The problem of 'adverse selection' in the (proposed) regulation of financial advice in New Zealand

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Abstract - This paper considers the changes to the current regime for the regulation of financial advice in New Zealand contained in the (draft) Financial Services Legislation Amendment Bill. It critically examines the regulatory strategies that have been deployed and how the new rules may help consumers to overcome asymmetric information and limitations in their own decision making capacity. Special emphasis is placed on the main conduct of business obligations that address the perceived imbalance in the relationship between financial advisers and their clients and in particular on the measures designed to deal with remuneration-based risks.

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1. Introduction

In a recent collection of essays in search of the "latest batch of hypothetical conjecture for signs of the next surprises about to upend conventional wisdom", The Economist presented a number of scenarios that have no chance of actually happening but which nevertheless throw intriguing light on the world and ways to think about it.[1] One of such hypotheticals titled "If Advisers Followed a Fiduciary Rule – Honest Brokers'" at first observes that while 'putting clients first' ought to be the principle underlying the provision of investment advice, there is a long history of investors being recommended to buy high-charging products when cheap alternatives are available. It then asks: "what would the world be like if all those in positions of responsibility had to follow the fiduciary rule?"[2]

The aim to eliminate, or at least expose, conflicts of interest, such as when advisers get paid more to recommend one product than another has been at the hearth of an intense debate among regulators, policy makers and academics internationally for more than twenty years. It eventually became part of the New Zealand law reform agenda in 2005,[3] leading to the enactment of the Financial Advisers Act 2008 ('FA Act') and the Financial Service Providers (Registration and Dispute Resolution) Act 2008 (FSP Act).[4] The two Acts introduced for the first time in New Zealand professional standards on financial advisers to be accountable for their advice in compliance with minimum conduct obligations and rules to improve access to redress by requiring those who provide advice to retail consumers to belong to a dispute resolution scheme.

While the FA Act and FSP Act still provide the fundamental regulatory regime for financial advice in New Zealand, they will soon be repealed by the enactment of the Financial Services Legislation Amendment Bill (FSLA Bill), which has been introduced to Parliament (Draft FSLA Bill[5]) as the product

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[1] The Economist, 'The World If – The Joy of Hypotheticals', 13 July 2017, available at https://www.economist.com/news/leaders/21724957-introduction-economists-latest-collection-essays-ask-what-if-joy (accessed 30 August 2017).

[2] The Economist, 'If Advisers Followed a Fiduciary Rule – Honest Brokers', 13 July 2017, available at http://worldif.economist.com/article/13521/honest-brokers (accessed 30 August 2017).

[3] Originated from a report submitted by the Taskforce on Financial Intermediaries 'Confidence, Change and Opportunity' (July 2005), appointed by the Minister of Commerce in October 2004 to consider and report on the regulation of financial intermediaries in New Zealand, available at http://www.goodreturns.co.nz/pics/cab-20051212.pdf, accessed (30 August 2017). The Taskforce did not consider the financial advice sector to be in crisis and it recommended a system of co-regulation between the then New Zealand Securities Commission (now the FMA) and professional bodies. This regulatory model changed significantly in the course of the policy development and legislative stages when it was abandoned in favour of direct regulation by FMA.

[4] While the FA Act came into effect on 1 July 2011, financial advisers were required to register under the FSP Act as from 1 April 2011. The enactment of the Financial Markets Conduct Act 2013 (FMC Act) introduced new disclosure and governance regimes for financial products and some financial services in New Zealand and brought to changes to the FA Act, including to the definitions of financial products and wholesale clients, and to the regulation of discretionary investment management services (DIMS).

[5] The Draft FSLA Bill is available at http://legislation.govt.nz/bill/government/2017/0291/latest/DLM7386310.html?search=ts_act%40bill%40regulation%40deemedreg_financial+services+legislation_resel_25_a&p=1 (accessed 30 August 2017) and the accompanying Cabinet paper is available at http://www.mbie.govt.nz/publications-research/publications/business-law/financial-services-legislation-amendment-bill-approval-for-intro.pdf (accessed 30 August 2017).

of a comprehensive review of the current legal framework[6] carried out by the Ministry of Business, Innovation and Employment (MBIE) pursuant to the statutory review requirements contained in the FA Act and FSP Act.[7]

This paper does not offer a detailed commentary of the Draft FSLA Bill, but it uses the hypothetical conjecture posed by The Economist to critically discuss the main conduct of business obligations that will (likely) be put in place in New Zealand. In particular, the inquiry examines how mis-selling risks and conflicts of interest impact the quality of advice received by investors and the regulatory response in New Zealand. Special emphasis is placed on conflicts of interest in relation to intermediary remuneration structures and incentives. The economic roots of the problem are well known. Not all investors are able to afford an independent advice and, even when they can afford to pay, they may rationally decide not to do (or possibly decide to significantly discount its value) because of the 'adverse selection problem' they face in choosing a financial adviser (and relying on the advice) as a consequence of asymmetries of information and behavioural biases. Common practice has offered a way to ameliorate this problem by introducing commission-based advisers who do not charge fees on the investors at the point of use of their services, but are rather remunerated through commissions paid by the financial products suppliers whose products investors select upon the adviser's recommendation. While this practice allows (at least partially) to address the 'adverse selection problem' mentioned above, the advice provided under such circumstances is inherently biased by a conflict of interest.

The structure of this paper is as follows. Paragraph 2 provides the general context, describing the essential features of the regulation of financial advisers in New Zealand and the proposed changes contained in the Draft FSLA Bill. Paragraph 3 introduces to the subject matter of the paper. In particular, it discusses how financial advice can help investors to overcome asymmetric information and limitations in their own decision making capacity, but it also points out how its effectiveness can be jeopardized by the 'adverse selection problem'. A minimal acquaintance with the economic justification for regulating investment advice is essential for the scope of this paper. It is only from understanding that economic background that it is possible to give meaning to the legal discussion on (and critically engage with) the regulation of conflicts of interest in relation to intermediary remuneration and incentives. Paragraph 4 grounds the economic inquiry into the regulatory discussion, focusing on the Draft FSLA Bill in the light of the legislation currently in force, but it also

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[6] See MBIE *Review of the operation of the Financial Advisers Act 2008 and the Financial Service Providers (Registration and Dispute Resolution) Act 2008 Final Report* (2017), available at http://www.mbie.govt.nz/publications-research/publications/business-law/Final%20report%20on%20the%20review%20of%20the%20FA%20and%20FSP%20Acts.pdf (accessed 30 August 2017). The review involved the release in 2015 of an *Issues Paper* to seek feedback on the fundamental concerns with the regime (available at http://www.mbie.govt.nz/info-services/business/business-law/financial-advisers/review-of-financial-advisers-act-2008/pdf-document-library/final-issues-paper-20-may-2015.pdf - accessed 30 August 2017) and later in time of an *Options Paper* (available at http://www.mbie.govt.nz/info-services/business/business-law/financial-advisers/review-of-financial-advisers-act-2008/options-paper/options-paper-consultation/options-paper.pdf - accessed 30 August 2017), which outlined opportunities for addressing a number of problems impeding the functioning of the FA Act and FSP Act.

[7] FA Act s 161 (review the operation of the FA Act since its commencement and prepare a report on the review for the Minister of Commerce and Consumer Affairs, including recommendations on whether any amendments to the FA Act are necessary or desirable, by July 2016) and FSP Act s. 45 (review the operation of Part 2 of the FSP Act since its commencement and prepare a report on the review for the Minister of Commerce and Consumer Affairs, including recommendations on whether any amendments to Part 2 of the FSP Act are necessary or desirable, by August 2015).

compares the New Zealand legal framework against the authoritative benchmark offered by existing conduct of business rules in the US and in the EU. Paragraph 5 concludes.

2. The New Zealand regulatory framework

As suggested above, the regulatory regime for financial advice in New Zealand is currently based on the FA Act and FSP Act. A rapid overview of that regime is helpful to explain the proposed changes contained in the Draft FSLA Bill and its connections with the review process carried out by MBIE in the past two years.

The overarching purpose of the FA Act is 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.[8] It is structured around the concept of financial adviser services (i.e. financial advice,[9] investment planning service[10] and discretionary investment service[11]) and distinguishes the requirements for providing a financial advice on the basis of the type of financial product,[12] on whether the client is retail or wholesale[13] and on whether the advice is personalized or not.[14] Moreover, financial advice, subject to registration under FSP Act[15] and a number of possible exemptions,[16] can be provided by three fundamental different types of advisers: Registered Financial Advisers (RFAs),[17] Authorized Financial Advisers (AFAs),[18] Qualifying Financial

[8] FA Act s. 3.

[9] I.e. when a person makes a recommendation or gives an opinion in relation to acquiring or disposing of a financial product – see FA Act s. 10.

[10] I.e. the design of a plan for an individual based on an analysis of their current and future overall financial situation, and identification of their investment goals, including a recommendation or opinion on how to realise them – see FA Act s. 11.

[11] I.e. any service in which the provider decides which financial products (as defined under FA Act s. 5) to acquire or dispose of on behalf of and authorised by their client – see FA Act s. 12.

[12] The FA Act distinguishes financial products into Category 1 and Category 2 products. Category 1 products are riskier or more complex products and therefore advice on these products is subject to higher regulatory requirements (e.g. equity securities and KiwiSaver funds). Category 2 relates to financial products that have been assessed as being lower risk or less complex (e.g. insurance products, credit contracts and many savings products) and subject to lower regulatory requirements – see FA Act s 5.

[13] Most of requirements in the FA Act only apply to financial adviser services provided to retail clients (i.e. a client who is not a wholesale client – FA Act s. 5B). Wholesale clients are clients who, due to their assets, size or sophistication, are regarded to be able to effectively choose a financial adviser without regulatory assistance – FA Act s. 5C.

[14] While a personalised advice takes into account the client's particular financial situation or goals and is subject to tight regulatory restrictions, 'class service' is an advice that does not come under the definition of a personalised financial service (FA Act s. 15). The reason for the distinction is that someone receiving personalised advice has a reasonable expectation that his circumstances have been taken into account by the adviser and that such assessment involves a higher level of skill and competence.

[15] FSP Act s. 13.

[16] Some persons are exempted from the requirements of the FA Act regime (e.g. lawyers and accountants are exempt from the application of the FA Act to the extent that they provide a financial adviser service or broking service in the ordinary course of their business) – see FA Act s. 15 and Financial Advisers (Definitions, Voluntary Authorisation, Prescribed Entities, and Exemptions) Regulations 2011. The rationale for the exemptions is based on the fact that these professions are already subject to tight regulatory oversight, and there would not be any sensible economic benefit in requiring another layer of regulatory compliance with the FA Act.

[17] i.e. individuals who have registered on the Financial Service Providers Register to provide a financial adviser service but have not been authorised by the FMA. The term is not expressly used in the definition under FA Act s. 16 (b).

Entities advisers (QFEs).[19] Disclosure obligations apply only to personalised services to retail clients,[20] must not be misleading, deceptive or confusing[21] and vary significantly in accordance to the different types of financial advisers in accordance with the rules set out in the Financial Advisers (Disclosure) Regulations 2010. All financial advisers are also subject to certain conduct obligations,[22] but AFAs must also comply with the Code of Professional Conduct for Authorised Financial Advisers (the Code of Conduct), which sets out minimum standards of ethical behaviour, client-care, competence, knowledge and skills, and for continuing professional training.[23] Similar provisions are provided for QFEs under the FMA Standard Conditions for Qualifying Financial Entities (Standard Conditions).[24]

The MBIE review of the FA Act and FSP Act[25] highlighted a number of problems with the existing regime for financial advice suggesting that some types of advice were not provided,[26] the quality of advice was often suboptimal,[27] it was unnecessarily complex[28] and compliance costs were unbalanced.[29] In the light of these concerns, in November 2016 the New Zealand Government[30]

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[18] A person registered on the Financial Service Providers Register and authorised by the FMA – FA Act s. 16 (a).

[19] Individuals who are not personally registered and authorised but who are employee of an entity registered under the Financial Service Providers Register and with QFE status (in compliance with the eligibility criteria pursuant FA Act s.66) - FA Act s. 16 (c).

[20] FA Act s. 21.

[21] FA Act s. 27.

[22] All financial advisers must exercise the care, diligence and skill that a reasonable financial adviser would exercise in the same circumstances (taking into account a number of requirements expressly provided in the legislation - FA Act s.33), not engage in misleading or deceptive conduct (FA Act s. 34) or advertise a financial adviser service in a way that is misleading, deceptive or confusing (FA Act s. 35).

[23] FA Act s. 37 and FMA *Code of Professional Conduct for AFAs* (December 2016), available at https://fma.govt.nz/assets/Code-of-Professional-Conduct-for-AFAs/Code-of-Professional-Conduct-for-AFAs.pdf (accessed 30 August 2017). The Code of Conduct is set and developed by a Code Committee, whose members are appointed by the FMA. The FMA monitors AFAs' compliance with the Code of Conduct and with the general conduct provisions set out in the FA Act.

[24] FA Act s. 67 and FMA *Standard Conditions for Qualifying Financial Entities* (QFEs) (June 2015) (available at https://fma.govt.nz/assets/Compliance-section/Standard-conditions-and-explantory-notes-AFA-2015.pdf (accessed 30 August 2017).

[25] MBIE, *Review of the operation of the Financial Advisers Act 2008 and the Financial Service Providers – Final report (Registration and Dispute Resolution) Act 2008* (July 2016), available at http://www.mbie.govt.nz/publications-research/publications/business-law/Final%20report%20on%20the%20review%20of%20the%20FA%20and%20FSP%20Acts.pdf (accessed 30 August 2017) 39-51.

[26] E.g. the availability of 'personalized advice' was limited and there were barriers to the provision of robo-advice (automated advice provided online).

[27] While commissions and remuneration structures were not regulated, different types of advisers were held to different standards of competence despite providing some of the same types of advice.

[28] Terminology and definitions in the FA Act were regarded to be confusing and disclosure documents unwieldy.

[29] E.g. some businesses were licensed at a firm level (QFEs), while some individual advisers were required to be individually authorised (AFA).

[30] Office of the Minister of Commerce and Consumer Affairs - Cabinet Economic Growth and Infrastructure Committee, *Improving Access to Quality Financial Advice: Recommendations to Amend the Financial Advisers Act 2008 and Financial Service Providers Act 2008* (November 2016), available at http://www.mbie.govt.nz/publications-research/publications/business-law/Cabinet%20Paper%20-%20Improving%20Access%20to%20Quality%20Financial%20Advice.pdf (accessed 30 August 2017) - the changes represent a shift away from the current regime which sought to professionalise a subset of advisers, towards a regime which establishes a level playing field of regulation for all who provide advice..

decided to make changes to improve access to quality financial advice for all New Zealanders, without imposing any undue compliance costs on industry. In August 2017 the Draft FSLA Bill was introduced to Parliament with the purpose to ensure "that financial services are provided in a way that promotes the confident and informed participation of businesses, investors, and consumers" and "that the conduct and client-care obligations of financial service providers and the regulation of financial markets remain fit for purpose."[31] It is an omnibus bill that repeals the FA Act and amends both the Financial Markets Conduct Act 2013 (FMC Act) and FSP Act. The majority of new regulation will form part of the FMC Act enacting therefore a system of firm-level licensing for financial advice consistent with certain financial market services already offered under the FMC Act.

In an attempt to establish an even playing field and more proportionate conduct and competence requirements for financial advisers, significant structural changes are introduced in the Draft FSLA Bill. The distinction between types of advisers (i.e. AFAs, RFAs and QFE advisers) is abolished[32] and term 'financial advice product', replaces the categories of products described under the FA Act.[33] According to Draft FSLA Bill, a person (including a legal person such as a firm) provides a 'financial advice service' if, in the ordinary course of his business, gives a 'regulated financial advice'[34] or engage a person to give regulated financial advice on his behalf.[35] Contrary to the FA Act, the Draft FSLA Bill is technology-neutral. This means that the existing restriction that some types of advice need to be given by a natural person are lifted and when a consumer uses a robo-advice platform, the advice has to be treated as having been given by the financial advice provider. All financial advisers and financial advice providers (including providers giving advice through robo-advice platforms) have to place the interests of the consumer first[36] and only provide advice where competent to do so.[37] All the persons giving regulated financial advice (and not only AFAs like under FA Act) will also be subject to a Code of Conduct which will set specific standards of knowledge, competence and skill.[38] Moreover, advice providers and financial advisers must not give advice as

[31] Draft FSLA Bill Explanatory note.

[32] Clause 5(1) Draft FSLA Bill.

[33] Clause 5(2) Draft FSLA Bill.

[34] A person gives financial advice if he makes a recommendation or gives an opinion about acquiring or disposing of a financial advice product or if he design an investment plan for a person - Clause 27 Draft FSLA Bill - FMC Act s 431 C. Advice is 'regulated financial advice' if it is given in the ordinary course of business (Clause 27 Draft FSLA Bill - FMC Act 431 D) and is not listed as one of the exclusions from regulated financial advice listed in clauses 7–14 of the new schedule 5 FMC Act (in schedule 2 of the Draft FSLA Bill). Please note a new exclusion (not one carried over from the FA Act relating to a lender under a consumer credit contract or insurance contract for the purpose of complying with the lender's responsibilities under section 9C(3)(a) to (e) of the Credit Contracts and Consumer Finance Act 2003.

[35] A person that provides a financial advice service is a 'financial advice provider' (Clause 6(2) Draft FSLA Bill). A financial advice provider may engage both 'financial advice representatives' (Clause 27 Draft FSLA Bill - FMC Act s 431 S) and 'financial advisers' to give regulated financial advice on its behalf (Clause 6(2) Draft FSLA Bill).

[36] Clause 27 Draft FSLA Bill - FMC Act s 431J– In case of a conflict of interest between the financial adviser or financial advice provider and the client, priority must be given to the client's interests. The client's interest must be the primary motivation for the advice.

[37] Clause 27 Draft FSLA Bill - FMC Act s 431K– i.e. use care, diligence, and skill that a prudent person engaged in the business of giving regulated financial advice would exercise in the same circumstances

[38] Clause 27 Draft FSLA Bill - FMC Act s 431 L. In July 2017 Minister of Commerce and Consumer Affairs has appointed a Financial Advice Code Working Group (Code Working Group) to develop the new Code of Conduct for financial advice. The terms of reference for the group are available at http://www.mbie.govt.nz/info-services/business/business-law/financial-advisers/review-of-financial-advisers-act-2008/pdf-document-library/terms-of-reference-for-the-code-working-group.pdf (accessed 30 August 2017). The Code of Conduct will apply to all financial advice and will contain minimum standards of: general competence, knowledge, and skills that apply to all persons that give financial advice; and particular competence, knowledge, and skills that

part of a retail service unless they agree the nature and scope of the advice with the client and take reasonable steps to ensure that the client understands any limitations on the nature and scope of the advice.[39] In addition to the civil liability for the financial advice provider who contravenes any of its duties,[40] the Draft FSLA Bill maintains disciplinary measures for financial advisers.[41] Anyone giving financial advice to retail clients will need to be operating under a licence under Part 6 of the FMC Act, including any person giving financial advice through a robo-advice platform. To ensure this does not impose undue costs on industry or Government, licensing will be required at the firm level in accordance to specific licensing requirements that will be set in regulations by FMA. Likewise, detailed disclosure requirements to retail and wholesale clients will be prescribed in regulations and designed to ensure consumers receive core information such as remuneration (including commissions) at the time most relevant to their decision making.

3. The Economic Justifications for Regulating Investment Advice

This paragraph takes a step back from the legal inquiry on the New Zealand legal framework and examines the economic background for regulating investment advice. An analysis aimed at providing a substantive foundation for the critical discussion of the regulatory strategies put forward by the Draft FSLA Bill and addressed in paragraph 4. It will show that recourse to a financial adviser is often the only sensible option for investors who want to purchase financial products and that choosing a financial adviser presents the same types of asymmetries of information and behavioural biases as the underlying decision of which financial contract to enter. And, of course, the same 'adverse selection problem'.

3.1. Overview

Not all investors who want to access the financial system are capable or willing to make their investment decisions just relying on their knowledge and experience. While there is evidence that, following a combination of technical innovations, access to credit and regulatory changes, individual investors' autonomy to make financial decisions has significantly improved starting from the 1950s ('do-it-yourself' finance),[42] a perceived deficit in financial capability[43] and uncertainty over

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apply in respect of different types of financial advice, financial advice products, or other circumstances; and ethical behaviour; and conduct and client care - Clauses 28 to 36 of the new Schedule 5 of the FMC Act, located in Schedule 2 of the Draft FSLA Bill.

[39] Clause 27 Draft FSLA Bill - FMC Act s 431I.

[40] Clause 27 Draft FSLA Bill - FMC Act ss. 431H-431O.

[41] Clause 27 Draft FSLA Bill - FMC Act s 431G. In particular, financial advisers will be subject to a disciplinary action before the financial advisers' disciplinary committee (as set out in Part 5 in Schedule 2 of the Draft FSLA Bill).

[42] This trend (and especially the availability of mutual funds that allowed individual investors to access to diversified pools of investments at lower costs) also influenced the ways according to which consumers saved, invested, and protected against financial risk. See generally A Ryan, G Trumbull and P Tufano, 'A Brief Postwar History of US Consumer Finance' (2010). *Harvard Business School BGIE Unit Working Paper No. 11-058,* at 31 *et seq*., available at http://dx.doi.org/10.2139/ssrn.1723397 (accessed 30 August 2017).

[43] *Ex multis*, see T Bucher-Koenen and A. Lusardi 'Financial literacy and retirement planning in Germany (2011) *Journal of Pension Economics and Finance* 584 and A Lusardi and P Tufano, 'Debt Literacy, Financial Experience, and Overindebtedness' (2008) NBER Working Paper 14808, available at http://www.nber.org/papers/w14808.pdf (accessed 30 August 2017) who gathered evidence on debt illiteracy, focusing in particular on the limited understanding of the effects of interest compounding and the workings of credit cards (showing how these are sources for concern in an economy like the US in which consumers routinely borrow and save using debt-like instruments).

appropriate investments' choices[44] are still widely regarded to be sources of concern (with non-trivial financial consequences[45]) both by investors and regulators.[46]

Constraints on investors' ability to make choices in accordance with their financial needs are further exacerbated by the limited support provided by 'experience'[47] in financial transactions.[48] Significant financial decisions are indeed made infrequently[49] and in the context of the rapid pace of financial innovation. Not to mention the existence of social taboos in sharing experience in personal finances.[50]

It is against this background that investors seek professional advice and guidance to choose the most appropriate financial products and effective investment strategies. However, this is not always a straightforward search. Nor seeking a financial advice is *per se* the most sensible option to overcome the risk of making mistakes in entering into financial transactions, as the quality of a financial advice is not exclusively linked to the competence of the financial adviser. It also needs to factor the financial adviser's loyalty in relation the form of investment advice offered, depending on whether there is a stable employment-based relationship (or even a distribution agreement) between the adviser and the originator of the financial products.

3.2. The rationales for regulatory intervention

Two fundamental economic justifications for regulatory intervention in the area of financial advice can be singled out:[51] asymmetries of information and behavioural characteristics of investors.

3.2.1 Asymmetries of information

Asymmetries of information is concerned with the transfer of information during the process of entering into a financial contract. It is a trite assumption of consumer finance literature that making a decision on whether to enter into financial contracts requires considerable information on terms

[44] A typical case of price dispersion in the financial markets is the one relating to the fees charged for almost identical stock market index funds (e.g. when all based on Standard & Poor's 500 index). See A. Hortacsu and C. Syverson 'Product Differentiation, Search Costs, and the Welfare Effects of Entry: A Case Study of S&P 500 Index Funds' (2004) 119 *Quarterly Journal of Economics* 403.

[45] O. Bar-Gill and E. Warren, 'Making Credit Safer' (2008) 157 *University of Pennsylvania Law Review* 1. These consequences are very significant among investors with lower levels of education and income – see L Calvet, J. Campbell and P. Sodini 'Fight or Flight? Portfolio Rebalancing by Individual Investors' (2009) 124 *Quarterly Journal of Economics*, 301

[46] Welfare may be possibly improved by the enactment of regulations on market conduct that reflect the presumed judgment of what most consumers would want, were they fully informed and well advised. This is the rationale for 'libertarian paternalism' or 'nudges'. See R. Thaler and S Cass, *Nudge: Improving Decisions About Health, Wealth, and Happiness* (New Haven: Yale University Press, 2008).

[47] I.e. the opportunity to learn about quality attributes of financial products by regular consumption.

[48] A. Schwartz and L. Wilde 'Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis' (1979) 127 *University of Pennsylvania Law Review* 630.

[49] Mortgages are a typical example of financial product where consumers make occasional investment decisions which are often accompanied by lower return and hardly designed to take into consideration compensating benefits (because of the limited understanding how interest rate work or the benefit of refinancing when interest rate fall, respectively) – see JY Campbell 'Household Finance' (2006) *Journal of Finance*, 1553-1604

[50] V. Zelizer, *The Social Meaning of Money: Pin Money, Paychecks, Poor Relief, and Other Currencies* (Princeton, Princeton UP 2017)

[51] Especially in (but not necessarily restricted to) the case of retail investors. See D Langevoort 'Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics about Stockbrokers and Sophisticated' (1996) 84 *California Law Review* 627.

and conditions and not just knowledge of prices.[52] However, this specific information may not be always (freely) available and investors may not be in the best position to gather and competently assess it, even in the presence of mandatory disclosure rules.

This scenario generates two significant economic consequences. First of all, investors will likely not act as 'rational utility maximizers', as they will not be able to fully understand and evaluate the consequences of their investment decisions.[53] Moreover, as empirical studies from market failures[54] have highlighted, even when disclosure rules are in place, information is (freely) available and investors' financial literacy is not a cause of concern, lack of confidence in the fairness of the financial system will negatively impact investment decisions and, therefore, stock market participation. This is because, once rational investors cease to trust the reliability of financial data in their possession and the fairness of the financial system, they will try to avoid the use of financial products altogether.[55]

A similar pattern to the selection of financial products characterizes the choice of financial advisers and the perception of the quality of a financial advice. The influence of asymmetries of information in this case is perhaps more problematic because financial advice is a typical 'credence good'.[56] As with taxicab rides where a stranger in a city cannot be sure that the driver takes the shortest route to his destination, investors do not often know which quality of a good or financial service they need.[57]

In essence, financial advisers first identify the quality of financial contracts that is more appropriate for the investors' needs by performing a diagnosis and then they recommend financial contracts of the right quality. While acting, they have the chance to exploit the existing informational asymmetry

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[52] JY Campbell, EJ Howell E. Jackson, CM Brigitte and P Tufano, 'Consumer Financial Protection' (2011) 25 *Journal of Economic Perspectives* 91 at 95.

[53] Studies on consumer credit suggest that consumers make systematic mistakes in their choice of credit products and in their use of these products. These mistakes indicate the existence of deficits in either information or rationality—or both – see O.Bar-Gill and E. Warren, 'Making Credit Safer' (2008) 157 *University of Pennsylvania Law Review*, 101. A substantially similar pattern is also well explained in an interesting study on consumers' selection of annual gym membership plans. The study suggests that consumers often overestimate attendance and on average use the gym infrequently (making the monthly, automatically renewed contract – rather the annual one - the best rational economic option) - S. DellaVigna and U. Malmendier, 'Paying Not to Go to the Gym' (2006) 96 *The American Economic Review* 694

[54] E.g. the collapses of Enron and Parmalat - see T Bucher-Koenen and M Ziegelmeyer 'Who Lost the Most? Financial Literacy, Cognitive Abilities, and the Financial Crisis' (2011) *ECB Discussion Paper No. 1299*, available at https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1299.pdf?ce13373f9d7d8fc4eb2fffe7e04582b9 (accessed 30 August 2017).

[55] L Guiso, P Sapienza and L Zingales 'Trusting the Stock Market' (2008) 63 *Journal of Finance, American Finance Association*, 2557; S Cole and GK Shastry, 'Smart Money: The Effect of Education, Cognitive Ability, and Financial Literacy on Financial Market Participation' (2009) *Working Paper Harvard Business School 09-071, a*vailable at http://www.people.hbs.edu/scole/webfiles/smarts-revised-08-02.pdf (accessed 30 August 2017) and D Christelis, T. Jappelli and M. Padula, 'Cognitive Abilities and Portfolio Choice' (2010) 18 *European Economic Review* 54.

[56] I.e. goods and services where an expert knows more about the quality a consumer needs than the consumer himself – See M. Darby and E. Karni 'Free Competition and the Optimal Amount of Fraud' (1973) 16 *Journal of Law and Economics* 67; W Emons 'Credence Goods and Fraudulent Experts'(1997) 28 *Rand Journal of Economics* 107 and A Wolinsky 'Competition in Markets for Credence Goods' (1995) 151 *Journal of Institutional and Theoretical Economics* 117.

[57] "Education and experience gives experts the ability to diagnose the exact needs of customers who themselves are only able to detect a need but not the most efficient way to satisfy it" - U Dulleck and R Kerschbamer, 'On Doctors, Mechanics and Computer Specialists - The Economics of Credence Goods' (2006) *Journal of Economic Literature* 5 at 42.

to maximize their personal welfare rather than acting for the interest of the investors.[58] If they do it, it will be problematic to ascertain and investors will struggle to assess whether the cause of the possible underperformance of the financial contract they have entered into has to be linked to the risk underlying the contract itself or whether it rather originated from the suboptimal quality (or the fraud involved in the delivery) of the financial advice.

There are also other, perhaps more problematic, practical consequences deriving from asymmetries of information. If investors are not able to verify the quality of the advice provided and are not able to enforce their rights when they realize *ex post* that the advice is not appropriate to meet their needs, they will generally assume that the adviser has taken his chances and tried to defraud them by providing either a sophisticated advice when a simple, inexpensive one was required (i.e. 'overtreatment')[59] or a cheap advice, charging for the expensive one (i.e. 'overcharging').[60] The uncertainty on the quality of the advice may in turn lead to a classic 'adverse selection problem', in similar terms to the ones outlined by Akerlof when describing the dilemma facing buyers of used cars in a seminal paper in information economics.[61] Assuming the existence of used cars in good repairs (which in America are known as 'peaches') and bad cars (which in America are known as 'lemons'), considering that buyers would pay for a 'lemon' half the price than a 'peach' and supposing that buyers do not have the information to spot the quality difference between 'lemons' and 'peaches', there will be effectively only one price for all used cars. And that will be the price (or close to the price) of 'lemons'. This is because to account for the risk that a car is a 'lemon', buyers will cut their offers and will be ready to pay at most the average price between a 'peach' and a 'lemon'. Rational sellers of 'peaches', in turn, will not sell cars whose real value is higher than the average price between a 'peach' and a 'lemon'. They will refuse to sell at a loss and rather exit the market. As a consequence, only sellers prepared to accept the average price between a 'peach' and a 'lemon' will be those who are offloading cars whose real value is lower than the average price between a 'peach' and a 'lemon'. Aware of this risk, prospective buyers will be inclined to offer to buy used cars for the price (or close to the price) of a 'lemon', leading to the point where the only available cars remaining in the market will be effectively 'lemons'. Hence, 'adverse selection' will be detrimental both for buyers of second hand cars who will not be able to purchase 'peaches' and for the market of second hand cars in general because 'peaches' will remain in the garage.

It follows from the example above that rational investors will discount the value of the financial advice in the light of asymmetry of information and will be ready to pay an adviser only if the price of the advice is such that, by obtaining it, their expected utility will for sure increase. If investors are not persuaded by the economic benefits provided by the advice, they will not pay a price for that

[58] For example by choosing a financial product that earns them a larger commission with limited economic benefits for the investor.

[59] Up to the point that empirical research has pointed out that all 'treated' consumers are 'overtreated', as that receive a high quality intervention independently of the outcome of the diagnosis – H. Richardson 'The Credence Good Problem and the Organization of Health Care Markets', (1999) *Department of Economics, Texas A&M University*, available at http://ibrarian.net/navon/paper/The_Credence_Good_Problem_and_the_Organization_of.pdf?paperid=550986 (accessed 30 August 2017)

[60] An economic analysis of the experts' temptation to overcharge customers is offered by Y Fong, 'When Do Experts Cheat and Whom Do They Target' (2005) 28 *Rand Journal of Economics* 113 and K Sülzle and A. Wambach 'Insurance in a Market for Credence Goods' (2005) 72 *The Journal of Risk and Insurance* 159.

[61] G Akerlof, 'The Market for Lemons: Quality Uncertainty and the Market Mechanism' (1970) 88 *Quarterly Journal of Economics* 488-500.

service, trades will not take place and the market for financial advice will shrink, possibly ceasing to exist.[62]

3.2.2 Behavioural biases

The second economic justification for regulatory intervention in the area of financial advice relates to the 'behavioural biases' on the part of investors. Studies in consumer finance suggest that in selecting financial products investors do not always make rational and calculated choices that promote their financial interest. They often make mistakes and accept to achieve lower returns from investment decision, apparently without any sensible economic explanation.[63] The case of retirement savings provides a telling example of underutilization of financial products. Employees who have little training upon which to draw in making the relevant decisions are not usually active to join advantageous plans, make changes to the existing ones and engage into effective diversification strategies.[64] In this way, effectively, making suboptimal decisions today that reduce their future welfare in ways that they will probably later regret.

While one explanation to investors' mistakes can be ascribed to the possible existence of asymmetry of information between investors and financial institutions, this is not the only possible one. Mistakes could also be explained by the investors' ability to process information available rationally, by the limited capacity of individual cognitive processing. Contrary to the conventional economic view that investors are capable of forming accurate expectations about the likelihood of future events, and select financial product suited for their needs after a comprehensive analysis of all the relevant costs and benefits, psychologists have established that investors' choices are often inconsistent with each other and variable depending on time and individual circumstances. Investors often lack motivation to invest time and effort to make informed decisions. They are unable to assess future uncertainty and sometimes make decisions driven by emotions such as stress, anxiety, fear of losses.[65] In essence, behavioural biases may cause investors to misjudge important facts and lead them to make choices that are predictably mistaken.[66]

The above discussion[67] suggests that there are cases where the choices of an investor do not reflect investor's true interests and rational preferences, but rather the combined influence of personal

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[62] U Dulleck and R Kerschbamer, 'On Doctors, Mechanics and Computer Specialists - The Economics of Credence Goods' (2006) *Journal of Economic Literature* 5 at 36. Investors' reluctance to pay a fee for advice was a recurring theme in many reports at national level (eg. *The Delmas-Marsalet Report on the marketing of financial products* for the French government (2005) and FSA's *Consumer Research No. 73 Accessing investment products - Consumer perceptions of a simplified advice process* (2008)) and comparative researches (eg. *OPTEM Report on Pre-Contractual Information for Financial Services*, commissioned by DG Health and Consumer Protection (2007)) that brought to the changes in EU legislation

[63] See R. Strotz, 'Myopia and Inconsistency in Dynamic Utility Maximization' (1955) 23 *Review of Economic Studies* 165 and D Laibson, 'Golden Eggs and Hyperbolic Discounting' (1997) 112 *Quarterly Journal of Economics* 443.

[64] An investigation on both the heuristics and the biases that emerge in the area of retirement savings, (starting from the decisions employees make about whether to join a savings plan, how much to contribute, and how to invest) is provided by S. Benartzi and R. Thaler, 'Heuristics and Biases in Retirement Savings Behaviour' (2007)21 *Journal of Economic Perspectives* 81.

[65] C. Colin and G. Loewenstein "Behavioral Economics: Past, Present, and Future" in C. Camerer, G. Loewenstein and M. Rabin (eds) *Advances in Behavioral Economics* (New York: Russell Sage Foundation 2004).

[66] N. Wilkinson and M. Klaes, *An Introduction to Behavioural Economics* (Basingstoke: Palgrave Macmillan 2008).

[67] Please also note the interesting advances in explaining the origin of the economic behavioural bias and the way according to which information is processed recently offered by 'neuroeconomists'. Neuroeconomists analyse the seemingly irrational behaviour of investors highlighted by behavioural economists by using

preferences and decision-making errors.[68] This pattern is particularly instructive in evaluating the investor's choice of financial advisers and explaining cases where conflicts of interest that characterize the relationship between investors and financial advisers have been neglected or underestimated.[69]

Even in this case, as soon as investors become aware of potential behavioural biases, they will rationally react by discounting what they are willing to pay for the advice.[70] In this way, effectively replicating the identical 'adverse selection problem' discussed in the sub-paragraph above.

3.3. Challenges for regulators

A number of regulatory techniques may be deployed to address the problem of asymmetries of information and mitigate behavioural biases for investors entering into financial transactions (eg. information regulation, product regulation and conduct regulation), but, especially in the case of retail investors, they are far from being be conclusive in tackling the 'adverse selection problem' outlined above.[71] And that is why recourse to financial advisers in often the only sensible option

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findings from neuroscience researches that challenge the understanding of the relation between mind and action focusing on brain activity and other techniques (see G. Wolford, B. Miller and M. Gazzaniga 'The Left Hemisphere's Role in Hypothesis Formation' (2000) 20 *Journal of Neuroscience* 1). They essentially question two generic inadequacies of the standard economic theory economic underlying decision making based on consumption and careful deliberation: the role of automation and emotional processing (see H.S. Houthakker, 'Revealed Preference and the Utility Function' (1950) 17 Economica 159.). This is because studies of the brain and nervous system point out that the brain primarily implements 'automatic' processes, which are faster than conscious and do not require awareness from the investors (see C. Camerer, G. Loewenstein and D. Prelec, 'Neuroeconomics: How Neuroscience Can Inform Economics' (2005) 43 *Journal of Economic Literature* 9) and no balancing of the costs and benefits of different options operates in this case (see J Bargh, S. Chaiken, P. Raymond and C. Hymes 'The Automatic Evaluation Effect: Unconditional Automatic Attitude Activation with a Pronunciation Task' (1996) 32 *Journal of Experimental Social Psychology*, 104). They also suggest that human behaviour is strongly influenced by affective (emotion) systems up to the point that when they are hurt, the logical-deliberative system is unable to regulate behaviour appropriately (see E. Rolls, *The Brain and Emotion* (OUP 1999)).

[68] J. Beshears, J. Choi, D. Laibson and B. Madrian 'How are preferences revealed?' (2008) 92 *Journal of Public Economics*, 1787.

[69] An interesting example is the mis-selling of payment protection insurance ('PPI') in the UK in the period between 2007 and 2014. PPIs were generally sold to borrowers to cover the repayment of specified borrowings upon the occurrence of an insured event, generally sickness, accidental injury, or unemployment. They were usually sold as part of a package with the loan itself, and in those cases usually provided for a single premium to be paid upfront at the time of the transaction and added to the amount borrowed. However, commissions payable to intermediaries were much higher than the interest on the original loan, which meant that a large proportion of the profits of loan brokers was derived from selling PPIs policies. Acting in this way, financial firms were therefore able to earn large profits on PPIs products because many buyers fundamentally misunderstood PPIs pricing and the limitations in its coverage. In November 2014, the UK Supreme Court ruled in *Plevin v Paragon Personal Finance Ltd (Plevin)* [2014] UKSC 61 established that failure by a lender to disclose to a borrower at point of sale the large commissions payable out of the PPI premium made the relationship between the lender and the borrower unfair under section 140A of the Consumer Credit Act 1974 – see The Financial Conduct Authority's Statement on Payment Protection Insurance (PPI) 2 0ctober 2015, available at https://www.fca.org.uk/news/statements/financial-conduct-authority%E2%80%99s-statement-payment-protection-insurance-ppi (accessed 30 August 2017).

[70] And, therefore, possibly undervaluing the services offered by financial advisers.

[71] While the case of information regulation, mere presentation of information may be non sufficient to ensure that investors actually understand it or a capable of processing it (see O. Ben-Shahar and CE. Schneider, *More Than You Wanted to Know: The Failure of Mandated Disclosure* (Princeton UP 2014) 138-150), with product regulation, restrictions on the enforceable contracts can make consumers worse off by impeding access to contracts that they would have wanted (see J. Campbell, HE. Jackson, BC Madrian, and P. Tufano 'Consumer Financial Protection' 25 (2011) *Journal of Economic Perspectives* 91-114).

available for investors. However, while in an ideal world financial advice would provide an effective mean to mitigating the problem of asymmetry of information and support the investor's decision-making, choosing a financial adviser presents the same sources of concern (and the same 'adverse selection problems') as the choice of the underlying financial contracts.

The monetary concern linked to the 'adverse selection problem' has been largely addressed by market practice with the 'no fees model'. Nowadays, financial advisers offer their services to investors for no fees, as they are paid by product originators through commissions when investors purchase one of the originators' products following the adviser's recommendations. While this arrangement helps (to a certain extent) to tackle the asymmetry of information problem, it is a source of possible agency costs in its own right, if only considering that the adviser has a strong economic incentive to encourage the investor to select a product that maximises the value of his commission rather than to promote the investor's economic interest. In essence, a scenario not very different from the conflicts of interest generated by securities analysts who work for underwriters.[72] Because of the nature of the revenue model adopted,[73] while performing their functions in interpreting corporate disclosures and making predictions on company's future prospect for investors, securities analysts have an economic incentive to make over-optimistic recommendations for investors in order to maximise the value of the commissions they receive from underwriters.[74]

It follows from the inquiry carried out in this paragraph that because of the 'adverse selection problem' the cases where investors will be willing to transact and pay for an investment advice will be rare, usually limited to net-worth individuals who are able to identify and afford high quality advisers. The commission-based advisers do not provide a viable alternative *per se*, if intense agency problems are not addressed. Briefly, if no regulation is introduced to control conflicts of interest relating to commission-based advisers, financial advice ceases to be a service for investors and ends up to merely performing the role of a marketing tool for financial firms.

4. The Relationship between the Adviser and the Investor under the Draft FSLA Bill

The discussion in paragraph 3 outlined the substantial economic justifications for the need to recourse to financial advisers, the 'adverse selection problem' that investors face in (choosing and) relying on financial advisers and the market practice response to that problem. The scope of this paragraph is to examine the legal strategies that are put in place in the Draft FSLA Bill to provide investors with protection when they make financial decisions in reliance of advisers.

It is perhaps worth preliminary mentioning that (public law) regulation is not the only option available. The relationship between financial advisers and investors can be governed both by private law (contract and equity) and public law. The two approaches converge and rub together. In

[72] Usually, but not necessarily. Empirical research has shown that similar analysis applies to independent analysts – see A. Cowen, B. Groysberg, and P. Healy, 'Which Types of Analyst Firms Are More Optimistic?' (2006) 41 *Journal of Accounting & Economics* 119.

[73] Securities analysts are paid a commission by underwriters.

[74] I.e. 'buy recommendations' generate more commissions than do 'sell recommendations'. See R. Michaely and K. Womack 'Conflict of Interest and the Credibility of Underwriter Analyst Recommendations' (1999) 12 *Review of Financial Studies* 653 and B. Barber, R. Lehavy and B. Trueman 'Comparing the Stock Recommendation Performance of Investment Banks and Independent Research Firms' (2007) 85 *Journal of Financial Economics* 490.

particular, principles of conduct regulation according to which financial advisers when providing investment services or, where appropriate, ancillary services to clients, have to act honestly, fairly and professionally in accordance with the best interests of their clients are consistent and largely overlap with similar private law obligations. While there are critical views on the validity[75] and need for conduct regulation when the same level of investors' protection can be achieved by private law,[76] there are fundamental reasons that suggest that recourse to public law is necessary. First of all, considering that fiduciary duties can be excluded by contract, the interests of vulnerable parties with limited understanding of the terms of the transaction may not be adequately protected by private law.[77] In contrast, conduct of business obligations under financial services law cannot be waived under New Zealand law[78] and the law of most common law jurisdictions.[79] The second fundamental justification for the need of conduct of business rules concerns the problem of enforcement and consists, especially for retail investors, in the existence of significant asymmetries of information and the lack of economic incentives[80] to promote litigation against financial advisers. In contrast, regulatory obligations are part of public law and would be monitored and enforced by an independent regulator.

The analysis below largely focuses on conduct of business rules contained in the Draft FSLA Bill in the light of the current legal framework. From the reading of the general principles set out under Part 3 of Draft FSLA Bill,[81] very limited changes can be traced from the existing framework in relation to conduct of business obligations. However, this is to a certain extent a tentative analysis, as the reform is still 'work in progress' and a comprehensive assessment will be possible only when the new Code of Conduct[82] clarifies the specific standards of knowledge, competence and skill for financial advisers. Likewise, in relation to the duty to disclose prescribed information,[83] the content, format and timing of disclosure will be detailed in future regulation.

What is surprising is the lack in the Draft FSLA Bill of any reference to the regulation of commission-based advisers. Considering that investment advice and product distribution often occur through commission-based tied agents of financial product providers, remuneration-based conflicts of

[75] The idea that the economic costs and the benefits of regulatory intervention can be measured is flawed. Costs are difficult to estimate in advance and benefits are uncertain. "Despite being framed in a quasi-scientific methodology, the justification for regulatory rules through CBA is largely qualitative and judgemental because the impact of regulation is hard to predict and the comparison of costs and benefits is so complex that the reasoning often reverts to simple assertion that the (uncertain) costs are justified by reference to the high-level investor protection objective" - I MacNeil, 'Rethinking Conduct Regulation' (2015) 30(7) *Butterworths Journal of International Banking and Financial Law* 413 at 421.

[76] Advocating the advantages of fiduciary law in providing coherent standards of conduct across a wide range of financial transactions and offering a direct scheme that focuses on the requirement for ethical judgement – P. Hanrahan, 'Regulation, Ethics and Collective Investments' in I MacNeil and J O'Brien (eds) *The Future of Financial Regulation* (Hart, 2010).

[77] J Getzler, 'Financial Crisis and the Decline of Fiduciary Law' in N Morris and D Vines (eds) *Capital Failure: Rebuilding Trust in Financial Services* (OUP 2014), chapter 9.

[78] FA Act ss. 34-36 and in the case of AFAs the standard of professional conduct set out in the Code of Conduct (FA Act s. 37).

[79] E.g. under FCA's Conduct of Business sourcebook COBS 2.1.2 it is not allowed to contracting out of regulatory rules applicable to retail clients.

[80] I.e. opportunity cost.

[81] Clause 27 Draft FSLA Bill - FMC Act ss. 431 F – 431M.

[82] Prepared by a Code Working Group, as if it were the Code Committee - to be established under *Part 4* of *new Schedule 5* of the FMC Act.

[83] Clause 27 Draft FSLA Bill – FMC Act s 431N.

interest are probably the most significant causes of poor investment advices.[84] This is for example the case of a financial adviser who has discretionary control over his client's allocation of investment assets and chooses high margins (and likely riskier) investments[85] to increase the size of his commission, even when the 'asset allocation' is unsuitable for the client. Or the case of a financial adviser who is able to influence the investor's beliefs concerning the attributes of risky assets by providing a misleading evaluation on the variance and expected return of risky assets.[86] Not to mention the case of non-monetary incentives attached to the distribution of a certain financial products.[87] That regulatory gap in New Zealand noted, a discussion on remuneration structures will not be overlooked in this paper. However, it will be examined from a comparative perspective looking at MiFID II to be implemented in 2018[88] and 'COBS' regulation introduced in the UK in 2013[89] with the view to assess whether those approaches could be a source of inspiration or possibly transplanted in the New Zealand legal framework.

4.1. Conflicts of interest and remuneration-based risk

As suggested in paragraph 3, the interests of financial advisers and investors are not always aligned. Numerous principal-agent risks exist in their relationship, originating either from asymmetry of information or behavioural biases on the part of the investors in understanding the relevance of potential dangers. The typical circumstances where these risks materialize relate to advisers' engagement in fraud,[90] incompetence[91] and conflicts of interests.[92]

In the light of these economic and practical concerns, the regulatory responses in New Zealand amount to a variable combination of a general duty for the financial advisers to act fairly in the client's best interest (para 4.1.1), some organizational requirements (para 4.1.2.) and disclosure obligations (para 4.1.3.). The specific concerns relating to commission-based adviser, which largely neglected in New Zealand, require additional and more radical measures (4.1.4.).

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[84] The issue has been highlighted as particularly relevant in the G20/OECD 'High-Level Principles on Financial Consumer Protection', available at https://www.oecd.org/g20/topics/financial-sector-reform/48892010.pdf (accessed 30 August 2017) where under principle 6 para 3 it is stated that "the remuneration structure for staff of both financial services providers and authorised agents should be designed to encourage responsible business conduct, fair treatment of consumers and to avoid conflicts of interest" and IOSCO 'Suitability Requirements With Respect to the Distribution of Complex Financial Products' (2013), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD400.pdf (accessed 30 August 2017).

[85] As the commission is usually proportional to the value of the risky asset in the portfolio of the investor.

[86] M. Krausz and J. Paroush 'Financial advising in the presence of conflict of interests,' (2002) 54 *Journal of Economics and Business*, 55. It is in the specific bank-based distribution channel that the concerns are greater for the potential risk that the sale of proprietary products is driven by internal remuneration incentives. Recent empirical studies that draw on a dataset which combines customers and advisers' attributes with customers' portfolio records of a large German retail bank, for example, suggest that the fundamental cause of the unsuitability of the asset allocation are advisers' incentives to sell high-margin products together with a systematic underestimation of investors' risk aversion - C. Jansen, R. Fischer and A. Hackethal 'The influence of financial advice on the asset allocation of individual investors' (2008), *EFA 2008 Athens Meetings Paper*, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1102092 (accessed 30 August 2017).

[87] I.e. 'soft commissions'.

[88] MiFID II, Art. 24(4).

[89] FCA Handbook – COBS 6.1.A.

[90] E.g. misappropriation of investor's funds.

[91] E.g. misunderstanding investor's wishes and offering of unsuitable financial advices. See, taking the adviser's perspective, T. Odean, 'Are Investors Reluctant to Realize Their Losses' (1998) 53 *The Journal of Finance*, 1175.

[92] E.g. recommending an unsuitable product in order to earn a larger commission.

4.1.1. Fiduciary-style obligations

Open-ended standards of conduct primarily try to address concerns related to investors' behavioural biases in order to prevent financial advisers to take advantage of their dominant position in the relationship with investors. Financial advisers have to act honestly, fairly and professionally and communicate to investors in a way which is fair, clear and not misleading.[93]

Under the current New Zealand legal framework, all financial advisers are required to meet certain conduct obligations. In particular, when providing financial adviser services, they must exercise the care, diligence, and skill that a reasonable financial adviser would exercise in the same circumstances and must not engage in conduct in relation to the provision of a financial adviser service that is misleading or deceptive or likely to mislead or deceive.[94] In addition to those obligations, AFAs, but not RFAs and QFE advisers,[95] are required to meet minimum standards of ethical behaviour and client-care, which are set out in the Code of Conduct.[96] This includes requirements to place the interests of the 'client first' in making an investment decision.[97]

The Draft FSLA Bill, in an attempt to establish a level playing field of regulation for all who provide a financial advice, addresses the potential conflict of interest between financial advisers and investors by incorporating the 'client-first' principle in the statute. In particular, it expressly states that any person giving regulated financial advice or doing anything in relation to the giving of the advice must put the client's interests first.[98] This general obligation should also provide a clear direction to the code working group in preparing a new Code of Conduct for financial advice later in 2017.

This approach is a common regulatory trend also outside New Zealand. A general fiduciary-style obligation to act fairly in the client's best interest is for example imposed on investment firms in Europe. Article 24(1) MiFID II, following a more interventionist regulatory approach from mere disclosure already introduced under Article 19(1) MiFID I, states that an investment firm when providing investment services to professional and retail clients (and starting from the marketing phase[99]) must act honestly, fairly and professionally in accordance with the best interests of its clients and in compliance with various conduct of business requirements described under Article 25 MiFID II.[100] Similarly, in the US, investment advisers regulated by the SEC pursuant to the Investment Advisers Act 1940[101] (but, quite confusingly,[102] not 'broker-dealers'[103] who do not

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[93] This is effectively a form of principles-based regulation according to which on the basis of high level principles and outcomes set out by regulators, financial advisers are supposed to design processes, systems and controls to limit the imbalance in the relationship with investors. Principles-based regulation provides a significant level of discretion to financial advisers, but at the same time allows to rapidly respond to changes in market practice without the need to introduce detailed prescriptive rules.

[94] FA Act ss. 33(1) and 34(1)

[95] Unless they are providing personalised advice on Category 1 products. See FMA *Standard Conditions for Qualifying Financial Entities* (QFEs) (20 January 2011) at 1.2(ii)

[96] FA Act s. 37.

[97] FMA Code of Conduct for AFAs (December 2016) Code Standard no. 1.

[98] Clause 27 Draft FSLA Bill - FMC Act s 431 J(2).

[99] "All information, including marketing communications, addressed by the investment firm to clients or potential clients shall be fair, clear and not misleading" – MiFID II, Art 24(3).

[100] I.e. knowledge and competence to fulfil the fiduciary-like obligations.

[101] Investment Advisers Act 1940, para 202(a)(11).

[102] The different regulatory treatment is difficult to justify, especially when broker-dealers provide personalized investment advice to retail customers. See A Laby 'Selling Advice and Creating Expectations: Why Brokers Should be Fiduciaries' (2012) *Washington Law Review* 707.

[103] Regulated pursuant Securities Exchange Act 1934 paras 39(a)(4)(A) and 3(a)(5)(A).

provide a financial advice incidentally to the conduct of their business[104])[105] are regarded as fiduciaries and subject to duty of loyalty obligations that derive from their status as fiduciaries.[106]

All in all, a general 'client-first' principle has an important educational function, but may become problematic with respect to *ex post* enforcement. It has been strongly argued that it can create an opportunity for value judgements on the investment process and, contrary to the predictability provided by rules-based regulatory regime, become *per se* a source of legal uncertainty.[107] Moreover, there are other challenges for this regulatory strategy to succeed, connected with possible problematic trust relationship between the financial advisers and the regulator, legal uncertainty on the interpretation of the principles and the risk that the dialogue leads to forms of 'market capture' and control of the regulators.[108] That said, in offering to investors a catch-all mechanism for reviewing financial advisers' behaviour and for tackling the information misalignment in the relationship between investors and financial advisers, a flexible 'client-first' principle remains an imperfect, but (potentially) validway to both defend investors against advisers' breaches of fiduciary duties and to protect widely accepted societal values.[109]

4.1.2. Governance

Governance obligations require financial advisers to have in place sound administrative and accounting procedures, internal control mechanisms to ensure effective and prudent management of their business, including the prevention of conflicts of interest so to promote both the integrity of the market and the interest of the clients. Effectively, a regulatory regime designed to operate *ex*

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[104] In this case they will be regarded as investment advisers – 15 USC s 80b-2(a)(11)(c).

[105] An inquiry on the historical and regulatory divide between broker-dealers and investment advisers is offered by B Black 'Brokers and Advisers- What's in a Name?' (2005) 11 *Fordham Journal of Corporate and Financial* Law 31. The standards are not higher even for broker-dealers that deal with the public who have to register with the Financial Industry Regulatory Authority ('FINRA') – eg FINRA Rule 2010 according to which broker-dealers must observe "high standards of commercial honor and just and equitable principles of trade". See R Karmel 'Is the Shingle Theory Dead?' (1995) 52 *Washington and Lee Law Review* 1271.

[106] See the US Supreme Court interpretation of in the Investment Adviser Act 1940 paras 206(1) and (2) in *SEC v Capital Gains Research Bureau, Inc* 375 US 180 (1963). A critical discussion on the reasons why broker-dealers are not regarded as fiduciaries is offered by T Hazen 'Are Existing Stock Broker Standards Sufficient? Principles, rules and Fiduciary Duties' (2010) *Columbia Business Law Review* 710.

[107] Briefly, 'client-first' principle is a form of principle-based 'regulation by enforcement', which describes a tendency of securities regulators to establish norms *ex post* through enforcement actions rather than *ex ante* through rulemaking. The fundamental critique of this principle is that in making policy through enforcement actions rather than through rulemaking, the regulator becomes unnecessarily antagonistic toward business and pursues cases that are only lightly related to securities regulation – see R Karmel, *Regulation by Prosecution: The Securities and Exchange Commission versus Corporate America* (Simon and Schuster, 1982). Securities regulators are inclined to proceed by enforcement actions because it is easier to bring an action retrospectively against specific acts than prospectively design rules that describe different types of conduct. However, 'regulation by enforcement' is problematic because "notions of due process require ample, advance notification of precisely what types of conduct will be prohibited, before any person may be civilly or criminally prosecuted for a violation of those standards" - L. Pitt and L. Shapiro, 'Securities Regulation by Enforcement: A Look Ahead at the Next Decade', (1990) 7 *Yale Journal on Regulation* 149, at 167. Historically, aggressive enforcement actions qualify as a response to greater public influence in the wake of a market collapse – see J Macey, 'Who is Protecting the Investor?: State-Federal Relations Post-Eliot Spitzer' (2004) 70 *Brooklyn Law Review* 117 and J Coffee Jr, 'Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms', (2004) 84 *Boston University Law Review* 301, at 342–43.

[108] J Black, M Hopper and C Band, 'Making a success of Principles-based regulation' (2007) 1 *Law and Financial Markets Review* 191; J. Black 'Forms and paradoxes of principles-based regulation' (2008) 3 *Capital Markets Law Journal*, 245 and SL. Schwarcz, 'The "Principles" Paradox' (2009) 10 *European Business Organization Law Review* 175.

[109] J. Park, 'The Competing Paradigms of Securities Regulation', (2007) 57 *Duke Law Journal* 625.

ante, aimed at containing (rather than eliminating) damaging conflicts of interest through managerial techniques.

Organizational requirements in New Zealand are not imposed on all financial advisers, but only on AFAs, amounting to a disclosure obligation to identify, and clearly and effectively communicate to the client, all interests of the AFAs or related persons that might influence the services the AFAs provides to the client. If the AFA is unable to manage the conflict, placing the interests of the client ahead of its interests or of a related person, then he must decline to act. [110]

While the Draft FSLA Bill is silent on this issue[111] and it is yet unknown what will be the standard provided under the Code of Conduct, MiFID II endorses a different and more proactive approach to management techniques and to different outcomes in regulating the relationship between financial intermediaries and investors. In particular, in addition to a general obligation to avoid prejudicial conflicts of interest implicit in the fair treatment principle set out under MiFID Article 24(1), an investment firm has to maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest within the firm that arise in the course of providing any investment services[112] adversely affecting the interests of its clients.[113] Where these organisational or administrative arrangements are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the investment firm has to disclose to the client the general nature and/or sources of conflicts of interest and the steps taken to mitigate those risks before undertaking business on its behalf.[114]

4.1.3. Disclosure

This regulatory strategy primarily aims to promote informed and active investors' decision-making.[115] In combination with enhanced financial capability, education and awareness of choice strategies,[116] it is supposed to equip and encourage investors to autonomously make a risk assessment in relation to the choice of a financial adviser and to the quality of the financial advice.[117] Disclosure regulation does not prohibit a specific behaviour, but it requires prescribed information

[110] Code of Conduct for AFAs (December 2016) Code Standard no. 5.

[111] With the exception to duty that requires the financial advice provider to be clearly controlling any advice given by representatives (Clause 27 – FMC ACT s. 431P) and the duty not give a representative any kind of inappropriate payment or other incentive (Clause 27 – FMC ACT s. 431Q(b)).

[112] As identified by MiFID II, Art. 23(1) – e.g. conflicts of interest between investment firms, including their managers, employees and tied agents, or any person directly or indirectly linked to them by control and their clients or between one client and another that arise in the course of providing any investment and ancillary services, including those caused by the receipt of inducements from third parties or by the investment firm's own remuneration and other incentive structures.

[113] MiFID II, Art. 16(3). This is largely a specification to the general obligation of the management body of an investment firm to define, oversee and be accountable for the implementation of the governance arrangements that ensure effective and prudent management of the investment firm, including the segregation of duties in the investment firm and the prevention of conflicts of interest, and in a manner that promotes the integrity of the market and the interest of clients – MiFID II, Art. 9(3).

[114] MiFID II, Art. 23(2).

[115] Informed investors would become "individualistic and acquisitive participants in a market exchange looking after their own interests and taking responsibility for their choices" - J. Gray and J. Hamilton, *Implementing Financial Regulation: Theory and Practice* (Chichester, John Wiley & Sons, 2006) 192.

[116] T. Williams, 'Empowerment of Whom and for What? Financial Literacy Education and the New Regulation of Consumer Financial Services' (2007) 29 *Law and Policy* 226.

[117] See N. Moloney, *How to Protect Investors: Lessons from the EC and the UK* (Cambridge CUP 2010) 53-58 and H. Jackson, 'Regulation in a Multisectored Financial Services Industry: An Exploration Essay' (1999) 77 *Washington University Law Quarterly* 319 at 333.

to be given by the financial adviser in order to ensure that financial risk is assumed with informed consent.[118] Disclosure obligations are used in different phases of the relationship between financial advisers and investors from advertising to contract and order execution. They generally aim to prevent possible conflicts of interest by requiring investment advisers, as part of their fiduciary duties, to disclose to their clients certain material facts in order to "eliminate, or at least to expose, all conflicts of interest which might incline as investment adviser-consciously or unconsciously-to render advice which was not disinterested."[119] This is for example the case of compensation arrangements between financial products suppliers and financial advisers. Contrary to *ex post* fiduciary-style obligations to act fairly in the client's best interest, disclosure obligations operate *ex ante* and usually in support of other regulatory strategies.[120]

According to FA Act all financial advisers are required to disclose certain information about the nature of services they offer prior to providing a personalised service to retail clients.[121] The disclosure statement[122] must comply with the provisions set out in Financial Adviser (Disclosure) Regulations 2010, depending on whether financial advices are provided by AFAs,[123] RFAs[124] or QFEs.[125] Additional disclosure obligations are imposed on AFAs in the management of conflicts of interest.[126]

The Draft FSLA Bill simply states the general principle according to which a person who gives regulated financial advice must provide the prescribed information to clients at the prescribed time and in the prescribed manner. The detail on what must be disclosed and when will be set out in regulations.[127]

Similarly, MiFID II, in addition to a high level general requirement that communications must be 'fair, clear and not misleading',[128] requires that information has to be provided in good time and in a comprehensible form[129] to clients or potential clients with regard to the investment firm and its services, the financial instruments, proposed investment strategies,[130] execution venues, all costs

[118] E.g. information on how they are paid for the service they provide, the type of financial products being offered and the complaints procedure available to the investor.
[119] *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 191-92 (1963).
[120] L. Enriques, 'Conflicts of Interest in Investment Services: The Price and Uncertain Impact of MiFID's Regulatory Framework', in G. Ferrarini and E. Wymeersch (eds) *Investor Protection in Europe: Corporate Law Making, The MiFID and Beyond* (OUP 2006), 326.
[121] FA Act ss. 21(2), 22 and 23.
[122] FA Act ss. 22(1)(a) and 22(2) and sections 4-6 of the Financial Adviser (Disclosure) Regulations 2010. According to the Code of Conduct for AFAs (December 2016) Code Standard 7, "in some circumstances additional information may need to be provided to a retail client to ensure the client has sufficient information to be able to make an informed decision".
[123] FA Act s. 24.
[124] FA Act s. 22 and section 7 of the Financial Adviser (Disclosure) Regulations 2010.
[125] FA Act s. 25 and section 8 of the Financial Adviser (Disclosure) Regulations 2010.
[126] I.e. AFAs are required to identify, and clearly and effectively communicate to the client, all interests of the AFAs or a related persons that might influence the services the AFAs provide to the client - FMA Code of Conduct for AFAs (December 2016) Code Standard 5.
[127] Clause 27 – FMC ACT s. 431N. Moreover, the information that is disclosed must not include any false or misleading statements or omissions - Clause 27 – FMC ACT s. 431O.
[128] MiFID II, Art. 24(3).
[129] MiFID II, Art. 24(4).
[130] Including appropriate guidance on the warnings of the risks associated with these instruments or particular investment strategies.

and related charges. [131] A delegation to administrative rulemaking contained in MiFID II will generate substantive rules governing the contents and format of the information.[132]

In the US, similar disclosure obligations exist (with different degree of detail) both for investment advisers[133] and broker dealers.[134]

Considering the complexities of financial services, over-reliance on disclosure, without appropriate consideration as to how conflicts of interest may appropriately be managed,[135] is not a particularly effective regulatory strategy.[136] Especially in the case of retail investors, it is difficult to assess the level of understanding of the information provided, utility consequences of the choices made[137] and, if a conflict of interest materializes, how they will be able to (economically) discount the price of the advice.[138] The effectiveness of this strategy in addressing the 'adverse selection problem' is therefore questionable. Even without emphasizing that it does not specifically address issues related to investors' behavioural biases and decision-making weaknesses,[139] disclosure regulation may become burdensome both for financial advisers and investors, as it may impose additional operational costs and cause 'information overload'. An increased level of mandatory disclosure will simply not incentivize investors to read complex contractual terms.[140] It could rather mislead them in identifying some of the most important issues. Unless, of course, information is disclosed in specific ways capable of assisting investors' understanding of the relevant provisions and therefore contributing to informed decision-making.[141]

4.1.4. Remuneration structures, inducements and allocation of proprietary products

The main source of conflicts of interests in the relationship between financial intermediaries and investors relates to remuneration structures and, perhaps not surprising, to the cases where advisers' compensation is provided through commissions paid by financial product suppliers. As suggested earlier, while the compensation model based on commission has been the market response to ameliorate the 'adverse selection problem' faced by investors, it has also generated

[131] Including the cost of the advice and the costs of the financial instrument recommended or marketed to the client and how the client may pay for it.
[132] MiFID II, Art. 24(13).
[133] Investment Advisers Act 1940 Rule 204-3.
[134] The source in this case are the anti-fraud provisions of the federal securities laws – *In the Matter of Richmark Capital Corp*, Exchange Release No 48758 (7 November 2003), available at https://www.sec.gov/litigation/opinions/33-8333.htm (accessed 30 August 2017).
[135] I.e. disclosure does not impose a specific requirement to avoid or address possible conflict of interests
[136] D. Schwarcz, 'Beyond Disclosure: The Case for Banning Contingent Commissions', (2007) 25 *Yale Law and Policy Review* 289.
[137] See O. Ben-Shahar and C Schneider, 'The failure of mandated disclosure' (2011) 159 *University of Pennsylvania Law Review* 659, at 704-28.
[138] D. Cain, G. Loewenstein and D. Moore 'The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest' (2005) 34 *The Journal of Legal Studies* 1.
[139] O. Ben-Shahar and C Schneider, 'The failure of mandated disclosure' (2011) 159 *University of Pennsylvania Law Review* 659 at 704 and Id., *More Than You Wanted to Know: The Failure of Mandated Disclosure* (Princeton UP, 2014) 14-32
[140] One recent empirical study on online purchasing suggests that what is costly is not accessing the contract, but rather reading it. Either people do not spend enough time reading the contract, they do not understand the terms well enough to incorporate them in their purchase decision, or both – see F. Marotta-Wurgler, 'Does Contract Disclosure Matter?' (2012) 168 *Journal of Institutional and Theoretical Economics* 94.
[141] A critical analysis of 'testing' of proposed disclosures with the view to establishing the benefits of disclosure is put forward by TB Gillis, 'Putting Disclosure to the Test: Toward Better Evidence-Based Policy', (2015) 28 *Loyola Consumer Law Review* 31.

significant agency concerns caused by the advisers' inherently biased economic incentives in offering the service.

In line with the FA Act tradition, remuneration-based risks are not addressed in the Draft FSLA Bill, if not in a very marginal way. In the preparatory works it is only suggested that "disclosure will be re-designed to ensure consumers receive core information such as remuneration (including commissions) at the time most relevant to their decision making" and that the FMA "will undertake further work on the impact of soft commissions on advice".[142]

While conflicts of interest arising from remuneration structures are also not specifically regulated in the US,[143] MiFID II requires a firm which provides investment services to clients not to remunerate or assess the performance of its staff in a way that conflicts with its duty to act in the best interests of its clients. Additionally, the firm must not make any arrangement by way of remuneration, sales targets or otherwise that could provide an incentive to its staff to recommend a particular financial instrument to a retail client when the firm could offer a different financial instrument which would better meet that client's needs.[144]

Inducements are permitted under MiFID II with some limitations. Where a firm pays or is paid any fee or commission, or provides or is provided with any non-monetary benefit in connection with the provision of an investment service or an ancillary service, it will be regarded as non-fulfilling the conflict of interest obligation under MiFID II Art. 23 or the fair treatment obligation user MiFID II Art. 24(1), unless the payment is designed enhance the quality of the relevant service to the client and does not impair compliance with the investment firm's duty to act honestly, fairly and professionally in accordance with the best interest of its client. Moreover, the existence, nature and amount of the payment or benefit, or, where the amount cannot be ascertained, the method of calculating that amount, must be clearly disclosed to the client, in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant investment or ancillary service. Where applicable, the firm must also inform the client on the mechanisms available for transferring the payment in question to the client. The payment or benefits necessary for the provision of services which by their nature[145] cannot give rise to conflicts with the investment firm's duties under MiFID II Art. 24(1) are not subject to this regime.[146]

There is effectively only one circumstance under MiFID II when commissions are banned and this is when the advice is provided on an 'independent basis'.[147] With a *de minimis* exception to permissible inducements mentioned above, the financial adviser cannot accept and retain fees, commissions or any monetary or non-monetary benefits paid or provided by any third party or a

[142] MBEI Consultation Paper – *New Financial Advice Regime - The draft Financial Services Legislation Amendment Bill and proposed transitional arrangements* (2017), available at http://www.mbie.govt.nz/info-services/business/business-law/financial-advisers/review-of-financial-advisers-act-2008/exposure-draft-and-transitional-arrangements/consultation/consultation-document-new-financial-advice-regime.pdf (accessed 30 August 2017) at 9 and 52, respectively.

[143] See Dodd-Frank Act, para 913(g) that empowers the SEC to prohibit or limit remuneration schemes for broker-dealers. And the critical view on market practice and soft-commission put forward by D. Johnsen, 'Property Rights to Investment Research: The Agency Costs of Soft Dollar Brokerage', (1994) 11 *Yale Journal on Regulation* 75.

[144] MiFID II, Art. 24 (10)

[145] E.g. custody costs and settlement and exchange fees.

[146] MiFID II, Art. Art. 24(9). This provision is largely based on the 2004 MiFID I administrative regime on inducements.

[147] MiFID II, Art. 24(4).

person acting on behalf of a third party in relation to the provision of the service to clients.[148] Where a payment is received, all fees, commissions and any monetary benefits paid or provided by a third party must be returned in full to the client as soon as possible after receipt of those payments by the firm and the firm should not be allowed to offset any third-party payments from the fees due by the client to the firm and a policy must be set up to ensure that third party payments received are allocated and transferred to the clients.[149]

A second (less relevant) constrain applies when the advice is provided on as 'independent' basis and it relates to the possible allocation of proprietary products to the investor's portfolio. MiFID II imposes a requirement that independent investment advises be based on an assessment of a sufficient range of financial instruments available on the market and not limited to proprietary products issued by the investment firm itself[150] as to pose a risk of impairing the independent basis of the advice provided.[151]

The commission prohibition when the advice in provided on an 'independent basis' under MiFID II[152] is consistent with an international trend to tackle conflict of interest risks in the product distribution market. However, while this model indirectly promotes structural reform by imposing a mandatory link between 'independent investment advice' and fee-based advice, it affects a very small segment of the EU product distribution market, as 'independent fee-based advise' is relatively rare with the retail market dominated by the bank distribution channel and commission-based product distributors. This has been clearly pointed out in the EC MiFID II/MiFIR Proposals Impact Assessment (2011) where it is highlighted that the penetration of independent advisers in France, Italy, Germany and Spain is five per cent and 'that across the EU 7–7.5 million of the wealthy individuals are receiving advice on an independent basis (i.e. 16 and 18 per cent of the total).'[153]

A possible solution to this problem has been put forward by the UK with the introduction of a ban on commissions for retail investment advice in 2013. This was the outcome of thorough examination of the retail investment industry named Retail Distribution Review (RDR) carried out in 2007 by the Financial Service Authority (FSA).[154] The initial discussion paper pointed out that even if the retail investment sector had been regulated for two decades, numerous features of the industry, and in particular the reliance on commission based advisers, suggested the existence of an inefficient market and unbalanced in favour of a class-based system of 'professional financial planning' for high

[148] MiFID II, Art. 24(7)(b).
[149] Recital 74 MiFID II.
[150] Or by entities having close links with the investment firm or other entities with which the investment firm has such close legal or economic relationships, such as contractual relationships.
[151] MiFID II, Art. 24(7)(a). The criteria governing this assessment will be addressed by administrative rules - MiFID II, Art. 24(13). MiFID II, Art. 24(11) deals with the conflict of interest risks in product/service bundling and states that when an investment service is offered together with another service or product as part of a package or as a condition for the same agreement or package, the firm has to inform the client whether it is possible to buy the different components separately and provide for a separate evidence of the costs and charges of each component.
[152] MiFID II, Art. 24(7) (b).
[153] 2011 MiFID II/MiFIR Proposals Impact Assessment (SEC(2011) 1226) at 190.
[154] Financial Services Authority DP07/1, *A Review of Retail Distribution*, June 2007, available at https://www.fca.org.uk/publication/discussion/fsa-dp07-01.pdf (accessed 30 August 2017). This process originated from an earlier 2005 FSA review of the responsibilities of product providers and intermediaries as part of its TCF theme-based work (FSA, treating Customers Fairly – Building on Progress' (July 2005), available at https://www.fca.org.uk/publication/archive/fsa-tcf-towards.pdf (accessed 30 August 2017)), following *Seymour v Caroline Ockwell &Co (a firm)* [2005] EWHC 1137 (QB) [2005] PNLR 758 (Bristol Mercantile Court), which established that a marketing company must share liability to the end consumer with an adviser.

income consumers.[155] The FSA feedback published in the Retail Distribution Implementation Programme (RDIP) in 2008 highlighted that merely disclosing conflicts of interest regarding the remuneration of financial advisers did not sufficiently protect investors and that the only way to end commission-driven (mis)sales was to remove product providers from a role in advisers' remuneration.[156] The concept that all investment advice firms must set their own charges with an explicit ban on product providers to offer commission to secure sales[157] was later incorporated in the consultation paper on delivering the RDR, including the draft Handbook text.[158] The rules implementing the ban on commission, which is applicable to all investment advisers irrespective of whether they give independent or restricted advice to retail clients, were introduced in January 2013 and are to be found in the FCA Handbook COBS 6.1A.4R.[159]

This is not the end of the story. Three years after the implementation of the RDR, the Financial Advice Market Review (FAMR),[160] a review of the retail market promoted by the Financial Conduct Authority (FCA) and HM Treasury (HMT), observed an increase in professionalism in the industry, a reduction in the number of financial advisers[161] and, as a consequence of the move to fee-based advice on retail investment, the end of the conflicts of interest caused by commission-based advisers. However, the FAMR also highlighted the existence of an 'advice gap', as many investors found independent fee-based advice unaffordable.[162] This was primarily the result of the significant costs of providing face-to-face advice, meaning that it was not economical for firms to serve consumers with lower amounts to invest or with simple needs and that financial advice became available effectively only to high-income investors.

In essence, while the RDR allowed to tackle the intense conflict of interest when commissions are paid by product originators to advisers, it did not address the concerns of retail investors who are

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[155] Financial Services Authority DP07/1, A Review of Retail Distribution, June 2007, available at https://www.fca.org.uk/publication/discussion/fsa-dp07-01.pdf (accessed 30 August 2017) 7-8.

[156] Financial Services Authority 08/6, *Retail Distribution Review Including feedback on DP07/1 and the Interim Report*, (November 2008), available at http://www.fsa.gov.uk/pubs/discussion/fs08_06.pdf (accessed 30 June 2017).

[157] Covering all products classified as packaged products and more widely to retail investment products, including unregulated collective investment schemes, all investments in investment trusts and structured investment products.

[158] FSA CP09/18, *Distribution of Retail Investments: Delivering the RDR*, (June 2009), available at http://www.fsa.gov.uk/pubs/cp/cp09_18.pdf (accessed 30 August 2017) chapter 4 at 23.

[159] "[….] A firm must: (1) only be remunerated for the personal recommendation (and any other related services provided by the firm) by adviser charges; and (2) not solicit or accept (and ensure that none of its associates solicits or accepts) any other commissions, remuneration or benefit of any kind in relation to the personal recommendation or any other related service, regardless of whether it intends to refund the payments or pass the benefits on to the retail client; and (3) not solicit or accept (and ensure that none of its associates solicits or accepts) adviser charges in relation to the retail client's retail investment product or P2P agreement which are paid out or advanced by another party over a materially different time period, or on a materially different basis, from that in or on which the adviser charges are recovered from the retail client."

[160] The Financial Advice Market Review (FAMR) was launched in August 2015 and the final report published in March 2016: *Financial Advice Market Review – Final Report,* available at https://www.fca.org.uk/publication/corporate/famr-final-report.pdf (accessed 30 August 2017).

[161] Primarily those employed by the banks and building societies, as a result of the declining profitability of branch-based distribution models in anticipation of the introduction of RDR.

[162] 62% of people would take advice on investing a sum worth £50,000 but only 27% of people would take advice on a sum worth £10,000 - NMG Consulting, 'Impact of the Retail Distribution Review on consumer interaction with the retail investments market - A quantitative research report' (2014), available at https://www.fca.org.uk/publication/research/impact-of-rdr-consumer-interaction-retail-investments-market.pdf (accessed 30 August 2017).

not able to afford the advice and the 'adverse selection problem' (and the reluctance to pay) that face those who able to afford it.[163] In the light of the potential risks in taking long-term investment decisions, a choice between 'no advice' and 'biased advice' is far from satisfactory.

A promising way of lowering the cost of financial advice, limiting the possible agency problems and the negative consequences on the quality of the advice, without restricting the distribution of the advice to a large group of investors, is automation of advice (robo advice). This is the view suggested in the FARM report where it is argued that that technology and innovation can play a big role in "reducing the cost of advice, ensuring consistently high standards of advice and increasing the accessibility of advice for consumers"[164] and also endorsed recently by the European Supervisory Authorities (EBA, ESMA and EIOPA) in their Report on Automation in Financial Advice.[165]

4.2. Suitability rules

The perceived imbalance in the relationship between intermediaries and their clients is also addressed by the suitability rules. In attempting to minimize investors' behavioural weakness,[166] suitability rules seek to ensure that the financial advice recommended reflects the investor's profile.[167]

In New Zealand, suitability rules apply to AFAs under the Code of Conduct when providing a personalised service to a retail client.[168] AFAs must determine suitability on basis the information provided by the client, but also have to make reasonable enquiries to ensure the they have an up-to-date understanding of the client's financial situation, financial needs, financial goals, and tolerance for risk, having regard to the nature of the personalised service being provided. It is also possible for a client to instruct an AFA (or an AFA's employer or principal) not to determine the suitability of the financial adviser service provided and in that case the AFA is relieved from the obligation to determine suitability according to the terms of the instruction. While similar suitability rules are imposed on QFE advisers under the QFE Adviser Business Statement Guide, [169] RFA are only subject to the general conduct obligation FA Act s. 33.

Same suitability rules to the ones applicable to AFAs are imposed on financial advice providers, financial advisers, and financial advice representatives who give regulated financial advice under Draft FSLA Bill (to be refined in the new Code of Conduct). They must not give advice as part of a retail service unless they agree the nature and scope of the advice with the client and take reasonable steps to ensure that the client understands any limitations on the nature and scope of the advice.[170]

In the EU and the US, suitability rules are 'process-based' and exists in relation to both retail and institutional investors. They do not prescribe a specific outcome, but, in the case of investment

[163] See footnote no 21 [**controllare**]

[164] *Financial Advice Market Review – Final Report,* available at https://www.fca.org.uk/publication/corporate/famr-final-report.pdf (accessed 30 August 2017) at 39.

[165] EBA, ESMA and EIOPA *Report on Automation in Financial Advice Available* (2016) at https://esas-joint-committee.europa.eu/Publications/Reports/EBA%20BS%202016%20422%20(JC%20SC%20CPFI%20Final%20Report%20on%20automated%20advice%20tools).pdf (accessed 30 August 2017)

[166] L Cunningham, 'Behavioural Finance and Investor Governance' (2002) 59 *Wash. & Lee L. Rev.* 767.

[167] Suitability rules have also been historically associated with a paternalistic approach to regulation - see J. Markham, 'Protecting the Institutional Investor- Jungle Predator or Shorn Lamb?' (1995) 12 *Yale Journal on Regulation* 345.

[168] Code of Conduct for AFAs (December 2016) Code Standard 9.

[169] Regulatory Guide: FAA 01.2 [September 2010] at 35.

[170] Clause 27 - FMC s 431I.

advice and discretionary asset management, they require financial advisers to conduct an investigation and gather 'the necessary information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, that person's financial situation […] and his investment objectives including his risk tolerance.'[171] A lighter 'appropriateness' regime applies in the EU to other investment services such as execution only transactions in complex products.[172] The assessment in those cases only considers whether the client has the necessary knowledge and experience in the investment field relevant to the specific type of product or service offered or demanded.

Needless to say that suitability rules face a number of limitations as the diagnosis of 'investment suitability' is very complex[173] and subject to the adviser's own personal experience and evaluations. Not to mention the difficulties in *ex-post* benchmarking of advice as a mean to achieve compliance.[174]

4.3. Appropriateness obligations

Even if a financial advice is not provided and suitability rules do not directly apply, unsophisticated investors may still rely on the information circulated by the financial adviser and interpret it as if it was a financial advice. Regulators have usually addressed this risk by imposing an obligation on financial advisers to determine the appropriateness of the financial product or service provided to clients.

The Code of Conduct does not impose obligations to AFAs to determine the appropriateness of financial transactions, nor similar conduct obligations are mentioned in Draft FSLA Bill.

Appropriateness obligations in EU are set out under Article 25(3) MiFID, with two significant exceptions in relation to the offering of information to professional clients[175] and to the distribution of 'non-complex' instruments sold in 'execution mode'.[176] Appropriateness obligations do not exist

[171] MiFID II, Art. 25(2). Similarly, in the US, investment advisers owe their clients the duty to provide only suitable investment advice and an adviser must make a reasonable determination that the investment advice provided is suitable for the client based on the client's financial situation and investment objectives – see See *Status of Investment Advisory Programs under the Investment Company Act of 1940*, Investment Company Act Release No. 22579 (Mar. 24, 1997). In the case of broker-dealers, see FINRA Rule 2111.

[172] MiFID II, Art. 25(3).

[173] Especially when considering the concerns in determining the boundaries between suitable/unsuitable advices under the specific factual scenarios - D Langervoort 'The Behavioural Economics of Corporate Compliance with Law' (2002) *Columbia Business Law Review* 71 at 95.

[174] A study commissioned by the European Commission, Directorate-General Heath and Consumer Protection to examine the current state of retail investment advice across EU Member States, and to evaluate whether advisers provide suitable investment advice to retail clients in 2011 found out that while most advisers covered a number of baseline requirements specified under MiFID, a closer examination showed limitations in the information gathered in relation to the customers' financial needs and background. This, in turn raised concerns as to the ability of adviser to conduct a proper process, deliver appropriate advice and/or to develop a customised investment recommendation – Synovate - *Consumer Market Study on Advice within the Area of Retail Investment Services* – Final Report (2011) , available at http://ec.europa.eu/consumers/financial_services/reference_studies_documents/docs/investment_advice_study_en.pdf (accessed 30 August 2017). Along the same lines, see *FMA Monitoring Report: 1 January – 30 June 2014* (2014) available at https://fma.govt.nz/assets/Reports/_versions/3944/140912-qualifying-financial-entities-monitoring-report-2014.1.pdf (accessed 30 August 2017)

[175] MiFID Implementing Directive, Art. 36.

[176] An 'execution only' transaction is one initiated by the client and a financial instrument which is not specified in the first indent of MiFID Art. 19(6) and is considered as non-complex if it satisfies the criteria set out under MiFID Implementing Directive, Art. 38.

in the US because the assessment on the distinction between investment advice and non-advised transaction is an objective inquiry based on whether the advice would reasonably influence the client's decision.[177] The determination of the existence of a recommendation has always been based on the facts and circumstances of the particular case.[178]

Financial adviser's obligations carry limited consequences under this scenario: if the client receive adequate warning on the limited information to make an appropriateness assessment or that the product or services are unsuitable, the transaction remains valid.

4.4. Best execution

Best execution rules deal with the trading process itself. They do not protect investors against possible behavioural biases, but aim to tackle agency costs in relation to intermediary's order execution.

In New Zealand there are not rules directly applicable to financial advisers to take reasonable steps, when executing orders, to obtain the best possible result for their client. With the exception perhaps of NZX Firms who have an obligation to be 'diligent in effecting the best execution of client orders. This means prompt execution at the best available price'.[179]

Best execution requirements are part of the legal framework in the EU and the US.[180] Intermediaries when executing the client's trade must take reasonable steps to achieve the best possible result for their clients 'taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order.'[181] In the case of a retail client, the best possible result is generally determined in terms of the total consideration, representing the price of the financial instrument and the costs relating to execution.[182]

5. Conclusion

This paper has discussed the developments in the regulation of financial advice in New Zealand and in particular the conduct of business obligations that are put in place in the Draft FSLA Bill to address the perceived imbalance in the relationship between intermediaries and their clients.

An outline of the structural differences of the new regulatory regime for financial advice *vis a vis* the FA Act and FSP Act in paragraph 2 highlighted how the proposed legislation represents a shift away from the current framework which sought to professionalise a subset of advisers, towards a regime which establishes a level playing field of regulation for all who provide financial advices. This direction is evident when considering the simplification of the regime for delivering financial advice (i.e. the definitions of class and personalised advice and the categorisation of products are removed), the amendments to current advisers' designations (i.e. AFAs RFAs and QFE advisers will be replaced with the 'financial adviser provider'), the introduction of a new licencing system at firm level and the new FMA's centralized enforcement role for all licensed financial services.

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[177] See FINRA *Know Your Customer and Suitability*, Regulatory Notice 11-02 (2011) at 2-3.

[178] *Michael Frederick Siegel*, Securities Exchange Act Release No. 58737, 2008 SEC LEXIS 2459, at 21 (October 6, 2008), explaining that whether a communication "constitutes a recommendation is a 'facts and circumstances inquiry to be conducted on a case-by-case basis'".

[179] New Zealand Exchange Limited *Code of Practice* (May 2003) at para 4.2.

[180] MiFID II, Art. 27(1). Similarly in the US, see FINRA 2320 for broker dealers and Investment Advisers Act 1940, Rule 206(3)-2(c) for investment advisers.

[181] MiFID II, Art. 27(1).

[182] MiFID II, Art. 27 (2).

The specific assessment of the regulatory response to mis-selling risks and conflicts of interest between the intermediary and its client under the Draft FSLA Bill was then postponed after the analysis of the fundamental economic issues underlying the regulation of financial advice. Paragraph 3 pointed out that that choosing an adviser is a decision characterized by the same problems of asymmetric information and behavioural biases as the choice of the underlying financial contracts. It also suggested that these issues may generate an 'adverse selection problem' according to which rational investors alternatively decide not to make a financial investment or to make it only if able to discounting the value of the advice in the face of the uncertainty about its quality. That problem noted, the recourse to a financial adviser, especially in the case of retail investors, remains the most sensible option to guide investors in choosing a financial product. While there are cases where the investor rationally decide not to pay for a financial advice because of the 'adverse selection problem' mentioned above, there are also cases where the investor is simply not able to afford the advice. Market practice in those cases has provided a solution by allowing advisers to offer financial services to investors for no fees at the point use, but with payment through commissions paid by financial product suppliers whose products are purchased following financial adviser's recommendation. This model, however, is prone to fundamental agency problems.

Paragraph 4 examined the available narratives to regulate the relationship between financial advisers and investors in the light of the rules adopted in the Draft FSLA Bill (in the wake of the terms of new Code of Conduct). While disclosure and conduct regulation obligations, based on informed consent and fiduciary relationships respectively, allow to overcome some of the concerns relating to asymmetric information and behavioural limitations in investors' decision making,[183] they are not necessarily effective, as they do not conclusively tackle the 'adverse selection problem'. Investor's ability to make disclosure-based decisions for himself is largely a myth[184] and conduct of business rules are complex to monitor and enforce.[185] Most importantly, both the regulatory strategies do not directly address the fundamental concern of the costs of the advice and the agency problems generated by the remuneration structures based on commissions paid by financial product suppliers. And that is a missed opportunity in the Draft FSLA Bill.

One commentator has recently argued that transplanting the rules around receipt of commissions, suitability requirements and best execution obligations from Australia and the UK, would be beneficial for New Zealand as a way to increase confidence in the financial advice industry.[186] While it remains to be seen the practical impact of the implementation of some refined types of conduct obligations, in the case of the ban on commissions, the UK experience suggests that a legal transplant would be detrimental for the growth of the retail market. A ban on commissions simply does not grapple well with the fundamental economic problem of payment for financial advices and the reality of market practice. While it cannot be denied that commission-based advisers are subject to an intense conflicts of interest, it is also true that the offering of financial services for no fee taken at the point of use of the financial services is an effective (and probably the only viable) response to ameliorate the 'adverse selection problem' faced by investors. In order to avoid to fall in the advice gap, it is therefore essential to restructure the remuneration system of the advice market. This

[183] N. Moloney, *How to Protect Investors: Lessons from the EC and the UK* (Cambridge CUP 2010) 53-58.
[184] O. Ben-Shahar and C Schneider, 'The failure of mandated disclosure' (2011) 159 *University of Pennsylvania Law Review* 659 at 704-728
[185] J. Black 'Forms and paradoxes of principles-based regulation' (2008) 3 *Capital Markets Law Journal*, 245 and A. Cunningham, 'A Prescription to Retire the Rhetoric of "Principles-Based Systems" in Corporate Law, Securities Regulation and Accounting' (2007) 60 *Vanderbilt Law Review* 1409
[186] V. Stace, 'New Zealand's Financial Advisers Regulation: Falling behind in the Wake of Overseas Reforms' (2015) *New Zealand Universities Law Review* 869.

paper has argued that a 'robo advice' might be a promising way of reducing the cost of financial advice without compromising the quality and the independence of the advice and without restricting the distribution of financial services to a limited group of wealthy investors. The study of these rules and their regulation should be the focus of the law reform agenda for Improving access to quality financial advice in New Zealand.

To conclude on the fundamental paradox in regulating financial advice, it can be argued that while is true that many of those who work in finance have become rich looking after other people's money, it would be nice to think that their clients had done as well: "without a fiduciary rule, one is tempted to remember the story of the naive trainee being shown the yachts of his firm's partners in the harbour. But, he asked, where are the customers' yachts?"[187]

[187] The Economist, 'If Advisers Followed a Fiduciary Rule – Honest Brokers', 13 July 2017, available at http://worldif.economist.com/article/13521/honest-brokers (accessed 30 August 2017).