July 2016

A guide to the FMA's view of conduct

This guidance note is for:

directors and executives of licensed financial services providers.

It gives guidance on what we will focus on when examining how licensed financial services providers demonstrate good conduct, and how they have met their governance and management responsibilities.

About FMA guidance

Our guidance:

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

Guidance notes: provide guidance on a topic or topic theme. Typically we will seek industry feedback via a public consultation paper, or more targeted consultation before we release a guidance note.

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

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

Document history

This version was issued in July 2016.

www.fma.govt.nz

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Overview

Why conduct matters

Conduct is at the core of the *Financial Markets Conduct Act 2013* (FMC Act). Good conduct is vital to fair, efficient and transparent markets, and ensures the confident and informed participation of businesses, investors and consumers.

The FMC Act gives us a mandate to focus on conduct. This is a shift in emphasis for us, in terms of how we determine whether the financial services providers (providers) we regulate have the interests of their customers at their heart. Demonstrating compliance with the regulations, including disclosure, is necessary but not sufficient. What we are interested in is how they go about this, and any extra steps they take, to consistently deliver good outcomes to their customers.

This is also a shift for those we regulate. They may need to think differently about what they do with their people and organisational culture, and their processes and controls, to show both us and their customers that they understand what good conduct is, and can habitually demonstrate it.

Conduct is particular to each business or person. A regulator cannot, and should not, prescribe how that happens. We appreciate that some people have already thought deeply about this. Others are still coming to grips with it. We expect this document to prompt those we regulate to examine how they think about good conduct to ensure they consistently deliver good outcomes to their customers.

What we want to achieve

We will use conduct as a 'lens' for how we view the activities of those we regulate, and interact with them. Our main focus will be ensuring that providers:

- are demonstrably delivering the outcomes their customers want
- can clearly articulate, and support with examples, how their conduct reflects the appropriate alignment of customer, business and, where relevant, shareholder interests
- are disclosing to investors and the public what they are doing to meet their regulatory obligations and the principles of good conduct, and how they are doing it.

How we will achieve it

To help providers understand our perspective, we will help them to assess:

- their capabilities, and to communicate how they can help their customers
- why their products and services are fair value, and to communicate this
- their business structure, strategy, services and products, and to communicate how their desired outcomes are aligned to good customer outcomes
- their governance and culture, and to communicate how their conduct demonstrates high standards of governance and culture

- their systems and controls, and to communicate how they support, as a minimum, a culture of compliance with regulatory obligations, and also meet the principles of good conduct
- the potential for misconduct, including market misconduct, and to communicate how they will identify, evaluate and address these risks.

This guide should not be seen as a checklist or manual. It is principles-based guidance about how we view conduct. It underpins how we think about licensing (and re-licensing), supervision, monitoring, and enforcement. It affects, for example, how we consider customer complaints and view customer outcomes. We have included questions to indicate what we will be looking for and asking about.

We hope providers find this guide useful when considering what they do and how they do it — particularly directors and senior managers who are not yet fully confident they can demonstrate good conduct.

Why we talk about customers

We think of a customer as an individual who buys financial products or services, including investment products. Providers of these products and services need to be aware of, and responsive to, their customers and their customers' financial capability, and tailor their own conduct accordingly. We emphasise this because financial judgments and investment decisions are typically complex. Customer knowledge of financial markets and products – even of their own savings and investment goals – varies widely. Providers should be particularly sensitive to this and be able to show how they have taken steps to minimise the risk of misunderstandings and poor customer outcomes (and therefore poor business outcomes).

Who should read this guide

This guide is aimed at the directors and senior managers of providers licensed by us under the FMC Act. However, because conduct is at the heart of all customers' experiences of financial products and services, it will also be relevant to other leaders and managers in the financial services industry.

How this guide fits with other FMA publications

See also:

- *Strategic Risk Outlook 2015,* which outlines our strategic priorities, including our focus on conduct, for the medium term
- *Investor Capability Strategy 2015-2018,* which outlines how we want to improve investor understanding and confidence
- *Corporate governance in New Zealand: Principles and guidelines* (December 2014).

Further detail on some of the subjects discussed in this guide, which in some cases are intended for specific types of businesses or professionals, is available on our website. For example:

- Information sheet: Market misconduct risks — a guide for MIS managers (August 2015)
- Guidance note: Governance under Part 4 of the FMC Act (September 2014)
- Guidance note: Monitoring investment risk in KiwiSaver schemes (March 2014).

Conduct

Why good conduct matters

Good conduct matters because at its most basic level, conduct is how people behave. Standards, systems, processes and controls are all necessary, but they are predictable and can be exploited by behaviour.

Providers can explain to a customer – or even show them – things like risk management tools and governance structures. But conduct is what the customer actually experiences.

Customers must be confident that their interests are being properly considered; that they are getting the right financial products and services at reasonable cost; and that they understand them. When this is the typical customer experience, it not only creates investor and public confidence in the fairness and transparency of specific businesses, but in the market in general. Therefore good conduct ultimately creates more depth and resilience in financial markets.

What is good conduct?

At its core, good conduct means focusing on customers. The result is good customer outcomes. It requires sound systems and controls, being disciplined about meeting compliance obligations, and good disclosure. Most importantly, it needs to be part of an organisation's culture. This includes setting clear expectations, but it is even more important to lead by example and to demonstrate consequences if those expectations are not met.

In all workplaces, people look to examples set by their colleagues, and especially their leaders, for a sense of whether formal conduct expectations are real, or just rhetoric. They also observe whether there are clear consequences, including for the leadership, if those expectations are not met.

In other words, conduct is what actually happens regardless of the systems, controls and formal rules that are in place. From a customer's perspective, it means:

What the provider does:

- Whether the provider has the skills and experience to competently provide the right service or product to the customer, and can meet professional standards of care.
- Whether the cost of the product or service significantly reduces the provider's ability to meet the customer's needs, by significantly reducing the return they get from it.

How the provider does it:

- Whether the customer's interest and the provider's business interests are clearly aligned, and any arrangements with associated parties are transparent.
- Regardless of the appearance of alignment, whether the provider will actually act in the customer's interest, and has the attitude and behaviour that produces good conduct, from the leadership down.
- Whether the provider will act with integrity, fulfil their responsibilities and obligations, and act honestly and fairly.

- Whether the provider has checks and balances to support good conduct, and identify and address poor conduct (including complaints and disputes resolution).
- Whether the provider can convincingly demonstrate all of this in a clear, concise and compelling way.

We believe these factors form a good conduct profile, and this is what we will use when we address conduct issues.

Good conduct profile framework

Our view of good conduct behaviour

Conduct is our lens for viewing and interacting with those we regulate. We will use the good conduct profile as a guide for how we try to influence their behaviour. It is the basis of the questions we have included in the 'Good conduct in practice' section of this guide, and it will be used by FMA staff when they deal with conduct issues.

Capability

What the customer cares about:

Whether the provider has the skills and experience to competently provide the right service or product, and can meet professional standards of care.

Our focus:

- The purpose of the services and products should be clear. It should also be clear what the benefits and risks are to customers. We will look at the professionalism, skills and experience of the provider and how it continually improves its skills through training.
- It should be clear how performance (such as returns) is measured, and over what period. The provider should explain why the benchmark is appropriate, and how it is aligned with its stated investment philosophy and objectives. It should also be clear why the provider believes its performance is 'a good story' for customers.

Conflict

What the customer cares about:

Whether their interests and the provider's business interests are clearly aligned, and any arrangements with associated parties are transparent.

Our focus:

- The provider should clearly identify, manage and disclose its actual and potential conflicts, particularly how staff are paid or incentivised. It should explain why it believes its approach is aligned to customer interests. This includes what services and products are recommended to customers, and how any performance benefits (such as returns) are shared with the customer.
- The provider should clearly explain any arrangement with associated parties.

Culture

What the customer cares about:

Whether the provider will act in the customer's interest, treat them honestly and fairly, and fulfil its duties and obligations, regardless of what it has said.

Our focus:

- It should be clear what behaviour is expected from everyone at the provider (including the leaders).
- More importantly, we want to see examples of how staff (including leaders') conduct makes those expectations clear and that any breaches are identified and appropriately acted upon.

Control

What the customer cares about:

Whether the provider has checks and balances in place to support good conduct and identify and address poor conduct, including complaints and disputes resolution.

Our focus:

- Leaders should be able to show, by referring to whatever is appropriate and effective for their circumstances, how they know good conduct is occurring.
- The provider should be able to demonstrate a transparent and effective complaints and disputes resolution process, and show that lessons learned are integrated into business practices.

Communication

What the customer cares about:

Whether the provider listens to what they want, and the customer can easily understand its services or products.

Our focus:

- It should be clear to customers what they are paying in fees and expenses, how these are calculated, and why the provider believes this is reasonable.
- The provider should communicate proactively and often with customers, especially if something goes wrong.
- The provider should communicate clearly, in plain language.
- The provider should have clear and effective lines of communication between boards, senior management, and frontline staff, to ensure a focus on customer outcomes at all levels of the business.

What this means for boards and senior management

The FMA does not prescribe culture. Boards and senior leaders decide culture, and are accountable for it. This means they are accountable for what actually happens at their organisation, and for customers.

A good culture encourages all staff to look out for, and look after, customers. It values customers, and gives customers what they want to help the business succeed. It means that across an organisation, from the leadership down, there is a common understanding of desired business outcomes and how they align with customer outcomes.

If a business achieves this, it is far easier for:

- legal advisers to clearly understand what the provider is trying to do, and how it is trying to do it
- staff to see that business and customer outcomes are closely related, and that what they do directly influences both outcomes
- leaders to demonstrate to us, customers and stakeholders that what they do and how they do it meets compliance obligations and good conduct principles.

Good conduct in practice

This section is designed to help providers understand our view of conduct. The questions below reflect topics and questions our staff are likely to ask when monitoring and engaging with those we regulate. We have included a glossary, incorporating some other useful concepts.

While we hope this guide is helpful, it is not a checklist or a manual. Ultimately providers are accountable for ensuring that their governance structures, control mechanisms and organisational culture are sufficiently relevant, suitable and sustainable to support good organisational conduct. If further guidance or help is required, we strongly encourage providers to seek independent advice from a trusted professional adviser, including, if appropriate, their supervisor.

Capability

- How do you know your products and services can meet, and are meeting, your customers' needs?
- How do you know you are good at knowing your customers, including their level of financial sophistication? Are you good at helping the least sophisticated to identify their needs, including that their needs may be better met by a product or service you don't offer?
- How do you know that the performance of your products and services is consistent with good outcomes for customers? How do you know that customers will have the same or better outcome with your services and products as they would have with similar services and products offered elsewhere? And how do you communicate all of that?
- How do you ensure you have effectively identified and addressed any capability gaps?
- How do you ensure you have the right capability before implementing growth strategies?
- How do you benchmark your capabilities? What standards do you use and why are they relevant and appropriate?

Conflict

- How do you demonstrate that your customer and business strategies are aligned?
- How do you demonstrate that the way leaders and staff are paid is aligned to customer outcomes?
- How do you know whether your cross-selling strategies, and practices, are appropriate?
- How do you demonstrate that fast growth is not at customers' expense?
- Are you comfortable that the risk your customers face is appropriate to their objectives and is properly compensated by the returns they receive? And are you also comfortable you have demonstrated that clearly to your customers?

Culture

- How do you evaluate and reward good conduct and appropriate behaviour within your organisation? How do you address poor conduct, and how could you demonstrate that?
- If problems arise, do you have the right structures, capabilities and courage to address them, including at the board level? How would you demonstrate that?
- How do you know that all staff are comfortable raising concerns with the board and senior management?
- How do you know you are good at challenging people, having difficult conversations, and providing constructive feedback to ensure accountability?
- How do you know you learn lessons from your mistakes and failings?
- How do you know that you stick to good conduct principles when under pressure?

Controls

- How do you know that the culture you claim to have is actually followed in the business? Do you have, for example, robust customer satisfaction methodologies?
- How do you ensure your perspective on your customers remains relevant? Do you use, for example, mystery shopping, customer call-backs, or surveys?
- Given your size and complexity, and your customer base and stakeholders, do you have the right skills, expertise and experience to provide the necessary oversight, challenge and action? How do you demonstrate that you have considered whether you need more or stronger capabilities by adding new board members and/or outsourcing?
- Given your resources and the risks you manage, how do you assess your controls and prioritise compliance activities?
- If you outsource your operational functions, how do you ensure you have the right monitoring mechanisms and controls in place to ensure you understand what your outsource partner is doing and how they are doing it?
- Does your board regularly assess its own effectiveness, and whether its role and objectives remain suitable for your operating environment?
- Do you have sufficient knowledge of, and insight into, what management is doing, from sources other than management? How do you know that good conduct principles are being put into practice, and that the right people are being held to account?
- How are you satisfied that there is a clear separation of accountabilities and an appropriate division of responsibilities amongst management?
- How are you satisfied you have spent sufficient time deciding how much risk you are prepared to tolerate? And that your parameters are supported with appropriate controls, such as early warning indicators and hard-stop mechanisms? And that these are sufficiently proactive and frequent?
- Do you have an appropriate whistleblowing process, and how can you demonstrate its effectiveness?

Communication

- Is your business model, and how you operate, open and transparent to your customers?
- How do you ensure your staff understand the alignment between your business and customer outcomes, and their direct impact on that relationship? How do you ensure they deliver this?
- Is your disclosure to customers accurate, clear, concise, effective and timely? What about when things go wrong? Is that quality consistent across all your communication channels, such as your website, advertisements, statements, and brochures? How do you know this?
- How do you know whether your customer complaints management and feedback process is effective?
- Are your customers paying a reasonable price for your products and services, and how do you demonstrate to your customers – through disclosure and discussion – that the price and the way it is calculated is reasonable?
- Are you transparent about the costs passed on from associated parties, third-party suppliers, or outsourced providers?

Glossary & useful concepts

Compliance assurance programme	Provides assurance by challenging and testing the effectiveness of controls, and the adequacy of governance and management information that ensures the business meets its regulatory obligations. Minimum standards for a compliance assurance programme are set out in the licensing guide for managed investment schemes. It must: • include in-depth (not just day-to-day) testing of processes and controls. This testing, and its design, should be done independently of those involved in day-to-day processes and oversight, or by an external organisation • be sufficiently resourced, and undertaken by people with sufficient skills and experience • be approved by the provider's oversight body • include regular updates on the provider's progress against the programme. These should be regularly provided to the oversight body, and significant findings should be promptly reported and acted on.
Conduct risk	The risk that conduct may contribute to poor outcomes for customers.
Control environment	The control environment defines what is, and is not, acceptable. Control environment factors include the integrity, ethical values and competence of the organisation's people; management's philosophy and operating style; the way management assigns authority and responsibility, and organises and develops its people; and the attention and direction provided by the board of directors. It sets the tone of the organisation and is the foundation for all components of control.
Demonstrate	To show with evidence. This proves that you do what you say you do by 'walking the talk'.
Good conduct	Good conduct is about doing the right thing by stakeholders: customers, investors, shareholders, employees and the public.
Governing guides	These outline accountabilities, roles, responsibilities, and the frameworks for how the business is governed. They may include charters, terms of reference, mandates, delegations, policies, procedures, and frameworks.
Internal audit	Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluating and improving the effectiveness of risk management, control and governance processes. Internal auditing is a catalyst for improving an organisation's governance, risk management and management controls by providing insight and recommendations based on analyses and assessments of data and business processes. With commitment to integrity and accountability, internal auditing provides value to governing bodies and senior management as objective independent advice.

Key risk indicators	Indicators that are aligned to their risk profile and risk tolerance levels. Once breached, they have prescribed actions that must be undertaken, such as escalation to the board via a chief executive or risk committee. Early warning indicators are identified metrics and elements that could signal a potential issue or risk, and drive further investigation and analysis, such as an increase in customer complaints.
Material information	If it would affect an investor's decision-making then it is material and should be disclosed and explained. It should be explained in the context and understanding of the intended and perceived market.
Net promoter score	A tool used to gauge the loyalty of an organisation's customer relationships. It is calculated from responses to a single question: 'How likely is it that you would recommend our company/product/service to a friend or colleague?' Scoring is generally on a 0 to 10 scale. Scorers of 9 or 10 are called 'promoters', and scorers of 0 to 6 are labeled 'detractors'. Responses of 7 and 8 are labeled 'passives', and are not included in the score. The net promoter score is calculated by subtracting the percentage of customers who are detractors from the percentage of customers who are promoters.
Oversight functionality	An oversight body (or 'functionality') that considers the adequacy and effectiveness of governance and compliance.
Risk and control self-assessment and attestations	This is a technique developed in 1987 and used by organisations to assess the effectiveness of their risk management and control processes. Management usually attests on a quarterly, six-monthly or annual basis that they have effectively managed the risk and controls they are responsible for. Self-assessment and attestation form part of an organisation's compliance framework but cannot be solely relied on. They must be used alongside other types of assurance, such as independent monitoring and assurance.
Risk appetite	The level of risk an organisation is willing to accept as manageable.
Risk management	Coordinated activities and processes to identify, assess, manage, direct and control potential risk events or situations. See also Enterprise Risk Management (ERM)
Risk tolerance	The level of risk an organisation is prepared to tolerate to achieve its objectives. These levels are generally quantitative, such as 'zero tolerance to mandate breaches' and '2% tolerance on data inputting errors'. They are driven by likelihood and consequence (or impact) factors.
Stakeholder	Any party that has an interest in or is impacted by an organisation. These parties can be internal or external to the organisation and include customers, investors, employees, suppliers and the public (via consequences).
Whistleblowing	The reporting of insider knowledge of illegal or inappropriate activities occurring in an organisation. Whistleblowers can be employees, suppliers, contractors, clients or individuals who are concerned about activities taking place in an organisation, either by witnessing the behaviour or being told about it. Employees who report 'serious wrongdoing' in their workplace can be protected under the Protected Disclosures Act.