

AFA Monitoring Report

**Thematic Review: Discretionary Investment Management Services
January to March 2013**



Financial Markets Authority

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Our Conduct Focus

FMA's overarching focus is on raising standards of good conduct, ethics and integrity amongst market participants. Where activities have been subject to regulation for some time, we expect that participants will operate above the bare minimum required and that senior management will sponsor a culture of integrity and good conduct.

As part of FMA's ongoing monitoring of Authorised Financial Advisers (AFAs), we review AFA compliance with the conduct and disclosure obligations set out in the Financial Advisers Act 2008 (FA Act), the Code of Professional Conduct for Authorised Financial Advisers (Code). See Appendix One on page 16, for the Standard Conditions for AFAs.

Adviser conduct obligations

All financial advisers are required to have regard to the general conduct obligations under the FA Act. These include:

- financial advisers must exercise care, diligence and skill
- financial advisers must not engage in misleading or deceptive conduct.

In practice, when giving advice and applying the general conduct obligations, AFAs must:

- assess advice and product suitability for the client's needs
- explain the key features, risks and any limitations of the product to the client
- clearly articulate any limitations on the scope of the service being provided.



Introduction

FMA's monitoring programme enables us to observe and record how AFAs are complying with their legal obligations, and provides us with a unique opportunity to give feedback to AFAs about our observations. It also gives AFAs the information they need to make any necessary improvements to their processes.

Monitoring market participants is an important activity that helps us to deliver one of FMA's key legislative functions, which is to collect and disseminate information or research matters relating to financial markets.

Thematic Review – Discretionary Investment Management Services

During the January to March 2013 period, we carried out a thematic monitoring project focused on AFAs licensed to provide Discretionary Investment Management Services (DIMS). There are currently around 1,300 AFAs licensed to provide this type of service. A DIMS is defined as an investment arrangement under which an adviser makes buy-sell decisions in respect of a portfolio of investments, without referring to the client for each transaction. The purpose of the project was to:

- confirm which AFAs are licensed to provide DIMS are currently providing this service to clients
- monitor a selection of AFAs who are currently providing DIMS and understand how these services are being provided and if there are any potential compliance issues
- provide specific monitoring feedback to individual AFAs who have been visited by FMA.

Our approach

FMA contacted all AFAs who are licensed to provide DIMS and asked them to confirm whether or not they provided DIMS. We then selected a sample of AFAs' operating as a part of a national brand/dealer group, and AFAs operating their own business and requested that they provide a copy of their Adviser Business Statement (ABS).

Based on the approach above, we carried out a number of monitoring activities which included:

- seven stand-alone ABS reviews
- 46 ABS reviews, followed by telephone interviews with no further action
- 18 full visits
- one verification visit
- 11 stand-alone phone interviews to AFAs who responded that they do not provide DIMS
- 11 verification visits after ABS assessment/phone interview
- 12 full visits after ABS reviews/phone interviews.



Executive Summary

A significant number of AFAs who are licensed to provide DIMS advised FMA that they do not currently provide this service to clients and do not expect to do so in the near future. For some advisers, this may have been the result of changes to their advice practice since the licensing regime came into effect under the FA Act.

We also found that some advisers were unsure of whether the types of financial adviser services they provided included DIMS. In addition, where DIMS were being provided, there was no standard service model and practice and compliance with the Code was quite variable. To assist AFAs, more clarification is needed on whether or not certain adviser services are considered to be DIMS, and what FMA's view is on key aspects of client care, professionalism and regulatory compliance.

The content in this report is intended to demonstrate our approach to monitoring AFAs and bring to light some of the issues that can arise.

Next steps

FMA will be publishing guidance to outline our views on good practice for providing DIMS and our expectations of AFAs. This guidance will also explain the approach we intend to take in supervising compliance with legal and professional requirements for the provision of these services. The guidance is primarily intended for AFAs who are licensed to provide DIMS and will be updated to reflect the changes that will be brought about by the Financial Markets Conduct Bill (FMC Bill) and associated regulations.

Once AFAs have considered our guidance, they should review the services for which they are licensed. Any AFA who is licensed to provide DIMS, but is not currently providing it, should take the following steps:

- notify FMA under Standard Condition 3 that you do not want to provide DIMS as part of your service and request cancellation of your authorisation to provide DIMS
- update your AFA disclosure statement and ABS. These documents can be amended to show that the adviser services that you are licensed to provide do not include DIMS.

Overview of Market

What is a Discretionary Investment Management Service?

A DIMS is an investment arrangement under which an adviser makes buy-sell decisions in respect of a portfolio of investments, without referring to the owner (client) for every transaction or investment decision. DIMS are currently regulated as 'financial adviser services' under the FA Act.

Who can provide DIMS?

Only an AFA who is licensed to do so under the FA Act can provide personalised DIMS to a retail client for Category 1 products.

While a person who provides personalised DIMS only, to wholesale clients is not required to be licensed to do so under the FA Act, if an AFA does provide personalised DIMS to a wholesale client, he or she must do so in accordance with both the Act and the Code. A Qualifying Financial Entity (QFE) adviser can also provide personalised DIMS, but only in respect of Category 1 products of which the QFE is the product provider or promoter.

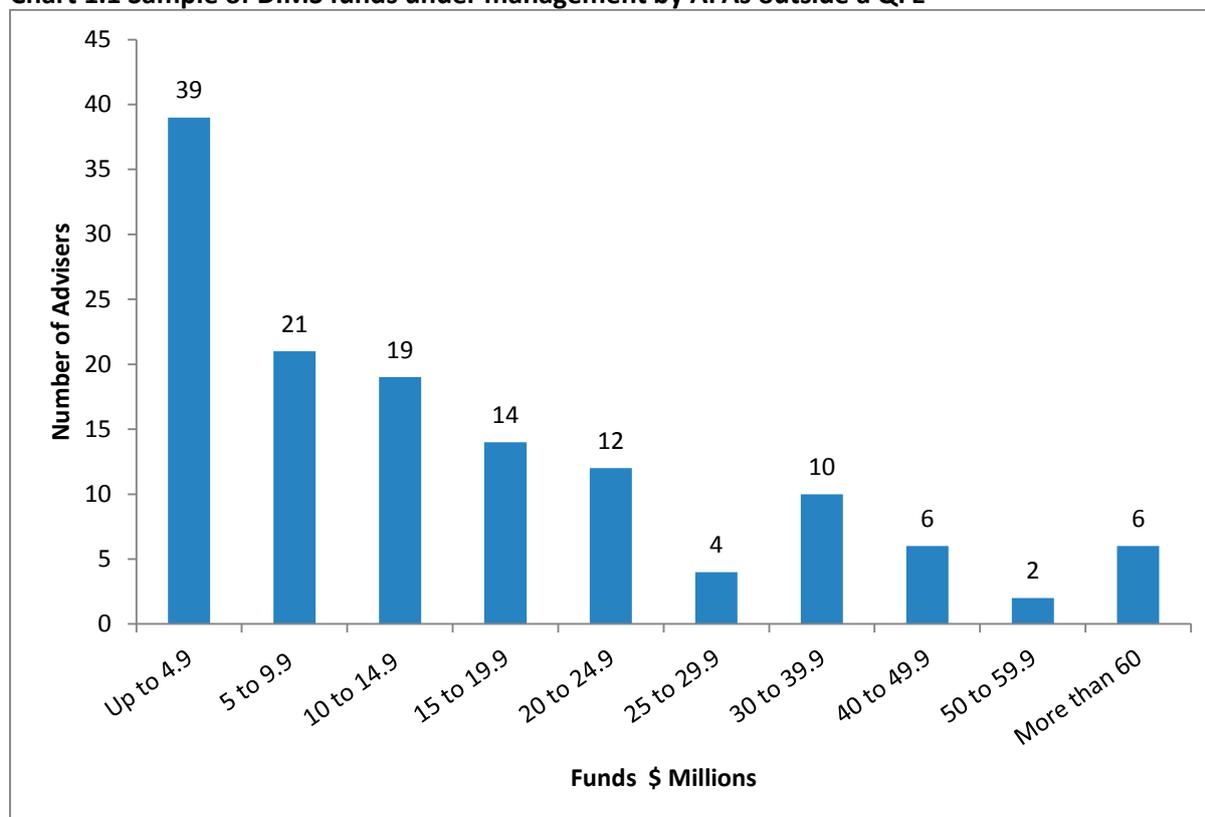
The Sector

- There are currently around 1,300 AFAs licensed to provide DIMS:
Only 44% (572) of those provide DIMS
- Of the 1300 AFAs authorised to provide DIMS:
55% (715) operate outside QFEs and 45% (585) operate inside QFEs
- Of AFAs' authorised to provide DIMS operating outside QFEs:
Around 48% (343) provide DIMS
- Of AFAs' authorised to provide DIMS operating inside QFEs:
Around 40% (234) provide DIMS
- Of the nine QFEs that have AFAs licensed to provide DIMS, only six of them have AFAs providing DIMS.

DIMS funds under management

As part of the review, 133 AFAs (outside a QFE) provided us with details of DIMS funds under management. Details are shown in Chart 1.1.

Chart 1.1 Sample of DIMS funds under management by AFAs outside a QFE



Questions and further information

As a professional adviser, AFAs need to be aware of their obligations under both the Act and the Code. If you have any questions, please check FMA's website to see if there is information available to assist with your query.

FMA's information line is open Monday to Friday from 8.30am to 5.00pm, Tel: 0800 434 567 (+64 3 962 2698 for overseas callers).

We recommend that all advisers visit our website regularly to keep up to date with the implementation of the new regulatory regime. All AFAs should receive AFA Updates, sent out periodically, relating specifically to AFA matters. If you do not currently receive this, please contact renee.ji@fma.govt.nz to be added to the list. You can also subscribe to receive FMA Updates for the latest news.

AFAs should also seek advice from their professional body, employer or QFE as necessary.

The following sites provide further useful information:

www.financialadvisercode.govt.nz - Code of Professional Conduct for AFAs

www.afacompetence.org.nz - the Skills Organisation information on competence standards and assessment

www.fspr.govt.nz - the Financial Service Providers Register.

Key findings and observations

Below is a summary of the key findings and some observations from our monitoring activities over this period. Where we identified short comings we have required the AFA to take appropriate steps to ensure these were addressed.

- Not all ABS were maintained in accordance with the most recent version of the AFA ABS Guide (see Box One).
- Not all AFAs were providing an analysis of the client's future overall financial situation, in addition to completing an analysis of the client's current financial situation as required by Code Standard 8, when providing an investment planning service – **see Case Study One**.
- Not all AFAs providing a personalised service to retail clients were disclosing information as required under sections 21-31 of the FA Act.
- Not all client agreements or investment mandates provided or presented the information we would expect, in a clear, concise and effective way, as required by Code Standard 7 and 9. For example, asset allocations were not well identified.
- Not all AFAs were taking reasonable steps to ensure that the client is aware of the principal benefits and risks involved, as required by Code Standard 9.
- Not all AFAs were explaining the limitations of their service as required by Code Standard 7. This included a situation where we considered that an AFA had not provided an adequate explanation of risks for using a class service – **see Case Study Two**.
- Not all AFAs provided adequate evidence that clients are wholesale under the FA Act – **see Case Study Three**.
- We also had concerns relating to advisers managing client requests to cash up their DIMS portfolio. Refer to our **general comment below** for more detail.

General comments

One area of concern FMA identified relates to AFA processes to action a client's request to cash up their DIMS portfolio. While we appreciate that clients may reasonably ask their advisers for their opinion on whether or not to make withdrawals or cash up, and may choose to retain their investments in their portfolio as a result of their adviser's recommendation, AFAs must ensure that they are not unduly pressuring or influencing their clients' decisions.

AFAs are reminded of Code Standard 1, which states: *"An Authorised Financial Adviser must place the interests of the client first, and must act with integrity"*.

Termination of a DIMS portfolio must be managed by an AFA with reasonable care. AFAs should also provide reasonable assistance during the closure of a DIMS portfolio, particularly where portfolio assets are not liquid. We remind AFAs to have a portfolio termination plan and to make clients aware of the termination process at the outset of establishing new arrangements with them. In particular, clients should be informed about the liquidity risk relating to the nature of the underlying assets, and the likely waiting period for closing the portfolio to allow an orderly sell-down of assets.

Box One: ABS and DIMS requirements

In order to comply with the terms and conditions of your authorisation (Standard Condition 1), an AFA is required to have and maintain an ABS in accordance with the most recently published version of the AFA ABS guide.

Your ABS should consist of two parts. Part 1, which should describe your adviser business and Part 2, which should explain the systems and procedures you have in place to comply with the requirements.

Where AFAs are providing DIMS, we expect to be able to ascertain the following from reading your ABS:

- that you are providing DIMS
- any custodial relationships that you have in place (including the identity of any custodians, wrap platforms or agents, disclosure of any interests in the custodian)
- whether you handle client money or property, and if so how; any checks that are carried out on your handling of client money; and who carries them out, including their relationship to you.

For more information about the ABS, please refer to the to our website:

<http://www.fma.govt.nz/compliance/licensing-and-registration/licensing-forms-and-resources/financial-advisers/afa-testimonial-templates-and-guidelines/>

Case Studies

For the purpose of this report, we have included three case studies to illustrate particular issues facing AFAs providing DIMS, as revealed by our monitoring. In each case, we have included the relevant legal requirements that relate to the service being provided, the reason for our intervention and what action we required the AFA to take.

DIMS Case Study One – insufficient identification of financial goals

Issue

The AFA indicated on all the client files we reviewed that the clients' financial goals were for 'capital growth', even though the clients' were receiving personalised services. We were not satisfied that the adviser had demonstrated that reasonable steps were taken to identify the clients' financial goals, as it is unlikely any two clients will have identical goals.

Background

The AFA is licensed to provide the following services:

- ✓ Financial Advice
- ✓ DIMS or Discretionary Investment Management Services
- ✓ Investment Planning Services

The relevant service relating to the issue:

- ∇ Investment Planning Service

Applicable requirements AFA must meet:

Code Standards	Code Standards relating to Ethical behaviour (1 – 5) Code Standards relating to client care (6-9, 12) Code standards relating to competency, knowledge and skill (14)
Financial Advisers Act 2008	Section 33 Section 34

Relevant conduct

- An AFA may design an investment plan for a client in connection with providing an investment planning service, which can then form the basis of the client's DIMS portfolio.

Suitability of advice

- Code Standard 8 provides that an AFA must take reasonable steps to ensure that a personalised service is suitable for the client and continues to be so. An AFA must make reasonable enquiries to ensure that the AFA has an up-to-date understanding of the client's financial situation, needs, goals and tolerance for risk.

Our response

An AFA must identify the client's expected investment outcome, either over a period of time or at a certain point in the future. To reach this outcome the AFA must make reasonable enquiries about the client's financial situation, financial goals, financial needs and tolerance for risk.

Under Code Standard 8, a description of a client's financial goals as 'capital growth', with no discussion of how a particular goal can be achieved, does not demonstrate that the AFA has made reasonable enquiries to have an up-to-date understanding of the client's financial needs and goals. This is because Code Standard 8 requires AFAs to make these enquiries having regard to the nature of the personalised service being provided, i.e. an investment planning service:

An investment planning service requires the AFA, among other things, to design a plan that is based on:

- analysis of the individual's **current** and **future** overall financial situation which must include his or her investment needs, (our emphasis)
- identification of the individual's investment goals.

Therefore, describing a client's financial goal simply as achieving capital growth in a portfolio does not in itself identify a particular need, such as retirement provision, nor does it appear specific enough to allow for any meaningful analysis of the client's future overall financial situation based on the plans we reviewed.

General comment

In almost all cases, a client will have quantifiable or measurable goals. The adviser must not influence the client or persuade them against having this goal unless it is not a rational or reasonable goal. Where the client does not present a goal in mind, it is the adviser's responsibility to work hand-in-hand with the client to identify their goals. Only in very limited circumstances will a client have a general goal which is not quantified by timeframes or investment outcome.

Case Study Two – Class DIMS and explanation of risks

Issue

AFAs within a firm offer DIMS as a class service (i.e: a financial adviser service that is not a personalised service). They offer one particular model which they described as a ‘fund’, although beneficial ownership of assets is actually held separately on behalf of the individual clients. Monthly reports sent to clients refer to overall portfolio performance rather than individual portfolio performance, which is based on the average portfolio performance of the last quarter. Performance reports are described as investment statements – which is a managed funds concept – that confuses the service proposition of DIMS.

In addition to this, the underlying investments are predominantly considered to be high risk, and therefore unlikely to be suitable for the personal circumstances of most retail investors.

Background

The AFA is licensed to provide the following services:

- ✓ Financial Advice
- ✓ DIMS or Discretionary Investment Management Services
- ✓ Investment Planning Services

The actual service provided to clients:

Class DIMS

Code Standards	Code Standards relating to Ethical behaviour (1-5) Code Standards relating to client care (6,7,10) Code Standard relation to competency, knowledge and skill (14)
Financial Advisers Act 2008	Section 33 Section 34

Our response

We engaged the AFA and advised them to stop advertising the portfolios as a fund. We also required the AFA to:

- write to the clients to explain why they had stopped referring to the investment portfolios as a fund and outline what the general risks of investing in a portfolio of this nature were, particularly given there are liquidity problems with some of the underlying investments held within the portfolio.

DIMS Case Study Three – Inadequate evidence that clients are wholesale under the FA Act

Issue

The advisory firm establishes companies to invest in wholesale opportunities and offers shares in these companies to clients and intends that those offers will not be public offers for the purposes of the Securities Act 1978 (**Securities Act**). In this case, for the purposes of the Securities Act and the FA Act, the AFA has been unable to provide evidence to show that the clients are wholesale clients for the purpose of the FA Act in the absence of any Eligible Person Certification (Securities Act) or Eligible Investor Certificate.

Background

The AFA is licensed to provide the following services:

- ✓ Financial Advice
- ✓ DIMS or Discretionary Investment Management Services
- ✓ Investment Planning Services

The relevant service relating to the issue:

- ∇ Financial Adviser services to wholesale clients

Applicable requirements AFA must meet:

Code Standards

Code Standards relating to Ethical behaviour (1 – 5)

Code Standards relating to client care (6)

Code standards relating to competency, knowledge and skill (14)

Financial Advisers Act 2008

Sections 5C, D & E

Section 33

Section 34

Securities Act 1978

Section 3(2) (a)

Refer to FMA's website for more information about eligible persons and eligible investors:

<http://www.fma.govt.nz/compliance/financial-advice/eligible-persons-and-eligible-investors/>

Classification of investor – retail or wholesale

- Under section 5 of the FA Act, clients can opt out of being regarded as 'retail investors' in relation to the provision of a DIMS and/or broking services by certifying that they are 'eligible investors'. By doing so they are regarded as a wholesale client, which means that the client does not have the same level of protection under the FA Act as a retail client.
- When DIMS are provided to a wholesale client Code Standard 6 requires the adviser to take all reasonable steps to ensure that the client is aware that they are regarded as a wholesale client for the purposes of the FA Act and the Code – and are aware of the consequences of that status.

Our response

The terms 'eligible persons' and 'eligible investors' are similar so it is important that AFAs understand these terms come from different legislation and different tests, processes and consequences apply.

We have requested the adviser to provide us with evidence or to explain the basis on which he had been determining that his clients are wholesale under the FA Act, in the absence of obtaining an 'eligible investor' certificate under the FA Act, or an 'eligible persons' certificate under the Securities Act.

If the AFA is unable to provide the evidence, there will be serious consequences under both the FA Act and the Securities Act.

Appendix One

Code of Professional Conduct

The Code of Professional Conduct contains the operative provisions which must be complied with by all AFA. Each standard in the Code consists of an overarching principle identified as a Code Standard together with additional provisions that contain further details about the application of the Code Standard. These are outlined below:

Minimum standards of ethical behaviour

- **Standard 1** Placing client interests first and acting with integrity
- **Standard 2** Not bringing the financial advisory industry into disrepute
- **Standard 3** Using the term 'independent'
- **Standard 4** Borrowing from or lending to a client
- **Standard 5** Restrictions that apply where AFA is related person of product provider

Minimum standards of client care

- **Standard 6** Behaving professionally
- **Standard 7** Ensuring retail clients are able to make informed decisions
- **Standard 8** Suitability of personalised services for retail clients
- **Standard 9** Explaining the basis of personalised services for retail clients
- **Standard 10** Providing class services for retail clients
- **Standard 11** Complaints processes
- **Standard 12** Keeping information about personalised services for retail clients
- **Standard 13** Record retention

Minimum standards of competence, knowledge, and skills

- **Standard 14** Overarching competence requirement
- **Standard 15** Requirement to have an adequate knowledge of Code, Act, and laws
- **Standard 16** National Certificate in Financial Services (Financial Advice) (Level 5) requirement and alternative qualifications



Minimum standards for continuing professional training

- **Standard 17** Professional development plan requirement
- **Standard 18** Undertaking continuing professional training

For the full Code please refer to FMA's website:

http://www.fma.govt.nz/assets/Code-of-Professional-Conduct-for-AFAs/_versions/2678/140501-Code-of-Professional-Conduct-for-AFAs.2.pdf



