

Response to Submissions

Derivatives Issuer Standard Condition: Suitability of Products for Clients

13 April 2015

About the FMA

The FMA is an independent Crown entity with a mandate to promote and facilitate the development of fair, efficient and transparent financial markets. We work with financial markets participants to raise standards of good conduct, ethics and integrity, and to achieve best standards of practice and compliance.

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Response to submissions on the derivatives issuer standard condition: suitability of products for clients

Consultation process

In November 2013 we consulted on the minimum standards and conditions for derivatives issuers wishing to be licensed under the Financial Markets Conduct Act 2013 (the Act). As part of that consultation we sought feedback on a condition relating to the assessment of suitability of products for clients. Two options were provided, one being disclosure based and the other an assessment by the issuer.

Submitters were of the view that this standard should focus on assessing suitability for retail investors. They noted the potential for overlap with other regulatory requirements and sought greater clarification on what the requirement would be.

In September 2014 we released a consultation paper that outlined our proposed suitability standard, which was based on an assessment by the issuer.

As a result of our formal consultation, we received five written submissions. These submissions were received from the NZ Bankers' Association, two registered banks, an NZX Participant and a company that deals in international money transfers, as listed in the appendix of this document.

We received suggested changes, both substantive and some more technical. We would like to thank the submitters for their constructive feedback and the general support shown for the revision of the standard condition.

Having considered the feedback from the consultation process and investigated how similar standards apply in other jurisdictions, we have made changes to the draft standard condition where appropriate.

The standard condition on suitability will take effect from 1 December 2015.

Key themes from submissions

The following is a summary of the key themes from submissions, and our response.

1. Suitability assessment under the Financial Advisers Act 2008

Some submitters said that there was potential for confusion between the suitability assessment made under the Financial Advisers Act 2008 and the proposed suitability standard set out in the draft standard condition.

We recognise that there was potential for confusion. We have provided clarification in the explanatory note to this standard condition, which now expressly states that this requirement is independent of, and not related to any obligation under the Financial Advisers Act 2008 or the Code of Professional Conduct for Authorised Financial Advisers.

2. UK Financial Conduct Authority's 'appropriateness test'

Some submitters noted that the draft standard condition appeared to be based on the United Kingdom Financial Conduct Authority's (FCA) 'appropriateness test'. Submitters noted that the draft standard condition focused on 'knowledge and experience,' but that the FCA appropriateness test was wider than this, and includes other factors to take into account when assessing suitability. These include the customer's understanding of the agreement, the derivative and its risks. Submitters noted that this had an important outcome for new customers who cannot have any knowledge or experience but may have the capability to understand the product and associated risk.

We have amended the standard condition so that it is extended beyond pre-existing knowledge and experience and now also includes the retail investor's *level of understanding* of the relevant type of derivative.

3. Existing customers

Submitters noted that the standard condition should contain a grandfathering provision, so that existing customers do not have to be assessed in terms of suitability. Submitters noted that the equivalent FCA condition contained a grandfathering provision.

We have amended the explanatory note in accordance with this feedback. The explanatory note now states that the standard condition only applies to transactions entered into on or after 1 December 2015 and that no review or assessment of transactions entered into before 1 December 2015 is required.

4. Warning mechanism

Submitters requested clarification of the warning mechanism to be made to retail investors. Submitters were concerned that a transaction could proceed where an issuer formed the view that the retail investor did not have the requisite knowledge or experience, but that the transaction could proceed as long as the warning was given. Submitters also suggested that the warning should be acknowledged by the investor.

We have amended the standard in accordance with this feedback to clarify the circumstances in which a transaction can proceed. In particular, if a derivatives issuer considers that a retail investor does not have the ability to understand the particular type of derivative and the risks involved, then they must not enter into that derivative with them.

5. Investors that are not individuals

Submitters noted that the draft standard condition as currently drafted may pose difficulties for assessing suitability for investors who are not individuals, such as corporate entities, trusts and partnerships.

We have amended the explanatory note in accordance with this feedback, providing that a licensee must assess the ability of the relevant director(s), employee(s) or agent(s) (as appropriate), who act on behalf of the investor to determine whether they, either collectively or individually, have the ability to understand the particular type of derivative and the risks involved.

6. Deliverable forward foreign exchange contracts

One submitter presented the view that the standard condition should not apply to deliverable forward foreign exchange contracts on the basis that they are simple contracts mostly used for international payments, as opposed to more complex investment products which are used for speculative or investment purposes.

We have carefully considered this submission and have taken into account the approach taken in other jurisdictions – in particular Europe and Australia. In the UK, the FCA has excluded FX forwards from the definition of 'derivative'. In New Zealand however, the Financial Markets Conduct Regulations 2013, make it clear that these types of transactions are derivatives as long as settlement is required 3 business days or longer after the transaction date. MiFID II is however expected to bring the UK in line with the rest of Europe by bringing transactions with settlement longer than 3 days explicitly into the definition of 'derivative' and

therefore within scope of the appropriateness test. It also appears that Australia is moving towards the European model where additional requirements apply in relation to complex products. Australia currently has a 'client qualification' benchmark for OTC derivatives. This benchmark is however guidance only.

Having carefully considered this submission we have not made any changes to the standard condition. We believe that it is appropriate for the suitability assessment to apply to all derivatives. Where derivatives are simpler to understand, then it will be easier to show that they are suitable for a client, but it doesn't mean that they will *always* be suitable. We have added further commentary to the explanatory note to assist participants in meeting this standard condition for simple products such as deliverable forward foreign exchange contracts.

7. Other jurisdictions

Some submitters noted that other jurisdictions (such as Australia) do not have this type of condition and that imposing it in New Zealand may result in increased compliance costs which may tilt the playing field in favour of Australian derivatives issuers.

We note that Australia currently has a 'client qualification' benchmark for OTC derivatives. This benchmark is set out in ASIC's Regulatory Guide 227 (Over-the counter contracts for difference: Improving disclosure for retail investors). Whilst RG 227 is not mandatory, it appears that Australia is moving towards the European model where additional requirements apply in relation to complex products. Accordingly, we have not made any changes to the condition.

8. Allow provisions in the Act to entrench first

One submitter noted that the Act and regulations contained sufficient provisions to legislate for the matters that the standard condition was attempting to address, and that it would be preferable to allow the existing requirements to entrench before fully assessing whether the standard condition was required.

We have considered this feedback and have looked carefully at the requirements in other jurisdictions. Our preference is however to introduce the standard condition on suitability from 1 December 2015.

Identifying areas of change in the final publication

Where appropriate, we have incorporated comments from each of the previously mentioned eight themes in our revised version. The revised standard condition is available to download from our [website](#).

The original consultation paper is available for download from the [consultations page](#) of our website.

You can contact us at:

Phone: 0800 434 567

Email: consultation@fma.govt.nz

Appendix A: List of submitters

1. ANZ Bank New Zealand Limited
2. HiFX Limited
3. NZ Bankers' Association
4. OM Financial Limited
5. Westpac Banking Corporation