What does the "client first" Code rule mean in practice?

David Maida | financialalert | 12 March 2014

The Financial Markets Authority (FMA) has approved the new revised Code of Professional Conduct for Authorised Financial Advisers (AFA). The document is now sitting with the Ministry of Business Innovation and Employment (MBIE) for approval. Despite some revisions to professional development requirements, the most distinct change to the Code is the prioritising of the concept of putting the client first. We asked some advisers what this actually means in day-to-day business and what they should be doing to keep from falling afoul of the new Code.

David Ireland, Code committee chairman and Kensington Swan partner, said that he would expect MBIE to give the Code the final tick sometime in March. It will then go back to the FMA to be gazetted and become law 28 days later.

"I don't think there is any desire on [the FMA's] part to sit on it. They have been appraised and aware of the process behind the scenes. We've had informal discussions and they haven't raised any concerns," Ireland told financialalert.

He said the client first principle has been in the Code since day one. So, if any advisers who are not already putting their clients first shouldn't be surprised to get a knock on the door from the FMA. "Everybody can say 'I'm a good guy. I know I'm a good guy because that's the way I do things.' But then how do you prove to an inquisitive third-party that that is the case?" Ireland asked.

That inquisitive third-party might already have negative presumptions about an adviser, in which case the adviser's job is going to be a lot more difficult.

"It might be a cause for advisers to step back and just look at their documentation and processes," Ireland said. "Ninety-nine cases out of 100, I'd expect them to say they are all good, it doesn't change my overall focus and approach. It might change a little bit of the detail potentially. But, overall, there should not need to be wholesale changes in response to what we have put in place. It's hopefully more about adding some clarity."

Many advisers will have an approved product list or a preferred range of products that they use with most clients. Yet it's quite possible that something outside this preferred product range could be better for certain clients in certain circumstances. Ireland understands that advisers can't recommend every product on the market - so he suggests that advisers just become very familiar with the products that they do advise on and make sure their clients understand them. He said advisers should make it clear to clients that there is a certain limited scope of products that they advise on.

"If I've restricted myself to a particular range of products, I need to make sure that the client is actually aware of that when considering the advice they've been provided," Ireland explained. "It's a question that can only be answered really in a particular scenario. It's not fatal to your ability to put the client first that you have restricted yourself to a particular range of products."

Ireland believes it is actually good for adviser to limit the range of products they use with clients, so it's possible to have a good, in-depth knowledge of what they're offering.

If the product range is comprehensive and covers all of an adviser's clients' needs, the adviser just needs to make sure they communicate their scope of service, Ireland said. "The client understands what the deal is and what I'm going to advise on. It's hard to see that going wrong as far as putting the client first. But, if there are kickbacks or any particular benefits from the range of products they're advising on, the adviser probably has a harder task in evidencing that they put the client first."

In the second scenario, the best defence is for the adviser to document how they've actively managed any conflicts of interest in recommending the specific products.

The new Code does not discourage commissions, Ireland said, but it does require transparency and informed consent.

"If I've got a very high performing product and it so happens that I'm getting a higher commission on that than I would get from another product, it doesn't mean that by recommending that to the clients I am not putting their interests first," Ireland said. The key in the situation is just to make sure that the client is aware of the situation.

Ireland also believes that putting the client first doesn't require putting all clients on the same level. "It is inevitable that if I've got a multiplicity of clients, some are going to get more face time with me than others," Ireland agreed. "That is a commercial reality. All of your clients are not going to be treated 100% equally between themselves."

Alan Lawton, senior client adviser with New Zealand Financial Planning in Wellington, knows a bit about the FMA's expectations as he was one of the first advisers audited when they began inspections. He told financialalert the idea of client first is certainly nothing new.

"The principle of client first was enshrined in our minds back in 1989. So I'm not surprised that this is in the legislation. At New Zealand Financial Planning, we have always worked on the principle that you put the client first."

Lawton maintains that if you put the client first, everything else is irrelevant. But he also has another twist on the concept. "If that is enshrined in the legislation and the people who are responsible for administering the legislation are the FMA, then we are their clients and they should always put our interests first! But it doesn't work that way because of the people they employed." Because the FMA has not primarily employed financial planners, they do not have "client first" embedded mentality as their first principle, Lawton believes.

He also questions whether banks which are operating as QFEs can be abiding by the principle. "I would think that if you look at a plan from a bank, you will find a huge amount of the bank's product in that plan. Is that putting the client first? Is that doing what is right for the client?"

Any time an adviser is associated with a wealth management organisation, you will find that a good 30% to 40% of the products on the preferred product list are branded by the institution that they are part of, Lawton contended. He believes this causes all sorts of issues in terms of independence.

He also believes all advisers should be subject to the Code regardless of whether they are an AFA or not. "I think the FMA has recognised that not all advisers were putting their clients first. If you're selling a single product, it's hard to do that."

Another key element in putting the client first is having a proper succession plan in place, Lawton argued. He calls this the elephant in the room of the financial services profession. "We've got a number of young people coming in behind us because our philosophy is that by putting your clients first, you have somebody to take over your portfolio when you retire."

Despite the requirements on financial advisers, Lawton firmly believes that it is still a great profession. "If you truly want to help people, this has been the most rewarding thing I've ever done. I have been a financial planner for 25 years."

Cindy Liu, director and senior client adviser with Global Village Personal Finance Planning and Wealth Management, works a lot in the Chinese community within New Zealand. She pointed out some subtle nuances around what putting the client first means for the Asian immigrant market.

The first thing is to never touch the client's money and to have things set up on a platform or custodial account.

"The second thing is that the public needs to know there are ups and downs in the market. It's the basic value that they're investing in instead of the price. it takes time for them to realise that over time you can make money."

Sometimes Liu says clients don't know what investments they need and it is up to her to figure out what is best for the client and make that her priority. She accepts no commissions from product providers so there is no issue there. "Our clients pursue the profit. We need to talk to them again and again about steady growth being much better than up-and-down. I think the Asian community fails to realise that. You can get rich quick and then you get poor quick again."

She says the Chinese community is also not aware of the wide range of opportunities with financial products because their main focus has always been to invest in property. "The tradition in the Chinese blood is residential property or commercial property. That's all."

This is in part due to the language barrier. Liu said she doesn't know of many product providers with sales people who speak Mandarin. Many Asians don't feel comfortable enough with their English to purchase financial products.

Liu has a lot of very wealthy clients and she is under no illusion as to whether they have all their money invested with her. "They'll give me a little bit to test me. When I make money for them, they are happy and then they do not mind paying me a fee."

Liu is working on a campaign with different fund managers to promote their funds to the Chinese community. "But, they need to be good fund managers and I don't receive anything from them. It's just to wake up the market. They don't know there is the option there. They only know residential property."

Garth Clarricoats, director of Optimum Professional Services, questions the changes to the Code and is concerned that the Committee feels they have to raise "client first" to a higher level.

"The requirements of the Code are very straightforward. The requirement to place clients first has always been there anyway. Anybody who has got skin in the game and is not doing it shouldn't be in the game."

Clarricoats believes most advisers are generally compliant – but there are still some who pay lip service to the notion of client first. The principle should be paramount in an adviser's practice and not have to be legislated, he argued – in fact, he voluntarily follows AFA practice although he has decided to remain at Registered Financial Adviser status. But, new changes to the Code could change that as well. "I've elected to remain at the registered level. There is a move afoot to see AFAs whose specific areas of competence are around insurance and Kiwi Saver. When that's finalised, I'll certainly be looking towards gaining AFA status then."

Tony Walker, AFA with Future History, told financialalert that the client first principle has always been the driving motivator for him and his business.

"I think the harder point will be if there is ever a challenge to it. What does it actually mean? It's one of those aspirational things mostly rather than a detailed legal thing that you can follow word for word."

He expects that over time the concept will be tested by case law.

Walker said the client first principle is just one of those things that an adviser either has or they don't. An adviser with values will naturally want to put their client first, he said.

Walker is an AFA in the insurance space which means he has to follow the Code while some of his competitors don't. "It's interesting because the RFAs don't have to worry about this but I think they do ultimately, because that client first principle is going to come back to haunt everybody in the long term if we don't get it right."

Walker believes the things that will catch advisers out are inadequate disclosure, explanation of processes and documentation. He said the advice process should be able to be robust enough that people can go back and look at it and see why you did what you did.

Also, the selection of product is going to be a thorny issue, particularly for product-based advisers, he believes. He doesn't feel conflicted because he charges a flat hourly rate.

"Why would you choose this product over of this one? How do you know that is better? How do you know that it's more appropriate for the client?"

Product selection is an increasingly important function for advisers because clients can go online and see the full range but expect an educated recommendation from their adviser.

"It's a complex business. We need to remind our clients that it's a complex business. And we need to remind ourselves that it is a complex business."