Proposed section 431H FMCA – Duty to put client's interest first

14 March 2017

This submission is made solely in my personal capacity.

This submission is restricted to single proposed clause s431H of the FMCA Act contained in Part 3 cl 24 of the Financial Services Legislation Amendment Bill 2017 [which introduces a new Subpart 5A of Part 6 of the FMC Act (Regulation of financial advice)).

This submission supports with two provisos the formulation of the duty to put client's interests first as expressed in the Exposure Draft.

The overarching Standard of the Code of Professional Conduct for Authorised Financial Advisers is Code Standard 1, which includes the duty to put the interests of the client first. This Code Standard however does not define what the obligation means.

As part of the Review of Financial Advisers Act 2008, Cabinet decided

(1) to extend the duty to put client's interests first to all financial advisers and

(2) to enshrine the duty in legislation.

There was no explanation of what the duty was in the Cabinet Paper, nor for that matter in any of the Issues, Options and Final Reports of the MBIE Review team.

Proposed clause 431H converts those Cabinet decisions into statutory form, and for the first time, sets out what the duty actually means.

431H Duty to put client's interests first

(1) This section applies if a person who gives regulated advice (A) knows or ought reasonably to know that there is a conflict between
    (a) The interests of the person to whom the advice is given (B); and
    (b) A's own interests or the interests of any other person
(2) In giving the advice or doing anything in the giving of the advice, A must give priority to B's interests including by taking all reasonable steps to ensure that A's own interests or the interests of any other person do not materially influence the advice.

Sub clause (1) clearly requires a conflict of interest to exist before the duty is triggered.

I applaud the fact that the duty is expressed so clearly. No-one should have difficulty in understanding the duty as expressed that way. The law is crystal clear.

I submit that it is critically important that the statute defines what the duty means. It should not be stated as a bald principle and be left to be decided what it actually means elsewhere.

I am not aware where the "client first duty" applies in any other statutory setting. I have not been able to discover any case law that has considered what a "client first" duty means in practice. The meaning of the duty in the Code of Professional Conduct for Authorised Financial Advisers has never been tested in the Financial Advisers Disputes Committee – there have been two cases where a charge of breach of Code Standard 1 was alleged by the FMA; both the defendants denied those charges, FMA declined to produce any evidence on the Code Standard 1 breaches and those charges were dismissed.

First Proviso

My first proviso is the range of conflicts of interest that trigger the duty is drawn too widely.

The draft legislation talks about conflicts between

- the client and the adviser; and/ or
- the client and any other person.

There can be no argument that conflicts between the client and the adviser should have to be handled. However the duty extends to conflicts between the client "and any other person" i.e. the universe.

I submit that "any other person" is too wide, and should be restricted to persons related to or associated with the adviser. There should be a consequential amendment in (2).

Other submitters might argue that the words "knows or ought reasonably to know" earlier in clause (1) can be interpreted to modify "any other person".

However I understand good drafting practice is that limiting words be expressed closer to the words that they limit rather than further away.

Second proviso

It is not entirely clear what the words in sub clause (2) "or doing anything in relation to the giving of advice" mean.

The example in the accompanying explanatory document talks about an adviser having to consider whether or not they should give Information Only advice. However Information Only is excluded from the definition of advice, and therefore cannot be regulated advice which is what sub clause (1) is clearly about; the advice in (2) must surely be related to the regulated advice in (1). So I don't see how the example relates to the legislation.

I would be very concerned if the adviser in providing some service or services to a client was obliged to determine in all cases whether or not the services they were providing, whether regulated advice or not, were the appropriate services to be providing. That logic could be extended to a situation where an adviser declined to provide any advice – could she be second guessed in hindsight that she should have provided advice? That would be akin to compelling an adviser to provide regulated advice. That does not seem to be right.

This is the end of my formal submission, but I now provide some additional material that may be relevant.

Further Material

I am aware that there may be submissions to the effect that either

(a) the duty as expressed in the draft is too narrow, and the definition of the duty should be widened in some undefined way, or alternatively
(b) that the Government restrict the clause to the statement that the adviser has a duty to put client's interest first and delete everything else in the proposed clause, and leave it to the Code/Courts to sort out over time what it actually means

I urge the review team to reject both of these submissions.

In my view, adopting (b) would be bad law – it certainly would not be clear and effective, as we would have absolutely no idea what was intended.

As far as I am aware, in the 8 years to date when the Code has been under discussion or in place, there has never been an exposition as to what Code Standard 1 is intended to mean. This paramount standard has no definition beyond the actual words.

I have heard a large number of different claims made about what else it means other than in the COI sense; this list includes

- it's a "best interests" standard,
- it establishes a fiduciary duty,
- advisers have to find the best product as a planning solution,
- Vertically integrated organisations (VIOs) should not be able to sell their own product, unless they provide a comparison with all other products available in the market,
- that the adviser becomes their client's keeper in all circumstances.

I have tried to promote debate through the industry blog-site Good Returns [see Appendix for two contributions from mid 2016] and in other ways on what does the duty to put the client's interests first actually mean.

I have argued consistently that it is only a conflict of interest duty (as the drafters of the Exposure Draft have also seen it). I have challenged others to articulate that, if they think it means more than that, to elucidate what is the "more". The result to date – silence.

To reiterate clause 431H amended as I have submitted clearly sets out what the duty means. It's clear concise and effective.

I submit that looking at overseas jurisdictions provides little or no assistance.

Australia

Australia has a statutory "best interests" standard. The legislation does not anywhere explain what the best interest duty is; rather they set out a safe harbour of largely process steps such that if an adviser follows those steps, then they will be deemed to have discharged the best interest duty.

USA

USA Investment Advisers are subject to a fiduciary duty – this is founded in an early 1960s court decision involving interpretation of the 1940 Investment Advisers Act, in which investment advisers were judicially declared to have a fiduciary duty to their clients.

Brokers on the other hand have historically not had the same fiduciary duty. Rather they have had a "suitability" requirement. In 2016 the Department of Labour introduced a ruling that as from April 2017, brokers dealing with retirement accounts would also have a fiduciary duty. However President Trump has asked DOL to postpone introduction of the Ruling, and DOL has agreed to defer introduction for a period.

Canada

There have been several enquiries in Canada. Different Regulators have taken different positions. Some have agreed to do further enquiry on the introduction of a best interests duty; they have actively dismissed the possibility of introducing a fiduciary duty. There is no agreement on what the best interests duty would look like even if it were to be introduced.

This submission is made by an individual.

Contact details

Murray Weatherston AFA
REDACTED

APPENDIX

Excerpts from Good Returns blog www.goodreturns.co.nz

On 28 July 2016 at 1:09 pm Murray Weatherston said:

I need to provide the context about my quoted comment about what the words actually mean, lest anyone is misled into believing that I am bashing the FMA and the standard.

To make things crystal clear, I am not against the "putting the interests of the client first" (PTICF) standard per se.

But when I read a lot of the commentary on industry regulation, I see a big mixing up of PTICF with two other concepts that it is definitely not. These other concepts are "Best interests of the client" (BIOTC) and fiduciary standard.

For several months now, I have been trying to find out what the actual obligations of the adviser under PTICF. I have studied the Code Committees published documents, and all the FAAR papers. I have consulted Mr Google, not as a necessarily authority but rather to see if I can find others who have the same understanding difficulty as I have. But nowhere, repeat nowhere have I seen anyone even try to define PTICF.

I can see that the client can't prefer to recommend product A which costs the client more and pays the adviser more, cf Product B which does the same job, costs the adviser the same but pays the adviser less.

I can also see that the adviser has to execute client orders ahead of their own.

But what else?

I do intend doing a bigger piece on this to promote debate on the topic "what is the meaning of putting the interests of the client first."

I am as incredulous as Brent with REs comments that PTICF means something different when an ASB adviser wearing an ASB corporate uniform recommends an ASB product than it does when a non-aligned adviser who has a choice of product is talking to the same consumer.

Who explains to the ASB customer that if they had gone to a non-aligned adviser, the duties owed would be different?

On 1 August 2016 at 5:02 pm Murray Weatherston said:

What are the PTICF duties?

I have tried two ways to capture the elusive meaning of PTICF.

The first, and the way I started looking at the question, was to define or say what PTICF is.
Apart from the “apple pie and motherhood’ formulation of PTICF, I pretty much drew a blank on this.

It now seems to me that formulating a rule from this perspective requires a clear and objective dividing line; e.g. speeding. If the speed limit is 50, then travelling a speed above 50 is speeding, and this can be determined in an objective fashion. (e.g. by radar gun).

Maybe the problem with positively defining PTICF is that there isn’t such a clear cut dividing line between Yea and Nay.

So the other (negative) way I have approached the problem is to try and specify some situations where we could say “this conduct doesn’t seem to be PTICF”. And analogously, we could try and define what wouldn’t be not PTICF. I have had much more success looking at the issue this way, and offer the following.

The following is not all original; it’s drawn from a variety of sources and contexts. The list is not intended to be the final say or comprehensive, as other readers will be able to find other examples.

What is not, or might not be, PTICF?
[If you prefer, this could be restated as when might an adviser be found in breach of the duty to PTICF]

1. the most obvious starter is commissions; the adviser had two possible products, A and B. Assuming both of them have the same expected (i.e. ex ante) return. A costs the client 3% and the adviser is paid 2%; B costs the client 1.5% and the adviser gets paid 1%. The adviser recommends A, the one that pays him more.

2.Order of Execution – the adviser doesn't execute client orders before his own;

3.The adviser doesn't have suitable product on his approved list that fully meets the needs of his client; however adviser doesn't tell client to go elsewhere, but rather recommends client buys something different, and which doesn't meet all of the client's bill but is on the adviser's approved list

4.The adviser actively discourages client from withdrawing lump sum out of portfolio (to buy a new car/take a big trip) because it would reduce FUM or AUM

5.The adviser discourages client from selling low yielding bonds/term deposits to pay down debt that has a higher interest rate than the deposit pays, and second the debt interest is not tax deductible

6.The adviser encourages client to keep working till 65 (or in general later) rather than retiring early if it means that the client will have to draw down capital in the meantime.

7. The adviser pushing client to save more when spending might give them more pleasure – balance between living and saving. Remember "no-one gets out of life alive", and we typically don't have a choice in our end date.

8. The adviser discourages client from distributing early to heirs because it would reduce AUM or FUM. Mum seeing her heirs getting the benefit of Mum's money now rather than having to wait until she is cold may actually give Mum more pleasure now than counting her larger investment portfolio.

What is probably not not PTICF?
[The restatement here is when might the adviser not be in breach of PTICF].

1. Where the adviser works off a very limited range of products (maybe only his employers products) then not picking a better product from outside of the limited list available to him.

This seems to me to be the "get out of jail free" card for institutions provided that:

(a) The adviser makes it clear to the client that he is restricted to a narrow range of products; and

(b) The adviser picks the product off the list that both meets the customer's needs and is the best deal for the client (and not the one that incentivises the adviser the most).

My challenge to Good returns readers is to debate this, to add and subtract so that in the end we can all recite what PTICF is [just as we can recite the 10 Commandments (or at least some of them).].