

Custodians' obligations

This information sheet outlines the obligations of custodians under the Financial Advisers (Custodians of FMCA Financial Products) Regulations 2014.

Overview

Under the regulations, custodians must meet obligations such as providing regular reports to clients and getting assurance reports from qualified auditors, among others. The regulations, enacted under the Financial Advisers Act 2008 (FA Act), relate closely to broker disclosure and conduct obligations under Part 3A of this Act.

This information sheet explains the difference between a broker and a custodian, custodians for wholesale and managed investment scheme (MIS) clients, and custodians' statutory obligations. We also list examples of different custodial arrangements.

Who is a custodian (and who is a broker)

Under the FA Act, a broker is defined as a financial services provider who holds, transfers, or makes payments with client money or property, on behalf of clients.

Broadly speaking, under the regulations a custodian is a broker who holds money or property for clients, rather than someone who merely executes orders to pay or transfer money or property to another person. All 'custodians', as defined in the regulations, will also be brokers.

The regulations define a custodian as a person who is in the business of providing, or offering to provide, FMCA custodial services to a client.¹

Custodial services is defined in Section 77B(1)(b) of the FA Act as including:

'the holding of client money or client property by a person (A) in trust for, or on behalf of, a client (C), or another person nominated by C, under an arrangement between A and C or between A and another person with whom C has an arrangement (whether or not there are also other parties to any such arrangement).'²

A person ('A' for the purposes of section 77B(1)(b)) is a custodian when:

- holding client money or client property in trust for a client (C) or another person nominated by C under an arrangement between A and C
- holding client money or client property in trust for another person with whom C has an arrangement.

In this section, the phrase 'another person nominated by C' refers for example to an executor of a will, power of attorney, trustee, receiver, and so on. See pages 6, 7 and 8 for examples of the different types of custodial arrangements.

¹ Clause 4(1) Regulations

² Custodial service is defined in s77B(2) of the FA Act as the type of broking service set out in s77B(1)(b).



The regulations apply to client money or client property related to debt securities, equity securities, managed investment products and/or derivatives (all FMCA financial products).

Exemptions

Under the regulations, a person is not considered a custodian under the circumstances listed below:

- They hold the client money or client property solely to complete a transaction or to secure an obligation, or both. For example, a broker is not a custodian when they provide execution-only services to clients on a T+3 basis, where the client money and property are returned to the client (or a party acting on the client's behalf) immediately following execution.
- The custodian and all their associates provide the services to no more than five clients in aggregate.
- They are a trustee of a family trust in respect of the trust's assets.
- They are an executor, an administrator, or a trustee, of a deceased person's estate in respect of the estate's assets.
- They are an attorney acting under an enduring power of attorney in respect of a donor's property where the donor is mentally incapable.
- They are appointed by the court in respect of a person's assets.
- They are a sub-custodian.

Who is responsible under the regulations?

The custodian is responsible for meeting the regulations' requirements. However, where a broker has outsourced the custodial services to a third-party custodian³, the broker must ensure the custodian complies with the regulations' requirements (for example, obtaining an assurance report). This means the broker will be held responsible when the custodian fails to meet the regulations' requirements for custodial service providers.

The broker should have compliance reporting arrangements in place and properly supervise the custodian (or any other broker) providing the FMCA custodial services for the broker.

Sub-custodians

The regulations do not apply to a sub-custodian. A sub-custodian is 'a person who provides FMCA custodial services under an arrangement with a custodian where the custodian holds a beneficial interest in the FMCA financial product (to which the FMCA custodial services relate) in trust for, or on behalf of, the client'.

Generally, the custodian will have the contractual arrangements either directly with the client or with the broker to comply with the regulations' requirements. The custodian can either:

- have the sub-custodian report to the clients in complying with the regulations or
- have the sub-custodian report directly to the custodian, who then reports to the client.

Where the custodian has contracted or outsourced the custodial obligations to a sub-custodian, the custodian should ensure that the sub-custodian meets the custodian's obligations. The obligation remains with the custodian, not the sub-custodian, to ensure compliance.

³ Section 77U Financial Advisers Act 2008.



Registration on the Financial Service Providers Register

Custodians (and brokers) are required to register on the Financial Service Providers Register.⁴ We expect this registration to be regularly checked and updated.

Assurance engagement

Custodians must, within four months of the close of their accounting period, obtain an assurance engagement with a qualified auditor⁵. The assurance engagement must meet the applicable auditing and assurance standards ([regulation 9\(1\)](#)).

The custodian must also, within 20 working days of receiving the assurance report, provide a copy of the report to the Financial Markets Authority unless we waive this requirement. Reports should be emailed to compliance@fma.govt.nz with the heading '(company name) Custody Assurance Report'.

If a client requests a copy of the assurance report, the most recent copy must be sent within 10 working days of receiving the request.

The auditor must state in the assurance report whether, in their opinion, the custodian's processes, procedures, and controls were suitably designed to meet the control objectives in [regulation 10\(2\)](#), and whether those processes, procedures and controls operated effectively throughout the accounting period.

Reporting

The requirements for reporting and reconciliations clarify and extend existing obligations that apply to all brokers.

Custodians must send a report to clients at least every six months, detailing the reporting period's transactions covering the client money and property held by the custodian.

The required information⁶ can also be provided on an electronic facility if the client agreed to this, and the information is made available on a substantially continuous basis.⁷

Reporting period, according to [regulation 5\(3\)](#), means either:

- every six months (or any shorter period determined by the custodian) for which the person is a client of the custodian, or
- if a person ceases to be a client on a date within that period, the shorter period ending on that date.

We are willing to adopt a broad interpretation of what the electronic delivery of a custody report to an 'electronic address' means. Reports can be emailed or 'posted' to an electronic portal (that is, a secure website login) provided the client has agreed to this form of delivery.

Both versions of the reports have to be based on a point in time (not continuous) so the client would have the same version, whether in electronic or in paper form.

Regulation 5(1)(b)(ii) requires custodians to include the following information in their report:

⁴ See sections 5(1)(ab) and 11 of the Financial Service Providers (Registration and Dispute Resolution) Act 2008.

⁵ See section 461E of the [Financial Markets Conduct Act 2013](#) for the definition of a qualified auditor.

⁶ See [regulation 5](#) for the required information.

⁷ See [regulation 6](#) for required information



‘...all entries made in a ledger of client money during the reporting period, which for each entry must, at a minimum, include references that identify the source or destination of client money and that enable it to be traced backward or forward’.

Our interpretation is that it would be prudent to include references in all cases, to fulfill this requirement.

Reconciliations

Custodians must reconcile records of client money and property, and must promptly and fully rectify any discrepancies. Records of client money must be reconciled daily.

Fees

Regulation 5(1)(d) requires custodians to disclose to their clients any fees charged (deducted) by the custodian for holding client money or client property on their behalf. We expect custodians to disclose, in a way that the client can understand clearly, what the dollar value of the fees is, and what the total fees are.

Some brokers deduct a ‘margin’ from client money. For example, they deduct margins from interest earned by retail clients on their money (including custodians), and when client money is subject to foreign currency conversions. We understand that those margins are taken as fees for services provided.

In our view, clients must consent to margin deductions. These must be clearly disclosed as a fee to the client by the custodians, and documented in the relevant agreement between the two.

We are not suggesting that brokers and/or custodians cannot deduct fees from client money, only that they should obtain the necessary and informed consent from the client before making such deductions.

Wholesale clients

Under regulation 11, [sections 77P to 77T](#) of the FA Act (obligations for handling client money and client property) apply to a FMCA custodial service provided by a custodian to a wholesale client.⁸

However, this does not apply to the following categories of wholesale client:

1. A person in an investment business, which is if the person is—
 - a. an entity whose principal business consists of one or more of the following:
 - (i) investing in financial products
 - (ii) acting as an underwriter
 - (iii) providing a financial adviser service (within the meaning of section 9 of the Financial Advisers Act in relation to financial products)
 - (iv) providing a broking service (within the meaning of section 77B of the Financial Advisers Act in relation to financial products)
 - (v) trading in financial products on behalf of other persons
 - b. a registered bank
 - c. a non-business deposit taker
 - d. a licensed insurer (within the meaning of section 6(1) of the Insurance (Prudential Supervision) Act 2010)

⁸ Regulation 11(1)



- e. a manager of a registered scheme, or a discretionary investment management service, that holds a market services licence
 - f. a derivatives issuer that holds a market services licence
 - g. a qualifying financial entity or an authorised financial adviser.
2. A 'large person' within the meaning of clause 39 of schedule 1 of the Financial Markets Conduct Act 2013, which is a person to whom at least one of the following applies:
 - as at the last day of each of the two most recently completed financial years of the person before the relevant time, the net assets of the person and the entities controlled by the person exceeded \$5 million
 - in each of the two most recently completed financial years of the person before the relevant time, the total consolidated turnover of the person and the entities controlled by the person exceeded \$5 million).
 3. 'Government agencies' within clause 40 of schedule 1 of the Act.

Discretionary management services provider

A financial services provider who holds client money or client property under a discretionary investment management service (DIMS) is separately defined in the Financial Markets Conduct Act 2013 (FMC Act) as a DIMS custodian. DIMS custodians are subject to the regulations.

Certain broker obligations of the FA Act are enforced under the FMC Act. If you are a DIMS licensee or custodian, we encourage you to familiarise yourself with [section 446](#) which states:

'A DIMS licensee, and a custodian of investor money or investor property under the service, must provide the custodial and other broking services under the service to every investor in accordance with the conduct obligations in [sections 77P to 77T](#) of the Financial Advisers Act 2008.'

From December 2014, client money and client property under a retail DIMS must be held by a custodian who is independent of the DIMS provider, except where the client money and client property are held directly by the client. We may, under limited circumstances, allow the use of an associated party custodian as a condition for a DIMS licence. We note that the DIMS licensee and the custodian are jointly and severally liable⁹.

The definition of 'other charges' in clause 37 of schedule 21 of the Financial Markets Conduct Regulations 2014 (FMC Regulations) specifically excludes trading expenses. Regulation 210 of the FMC Regulations in turn relies on this definition of 'other charges'. This implies that brokerage fees for ongoing DIMS reporting are not expressly required to be disclosed under regulation 210. However, we would expect that, to be able to reconcile the cash balance held for the investor and which is to be reported under regulation 210(3)(b), that the brokerage fees would need to be disclosed.

MIS custodian

A financial service provider who holds the property of a managed investment scheme is separately defined, under the FMC Act, as an MIS custodian.

For managed investment scheme property, MIS custodians are not custodians under the regulations. Therefore, MIS custodians do not need to comply with broker obligations under the FA Act.

⁹ Section 445(3) of the Financial Markets Conduct Act 2013.



However, MIS custodians have similar obligations under the FMC Act where they hold scheme property, including meeting the standard of care, skill and diligence required, holding scheme property in trust, record-keeping and reporting.

Transitional periods

The reconciliation obligations apply from 1 April 2014, the date the regulations came into force. The other obligations in the regulations apply from later dates.

- The reporting obligations apply to transactions or entries from 1 December 2014. The first reports were not required until on or after 1 April 2015.
- The assurance engagement obligations apply to an accounting period that begins on or after 1 April 2014. Assurance reports do not apply to the design or operation of processes, procedures, and controls before 1 December 2014.

Since 1 December 2014, the regulations apply to custodial services provided to certain limited wholesale clients (see regulations 2 and 11).

We have considered the impact and effect of regulation 12. As discussed, there are a number of plausible interpretations.

What is clear is that regulation 12 requires reporting for the first reporting period ending on or after 1 April 2015. The issue is when the first reporting period begins. Due to this uncertainty, and taking into account that the only question is over the timing of transition, for the purposes of regulation 5 we are comfortable with the first reporting period beginning no later than 31 March 2015.

If, however, a custodian is relying on regulation 6¹⁰, the reporting period starts on 1 December 2014, or the date the person became a client of the custodian (if later).

Types of custodial arrangements

Example 1

A custodial service includes **a person (A)** holding client money or client property **in trust for, or on behalf of, a client (C)**, or another person nominated by C, **under an arrangement between A and C**, or between A and another person with whom C has an arrangement (in other words, an underlying client of C).



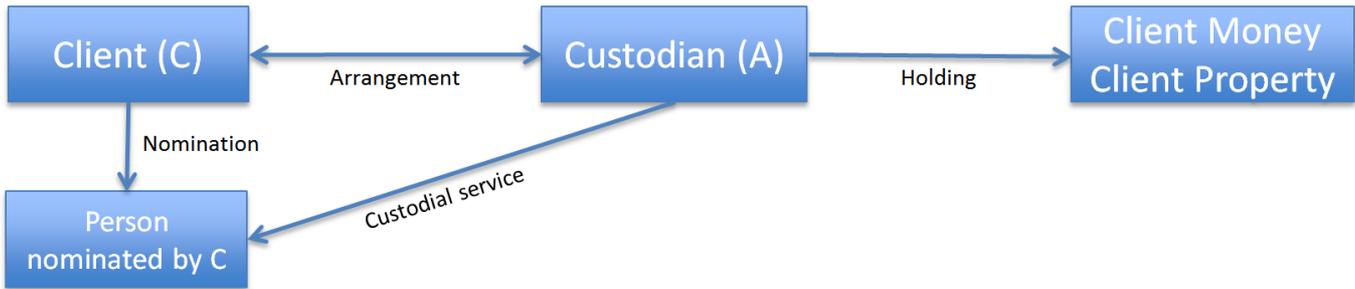
To put this in context, in example 1 the client is an individual investor, Mr Smith, and custodian A could be his financial advice firm who also provides custody.

¹⁰ See [regulation 6](#) for the required information.



Example 2

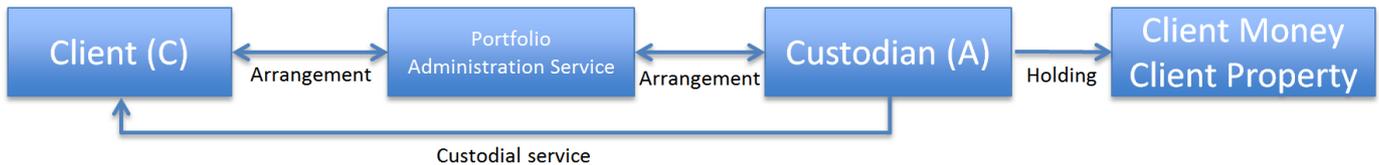
A custodial service includes a person (A) holding client money or client property in trust for, or on behalf of, a client (C), or another person nominated by C, under an arrangement between A and C, or between A and another person with whom C has an arrangement.



In example 2 the client is an individual investor, Mrs Smith (C), who has nominated a person by way of a power of attorney to manage her financial affairs, and custodian (A) could be her financial advice firm who also provides custody.

Example 3

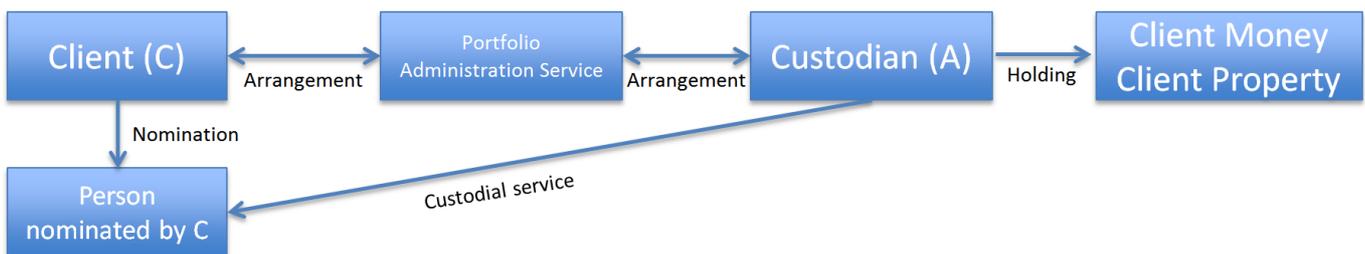
A custodial service includes a person (A) holding client money or client property in trust for, or on behalf of, a client (C), or another person nominated by C, under an arrangement between A and C, or between A and another person with whom C has an arrangement.



In example 3, Mr Smith the investor (C) has an agreement with his financial advice firm to provide advice and custodial services, but they outsource this service to custodian (A) who provides custodial services directly to Mr Smith.

Example 4

A custodial service includes a person (A) holding client money or client property in trust for, or on behalf of, a client (C), or another person nominated by C, under an arrangement between A and C, or between A and another person with whom C has an arrangement.





In example 4, Mr Smith the client has settled the investments into a trust (C), and the trust has nominated an individual to manage and maintain the client property. The trust (C) has an arrangement with the Portfolio Administration Service. In this example, this is financial advisers who outsource custody to the custodian (A). A is providing the custodial service to the person nominated by (C).

Where can I find more information?

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