Disclosure framework for integrated financial products

This guidance note is for issuers of financial products that incorporate non-financial factors.

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This note gives guidance on the advertising and disclosure expectations of the Financial Markets Authority in respect of financial products that incorporate non-financial factors.

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TĀTAI HOKOHOKO
AOTEAROA - NEW ZEALAND

About FMA guidance

Our guidance:

- explains when and how we will exercise specific powers under legislation
- explains how we interpret the law
- describes the principles underlying our approach
- gives practical examples about how to meet obligations.

Guidance notes: provide guidance on a topic or topic theme. We sought industry feedback via our public consultation paper Proposed guidance on green bonds and other responsible investment products in October 2019.

The consultation sought issuer and investor input on green bonds and other responsible investment products that expressly take into account environmental, social, and/or governance considerations.

We have taken into account the submissions received in developing this guidance for issuers.

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

You might also like to check the reports and papers on our website. For example, our monitoring reports describe actual practice we are seeing and our comments on this.

Contents

Integrated financial products	**4**
Supporting transition to an integrated financial system	4
Purpose	5
A principles-based approach	6
Fair dealing provisions	**7**
Broad application	7
It is the overall impression that counts	8
Omissions can be confusing or misleading	8
Substantiate your claims	8
Disclosure expectations	**9**
Framework	9
Example – green bonds	14
Enforcement	**15**

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Integrated financial products

Supporting transition to an integrated financial system

The Financial Markets Authority (FMA) is committed to supporting New Zealand's transition to an integrated financial system that looks beyond financial returns and incorporates consideration of non-financial factors[1].

The FMA's strategic priorities, in particular trust and confidence in capital markets, and investor and customer decision-making, directly align with our support for the transition to an integrated financial system.

An integrated financial system requires organisations to consider the impact of their activities on the environment, communities and individuals, alongside traditional financial factors. Although not the focus of this guidance, an integrated financial system will also require organisations to identify natural, social and human capital risks and opportunities for their businesses, and to disclose how these will impact the organisation's financial performance alongside financial returns. This, for example, will be the focus of the climate related financial disclosure requirements[2].

The global transition to an integrated financial system (see diagram opposite) is reflected in an increase in investor demand for financial products that look beyond financial capital by integrating non-financial factors (such as environmental, social and human capital impacts)[3].

This guidance collectively refers to financial products that incorporate non-financial factors alongside financial factors as 'integrated financial products'. These integrated financial products typically take one of two forms:

- **debt securities** such as 'green bonds', which fund projects or organisations claiming positive environmental impacts; or
- **managed investment products** (including some KiwiSaver funds) claiming non-financial impacts.

Our choice of the term 'integrated financial product' reflects that other terms for the concept, while commonly used, do not have commonly shared meaning (including the terms 'ethical', 'responsible'[4], 'sustainable', 'green' and Environmental, Social and Governance (ESG)).

As demand for these types of financial products grows, we want to ensure that investors can be confident these products deliver what they promise and that investors are protected from poor product design and confusing or misleading disclosure and marketing (i.e. greenwashing).

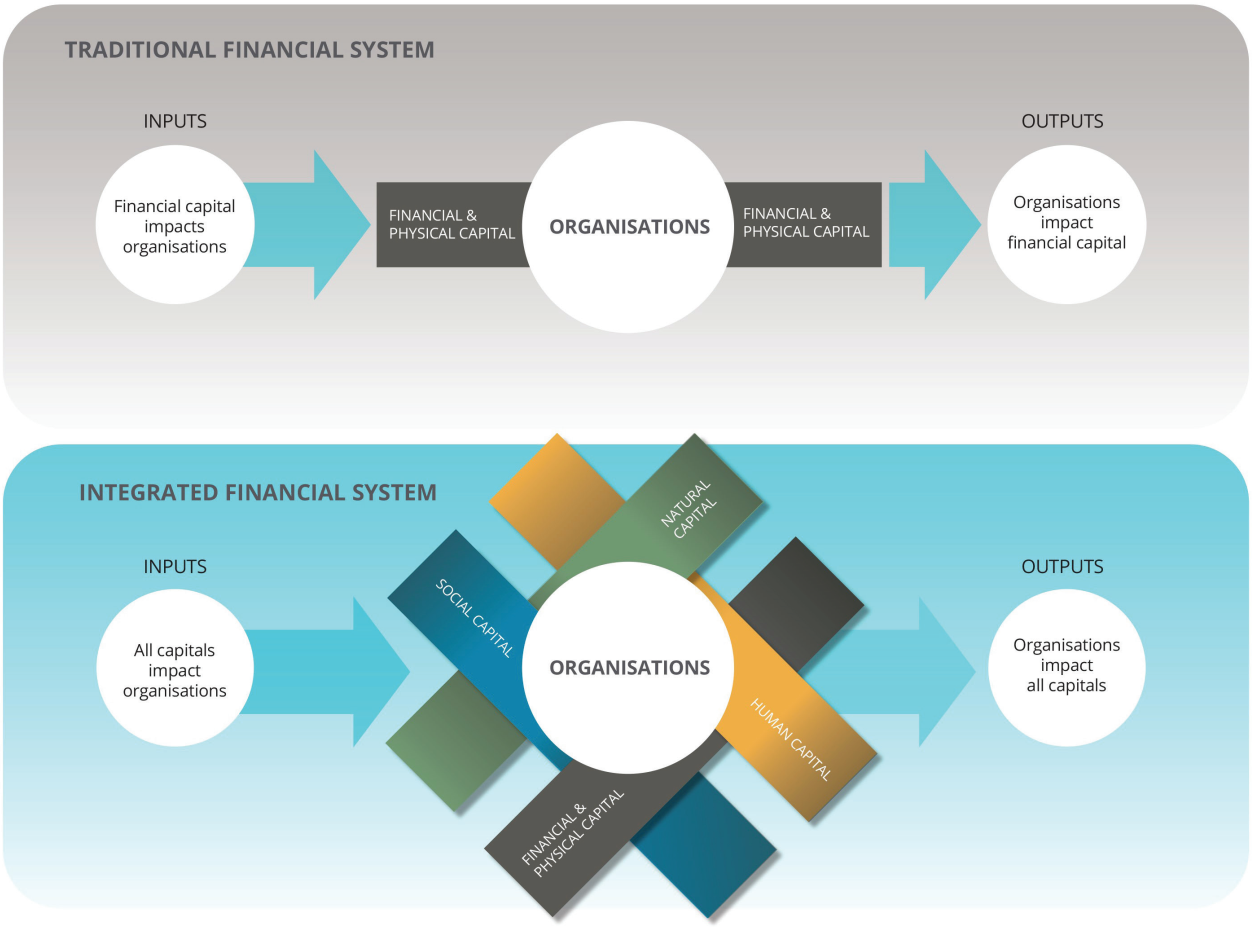
1: The Treasury's Living Standards Framework describes these non-financial factors as natural, social, and human capitals (in addition to traditional financial and physical capital).

2: In August 2020, Cabinet made policy decisions to amend the Financial Markets Conduct Act 2013 to introduce mandatory (comply or explain) climate-related financial disclosures for some organisations. Following the Parliamentary process, these disclosures will be required from 2023 at the earliest.

3: One such example is the decision by the Minister of Finance and Minister of Commerce and Consumer Affairs to require KiwiSaver default funds to exclude investments in fossil fuel production and illegal weapons.

4: The term 'responsible investment' is used in the KiwiSaver Act 2006.

Traditional financial system transitioning to an integrated financial system



Purpose

The purpose of this guidance is to outline for issuers of integrated financial products:

- the principles underlying our approach to confusing or misleading advertising and disclosure;
- a disclosure framework aimed at ensuring investors have a clear and holistic understanding of what they are being offered, including associated risks and costs;
- our approach to taking enforcement action against advertising and disclosure that is confusing, misleading or that otherwise falls short of legal requirements.

A principles-based approach

Integrated financial products face common challenges in terms of disclosure. Ultimately, the purpose of disclosure is to aid decision-making by investors. By their nature, financial products that incorporate any non-financial factors need additional explanation for investors. Issuers need to fully explain the features of the product that are important to their investors and also avoid 'greenwashing', or selling the product on the basis of misleading labels and hype.

We have decided to take a holistic view of integrated financial products, rather than focusing on specific terms or categories of non-financial capital (such as ethical, responsible, socially responsible, sustainable, impact or green etc.). This guidance sets out broad principles that issuers should consider when designing disclosure, which can be applied to all integrated financial products.

Market practices and investor expectations are both evolving in this area. For this reason we think it is more useful to set out broad principles to guide disclosure for any type of integrated financial product, rather than seeking to categorise and prescribe terms for different products. This approach will encourage further innovation, which could be constrained by a more prescriptive approach.

We consider that a principles-based approach provides flexibility for issuers to describe the unique features of their products, while also requiring a focus on the objective of disclosure, which is to help investors to make informed investment decisions.

We acknowledge that prescriptive definitions and taxonomies of integrated financial products would provide certainty by setting concrete parameters and establishing clear standards for issuers and investors. However, we consider that such an approach would not adequately capture the subjective nature of non-financial factors and would need to be constantly updated to reflect changing values and attitudes as societal norms and expectations evolve.

Fair dealing provisions

Conduct is at the core of the Financial Markets Conduct Act 2013 (FMC Act). Central to the FMC Act are the fair dealing provisions in Part 2, which set out the standards of behaviour that those operating in the financial markets must comply with.

These provisions require 'fair dealing' in relation to all financial products and services. They prohibit:

- misleading or deceptive conduct, including conduct that is likely to mislead or deceive;
- false, misleading or unsubstantiated representations;
- offers of financial products in the course of unsolicited meetings.

Additionally, under Part 8 of the FMC Act, the FMA may use a stop order in various circumstances, including to stop or prevent advertising or disclosure that confuses, or is likely to confuse, consumers or investors, on matters that influence investment decisions. For example, the FMA could issue a stop order to require an issuer to cease offering financial products, if the FMA was satisfied that content in the Product Disclosure Statement (PDS) is 'likely to confuse' investors.

A key difference between the fair dealing provisions and the stop order provisions is the reference to disclosure that is 'likely to confuse' – this is a lower threshold than 'likely to mislead'.

The enforcement section on page 15 outlines other situations where the FMA can use a stop order and provides further information on other enforcement options available (e.g. direction orders). The purpose of noting stop orders in this section is to highlight the different threshold to the fair dealing provisions.

The following principles underpin the fair dealing and stop order provisions, and inform the FMA's approach to enforcing confusing or misleading advertising and disclosure for integrated financial products.

Broad application

The fair dealing provisions apply widely with few exceptions, including to conduct both inside and outside of New Zealand:

- relating to financial products (i.e. debt securities, equity securities, managed investment products or derivatives) regardless of whether the person engaging in the conduct is licenced or authorised by the FMA or whether those products are aimed at retail or wholesale investors; and
- relating to financial services (as defined in section 5 of the Financial Service Providers (Registration and Dispute Resolution) Act 2008), with the exception of being a creditor under a credit contract (which is covered by equivalent provisions under the Fair Trading Act), regardless of whether the person engaging in conduct is registered on the Financial Service Providers Register or licensed or authorised by the FMA, or whether the financial services are aimed at retail or wholesale investors.

Persons 'involved' in conduct relating to a financial product or service may also be liable under the fair dealing provisions, even if they did not directly engage in any misleading or deceptive conduct themselves. For example, directors and senior managers of a provider offering financial products or services can be liable for misleading conduct carried out by the provider if they aided, induced, or otherwise were directly or indirectly a party to the misleading conduct.

It is the overall impression that counts

Whether conduct or disclosure is likely to mislead or confuse depends on the overall impression as perceived by the investor. This means that:

- conduct and disclosure that is likely to mislead or confuse, without actually being misleading or confusing, is sufficient to breach the fair dealing or stop order provisions;
- whether or not the conduct or disclosure was intentionally misleading or confusing is irrelevant;
- relatively complex financial products (such as integrated financial products) or services can be more likely to confuse and mislead compared to standard 'vanilla' or simpler financial products and services;
- investors and consumers who are vulnerable due to personal circumstances are more susceptible to being misled or confused; and
- representations that are true and verifiable in isolation may nonetheless leave a confusing or misleading overall impression. This may be the case where material information or qualifications to the representation (e.g. exceptions to an exclusions policy) are in fine print.

Omissions can be confusing or misleading

Confusing or misleading conduct extends beyond positive actions or positive statements – it also includes omissions. An omission can be either deliberate or inadvertent. Therefore, it is not a defence to 'do or say nothing' if silence or partial disclosure (e.g. cherry-picking) is likely to leave an overall misleading or confusing impression on the consumer.

Substantiate your claims

The fair dealing provisions generally require representations to be substantiated, although some exceptions exist (such as for representations in a disclosure document or a register entry). Substantiation requires having a reasonable basis at the time the representation is made. Anecdotal evidence, unsupported opinions and/or assumptions do not constitute a reasonable basis. We are particularly interested in representations regarding the nature, suitability and characteristics of an integrated financial product.

A representation that was unsubstantiated at the time it was made will remain unsubstantiated, even if the representation turns out to be true or is subsequently substantiated.

Disclosure expectations

The framework below outlines the type of disclosure we expect from issuers of integrated financial products, which should align with the principles outlined in the previous section. In particular, in the context of a regulated offer, we consider the type of disclosure outlined in the framework below would likely constitute material information and, as such, *require* disclosure. Accordingly, for regulated offers, we would expect issuers of integrated financial products to include the types of disclosure below in their PDS or on the register (unless such disclosure is clearly not material).

For managed investment schemes, some of this information is likely to be in the Statement of Investment Policy and Objectives (SIPO) lodged on the register, given that the SIPO should be a complete, standalone picture of the investment policy and objectives of the managed investment scheme.

Where word counts or page limits are too restrictive to allow this expected disclosure in the PDS, a link should be provided to where this other material information can be accessed, both on the register (as required by the Financial Markets Conduct Regulations 2014) and ideally also on the issuer's website (which may be more accessible for some investors).

While the below framework focuses on products, issuers should note each requirement will also apply in full where an issuer uses labels to describe its broader investment philosophy or strategy, and/or its overall corporate approach.

Framework

Type of disclosure	Explanation and examples
The standard 'vanilla' elements of the integrated financial product	Underlying each integrated financial product are features of a standard 'vanilla' financial product. It is important for investors to understand the purpose of the offer and what their money is being invested in. This includes: • for a debt security or equity security, the nature of the underlying assets being funded (e.g. is it a specific asset, unallocated across the full balance sheet of the issuer, or a special purpose vehicle for a specific project?); • for a managed investment product such as interests in a KiwiSaver fund, the nature of the underlying investments that may and may not be made.
What does the integrated financial product purport to offer beyond a standard financial product?	The purpose of this disclosure is to outline the specific non-financial features of the integrated financial product that differentiate it from a standard financial product. This allows investors to understand the basis for the marketing label and provides an opportunity for the investor to assess whether the criteria aligns with their expectations.

<table>
<tr><th>Type of disclosure</th><th>Explanation and examples</th></tr>
<tr><td></td><td>What specifically justifies the label the issuer has attached to the integrated financial product? Evidence and support for the label may be required to avoid breaching the fair dealing provisions by making unsubstantiated representations.
Is the label confusing or misleading due to exceptions that are only noted in fine print (e.g. exceptions to exclusions)? As noted above, it is the overall impression that counts. For example, to say “We say no to fossil fuels” with a footnote to explain exceptions to this statement is very different to “We limit our exposure to fossil fuels” with a footnote to elaborate.
Outlining the specific non-financial features of the integrated financial product could include describing whether the integrated financial product is intended to achieve a particular non-financial outcome or whether it is a screening product. For example:
An outcome-focused integrated financial product could be aimed at reducing CO_2 by a certain amount by a particular date.
A screening product could be a managed investment product of a managed investment scheme that excludes certain investments based on ethical criteria, or only includes investments that meet a specific set of non-financial criteria.</td></tr>
<tr><td>Measurement and evidence of non-financial performance</td><td>To hold issuers accountable, the non-financial outcomes that integrated financial products aim to achieve should be measured and reported on. This could include:
the specific intended outcome;
the timeframe for the outcome to be achieved;
explanation of how progress (or lack of progress) against that outcome will be measured;
evidence of progress against that outcome.
Similarly, issuers of financial products designed to screen out certain investments or only invest in particular investments need to include details such as:
the initial eligibility criteria for exclusion or inclusion in the investable universe;</td></tr>
</table>

Type of disclosure	Explanation and examples
	• the ongoing criteria, if different to the initial criteria; • any exceptions to the criteria, such as a certain percentage of the portfolio being allowed to fail the eligibility criteria, targeted percentage allocations, or non-breach thresholds; • disclosure of the entire investment portfolio to evidence adherence to the criteria (or otherwise), or an explanation of why this is not possible. In all cases, the issuer should explain (and substantiate) why the intended outcomes of their integrated financial product are beneficial to investors. These benefits could include: • reduced risk; • more stable or diversified returns; • purely non-financial outcomes (e.g. the return on an impact product is 100% the impact with negligible or no financial return); • purely ethical outcomes (e.g. the issuer simply believes it is 'not right' to invest in tobacco, and avoiding such investments is the benefit for those sharing that view).
Governance framework	This allows investors to understand the extent of oversight from the board of directors in respect of the non-financial claims made by the issuer, and the controls and processes implemented by management. Possible disclosure themes include: • Does the board attest to adhering to an integrated financial products policy (whether captured within the SIPO or in a separate policy document) and, if so, how often is this attestation made? • What is the procedure when a breach of the policy is identified (e.g. inadvertent inclusion of an investment that should have been excluded, purported outcome not eventuating, use of proceeds not allocated correctly)? What are the consequences of a breach of the policy? • When was the policy last reviewed? What were the outcomes of the review or amendment? • How frequently is the policy reviewed?

Type of disclosure	Explanation and examples
Internal audit or external assurance provided	An issuer may engage its internal audit function or obtain external assurance services for its integrated financial product. Some external reviewers may provide endorsements through certification or membership services. It is important for issuers to explain why these services have been obtained and their appropriateness for the purposes of advertising their integrated financial product. Possible disclosure topics include: • What does the internal function or external service purport to do and what does the resulting assurance, certification or membership mean for the investor? For example, is it an endorsement? An unenforceable commitment to adhere to certain standards? • Why was this particular internal function or external provider selected to provide assurance, certification or membership services? • What was the process undertaken by the internal function or external provider? • When does the assurance, membership or certification expire, and what are the implications of expiry? • Will the issuer remove reference to the external provider if the issuer or product fails to meet the external provider's criteria? If not, why not?
Risks or costs associated with the integrated financial product	Compared to standard financial products, integrated financial products may have different risks that need to be considered and understood by investors. Issuers should explain this to investors. Possible disclosure topics include: • If there are non-financial outcomes being sought (e.g. reducing CO_2 emissions by a certain date), what is the risk of these outcomes not eventuating, and what are the implications of failure to achieve the outcomes? • What are the financial performance implications (positive or negative) of integrating non-financial factors into the investment decision (e.g. due to reduced investment universe, competing traditional quantitative financial analysis and non-financial factors)? What is the basis for this?

Type of disclosure	Explanation and examples
	• What are the fee implications due to integration of non-financial factors into the investment decision, such as additional external assurance costs, additional operational costs, extra fees due to non-financial analysis? • What is the risk of the integrated financial products policy (whether captured within the SIPO or in a separate policy document) being breached and therefore investor funds not being allocated as intended or expected, and what would be the resulting implications?
Consequences of failure	Issuers must let investors know whether there are any consequences for the product not achieving its non-financial outcomes (e.g. the product loses its green certification or otherwise doesn't deliver the promised outcome), and the options for holding the issuer to account if outcomes are not delivered. If there is a breach of the integrated financial product policy (whether captured within the SIPO or in a separate policy document), the issuer should disclose what the breach was, the extent of the breach, consequences of the breach and what is being done to remedy the breach. Depending on the context and the nature of the integrated financial product, consequences may include: • no consequences whatsoever (if so, why not?); • a sale position within a prescribed timeframe or a limit break; • a redemption or return of funds to the investor. Disclosure should also cover: • Whether the issuer will remove the non-financial label when referring to the integrated financial product if a breach occurs, to avoid misleading or confusing investors. If not, why not? • Does the investor have any redress?

Example – green bonds

Green bonds are one example of an integrated financial product. The points below show how the disclosure framework could be applied specifically to green bonds – this could also apply to other types of labels (e.g. 'socially responsible' funds or 'sustainability' bonds).

- What is the basis for this issuance being labelled 'green'?
- Does the 'greenness' relate to a specific asset or project, and if so how does that relate to the overall greenness of the issuer? Or does the greenness derive from the core activity of the business? This distinction is important because it distinguishes between a bond being labelled 'green' and the issuer of the bond being a 'green' entity itself – this is a material distinction.
- Is anything preventing the issuer from trading away this greenness, for example, through the use of derivatives or other contracts or arrangements such as virtual asset swaps or contracts for difference, or the sale of emissions units or carbon offsets?
- What would constitute a loss of green status, and what would be the implications? For example, is there any contractual right of review or repayment, or any limitation on the redeployment of funds to different projects? If not, why not?
- Are 100% of proceeds (or other prescribed percentage) ring-fenced to green uses? If not, explain how this does not compromise the green claim or use of 'greenness'.
- Are bond obligations 100% (or other prescribed percentage) funded by green sources?
- What are the criteria for a source or use to constitute 'green'?
- How do you measure 'greenness' and your success against this measurement?
- Specifics on the use of proceeds, including amounts dedicated to each use.
- Is there any independent assurance of the green claim? If yes, what are the criteria? If not, why not?
- How is this different to previous issues that did not have the green label?

Readers may also find our information sheet on the application of the same class exclusion to green bonds relevant.

Enforcement

The FMA has a variety of enforcement options available to address false, misleading, deceptive or confusing behaviour. The action taken will depend on the severity of misconduct and the risk of harm.

For example, there may be instances where engagement and amendment through dialogue is sufficient to address a breach. In other cases a formal feedback letter, or issuance of a public warning, stop order or direction order may be more appropriate. If poor practices appear widespread we may publish a monitoring report to help educate the market.

A stop order can be issued in some circumstances where the spread of information is likely to confuse investors on material matters (i.e. matters that would influence a reasonable investor's decision to invest in the financial product or obtain financial services). A stop order is required to be published, and prohibits the issuer from continuing the relevant activity, to protect investors and the integrity of the market. For example, we can issue a stop order to prevent or stop the issuer of a financial product from:

- distributing a PDS, other disclosure document or advertisement (including keeping its website up);
- continuing to offer a financial product;
- accepting applications or deposits from customers for a financial product.

Failure to comply with a stop order can result in a fine of up to $300,000.

If we consider it is in the public interest to do so, we may issue an interim stop order while we consider the grounds for a stop order.

Another relevant regulatory tool available to the FMA is direction orders. We can make a direction order where it is likely there will be a contravention of the Part 2 fair dealing provisions (among various other provisions). Whereas a stop order is to stop behaviour, a direction order is intended to modify behaviour by directing compliance or stipulating specific steps that must be taken (e.g. amending website content as opposed to taking the website down).

More serious breaches may result in the FMA taking court action.

The fair dealing provisions are civil liability provisions. This means the courts, following an application from the FMA, have the discretion to issue civil liability orders, such as a pecuniary penalty order or compensatory order, for a breach of the fair dealing provisions. In addition, civil liability orders can be made against not just the person in contravention, but also against those involved in the contravention. The aim is both to sanction the issuer for its misleading conduct and, where necessary, to seek redress for affected parties.

For more information on the enforcement options available to the FMA, please refer to our Regulatory Response Guidelines.

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