

## **Guidance Note: Code Standard 6 (d) – Analysis Before Recommendation**

Date: December 2011

### **About this guidance note**

This guidance note is intended for Authorised Financial Advisers (AFAs). It clarifies FMA’s expectations in relation to the application of, and compliance with, Code Standard 6 (d) of the Code of Professional Conduct for AFAs, particularly in relation to public issues.

### **Status of this guidance note**

This guidance note describes FMA’s interpretation of the law and how we will apply and enforce it. If a person complies with this guidance note, then we will consider they have complied with the relevant law. While this guidance note has no other legal status and it is not binding on the Courts or third parties, we will ensure that relevant stakeholders are aware of our interpretation.

Examples are provided for illustration. They are not exhaustive and do not impose or imply particular rules or requirements.

It does not constitute legal advice. We encourage you to seek your own professional advice to find out how the legislation discussed and any other applicable laws apply to you, as it is your responsibility to determine your obligations.

## A. Overview

1. FMA's principal objective is to promote and facilitate the development of fair, efficient, and transparent financial markets. To perform our functions and deliver on our objectives, we seek to ensure:
  - financial markets participants have clear and well understood responsibilities; and
  - retail investors have access to the information they need to make informed decisions.
2. This guidance note aims to assist AFAs as financial markets participants in determining their responsibilities and ensuring that their clients have sufficient information to inform their decision making, particularly in relation to public issues.
3. The Code of Professional Conduct for Authorised Financial Advisers (Code) is specifically designed to be principles based regulation. Each Code Standard consists of an over-arching principle followed by further detail explaining how the Code standard should be applied.
4. Because of this principles based approach in the Code, FMA does not intend to issue prescriptive guidance for particular Code Standards as this would undermine the fundamental 'design' of the Code. We therefore expect AFAs to exercise their own professional judgement in applying the Code to the services they provide, to have regard to the principles expressed in each of the Code Standards and also to have regard to the overarching purpose of the Financial Advisers Act, namely:

*[...] to promote the sound and efficient delivery of financial adviser and broking services, and to encourage public confidence in the professionalism and integrity of financial advisers and brokers<sup>1</sup>.*
5. This guidance describes the factors and considerations AFAs should take into account to comply with Code Standard 6 (d).

## B. Background

6. AFAs must comply with the Financial Advisers Act 2008, which includes an express obligation to comply with the Code.<sup>2</sup> The Code is a regulation made pursuant to the Financial Advisers Act. Code Standard 6 provides:

*An Authorised Financial Adviser must behave professionally in all dealings with a client, and communicate clearly, concisely, and effectively.*

Code Standard 6 sub clause (d) provides:

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<sup>1</sup> Section 3(1) Financial Advisers Act 2008

<sup>2</sup> Section 37 Financial Advisers Act 2008

*When providing financial adviser services to a client, an AFA must: [...] make recommendations only in relation to financial products that have been analysed by the AFA to a level that provides a reasonable basis for any such recommendation, or analysed by another person upon whose analysis it is reasonable, in all the circumstances, for the AFA to rely.*

7. FMA is aware of uncertainty regarding the extent of the ‘analysis’ required to be undertaken or obtained by an AFA under this Code Standard, before he or she can make a recommendation to a client to acquire (or to refrain from acquiring) securities by way of initial public offerings, or to acquire or dispose of (or to refrain from acquiring or disposing of) securities listed, or to be listed, on a registered market (public issues).
8. This guidance is provided particularly in the context of recommendations in relation to public issues, but it is also relevant to recommendations in relation to other financial products.

## C. Code Standard 6 (d)

9. Code Standard 6 is the first Code Standard in the section of the Code titled **Minimum Standards of Client Care**. The overarching principle of Code Standard 6 is about the professional behaviour of AFAs and effective client communication.
10. Further detail about the application of Code Standard 6 is provided by the additional provisions set out under that Code Standard. This includes paragraph 6 (d) referred to in paragraph 6 above.
11. The Code makes it clear<sup>3</sup> the details in the additional provisions under Code Standard 6 (d) do not limit the application of the overarching principle in Code Standard 6, or the application of any other Code Standard. Further, the Code states AFAs must apply Code Standard 6 in a way that encourages public confidence in the professionalism and integrity of financial advisers.

## D. FMA’s interpretation of Code Standard 6 (d)

12. The word ‘analysed’ is not defined in the Code. It therefore carries its ordinary meaning of ‘to examine or think about something carefully, in order to understand’<sup>4</sup>.
13. Code Standard 6 (d) therefore relates to the process of the AFA understanding the product sufficiently to make a recommendation to a client in relation to acquiring or disposing of it.

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<sup>3</sup> Code Section B Introduction

<sup>4</sup> Longman English Dictionary

14. What is a reasonable level of analysis must be determined on an objective basis in the particular circumstances and requires the AFA to apply reason - not irrational or un-informed factors - to the formulation of his or her recommendation.
15. What is reasonable in particular circumstances must be assessed in light of the overarching principle in Code Standard 6 (with its focus on professional behaviour and client communication) and all other relevant Code Standards, particularly:
  - Code Standard 1: put the interests of the client first and to act with integrity.
  - Code Standard 7: ensure that a client has sufficient information to enable him or her to make an informed decision about whether to use the AFA's services and/or to follow any financial advice provided by the AFA.
  - Code Standard 8: take reasonable steps to ensure that a personalised service is suitable for the client.
  - Code Standard 9: provide a written explanation to the client of the basis on which the service is provided.

## **E. FMA's expectations: complying with Code Standard 6**

### **General comments**

16. We expect all AFAs, before making a recommendation in relation to a financial product, to:
  - understand the nature of the investment, its structure and terms and the risks involved in investing in it, to the extent necessary to enable him or her to determine suitability for the particular client in terms of Code Standard 8; and
  - ensure the client is aware of the scope and basis of the service provided by the AFA in relation to the recommendation, and any limitations on the service provided by the AFA in relation to the recommendation in terms of Code Standards 7, 9 and 10. This includes ensuring the client understands whether or not any recommendation is supported by written research.

### **Extent of analysis expected**

17. The extent of analysis we expect in any particular case, including whether written research must be obtained in respect of a financial product before it is recommended by the AFA, will depend on the context in which the recommendation is made – including:
  - the nature of, and risks associated with, the particular financial product;
  - the nature of the relationship between the AFA and the client and the client's resulting expectations of the level of service the AFA will provide;
  - the scope of the service the AFA has agreed to provide to the client;

- the information provided to the client by the AFA about the service he or she will provide, in terms of Code Standard 7.
18. We expect AFAs to consider:
- **initial public offerings:** the financial product’s registered prospectus and investment statement;
  - **listed securities:** material information released by the issuer (such as information released as part of an issuers’ continuous disclosure obligations), or information available on NZX or another exchange on which the product is listed.
19. We do not expect an AFA in every case to obtain detailed written ‘analysis’ or ‘research’ of the type performed by securities, investment or financial analysts (written research) before making a recommendation about a financial product. Nor do we expect AFAs to review all material that is publicly available. In each case professional judgement should be applied as to what information is material and relevant to inform the client’s decision making process. We note also the obligations of NZX Participants under the NZX Participant Rules<sup>5</sup>.

## Analysis by another person

20. In all cases, AFAs have a personal obligation to understand the nature and features of a financial product, and the risks associated with investment in that product, to the extent necessary for him or her to determine suitability for the particular client as required by Code Standard 8.
21. Nonetheless, Code Standard 6(d) recognises it may be appropriate in some circumstances for an AFA to rely on analysis of a financial product (including analysis of its prospectus and investment statement) undertaken by another person, if it is reasonable, in those circumstances.
22. The question of whose analysis an AFA may reasonably rely on, will be determined on an objective basis in the particular circumstances. We expect AFAs to exercise reason and professional judgement in deciding on whose analysis they can rely.
23. We expect AFAs to consider factors such as:
- the nature of the relationship between the AFA and the person providing the analysis;
  - the nature of the relationship between the person providing the analysis and the issuer of the financial product;
  - the capability of the person or persons providing the analysis and the process that person has undertaken to conduct the analysis.
24. For example, it will be reasonable for an AFA working within a dealer group to rely on analysis and/or portfolio asset allocation or direction provided by the dealer group’s investment strategist or investment selection committee; or for a

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<sup>5</sup>NZX Participant Rule 9.1.1(a): ‘Each Client Advising Participant and its Advisors and any Employees...when providing investment advice, securities recommendations and/or research analysis to clients, have a duty of care to ensure that advice is properly researched and that there is a reasonable basis for any recommendation.’

sharebroker working in a firm that does not provide an internal research capability to rely on analysis provided by a reputable independent research house.

25. Subject to the considerations in the paragraphs above, an AFA may also refer to information provided, or funded, by the issuer of the financial product, provided the client is made aware of the source of the information.
26. ***None of the above derogates from an AFA's personal obligation to understand the financial product and apply his or her own professional judgement as to the suitability of any recommendation.***

## **Verification of research/analysis**

27. We do not expect an AFA to independently verify the information contained in a registered prospectus and investment statement prepared in respect of the initial offer, nor to restrict his or her recommendations to only those public issues that have been independently analysed and rated by an independent rating agency.

## **Client's awareness of scope of service**

28. FMA expects all AFAs, before making a recommendation in relation to a financial product, to ensure the client is aware of the scope and basis of the service provided by the AFA in relation to the recommendation, and any limitations on the service provided by the AFA in relation to the recommendation in terms of Code Standards 7, 9 and 10.

This includes:

- ensuring the client understands whether or not any recommendation is supported by written research;
- ensuring the client is aware of any potential conflicts, material relationships the AFA may have and steps taken by the AFA to manage those conflicts.

## **Application to Discretionary Investment Management Services (DIMS)**

29. This guidance also applies to AFAs who provide a DIMS service. DIMS providers must apply Code Standard 6 to their services and the circumstances of each client, having regard to the overarching requirements of professionalism and effective client communication.

## F. Further information

30. For a copy of the Code of Professional Conduct please see:  
<http://www.fma.govt.nz/help-me-comply/financial-advisers/your-obligations/authorised-financial-advisers/code-of-professional-conduct-for-afas/>

For further information about the obligations of AFAs, including disclosure and Standard Conditions for AFAs, please see: <http://www.fma.govt.nz/help-me-comply/financial-advisers/your-obligations/authorised-financial-advisers/>