buy a house, as soon as she could find a suitable one, she clearly indicated that the investment should be of such a nature that she would be able to withdraw funds from the investment at short notice. Mr Maistry duly indicated that the complainant would not be able to make withdrawals for any personal reasons, but she would be able to withdraw money in order to buy a property, since property is also an investment. At no stage during their dealings did Mr Maistry do a proper financial needs analysis in order to assess the complainant's financial needs.

About four months after the investment had been made, the complainant found a house that she wanted to buy and contacted Mr Maistry to take the necessary steps to release funds from the investment. The complainant was informed that she could only withdraw R80 000 from the investment and that about R4 000 must be left in the account for "admin charges".

Despite the fact that almost R4 000 would go towards "admin charges", the complainant completed forms in order to access her investment. About two weeks after the completion of the forms, the complainant was informed that she could only access R70 000 of the investment since Mr Maistry had invested the funds for a fixed period of five years in direct contrast to the instructions that the complainant had given to her advisor.

4 2 2 *The determination*

The Ombud found that the fact that the respondent did not seek appropriate and available information regarding the complainant's financial situation, financial product experience and objectives meant that he could not provide the client with appropriate advice. The fact that no financial needs analysis was done supported this suggestion. It was stated that the main focus was on selling a product to the complainant as opposed to rendering a professional service that took her needs and objectives into account (par 39). The advice rendered could not be described as being appropriate in the circumstances and the respondent was ordered to repay the entire investment plus interest back to the complainant.

These determinations should sound a clear warning to FSPs and their representatives. It seems clear that the Ombud places a premium on the fact that clients should be properly advised and that they should be able to make

a well-informed decisions regarding their financial needs. In neither of the determinations discussed were the claimants properly advised and they suffered financial damage as a result. Had the financial advisors acted in accordance with their instructions and advised the clients accordingly the financial damage could have been averted.

5 Conclusion

The introduction of the FAIS Act brought about some significant changes in the financial services sector. For the first time the conduct of financial advisors is not only being legislated, but also properly policed through the FSB and the Ombud. Only time will determine whether or not the FAIS Act will achieve its ultimate goal and that clients will indeed be able to make informed decisions through the high standard of advice that they receive from their advisors. Fortunately the Act also makes provision for corrective measures against financial advisors in instances of non-compliance with the Act. Financial advisors are under threat of being debarred and having their licences suspended should they be found guilty of contravening the stipulations of the Act. The threat of losing their authorisation, together with the monetary penalties (up to R1-million), might prove to be sufficient to ensure that advisors strictly adhere to the Act.

The Financial Services Ombud is taking up the challenge to protect clients from advisors who simply sell them a policy instead of taking their needs into account. The Ombud is sending out a clear message to all financial advisors to get their acts together and start acting in the best interests of their clients, and not themselves.

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