

September 2014

Qualifying Financial Entities Monitoring Report

1 January – 30 June 2014

This report should be read by:

- Auditors
- Compliance managers
- Directors
- General managers
- Legal counsel
- Regulatory managers
- Risk managers

About the FMA

The FMA is an independent Crown entity with a mandate to promote and facilitate the development of fair, efficient, and transparent financial markets. We work with financial markets participants to raise standards of good conduct, ethics and integrity and to achieve best standards of practice and compliance.

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Executive summary

Monitoring at a glance

Key themes identified from our QFE monitoring

- Supervision
- Management reporting
- Record keeping
- KiwiSaver sales and advice processes
- Monitoring of AFAs within QFEs

We have provided additional feedback on issues that our wider monitoring activities have identified, which include:

- Breach reporting
- KiwiSaver sales and advice processes

The FMA regulates conduct across New Zealand's financial markets, which are covered by more than 20 separate Acts. We carry out a range of monitoring activities to assess market participants' compliance with their obligations and encourage voluntary compliance. Qualifying Financial Entities (QFEs) are one of these market participants with licences first issued to them in March 2011.

This is the FMA's first report on QFE monitoring. We cover site visits and wider monitoring activities up to June 2014. We provide an overview of our key findings from on-site QFE inspections of some of the major banks as well as non-bank entities, and have identified areas that could be improved by adopting better practices.

When raising standards of conduct, ethics and integrity, the FMA maintains a strong emphasis on placing the interests of the customer first. The monitoring activities covered by this report included the review of a selection of Authorised Financial Advisers (AFAs) working within QFEs, to determine whether they were complying with their professional obligations, including the Financial Advisers Act 2008 (FA Act), the Code of Professional Conduct (the Code), and the terms and conditions of their authorisations.

The purpose of the QFE on-site visits was for us to determine the QFE's suitability of advice processes and their approach to supervision of their financial advisers, as well as their compliance assurance arrangements. We were particularly interested in the selling and provision of class and personalised financial advice, with an emphasis on KiwiSaver. We also looked at management information and reporting generated from QFE processes.

Findings from our visits

Supervision

Supervision processes raised a few red flags

Supervision lets QFEs know whether their advisers and employees are doing what they should be.

Our review of QFEs' supervision processes raised a few red flags around:

- a lack of formal observation processes
- a lack of assurance for senior management.

We found the banks were largely dependent on branch managers to ensure branch staff were actively supervised, but this was not necessarily a formal process and therefore provided little assurance to senior management. Lack of reporting also made it difficult for senior management to identify any performance issues. An issue occurring in one branch might be an issue across the entire network and if so, would present a very different risk. Current systems had no way of determining this.

An example of good practice

One QFE had an automated supervision system in place to provide a comprehensive overview of staff performance and reporting to a high level. This enabled the QFE to monitor how many employees were being observed, who they were and when the observations were carried out. It also helped branch managers keep a supervisory record.

We recommend that QFEs formalise their supervision processes (including quality assurance reviews) to ensure their advisers are behaving appropriately, providing suitable advice and complying with the QFE's processes.

Reports on supervision should identify issues as being either isolated or occurring more widely across the organisation.

Management reporting lacking in detail

QFEs' internal reporting is often done using a risk-based approach, which means assessing the risks of the non-compliance, and as a result incidents occurring within the business are sometimes identified and resolved without reporting to senior management.

Under the FA Act directors have a responsibility for compliance and it is important they have adequate oversight of all issues arising to ensure this obligation can be fulfilled.

The FMA believes that employees of QFEs charged with governance need to be better informed by receiving structured and targeted reports. QFE and KiwiSaver related initiatives, and any linked or identified risk exposures such as those arising from complaints or mystery shopping exercises, should also be included in management reporting.

An example of good practice

One QFE provided monthly reports to senior management for each business unit, which contained:

- an Executive Overview
- key areas of focus
- quantitative data from the training, supervision and compliance programmes (including complaints analysis) using red, amber and green colour coding
- visual aids including graphs
- comments on the activity of the business unit during the month

Adopting 'dashboard' colour coding and visual aids makes it easy to identify any areas that require more consideration.

We expect QFEs to have the appropriate governance and compliance procedures in place to ensure there is a high level of adviser oversight. This should be documented in a framework that supports informed management reporting.

Management information and controls over the supervisors might include:

- dashboard reporting to enable management to identify trends in behaviours, 'red flag' behaviours and lower level but consistent underperformance
- results of the calibration of supervision nationally, and how trends and issues are being identified and addressed
- results of supervision activities collated and discussed at monthly compliance and business meetings
- reporting that reflects advancements made in systems, processes and training in reaction to incidents occurring within the business.

Qualifying Financial Entities record keeping

Interactions with customers

We found that in some QFEs no diary notes or file records were required to be completed after certain interactions with customers. When records are made of customer interactions, there is often no requirement for those records to be reviewed by a supervisor to determine the suitability of advice given or the consistency of the advice across advisers.

Proper record keeping is important. It plays a critical role in helping an adviser determine whether they have a complete and up-to-date understanding of a customer's situation before they provide financial advice. Advisers must ensure they are fully aware of customers' circumstances when assessing the suitability of a product or service for that customer. Accurate and up-to-date records of all customer interactions are vital to this process.

QFEs must develop formal processes for recording all customer interactions to help ensure their employees and advisers have all the information they need to recommend suitable products to their customers. If a QFE does not currently require notes of all customer interactions they should review their processes.

Registration details on the Financial Service Providers Register

Registered financial service providers, including QFEs, are required to apply for and maintain their registrations online via the Financial Service Providers Register (FSPR) website, which is administered by the Companies Office.

During the registration process QFEs are asked to select all of the activities they wish to be registered for. We have noticed that changes have been made to the FSPR over time of which we have not been notified. We are also aware of changes occurring within QFEs that have not been updated on the FSPR.

QFEs should have a process in place to regularly review and update their information on the FSPR to ensure it contains an accurate and up-to-date list of the financial adviser activities of the organisation. This process should also include updating the QFE information held by the FMA if necessary.

KiwiSaver sales and advice processes

The FMA aims to identify where poor conduct in the financial markets could lead to the most harm for consumers. QFE advisers and nominated representatives must act with customer interests in mind to deliver good outcomes for KiwiSaver customers.

We found some positive improvements have been made by QFEs, for example, undertaking targeted mystery shopping exercises to gain more insight. Viewing customers during sales interactions can lead to improved processes and outcomes and help to ensure the QFE is meeting its obligations.

Improvements for Qualifying Financial Entities offering KiwiSaver products

What is customer awareness of personalised advice?

Although QFEs have AFAs available to assist with KiwiSaver sales, we found that very few customers are being referred to them or have asked for this service when considering a QFE's KiwiSaver products.

Customers need to be made more aware that personalised advice is available to them and can be provided by an AFA within the QFE. Specifically, how that advice is relevant to them as a customer and to their unique financial circumstances.

Inclusion of KiwiSaver in the advice process

We found instances where QFEs provided investment recommendations to customers on their investment portfolio without taking their existing KiwiSaver investments into consideration.

We must stress the importance of including KiwiSaver as a significant element of an investor's portfolio, when considering retirement planning.

Making customer feedback more relevant

Customers are often encouraged by QFEs to provide feedback on the service they have received but the questions are usually of a generic nature. We identified areas where feedback from customers could be more personalised to enable QFEs to improve their service, reduce complaints and identify where they are susceptible to risk, for example by providing inappropriate advice.

General monitoring feedback

Separate to our onsite visits, the FMA's monitoring also incorporates the receipt of complaints, notifications and general industry intelligence. It is from this information that we provide this additional feedback, which reflects our wider monitoring activities.

While on site we were shown systems and processes, however some of these systems and processes appear not to be working effectively, given the results of the wider findings set out below.

Breach reporting

Identification and reporting of breaches

Under section 77 of the FA Act, a QFE is required to provide an annual report to the FMA. This must include any breaches of financial adviser obligations by its employees, agents or nominated representatives. We are seeing unexpectedly low numbers of breaches detailed in QFEs' annual reports, particularly from those entities with very large customer bases and large numbers of advisers and employees. This causes FMA to be concerned that the QFEs' systems are not identifying issues and responding to them.

QFEs appear to be applying a materiality threshold to the reporting of breaches, and only reporting those breaches that exceed the threshold. This appears to be driven by concerns about the potential consequences of a breach of a QFE's terms and conditions. As a result, not all breaches are being reported to the FMA. It is of more concern to the FMA to ensure QFEs identify and address issues. In cases where issues are appropriately addressed, the FMA would be unlikely to engage further on these issues.

The FA Act intends that all breaches should be mentioned in the annual report. In each case, the amount of information provided about the situation, its impact and the entity's response should reflect the nature and severity of the breach. In some cases this might be that the breach occurred, without further detail beyond noting that fact.

In addition to the annual reporting requirements, QFEs are explicitly required to notify the FMA at the time any material breach is identified and likely to affect the QFE's ability to discharge its responsibilities under the QFE terms and conditions. Given that the regime in which QFEs operate is principles based, what is material for one organisation may not be material for another.

An example of good practice

- A number of QFEs engage early with the FMA when issues or incidents are identified, to discuss the matter and to review the actions that they propose to take. This is followed by a progress update and depending on the result may end with a written notification, which is then included in the annual report
- When a QFE identifies a breach made by an AFA who then resigns from employment prior to the QFE taking any formal disciplinary action against him or her, it is not mandatory to report the breach to the FMA under the Reporting and Notifications Standard Conditions. However, an open relationship with the FMA has resulted in the sharing of this information. When a QFE shares information with us, it enables us to proactively monitor the activities of the adviser in any subsequent employment and potentially mitigate any further risk to customers

Any material breaches that have been notified to us at the time of occurrence should be included in the annual report. This may require QFEs to reassess what a failure to act with care, diligence and skill, or misleading and deceptive conduct might look like within the business. To help demonstrate their frontline regulatory frameworks, QFEs could also consider including information about any improvements the QFE has made in systems, processes or training as a result of breaches identified.

In the period between annual reports we invite QFEs to engage with us to determine what level of reporting is appropriate for their organisation. The information provided assists the FMA to understand the key issues and themes being identified by QFEs and be in a better position to provide industry guidance on matters of relevance, for example, emerging or systemic issues.

KiwiSaver sales practices

We continue to receive reports from various sources about concerning KiwiSaver sales and switching practices in the marketplace. Although these practices may apply to all KiwiSaver providers and not just QFEs, here are some examples of practices within banks which the FMA has been made aware of:

- asking customers if they would like to be able to access their KiwiSaver information online alongside other bank account information, without explaining that this will mean the customers must transfer to the bank's KiwiSaver product
- stating that an application for credit (e.g. student loan, credit card, mortgage or other) will be more favourably considered if the customer transfers their KiwiSaver to the bank
- signing customers up for a credit card, personal loan or other products and providing a KiwiSaver transfer form alongside other documentation for signing, leading to customers inadvertently agreeing to transfer their KiwiSaver to the bank.

None of these examples place the interests of the customer first. They reflect poorly on the provider's attitude towards the customer or the product.

We encourage KiwiSaver providers to think about the value they can add for customers in relation to their KiwiSaver investments. For many New Zealanders, KiwiSaver is their first investment and will play an important role in their future financial security.

An example of good practice

To assist KiwiSaver investors, the industry could consider:

- asking customers about their understanding of their own risk profiles and whether their KiwiSaver is invested in line with that profile. This is particularly relevant for default investors who may not have considered their risk profile or the fund they are invested in
- with the customer, examining their needs in relation to first home buying and whether their KiwiSaver is appropriately invested with that goal in mind
- the customer's retirement goals and whether their KiwiSaver is invested appropriately to meet those goals
- identifying when a customer will reach retirement and whether they have considered a de-accumulation programme for their investments

The FMA recognises that frontline staff of QFEs are not normally qualified to give personalised advice on these matters, but they are able to initiate discussions with customers to identify possible needs and then refer them to the QFE's AFA or other competent QFE employees to address their requirements.

More information on the guidance that the FMA issued in this area is available on our website www.fma.govt.nz.

Monitoring of Authorised Financial Advisers within Qualifying Financial Entities

Our monitoring of QFEs helps us to better understand how their frontline regulation of AFAs is structured and carried out. We will continue with our multi-focused monitoring visits of QFEs to build a more robust, comprehensive and integrated monitoring programme across the different aspects of QFEs' licensed businesses.

Key findings and observations from our Authorised Financial Adviser visits

- Acknowledgements of disclosure documents need to be accurately recorded, including specifying whether it relates to Primary or Secondary Disclosure
- Disclosure documents should be reviewed regularly to ensure they comply with the Regulations
- Scope of Service documents need to match the services being provided and customers should be helped to understand the scope and any limitation of the advice being given
- There was a lack of detail recorded around customers' financial situations, needs, goals and tolerance to risk
- Principal risks and benefits of following the advice given are not always personalised to customers
- Information about risks and benefits needs to be put in writing at the time the advice is given or as soon as possible afterwards.
- Some advisers were licensed for DIMS but not providing that service
- Adviser Business Statements (ABS) were not always maintained and in some cases did not meet the requirements outlined in the FMA's AFA ABS Guide

Some QFEs have well-structured compliance and legal departments that have significant oversight and input into their AFAs' compliance obligations. These structures appeared to work well in assisting the AFAs to meet their regulatory obligations.

We did notice however, that despite these internal structures many of the issues identified for AFAs working in QFEs remain very similar to those we see across the entire AFA population.

We acknowledge that because of the nature of the businesses in which they work, AFAs within a QFE may not have the same level of input into the implementation of any changes that the FMA requests or recommends. QFEs must therefore assist their AFAs to meet their obligations and work with the FMA as necessary.

QFEs have obligations under the FA Act and its regulations and AFAs have obligations under the FA Act, the Code, the terms and conditions of their authorisation, and the Financial Service Providers (Registration and Dispute Resolution) Act 2008 (FSP Act) and its regulations. When we monitor AFAs working for a QFE, we expect the AFAs and QFEs to work together to amend systems, processes and documentation, and respond to any relevant findings.

Disclosure documents

Customer acknowledgement

When customers acknowledge receipt of disclosure documents, it is sometimes unclear from the forms which documents customers are receiving and acknowledging (e.g. primary disclosure, secondary disclosure or both). Generic declarations stating that the customer has received a 'Disclosure Statement' could cause an assumption in future about which documents are being referred to. As a result, we recommend that acknowledgement of the receipt of disclosure documents from the customer should state which documents have been received.

Format of disclosure

Some Primary Disclosure Statements did not follow the prescribed format. The Financial Advisers (Disclosure) Regulations 2010 (Disclosure Regulations) sets out what must be included in an AFA's Primary and Secondary Disclosure Statements.

We recommend that disclosure documents are reviewed regularly to ensure they meet the requirements set out in the Regulations and also reflect any material changes to AFAs' circumstances.

Financial interests

Some AFAs are being given shares by QFEs as a bonus and not disclosing it in their Secondary Disclosure Statement. This could be perceived as a potential conflict of interest when an AFA recommends the products marketed by their QFE. The FMA expects AFAs to disclose any shareholdings in the firm (or its ultimate parent company) for which they provide financial adviser services.

Code Standard 7: Scope of service

Code Standard 7 sets out that 'An AFA must ensure each retail customer has sufficient information to enable them to make an informed decision about whether to use the AFA's financial adviser services.'

While Disclosure Statements can meet this obligation, AFAs generally provide customers with a Scope of Service document. However, we saw instances where the Scope of Service document did not match the service provided or was unclear.

It is important that customers understand the scope and in particular any limitations of the advice being given. We recommend that AFAs set out a clear scope of the services that will be provided (and in some cases, clearly outline the services they will not be providing), to ensure that their customer is able to make an informed decision about whether or not to use that AFA's financial adviser services and follow any advice provided.

Code Standard 8: Customer needs and goals, and suitability of advice

Needs and goals

We found that some AFAs were not documenting their customer's financial situation, needs, goals and tolerance to risk in enough detail.

If recommending risk products, it is important for AFAs to ensure they can justify the rationale for the sum assured and benefit levels of the policies put in place for customers. Ideally this information should be set out in the Statement of Advice document so it is clear to the customer why the recommendations have been made.

If a customer has no specific financial needs and goals this should be appropriately challenged and the customer's response recorded.

Personalised service

Code Standard 8 requires that when providing a personalised service to a retail customer, an AFA must take reasonable steps to ensure that the personalised service is suitable for that customer.

The FMA observed generic terms such as 'income' and 'growth' being applied to describe the investment needs and goals of individual customers. Our view is that where possible, dollar values and time frames should be used to assist in defining customers' needs and goals. These parameters are more meaningful when determining the suitability of the service provided. For example, time frames and dollar values not only assist in assessing how SMART (Specific, Measurable Achievable, Realistic Time-bound) the customer's goals are, but also assist in determining the suitability of the adviser's recommendation.

As part of AFAs' continuing professional development, industry should continue to challenge the availability of training on suitability, especially now that Code Standard 1 has been updated to emphasise that 'An AFA must place the interests of the customer first, and must act with integrity'.

Code Standard 9: Principal risks and benefits

We expect AFAs to set out the principal benefits and risks to their clients where a Category 1 product is being recommended. Given the revisions to this Code Standard, these should always be set out in writing as opposed to just verbal conversations with the client. AFAs should tailor the risks and benefits to their client to ensure that the information is relevant. As good practice, AFAs should consider including information on the principle benefits and risks of following advice regarding Category 2 products too.

We came across documentation that contained generic sections on principal risks and benefits which would have been irrelevant for some customers.

Below are some examples of the issues we identified with documentation:

- risks and benefits were outlined for new customers, but not provided to existing customers receiving new advice
- risks and benefits were outlined for some product solutions but not others
- risks of investing were outlined but benefits were not covered in the same way
- benefits of the investment solution were outlined but risks were not covered
- AFAs described robust conversations they had with customers about the risks and benefits, but only some of that information was included in the Statement of Advice and it was across different sections of the document, making it difficult for the customer to easily understand.

Various risks and benefits will apply to some customers and not others depending on the investment mandate, however some risks will apply to all customers and should be included. Overall, the FMA considers a more customer-focused and customer-specific outline of principal risks and benefits should be provided to all customers.

Who is authorised to provide advice on Discretionary Investment Management Services?

It is important that QFEs and QFE Advisers providing a Discretionary Investment Management Service (DIMS) understand the restrictions that exist in regards to delivery of this service. Changes to the law relating to the provision of DIMS become effective on 1 December 2015 and QFEs and their advisers need to be aware of these changes.

DIMS is an investment arrangement under which an adviser makes buy and sell decisions in respect of a portfolio of investments, without referring to the customer for each transaction.

Pursuant to the FA Act a DIMS-licensed AFA can provide a personalised DIMS to a retail customer relating to both Category 1 and Category 2 products.

Currently a QFE Adviser:

- Can provide a personalised DIMS to a retail customer relating to Category 1 products if the QFE or a member of the QFE group is the product provider, or in the case of securities, promoter for the relevant Category 1 product and subject to any terms and conditions of the grant of QFE status imposed by the FMA), but only up until 1 December 2014
- Cannot provide a personalised DIMS relating to other Category 1 products to a retail customer (although a QFE could employ a DIMS authorised AFA to provide this service to the QFE's retail customers)
- Can provide personalised DIMS relating to Category 2 products to retail customers, but only up until 1 December 2014
- Can provide class DIMS (within the pre-December 2014 meaning of the term) relating to Category 1 and Category 2 products to retail customers, but only up until 1 December 2014
- Can provide both Category 1 and Category 2 personalised and class DIMS to wholesale customers.

Changes to the licensing regime for providers of DIMS are due to come into force on 1 December 2014. For QFE's and QFE Adviser's the major changes to note are:

- You must be either a licensed DIMS provider (under the FMC Act), an employee of a licensed DIMS provider or an AFA authorised to provide personalised DIMS to be able to provide personalised DIMS to a retail customer
- The definition of a class service is changing in relation to DIMS and you must be a licensed DIMS provider (under the FMC Act) or an employee of a licensed DIMS provider to be able to provide class DIMS to a retail customer.

There will be transitional provisions to allow time for current AFAs providing DIMS to comply with the new regime. For further details refer to our [Guide to licensing small DIMS businesses](#). QFEs will need to establish the way in which they wish to operate in the transitional period and in the future.

All AFAs, including those working in QFEs, should now consider whether or not they are providing a Discretionary Investment Management Service. For AFAs currently authorised to provide DIMS but in practice not providing that service, we request that they contact us to ask us to remove their authorisation to accurately reflect the financial adviser services they do provide. Removing DIMS licensing is a two-step process for AFAs:

- Notify the FMA that you no longer want to provide DIMS services and request cancellation of your DIMS authorisation status. This can be done by emailing afa.monitoring@fma.govt.nz
- Update your Adviser Business Statement (ABS) to indicate clearly that your adviser services do not include DIMS.

The FMA has recently issued [guidance](#) on this topic, available on our website. We will continue to focus on QFEs providing DIMS, to ensure that those services being provided are in accordance with the relevant regulatory requirements.

Review of Authorised Financial Advisers' Adviser Business Statements

As part of the AFA monitoring process we review AFAs' ABSs. The ABS is a requirement for authorisation and must be maintained as part of AFAs' ongoing obligations.

Our observations are set out below:

- there is a lack of personalisation by some AFAs within QFEs
- the breakdown of remuneration needs to be more clearly outlined (Remuneration and Reward)
- potential conflicts of interest need to be more clearly outlined (Ethical Behaviour)
- ABSs must indicate whether the contractual relationship is between the customer and the AFA or the customer and the entity
- ABSs must clearly outline the services the AFA is licensed to provide (and should also align with the services noted on the FSPP)
- the Code of Conduct or Code of Ethics the AFA is obliged to abide by should be explicitly stated in the ABS and should accompany a statement about why this is relevant
- QFEs and AFAs must have a system in place to maintain AFA ABSs and ensure they meet the requirements outlined in the Standard Terms and Conditions for AFAs and the FMA's AFA ABS Guide.

Looking forward

The FMA will continue to carry out on-site inspections of QFEs focusing on their specific obligations, as well as any issues that come to light as a result of market feedback or complaints. Over the coming 12 months we will continue our on-site monitoring visits of QFEs and work with them to achieve improvements.

KiwiSaver will remain a key focus for the FMA as we work to ensure that investors have access to resources that help them make more informed decisions. We will also continue to provide guidance where we believe important aspects of market participants' direct responsibilities are not well understood or where standards of market conduct could be improved.

Questions and more information

As professional advisers, AFAs need to be aware of their obligations under the FA Act, the Code and other relevant financial market legislation. For any questions, please check the [FMA's website](#) to see if there is information available to assist with your query.

We recommend that all advisers visit our website regularly to keep up to date with regulatory changes. All AFAs should receive AFA email updates, sent out periodically, relating specifically to AFA matters. Visit our website to be added to the list. You can also subscribe to receive general FMA email updates for the latest on industry news.

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

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

The following sites provide further useful information:

- www.financialadvisercode.govt.nz – Code of Professional Conduct for AFAs
- www.afacompetence.org.nz – the Skills Organisation information on competence standards and assessment
- www.fspr.govt.nz – the Financial Service Providers Register
- www.fadc.govt.nz – the Financial Advisers Disciplinary Committee

Glossary

ABS	Adviser Business Statement – a customer-facing document in which AFAs describe the professional services they offer
AFA	Authorised Financial Adviser – either an independent adviser authorised by the FMA and registered on the Financial Service Providers Register, or an adviser embedded as an employee within a QFE
Code	Code of Professional Conduct for Authorised Financial Advisers
DIMS	Discretionary Investment Management Services
FA Act	Financial Advisers Act 2008 (FA Act)
FMA	Financial Markets Authority
FSPR	Financial Service Providers Register
QFE	Qualifying Financial Entity

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