

Guidance Note: Discretionary Investment Management Services

Draft for consultation 25 July 2013

About this guidance note

This guidance note is primarily intended for Authorised Financial Advisers (AFAs) who are licensed to provide discretionary investment management services (DIMS). It is also relevant to:

- entities that employ AFAs providing DIMS
- financial advisers providing DIMS to wholesale clients
- QFEs

(together with AFAs providing DIMS, called DIMS providers). Parts of this guidance are also relevant to entities providing 'custody' or broking services in connection with DIMS.

This guidance note provides the Financial Markets Authority's (FMA's) views on aspects of expected practice for AFAs providing DIMS and explains the approach we intend to take when monitoring compliance with relevant legal requirements. It also covers the handling of client money and property in connection with DIMS. It does not cover schemes that are authorised to hold investments collectively (for example, a fund manager under a unit trust), where investments are not individually identified for particular clients.¹

Significant changes will come into force when the Financial Markets Conduct Bill (Bill) and associated regulations come into effect (expected to be from 2014). One change is that provision of class DIMS will require a licence. However, AFAs will be able to continue to provide personalised DIMS². For information, some of the changes proposed under the Bill are noted briefly at the end of relevant sections of this guidance.³ The Code of Professional Conduct for AFAs, standard conditions for AFAs and any individual terms and conditions of authorisation will continue to apply to AFAs providing DIMS after the Bill takes effect.

¹ That kind of arrangement is a 'security' for purposes of the Securities Act 1978. Different requirements apply to those types of arrangements and are not within the scope of this guidance.

² The definition of personalised service in connection with DIMS will be refined under the Financial Markets Conduct Bill.

³ Some of the proposed changes are also likely to come through as a result of the Ministry of Business, Innovation and Employment's consultation on regulations to be made on how DIMS and custodians are regulated under the Financial Advisers Act 2008 ("Financial Adviser Regulations"). For further information, see <http://www.med.govt.nz/business/business-law/current-business-law-work/consultation-dims/discussion-document-dims-and-custody.pdf>

Why are we issuing guidance

We are issuing this guidance note to describe our expectations and the issues we will consider when regulating persons who provide DIMS and related services. While industry will set the standards for best practice for these services, this guidance provides our view on key aspects of client care, professionalism and regulatory compliance. It does not change the legal requirements for those who provide DIMS. We have also provided examples in the guidance to help explain our approach.

We recommend that AFAs read this guidance in conjunction with the **Guidance Note: Client Communications and Record-Keeping**.

Structure of this guidance note

This guidance note covers the topics in the table below.

Topic	What our guidance covers		Where to find it
Introduction	What are DIMS Typical 'life-cycle' of a DIMS		Part 1
Guidance on conduct	Client on-boarding	Investment authority	Part 2 Section A
		Explaining DIMS	
		DIMS review	
	The DIMS proposition	Investment mandate	Part 2 Section B
		Custody	
		Reporting	
	Ongoing Service	Instructions	Part 2 Section C
		Record keeping	
		Maintaining your ABS	

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Part 1: Introduction

What are DIMS?

1. A DIMS is an investment arrangement under which a person is authorised to make buy-sell decisions for the owner (**client**) in respect of a portfolio of investments (**investment portfolio**), often without referring to the client for every transaction or investment decision.

Financial Advisers Act definition

2. DIMS are currently regulated as 'financial adviser services' under the Financial Advisers Act 2008 (**Act**). Under Section 12 of the Act:

- “(1) A person (A) provides a discretionary investment management service if A:
- (a) decides which financial products to acquire or dispose of on behalf of a client (B); and
 - (b) in doing so is acting under an authority granted to A (or A's employer or principal) to manage some or all of B's holdings of financial products.
- (2) In determining whether A has that authority, it does not matter if B has the right to be consulted on, or to countermand, A's decisions.”

Investment authority

3. In this guidance note, we refer to the **investment authority** as the basis on which an AFA provides DIMS to a client. The investment authority is more than just the terms of service (such as reporting, fees, custody and so on, contained in a 'Terms of Business' or 'Client Agreement') and must include:
 - an **authority** granted by the client for the AFA (or the AFA's employer) to manage the client's portfolio of investments
 - **discretion** given to the AFA to decide which financial products to acquire or dispose of for the client.
4. In many cases, the investment authority will refer to a further document called the **investment mandate**. The investment mandate forms part of the investment authority, and is the framework for establishing and managing an investment portfolio through DIMS. The investment mandate may range from being a detailed investment programme that identifies particular classes of financial products in which client money may be invested, and the proportion that may be invested in each class (specifying ranges within which the proportions may fluctuate), to simply identifying an investment strategy or objective.
5. An AFA who provides personalised DIMS relating to a Category 1 product is required to provide a written explanation to the client on the basis of which DIMS is provided under Code Standard 9. This means that AFAs providing personalised DIMS must ensure that the investment authority is in writing.

Legal structure

6. The legal structure under which DIMS is provided can take a variety of forms. It can range from a relatively informal arrangement between a client and an individual AFA established by a simple one or two page power of attorney, to more complex arrangements promoted by large financial markets participants, and established under several contractual arrangements involving client, AFA, investment manager and independent custodian.
7. Particular care needs to be taken when the scope of the authority is open-ended or not explained clearly in writing. The Bill will bring in requirements for core documentation. Therefore, we encourage all advisers holding powers of attorney to review these arrangements ahead of the new requirements coming into effect, by ensuring that the scope of the investment authority is documented and has been explained to clients.

Platforms

8. AFAs may provide DIMS in connection with a 'platform' or 'wrap' provider. Platforms are investment portfolio services, used by financial advisers (and sometimes their clients directly) to view and administer their clients' investment portfolios. Platforms provide facilities for buying and selling financial products and can arrange custody for client property. Platform providers offer a range of tools, which may be integrated with an intermediary's back office system or accessed over the internet.
9. Some platform providers have direct responsibility to the client for holding and handling client money and property, while other platform providers only have contractual responsibility to a financial adviser acting as their agent.

Requirements

10. DIMS providers must comply with the legal requirements under the Act and its regulations. AFA's must also comply with:
 - the Code of Professional Conduct for AFAs (**Code**)
 - the standard conditions for AFAs (**Standard Conditions**)
 - individual terms and conditions of authorisation (if any).
11. DIMS providers or their employers may also be providing **broking services**⁴ if they handle client money or client property in the course of providing DIMS. DIMS providers or entities that hold client money or property are **brokers** and must comply with the conduct obligations (including trust accounting requirements), which apply to brokers under the Act. In the context of DIMS, 'client property' will generally mean financial products in an investment portfolio and 'client money' will include the cash account from which client funds are drawn for the purchase of client property, and into which the proceeds of any

⁴ Section 77A of the FA Act defines a broker as 'an individual or an entity who carries on a business of providing or offering to provide a broking service to a client (whether or not the business is the provider's only business or the provider's principal business)'. Section 77B defines a broking service as 'the receipt, holding, payment, or transfer of client money or client property by a person acting as an intermediary for a client'.

client property (sale proceeds, any dividends or distributions etc) are paid (where this is not the client's own bank account).

12. In this guidance note, we refer to the all of the requirements applying to DIMS providers or to any broker which provides services in connection with DIMS as the **Requirements**.
13. We note also the obligations of NZX Participants under the NZX Participant Rules with regard to discretionary accounts.⁵

Who can provide DIMS?

14. Personalised DIMS can only be provided to a retail client for Category 1 products by:
 - an AFA who is licensed to do so under the Act
 - a QFE adviser, but only in respect of Category 1 products of which the QFE is the product provider or promoter.
15. Category 1 products are defined in the Act and are generally investment products, including securities such as bonds, shares, managed funds (including KiwiSaver) and futures contracts.
16. Personalised DIMS provided to retail clients for Category 2 products can be provided by an AFA, QFE adviser or a registered individual. Class DIMS for retail clients and DIMS provided to wholesale clients can be provided by an AFA, QFE adviser, any registered individual or entity or an exempt provider. In all cases, the DIMS provider must act with care, diligence and skill.
17. While a person who provides personalised DIMS only to wholesale clients is not required to be authorised to do so under the Act, an AFA providing personalised DIMS to wholesale clients must comply with all the Requirements, including the Code.

Examples of DIMS

18. Here are a few examples of activities that are DIMS:
 - An adviser regularly realigns a client's portfolio to an agreed asset allocation in response to market movements (manually or automatically), without seeking the prior consent/approval of the client
 - A wrap provider offers a model portfolio service for clients who have been introduced by their adviser to use the wrap service. The client's money is invested into a specific selection of investments and in pre-determined proportions, and is re-balanced from time to time, to reflect the wrap provider's model portfolio. The wrap provider will not accept any buy-sell instructions from the client's adviser.
 - The wrap provider will not accept any buy-sell instructions from the adviser, as this would be inconsistent with the application of a model portfolio.
 - An adviser agrees to manage and take decisions on a client's share portfolio while the client is overseas

⁵ See NZX Participant Rule 9.10 and corresponding rules.

- A client gives authority to her financial adviser to select and trade investments on her behalf on an ongoing basis, and the adviser consults the client before each trade is made and sends confirmation after each trade is settled
- A client authorises an adviser to buy and sell investments to rebalance a portfolio as the investment values change from time to time, without seeking the client's instructions for each transaction.⁶ The adviser has initially agreed with the client that they maintain an investment portfolio that consists of 40 percent equities, 40 percent fixed interest and 20 percent cash, and the client approved the investments initially selected
- An adviser trades investments on behalf of his client from the menu or model portfolio designed by a platform provider without asking the client.

The sector

19. At the date of this guidance note approximately 1300 AFAs are authorised to provide DIMS. Of these, approximately 40 percent do so outside a QFE or a national advisory firm. However, our surveillance activities indicate that a significant number of those AFAs who are authorised to provide DIMS do not in fact do so.
20. FMA will actively monitor AFAs for compliance with the Requirements and will review their practice against the expected practice in this guidance note

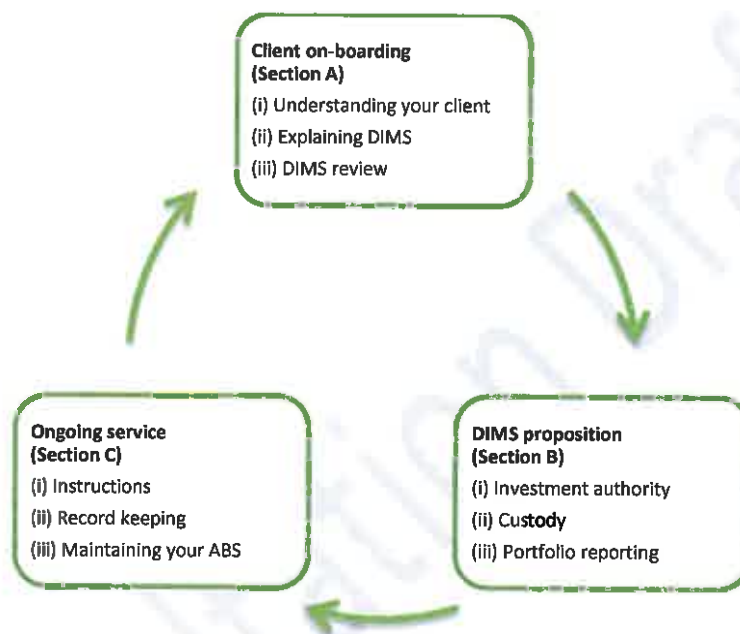
⁶ This is an example of DIMS because the client has authorised the adviser to buy and sell re-balance the client's portfolio, not simply because the adviser has agreed the asset allocation of the investment portfolio with the client.

Conduct during the provision of DIMS

21. In this guidance note, we describe conduct that is provided by an AFA during the various stages or 'life-cycle' of DIMS. We have detailed these stages and some of the typical components within each stage in **Diagram 1** below to illustrate the continuous nature of DIMS.

The typical 'life-cycle' of DIMS

Diagram 1



22. In each section under Part 2, we analyse the activities in the above diagram:
- describing what each activity might look like in general
 - setting out the legal requirements
 - explaining our views on expected practice.
23. AFAs must comply with the Requirements, and we encourage you to apply the aspects of good practice in this guidance at every stage of the service to reflect the continuous nature of DIMS – not just at the outset of the client relationship or when the services are initially provided.

Part 2: Guidance on conduct

Section A: Client on-boarding

(i) Understanding your client

What this might look like

24. An AFA requests her client to complete a client fact-find document, needs analysis and risk assessment questionnaire. She uses this information to propose an investment portfolio for a typically balanced investor, investing principally in shares and fixed interest assets, with a lesser exposure to listed property and cash assets.

Requirements

Suitability of personalised service

25. 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 remain suitable. 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.

Classification of investor – retail or wholesale

26. Clients of a financial adviser or broker will be regarded as retail clients unless they qualify as wholesale clients. Greater protections apply for retail clients than for wholesale clients under financial adviser legislation, including disclosure requirements for financial advisers providing personalised advice to retail clients, trust accounting obligations and access to a dispute resolution scheme in respect of any complaints.
27. A client can qualify as a wholesale client under one or more categories under section 5C of the Act. These categories include a person who is an 'eligible investor' (under section 5D) who certifies to the financial adviser that they have sufficient knowledge, skills or experience in financial matters to assess the value and risks of financial products and the merits of those services.
28. Retail clients should **not** be incorrectly categorised as wholesale. The Act and Code Standard 6 require the AFA 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 Act and the Code, and are also aware of the consequences of that status.
29. If a financial adviser or broker is not satisfied about a client's reasons for providing an 'eligible investor' certificate or has reason to believe that it is incorrect, the Act requires that the certificate must not be accepted. The Act includes penalties for accepting a wholesale certificate in contravention of these requirements.

Expected practice

30. The level of client analysis needed to satisfy Code Standard 8 will depend on the nature of the personalised service being provided. For example, an AFA who provides an investment planning service in addition to DIMS should complete a more detailed analysis than another AFA that simply provides DIMS. Having regard to the continuous nature of DIMS, we expect all AFAs providing DIMS to make reasonable enquiries to identify at the following:
- the risk profile of the client
 - the client's expectations with regard to returns and capital growth
 - the client's need to receive regular income.
31. With regard to classifying clients as retail or wholesale under the Act, we expect you to:
- have robust systems in place to ensure that you correctly identify and distinguish between all retail and wholesale clients
 - explain to your clients how clients are categorised and how you have determined this
 - be able to demonstrate to us, , how each decision was made to categorise your clients as wholesale or retail, and to retain records of those decisions
 - review each client's categorisation as wholesale or retail at least on an annual basis or more frequently.

Financial Markets Conduct Bill

AFAs providing DIMS will have specific statutory obligations in the provision of DIMS to retail clients including:

- duty to act honestly and in best interests of clients
- duty to comply with professional standard of care

There will be some changes to the definitions of "wholesale clients" and "eligible investors" which impact on where an AFA provides DIMS.

(ii) Explaining DIMS

What this might look like

32. After an AFA has prepared a proposed investment authority for a client, she gives her client an overview of key information relating to the DIMS and explains the benefits and risks of managing the client's investment portfolio through the DIMS.
33. For example, a potential benefit might be that her client wants to keep track of his investments by receiving one consolidated report for his investment portfolio managed through DIMS, instead of one for each of his investments.
34. The AFA also explains that her client can alternatively choose to manage his investment portfolio by receiving financial advice (instead of DIMS), and explains the comparative benefits and matters to consider for both types of services.

Requirements

35. AFAs providing personalised DIMS to retail clients must provide clients with a primary and secondary disclosure statement (sections 21-31 of the Act). This includes information about the AFA regarding their authorisation to provide DIMS, the fees/commissions that they will receive and any actual or potential conflicts of interest.
36. For AFAs, the disclosure statements are minimum disclosure requirements. AFAs also need to comply with Code Standard 7, which requires additional information to be provided to clients to enable them to make informed decisions about whether to use the AFA's services. AFAs are expected to give clients a brief, but comprehensive explanation of the proposed DIMS. This includes informing the client of the principal benefits and matters to consider when deciding to allow an AFA to manage their investment portfolio through DIMS.
37. For AFAs providing personalised DIMS, the AFA's explanation of DIMS must be summarised in writing in the investment authority to comply with Code Standard 9. The explanation forms part of the basis on which the client receives DIMS. Please refer to our comments on investment authorities under **Section B** for more information.

Expected practice

38. AFAs providing personalised DIMS are expected to clearly explain the following to their clients:
 - the scope of the AFA's **authority** to manage the investment portfolio (including what is outside the AFA's authority)
 - the scope of the AFA's **discretion** to decide on which financial products the AFA can buy or sell for the client (include what is outside the AFA's discretion). You may refer the client to the **investment mandate** for a more detailed explanation of the scope of the AFA's discretion (refer to **Section B** for more information)
 - the **principal benefits and risks** involved in having the client's portfolio managed through DIMS

- the **fees payable by the client** (include all fees paid to the AFA, platform providers and other third parties)
 - whether the AFA (or their employer) is responsible for holding any **client money or property**
 - whether a **platform provider, custodian, agent or other third party** has been appointed to provide any services in connection with the DIMS, and if so, an explanation of the scope of service and information about the platform provider, custodian, agent or third party
 - how **additional cash** will be treated (for example, from client contributions, dividends from client property, proceeds of the sale of financial products)
 - the likely **timeframe for making withdrawals** from the DIMS portfolio, including any likely **liquidity risk** that may affect processing withdrawals within usual timeframes
 - the process for **terminating** the DIMS and winding-up the investment portfolio.
39. AFAs can give clients a brief explanation of the above matters and refer to the investment authority, client agreement or terms of business for more details.
40. AFAs should exercise their professional judgment to decide whether to include additional relevant information that would enable the client to make an informed decision about using their services.

Good practice

41. While not yet a Requirement, we consider it is good practice for AFAs to request that their clients appoint an independent custodian to hold client property in an investment portfolio instead of the AFA or a related entity. AFAs that do not follow this best practice should draw their client's attention to this fact and give a simple and accurate explanation about why an independent custodian has not been appointed.
42. Where a DIMS provider has arranged for a platform provider to hold client money and/or property,⁷ the client should enter into a separate written agreement with the platform provider, under which the platform provider has direct obligations to the client.

Financial Markets Conduct Bill

AFAs providing DIMS will be required to have a legally enforceable written client agreement with their retail clients. This will need to adequately cover the matters required by regulations. AFAs will have to select and use an independent custodian to hold client money and client property unless otherwise permitted by the terms of their authorisation or regulations. In addition to current disclosure requirements for AFAs, regulations will set out additional matters that AFAs must disclose to retail clients in relation to DIMS.

⁷ See paragraph 75 for more information.

(iii) DIMS review

What this might look like

43. An AFA arranges a time to speak with her client over the phone to conduct an annual review of his investment portfolio and the DIMS being provided. The client has received a copy of his statement of portfolio holdings from the platform provider who he has contracted to provide custody, administrative and reporting services with regard to his investment portfolio.
44. The AFA compares the client's holdings of financial products in the investment portfolio against the asset allocation and benchmarks contained in the investment authority. She draws the client's attention to the returns earned on the portfolio that are reported in the statement, and explains what factors are likely to have influenced these returns. She also asks her client a series of questions designed to prompt him to inform her of any changes to his circumstances that are relevant to the suitability of the DIMS being provided.

Requirements

45. Code Standard 8 requires AFAs to ensure that they have an up-to-date understanding of a client's financial situation, financial needs, financial goals and tolerance for risk, having regard to the nature of the personalised service provided.

Expected practice

46. Given the continuous nature of DIMS, the client's circumstances will very likely change while the service is being provided. Without regular updating to the investment authority, the investment portfolio may become unsuitable for the client. Therefore, reviews of the client's circumstances and the portfolio allocations and benchmarks should be conducted annually, or more frequently as required by the client to ensure that the investment portfolio managed through DIMS remain suitable for the client.
47. The level of inquiry undertaken at the annual review will depend on the nature of the personalised service being provided, for example, if an investment planning service is provided in conjunction with DIMS more information may be gathered. Similarly, the investment authority may specify an indicative timeframe for how long or short an investment strategy or position should be held. If so, a more comprehensive inquiry may be required at the time that the investment strategy is reviewed.
48. We also expect AFAs to regularly inform clients about any material or adverse changes in the underlying client property in their portfolios – for example credit rating downgrades, or significant increases or decreases in value of the overall portfolio.

Financial Markets Conduct Bill

AFAs providing DIMS to retail clients will have a duty to exercise the care, diligence and skill that a prudent person engaged in that profession would exercise in the same circumstances.

Section B: The DIMS proposition

(i) Investment authority

What this might look like

49. An AFA uses relevant information obtained during the client on-boarding phase described in **Section A** to prepare the investment authority for the client with a detailed investment mandate that specifies the portfolio's investment objectives, asset allocation (asset classes, sectors and geographic regions), ranges, benchmarks and a broad selection criteria for choosing financial products. The AFA prepares a letter for her client that encloses the investment authority, the terms of service and summarises the explanation she gave to her client about the DIMS. The client authorises the AFA to establish and manage an investment portfolio in accordance with the investment authority by accepting the terms of service.
50. The Code does not prescribe the format of the written investment authority. It may be contained in a terms of service with the client or in a letter of advice that is accepted by the client.

Requirements

51. Code Standard 9 requires that where AFAs provide personalised DIMS to a retail client, the AFA must provide a written explanation of the basis on which the service is provided. Therefore, an AFA who provides personalised DIMS must give a written investment authority to the client.
52. Code Standard 7 requires AFAs to ensure that retail clients receive sufficient information to enable them to make an informed decision about whether to use the AFAs services.
53. Therefore, An AFA's written investment authority should comprehensively set out the following, in a clear, concise and effective manner (Code Standard 6):
- **information** about the proposed DIMS as described in paragraph 38 above
 - the framework, or **investment mandate** for establishing the investment portfolio managed through DIMS
 - key facts about the **client's circumstances** that are relevant to the proposed DIMS
 - a brief explanation of why the proposed DIMS is **suitable** for the client.

Expected practice

54. FMA expects all investment authorities to be set out in writing and signed by the client.
55. FMA expects investment authorities to set out clear arrangements to deal with the following:

- how frequently the investment portfolio is re-balanced or re-aligned to the asset allocation, and whether re-balancing also occurs following specified events
- frequency of reports on the investment portfolio's value
- documents relating to investments, or transactions and other communications relating to investments (e.g. shareholder reports, notices, proxies relating to investments) and whether these should be sent to the client
- who will be responsible for exercising voting and other rights attaching to client property in the investment portfolio
- collecting and reinvesting or distributing income (including dividends and distributions of any kind) and principal (including the proceeds of the sale of client property)
- method and addresses for communications.

56. FMA expects the investment mandate to at least state:

- the nature and type of assets that can make up the portfolio
- the benchmark asset allocation for those types of assets
- the methods for valuing those assets
- the limits or ranges within each benchmark asset allocation.

Good practice

57. It is good practice to enter into a written agreement containing the general terms of service including a general authority for the AFA to provide DIMS in accordance with a more detailed investment mandate. This will allow the investment mandate to be updated from time to time, without also needing to update the agreement each time a change is made to the investment mandate.

Financial Markets Conduct Bill

AFAs providing DIMS to retail clients will be required to have a legally enforceable client agreement and a written investment authority in place. The investment authority will need to clearly disclose the scope of the investment authority granted by the retail client. This will need to include any limits on the nature or type of investments and on the proportion of each type of assets invested in. If there are no limits on any of these matters or the authority can be changed without the retail client's prior written consent, clear disclosure of this fact will need to be given.

(ii) Custody

What this might look like

58. The person responsible for broking services in connection with DIMS (**broker**) might be the DIMS provider, a related entity to the DIMS provider, an internal platform provider, or an independent custodian, such as a wrap platform provider.

Example 1 – AFA has responsibility for client money and property

59. An AFA has direct responsibility to the client for handling and holding the client’s property in the investment portfolio and the client’s money in a trust account (**broking services**). The AFA contracts-out (‘outsources’) broking and other administrative services to a third party or an agent. See **Diagram 2** below. In this case, the third party (and any other parties that it sub-contracts) acts as an agent, but does not have direct responsibility to the client.

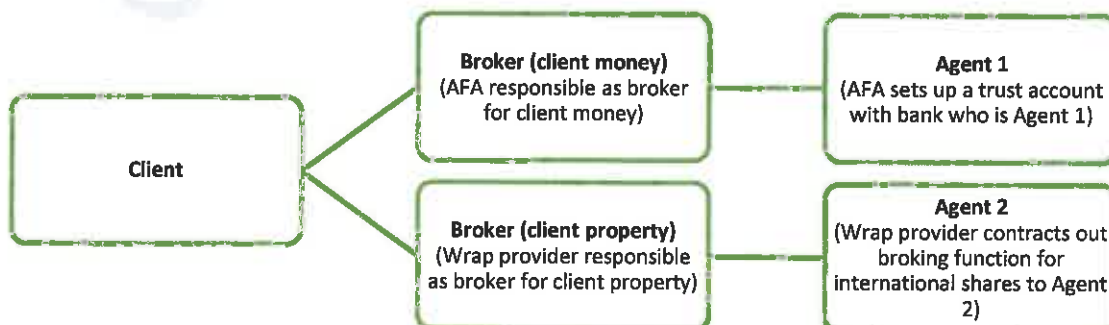
Diagram 2



Example 2 - AFA has responsibility for client money; third party has responsibility for client property

60. A client is requested by her AFA to appoint a ‘wrap provider’ to hold client property. The client enters into an agreement with the wrap provider to hold the client’s property in an investment portfolio (called a **custody agreement**), and to facilitate buy and sell orders it receives from the AFA. The client regularly deposits cash into the AFA’s client trust account for the purpose of making further investments into the investment portfolio. See **Diagram 3** below. In this case, the third party wrap provider has direct responsibility for holding and handling client property, and the AFA has responsibility for holding and handling client money.

Diagram 3



Requirements

61. Entities and individuals⁸ who hold client money or property in the course of providing DIMS (i.e. acting as the intermediary for a client in the receipt, holding, payment or transfer or client money or property) must comply with the conduct obligations under Part 3A of the Act. This person is a 'broker'. Brokers must be registered to provide 'broking services' on the Financial Services Providers Register. AFAs do not need to be separately registered as a broker if their employer is registered (although they may still be dealing with client money or property). However, for ease of reference, we'll describe all persons who are responsible for handling client money and/or client property as 'brokers'.
62. Standard Condition 5 requires an AFA providing DIMS to act in accordance with the obligations on a broker, for the activities that he or she undertakes relating to client money and property.⁹ Therefore, an AFA dealing with client money or property whose employer is registered as a broker should consider whether the employer's broking arrangements meet the Requirements.
63. The general conduct obligations (set out in sections 77J to 77O of the Act) include obligations:
- to exercise care, diligence and skill
 - not to engage in misleading or deceptive conduct
64. In addition, there are specific obligations for broking services for retail clients (sections 77P-77T of the Act), which include requirements:
- to hold client money and property on trust in a separate trust account
 - to properly account to the client for money and property held
 - to maintain adequate records of the client money and property
 - not to use or apply client money or property except as expressly directed by the client. The money or property cannot be used to pay creditors of the broker.

Expected practice - Brokers

65. The expected practice below is relevant in a DIMS context, but is not an exhaustive guide to broking services.
66. Brokers should enter into a Custody Agreement with clients clearly setting out client money and property handling arrangements, including:

⁸ Individuals do not need to register for broking under the Financial Service Providers Register if they are employees and their employer is registered for broking.

⁹ The explanatory notes to the Standard Conditions explain that the AFA is not expected to have separate systems from those operated by their employer, but does need to take reasonable steps to handle money or property appropriately where directly involved and to satisfy his/herself that the employer's systems enable the AFA to fulfil his or her responsibilities under the Act.

- whether money and property will be held in a **separate client account** for each client, or in an aggregated client account
 - whether handling of money and property is **outsourced**
 - **administrative fees** and other expenses that will be charged for handling money and property, how and when these will be collected.
67. Brokers must have adequate systems and processes in place to ensure that client money and property is:
- **identified and recorded** on a timely basis (at least daily) in a client register or ledger, which separately identifies each client's portfolio holdings
 - **segregated** from the broker's own assets
 - held in a **trust account**. The trust status of each client money or property account should contain the word 'trust' and the broker should obtain a letter from each trust account provider acknowledging the trust status
 - **reconciled** on a regular basis to money and property records of external providers (for example, banks, external custodians and sub-custodians). The frequency of reconciliation will depend on the frequency of trading of the investment - for example, reconciliations relating to equities are likely to be daily, whilst direct physical property investments might be reconciled when transactions occur.¹⁰
68. IT systems should be sufficiently robust and protected from potential threats (including from fraud). Records should be backed-up regularly and systems should include disaster recovery arrangements (for example, by having records stored off-site).
69. FMA expects systems for wholesale clients to include similar processes and controls to those for retail clients, in order to meet the care, diligence and skill requirements (section 77K).

Contracting-out (or outsourcing) to agents

70. Where the broker contracts out broking services to a third party (**agent**), the broker remains responsible to the client for broking services (section 77U).¹¹
71. In selecting an agent, the broker should carry out (and record) a due diligence process to consider the agent and the proposed arrangements under an agency agreement between the broker and the agent. This should include consideration of:
- whether the agent has adequate processes and controls to ensure compliance with this expected practice for brokers
 - whether the agent has internal audit or external review processes to verify compliance with this expected practice for brokers
 - whether the agent will be allowed to appoint any sub-agents

¹⁰ Reconciliations should be carried out by a person independent of the person taking decisions on the investment portfolio and processing the transactions.

¹¹ The agent will need to be registered to provide 'broking services' on the Financial Services Providers Register but will not be treated as the broker having the broker obligations to the underlying client under the Financial Advisers Act 2008.

- the agent's standing and reputation with other brokers and publicly available information on the agent's compliance history, owners and directors
 - the agent's capability to perform core administrative activities, including IT, accounting and risk management systems, proven capability of managing risk events and the agent's arrangements for how various types of assets are held
 - whether the agent has adequate professional indemnity insurance in place (and any requirements as to their capital adequacy)
 - whether the broker's fees are reasonable
 - the manner in which the agent must hold and deal with client money and property. This is particularly important if overseas custodians are used.
72. Brokers should consider how they will monitor an agent's performance and compliance on a regular basis.
73. Brokers should review their appointment of agents at least annually.
74. An AFA who handles client money or property but is not registered as a broker (because their employer is) should take reasonable steps to be satisfied that the agent is appropriate.

Expected practice - DIMS providers who do not handle client money and property

75. Where a DIMS provider arranges for a client to enter into a Custody Agreement with a broker, the DIMS provider should exercise reasonable care, diligence and skill in selecting and referring the client to the broker (section 33 of the Act).
76. AFAs should document the reasons for selecting a broker for referral, which should include consideration of:
- the **Custody Agreement** to ensure that it clearly explains how broking services will be provided and does not appear to contravene any broking requirements
 - the adequacy, frequency and quality of the broker's **reporting** on the investment portfolio
 - publicly available **information** about the custodian, its directors and owners, and its reputation with other AFAs or DIMs providers.
77. The AFA or DIMS provider should take additional care if recommending an overseas custodian (for example as contractual or regulatory requirements may be different).
78. The AFA should ensure that information used to instruct the broker (as permitted by the custodian's Custody Agreement with the client) is held securely.

Expected practice – All AFAs (whether handling client money or not)

79. As stated in **Section C** below, AFAs should ensure that clients receive reports on the value of their investment portfolio, regardless of whether the AFA handles the client's money or

property directly. The AFA should take steps to ensure that valuations are up to date and are appropriate (Code Standard 7 and section 33).

80. Where a person other than the AFA prepares investment portfolio reports, the AFA should understand the methods used for valuation, the frequency of the valuations and should be reasonably satisfied with the output. If the AFA needs to adjust a valuation recorded by a custodian (for example for physical property or an asset in liquidation), it should be clear to the client that this has been done and a reason given.

Good practice

81. As explained in paragraph 41 above, we consider it is best practice for DIMS providers to request that their clients appoint an independent custodian to hold client property and money. AFAs that do not follow this best practice should draw their client's attention to this matter. Under the proposed Financial Adviser Regulations, client property and client money must be held by an independent custodian.
82. It is good practice for brokers to obtain assurance from an appropriately qualified, experienced and independent person in relation to:
- the design and operation of the broker's processes and controls are adequate
 - the existence of client money and property as recorded in the broker's records.

For example, an AFA or broker might ask an auditor, internal auditor or compliance professional to provide a written opinion.¹² FMA may take into account any such opinion when determining what monitoring to undertake.

Financial Markets Conduct Bill

AFAs providing DIMS to retail clients will be required to use an independent custodian to hold client money and client property unless otherwise permitted by the terms of their authorisation, or by regulations or in situations where the client directly holds the property themselves. AFAs will need to be satisfied on reasonable grounds that the custodian is appropriate to hold and safeguard that money or property. The Bill confirms that custodians must comply with broker obligations under the Act. Regulations to be made under the Act will also specify requirements relating to custodians' record keeping and reporting and to audit, review and inspection of custodians' records. Regulations may potentially extend the conduct obligations relating to handling client money and property to wholesale broking services.

¹² For example, an auditor might carry out an engagement under International Standard for Assurance Engagements (ISAE) 3100 Compliance Engagements, as to whether:

- the custodian has adequate processes, procedures and controls for compliance with the requirements of the FAA in respect of its broking services;
- these have operated effectively during the period; and
- at the end of the custodian's financial year, the custodian was in compliance (including an audit of the client trust account).

(iii) Reporting

What this might look like

83. The AFA produces or arranges for the broker to produce statements that contain information regarding the content, value and performance of the client's DIMS portfolio at regular intervals. The AFA analyses the report having regard to the client's relevant circumstances to determine whether the investment portfolio remains suitable for the client. The AFA also uses the report to determine whether the investment portfolio needs to be re-balanced back to the asset allocations in the investment authority.

Requirements

84. To ensure that the investment portfolio remains suitable for the client (Code Standard 8) and is being professionally and transparently managed by the AFA (Code Standard 6), AFAs need to consider regular reporting on the investment portfolio.
85. Code Standard 6 also requires AFAs to communicate in a manner that is clear, concise and effective, so portfolio reports should be able to be easily understood by a non-expert investor.

Expected practice

86. We expect portfolio reports to contain:
- accurate information about the content, value and performance of a portfolio
 - a brief explanation of what performance figures relate to (for example, whether fees include deductions for tax and what is the period for measuring performance)
 - a transaction summary recording investment decisions made within the relevant reporting period.
87. Clients should be able to keep track of their investments by receiving portfolio reports from their AFA or platform provider at least twice a year.
88. AFAs who hold client money or property should have sufficiently robust IT systems in place to support this type of regular reporting.

Financial Markets Conduct Bill

AFAs providing DIMS to retail clients will be required to report to their clients on a periodic basis in accordance with regulations. AFAs will be required to provide certain information to clients about the occurrence of certain events. Independent custodians will also be subject to broking requirements relating to reporting obligations and to audit, review and inspection of their records.

Section C: Ongoing service

(i) Client communications

What this might look like

89. After the investment portfolio has been established and is being managed by the AFA under DIMS, the client informs the AFA that he wants to add a new authorised signatory to the account while he goes on holiday overseas.

Requirements

90. Given that the investment authority is usually agreed at the beginning of the client's relationship with an AFA, the AFA has an ongoing responsibility to ensure that the investment authority continues to meet the client's service requirements (Code Standard 8).
91. AFAs must act promptly in relation to duly authorised instructions from clients. This is required under section 33 of the Act and Code Standard 6 (behave professionally in all dealings with a client).

Expected practice

92. The following types of client instructions should be in writing and should be properly authorised and signed by the client:
- instructions to change or terminate the investment authority
 - instructions to change authorised signatories under the investment authority
 - instructions about where to deposit the proceeds of any withdrawal requests, which should only be paid to the client's bank account. In limited circumstances, such as where payments are made to an estate, withdrawal proceeds may be paid to a verified third party's bank account e.g. a solicitor's trust account. Payments should not be paid to the AFA's personal or corporate bank account.
 - instructions to debit fees or charges incurred by the AFA or platform provider not already set out in the investment authority
 - changes to bank accounts and personal contact details.
93. We expect AFAs to ensure clients have alternative arrangements with an independent person, solicitor or trustee if they become sick, are absent or unable to conduct their own affairs for a long time.

Financial Markets Conduct Bill

AFAs providing DIMS to retail clients will be required to have a written client agreement and client investment authority in place. Generally any changes to matters dealt with in those documents will need to be recorded in writing and agreed to by the retail client.

(ii) Record keeping

Requirements

94. Section 33 of the Act and Code Standard 6 require AFAs to ensure that they make investment decisions in relation to financial products that have been analysed by the AFA to a level that provides a reasonable basis for making a decision, or analysed by another person upon whose analysis it is reasonable, in all the circumstances, for the adviser to rely.
95. Code Standard 12 requires AFAs to record in writing adequate information about any personalised services provided to a client. All investment decisions must be recorded and copies of relevant research material should be retained.
96. AFAs are also required under Standard Condition 4 to ensure that all records pertaining to their financial adviser business are available for inspection by FMA at any time.
97. AFAs who are also brokers must keep records of client money and property under section 77R of the Act. Records must be complete, accurate and made on a timely basis, with property appropriately valued and ownership by the specific client must be clear.

Expected practice

98. We expect AFAs to record sufficient information to demonstrate that buy-sell decisions made were consistent with the investment authority.
99. The kinds of records that we expect AFAs to be keeping in their client files are set out below. These can be held electronically or in hard copy, or both, provided they are retrievable and readily accessible in a readable format.
 - copies of the investment authority, investment mandates and terms of service
 - the results of the inquiry to determine suitability of the proposed DIMS
 - information relating to investment decisions including research and analysis conducted by the AFA or another person who the AFA has reasonably relied on
 - if a platform provider has entered into an agreement with the client, copies of any agreements entered into between the platform provider and the client, showing the extent of the AFA's authority over the portfolio.
100. We expect AFAs who are brokers to maintain records that demonstrate the following:
 - **Receipt of money or property from clients** – all money received is accurately entered into the client trust account or general ledger, and then entered into the client ledger and allocated to the correct client on a timely basis.
 - **Holdings of money or property** – records clearly show the client's money or property (including money earned on client property and money) in the trust account, with regular reconciliations carried out to external sources of information and independently reviewed and authorised.

- **Use of money or sale of property, including for acquiring and disposing of property** – use and receipt of money or property is accurately recorded in the general ledger and the client ledger on a timely basis, and allocated to the correct client account. Records show that the use of money or sale of property is within the client’s instructions and money not reinvested has gone to a bank account authorised by the client.

Financial Markets Conduct Bill

AFAs providing DIMS to retail clients will be required to exercise the care, diligence and skill a prudent person in that profession would exercise in the same circumstances. Independent custodians will be required as brokers under the Act to keep records of client money and client property in a manner that enables them to be conveniently and properly audited, reviewed or inspected.

Consultation Draft

(iii) Maintaining your Adviser Business Statement (ABS)

Requirements

101. To comply with the terms and conditions of your authorisation (Standard Condition 1), you are required to have and maintain an ABS in accordance with the most recently published version of the AFA ABS guide.
102. Your ABS should consist of two parts. Part 1 should describe your adviser business and Part 2 should explain the systems and procedures you have in place to comply with the Requirements.
103. Where you are providing DIMS, you are required to provide the following information in your ABS:
- that you are providing DIMS (Expected information - Role)
 - whether you handle client money or property, the context and your involvement in this (Expected information - Products and services)
 - any custodial relationships that you have in place (including the identity of any custodians, platform providers or agents, disclosure of any interests in the custodian) (Suggested information – Client money, property and information)
 - if you handle client money or property, any checks that are carried out on your handling of client money, who carries them out – and their relationship to you, if any (Expected information – Client money, property and information).

Expected practice

104. In relation to DIMS, we expect your ABS to include:
- the compliance and other procedures that you have in place in relation to providing the DIMS and any broking services - the expected practice guidelines set out in this document and the Requirements should be addressed
 - that the service you are providing is DIMS (because you are providing management of a client's property on an individual basis) and not a managed fund.

Good practice

105. In relation to DIMS, it is good practice to include in your ABS:
- where a custodian is appointed, information about the approximate value of client property they are holding, including the level of fees
 - information about the investments that you can invest in and the types of clients for whom you are providing this service.