FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TĀTAI HOKOHOKO

SEPTEMBER 2022

Consultation: Proposed guidance for client money or property service providers

About this consultation

In 2014, we published a guidance note on broker obligations. Since then, the Financial Advisers Act 2008, which set out the obligations for brokers, has been repealed. The equivalent obligations are now contained in the Financial Markets Conduct Act 2013, and brokers are now referred to within that legislation as 'client money or property service providers'.

We are proposing to update the 2014 guidance, to align with the new regulatory regime, and incorporate additional information to address issues we have observed through recent monitoring and misconduct cases. We are also proposing to incorporate additional guidance for custodians, who have specific obligations in addition to those that apply to all client money and property service providers.

Have your say

We welcome your feedback on the proposed guidance. Please use the feedback form to provide us with any comments. We are seeking general feedback, as well as responses to the specific questions in this paper.

If you have queries about this consultation, please email questions@fma.govt.nz or call us on 0800 434 566 (+64 3 962 2695).

Submissions close at **5pm on 1 November 2022.** After this date, we will consider all submissions and publish the finalised guidance on our website.

This consultation is for client money or property service providers (brokers and custodians), as well as users of those services, and other interested parties.	It asks for feedback on the proposed guidance note that will replace our 2014 document on broker obligations.

Contents

Proposed guidance

About this guidance note

This document sets out guidance for how providers of client money or property services (providers) can meet their obligations under the Financial Markets Conduct Act 2013 (FMC Act).

Who is a client money or property service provider?

Previously, providers of client money or property services were referred to as brokers under the Financial Advisers Act 2008 (FAA), which has now been repealed.

Broadly speaking, a 'provider' under the FMC Act is a financial services provider who holds or deals with client money or property on behalf of clients[1]. This can include stockbrokers, providers of portfolio administration services and financial advisers who receive property or money from clients.

Some financial services providers are commonly known as brokers but do not hold client money or property, such as some financial advisers or financial advice providers who provide insurance or mortgage advice. This guidance does not apply to those people in relation to that advice service.

Certain persons are not classed as providers under the FMC Act, including law firms, accountants and real estate agents acting in the ordinary course of their businesses, and licensed derivatives issuers providing a service in the ordinary course of business (who are subject to separate obligations).

The first part of this guidance applies to providers and to custodians of client money and client property. Custodians are a subset of providers under section 431W of the FMC Act, and as such are subject to the provider obligations in addition to the custodian obligations.

Guidance specific to custodian obligations is provided in the second part of this guidance.

Providers' legal obligations

Providers' obligations are set out in Subpart 5B of Part 6 of the FMC Act. The general conduct obligations (in sections 431ZA to 431ZB) include obligations to:

- exercise care, diligence and skill
- not to receive client money if the offer contravenes FMC Act or Financial Markets Conduct Regulations 2014 (FMC Regulations).

The obligations for handling client money and client property for retail clients (sections 431ZC to 431ZH) include obligations to:

[1] For detailed definitions of client money or property service provider or client money or property service, see section 431W of the FMC Act.

- hold client money and property on trust in a separate trust account
- properly account to the client for money and property held
- report on client money and client property
- maintain adequate records of the client money and property
- not use or apply client money or property, except as expressly directed by the client.

Our expectations

These obligations for client money or property service providers have now been in force since 2011[2] and all providers should be fully compliant with them.

Our expectation is that senior management of providers:

- actively promote high standards of conduct
- ensure they have robust risk management and compliance monitoring processes in place.

Accordingly, senior management should consider this guidance note and ensure that the controls and systems in their organisations are adequate.

[2] The FAA regime commenced in 2011, and while the FMC Act regime replaces this, it is essentially a continuation of the same regime, and we expect providers to continue to be fully compliant with the new regime.

General obligations

Outsourcing of client money and property services to third parties

Where a provider outsources client money or property services to another business (e.g. a custodian), the provider remains responsible to the client for the client money or property services (see section 431ZI of the FMC Act). The outsource provider is required to register on the Financial Service Providers Register (FSPR) as providing these services, but will not have any client money and property services obligations under the FMC Act if it is acting on behalf of the other provider's business.

Where such an arrangement is in place, the provider should carry out (and record) a reasonable level of due diligence on that outsource provider and the proposed arrangements under the agreement between the provider and the outsource provider. This could include consideration of:

- whether the outsource provider has adequate processes and controls to ensure compliance with the FMC Act and other requirements
- whether the outsource provider has internal audit or external review processes to verify this compliance
- whether the outsource provider will be allowed to appoint any sub-agents
- the outsource provider's standing and reputation with other providers, and publicly available information on the their compliance history, owners and directors
- the outsource provider's capability to perform core administrative activities including IT, accounting and risk management, proven capability of managing risk events, and their arrangements for how various types of assets are held
- whether the outsource provider has adequate professional indemnity insurance in place (and any requirements related to their capital adequacy)
- whether the outsource provider's fees are reasonable
- the manner in which the outsource provider must hold and deal with client money and property. This is particularly important if overseas custodians are used.

Protection of client CSNs, SRNs and FINs

New Zealand listed share registries use a Common Shareholder Number (CSN) to identify a shareholder and Faster Identification Numbers (FIN), which are the equivalent of a bank account PIN code, to identify the shareholder as the unique holder of their securities. The Australian equivalent of a CSN is a Security Reference Number (SRN).

Provider obligations relating to the use and management of FINs are governed by section 431ZA of the FMC Act, which requires providers to exercise the care, skill and diligence that a reasonable provider would exercise when providing client money and property services. We expect that a reasonable provider would, where it is necessary to hold a FIN on file, encrypt it electronically. We do not consider it is appropriate to forward clients' CSNs, SRNs and FINs by email. Where FINs are not required to be held on file, they should be destroyed immediately after each transaction.

Cross-use of client money

Sections 431ZC and 431ZG of the FMC Act set out clear obligations and restrictions for how providers hold and apply money and property of retail clients. Providers cannot use client money held on trust for one client to fund shortfalls in client money for other clients, even temporarily. This includes:

- transferring balances between client ledgers to fund shortfalls in client money for particular clients
- permitting a client to incur obligations to be settled from the client trust account without holding sufficient client money from that client to meet those obligations (which gives rise to effective transfer between clients).

Generally, a provider must ensure that client money and client property are held separately from money or property held by or for the provider. This means that use of provider money 'buffers' in trust accounts to make up shortfalls in client funds is not generally permitted. However, section 431ZC of the FMC Act permits co-mingling of provider/custodian money with client money in client money trust accounts in prescribed circumstances, subject to complying with various specified duties. In this case, provider money or property that is not held separate from client money or property is treated as client money under section 431ZC. This is discussed in greater detail below.

Deducting margins from client money

Some providers deduct a 'margin' from client money, such as interest earned by retail clients, or funds subject to foreign currency conversions. Those margins are taken as fees for services provided. Before a margin can be deducted, it must be expressly, clearly and unambiguously disclosed in the relevant agreement between provider and client, as the law requires providers to obtain the necessary informed consent from the client before making such deductions.

Express, clear and unambiguous disclosure requires stating the value of the margin (e.g. as a dollar amount or percentage of interest earned), and the purpose for which the margin is taken. Additionally, the purpose for which the margin is taken must be associated with the services provided to the client. It is not sufficient in the agreement to:

- state that a specified rate of interest will be paid, without disclosing that it is less than the actual rate of interest paid on the client money bank account (with the difference being the provider's margin)
- disclose deduction of a margin using language that is likely to be confusing or mislead clients as to the true nature of the deduction.

Failure to obtain informed client consent prior to deducting such margins from a retail client is a contravention of sections 431ZC (Provider must pay client money into separate trust account) and 431ZG (Restrictions on use of client money and client property) of the FMC Act. It may also lead to a contravention of section 431ZD (Provider must account for client money and client property).

Naming and notification of client money trust accounts

To ensure compliance with section 431ZC of the FMC Act, the actual bank account name must contain the words 'trust' and/or 'client funds account', to clearly reflect the status of the account. It is not acceptable to use names such as 'working account' or 'business account'.

Providers must obtain written confirmation from third parties (e.g. registered banks, custodians) with whom they hold client money, acknowledging the status of the accounts as trust accounts.

Bank account and custody reconciliations

Section 431ZE of the FMC Act requires that specific records are kept in a manner that enables those records to be conveniently and properly audited or inspected. It is up to individual providers to determine how best to comply with these obligations.

Regular reconciliations must be performed against money and property records of external providers (for example, banks, external custodians and sub-custodians). The frequency of the reconciliations will depend on the nature of the provider's business, e.g. the frequency of trading, scale of operations, nature and complexity of products, and availability of valuation data. For larger providers of equity securities, we recommend the use of automated feeds and auto-reconciliations, as well as appropriate and timely (preferably daily) reconciliation. Direct physical property investments may be reconciled when transactions occur. Reconciliations necessarily require that variances are promptly followed up and resolved.

The regulations applying to custody require custodians to comply with more detailed obligations regarding reconciliations and other matters.

Keeping documentation up to date

We expect providers to have processes to ensure client contract documentation is regularly reviewed and updated to reflect other relevant legislation, e.g. the Anti-Money Laundering and Countering the Financing of Terrorism Act 2009.

Reporting to clients

Regular client reporting is a very important part of client money and property services. Failure to report appropriately will lead to a contravention of section 431ZA of the FMC Act. The frequency and extent of reporting will depend on the nature of the provider's business and services, and we expect providers to have processes in place to determine this. For most portfolios, providers should be reporting trading activity to clients at least quarterly.

The regulations applying to custody require custodians to comply with minimum standards regarding reporting (see discussion below).

Identification of wholesale clients

Whether a client is a 'wholesale client' is determined by clause 4 of Schedule 5 of the FMC Act. Providers should maintain adequate processes, systems and records in relation to identifying wholesale clients.

If providers want certain wholesale clients to have the full benefit of the additional rights and protections given to retail clients under the FMC Act, providers must ensure those clients exercise their opt-out right under clause 5 of Schedule 5 of the FMC Act. Providers who advise their wholesale clients that they have

retail client protections and rights, but do not advise them of the need to opt out, will be misleading their clients.

Wholesale clients who do not opt out will not benefit from the obligations for disclosure to clients (see sections 431X and 431Y) and for handling client money and property (see sections 431ZC to 431ZH) and certain regulations (see regulations 229Q – 229V, and 229X and 229ZE).[3]

Registration of nominee companies on the FSPR

Nominee companies that hold client money or client property (i.e. as bare trustee) meet the definition of providing 'client money or property services' under section 431W of the FMC Act and need to be registered on the FSPR. For further information please refer to the FMC Act and to the FMA's information on who should be registered as a client money or property service provider. Section 431W(1)(b) of the FMC Act confirms that a custodial service is a client money or property service.

Intermediaries

Use of premiums by insurance intermediaries

Many key obligations of insurance intermediaries are governed by the Insurance Intermediaries Act 1994 (IIA). However, the FMA regulates particular activities of insurance intermediaries, and monitors their compliance with financial advice and client money and property provider conduct obligations in the FMC Act (e.g. sections 431J to 431ZB) and other financial markets legislation, including the Companies Act 1993.

The IIA does not permit intermediaries to use premiums held for insurers to fund their own businesses and related premium funding companies. An insurance intermediary's right to invest premiums held in the client account is subject to the obligation to exercise the care, diligence and skill that a prudent person of business would exercise in managing the affairs of others. If an intermediary uses premiums to fund its own businesses in contravention of the IIA, this raises concerns about the solvency of the intermediary.

We recommend that all insurance intermediaries review their use of premiums and cease any use of premiums to fund their businesses and related premium funding companies. Insurers may wish to increase their oversight of intermediaries' management and investment of premiums.

Non-broker insurance intermediaries

Section 431Z of the FMC Act clarifies that the specific obligations for handling client money and client property that apply to providers do not apply to a "broker" within the meaning of the IIA, in relation to money that broker is required to handle in accordance with equivalent provisions under the IIA. This avoids duplication of obligations and acknowledges that an IIA broker otherwise provides a client money or property service.

There are different views in the market as to whether a non-IIA broker (that is, a person who is an "insurance intermediary" for the purposes of the IIA but does not meet the definition of a "broker" under that Act) provides a client money or property service. This is because there is some ambiguity as to how the

[3] To determine if a person is a wholesale client see section 431Z FMC Act (in particular section 431Z(2)(c), and regulation 229W.

definition of a “client money or property service” applies in the context of a non-IIA broker, particularly given the overlay of the consumer protections in sections 4 and 5 of the IIA.

In our view, when a non-IIA broker receives money related to premiums or claims, or monies otherwise paid under or in relation to a contract of insurance, the non-IIA broker is not providing a client money or property service. We do not consider that money received by a non-broker IIA in these circumstances is “held”, “paid” or “transferred” in the sense contemplated by the definition of a client money or property service in the FMC Act.

Identifying the provider

It can sometimes be unclear who is the client money or property service provider responsible under the FMC Act and FMC Regulations, due to the number of parties or entities involved in the transactional chain. For instance, there will be a client, then a financial adviser, along with other intermediaries such as a wrap platform[4], and a custodian. In some cases the intermediaries involved may dispute who is the provider.

Those involved in the provision of these services must ensure that the contractual documentation and any client communications clearly identifies who is responsible for compliance with the relevant obligations under the FMC Act (including who is contracting with whom and for what services).

This should be done within the context of the interaction between section 431W and section 431ZI:

- Section 431W states that a client money or property service is where client money or client property is received by a person and the client money or client property is held, paid or transferred.
- Section 431ZI requires that where a client money or property service is provided by a person (A) on behalf of another person (B) then B (and not A) is treated as the provider. While A is required to be registered on the FSPR as providing client money and property services, it will not have any client money or property services obligations under the FMC Act if it is acting on behalf of B.

The parties should ensure they clearly understand who the provider is, and who is responsible for the provider obligations if one party is acting on behalf of another. They should also ensure these details are reflected clearly and unambiguously in the contractual documentation between the parties and in client communications.

Where the contractual documentation is unclear as to who is responsible under s431ZI, there is a risk that both parties may be liable under sections 431W and 431ZI. Where the parties contend they are not responsible, and in the absence of any party assuming the role, then the custodian may ultimately be responsible, as under s431W all custodians are also providers and in the absence of any other party assuming the role, the custodian may assume that responsibility.

Regulated client money or property service and exemptions

The requirements in subpart 5B of the FMC Act apply to regulated client money or property services.

A client money or property service is a regulated client money or property service if it is not excluded under any of clauses 19 to 23 of Schedule 5 of the FMC Act.

[4] Client money or property services are often outsourced to unrelated “wrap platform” providers that may transact or hold client money and client property, as well as providing other services such as trade execution and client reporting.

Clauses 19 to 23 of Schedule 5 exclude the following services:

- Services provided by a person in one of the following occupations in the ordinary course of carrying on that occupation and as an ancillary part of carrying on the principal activity of that occupation (not being an activity that is the provision of a financial service):
    - conveyancing practitioner
    - lawyer
    - qualified statutory accountant
    - real estate agent
    - registered legal executive
    - tax agent
    - other prescribed occupation
- Services provided by an incorporated law firm acting in the ordinary course of its business and as an ancillary part of providing legal services or conveyancing services.
- Services given in the ordinary course of business by Crown-related entities or by public servants in the ordinary course of carrying on their occupation or exercising their powers or functions
- Services provided by designated settlement systems that are provided by the receipt, holding, payment or transfer of money or property in accordance with the rules of that system
- Services provided by licensed derivatives issuers in the ordinary course of business
- Services provided by an employer to an employee in connection with products made available through the workplace
- Services given in prescribed circumstances

If a person benefits from one of the above exclusions, then the exclusions will also extend to any controlling owner, director, employee, agent or other person acting in the course of and for the purposes of that person's business.

Custodians' obligations

'Custodial services' as a subservice of 'client money and property services' is defined in section 431W(2) of the FMC Act. Persons providing custodial services (including entities such as nominee companies) are required to register on the FSPR as custodians.

The FMC Regulations require providers and custodians to comply with a number of extended or additional obligations in relation to the provision of custodial services, covering such matters as:

- Audit and assurance: obtain an annual assurance report in respect of client money and client property against client reports and an annual audit of controls.
- Reporting: comply with specified minimum obligations with respect to reporting.
- Reconciliations: comply with specified minimum obligations with respect to reconciliations, including in relation to frequency, escalation and resolution.

Who is a custodian?

Broadly speaking, under the FMC Act and FMC Regulations a custodian is a provider 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 FMC Regulations, will also be providers.

A person ('A' for the purposes of section 431W(2)) provides a custodial service 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; or
- 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 to roles such as executor of a will, power of attorney, trustee, or receiver.

Relevant custodial service and exclusions

The custodian obligations in regulations 229P to 229V of the FMC Regulations apply to a person who provides relevant custodial services to a client. Regulations 229P to 229V of the FMC Regulations broadly require a custodian to:

- provide information to clients
- meet client requests for information
- comply with the requirements for reconciling its records
- obtain an assurance engagement and assurance report
- comply with certain requirements in relation to the assurance engagement and report.

A relevant custodial service means a custodial service that is a regulated client money or property service and relates to a financial product but does not include a service where client money or client property is held solely for completing a transaction, securing an obligation or both.

Therefore, a provider will not be custodian if they provide execution-only services to clients on a T+3 (trade date plus three days) basis, where the client money and client property are returned to the client (or a party acting on the client's behalf) immediately following execution.

The custodian obligations in the FMC Regulations do *not* apply to services provided by a custodian in the following circumstances:

- 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 requirements of the FMC Regulations. However, where a provider has outsourced the custodial services to a third-party custodian, the provider must ensure the custodian complies with the requirements of the FMC Regulations (for example, obtaining an assurance report). This means the provider will be held responsible if the custodian fails to meet the requirements of the FMC Regulations. The provider should have compliance reporting arrangements in place and properly supervise the custodian (or any other provider) providing the custodial services for the provider.

Sub-custodians

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

In such arrangements, to comply with the FMC Regulations the custodian will generally have the contractual arrangements either directly with the client or with the provider. The custodian can either:

- have the sub-custodian report to the client; or
- have the sub-custodian report directly to the custodian, who then reports to the client.

The obligation remains with the custodian, not the sub-custodian, to ensure compliance – the custodian should ensure that the sub-custodian meets the custodian's obligations.

Registration on the Financial Service Providers Register

Custodians (and providers) are required to register on the FSPR. We expect this registration to be regularly checked and updated. Providers register under the providers of regulated client money or property services category, and custodians under the custodians and persons providing custodial services category.

Assurance engagement

Custodians must, within four months of the close of their accounting period, obtain an assurance engagement and report from a qualified auditor. This must meet the applicable auditing and assurance standards (regulation 229U). 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 229W(2), and whether those processes, procedures and controls operated effectively throughout the accounting period.

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

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

Reporting

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

This reporting from custodians to clients is fundamental to the custodial regime, as it provides independent assurance to clients about the activities of the financial adviser or provider.

Client's address

Regulation 229Q(2)(b) requires that the report must be provided to the client (not later than 20 working days after the last day of the reporting period) by giving it to the client, or delivering or sending it to the client's address. Address is defined in regulation 5.[5]

We consider this allows the client to specify the address to which the report will be sent. The address may also be an electronic address (email). The report may be sent to the actual or last known address of the client, (including the electronic address) if a current or new address specified by the client is not applicable (i.e. mail returned or email address fails) or the sender knows that this address is not correct.

In our view, the address specified by the client must be the client's own address. Reporting in this way enables the client to receive a definitive and independent record of their holdings, which will allow them to effectively monitor their investments.

There may be circumstances where the client's address is the address of someone nominated by them to receive the custodian reports on their behalf (for example, a close family member, attorney under powers of attorney, or accountant), but this should be by way of exception. The exceptional circumstances would be instances where a client is unable to manage their own affairs (is not competent or does not have legal

[5] **address**, of a person (**A**), means—

(a) the address (including an electronic address) specified by A for the relevant purpose; or

(b) the actual or last known address (including an electronic address) for A, if—

(i) paragraph (a) does not apply; or

(ii) the sender knows that the address referred to in paragraph (a) is not correct

capacity) and another person has been appointed to act on their behalf. In our view, the custodian reports should generally be sent to the client as well as the nominated person in these circumstances.

To ensure there is a definitive and independent record of the client's investment holdings, the nominated person must be independent from the transactions that are being reported on – i.e. not the financial adviser, the provider, or wrap provider/platform involved in the transaction. Custodians should ensure any changes made to client details continue to reflect this requirement, and that existing client information is amended if necessary.

We are aware of at least one instance where a financial adviser directed that a significant number of client reports be sent to his or associated entity addresses. While the clients may have agreed to this, our view is that it may facilitate the potential for fraud (as it did in this case), as clients do not have an independent record of transactions relating to their money and property, and must rely on information from the adviser.

The financial adviser may still receive reports, but this should be in addition to the client, or an independent person nominated by the client, to ensure adherence with the principle of independent reporting.

To help strengthen this, the assurance testing should include reviewing client addresses to ensure the independence of recipients. We consider that the current assurance reporting regulations[6] provide sufficient scope to enable this testing to be carried out.

Client's electronic address

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

We are willing to adopt a broad interpretation of what the electronic delivery of a custody report to an 'electronic address' means. As well as email, reports can 'posted' to an electronic portal (that is, a secure website login). The client must expressly opt in (agree) to this form of delivery, and be given access to it. In our view this means that the client has been given all necessary requirements to access the facility, as opposed to actually accessing it.

The person who opts in to this approach must (in light of our comments above) be the client and not someone who is involved in the transaction (e.g. a financial adviser).

Reports have to be based on a point in time (unless an electronic facility providing continuous reporting is provided to a client), so the client would have the same version whether in electronic or paper form.

Electronic delivery may be via an electronic platform other than the custodian's own, but before adopting this approach custodians should consider the following:

- The alternative electronic platform cannot be provided by a person who is involved in the transactions that are being reported on (see 'Client's address' above).
- Whether this approach maintains the independence of the custodian and their reporting obligations to clients.
- The obligation to comply with the FMC Act and FMC Regulations remains with the provider and/or custodian. Both will need to ensure that appropriate due diligence, monitoring and oversight of the provider of the alternative electronic platform are carried out (see 'Sub-custodians' section above).

[6] Regulation 229V Financial Markets Conduct Regulations 2014.

- The level of security measures in place to ensure client access is secure e.g. one-time passwords, multi-factor authentication.
- Whether the custodian assurance report will cover the processes, systems and controls of the provider of the alternative electronic platform in regard to the reporting being provided to clients; if not, what assurance the custodian will provide in this respect.
- What safeguards will be implemented to ensure the integrity of the custodial reporting is maintained (e.g. annual testing or sampling of the reports on the alternative electronic platform), and that the information is being made available on a substantially continuous basis.
- Whether the provider of the alternative electronic platform will obtain client consent to the information being provided via its website, and ensure access is being provided in accordance with regulation 229R.

Ledger entries

In addition to the other information reporting requirements, regulation 229Q(1)(b)(ii) requires custodians to include in their report "…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 fulfil this requirement.

Reconciliations

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

Good conduct includes monitoring transactions for unusual patterns, e.g. rapid reversal of transactions (or a reasonable fraction of those transactions being reversed) to monitor for fraud.

Fees

Regulation 229Q(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.

Custodians must also comply with the obligation to obtain informed consent from the client before making deductions (see page 5 'Deducting margins from client money').

Wholesale clients

Under regulation 229W, the obligations for handling client money and property in sections 431ZC to 431ZH of the FMC Act and the custodian obligations in the FMC Regulations apply to relevant custodial services provided by a custodian to wholesale clients.

However, some categories of wholesale client are excluded (see regulation 229W(2)):

- investment businesses (for example, an entity whose main business is investing in financial products, a registered bank, or a financial adviser)
- 'large' investors (i.e. investors with net assets or turnover exceeding $5 million for the last two completed financial years)
- Government agencies
- entities under the control of one of the above.

Discretionary investment management service providers

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

Certain provider obligations 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 client money or property services under the service to every investor in accordance with sections 431ZC TO 432ZH."

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. The DIMS licensee and the custodian are jointly and severally liable.

Brokerage fees

The definition of 'other charges' in clause 37 of schedule 21 of the FMC Regulations specifically excludes trading expenses. Regulation 210 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), the brokerage fees would need to be disclosed.

Custodians of managed investment schemes

A financial service provider who holds the property of a managed investment scheme is a custodian of that property. Regulation 229ZD of the FMC Regulations provides that to the extent that scheme property held pursuant to sections 156 to 160 of the FMC Act is a client money or property service, that service is not a *regulated* client money or property service.

Co-mingling

Under the Financial Advisers Act 2008 (FAA), co-mingling was prohibited. Brokers and custodians could not co-mingle firm money with client money. This created difficulties for some custodians as shortfalls in client funds (for a number of reasons) resulted in the potential for transactions failing[7].

Section 431ZC(2) of the FMC Act continues the prohibition against co-mingling firm money or property with client money or property. However, section 431ZC(3) provides that co-mingling may be permitted in prescribed circumstances. Regulations 229X to 229ZC of the FMC Regulations set out the rules that apply in respect of co-mingling. The main rule is that where firm money or property is held with client money or property, then the firm money or property must be treated as client money or property for all purposes.

In order to rely on the co-mingling provisions (under section 431ZC(4) of the FMC Act and regulation 229ZC in the FMC Regulations), a provider or custodian must comply with the duties set out in Schedule 21C of the FMC Regulations. These generally reflect the conditions in the former FAA exemptions[7]. It should be noted that there are specific duties that apply to NZX providers, to non-NZX providers, and to both. You should review the duties carefully to ensure full compliance to rely on the co-mingling exemptions.

[7] The FMA granted some limited exemptions to permit co-mingling in specified circumstances on conditions. Those exemptions were revoked along with the FAA. See Financial Advisers (NZX Brokers—Client Money and Client Property) Exemption Notice 2020 and Financial Advisers (Non-NZX Brokers—Client Money) Exemption Notice 2017.

Consultation questions

Non-broker insurance intermediaries

1. Do you agree with our overall approach to provide clarification in respect of the interaction between the Financial Markets Conduct Act (FMCA) and the Insurance Intermediaries Act (IIA)?
2. Are there any potential unintended consequences for insurance intermediaries (including sub-agents), consumers (e.g. policy holders), and/or insurance providers, in applying FMA's proposed view?

Identifying the provider

3. Do you agree with our expectations in regards to identifying who the provider is and documenting the nature of the arrangement? Are there any other aspects you consider it would be beneficial to include to assist with clarifying provider arrangements?

Reporting

4. Do you agree with our interpretation of what meets the threshold for a 'client address', and the limited circumstances in which this definition may be broadened? If no, please explain why.
5. Does your assurance testing include reviewing client addresses to ensure the independence of recipients? If not, please explain why, including whether extending the scope of your assurance testing to include this review is likely to incur any significant additional costs or time requirements.
6. Do you agree with our interpretation that a client's 'electronic address' may include access to an online portal through which reporting is provided? Please state the reasons for your view.

General questions

7. Are there any sections of the guidance you do not agree with? If so, please state what these are and explain why you disagree.
8. Are there any aspects of the guidance you think need to be improved or clarified? If so, please state what these are and explain what changes you would like to see.
9. Are there any other areas related to client money or property service providers that you think should be included in the guidance? If so, please state what these are.
10. Do you have any other comments on the guidance?

Feedback form

Consultation: Proposed guidance for client money or property service providers

Please submit this feedback form electronically in both PDF and MS Word formats and email it to us at consultation@fma.govt.nz with 'Consultation: Proposed guidance for client money or property service providers - [your organisation's name]' in the subject line. Thank you. **Submissions close on 1 November 2022.**

Date: Number of pages:

Name of submitter:

Company or entity:

Organisation type:

Contact name (if different):

Contact email and phone:

Question number	Response

Feedback summary – *if you wish to highlight anything in particular*

Please note: Feedback received is subject to the Official Information Act 1982. We may make submissions available on our website, compile a summary of submissions, or draw attention to individual submissions in internal or external reports. If you want us to withhold any commercially sensitive or proprietary information in your submission, please clearly state this and note the specific section. We will consider your request in line with our obligations under the Official Information Act.

Thank you for your feedback – we appreciate your time and input.