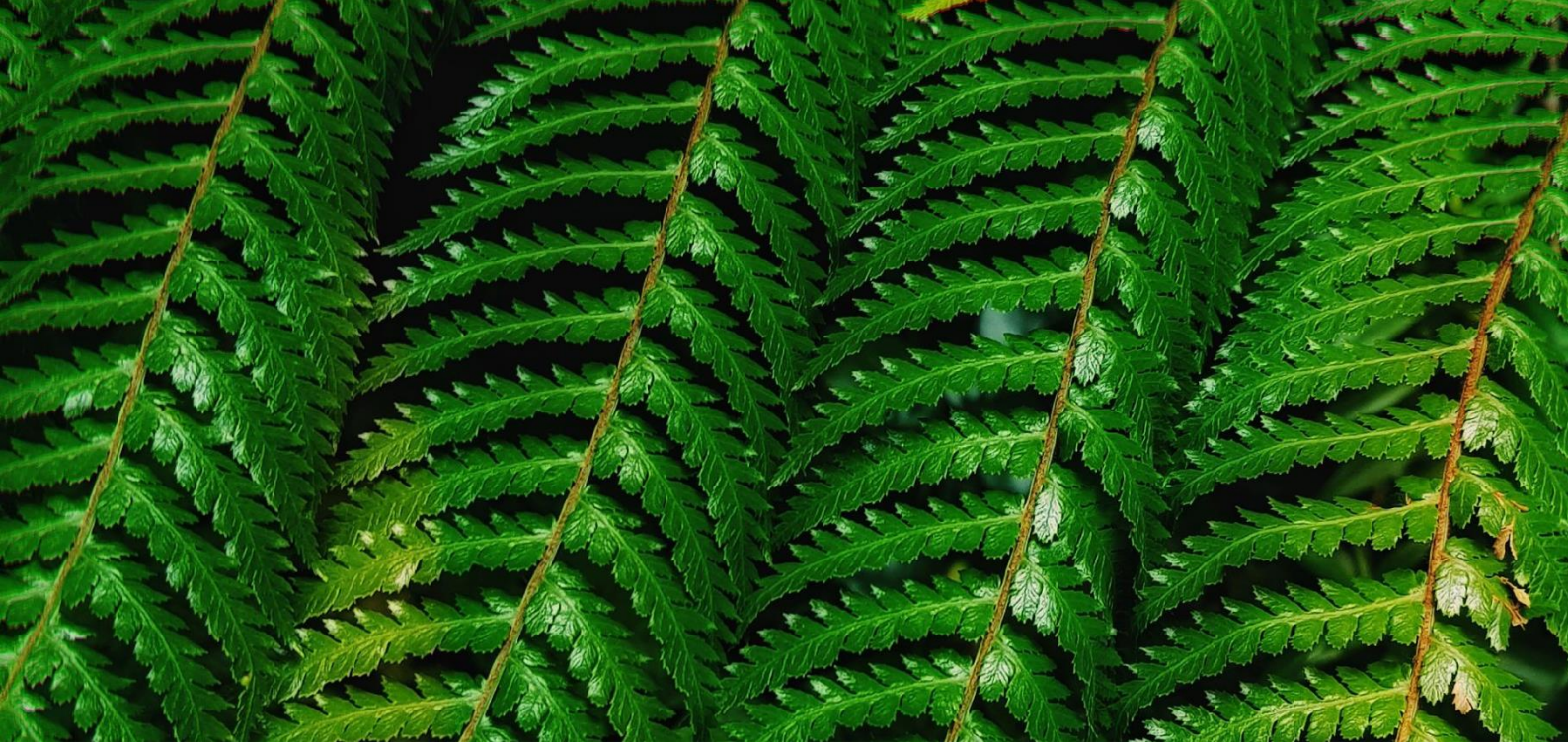

JULY 2024

Guide for providers of client money or property services

This document is for providers of client money or property services, and custodians.

It gives guidance on how they can meet their obligations under the Financial Markets Conduct Act 2013.

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TĀTAI HOKOHOKO

About FMA guidance

Our guidance:

- explains when and how we will exercise specific powers under legislation
- explains how we interpret the law
- describes the principles underlying our approach
- gives practical examples about how to meet obligations.

Guidance notes: provide guidance on a topic or topic theme. Typically we will seek industry feedback via a public consultation paper, or more targeted consultation before we release a guidance note.

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

You might also like to check the reports and papers on our website. For example, our monitoring reports describe actual practice we are seeing and our comments on this.

Document history

This version was issued in July 2024, following public consultation on a draft version. It replaces our 2014 guidance note on broker obligations.

Contents

About this guidance note

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

The Financial Markets Authority – Te Mana Tātai Hokohoko (FMA) is responsible for monitoring providers' and custodians' conduct and compliance with these obligations.

Who is a client money or property service provider?

Broadly speaking, a 'provider' under the FMC Act is a financial service provider who holds or deals with client money or property on behalf of clients[1, 2]. This can include stockbrokers, providers of portfolio administration services and financial advisers who receive property or money from clients.

Some financial service 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 the 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:

- hold client money and property on trust in a separate trust account

[1] For detailed definitions of client money or property service provider, and client money or property service, see section 431W of the FMC Act.
[2] 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.

- 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.

These obligations for client money or property service providers have been in force since 2011[3] and all providers should be fully compliant with them.

It is our view that senior management of providers should:

- 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 the controls and systems in their organisations are adequate.

[3] 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 or property services to third parties

Where a provider outsources client money or property services to another business (e.g. a custodian) (outsource provider), 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 or property service obligations under the FMC Act if it is acting on behalf of the 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 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) and Authorisation Code (formerly known as a Faster Identification Number (FIN), which is still the commonly used term) to identify a shareholder. These 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. This requires providers to exercise the care, skill and diligence that a prudent provider would exercise when providing client money or property services, so clients can trust providers to act in their interests. We expect that where it is necessary to hold a FIN on file, a prudent provider would encrypt it electronically. Where clients' CSNs, SRNs and FINs are forwarded by email, providers should ensure these

are sufficiently protected, for example by way of encryption or two-factor authentication. Where FINs are not required to be held on file, the record of them 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 money 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 client money 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 money with client money in client money trust accounts in prescribed circumstances, subject to complying with various specified duties[4]. In these circumstances, 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 can be 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, and providers should obtain an express direction from a client to make this type of deduction, before making such deductions.

The FMA's view is that this express, clear and unambiguous disclosure should state 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. We generally expect that the purpose for which the margin is taken would be associated with the services provided to the client; it should be clearly disclosed to the client if this is not the case.

We also expect the provider should ensure the client understands that a specified rate of interest will be paid, and (if applicable) disclose that this is less than the actual rate of interest paid on the client money bank account (with the difference being the provider's margin). Disclosure of the deduction of a margin should not use language that is likely to be confusing or mislead clients as to the true nature of the deduction.

Failure to obtain an express direction from a retail client prior to deducting such margins may result in 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).

[4] See Schedule 21C of the Financial Markets Conduct Regulations 2014.

Naming and notification of client money trust accounts

Section 431ZC of the FMC Act does not require the actual bank account name to contain the words 'trust' and/or 'client funds account'. However, to reflect the status of the account we consider it is best practice to do this, as it alerts the bank that the account is a trust account. It is not acceptable to use names such as 'working account' or 'business account'.

Providers should 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, but we recommend providers consider the following to meet FMA's expectations in regards to record keeping generally:

- Records are readily identifiable and comprehensible.
- Regular review and oversight of record keeping arrangements.
- Records are easy to access, use and understand, and can be made available for inspection in a timely manner.
- Record keeping is subject to effective systems of controls, and appropriate protections and safeguards.
- Records are retained for at least 7 years.

Record keeping requirements for other market participants generally reflect these practices. Client money and property service providers may find it useful to review these requirements[5] to understand the practices in more detail (noting there will be differences between regimes and market participants).

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 Financing of Terrorism Act 2009.

[5] Record-keeping-for-financial-advice-providers.pdf (fma.govt.nz); Guidance for keeping proper climate-related disclosure records (fma.govt.nz); Guidance and expectations for keeping proper accounting records (fma.govt.nz)

Reporting to clients

Regular client reporting is a very important part of client money and property services for two key reasons. It provides clients with useful information that aids good decision making about their investments. It is also a key control that can enable clients to ascertain the status and security of their investments, and therefore reduces the opportunity for fraud or errors by financial service providers to go undetected.

Failure to report appropriately will lead to a contravention of section 431ZF of the FMC Act and regulation 229Q of the FMC Regulations.

We expect providers to have processes in place to determine the frequency and extent of reporting, which will depend on the nature of their business and services. Regulation 229Q of the FMC Regulations specifies that a reporting period is each period of 6 months, or any shorter period determined by the custodian. We encourage custodians to provide more frequent reporting, e.g. on a quarterly basis. Increased reporting provides clients with the opportunity to review their portfolios more frequently.

The regulations applying to custody require custodians to comply with minimum standards regarding reporting (see page 14 ‘Reporting’).

Identification of wholesale clients

Whether a client is a ‘wholesale client’ in relation to a client money or property service is determined by clause 4 of Schedule 5 of the FMC Act (unless that person has opted out from being a wholesale client under clause 5 of Schedule 5 of the FMC Act). Providers should maintain adequate processes, systems and records in relation to identifying wholesale clients. It is important that retail clients can be clearly identified to ensure the FMA can check that the proper protections have been provided.

If a provider wants certain wholesale clients to have the full benefit of the additional rights and protections given to retail clients under the FMC Act in respect of a client money or property service, it must ensure those clients exercise their opt-out right under clause 5 of Schedule 5 of the FMC Act. We expect providers to ensure that wholesale clients clearly understand the requirements and follow the correct procedures for opting out. 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.

While providers and clients may agree contractually to a retail client level of protection, if this does not comply with the requirements set out in clause 5 of Schedule 5 of the FMC Act then we may take regulatory action.

Registration on the Financial Service Providers Register

Providers and custodians 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.

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. Nominees do not have regulatory obligations – these remain with the provider and/or custodian – but are still required 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, client money and property service conduct obligations in the FMC Act (e.g. sections 431J to 431ZB), and other financial markets legislation including the Companies Act 1993.

In certain circumstances money in an insurance broking client account may be invested, in accordance with section 15 of the IIA. However, we do not consider the IIA permits intermediaries to fund their own businesses and related premium funding companies with premiums held for insurers. 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 or 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 may raise 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. There is some ambiguity as to how the 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, there is merit in taking a purposive interpretation of a "client money or property service" that considers the overlay of sections 4 and 5 of the IIA, the purpose of the client money or property services

regime, and the legislative history of the relevant provisions in the IIA, the Financial Advisers Act 2008, and the FMC Act.

Applying this interpretation, it is our view that 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. This is because we do not consider that money received by a non-IIA broker 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.

This purposive interpretation reflects the economic reality of payments from an insured person to a non-IIA broker, in that once relevant monies are paid to the non-IIA broker the insured person's obligation to pay is discharged (on general principles of agency/employment law, and as further supported by section 4 and, where relevant (in the obverse scenario) section 5 of the IIA). In our view this aligns with the original intent of the IIA, in that IIA brokers are required to operate a trust account and handle client money in a certain way (see section 14 of the IIA), whereas non-IIA brokers are not. Further, we consider this interpretation to be consistent with the purposes of the client money or property service regime, which are to ensure client assets are safeguarded and promote consumer confidence.

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 a transactional chain. For instance, there may be a client, then a financial adviser, along with other intermediaries such as a wrap platform[6], a provider, 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 the contractual documentation and any client communications clearly identify 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 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.

We note that section 431ZI is concerned with outsourcing of the service, and where this occurs the provider remains the responsible party under the FMC Act and FMC Regulations. Outsourcing does not change who is the provider under section 431W.

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.

[6] 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.

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

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.

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 custodians to comply with several extended or additional obligations in relation to the provision of custodial services, covering such matters as:

- Audit and assurance engagement and report: Custodians' processes, procedures and controls must be suitably designed to meet the control objectives listed in regulation 229V(2) of the FMC Regulations, and must operate effectively throughout the relevant period. Custodians must obtain an annual assurance report in respect of client money and client property against client reports and an annual audit of controls.
- Reporting: Custodians must comply with specified minimum obligations with respect to reporting.
- Reconciliations: Custodians must 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[7], 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. These obligations broadly require a custodian to:

- provide information to clients
- meet client requests for information[8]

[7] Client is defined in clause 2(b) of Schedule 5 of the FMC Act and means the person on whose behalf the client money or client property is received, held, paid, or transferred under the service.

[8] We note that a client may request a copy of the custodian assurance report.

- 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, the FMA's view is that 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 or property are returned to the client (or a party acting on the client's behalf) immediately following execution. Where an execution-only service is delayed for any reason outside the ordinary course of business and exceeds the T+3 period, a provider may not be regarded as providing a custodial service, unless the money or property is held for purposes other than 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 with the custodian's obligations. This includes where a client requests a copy of the assurance report, ensuring the sub-custodian provides the report to the client, or providing it themselves. The custodian remains responsible for custodial obligations.

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 provide 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 reporting to clients about the activities of the financial adviser or provider.

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

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.[9]

[9] **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

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 the new or current 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 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.

In our view, a purposive interpretation should be taken of what 'client address' means, taking into account the context of the client money or property services regime, the legislative history of the relevant provisions in the Financial Advisers Act 2008, and the FMC Act. This interpretation reflects the underlying policy basis for the custodial obligations: to ensure there is independent reporting to clients that allows them to ascertain the status and security of their investments.

We are aware of at least one instance where a financial adviser directed that a significant number of client reports be sent to his address 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 the reports, but this should be in addition to the client (or an independent person nominated by the client), to ensure adherence to the principle of independent reporting.

To help strengthen this, the assurance testing should include testing the processes, procedures and controls over client addresses to ensure alignment with this principle. We consider that the current assurance reporting regulations[10] provide sufficient scope to enable this testing to be carried out. It would be advantageous for electronic facilities and assurance procedures to align with the independence principle This may be impracticable in some instances, e.g. where an electronic facility (online platform or portal through which clients can view or manage their investment information) is provided by an external party, but should be applied where possible.[11]

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

[11] For instance, when assurance reports are provided on the electronic facility.

Client's electronic address

In our view, a broad interpretation needs to be taken of what is defined as the electronic delivery of a custody report to an 'electronic address'.

As well as email, reports can be 'posted' to an electronic portal (that is, a secure website login), if the client agrees and the information is made available on a substantially continuous basis. The client must expressly opt in (agree)[12] 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 would ideally be the client and not someone who is involved in the transaction (e.g. a financial adviser). However, we acknowledge this may be highly restrictive where many of the parties in the transactional chain provide a suite of services to clients, which include financial advice, brokerage and custody services and offer clients a single online portal.

In our view, the overriding consideration is that the client receives accurate reporting, and that the information cannot be altered by any party involved in the transactions. We consider that an electronic platform other than the custodian's own platform may only be provided by a person involved in the transactions that are being reported on where the custodian is satisfied that appropriate systems and controls are in place. As part of this, custodians should consider the following:

- The reports and any information in them should not be able to be altered by the platform provider or any other party.
- 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).
- 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 the information is being made available on a substantially continuous basis.
- Whether the provider of the alternative electronic platform will obtain clients' agreement to delivery of information via its website, and ensure access is being provided in accordance with regulation 229R.

Verifying client's electronic address

We suggest providers and custodians take all reasonable steps to ensure electronic addresses are those of the clients or clients' nominated parties, and not those of parties involved in the transactional chain (noting the above comments on alternative electronic platforms). We expect custodians to address this for new

[12] Regulation 229R(1)(b) requires that 'the client agrees to the information being provided in that way'. Opt in means that the client must agree to information being provided in this way as opposed to the provider or platform saying that the client has agreed if they do not respond – it requires a positive response from the client to agree to this.

clients but acknowledge it take time to verify details for existing clients. We expect custodians to ask clients to confirm or update their current electronic address, and/or request other parties in the transactional chain to seek updated information from clients. We also note that it is common for persons to share email addresses. In these circumstances, we consider that the email address should not be one that is shared with the financial adviser or someone involved in the transactions.

Ledger entries

In addition to the other 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

Regulation 229T of the FMC Regulations requires custodians to reconcile records of client money and client property, and 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 express direction from the client before making deductions (see page 6 '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.

DIMS providers subject to client money or property services obligations

A financial service 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 providers and custodians are subject to the regulations that apply for client money or property services.

Certain provider and custodian obligations are enforced under the FMC Act. If you are a DIMS licensee or custodian, we encourage you to ensure you understand the requirements in 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 431ZH."

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.

MIS custodians are subject to an alternative custodial regime

A financial service provider who holds the property of a managed investment scheme (MIS) is a custodian of that property. Regulation 229ZD of the FMC Regulations provides that to the extent that holding scheme property 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[13].

Section 431ZC(2) of the FMC Act continues the prohibition of 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, 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 provisions.

[13] 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.

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