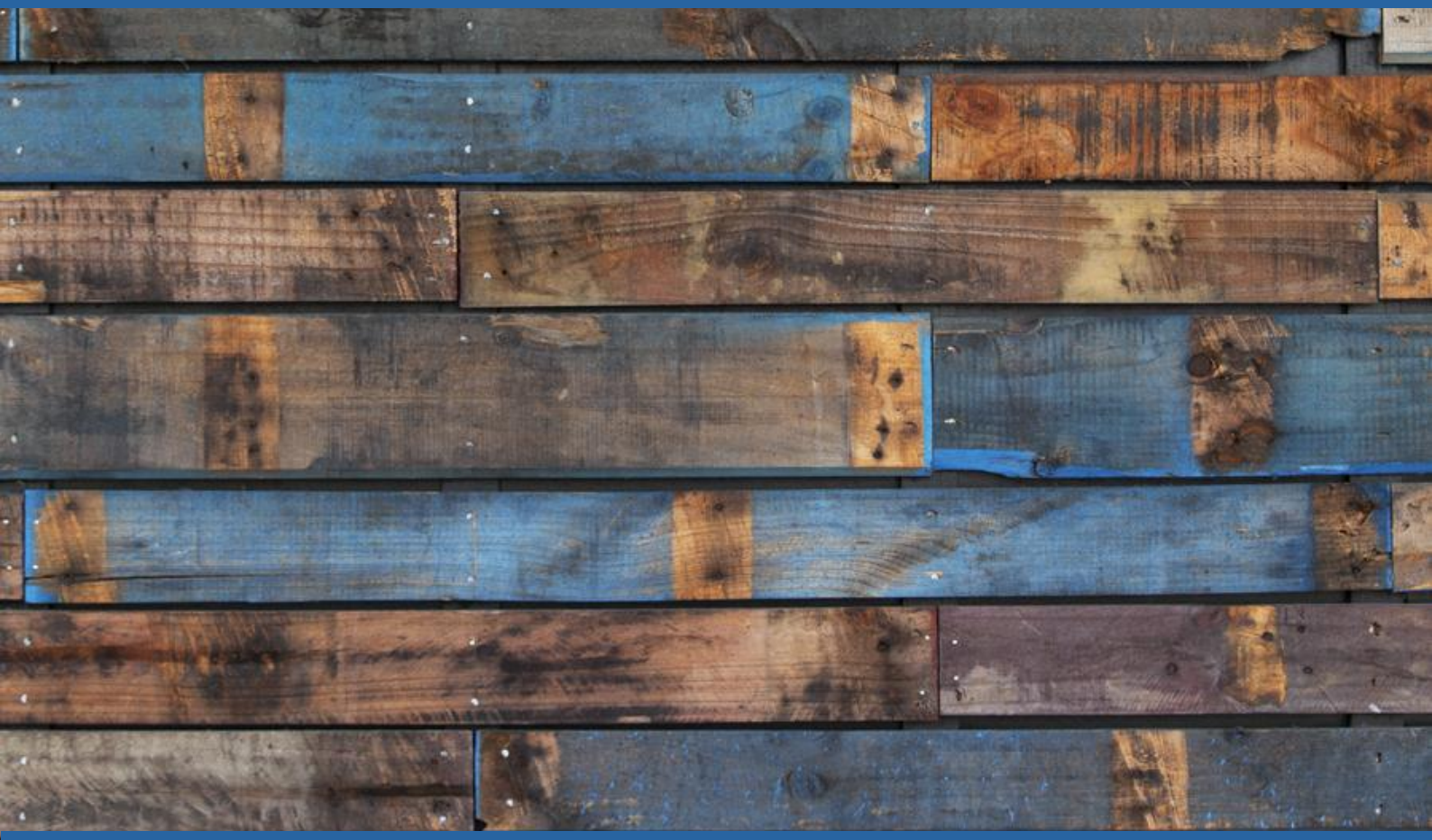
Guidance Note: Broker Obligations

February 2014



FMA

FINANCIAL MARKETS AUTHORITY

TE MANA TATAI HOKOHOKO - NEW ZEALAND

Financial Markets Authority
Website: www.fma.govt.nz

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

February 2014

Contents

About this Guidance Note **4**

Section 1: Overview **5**

Section 2: Upcoming changes to the law **8**

Section 3: Guidance **9**

Section 4: Operational considerations **13**

Section 5: Looking to the future **14**

About this Guidance Note

Issuing guidance is one of the ways FMA strives to be transparent and share our approach with the market. Guidance helps market participants to be confident that they understand how we interpret and intend to apply the law relating to broker obligations.

This guidance note is based on the law as at January 2014, and is for brokers (as defined in the Financial Advisers Act 2008 (**Act**)). This guidance does not change or add to existing legal requirements for brokers. It is aimed at improving compliance with broker conduct obligations and trust accounting obligations in Part 3A of the Act, by setting out how FMA interprets and applies certain parts of Part 3A. The focus of this guidance is on custody of client money and client property, and the key obligation of brokers to hold client money and client property on trust.

Significant changes to broker obligations are likely to come into force during 2014, through changes to the Act and the introduction of regulations governing custodians. These changes will clarify existing law and will impose new and extended obligations on brokers. The new law includes the introduction of an explicit prohibition on adding broker's own funds to client money trust accounts. It also mandates that custodians obtain annual assurance of the design and effectiveness of their controls relating to client money and property. Further details are provided in this guidance note.

This guidance is additional to guidance provided in relation to broking and custodial services in *Guidance Note: Discretionary Investment Management Services* published by FMA in October 2013.

Section 1: Overview

Who is a broker?

1. This guidance note is intended for "brokers", as that term is used in the Act. Broadly speaking a "broker" under the Act is a financial services provider who holds or deals with client money or property on behalf of clients.[1] This can include stock brokers, providers of portfolio administration services and financial advisers who receive property or money from clients (such as DIMS providers). Some financial services providers are known as brokers but do not hold client money or property, such as some insurance brokers and mortgage brokers. This guidance does not apply to those people.

2. Certain persons are not classed as brokers under the Act, including law firms, accountants and real estate agents acting in the ordinary course of their businesses, and authorised futures dealers (who are subject to separate obligations)[2].

3. As at 2 January 2014, there were 1,271 companies and individuals registered on the Financial Service Providers Register (**FSPR**) as providing broking services.

Legal obligations of a broker

4. Broker obligations are set out in Part 3A of the Act.

5. The general conduct obligations (in sections 77J to 77O) include obligations to:

   - exercise care, diligence and skill
   - not engage in misleading or deceptive conduct.

6. The trust accounting obligations for services to retail clients (sections 77P to 77T) include obligations to:

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

7. These obligations have now been in force for more than two years and all brokers should be fully compliant with them. FMA's expectation is that senior management of brokers will be actively:

   - promoting a culture of compliance

[1] For a detailed definition of "broker" and "broking services" see sections 77B, 77C and 77U of the Act (and the relevant definitions) and FMA's website: www.fma.govt.nz/help-me-comply/Brokers/who-needs-to-comply/. Note that amendments to these definitions are likely to come into force during 2014. See Section 2 of this Guidance Note for more information.

[2] See the Futures Industry (Client Funds) Regulations 1990.

- ensuring that robust risk management and compliance monitoring processes are in place.

Contracting-out (outsourcing) of broking services to third parties

8. Where a broker contracts out (outsources) broking services to another business providing broking services, for example to a custodian, the broker remains responsible to the client for broking services (see section 77U of the Act). The person providing the outsourced broking services is required to register on the FSPR as providing broking services, but it will not have any broker obligations under the Act if it is acting on behalf of the other broker's business.

9. Where a broker outsources provision of broking services to a third party for which the broker is responsible under the Act, the broker should carry out (and record) a reasonable level of due diligence on that third party and the proposed arrangements under the agreement between the broker and the third party. This should include consideration of:

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

Key areas of focus

10. FMA has identified several key themes as part of our monitoring of brokers:

    - client consent not being obtained by brokers before taking a margin on interest earned on client money
    - poor protection of client faster identification numbers, common shareholder numbers and security reference numbers
    - incorrect naming of client money trust accounts as a 'working account' or 'business account'
    - brokers not reporting to clients on money and property holdings with required frequency, or in some cases, accuracy
    - little or no documentation supporting the classification of wholesale clients
    - bank and custody reconciliations not being performed in a timely manner

- client money trust accounts overdrawn or with balances that are less than the amounts owed to clients.

We provide guidance on these matters in Section 3 below and expect that brokers will consider and use it to examine their existing compliance arrangements. We provide guidance on these matters in Section 3 below. We were concerned during our monitoring that some brokers were not meeting all the minimum legislative requirements. Improvements are needed to better comply with or demonstrate compliance with the obligations in the Act. Our expectation is that brokers will consider this guidance and use it to examine their existing compliance arrangements.

Section 2: Upcoming changes to the law

11. Custodian regulations and changes to the Act are likely to come into force during 2014. These changes to law and regulation will affect many brokers. The changes will include new obligations in relation to brokers who provide 'custodial services'. There will be additional requirements and limitations in relation to the provision of broking services. Some of the key changes are incorporated into the Act through the Financial Markets (Repeals and Amendments) Act 2013 (**FMRAA**).

12. FMA expects that brokers will already be considering the effect of these changes and making any changes to systems and controls necessary to comply. You can refer to the FMRAA and the Ministry of Business, Innovation and Employment's (MBIE) website www.mbie.govt.nz, as well as our own website www.fma.govt.nz for more detailed information on the new requirements and timetable for delivery[3]. All brokers will need to be fully compliant from the date the amendments to the Act and regulations come into force.

Key changes

13. 'Custodial services' as a subservice of 'broking services', will be defined in the amended Act in section 77B (1)(b). This will remove any ambiguity about whether brokers who provide custodial services only, such as nominee companies, are required to register on the FSPR.

14. The proposed custodian regulations will require brokers to comply with a number of extended or additional obligations in relation to the provision of custodial services:

    - *Audit and Assurance:* obtain an annual audit of client money and client property against client reports and an annual audit of controls. *Many brokers have already adopted audits and assurance checks as good practice.*
    - *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.

15. We consider that the proposed requirements in relation to reporting and reconciliations clarify and extend existing obligations in those areas.

16. The amended Act at section 77P(1A) will explicitly prohibit brokers from placing their own money in client money trust accounts, i.e. it clarifies that the practice of holding 'buffers' of broker funds in client money trust accounts is not permitted. We will conduct targeted consultation with industry participants to consider the effect of section 77P(1A) on current practice.

[3] See: www.med.govt.nz/business/business-law/current-business-law-work/dims-and-custody and www.fma.govt.nz/help-me-comply/brokers/your-obligations/upcoming-changes-to-law/.

Section 3: Guidance

Protection of client CSNs, SRNs and FINs

17. New Zealand share registries of listed equity securities 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**).

18. Brokers' obligations relating to the use and management of FINs are governed by section 77K of the Act. This requires brokers to exercise the care, skill and diligence that a reasonable broker would exercise when providing broking services. FMA considers that a reasonable broker 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

19. Sections 77P and 77S of the Act set out clear obligations and restrictions on how brokers hold and apply money and property of retail clients. Brokers cannot use client money held on trust for one client to temporarily fund shortfalls in client money for other clients. Such 'cross-use' can arise in a number of circumstances, none of which we consider are permitted under the Act. Uses that are not permitted include:

    - 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)
    - transferring 'buffers' of brokers' own funds to retail client money trust accounts to make up shortfalls in funds held for particular clients, except where such buffers are 'client money' at the time of transfer to the account.

20. We do not consider use of 'buffers' in trust accounts to be permitted, except where such buffers are allocated to specific clients to the extent of their outstanding obligations and are 'client money' of those clients. Nor do we consider that timing issues excuse or permit cross-use; if client obligations are to be settled from a client trust account that holds client money for more than one client sufficient client money (including by way of credit facilities) should be available to ensure that each client meets their own obligations.

Deducting margins from client money

21. Some brokers deduct a 'margin' from client money. For example, they deduct margins from interest earned by retail clients on their money and when client money is subject to foreign currency conversions. We understand that those margins are taken as fees for services provided. We consider before a margin can be deducted that the deduction must be expressly, clearly and unambiguously disclosed in the relevant agreement between broker and client, in order to obtain informed consent from the client. We are not suggesting that brokers cannot deduct fees from client money, but the law requires that brokers obtain the necessary informed consent from the client before making such deductions.

22. FMA considers that express, clear and unambiguous disclosure requires 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, be disclosed. We also consider that 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 to clients, without disclosing that it is less than the actual rate of interest paid on the bank account in which the client money is deposited
    - disclose deduction of a margin but using language that is likely to be confusing or likely to mislead clients as to the true nature of the deduction.

23. Failure to obtain informed client consent prior to deducting such margins from a retail client is a contravention of sections 77P (Broker must pay client money into separate trust account) and 77S (Restrictions on use of client money and client property) of the Act.

24. In some cases failure to make adequate disclosure could also constitute a contravention of section 77L (Broker must not engage in misleading and deceptive conduct) and of section 77M (Advertisement of broking services must not be misleading, deceptive or confusing). It may also lead to a contravention of section77Q (Broker must account for client money and client property).

Naming and notification of client money trust accounts

25. To ensure compliance with section 77P of the Act, the actual bank account name must contain the words 'trust' and/or 'client funds account', to clearly reflect the trust status of the account and that it comprises client money. It is not acceptable to use names such as 'working account' or 'business account'. Brokers must obtain written confirmation from third parties such as registered banks and custodians, acknowledging the status of the accounts as trust accounts.

Bank account and custody reconciliations

26. Section 77R of the 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 brokers to determine how best to comply with these obligations.

27. Compliance with these obligations requires that regular reconciliations are 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 broker's business e.g. the frequency of trading, scale of operations, nature and complexity of products and availability of valuation data. For larger brokers 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.

28. The proposed custody regulations will require custodians (as defined in the regulations) to comply with more detailed obligations regarding reconciliations and other matters.

Keeping documentation up to date

29. FMA expects processes to be in place to ensure that client contract documentation is regularly reviewed and updated to reflect new legislation (e.g. the Anti-Money Laundering and Countering the Financing of Terrorism Act 2009).

Reporting to clients

30. FMA considers that regular client reporting is a very important part of broking services and that failure to report appropriately will lead to a contravention of section 77K of the Act. The frequency and extent of reporting will be evaluated on a case by case basis and we expect that brokers will have processes in place to determine this. We expect that for most portfolios, brokers will be reporting trading activity to clients at least quarterly.

31. The proposed custody regulations will require custodians (as defined in the regulations) to comply with minimum standards regarding reporting.

Client money trust account cheque books

32. Cheque books for client money trust accounts should be held securely and failure to do this is likely to constitute a contravention of section 77K of the Act (Broker must exercise care, diligence, and skill).

Identification of wholesale clients

33. Whether a client is a 'wholesale client' is determined by section 5C of the Act.[4] We consider that brokers should maintain adequate processes, systems and records in relation to identifying wholesale clients.

34. If brokers wish certain wholesale clients to have full benefit of the additional rights and protections given to retail clients under the Act, brokers must ensure that those wholesale clients exercise their opt-out right under section 5G of the Act. Brokers who advise their wholesale clients that they have protections and rights as retail clients, but do not advise them of the need to opt out to gain full protection, could inadvertently be misleading their clients.

[4] Note that changes to the section 5C definition of 'wholesale client' are likely to come into force during 2014.

Registration of nominee companies on the FSPR

35. We consider that nominee companies that hold client money and client property (i.e. as bare trustee) meet the definition of providing 'broking services' under section 77B of the Act and need to be registered on the FSPR. For further information please refer to the Act and to FMA's information on who should be registered as a broker: www.fma.govt.nz/help-me-comply/Brokers/who-needs-to-comply/. Section 77B(1)(b) of the amended Act will confirm that companies holding client money or property on trust must register as providing broking services.

Use of premiums by insurance intermediaries

36. Many key obligations of insurance intermediaries are governed by the Insurance Intermediaries Act 1994 (**IIA**). However, FMA regulates particular activities of insurance intermediaries, including monitoring of their compliance with financial adviser and broker conduct obligations in the Act (e.g. sections 77J to 77O) and other financial markets legislation, including the Companies Act 1993. We consider that any failures of insurance intermediaries may have a wider impact on the financial markets, including harming the confident and informed participation of businesses, investors and consumers in the financial markets.

37. We do not consider that the IIA permits intermediaries to use premiums held for insurers to fund intermediaries' own businesses and related premium funding companies. An intermediary's right to invest premiums held in the insurance broking 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. Use of premiums by intermediaries to fund their own businesses in contravention of the IIA raises concerns about the solvency of those intermediaries.

38. 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.

Section 4: Operational considerations

39. We ask all senior management of brokers to consider this guidance note and to ensure that the controls and systems operating in their organisations are adequate. Suggested key controls to help manage risk and ensure compliance are:

- brokers conduct regular reviews of client contracts and business operations to ensure compliance with the requirements of the Act and other applicable financial markets legislation
- brokers have systems and processes that provide for the accurate calculation of client money inflows and client settlement obligations
- senior management promote the requirement for robust controls throughout the organisation and ensure those controls are implemented
- brokers adequately protect client FINs by having an electronic encryption system or clearly defined process to immediately destroy FINs after each transaction
- custody accounts and client money trust accounts are clearly named to reflect their trust status
- brokers obtain written confirmation from all third party custodians of client money and client property that is held on trust on behalf of clients.

Section 5: Looking to the future

40. As part of our risk-based approach to compliance monitoring, FMA will continue our onsite broker monitoring visits, concentrating on the following areas:

    - review of custodial services, particularly in relation to the provision of DIMS
    - reconciliation of client money and client property
    - accuracy and frequency of reporting to clients
    - further review of the practice of brokers taking margins from client money without adequate disclosure.

41. Within the next year we intend to conduct a survey of financial markets participants who are registered as providing broking services on the FSPR to identify the nature and scope of their broking services.

Financial Markets Authority
Website: www.fma.govt.nz

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