

# Consultation Paper: Proposed transitional relief for non-NZX brokers to allow limited use of buffers

## About this consultation paper

We are considering a class exemption from the Financial Advisers Act 2008 for brokers who are not NZX brokers\*. The proposal is to exempt these brokers for a transitional period (until November 2020) from the requirement to keep client money and property in a separate account from their own money and property. If granted, the exemption will enable these brokers to maintain a limited buffer of their own money in their client money trust account to reduce the risk of a temporary shortfall that may prevent client transactions settling or result in one client's funds being used to settle a transaction for another client. We granted similar relief for brokers who are NZX-brokers in 2015.

We welcome your feedback on the exemption proposal discussed in this paper, using the feedback form on page 12.

**Submissions close on 17 March 2017.**

## Next steps

After we consider all submissions, we will finalise our policy proposals. We aim to have any exemption in force by mid-2017.

## Who needs to read this consultation paper?

This consultation is for brokers, investors and other interested parties.

It seeks feedback on the exemption proposal explained.

\* 'NZX broker' means a broker that is a Market Participant Accepting Client Assets within the meaning of the NZX Participant Rules.



Document history

---

This version was issued in February 2017 and is based on legislation and regulations as at the date of issue.

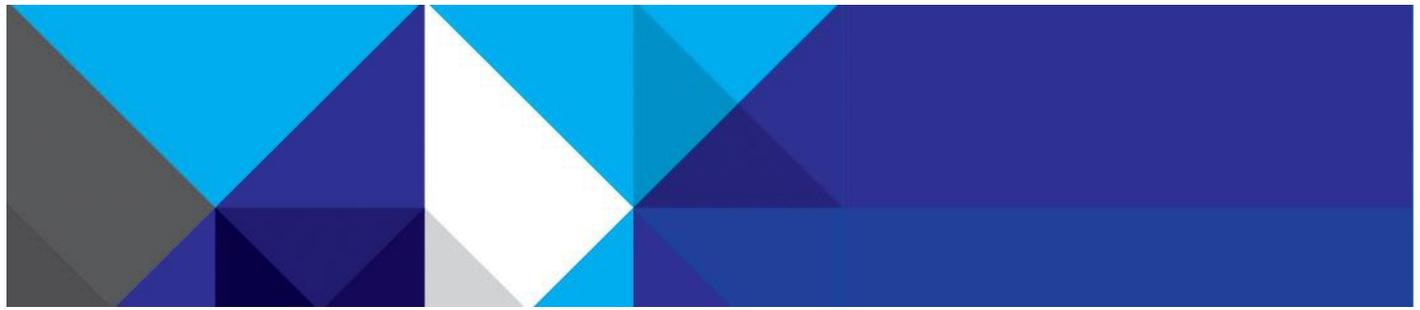
**FMA document reference code 3263721**



# Contents

---

<a href="#">Summary of issues</a>	<a href="#">4</a>
Segregation rule	4
Class exemption granted for NZX brokers	5
Similar issues faced by non-NZX brokers	5
<a href="#">Proposed solution</a>	<a href="#">6</a>
Segregation rule an important protection but transitional relief may be appropriate	6
Nature of exemption proposed	6
Proposed conditions to address risks	7
<a href="#">Questions</a>	<a href="#">10</a>
Feedback form	12



# Summary of issues

---

## Segregation rule

Under the Financial Advisers Act 2008 (FA Act) brokers and custodians have certain obligations when they handle client money and property. These include obligations to:

- hold client money and property on trust
- pay client money into a trust account at a bank in New Zealand (or approved overseas bank)
- properly account to clients for client money and property held
- keep clear trust account records
- only apply client money or property as expressly directed by the client.

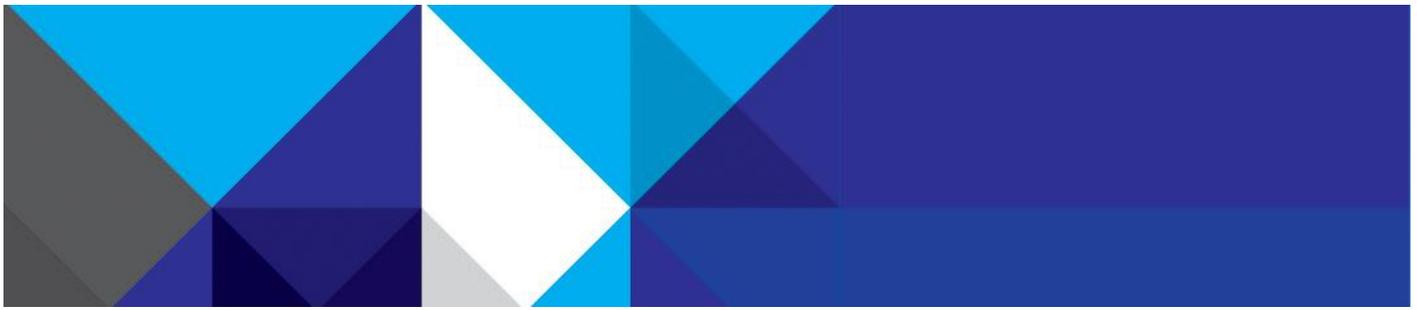
Section 77P(1A) of the FA Act also requires brokers to keep client money and property separate from their own money and property. This requirement, referred to in this paper as the segregation rule, ensures client money and property remains clearly identifiable and protected by a trust while in the broker's custody. Client funds that are not held on trust by brokers could be unprotected in the event of the broker's receivership or liquidation.

Existing brokers were granted transitional relief from compliance with the segregation rule between 1 December 2014 and 1 December 2015, after some brokers raised concerns with Government about how this obligation would work in practice.

This transitional relief provided time for further dialogue with industry on options for compliance. A Securities Industry Association (SIA) working group was formed to consider compliant solutions and other options, including potential exemptions.

Discussions with the SIA working group identified two circumstances where the requirement for strict segregation was problematic for NZX brokers:

- NZX brokers operate transfer accounts that serve as gateways for property and money going in and out of the NZX settlement system. Other offshore-based settlement systems used by NZX brokers also require a single account as the gateway point of entry and exit to the system. As NZX brokers have only one point of exit and entry into the NZX system or other systems, all money and property needed for transactions (including broker funds and property, client funds and property and administrative fees) would need to go into and out of the accounts that serve as these 'gateway' accounts.
- More broadly, an NZX broker's business involves time-sensitive chains of transactions that could fall over if funds or property needed to complete a transaction have not cleared by the time they are due to exit an account. There is a particular risk of incoming funds or property not being cleared in international transactions where market closing times impact whether a transaction completes, or is held back until the following day. NZX brokers



mitigate this risk by maintaining a buffer of their own money in their client money trust account to cover any temporary shortfalls that might otherwise arise and prejudice settlement of client transactions.

## Class exemption granted for NZX brokers

In December 2015, we granted a class exemption for NZX brokers: [Financial Advisers \(NZX Brokers—Client Money and Client Property\) Exemption Notice 2015](#) (NZX notice). The NZX notice grants exemptions:

- to allow gateway accounts to operate (accounts used specifically for transacting with particular settlement systems) and
- to permit a buffer of broker's money to be kept in their client money trust account.

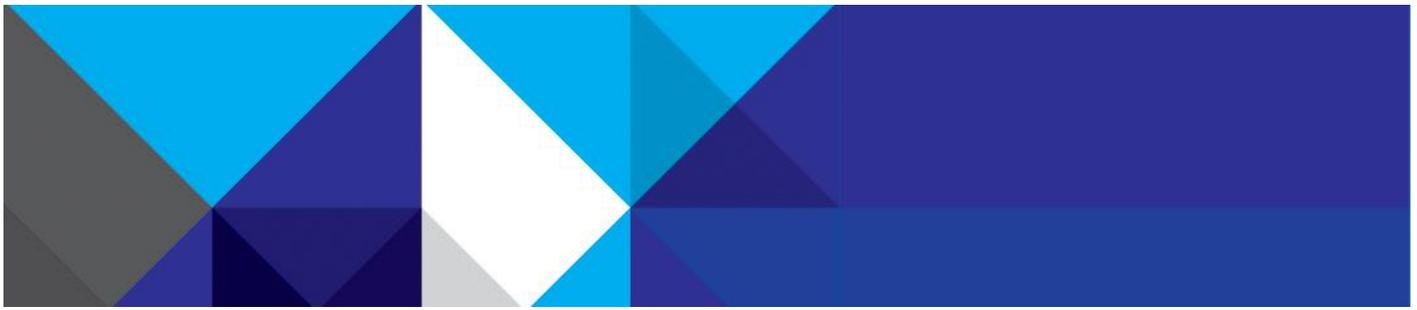
These exemptions permit the co-mingling of client money and property with the broker's money and property, to the extent that is reasonably necessary to either facilitate or arrange the settlement of clients' financial product transactions in a prudent and orderly fashion or reduce the risk of a shortfall in a client money trust account.

## Similar issues faced by non-NZX brokers

Some brokers who are not NZX brokers have told us that compliance with the requirement in section 77P(1A) also raises significant problems for them at this time. These brokers have historically operated a buffer in their client money trust account to cover any deficit in a client's funds which might arise. These brokers told us that shortfalls in a client money trust account occur for a variety of reasons, including timing issues (eg for off-shore trades), changes in foreign exchange rates, processing errors, tax or fee payment obligations, payments being dishonoured or reversed, failure by investors to lodge funds, and internal errors. They said many of these deficits are unforeseeable and that it is impracticable given current systems and processes for these to be pre-funded by clients.

The brokers told us that having a buffer of the broker's money enables a broker to effectively advance funds to clients to ensure trades are completed. The broker takes the credit risk pending receipt of cleared funds from the clients. Brokers note that maintaining a buffer of their own money also protects clients by ensuring that there is no cross-use of one client's money to settle a transaction for another.

Some brokers said that operating without a buffer would require substantial or fundamental redesign of their current business models, IT systems and processes to avoid shortfalls occurring. They said this would impose significant compliance costs that would be unreasonable in the short term. They said alternative solutions they had considered to prevent the need for a buffer might result in the loss of clients and client revenue, and in the worst case scenario, even make some current business models unviable.



## Proposed solution

---

### Segregation rule an important protection but transitional relief may be appropriate

The segregation rule provides an important protection for clients and we consider that brokers should be taking steps now to implement changes to their IT systems, processes and business to ensure that they become fully compliant.

We are aware, however, that requiring immediate compliance may, in the short term, result in significant compliance costs and business disruption for brokers and their clients. We are therefore considering whether it would be appropriate to provide relief for non-NZX brokers for a transitional period to allow limited use of buffers providing appropriate conditions can be put in place to manage any risks that may arise if a broker becomes insolvent.

If granted the proposed transitional relief will allow brokers to implement the changes needed for full compliance over a longer period. This may minimise overall costs and reduce disruption for brokers and their clients by allowing changes to be made when scheduled upgrades or reviews of systems or processes occur. It may also allow brokers to spread the costs of implementation over time.

Brokers have known about the segregation rule for some time and have already had a one-year transition period. We therefore propose that the exemption, if granted, expires at the same time as the NZX notice (on 30 November 2020). We expect this will give non-NZX brokers sufficient time to design, implement and fund any changes to their business that are needed to make them fully compliant with the segregation rule while also meeting their other client money and property handing obligations under the FA Act. This timeframe will also allow this notice to be reviewed in advance of the 30 November 2020 expiry alongside the review of the NZX notice.

### Nature of exemption proposed

The proposed exemption would be similar to the 'shortfall' exemption granted to NZX brokers under the NZX notice. It would only apply when it is reasonably necessary for a buffer of broker money to be held together with client money in the client money trust account in order to:—

- reduce the risk of a shortfall arising or
- manage any shortfall in client money held for a client in that account.

We understand that non-NZX brokers do not operate transfer accounts serving as gateways for property and money going into and out of the NZX settlement system. On that basis, subject to feedback we receive through this consultation, we are not proposing to grant an exemption that corresponds to the gateway exemption in the NZX notice.

Before granting an exemption under the FA Act, we must be satisfied that the costs of compliance with the relevant obligation:—

- would be unreasonable; or



- would not be justified by the benefit of compliance.

We will base our decision whether to grant the exemption on these issues. Our consideration will include whether we are satisfied that conditions can be put in place to appropriately manage the risks that arise when the segregation rule is not strictly followed. This includes the risk that client money may be in jeopardy if a broker becomes insolvent.

## Proposed conditions to address risks

Providing relief from the statutory obligation to segregate client money and client property from broker money and broker property that would otherwise apply could create complexity and delay in the return of client money if a non-NZX broker goes into receivership or liquidation. A buffer of broker's money could affect the protection of client money where the broker becomes insolvent, or put the existence of a trust over client money at risk.

To address these risks, we're considering the following conditions:

- broker money must be held together with client money only to the extent that is reasonably necessary for the purposes of the non-NZX broker conducting its clients' financial product transactions and carrying out its independent custodial business in a prudent and orderly fashion.
- the non-NZX broker must not place its own money into the client money trust account for any purpose other than to:
  - facilitate or arrange the specific settlement of financial transactions for a client, or
  - reduce the risk of a shortfall arising or manage any shortfall which has arisen in the client money held for a client in that account
- the non-NZX broker must take reasonable steps to ensure that the amount of the broker's own money in a client money trust account is no more than the calculated amount that is reasonably necessary to facilitate or arrange the settlement of 1 or more financial transactions for a client and to cover the risk of a shortfall arising and manage any shortfall which has arisen in the client money held for its clients at any time
- the non-NZX broker must document, implement, and monitor processes that are appropriate to manage the risks to clients associated with not separating the broker's money from client money, in reliance on the exemption, in the context of the non-NZX broker's financial product transaction and independent custodial business
- the non-NZX broker must take all reasonable steps to ensure that client money remains separately identifiable from its own money
- the non-NZX broker must maintain at least one client money trust account in each currency for which it accepts money from or on behalf of clients
- the non-NZX broker must give each of its clients a written document (before the broker holds any client money on behalf of a new client and as soon as practicable after the commencement of the exemption in the case of an existing client) that:
  - confirms that funds that the broker holds on behalf of the client will be deposited in a client money trust account and held on a trust that complies with section 77P(1) of the FA Act
  - provides a summary of the terms of that trust, and



- (iii) explains that an amount of broker's own funds will be deposited in the client money trust account as a buffer in an amount that the non-NZX broker calculates to be reasonably necessary to facilitate or arrange the settlement of 1 or more financial transactions for a client and to cover the risk of a shortfall arising and manage any shortfall which has arisen in the client money held for its clients at any time
  - (h) the non-NZX broker must, for each client money trust account:
    - (i) obtain from the bank holding that client money trust account a written acknowledgment of the trust status of that account and obtain a new written acknowledgement immediately on any change to the client money trust account, and
    - (ii) ensure that the words "trust account" and/or "client funds account" appear in the name of that client money trust account.
  - (i) any buffer deposited in a client money trust account by or on behalf of the non-NZX broker must be reasonably calculated in the circumstances
  - (j) the non-NZX broker must, on each business day, reconcile the records for each client money trust account with the records of the bank holding that client money trust account
  - (k) if the reconciliation identifies any shortfall in a client money trust account, the non-NZX broker must, prior to the end of that business day, pay into that account, by way of or on account of a buffer, an amount not less than the amount of that shortfall
  - (l) if:
    - (i) the non-NZX broker is unable to undertake a daily reconciliation of any client money trust account; or
    - (ii) its bank book ledger balance at the end of any business day or any physical bank account balance for any client money trust account becomes overdrawn for any reason; or
    - (iii) the non-NZX broker fails to pay any amount into a client money trust account as required by paragraph (k)
- then the non-NZX broker must provide to the FMA every six months a report of all breaches and failures under this paragraph, including the causes and nature of the breaches or failures and any remedial actions carried out to rectify the breach or failure
- (m) the non-NZX broker must provide a qualified auditor\* with full access to all its systems and records and otherwise cooperate fully with the qualified auditor to enable the qualified auditor to assess every six months ongoing compliance by the non-NZX broker with the conditions of the exemption and to provide the FMA with the reports and other information envisaged by those conditions
  - (n) the non-NZX broker must arrange for a qualified auditor to provide to the FMA every six months or at such other intervals as the FMA may require a report (in a form acceptable to the FMA) on the non-NZX broker's compliance with these conditions

---

\* 'Qualified auditor' has the same meaning as in section 461E of the Financial Markets Conduct Act 2013.



- (o) the non-NZX broker must provide to the FMA and the qualified auditor a written consent that authorises the qualified auditor to report to the FMA and provide any information to the FMA that it may request on the non-NZX broker's compliance with these conditions
- (p) the report to be provided by the qualified auditor to the FMA in respect of the non-NZX broker's compliance with these conditions must be conducted in accordance with the New Zealand Auditing and Assurance Standards Board (Standard on Assurance Engagements SAE 3100 Compliance Engagements).

These conditions are intended to constrain the extent of any co-mingling to a level consistent with good broking practice. They are also conducive to the continued efficient operation of capital markets, with the requirement that any co-mingling of client money and client property with broker money and property is no more than is reasonably necessary in the circumstances.

The conditions are similar to those under the NZX notice but take into account differences in regulation of these groups of brokers. NZX brokers are subject to a high level of oversight by NZX. This oversight extends to capital adequacy requirements with robust, tailored reporting and reconciliation requirements imposed by the NZX Participant Rules. Non-NZX brokers are not subject to NZX oversight and therefore we are proposing an alternative governance framework to provide a similar level of protection for investors. This requires reports to FMA and an assurance engagement by a qualified auditor.



# Questions

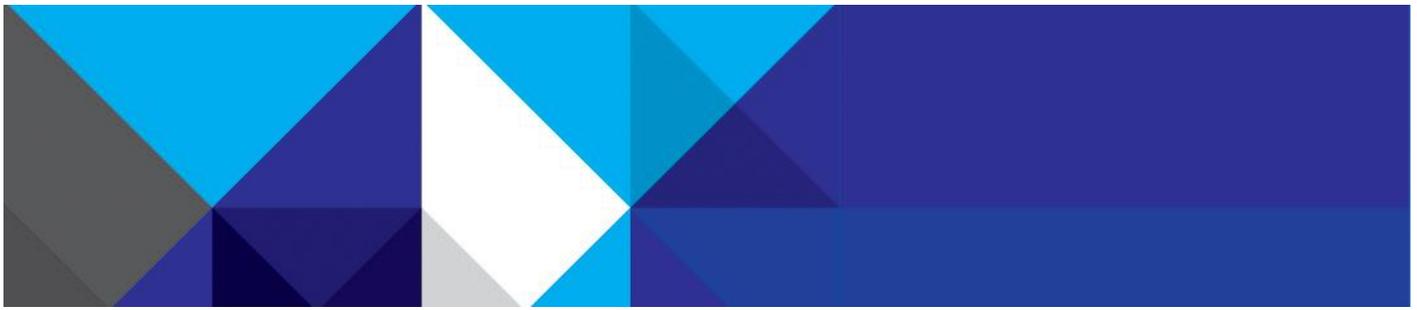
---

## General questions

- Q1. Do you support the proposed transitional exemption to allow non-NZX brokers a further period through to 30 November 2020 to implement changes to their systems, processes and business to ensure they comply with the segregation rule without any cross-use of client funds or other breach of the client money and property handling obligations in the FA Act? Please give reasons for your views.
- Q2. Do you consider the costs of immediate compliance by non-NZX brokers with the segregation obligation (if no exemption is granted):
- would be unreasonable? or
  - would not be justified by the benefit of compliance?
- Please give reasons for your views.
- Q3. The key risks we have identified if the proposed exemption is granted and brokers use a buffer of their own money in their client trust money account is that there may be delays in client money being returned, that client money may not be protected against the broker's creditors or that the trust status of the client money may be jeopardised if the broker becomes insolvent. Do you think the proposed conditions are necessary and appropriate to address this risk? Please give reasons for your views. If you think alternative or additional conditions are needed, please tell us what they are and why you think they are appropriate.
- Q4. What other risks or impacts do you think there may be for clients (additional to those described in this paper) if the proposed exemption is granted? How do you think these could be addressed by additional conditions (if at all)? If so, please explain what those conditions are.

## Specific questions for non-NZX brokers

- Q5. Do you intend to rely on the proposed exemption?
- Q6. Even if the proposed exemption is granted, we expect brokers to implement any changes to their systems, processes and business required to achieve full compliance with the segregation rule by 30 November 2020 (without any cross-use of client funds). Please explain any reason why you think this period of time will be insufficient to achieve this.
- Q7. Are there any conditions proposed in this paper that you consider will result in unreasonable costs or be unworkable for your business? If so, please explain what the condition is and what those costs or impracticalities are. Please also propose alternative conditions that would provide a similar level of protection, if possible.
- Q8. We understand that non-NZX brokers do not operate transfer accounts serving as gateways for property and money to go into and out of a New Zealand or offshore settlement system, that require a single account to serve as the gateway point of entry and exit to the system. Accordingly we are not proposing any



exemption for non-NZX brokers that would correspond with the 'gateway' exemption under the NZX notice. Please tell us if you do operate any gateway account and therefore do consider there is a need for an exemption that corresponds to the gateway exemption in the NZX notice.

Q9. Do you have any other comments?



AUCKLAND OFFICE  
Level 5, Ernst & Young Building  
2 Takutai Square, Britomart  
PO Box 106 672  
Auckland 1143

WELLINGTON OFFICE  
Level 2  
1 Grey Street  
PO Box 1179  
Wellington 6140

[www.fma.govt.nz](http://www.fma.govt.nz)  
21/02/2017

