JULY 2022

Consultation paper: Proposed guidance on reasonable grounds for financial advice about IPOs and listed equity securities

About this consultation

Code Standard 3 of the Code of Professional Conduct for Financial Advice Services requires people who give regulated financial advice to retail clients to ensure that the financial advice given is suitable for the client, having regard to the nature and scope of the financial advice. The commentary to the standard explains that ensuring financial advice is suitable for the client should include having reasonable grounds for the financial advice.

This proposed guidance[1] explains the FMA's approach to applying and enforcing Code Standard 3 in relation to financial advice about Initial Public Offerings (IPOs) and listed equity securities. We have focused on advice about IPOs and listed equity securities because it can be difficult to access expert research[2] for these, particularly for smaller market capitalisation companies[3].

In general, we think advisers will need to access or undertake research to support reasonable grounds for advice on IPOs and listed equity securities. We don't want to discourage those giving financial advice from giving opinions or recommendations not backed by expert research, as this could result in New Zealanders having less access to financial advice they may otherwise benefit from, and lower levels of investment and liquidity in smaller market capitalisation stocks. However, we also want to ensure there are reasonable grounds for financial advice, including advice given in the absence of expert research.

Next steps

We welcome feedback on the proposed guidance – its intent, content and how it is presented. Please use the feedback form for any comments. **Submissions close on 5 August 2022**. We will finalise the guidance after considering submissions.

This consultation is for those giving financial advice about IPOs and listed equity securities, and industry and consumer groups.	We are seeking feedback about the scope and content of the proposed guidance.

[1] Targeted consultation on a preliminary draft of the guidance was carried out earlier this year.
[2] See the proposed guidance (page 2) for what we mean when we refer to 'expert research'.
[3] See the Capital Markets 2029 report, Growing New Zealand's Capital Markets 2029, at page 41-42.

Contents

Proposed guidance

Reasonable grounds for financial advice about IPOs and listed equity securities

Purpose

This guidance explains our approach to applying and enforcing Code Standard 3 of the Code of Professional Conduct for Financial Advice Services (the Code), in relation to financial advice about Initial Public Offerings (IPOs) and listed equity securities. The guidance has this focus because those giving financial advice do not always have access to expert research for IPOs or listed equity securities – in particular, for smaller market capitalisation companies[4].

> *By 'expert research' we mean research published by individuals or teams with the necessary knowledge, experience, and relationships to understand and model the risks, drivers, management and other critical aspects of IPOs and listed equity securities. This research is often, but not exclusively, produced by institutions for their clients ('sell-side' research) and for their own investment teams ('buy-side' research).*

We do not intend to discourage those giving financial advice from giving opinions or recommendations not backed by expert research, as this could result in New Zealanders having less access to financial advice they may otherwise benefit from, and lower levels of interest – and liquidity – in smaller market capitalisation stocks[5].

However, there must be reasonable grounds for all financial advice, including advice given in the absence of expert research. IPOs and listed equity securities (particularly smaller market capitalisation stocks) can have distinctive risks[6] which often require time and direct engagement with the company to identify and assess, to gain an adequate grasp of what the company does, what drives its value, and its capability to manage the risks it faces.

This guidance does not constitute legal advice and is not binding on the Courts or third parties. We encourage you to seek your own professional advice to find out how the Code and legislation discussed, and any other applicable laws, apply to you. It is your responsibility to determine your obligations.

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[4] A guidance note that addressed similar issues in relation to the Code of Professional Conduct for Authorised Financial Advisers was published by the FMA in December 2011. This was withdrawn following a change to that Code in 2014.
[5] Capital Markets 2029 report, Growing New Zealand's Capital Markets 2029, at page 41-42
[6] This is particularly the case for IPOs where there is no share trading history. There is a risk that the share price may settle at a lower rate than investors initially paid, after there has been a period of trading.

In this guidance, the terms “adviser”, “you” and “your” refer to any person who gives financial advice, including financial advice providers, financial advisers and nominated representatives.

Code Standard 3

Code Standard 3 (see Schedule) requires that “[a] person who gives financial advice must ensure that the financial advice is suitable for the client, having regard to the nature and scope of the financial advice.”

The commentary to the standard explains that:

> “Ensuring that the financial advice is suitable for the client should include having reasonable grounds for the financial advice. Reasonable grounds for the financial advice means those grounds that a prudent person engaged in the occupation of giving financial advice would consider to be appropriate in the same circumstances, such as those in relation to:
>
> - any strategy supporting the financial advice
> - any assumptions underlying the financial advice
> - any financial advice product covered by the financial advice
> - the client’s circumstances that are relevant to the financial advice, such as their financial situation, needs, goals, and risk tolerance.”

Consequently, whether financial advice is suitable for the client is context dependent, based on the nature and scope of the financial advice and the circumstances.

Source of research

This guidance is neutral on the source of research used to support reasonable grounds to recommend a financial product.

If an adviser relies on another person’s assessment of an IPO or listed equity security, the adviser should be able to demonstrate that it is reasonable to do so[7]. The person relied on may be a person within the adviser’s financial advice business or a person who is external to that business. In both cases the assessment will need to be made by someone with appropriate experience and capability[8].

Content of research

This guidance does not prescribe the content of research used to support reasonable grounds. Such research does need to be fit for purpose, however. It should also be in writing and documented to a standard the financial advice profession would expect for the nature and scope of the advice and the circumstances.

Research does not need to be excessively long or detailed. But to be fit for purpose it should generally meet the following requirements:

- Describe the company’s activities – why it exists and how it generates cashflow (or intends to do so).

[7] Commentary to Code Standard 3.
[8] An adviser will also need to consider other relevant matters when deciding whether it is reasonable to rely on the assessment, including whether the person making the assessment has any conflict of interest.

- Encompass, quantitatively and qualitatively, the relevant financial and operational aspects of the company, its risks, its value drivers, its outlook, and the quality of its management.

In most cases, a recommendation would be difficult to make on reasonable grounds without being supported by research covering such matters.

Where the adviser has no access to expert research on a company – more common with smaller market capitalisation companies which may not appeal to many investment firms with expert research functions – the adviser may need to do the necessary research (or some of it) themselves (which may be time-consuming for some smaller-capitalisation companies). This guidance does not seek to discourage advisers from this work, providing their research meets the standards for supporting reasonable grounds for financial advice.

Is research always required?

Code Standard 3 does not require research in every situation for the financial advice to be suitable for the client, and there are some situations where research will not be required. The requirement for research (if any) will depend on the nature and scope of the advice and the circumstances.

Much of this guidance deals with an adviser proactively recommending IPOs or listed equity securities to the client. We expect in this situation that generally the adviser will need to access or undertake research to support having reasonable grounds for their advice.

However, there may be situations where research will not be required. For example, we are aware that there are situations where research is not available and having to wait to access or undertake it before providing advice will not be in the client's interests. This is mostly likely to occur where an adviser is being asked for advice on a specific investment a client is contemplating. The adviser will still need to have other information that supports reasonable grounds.

Here are two examples of situations where there are reasonable grounds for advice regardless of the absence of research. They relate to advice given to prevent non-diversified, high-risk investment of life savings; and advice to prevent dilution of an existing investment.

Example one – 'Preventing non-diversified, high-risk investment of life savings'

> A client asks an adviser whether to put all their house sale proceeds into an urgent opportunity to invest in 'micro-cap stock x'. In this situation, the adviser would have reasonable grounds to advise the client **not** to invest even without research. Going ahead would obviously be a bad decision and the client's interests are unlikely to be served by the adviser saying they cannot provide advice as they do not have access to relevant research.

Example two – 'Preventing dilution of existing investment'

A client asks an adviser whether they should take up a discounted rights issue. Even if the issue structure is complex, the client is an existing holder, their holding is small, the price is substantially discounted and taking up their rights will avoid the client's holding being diluted. Without access to research on the company offering the rights issue, the adviser is likely to have reasonable grounds for advising the client to take up their rights. The advice is uncontroversial and, on its face, sensible in the circumstances; having to get research before giving the advice would not be warranted in the circumstances, nor likely to be in the client's interests.

While in these examples the client's interests are served by the adviser making a recommendation without access to research, the adviser would still need to have and be able to evidence other information supporting reasonable grounds for the advice; in each case, by reference to other factors discussed in this guidance.

Time pressures by themselves don't change advisers' obligations. The timetable for an IPO may not provide much time to access or produce 'fit for purpose' research. This does not excuse the requirement to have appropriate research supporting reasonable grounds to proactively recommend an investment in the IPO.

Advisers should also keep the following key principles in mind when giving financial advice about IPOs and listed equity securities. Doing so will help you demonstrate how you meet the requirement to have reasonable grounds for your financial advice.

Key principles

Is the financial advice within the scope of your services and competence?

A person must not give regulated financial advice to a retail client unless the person meets the standards of competence, knowledge, and skill (including any continuing professional development requirements) provided in the Code for giving the advice. Some advice businesses may not have time, capacity, or resources to provide financial advice on more complex types of financial products. In this situation, we would expect the business to make it clear to a client seeking advice on complex financial products that the scope of their services does not cover those products.

Have you applied your professional judgement?

You need to apply cogent reason – not irrational or uninformed factors – to the formulation of your financial advice. Exercise your professional judgement based on your competence, knowledge, and skill. You should be able to explain your reasoning and the factors you took into consideration, and why the grounds for the financial advice you give are reasonable in the circumstances. Research is one input that may support reasonable grounds. If you rely on someone else's assessment of a financial advice product or strategy, you should be able to demonstrate that it is reasonable to rely on their assessment. This also requires the exercise of professional judgement.

Have you considered relevant material information to form a view?

When providing financial advice on IPOs and listed equity securities we expect you, or if relevant another person on whose assessment you rely, to consider certain fundamental information that is publicly available:

Initial public offerings (IPOs)

- The product disclosure statement or PDS (or equivalent overseas disclosure information)
- Information on the register entry (or equivalent overseas disclosure information)

Listed equity securities

- Material information publicly released by the issuer (such as information released as part of the issuer's continuous disclosure obligations)
- Information about the issuer or the equity securities on NZX or other financial product market on which the securities are listed

We do not expect you or the other person to verify the fundamental information.

You will also need to apply your professional judgement to determine what additional information and research is relevant, material, and sufficient to inform your financial advice. You will need to consider, among other things, the nature and features of the financial product, and the risks associated with investment in that product.

Have you considered your client's circumstances to ensure your financial advice is suitable?

Research on a particular financial product has a narrow focus. It only considers the merits and risks of the product itself, not wider aspects of client suitability. Therefore, while product research may help inform your view about suitability, it is not automatically the end of your enquiries. Even if you are relying on expert research, you may still need to consider the financial product, the risks and benefits of investing in the product and the provider of the product, so you can assess whether the financial product is suitable for your client.

To give financial advice that is suitable (including being based on reasonable grounds) you need to consider your client's circumstances that are relevant to the financial advice, such as their financial situation (including, for example, any existing portfolio of investments), needs, goals and risk tolerance.

You need to decide if a detailed analysis is required or if it is reasonable to make assumptions about the client's circumstances based on their particular characteristics. The nature and scope of the financial advice you are giving will determine the extent of the analysis of the client's circumstances that is required.

Particular attention should be given to your client's risk tolerance when selecting a strategy or giving financial advice. For example, advising a client to buy shares in a small or start-up company requires a good understanding of your client's risk tolerance for such financial products and the place these might have in their portfolio. Recommending a portfolio of several smaller market capitalisation companies as a client's sole investment has different risk (and suitability) dimensions than recommending the companies as an addition to an already-diversified portfolio.

If your financial advice is based on an investment strategy, this may help support the suitability of your financial advice. Asset allocation and diversification are important principles of wealth management advice. However, an investment strategy does not preclude the requirement for there to be reasonable grounds for recommending particular individual securities for a portfolio, even in a small allocation.

Have you kept records that show why the advice is suitable for your client?

Financial advice providers must create and maintain adequate records in relation to their financial advice service under licence conditions. These records will need to clearly demonstrate how their advice met Code Standard 3. For example, the records should generally include information on the nature and scope of the advice and the relevant circumstances. Generally, records will also need to refer to any research (or alternative basis) relied on for the advice and clearly explain why there are reasonable grounds for the advice.[9]

Further information

If you have questions about this guidance, you can email us at questions@fma.govt.nz. You can find further information on financial advice regulation on our website. Here are links to information on relevant regulatory requirements:

- Code of Professional Conduct for Financial Advice Services
- Financial Markets Conduct Act 2013
- NZX Participant Rules (relevant for NZX participants)

[9] Standard Conditions for full FAP licences; Record keeping for financial advice providers

Schedule

CODE STANDARD 3 – GIVE ADVICE THAT IS SUITABLE

A person who gives financial advice must ensure that the financial advice is suitable for the client, having regard to the nature and scope of the financial advice.

COMMENTARY

Ensuring that the financial advice is suitable for the client should include having reasonable grounds for the financial advice. Reasonable grounds for the financial advice means those grounds that a prudent person engaged in the occupation of giving financial advice would consider to be appropriate in the same circumstances, such as those in relation to:

- any strategy supporting the financial advice
- any assumptions underlying the financial advice
- any financial advice product covered by the financial advice
- the client's circumstances that are relevant to the financial advice, such as their financial situation, needs, goals, and risk tolerance.

Depending on the nature and scope of the financial advice, a detailed analysis of the client's circumstances may be required or it may be reasonable to make assumptions about the client's circumstances based on particular characteristics of the client.

If the financial advice includes a comparison between two or more financial advice products, the financial advice should be based on an assessment of each product.

A person who gives financial advice may rely on another person's assessment of a financial advice product or strategy. The person giving the financial advice should be able to demonstrate that it is reasonable to rely on the other person's assessment.

Consultation questions

1. Do you think the proposed guidance will help support advisers to provide quality advice on IPOs and listed equity securities, and improve access to advice on these products? Please give reasons for your view.

2. Do you consider that an adviser will generally need to access or undertake research to support having reasonable grounds for advice on IPOs and listed equity securities? Please give reasons for your view.

3. Do you agree that the two examples on pages 4 to 5 of the proposed guidance represent circumstances where research is not available and/or is not needed, but it is still possible to have reasonable grounds for advice on IPOs and listed equity securities? Please give reasons for your view.

4. Please describe any other situations where you consider that research would not be needed to support having reasonable grounds for advice on IPOs and listed equity securities.

5. Do you think that the proposed guidance should be neutral about the source of research used to support reasonable grounds for advice on IPOs and listed equity securities? Please give reasons for your view. If you disagree, please explain what you think the guidance should say about the source of research?

6. Generally, for research to be 'fit for purpose' to support reasonable grounds for advice on IPOs and listed equity securities, does it need to:
   - describe the company's activities – why it exists and how it generates cashflow or intends to do so
   - encompass (quantitatively and qualitatively) the relevant financial and operational aspects of the company, its risks, its value drivers, its outlook, and the quality of its management?

   Please give reasons for your view.

7. Please tell us about any situations where you think that research does <u>not</u> need to meet some or all of the criteria set out in question 6 to be fit for purpose to support having reasonable grounds for advice on IPOs and listed equity securities? Please describe the situations and the research that would instead be required and explain why this would support reasonable grounds for advice.

8. Should research used to support reasonable grounds to recommend IPOs and listed equities generally be in writing and documented to a standard the financial advice profession would expect for the nature and scope of the advice? And if other information is used to support advice on IPOs and listed equites – such as for the examples on pages 4 to 5 – should that information also generally be documented in writing to a standard the financial advice profession would expect for the nature and scope of the advice? Please give reasons for your views.

9. Do you have any other comments on the guidance?

Feedback form

Consultation paper: Proposed guidance on reasonable grounds for financial advice about IPOs and listed equity securities

Please submit this feedback form electronically in both PDF and MS Word formats and email it to us at consultation@fma.govt.nz with 'Feedback: proposed guidance on reasonable grounds for financial advice about IPOs and listed equity securities: [your organisation's name]' in the subject line. Thank you. **Submissions close on 5 August 2022.**

Date: Number of pages:

Name of submitter:

Company or entity:

Organisation type:

Contact name (if different):

Contact email and phone:

Question number	Response

Feedback summary – *if you wish to highlight anything in particular*

Please note: Feedback received is subject to the Official Information Act 1982. We may make submissions available on our website, compile a summary of submissions, or draw attention to individual submissions in internal or external reports. If you want us to withhold any commercially sensitive or proprietary information in your submission, please clearly state this and note the specific section. We will consider your request in line with our obligations under the Official Information Act.

Thank you for your feedback – we appreciate your time and input.