

# **Regulatory Impact Statement**

## **Financial Adviser Regulations: Discretionary Investment Management Services**

### **Agency Disclosure Statement**

This Regulatory Impact Statement has been prepared by the Ministry of Business, Innovation and Employment.

It provides an analysis of options to ensure that appropriate regulatory requirements apply to providers of discretionary investment management services (DIMS) under both the Financial Advisers Act 2008 (FA Act) and the Financial Markets Conduct Act 2013 (FMC Act). In general this involves increasing the requirements under the FA Act and adjusting the requirements under the FMC Act to make them more flexible.

These changes are intended to reduce the risk of regulatory arbitrage and to ensure that the regulatory regime for DIMS under the FMC Act does not pose an overly high barrier to smaller providers. It is difficult to quantify the level of harm that these problems could cause. There have, however, been cases where investors have suffered significant losses under the current regulatory regime for DIMS under the FA Act.

In addition, while improving investor confidence is a key aim of both these proposals and financial market regulation in general, it is not possible to quantify either how much these proposals would improve confidence by, or the benefits of improved confidence. It is also difficult to quantify the costs of the some proposals, given that they either reflect, or would only add marginal additional costs to, industry standard practice.

The regulation making powers under the Financial Advisers Act 2008 and the Financial Markets Conduct Act 2013 are key constraints for the policy options considered in this paper. Given that there is no immediate opportunity to amend these regulation making powers, we have only considered options that could be implemented through these powers.

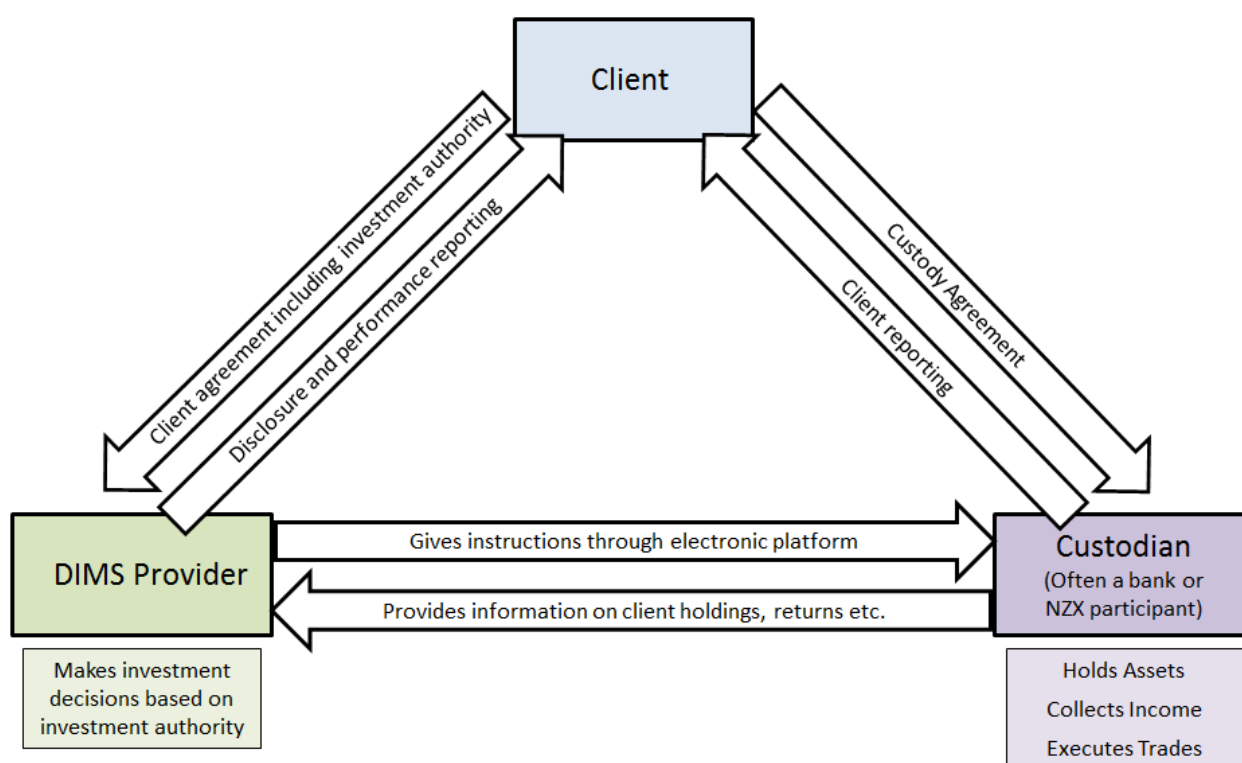
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Date: 3 June 2014

## Status Quo

- 1 DIMS are defined as any service where a provider has an authority from their client and makes decisions to acquire or dispose of financial products on their behalf. This covers a broad range of services, given that both the amount of discretion involved and the level of personalisation of the investment authority can vary significantly. Some DIMS offered under a generic investment authority can have similar characteristics to a financial product, while others are services that are entirely personalised to a client's circumstances.
- 2 An example of DIMS is an investment manager with discretion to make decisions on a client's behalf. If the investment manager is making the same decisions about the assets of a number of different clients, the DIMS would operate in a similar manner to a managed fund. Alternatively, if the investment authority is personalised to each client's circumstances, the investment manager would make independent decisions about each client's investments. Figure 1 provides an example of the roles of each party and the information flows in a DIMS.

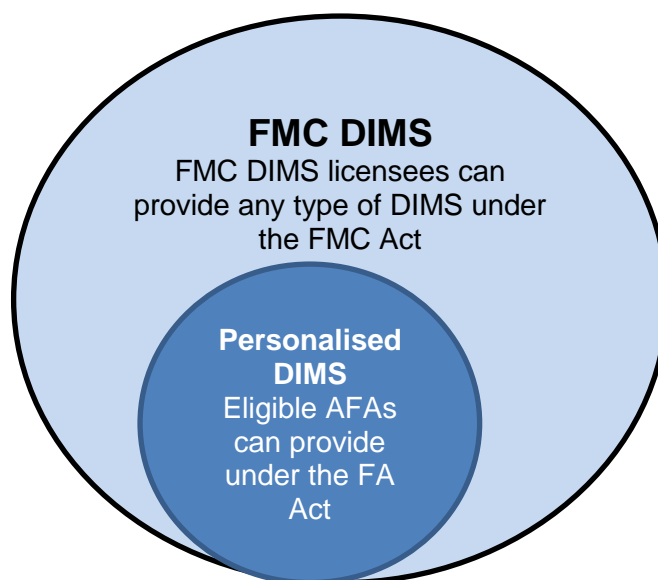
Figure 1: Example DIMS Arrangement



- 3 The FA Act currently permits certain financial advisers to provide DIMS (which is defined as a type of financial adviser service). While these advisers are subject to a range of requirements when providing advice, there are no additional reporting or disclosure requirements specific to providing DIMS and there is no assessment as part of the authorisation process of whether an adviser is capable of offering these services.
- 4 Authorised Financial Advisers (AFAs) make up the vast majority of DIMS providers at present. Currently 1,228 AFAs are permitted to offer DIMS, although FMA's research suggests that only approximately 560 AFAs actually provide DIMS.

- 5 The FA Act was part of the broader reform of financial sector regulation, of which the FMC Act is the final stage. The FMC Act, the second phase of which comes into force on 1 December 2014, will significantly alter how financial products are created, promoted and sold, and the ongoing responsibilities of those who offer, deal and trade them. The FMC Act will promote investor confidence in New Zealand's capital markets and is a cornerstone of the Business Growth Agenda.
- 6 Progress in improving investor confidence has been tarnished by incidents of DIMS providers being involved in misconduct that caused significant losses to investors. In particular, the Ross Asset Management fraud has highlighted the need to progress the reforms in the FMC Act and to strengthen how DIMS and custody are provided under the FA Act. While many of these issues will be addressed through the FMC Act, some of the detailed requirements are left to regulations under the FA Act.
- 7 The FMC Act will make significant changes to how DIMS are regulated. Most DIMS providers will need to be licensed at an entity level under the FMC Act. These providers will be able to provide any sort of DIMS, including both model portfolio type services that use a standardised investment strategy and DIMS that operate under a personalised investment strategy.
- 8 AFAs will continue to be able to provide truly personalised DIMS under the requirements of the FA Act rather than the FMC Act. The primary rationale for continuing to allow AFAs to provide personalised DIMS is that financial adviser services may often involve an adviser exercising some degree of discretion regarding their clients' investments and, given that personalised DIMS cannot operate like a managed fund, a separate DIMS licence is not warranted for these activities.

Figure 2: Regulatory Regimes for DIMS



## Problem Definitions

- 9 This regulatory impact statement considers responses to two related problems.

### *Problem 1: Misalignment between FA Act and FMC Act regulation of DIMS*

- 10 At present, there are a number of requirements that will apply to FMC DIMS licensees that will not apply to AFAs providing personalised DIMS. These include disclosure, regular reporting and requirements applying to client agreements.

- 11 In March 2013 Cabinet noted that there is a need to closely align regulation of DIMS provided under the FA Act and the FMC Act to limit the risk of regulatory arbitrage and promote investor confidence. Cabinet agreed to amendments to the FA Act through the FMC Act to allow for such requirements to be prescribed in regulations [CAB Min (13) 12/17]. These regulation-making powers allow for eligibility, disclosure and reporting requirements for AFAs offering DIMS to be prescribed.
- 12 There are two key risks of having significantly different requirements for DIMS under the two regimes:
- Investors are likely to expect requirements applying to DIMS to be similar, regardless of whether the investment strategy is personalised, and are unlikely to be aware of any differences between the regulatory regimes. When an investor chooses to enter into a DIMS agreement, they are likely to expect that they will be subject to the same protections and will receive the same information, regardless of whether the DIMS is offered under the FA Act or the FMC Act. This expectation could be taken advantage of, to the potential detriment of investors.
  - If the FA Act regime is significantly more attractive to DIMS providers, they may choose to modify their services to meet the definition of personalised DIMS. Given that personalisation for its own sake may not be in the interest of the investor (i.e. it could add costs or reduce investment returns), it is desirable to limit the incentives to undertake this behaviour.

13 In principle, we consider that persons offering very similar services should be subject to similar requirements, regardless of the particular legislation that applies to the service. The FA Act does not currently include requirements for DIMS that are equivalent to the FMC Act. Ensuring that similar kinds of systems and processes are in place for all DIMS and that investors are provided with enough information to make informed decisions would minimise risks to investors.

*Problem 2: The application of the FMC DIMS licencing regime to smaller providers*

- 14 Consultation suggests that only a relatively small proportion of AFAs will offer personalised DIMS, given that their investment strategies are normally the same or similar across a number of their clients.
- 15 The majority of current DIMS providers will therefore need to either obtain a licence under the FMC Act, change their service so that it meets the definition of personalised DIMS (which is not necessarily desirable, as noted above), or stop offering the service entirely. Consultation suggests that smaller providers, such as many AFA led businesses, do not plan to obtain an FMC DIMS licence, as they see it as unachievable or unaffordable.
- 16 Part of this problem is caused by the cost of applying for an FMC DIMS licence. The current level of the fee may be enough to dissuade smaller DIMS providers from applying for and FMC DIMS licence.
- 17 We are concerned about the effect that this might have on competition in the market and on the types of services that are available to consumers. Given that some types of DIMS are very limited in scope, under the status quo some of these providers may not be able to justify obtaining an FMC licence, possibly limiting consumer access to limited DIMS services.

18 In other instances, the real or perceived compliance costs of an FMC licence may encourage consolidation in the market in order to more easily absorb these costs. This consolidation may limit competition in the market for DIMS and for other related services, such as financial advice.

## Objectives

19 The Ministry has identified the following criteria for assessing whether options will help to address problem 1 and problem 2.

### Assessment criteria for proposals

Provides timely, accurate, and understandable information to persons to assist in decisions relating to financial products or the provision of financial services

Applies appropriate governance arrangements to financial products and certain financial services that allow for effective monitoring and reduce governance risks

Avoids unnecessary compliance costs

Promotes innovation and flexibility in the financial markets

20 These criteria need to be balanced against each other, in order to resolve the problems and achieve the main purposes of the FA Act and FMC Act. In the regulatory impact analysis sections below, we consider the extent to which the options impact on these criteria – both positively and negatively – compared to the status quo.

21 The four assessment criteria are based on the additional purposes of the FA Act. These purposes are shared by the FMC Act. There are trade-offs between these assessment criteria. In particular, regulatory options which improve investor information and governance generally add compliance costs for providers and limit the flexibility of their operations, and vice versa.

22 Options that provide the best balance between these criteria are likely to be best placed to address the problems identified.

23 In selecting preferred options, these criteria are accorded roughly equal weight. The preferred option takes into account the impacts on these criteria, and reflects a judgement about which option is likely to best achieve the main purposes of the FA Act and FMC Act.

### *Criteria for assessing fee changes*

24 Different criteria have been adopted for assessing the proposal to amend the fee for an application to act as a DIMS provider under the FMC Act. These criteria match the policy objectives used in the Regulatory Impact Statement for Financial Markets Conduct Act Licence Fees: <http://www.med.govt.nz/business/business-law/current-business-law-work/financial-markets-conduct-act/licence-fees/ris.pdf>.

## Regulatory Impact Analysis

25 In respect of Problem 1, we have considered options relating to:

- **Eligibility requirements for personalised DIMS**
- **Initial disclosure requirements for personalised DIMS**
- **Client agreement requirements for personalised DIMS**
- **Periodic reporting requirements for personalised DIMS**

26 In respect of Problem 2, we have considered options relating to:

- **An FMC Act exemption for contingency DIMS**
- **FMC DIMS licence fees**

27 In each case, the status quo is considered as an option. While, in general, we do not consider that the status quo will effectively address the problems identified, it has been included as context to show why it is not a viable option.

## Eligibility requirements (Problem 1)

28 Three options for eligibility requirements are considered:

- Option 1: No additional eligibility requirement (status quo)
- Option 2: Flexible eligibility assessment (preferred option)

### ***Option 1: No additional eligibility requirement (status quo)***

29 Option 1 is the status quo. Financial advisers would be able to provide truly personalised DIMS without meeting any additional eligibility requirements.

30 AFAs are limited to providing the financial adviser services specified in their authorisation. Therefore some AFAs are only authorised to provide financial advice, while others are also authorised to provide investment planning services and DIMS. However, at present AFAs are not subject to additional eligibility criteria in order to be to be authorised to offer DIMS.

31 Our analysis of the impact of this option against the criteria is as follows:

- **Investor information**. This option would make it more difficult for investors to determine whether a DIMS provider is capable of providing DIMS, as whether this is assessed as part of a licensing process would depend on whether they are offering the DIMS under the FA Act or the FMC Act. The Ross Asset Management fraud provides an example of where investors have expected that an AFA's authorisation to provide DIMS would be subject to some sort of licensing or eligibility test, when this was not the case.

- **Appropriate governance**. There is a risk that if AFAs are able to offer personalised DIMS without meeting any sort of additional eligibility criteria, AFAs may seek to modify their services to meet the definition of personalised DIMS, in a way that might not be in the best interest of clients. Given that personalisation for its own sake may not be in the interest of the investor (i.e. it could add costs or reduce investment returns), it is desirable to limit the incentives to undertake this behaviour.
- **Compliance costs**. This option has no additional compliance costs.
- **Innovation and flexibility**. This option has no impact on innovation and flexibility.

32 The above analysis suggests that this option will not help to resolve problem 1. In our consultation, no submitters supported this option. All submitters considered it preferable to add an additional eligibility requirement that considers an advisers capability to provide a DIMS, in order to align requirements with the FMC DIMS regime.

### ***Option 2: Additional eligibility criteria***

33 Option 2 requires FMA, as part of the authorisation process, to assess whether an AFA is capable of offering a DIMS service and whether there is any reason to believe that they will not comply with regulatory requirements. This requirement would only apply to those AFAs who wished to be eligible to offer personalised DIMS. In line with the FMC Act, only these high-level elements of the eligibility test would be prescribed in regulation, with FMA retaining significant discretion as to the level of assessment that it considers appropriate.

34 This approach would provide FMA with the flexibility to adjust its assessment to reflect the scope of the service that the AFA proposes to provide. The extent, and cost, of this assessment could vary from an assessment of an advisor's existing documentation about their business and compliance arrangements, through to an eligibility assessment that would be similar to that that will apply to FMC DIMS licensees. This reflects the fact that the scope, risks and complexity of a DIMS is not necessarily linked to whether it is offered on a personalised or class basis.

35 Our analysis of the impact of this option against the criteria is as follows:

- **Investor information**. Ensuring that all providers of DIMS are subject to an eligibility assessment that is appropriate to the type of DIMS they are offering will compensate for information asymmetries between investors and DIMS providers. One purpose of licensing regimes is to promote investor confidence by limiting the research costs associated with choosing a service provider. For the DIMS regulatory regime to work well investors need to be confident that DIMS providers offering similar services are subject to similar eligibility requirements, regardless of whether the service is offered under the FA Act or the FMC Act.
- **Appropriate governance**. The assessment of an AFA's processes and systems will allow FMA to ensure that the AFA has outlined an appropriate governance and compliance environment for the DIMS. This will provide a significant degree of additional assurance that all providers of DIMS have appropriate systems and procedures in place to ensure that investor's assets are appropriately protected.

In addition, having a similar level of eligibility assessment to FMC Act DIMS will limit any unintended effects caused by regulatory arbitrage. In particular, if personalised DIMS under the FA Act not subject to eligibility requirements, this may encourage AFAs to shift from offering class DIMS to personalised DIMS. Given that personalisation for its own sake may not be in the interest of the investor (i.e. it could add costs or reduce investment returns), it is desirable to limit the incentives to undertake this behaviour.

FMA has the ability to require any provider to be licensed under the FMC Act if this licensing test is deemed to be more appropriate in the circumstances (i.e. if they are proposing to offer a the service to a very large number of persons or in respect of a large value of funds).

- **Compliance costs.** The compliance costs of this option would be highly dependent on the scope of the service that the AFA proposes to provide. If the service is largely incidental to their normal adviser work, the impact of this assessment is likely to be minimal, as AFAs are already required to produce much of the information that would be assessed through their adviser business statement. If an AFA proposes to provide a “full service” personalised DIMS, then they may incur costs establishing the kinds of systems and procedures that FMA considers to be necessary to effectively provide such a service.
- **Innovation and flexibility.** This option may have a negative impact on innovation and flexibility, given that AFA providing DIMS will need to have the required systems and processes in place (to the extent that there may be other ways of providing a DIMS without these systems and processes). Given that these requirements consist of the basic measures necessary to appropriately provide such a service, and that FMA will have the ability to modify its eligibility requirements to reflect technological and industry developments, we consider this impact to be small.

36 The above analysis suggests that this option will help to resolve problem 1. All submitters supported some form of additional eligibility criteria for AFAs providing personalised DIMS.

### Summary

Options	Impact on objective: Investor information	Impact on objective: Appropriate governance	Impact on objective: Compliance costs	Impact on objective: Innovation & flexibility	Preferred option? (Y / N)
<b>1. No additional eligibility requirement (status quo)</b>	-	-	-	-	N
<b>2. Additional eligibility criteria</b>	Moderate benefit	Moderate benefit	Small negative	Small negative	Y

37 In summary, our preferred option is option 2. While an eligibility criteria will introduce costs, and limit the flexibility of AFAs who wish to be eligible to offer personalised DIMS, these negatives are outweighed by the benefits of limiting the potential for arbitrage between the FA Act and FMC Act DIMS regimes, and ensure that investors can be confident that the systems and processes of all DIMS provider have been subject to a level of scrutiny by FMA.



## **DIMS disclosure requirements (Problem 1)**

38 Three options for DIMS disclosure requirements are considered:

- Option 1: No additional disclosure requirements (status quo)
- Option 2: Additional disclosure through existing disclosure statements (preferred option)
- Option 3: Separate DIMS disclosure statement

### ***Option 1: No additional disclosure requirements (status quo)***

39 Option 1 is the status quo. While AFAs are required to provide their clients with disclosure statements outlining matters such as the types of services they offer, conflicts of interest and remuneration, this disclosure does not cover many of the matters that will need to be disclosed for DIMS under the FMC Act.

40 Our analysis of the impact of this option against the criteria is as follows:

- **Investor information**. Investors who utilise personalised DIMS under the FA Act will not necessarily have access to the same information that they would be provided with if those DIMS had been offered under the FMC Act. This information should be an important part of an investor deciding whether or not to utilise a DIMS.
- **Appropriate governance**. This option has no impact on appropriate governance.
- **Compliance costs**. This option has no additional compliance costs.
- **Innovation and flexibility**. This option has no impact on innovation and flexibility.

41 The above analysis suggests that this option will not help to resolve problem 1. In our consultation, no submitters supported this option. While some submitters differed on the form disclosure should take, no submitters considered the status quo to be an acceptable option, due to the lack of information required to be provided to investors about key elements of DIMS.

### ***Option 2: Additional disclosure through existing disclosure statements***

42 Option 2 would require AFAs offering personalised DIMS to add information to their existing disclosure statements to align with the requirements under the FMC Act. This additional information is expected to include:

- a. A prescribed statement outlining what a DIMS involves and what risks are associated with investing through DIMS
- b. Information about fees that will be charged in relation to the underlying investment products
- c. How custody over assets will be provided (including the name and details of the custodian) and whether the custodian is independent from the DIMS provider
- d. How the client may give instructions on corporate actions relating to financial products in their portfolio
- e. What will happen on the termination of the client agreement (whether the assets will be transferred to the client's control, or will be sold at the client's direction).

43 Our analysis of the impact of this option against the criteria is as follows:

- **Investor information.** Investors would receive substantively the same information as they would receive if they chose to utilise a DIMS offered under the FMC Act, but in a different form. While this might make it more difficult to compare disclosure statements between DIMS offered under the two regimes, we do not consider comparability of these types of disclosure documents to be as important in respect of personalised DIMS.
- **Appropriate governance.** This option has no impact on appropriate governance.
- **Compliance costs.** While this option would introduce some additional compliance costs for AFAs offering personalised DIMS, consisting primarily of the cost of revising their existing disclosure documents, consultation suggests that these costs will be small.
- **Innovation and flexibility.** This option has no impact on innovation and flexibility.

44 The above analysis suggests that this option will help to resolve problem 1. All submitters supported requiring further information about the DIMS service to be disclosed by AFAs. 15 out of 17 submitters supported requiring this information to be included in AFAs' existing disclosure statements.

### ***Option 3: Separate DIMS disclosure statement***

45 Option 3 would require AFAs offering personalised DIMS to provide prospective clients with a DIMS service disclosure statement, similar to that required for DIMS under the FMC Act. While the FMC Act service disclosure statements for DIMS are not finalised, the Ministry has consulted on requiring them to include the following matters:

- A prescribed statement about DIMS
- Details of the provider of the DIMS
- A description of the service being offered
- A statement about investment risk
- Details of conflicts of interest
- A statement about tax implications
- How investors will be provided with information on their investments
- Contact details for the provider and the custodian
- Information about complaint procedures.

46 Our analysis of the impact of this option against the criteria is as follows:

- **Investor information.** While a similar disclosure statement for personalised DIMS provided under the FA Act would aid in comparability with DIMS offered under the FMC Act, much of this information would duplicate information in existing disclosure statements provided by AFAs. For example, AFAs' secondary disclosure statements include information about conflicts of interest. Providing another disclosure document to investors increases the probability of investors being overwhelmed by disclosure information and not giving it proper consideration.
- **Appropriate governance.** This option has no impact on appropriate governance.

- **Compliance costs.** This option would introduce initial and ongoing additional compliance costs for AFAs offering personalised DIMS. These costs would consist of the preparation of these new disclosure documents and ongoing costs associated with producing this document and keeping it up to date.
- **Innovation and flexibility.** This option has no impact on innovation and flexibility.

47 The above analysis suggests that this option will not resolve problem 1 as effectively as option 2.

### Summary

Options	Impact on objective: Investor information	Impact on objective: Appropriate governance	Impact on objective: Compliance costs	Impact on objective: Innovation & flexibility	Preferred option? (Y / N)
<b>1. No additional disclosure requirements (status quo)</b>	-	-	-	-	N
<b>2. Additional disclosure through existing disclosure statements</b>	Moderate benefit	-	Small negative	-	Y
<b>3. Separate DIMS disclosure statement</b>	Moderate benefit	-	Moderate negative	-	N

48 We consider the benefits of option 2 to outweigh the relatively low costs involved for AFAs offering personalised DIMS. While option 3 may aid in the comparability of disclosure statements, we do not consider this factor to be as important when the service offering is personalised to the client.

## Client agreements (Problem 1)

49 Two options for regulating client agreements are considered:

- Option 1: No prescribed requirements for client agreements (status quo)
- Option 2: Prescribed requirements for client agreements (preferred option)

### ***Option 1: No prescribed requirements for client agreements (status quo)***

50 Option 1 is the status quo. While the FA Act is being amended to require there to be a client agreement governing the DIMS, it does not currently provide for any requirements for these agreements.

51 Our analysis of the impact of this option against the criteria is as follows:

- **Investor information**. This option has no impact on investor information.
- **Appropriate governance**. Under the status quo personalised DIMS would be subject to lower governance standards than DIMS under the FMCA. This may encourage misuse of the FA Act regime.
- **Compliance costs**. This option has no additional compliance costs.
- **Innovation and flexibility**. This option has no impact on innovation and flexibility.

52 The above analysis suggests that this option will not help to resolve problem 1. In our consultation, no submitters supported retaining the status quo. All submitters supported requiring the core elements of a DIMS service to be dealt with in client agreements.

### ***Option 2: Prescribed requirements for client agreements***

53 Option 2 would apply the same requirements in regards to client agreements for AFAs offering DIMS under the FA Act as will apply for FMC DIMS licensees. This is expected to consist of requiring the following matters to be adequately provided for in client agreements:

- How custody over assets will be provided and the DIMS providers responsibilities in connection with any custodian
- How rights relating to the client's assets (e.g. corporate actions) will be exercised
- What will happen at the termination of a client agreement, including, where relevant, adequate arrangements for the transfer or disposal of any unregulated products (i.e. products offered on a wholesale basis) held on termination
- The client to be able to terminate the client agreement without penalty on a reasonable notice period to transfer or liquidate the assets.

54 Our analysis of the impact of this option against the criteria is as follows:

- **Investor information**. This option has a benefit to investor information, as it will ensure that the key governance arrangements for the DIMS are set in writing in the client agreement. However, given that some clients may not adequately understand these legal documents, we consider the overall benefit in this area to be small.

- **Appropriate governance.** Setting certain minimum standards for client agreements is a key tool for ensuring that DIMS have adequate governance and contractual arrangements. It is not intended that this requirement will outline all matters that should be addressed in a client agreement, only ensuring that the central issues for all DIMS are always dealt with. Due to the level of information asymmetry between a DIMS provider and a retail client, we do not consider it sufficient to rely on due diligence on the part of the client.
- **Compliance costs.** Consultation suggests that the cost of the changes will be minimal, provided that there is sufficient transitional time for existing client agreements to be amended.
- **Innovation and flexibility.** This option has no impact on innovation and flexibility.

55 The above analysis suggests that this option will help to resolve problem 1. Submitters supported requiring most of the proposed matters to be adequately provided for in client agreements.

### Summary

Options	Impact on objective: Investor information	Impact on objective: Appropriate governance	Impact on objective: Compliance costs	Impact on objective: Innovation & flexibility	Preferred option? (Y / N)
<b>1. No prescribed requirements for client agreements (status quo)</b>	-	-	-	-	N
<b>2. Prescribed requirements for client agreements</b>	Small benefit	Moderate benefit	Small Negative	-	Y

56 Option 2 is the Ministry's preferred option because we consider the cost of updating client agreements to be outweighed by the benefits of ensuring that these agreements always provide for the core governance arrangements of DIMS.

## Periodic reporting requirements (Problem 1)

57 Two options for periodic reporting by AFAs providing DIMS are considered:

- Option 1: No periodic reporting requirement (status quo)
- Option 2: Align periodic reporting requirements with those that will apply to DIMS under the FMC Act (preferred option)

### ***Option 1: No periodic reporting requirement (status quo)***

58 Option 1 is the status quo. AFAs do not currently have to provide periodic reports on the performance of their DIMS.

59 Our analysis of the impact of this option against the criteria is as follows:

- **Investor information**. Under the status quo there is a wide variation in the form, content and frequency of the information that advisers providing DIMS provide to their clients on an ongoing basis. There is no legislative requirement to produce such reports, other than the high-level client care obligations in the Code of Conduct for AFAs.
- **Appropriate governance**. This option has no impact on appropriate governance.
- **Compliance costs**. This option has no additional compliance costs.
- **Innovation and flexibility**. This option has no impact on innovation and flexibility.

60 The above analysis suggests that this option will not help to resolve problem 1. In our consultation, no submitters supported this option.

### ***Option 2: Align reporting with FMC Act***

61 Option 2 would align the reporting requirements for personalised DIMS with those that will apply under the FMC Act. This would require AFAs providing DIMS to provide clients with quarterly performance reports, or annual performance reports if information about the service is available on a substantially continuous basis through an electronic facility such as a website.

62 In situations where investments are held by a custodian, the AFA could meet their reporting obligation by ensuring that the custodian provides this information to the client. This reporting would meet both the AFA and the custodian's regular reporting obligations. This would minimise any additional cost to AFAs using custodians and any potential confusion for clients. It would be up to AFAs to make these arrangements with the custodian if they wished.

63 Our analysis of the impact of this option against the criteria is as follows:

- **Investor information**. This option ensures that clients are provided with clear and comparable information about the performance of their investments. This should help clients to better understand what investment decisions have been taken on their behalf and how their investments have performed. These reports will need to include the same information as a report from an FMC DIMS licensee. This is important to ensure that the client is not disadvantaged due solely to the regulatory regime which the service falls under.

This option allows for reports to be provided on a less frequent basis, if information about the service is provided on a substantially continuous basis through an electronic facility as a website. This reflects the fact that clients may not want as regular written reports when they are able to monitor their investments on an ongoing basis. The annual report is still valuable as it allows the performance of the investment over the year to be assessed.

- **Appropriate governance.** This option has no impact on appropriate governance.
- **Compliance costs.** Consultation suggests that this option will only impose relatively small additional costs on AFAs providing DIMS. Most AFAs are providing some sort of a regular report to their clients, so most of the additional costs will be associated with updating these reports to comply with the new requirements. A significant proportion of clients have electronic access to information about their investments through an online investment platform, in which case the AFA will only have to report annually. The ability for AFAs to outsource their reporting to the custodian will provide a lower cost option for some AFAs.
- **Innovation and flexibility.** Under this option, AFAs would retain a significant degree of flexibility around how they report to their clients. Any written reports could be provided either via email or post. The option accommodates both changes in technology and AFA business models by reducing the reporting obligation where the client can access the information online.

64 The above analysis suggests that this option will help to resolve problem 1. The majority of submitters supported this requirement, although submitters varied on what reporting period was appropriate and whether online access to the information was a suitable alternative to regular reporting.

### Summary

Options	Impact on objective: Investor information	Impact on objective: Appropriate governance	Impact on objective: Compliance costs	Impact on objective: Innovation & flexibility	Preferred option? (Y / N)
<b>1. No periodic reporting requirement (status quo)</b>	-	-	-	-	N
<b>2. Align reporting with the FMC Act</b>	Moderate benefit	-	Small negative	-	Y

65 In summary, our preferred option is option 2. The benefits of ensuring that clients are provided with the same regular reports, regardless of whether the provider is regulated under the FA Act or FMC Act, outweigh the small additional costs associated with providing these reports. Allowing these reports to be provided via email, and for AFAs to send fewer reports where clients have access to information about their investments online, limits any additional costs and provides AFAs with flexibility.

## **FMC Act Exemption for Contingency DIMS (Problem 2)**

66 Two options for an exemption for AFAs providing DIMS on a contingency basis are considered:

- Option 1: No exemption (status quo)
- Option 2: A limited exemption for DIMS provided by AFAs on a contingency basis (preferred option)

### ***Option 1: No exemption (status quo)***

67 Option 1 is the status quo. From 1 December 2014 (subject to transitional provisions) AFAs will require a licence under the FMC Act to provide class DIMS.

68 Consultation suggests that a significant number of AFAs currently manage their client's portfolio on a discretionary basis only when their client is away on holiday, or it is otherwise temporarily inconvenient for them to be making investment decisions. A number of these services would technically fall within the definition of class DIMS, which will require a licence under the FMC Act in future. It appears unlikely that AFAs offering this limited type of DIMS service could justify the associated licensing and compliance costs, and may therefore decide to stop offering these services.

69 Our analysis of the impact of this option against the criteria is as follows:

- **Investor information.** The status quo, after the implementation of the FMC Act, will mean that investors will either need to actively agree to the investment recommendations of their adviser, even if they are not-contactable for a limited period of time. Alternatively they could employ a licensed FMC DIMS licensee to provide this temporary service. However, the costs of obtaining this service may outweigh the benefits where the client only needs this service for a limited period of time.
- **Appropriate governance.** Licensed class DIMS providers will have demonstrated that they have the capability to provide DIMS, and will be subject to client agreement requirements that will set out their contractual obligations to their clients.
- **Compliance costs.** The compliance costs of the status quo will be significant in comparison to the scope of the service offered by AFAs on a contingency basis. This would include cost of applying for a licence, plus the costs associated with ongoing reporting and compliance obligations.
- **Innovation and flexibility.** Consultation suggests that the status quo will dissuade many AFAs offering contingency DIMS from continuing to do so. This will limit the ability of AFAs to demonstrate value to their clients and will increase the difficulty that their clients face in managing their investments while on holiday, for example.

70 The above analysis suggests that this option will not help to resolve problem 2.

### ***Option 2: A limited exemption from FMC DIMS licence requirements for AFAs providing DIMS on a contingency basis (preferred option)***

71 Option 2 would exempt AFAs from the requirement to have a DIMS licence under the FMC Act subject to conditions to ensure that the exemption is not misused. These conditions could include:



- a. The main service that the AFA provides to the client is either financial advice or an investment planning service and the client's portfolio is not normally managed by the AFA on a discretionary basis (i.e. the client normally agrees to transactions).
- b. The AFA must either make reasonable endeavours to get agreement from the client before exercising the discretion, or have received confirmation in writing from the client of the period in which the discretion should be exercised.
- c. Client agreements must include duties of care, client reporting obligations, the maximum length of time that discretion can be exercised for, and any limits on the extent of the changes that can be made under the discretion, or if there are no limits on the extent of changes that can be made under the discretion this fact must be clearly disclosed to the client.
- d. AFA must disclose in writing to their client that they are not an FMC DIMS licensee and the limitations on the service they can offer.

72 Our analysis of the impact of this option against the criteria is as follows:

- **Investor information.** While clients of AFAs operating under this exemption will not receive the same disclosure and reporting information as under the FMC Act, the conditions of the exemption would require AFAs to inform their clients in writing that they are operating under the exemption, and for their client agreements to include a method of reporting to clients.
- **Appropriate governance.** The scope of the exemption will require AFAs to have appropriate governance obligations in their client agreement. While these will not be as demanding as those under the FMC Act, and there will be no licensing assessment of the AFAs ability to offer the service, these requirements are more appropriate for the scope of the service being offered.
- **Compliance costs.** We would expect the costs of complying with the conditions of this exemption would be significantly lower than the costs of a licence and ongoing obligations under the FMC Act. The reporting and written confirmation from the client could be sent electronically, minimising any additional compliance paperwork.
- **Innovation and flexibility.** We expect that this exemption will provide both AFAs and their clients with significantly more flexibility around how client assets are managed when their client is away on holiday, or it is otherwise temporarily inconvenient for them to be making investment decisions. AFAs would also have the flexibility to offer both class and personalised DIMS under this exemption.

73 The above analysis suggests that this option will help to resolve problem 2.

### Summary

Options	Impact on objective: Investor information	Impact on objective: Appropriate governance	Impact on objective: Compliance costs	Impact on objective: Innovation & flexibility	Preferred option? (Y / N)
<b>1. No periodic reporting requirement (status quo)</b>	-	-	-	-	N
<b>2. A limited exemption for DIMS provided by AFAs on a contingency basis (preferred option)</b>	Small negative	Small negative	Moderate benefit	Moderate benefit	Y

74 Overall option 2 is our preferred option. While it removes some of the protections and information requirements in place under the FMC Act, we consider that, for the limited circumstances covered by the exemption, these are outweighed by the costs associated with FMC DIMS licensing.

## **FMC Act DIMS Licensing Fees (Problem 2)**

- 75 Recent consultation suggests that fewer AFAs will offer personalised DIMS than originally expected and, as a result more AFA led businesses may require a licence under the FMC Act. FMA is preparing guidance on what it will expect from AFA led businesses that plan to offer more straightforward DIMS under the FMC Act. FMA expects that these types of licence applications will be simpler for these businesses to prepare and will take less time for FMA to assess.
- 76 The current base fee for an FMC DIMS licence application is \$3,565 (with FMA able to charge extra at an hourly rate for applications that take longer than 25 hours). The base fee was set based on an estimate that the average “standard” FMC DIMS application would take 20 hours to assess.
- 77 Our updated assessment of the licensed population for FMC DIMS and FMA’s guidance for straightforward DIMS is expected to result in a larger number of applications taking less than 20 hours to assess. The current fee may therefore result in FMA over-recovering its costs in this area.

### **Objectives**

- 78 Options for addressing this problem have been assessed against the same key policy objectives as were used in the March 2014 regulatory impact statement when the original fees were set:

Recover FMA costs in licensing market services providers from licensees

Each applicant pays a fee that reflects the cost of FMA resource used to process their application, minimising cross-subsidisation and over-recovery

Certainty and fairness to financial markets

Ease of implementation

### **Options**

- 79 Two options have been considered for amending DIMS licensing fees under the FMC Act:
- Option 1: Status quo
  - Option 2: A reduction in the base fee to reflect more straightforward DIMS applications (preferred option)

#### **Option 1: Status quo**

80 Option 1 is the status quo. From 1 December 2014 (subject to transitional provisions) AFAs will require a licence under the FMC Act to provide class DIMS. The fee for this licence is currently set at \$3,565 plus a fee of \$178.25 per hour for applications that take longer than 25 hours to process.

81 This fee model was adopted on the basis that it would provide a degree of certainty for most applicants with relatively “standard” applications, while ensuring that applicants with complex applications were not cross-subsidised. The level of the fee was set based on FMA’s estimate of how complex the applications would be.

82 The above analysis suggests that this option will not help to resolve problem 2.

**Option 2: A reduction in the base fee to reflect more straightforward DIMS applications (preferred option)**

83 Option 2 would reduce the base fee for an FMC DIMS licence to \$2,139 plus a fee of \$178.25 per hour for applications that take longer than 15 hours to process.

84 FMA estimates that straightforward DIMS applications made in line with its upcoming guidance will take, on average, 12 hours to assess. This figure is in line with other relatively straightforward licences under the FMC Act, such as independent trustees of restricted schemes.

85 It is important to note that this change does not mean that there will be a reduction in fees for more complex DIMS licence applications. For example, FMA still estimates that applications from larger corporate DIMS providers will take longer than 15 hours, after which the hourly rate would apply. Therefore, this option, will likely result in a higher proportion of applicants being charged an additional hourly fee than under the status quo.

86 The above analysis suggests that this option will help to resolve problem 2.

**Summary**

Options	Impact on objective: Recover costs	Impact on objective: Minimise cross-subsidisation	Impact on objective: Certainty and fairness	Impact on objective: Ease of implementation	Preferred option? (Y / N)
<b>1. Status quo</b>	-	-	-	-	N
<b>2. A reduction in the base fee to reflect more straightforward DIMS applications</b>	-	High benefit	Moderate benefit	Small negative	Y

87 Overall option 2 is our preferred option. It better reflects the wide range of services that fall within the umbrella definition of DIMS, and minimises the extent to which smaller DIMS providers are cross-subsidising larger providers. While we expect that this option will result in a higher proportion of providers being charged the hourly rate, possibly resulting in some additional administrative complexity for FMA, no providers will be charged more overall than under the status quo.

## Conclusion

### *Problem 1: Misalignment between FA Act and FMC Act regulation of DIMS*

Options	Impact objective: Investor information on	Impact objective: Appropriate governance on	Impact objective: Compliance costs on	Impact objective: Innovation & flexibility on
<b>Additional eligibility criteria</b>	Moderate benefit	Moderate benefit	Small negative	Small negative
<b>Additional disclosure through existing disclosure statements</b>	Moderate benefit	-	Small negative	-
<b>Prescribed requirements for client agreements</b>	Small benefit	Moderate benefit	Small Negative	-
<b>Align reporting with the FMC Act</b>	Moderate benefit	-	Small negative	-

88 We consider that, as a package of reforms, the introduction of eligibility, disclosure, client agreement and reporting requirements will help to address Problem 1 by better aligning the FA Act and FMC Act DIMS requirements.

89 While we have sought to minimise any additional costs for DIMS by basing these proposals on existing regulatory requirements and industry practice where possible, they will introduce some additional compliance costs. Consultation suggests that these costs will be relatively minor overall and we are satisfied that they will be outweighed by the reduced risk of fraud and misappropriation and by the benefits of aligning with the FMC DIMS regime.

### *Problem 2: The application of the FMC DIMS licencing regime to smaller providers*

Options	Impact objective: Investor information on	Impact objective: Appropriate governance on	Impact objective: Compliance costs on	Impact objective: Innovation & flexibility on
<b>A limited exemption for DIMS provided by AFAs on a contingency basis</b>	Small negative	Small negative	Moderate benefit	Moderate benefit

Options	Impact objective: Recover costs on	Impact objective: Minimise cross-subsidisation on	Impact objective: Certainty and fairness on	Impact objective: Ease of implementation on
<b>A reduction in the base fee to reflect more straightforward DIMS applications</b>	-	High benefit	Moderate benefit	Small negative

90 We also consider that the preferred options considered will go some way towards addressing problem 2, by removing some activities from the FMC Act regulatory regime where the regulatory costs exceed the benefits, and by making an FMC DIMS licence more affordable for smaller DIMS providers. These measures will need to be complemented by FMA guidance and exemptions in order to be fully effective.

## Consultation

91 The proposals in considered in this RIS were consulted on, or result from, two public consultation processes:

- a. In July 2013, the Ministry release a discussion paper on regulatory requirements on personalised DIMS and custody regulations under the FA Act. We received 26 submissions on this paper, which were largely supportive of the proposals relating to personalised DIMS preferred in this RIS.
- b. In December 2013, as part of a consultation on the stage 2 regulations under the FMC Act, the Ministry sought feedback on the services currently offered by DIMS providers and on how they intended to comply with the FMC Act. This information has informed the responses to problem two.

92 We plan to undertake further targeted consultation with submitters on an exposure draft of the regulations in July 2014.

## Implementation

93 The proposed implementation timeline for DIMS requirements, under both the FA Act and FMC Act is as follows:

Milestone	Transition progress
1 December 2014	<ul style="list-style-type: none"> <li>• New FMC DIMS providers are required to be licensed and comply with the requirements of the FMC Act.</li> <li>• New AFAs providing personalised DIMS are required to comply with the new regulatory requirements under the FA Act and associated regulations.</li> <li>• Persons currently permitted to provide DIMS (and the entities that they represent) are permitted to continue to provide DIMS in accordance with the current law as a transitional measure.</li> </ul>
1 June 2015	<ul style="list-style-type: none"> <li>• Persons providing class DIMS are required have applied for a licence under the FMC Act.</li> <li>• FMA will expect AFAs to have updated their adviser business statement to describe whether they intend to carry on providing personalised DIMS or take advantage of any exemption.</li> <li>• All DIMS providers are required to be using an independent custodian, unless they have applied for FMA permission to use a related party custodian and their application is still under consideration.</li> <li>• FMA's assessment of FMC DIMS licence applications and reassessment of eligibility of existing AFAs to provide personalised DIMS underway.</li> </ul>
1 December 2015	<ul style="list-style-type: none"> <li>• All class DIMS providers are required to be licensed.</li> <li>• FMC licensees' and AFAs' DIMS documentation, such as client agreements, is required to be compliant with the new requirements, including for existing clients.</li> </ul>

94 Consultation suggests that this is a sufficient length of time to allow existing providers to transition to the new regime, without undermining the intent of the reforms. The vast majority of DIMS offered in this transitional period will be offered through AFAs, who are subject to the Code of Conduct for AFAs. These measures will help to ensure a tidy implementation of the changes and will provide current DIMS providers with sufficient time to either change their business models or apply for the relevant licence.

### **Monitoring, Evaluation and Review**

95 The monitoring of these requirements would fall within the functions of FMA, as the regulator for financial markets participants. FMA has a risk based monitoring plan for financial advisers. This will form the basis of on-going monitoring once the additional custodian requirements are implemented.

96 There is a statutory requirement for the Ministry to undertake a review of the operation of the FA Act by mid-2016. This review will include an assessment of the regulations under the FA Act. We have begun scoping this review and expect initial assessment to commence in late 2014, with public consultation beginning in early 2015.

97 We have begun establishing a monitoring and evaluation plan for the FMC Act. We are currently in the process of establishing evaluation criteria and a baseline review and we expect that the various aspects of the reforms will be assessed over the next few years. An exact timetable for this review process has yet to be established.