FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

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Regulatory Impact Statement: Non-NZX Broker Client Money

This document is for non-NZX brokers and their clients

It discusses an exemption granted to non-NZX brokers

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Executive summary

This Regulatory Impact Statement (RIS) discusses an exemption we granted to non-NZX participant brokers (non-NZX brokers) from the Financial Advisers Act 2008 (FA Act) requirement that brokers keep client money and property separate from their own money and property (segregation requirement). The exemption will allow these brokers to maintain a limited buffer of their own money in their client money trust account to mitigate shortfall risks. Relief has been granted for a transitional period until 30 Nov 2020 when a notice granting similar relief for NZX participants expires.

In this RIS we provide an analysis of the exemption options considered, their impact and the reasons for our decisions. Our assessment was based on the relevant statutory exemption test and particularly on what we think is an appropriate level of risk to accept in light of the cost burden of the compliance requirements imposed by the FA Act if no relief is granted.

Exemption granted

After carefully considering both regulatory and non-regulatory impacts, we decided to grant an exemption for non-NZX brokers from FA Act client money and property segregation requirements on conditions providing for the responsible management of client money.

Objective

Where market participants encounter difficulties operating under the standard rules in the FA Act an exemption may be appropriate, in some instances. Before granting an exemption we must be satisfied the costs of complying with the relevant obligation would be unreasonable, or would not be justified by the benefit of compliance. Accordingly, we assessed the possible options against the objective of whether the costs of compliance with the segregation requirement would be justified by reduced risks for clients. In conducting this analysis, we compared the exemption option against the status quo (no exemption).

We considered the following stakeholders' interests:

- Non-NZX brokers
- Clients of non-NZX brokers.

Background

Segregation requirement

Brokers and custodians have obligations under the FA Act when they handle client money and property. This includes the obligation to keep client money and property separate from their own money and property (s 77P(1A)). We refer to this as the segregation requirement. The segregation requirement ensures client money and property remains clearly identifiable and protected by a trust while in the broker's custody. Client funds not held on trust by a broker could be lost in the event of the broker's receivership or liquidation. Additionally, a liquidator may freeze client accounts if client money is mingled with broker money until the broker's money can be identified and removed. This may result in a delay in the return of client money.

Historically, New Zealand brokers have maintained a buffer of their own money in their client money trust account to mitigate the risk of a shortfall in client funds needed to settle a transaction. This use of buffers contravenes the segregation requirement. It also raises risks that the trust over client money could be compromised. In New Zealand a broker's buffer remains the property of the broker. This contrasts with the position in Australia and the UK where limited buffers are allowed, but a broker's buffer becomes client money when deposited in the client money trust account.

Section 77P(1A) was included in the FA Act as part of Financial Markets Conduct Act reforms. The segregation requirement was supposed to come into force on 1 December 2014, but after existing brokers raised concerns about how this obligation would work in practice, they were given a one year transition period. This enabled further dialogue with industry on compliance options.

The Securities Industry Association (SIA) formed a working group to look at compliant solutions and other options, including potential exemptions. They identified two circumstances where the strict segregation requirement 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) need to go through 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, the FMA 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 to prevent a shortfall in client money:
  - preventing settlement of client transactions, or
  - resulting in one client's money being used to pay for a transaction for another client.

These exemptions permit the co-mingling of client money and property with the NZX broker's money and property. This is to the extent reasonably necessary to either facilitate or arrange 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.

Conditions in the NZX notice require NZX brokers to:

- take all reasonable steps to ensure client money and client property remain separately identifiable and
- document, implement, and monitor processes consistent with good practice to manage the risks involved.

They must also ensure that the amount of firm money held in a client money trust account is no more than is reasonably necessary to cover the risk of a shortfall arising.

NZX brokers are subject to the NZX Participant Rules and NZX supervision. The rules include minimum capital requirements to reduce the risk of insolvency. They also require NZX brokers to notify NZX if they intend to keep a buffer of their own money in their client money trust account, and tell them how it will be calculated. This must be consistent with the principles outlined in the rules and with good broking practice. Brokers must also notify NZX of any changes to the calculation method.

Similar issues faced by non-NZX brokers

When the NZX notice was granted we considered expanding the scope of the exemption to apply to all brokers, rather than just NZX participants. At that time we decided not to do so given non-NZX brokers weren't subject to minimum capital requirements and their accounts weren't subject to NZX oversight and account reconciliation rules, and therefore might present a higher risk. It was also unclear that there was the same need for exemptions for non-NZX brokers.

Subsequently we found that some non-NZX brokers were not complying with the segregation requirement. They were continuing to manage the risk of shortfalls in client funds by maintaining a buffer of their own money in their client money trust account. While non-NZX brokers did not operate 'gateway' accounts, they appeared to face similar issues as NZX brokers in relation to shortfalls. We decided that, although non-NZX brokers were not subject to NZX oversight and account reconciliation rules, it might be possible to provide appropriate protection in these areas through additional conditions in the exemption such as:

- a requirement for an external assurance report with a qualified auditor, and
- requirements to keep records and make these available to the FMA on request.

Some non-NZX brokers told us compliance with the segregation requirement would cause serious difficulties for them, given the way their platform operates and their client contract terms. They have historically operated buffers in their client money trust account to cover any deficit arising in a client's funds held in the account.

Brokers told us shortfalls in their client money trust accounts 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
- internal errors.

They said having a buffer of the broker's money enables a broker effectively to advance funds to clients to ensure trades are completed. Brokers think maintaining a buffer of their own money protects clients by ensuring that there is no cross-use of one client's money to settle a transaction for another as a result of a shortfall.

We explored with these brokers whether there are alternatives to maintaining a buffer that would enable them to comply with the segregation requirement. Feedback was that alternatives they had considered could result in the loss of clients and client revenue, or even make some current business models unviable.

Alternatives explored by one broker were:

- to prohibit placing of orders until one or two business days following receipt of client funds. They said if set at two days, this would remove the risk of subsequent reversal of payments by a paying bank. However they also said this practice would prejudice the interests of investors in obtaining their desired price of securities, given such delays. It would also place the broker at a competitive disadvantage to anyone with the benefit of the NZX notice.
- implementing a business rule to require an investor buffer in proportion to the size of the investor's account. However the broker thought the required size of the buffer would materially degrade the investor's ability to weight their portfolios efficiently. It was therefore unlikely to be palatable for investors.

We also discussed whether it would be an option for the broker to lend money to a client to cover any shortfall under a debtor/creditor relationship. This would mean it would be client money when in the client money trust account. None of the non-NZX brokers supported using lending facilities to comply with the segregation requirement. They thought this was impractical or impossible, costly, and would require significant complex system development and raise possible issues under the Credit Contracts and Consumer Finance Act 2003. NZX brokers consulted on the NZX notice raised similar objections.

Some non-NZX brokers said that complying with the segregation requirement would require substantial or fundamental redesign of their IT systems and processes, and considerable expense, and could also result in significant loss of client revenue.

Risks if brokers buffers are allowed

If a broker maintains a buffer of their own money in their client trust money account we think the main risks are:

- it might conceal deficiencies in record-keeping and encourage brokers not to maintain accurate client money records. Poor record-keeping could ultimately lead to cross-use of client money or delay in client money being returned if the broker goes into liquidation or receivership.
- in an insolvency event a liquidator is likely to freeze client accounts (if they contain a buffer of broker money) until the broker's money has been identified and removed and this may result in a delay in the return of client money
- keeping the broker's money in the client money trust account could make it more likely that the trust is successfully challenged. In particular, we think this risk might arise if the broker keeps a far larger buffer in the client trust money account than is reasonably required to mitigate the risks of any shortfall in client funds, or uses the buffer for working capital.

Options considered

We considered 2 options:

Option 1 (selected): Class exemption for non-NZX brokers from the segregation requirement

We considered the option of a class exemption from the segregation requirement for non-NZX brokers, to run until 30 November 2020 (the expiry date for the NZX notice). The exemption would only apply to the extent reasonably necessary for firm money to be held together with client money in a client money trust account in order to:

- 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.

Under this option, conditions would apply to address risks arising when broker money is not kept separate from client money. In summary, these are:

a) Broker money may only be held together with client money to the extent reasonably required to ensure prudent and orderly settlement of client transactions
b) The broker may only place their own money in the client money trust account to facilitate client transactions, reduce the risk of a shortfall, or manage a shortfall that has occurred
c) The broker must take reasonable steps to ensure the amount of the buffer is no more than the amount needed to facilitate settlement of client transactions, or cover any shortfall
d) The broker must reasonably calculate the amount of buffer required
e) The broker must implement, document and monitor processes to manage the risks of comingling of broker money and client money
f) The broker must take reasonable steps to ensure client money and firm money is separately identifiable
g) The broker must reconcile client records daily to ensure sufficient buffer is held to cover shortfalls
h) The broker must ensure client money trust accounts are identified as trust accounts, obtain a written acknowledgement of trust from the bank, and get an updated acknowledgement if the status of the account changes
i) The broker must provide clients with information on how client money will be held (a declaration of trust), a statement that a buffer of the broker's money may be deposited in the client money trust account to reduce the risk of a shortfall arising, and a description of any risks the broker is aware of that may arise as a result of client money not being kept separate from the broker's money
j) The broker must keep up-to-date records of the operation of each client money trust account. These records must include certain information and be made available to the FMA as soon as practicable after the FMA makes any request;
k) The broker must obtain an annual assurance engagement with a qualified auditor in accordance with applicable audit and assurance standards, and provide the assurance report to the FMA
l) The broker must notify the FMA if they intend to rely on the exemption.

Option 2 (not selected): No exemption - compliance with the segregation requirement (status quo)

The alternative option we considered was not to grant an exemption from the segregation requirement for non-NZX brokers. This would mean brokers would need immediately to comply with the segregation requirement, or remain in breach until they established effective account systems.

Impact analysis of options

Class exemption for non-NZX brokers from the segregation requirement

Impact analysis

The segregation requirement provides an important protection for client money held by a broker in the event a broker becomes insolvent. We considered that all brokers should have taken steps to implement changes to their IT systems, processes and business to eliminate any shortfalls arising in client money; or if this was not possible, to reduce shortfalls to the maximum extent possible.

However feedback indicated that despite the requirement being in place since the end of 2015, achieving immediate compliance with the segregation requirement would result in high compliance costs and business disruption for many non-NZX brokers and their clients. It appeared that brokers did not have the resources and systems to adequately mitigate the risks of shortfalls without using buffers. It was preferable for brokers to use their money for a buffer, rather than using other clients' funds. These were the two choices that existed, given the outdated systems used by some non-NZX brokers. In addition there were questions of fairness if NZX brokers had the benefit of relief that allowed them to continue to maintain a buffer in their client money trust account (and therefore avoid the immediate cost of upgrading their IT systems, processes and business), but non-NZX brokers did not.

On this basis we decided that transitional relief should be provided for non-NZX brokers, to allow limited use of buffers subject to conditions (described above) to minimise any risks that may arise if a broker becomes insolvent. The conditions are intended to constrain the extent of any co-mingling to a level consistent with good broking practice, and ensure brokers keep clear and up-to-date records so money in the trust account remains clearly identifiable.

The conditions are similar to those under the NZX notice but take into account differences in regulation of these groups of brokers. Non-NZX brokers are not subject to NZX oversight or the NZX Participant Rules, so the conditions put in place an alternative governance framework to provide a similar level of protection for investors. The framework includes requirements to engage a qualified auditor for assurance, robust reconciliation, record-keeping, and requirements to provide certain information to the FMA on request. The conditions also include a requirement for a declaration of trust to be made by the broker in relation to client money.

There may be some residual risks from granting the exemption, but we think the conditions should minimise these and that the actual risk to client money as a result is likely to be low.

The exemption allows brokers to implement the changes needed to comply (and spread resulting costs) over a longer period. This is likely to minimise overall cost and reduce disruption for brokers and their clients by allowing changes to be made when scheduled upgrades or reviews of systems or processes occur.

Alternatively the exemption will provide transitional relief until any legislative change to the segregation requirement comes into effect[1].

[1] Since the exemption was granted changes have been proposed to the segregation requirement under the Financial Services Legislation Amendment Bill to allow brokers to retain a buffer of their own money in the client account on the terms and conditions to be provided for in future Regulations. The Bill provides that any such buffer is to be treated as client money.

Decision and reasons

We decided option 1 (Class exemption for non-NZX brokers from the segregation requirement) best met the objective. The costs of compliance with the segregation requirement would be reduced through the exemption, but without resulting in any significant increase in risks for clients.

No exemption - compliance with the segregation requirement (status quo)

Impact analysis

If no exemption had been granted, non-NZX brokers would have incurred immediate, high compliance costs and suffered disruption to their business and clients, due to required upgrades to their IT systems, processes and business. The resulting compliance burden and costs would have been high. Brokers would not have been able to spread costs over time or plan changes around scheduled upgrades or reviews. Some brokers might have continued to be entirely non-compliant with the segregation requirement. We would have needed to determine what (if any) action we took to move brokers towards compliance. We thought the exemption was the most effective means of achieving this. It sought to ensure prudent safeguards were implemented within a reasonable timeframe.

Non-NZX brokers would have been at a competitive disadvantage to NZX brokers if this option had been chosen. NZX brokers have the benefit of relief that allows them to continue to maintain a buffer in their client money trust account, and avoid the costs of upgrading their IT systems, processes and business.

Decision and reasons

We decided that option 2 (no exemption – compliance with the segregation requirement) did not meet the objective of avoiding the costs of compliance that are not justified by the benefit of compliance. Compared with option 1, the costs of compliance with the segregation requirement would have been high in the short term and this would not have been justified by a significant reduction in risks for clients.

Selected option and summary of reasons

We decided option 1 would most effectively achieve the objective. Option 1 is a class exemption for non-NZX brokers from the segregation requirement (until 30 November 2020), subject to the conditions to the effect of those outlined in this RIS.

The key reasons we considered it appropriate to grant this exemption, on those conditions, and which are reflected in the exemption notice are:

- shortfalls in a broker's client money trust account may occur for a variety of reasons, including timing issues (eg, for offshore trades), changes in foreign exchange rates, processing errors, tax or fee payment obligations, payments being dishonoured or reversed, failures by clients to lodge funds, and internal errors:
- these shortfalls, unless addressed, may result in insufficient funds being available to settle financial product transactions on behalf of clients or one client's funds being used to settle another client's transaction:
- historically, many brokers in New Zealand have mitigated the risks of shortfalls arising by maintaining a buffer of their own money in their client money trust account. This practice contravenes the segregation requirement under the Act:
- upgrading or changing existing systems and processes to mitigate the risks of a shortfall arising without use of a buffer is likely to result in significant compliance costs and business disruption for brokers and their client. These brokers will be best able to minimise and manage the impact of the costs and disruption if they have a transition period that allows them to spread costs over time and take advantage of any scheduled upgrades or reviews:
- conditions will limit the use of buffers to where they are reasonably necessary in order to facilitate the settlement of financial product transactions for a client or reduce the risk of a shortfall arising, and brokers will be required to take all reasonable steps to ensure that client money remains separately identifiable and that the amount of firm money held in a client money trust account is no more than is reasonably necessary to cover the risk of a shortfall arising:
- requirements in relation to the establishment and operation of the client money trust account and for a declaration of trust promote the establishment of a trust to protect client money held by the broker in the client money trust account. Additionally, conditions will also require brokers to keep records on compliance with the requirements under this notice and make them available on request, and independent verification regarding compliance will be provided through an assurance engagement obtained from a qualified auditor:
- in these circumstances, the FMA is satisfied that the costs of full and immediate compliance by brokers with the segregation requirement (if an exemption was not granted) would not be justified by the benefit of a significant reduction in risks for clients.

Summary assessment of options against objective

Objective	Option 1: Exemption	Option 2: No exemption (status quo)
Avoids costs of compliance not justified by the benefit of compliance.	Costs of compliance with the segregation requirement will be reduced through the exemption, but without resulting in any significant increase in risks ✓✓	Costs of compliance with the segregation requirement will be high in the short term and this will not be justified by a significant reduction in risks for clients compared with option 1 ✗

Key

✓✓ Meets the policy objectives

✓ Partially meets the policy objectives

✗ Doesn't meet the policy objectives

Consultation

Consultation process

We consulted publically in February/March 2017, and received submissions from:

- Paul King
- Craigs Investment Partners Limited
- Yovich & Co Limited
- Trustees Executors Limited
- JBWere (NZ) Limited
- The New Zealand Guardian Trust Company Limited
- ASB Bank Limited (Aegis Limited and Investment Custodial Service Limited)
- NZX
- FNZ Limited.

Summary of submissions

Eight submitters supported relief from the segregation requirement; one opposed. The submitter who opposed relief thought buffers are a risk to client funds, and that the segregation requirement has been known for a long period and should have been addressed.

Despite the segregation requirement having been law since the end of 2015 (and a 12 month transition period applying prior to this) most submitters thought immediate compliance would be hugely costly. This was due to the scale of systems changes required and the difficulty in forecasting situations in which a shortfall might occur.

A strong theme in submissions was that relief should not just be transitional and that longer term relief is required to allow continued, controlled use of buffers. A few said this would be better provided through law reform rather than by an FMA exemption. One submitter noted that Australia and the UK allow brokers to maintain buffers. Another thought some continued relief would always be required due to limited instances of unforeseeable shortfalls, for example tax. However they said in the longer term, relief could be much more limited in scope. As buffering processes develop and are evaluated they said brokers will be in a position to know more about the situations which cause a requirement to buffer, and develop systems to prevent this.

Two submitters were concerned that relief for NZX brokers might not be continued following expiry of the NZX notice. They said continued relief would be required both for buffers and gateway accounts. One said that the success of many transactions is reliant on the co-mingling of funds.

In general, submitters who supported relief thought the proposed conditions were appropriate and practical, consistent with good broking practice and would address relevant risks.

However some concerns were raised:

- Some submitters thought the proposal for six-monthly assurance reports from a qualified auditor would be too costly and outweigh the reduced risk provided by that external verification. Some said the cost would be

prohibitive for smaller brokers who would not rely on the exemption as a consequence. Some proposed scrapping this requirement entirely (or one submitter said the condition should not apply where the buffer is no more than $10k or $20k) and others suggested an annual requirement (to align with the annual assurance requirement for custodians). One submitter thought an assurance report should not be required for market services licensees already subject to supervision and with a financial resources condition under their licence. We considered these points and concluded that the condition requiring an assurance report from a qualified auditor should be retained. This is because this provides external oversight of non-NZX brokers' buffering operations, in the same way NZX provides external oversight for NZX brokers. The requirements for market services licensees do not specifically address this point. However we agreed with submitters that an annual report would be sufficient.

- Some submitters thought the condition requiring provision of information to clients about how client money would be held (ie a declaration of trust) was too prescriptive and could be problematic to provide to investors. We considered the points raised but concluded this requirement should be retained to ensure that a trust is established over client money. However appropriate wording for this condition was discussed with concerned submitters before the notice was put in place.
- Submitters confirmed they did not operate a gateway account and therefore the NZX notice relief for gateway accounts was not required.