

1 November 2016

Financial Markets Authority
PO Box 1179
Wellington 6140

By email: consultation@fma.govt.nz

A guide to the FMA's view of conduct, July 2016

1. The New Zealand Law Society welcomes the opportunity to comment on the *Guide to the FMA's View of Conduct*, July 2016 (Conduct Guide).

Purpose of the Conduct Guide

2. Unlike the Financial Advisers Act 2008 and the Code of Conduct for Financial Advisers, the Financial Markets Conduct Act 2013 (the FMC Act), does not have an express statutory mandate to create conduct obligations which apply to financial service providers. This seems to have been one of the outcomes of the 2010 securities law review. During this review, it was considered whether (in addition to the specific regulatory framework created by securities legislation) there should be a principle-based overlay – requiring providers of financial services to retail customers to provide services in a fair manner. However, this was rejected and instead, Part 2 of the FMC Act imposes requirements of “fair dealing” which target misleading or deceptive conduct, false or misleading representations, and unsubstantiated representations.
3. The Law Society considers that the Conduct Guide is a useful document for directors and executives of licensed financial services providers. While this document will no doubt assist licensed financial service providers in providing better services to customers and in creating a culture of compliance (which is obviously a desirable outcome), the Law Society considers that it is important that the Conduct Guide provides a clearer description of its purpose at the beginning of the document and the consequences of not complying with it.
4. It should be made clear that the Conduct Guide does not introduce any new legal obligations and is not enforceable by the FMA or any other party. Without such clarification, the Guide could be seen as potentially expanding the obligations of licensed financial service providers without legislation or judicial mandate. For example, there are no general legal obligations under the FMC Act requiring the financial service provider to: ensure precise alignment of interests with the investor; to “assess whether the cost of the product or service significantly reduces the provider’s ability to meet the customer’s needs, by significantly reducing the

returns they get”; or to be “sensitive” to a customer’s financial capability.¹ Therefore, in many cases, a failure to meet the provisions set out in the Conduct Guide will not constitute a breach of statute triggering enforcement action by the FMA.

5. While the FMA has an educational role under the Financial Markets Authority Act 2011 in respect of the promotion and facilitation of the development of fair, efficient and transparent financial markets, it is ultimately up to financial services providers to determine how they discharge their obligations to their customers (provided they act in accordance with the law). The FMA can suggest that a profitable and successful financial services provider will ensure: best customer outcomes; that customer needs are met; and that the provider always acts in the customer’s best interests where appropriate. However, in the absence of a legal requirement, the FMA cannot convert these recommendations into obligations via the Conduct Guide.
6. It should therefore be clearly communicated that the aim of the Conduct Guide is to encourage market participants to take voluntary action to create a culture within the financial service provider which does not allow bad conduct to incubate.
7. The Law Society accepts that a serious failure to follow the principles outlined in the Conduct Guide could be a factor that the FMA might take into account in deciding whether a licensee should continue to be licensed. However, the failure to comply with the Conduct Guide cannot usurp the requirements for obtaining a license set out in the legislation.

Should the Conduct Guide have different sections which apply to different types of participants?

8. There is also other industry guidance which may need to be considered in drafting the Conduct Guide. For instance, in the case of banks, in addition to the capital adequacy measures that are a fundamental part of prudential supervision, there is industry practice on reducing ‘operational risk’. This is a very wide concept embracing the risk of loss resulting from inadequate or failed internal controls and the safeguards affecting the risks associated with people and systems or from external events. Consideration should be given to whether there are conflicting requirements between operational risk requirements and the Conduct Guide which may require separate sections for different financial service providers. Other types of financial service providers may have different potential risks which may require specific guidance. In addition, a number of general concepts of good conduct in the Conduct Guide may only be relevant to certain specific market participants.

Conflicts of interest and alignment

9. The Conduct Guide notes that there must be alignment of customer, business and (where relevant) shareholder interests (page 4). However, this may not always be possible. For instance, there may be times where a conflict of interest cannot be entirely eliminated but the customer is happy to agree to continue the engagement despite the conflict. In those circumstances, there may not be complete alignment between the customer and financial service provider.

¹ Conduct Guide, pages 5 and 6.

The emphasis on “demonstration” of good conduct

10. The Conduct Guide recommends that providers “demonstrate” actions that equate to good conduct. The Conduct Guide states (at page 4) that financial service providers may need to “think differently about what they do with their people and organisational culture, and their processes and controls, to show both us and their customers that they understand what good conduct is, and can habitually demonstrate it.”
11. There is a risk that this focus on “demonstrating” good conduct may lead to a focus on creating a paper trail of “good conduct” which can lead to increased costs for customers without much benefit. For instance, on page 9, the Conduct Guide states that the financial service provider should “be able to demonstrate a transparent and effective complaints and disputes resolution process”. It would be preferable if this instead stated that the “financial service provider should ... *have* a transparent and effective complaints and dispute resolution process and keep records of its processes for dealing with complaints and dispute resolution”.
12. Similarly, the Conduct Guide says at page 10 “how do you *demonstrate* that your customer and business strategies are aligned”. The Law Society submits that this should say “are your customer and business strategies aligned as far as possible?”, to recognise that total alignment might not be possible (as discussed at paragraph 9 above). There are a number of examples of this throughout the Conduct Guide which the Law Society suggests should be reconsidered.

Terminology

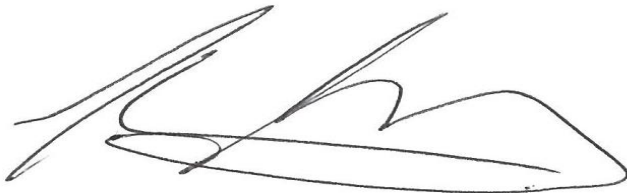
13. The Conduct Guide would be more accessible if some of the key concepts were described earlier in the document, as follows:
 - a. “Conduct risk” could be briefly described on page 4 as “the risk that conduct may contribute to poor outcomes for customers”. Currently this is only defined in the glossary.
 - b. “Good conduct” is not discussed until page 6. It could be briefly described on page 4, referring to the fuller discussion on page 6.
14. The Conduct Guide uses other phrases that would benefit from further explanation. For example:
 - a. What are “good outcomes”?
 - b. How does the FMA determine the outcomes the customers want / what the customer cares about?
 - c. Why must the interests of customers and other stakeholders always align? Is this realistic?

Conclusion

15. In summary, the Law Society considers that the Conduct Guide is a helpful guide to best practice which will assist financial service providers in considering areas for improvement and ways to reduce risks to customers. However, it would be desirable for the purpose and effect of the document to be more clearly stated.

16. The Law Society is happy to discuss the submission if that would be helpful. The convenor of the Law Society's Commercial and Business Law Committee, Rebecca Sellers, can be contacted via the committee secretary, Karen Yates (karen.yates@lawsociety.org.nz / 04 463 2962).

Yours faithfully

A handwritten signature in black ink, appearing to be 'K. Beck', written in a cursive style.

Kathryn Beck
President