MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
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Financial Adviser Regulations

Discretionary Investment Management Services and Custody

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Request for submissions

This discussion paper seeks submission on regulations to be made under the Financial Advisers Act 2008. It is divided into three chapters:

Chapter 1 – Discretionary Investment Management Services

Chapter 2 – Custodians and Other Brokers

Chapter 3 – Transition and Implementation

The Ministry of Business, Innovation and Employment seeks submissions on the questions asked in this discussion paper. When preparing your submission, please:

- Direct your comments to specific questions
- Provide electronic submissions in the submission template provided in both .pdf format (for publishing and filing) and an editable format such as Word (to assist compilation of submissions).

This will help your comments to be processed, understood and taken into account.

Please send comments to corporate.law@mbie.govt.nz.

The closing date for submissions is **Friday 23 August 2013**.

Publication of comments, the Official Information Act and the Privacy Act

The Ministry intends to publish all submissions on its website, other than submissions that may be defamatory. The Ministry will not publish the content of your submission on the Internet if you state that you object to its publication when you provide it.

However, your submission will remain subject to the Official Information Act 1982 and may, therefore, be released in part or full. The Privacy Act 1993 also applies. When making your submission, please state if you have any objections to the release of any information contained in your submission. If so, please identify which parts of your submission you request to be withheld and the grounds under the Official Information Act for doing so (e.g. that it would be likely to unfairly prejudice the commercial position of the person providing the information).

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Glossary

AFA: Authorised Financial Adviser. Under the Financial Advisers Act 2008, only AFAs can give personalised advice on complex financial products. They are required to meet certain eligibility criteria, such as competency and good character, and have a range of ongoing conduct obligations (such as disclosure and compliance with the Code of Professional Conduct).

The Code: The Code of Professional Conduct for Authorised Financial Advisers. The Code sets out minimum standards of ethical behaviour, client care, competence and training that Authorised Financial Advisers must meet. The Financial Advisers Act 2008 established an independent Code Committee to develop and maintain the Code.

Custodians: Persons who hold assets in trust for, or on behalf of, a client in connection to a financial product. Custodians are defined as a type of broker in the Financial Advisers Act 2008 and are subject to the requirements that apply to broking services.

DIMS: Discretionary Investment Management Services. DIMS are defined as any service where a provider has an authority to decide which financial products to acquire or dispose of on a client's behalf. This covers a broad range of services, given that both the amount of discretion involved and the level of personalisation of the investment authority can vary significantly.

FAA: The Financial Advisers Act 2008. The FAA, which came fully into force in mid-2011, introduced conduct and eligibility requirements for financial advisers. The types of requirements that apply depend on the type of advice being given, the type of financial product being advised on, and the type of client receiving the advice.

FMA: The Financial Markets Authority. The FMA is an independent crown entity with the responsibility for regulating securities exchanges, financial advisers and brokers, trustees and issuers – including issuers of KiwiSaver and superannuation schemes. It also enforces securities, financial reporting and company law as they apply to financial services and financial products.

FMC Bill: The Financial Markets Conduct Bill. The FMC Bill will replace the Securities Act 1978, Securities Markets Act 1988, Securities Transfer Act 1991, Superannuation Schemes Act 1989, and the Unit Trusts Act 1960 with the Financial Markets Conduct Act. This will change the regulation of how financial products are created, promoted and sold, and the ongoing responsibilities of those who offer, deal and trade them. The FMC Bill is in the final stages of the parliamentary process.

Retail clients: as defined in Section 5B of the Financial Advisers Act 2008. Financial advisers are subject to a range of eligibility, conduct and disclosure requirements when providing services to retail clients.

Wholesale clients: as defined in Section 5C of the Financial Advisers Act 2008. The majority of financial advisers' eligibility, conduct and disclosure requirements do not apply when providing services to wholesale clients.

Introduction

1. The Financial Advisers Act 2008 (FAA), which came into force in mid-2011, introduced a comprehensive regulatory regime for financial advisers, including conduct, authorisation and disclosure requirements. The FAA aimed to improve standards of advice and professionalism and to encourage public confidence in the financial adviser industry.

2. The FAA was part of the broader reform of financial sector regulation, of which the Financial Markets Conduct Bill (FMC Bill) is the final stage. The FMC Bill will introduce a number of changes to the regulation of how financial products are created, promoted and sold, and the ongoing responsibilities of those who offer, deal and trade them. In doing so it will change how discretionary investment management services (DIMS) and custodians are regulated under the FAA.

3. A number of the changes to the FAA enable specific requirements to be prescribed for AFAs providing DIMS and for custodians of client assets. The purpose of this discussion paper is to seek stakeholder views on potential regulations relating to DIMS and custody under the amended FAA.

4. We propose to, where appropriate, align the obligations of AFAs who offer personalised DIMS under the FAA with those that we anticipate will be applied to DIMS providers licensed under the FMC Bill. This would involve changes to the eligibility, disclosure, reporting and client agreement requirements for AFAs who wish to continue to offer DIMS under the FAA regime.

5. Inadequate custody arrangements were identified as an area of concern for submitters on the FMC Regulations. While custodians can provide an important role in safeguarding client assets and providing a definitive and independent record of their holdings, this is only effective where the custodian has adequate risk management systems in place and where the end client is provided with this information. The role of custodians is not well understood by retail investors and they often lack the knowledge necessary to ensure that adequate custodial arrangements are in place.

6. While many of these issues were raised in the FMC Regulations discussion paper, either at a general level or in the context of FMC DIMS licensees, this paper seeks input on specific proposals.

7. The latest version of the FMC Bill is available from http://www.legislation.govt.nz/bill/government/2011/0342/latest/versions.aspx.

8. Discussion papers, submissions and Cabinet decisions on the FMC Bill are available from http://www.med.govt.nz/business/business-law/current-business-law-work/review-of-securities-law.

Background

Discretionary Investment Management Services

9. DIMS are defined as any service where a provider has an authority to decide which financial products to acquire or dispose of on a client's behalf. This covers a broad range of services, as both the amount of discretion involved, and the level of personalisation of the investment authority, can vary significantly. Some DIMS offered under a generic investment authority can have similar characteristics to a financial product, while others are services that are entirely personalised to a client's circumstances.

10. The FAA currently permits financial advisers to offer DIMS. The type of adviser that can offer the DIMS is determined by the types of investments being made and whether the client is a retail or wholesale investor. These advisers are subject to the same conduct requirements when they provide DIMS as when they provide financial advice, including exercising care,

diligence and skill and not engaging in misleading or deceptive conduct. Authorised Financial Advisers (AFAs) are also subject to the ethical, client care, and competence requirements in the Code of Professional Conduct (the Code).

11. The FMC Bill will introduce different licensing requirements for two different types of DIMS:

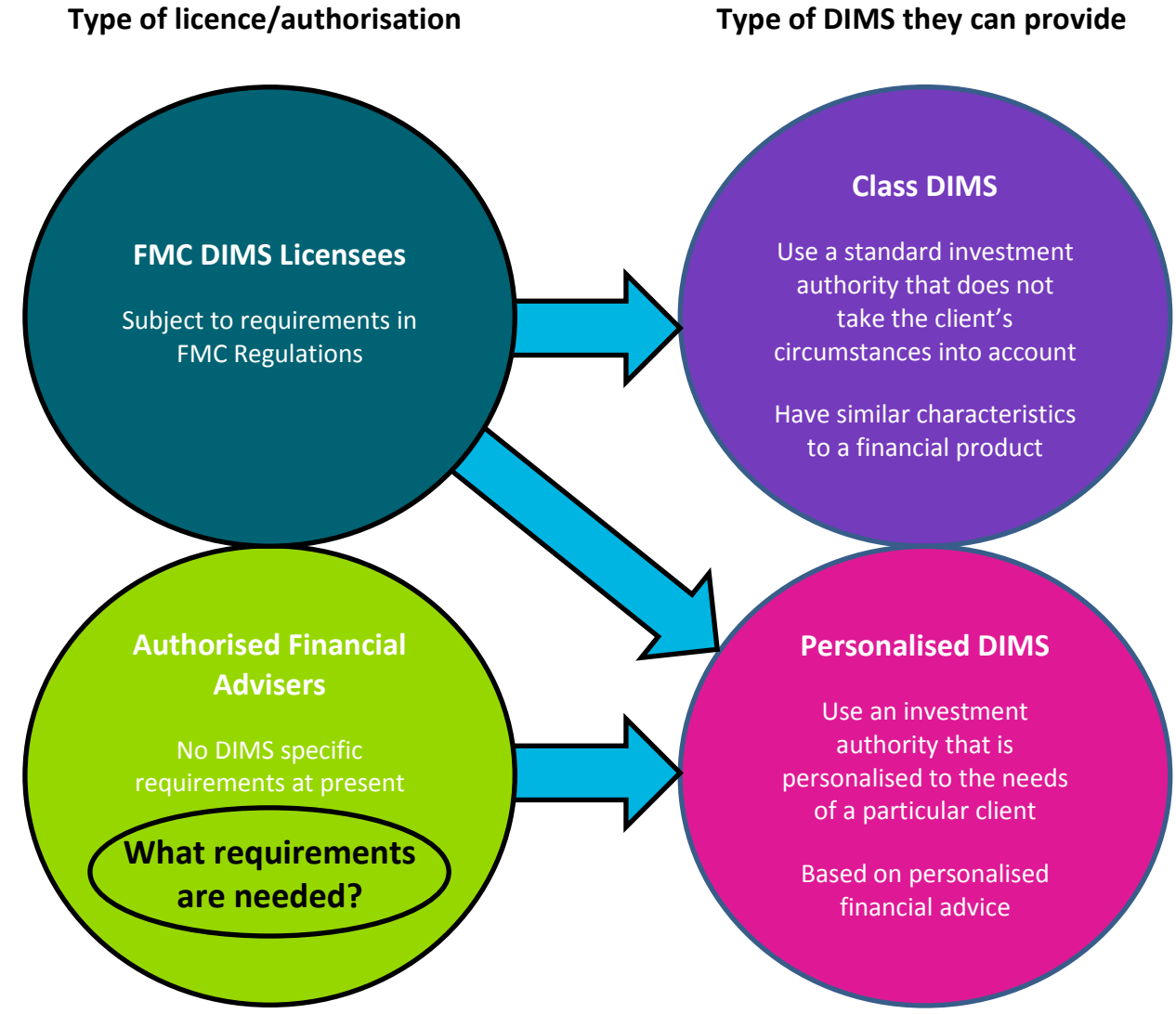
    a. Class DIMS, where investment decisions are made under an investment authority that does not take the client's individual circumstances into account. Class DIMS include model portfolio type services that use a standardised investment authority and can be similar in nature to a managed investment scheme.

    b. Personalised DIMS, where the investment authority is personalised to the circumstances of an individual client.

12. Providers of Class DIMS will need an entity-level licence under the FMC Bill (an FMC DIMS licence). These licensees will also be able to offer personalised DIMS.

13. AFAs will retain the ability to provide truly personalised DIMS. The primary rationale for continuing to allow AFAs to provide personalised DIMS is that it is not unusual for a personalised financial adviser service to involve exercising some degree of discretion over client investments.

Figure 1: Post-FMC Bill DIMS



Custody

14. Custodians are financial institutions that hold property and money on a client's behalf, execute transactions, and provide information to clients and intermediaries (such as DIMS providers). Custodians can provide an effective safeguard against misappropriation of client assets when custody is provided in conjunction with robust risk management systems and where custodians act as a definitive and independent source of information for clients. However, many retail investors do not understand the role of custodians and may lack the knowledge to ensure that appropriate custody arrangements are in place.

15. Custodians fall within the definition of being a broker under the FAA. Brokers are subject to a range of conduct requirements, such as a requirement to hold retail client funds in trust. The FMC Bill clarifies some of these requirements and allows for further requirements to be prescribed through regulations under the FAA.

FMC Bill Supplementary Order Paper

16. A number of further changes to the regulation of DIMS and custody under the FAA were introduced through a supplementary order paper (SOP) to the FMC Bill, which has been tabled in the House. These changes were made in response to market developments and to submissions on the FMC Regulations. They enable the alignment of the FAA and FMC Bill DIMS regimes and allow for comprehensive rules for custody to be prescribed across the financial services sector. The key changes introduced in the SOP were as follows:

    a. Requiring AFAs who provide DIMS to use an independent custodian for client property, unless otherwise permitted by the terms of their authorisation or by regulations – this mirrors the requirement for FMC DIMS licensees

    b. Providing for mandatory audit, assurance, record-keeping and client reporting duties for custodians of client property to be prescribed

    c. Removing the exemption from the licensing requirements in the FMC Bill for persons exempted from the requirements of the FAA, although further exemptions may be prescribed

    d. Harmonising the wholesale client definitions for DIMS provided under the FAA and FMC Bill

    e. Limiting the provision of personalised DIMS services to retail clients under the FAA to AFAs. The limited circumstances when Qualifying Financial Entities' advisers and registered financial advisers could provide DIMS services to retail clients under the FAA have been removed

    f. Aligning the duties of AFAs providing DIMS under the FAA with those of FMC DIMS licensees

    g. Clarifying that custodial services are a type of broking service under the FAA

    h. Enabling eligibility criteria for AFAs to be prescribed through regulations

    i. Allowing the FMA to make across-the-board changes to standard conditions for AFAs providing DIMS

    j. Enabling the scope of DIMS provided under the FAA to be limited

    k. Providing for trust account obligations to be extended to prescribed classes of wholesale investors.

Objectives

17. We will consider these proposals and stakeholder submissions in light of the updated purposes of the FAA:

Main, overarching purposes of the FAA

To promote the sound and efficient delivery of financial adviser and broking services, and to encourage public confidence in the professionalism of financial advisers and brokers

To promote the confident and informed participation of businesses, investors, and consumers in the financial markets

To promote and facilitate the development of fair, efficient, and transparent financial markets.

18. With the passage of the FMC Bill, both the main purposes and the additional purposes of the FMC Bill will be added to the FAA. The additional purposes will be balanced against each other when considering options in order to achieve the main purposes.

Additional purposes of the FAA

To provide for timely, accurate, and understandable information to be provided to persons to assist those persons to make decisions relating to financial products or the provision of financial services

To ensure that appropriate governance arrangements apply to financial products and certain financial services that allow for effective monitoring and reduce governance risks

To avoid unnecessary compliance costs

To promote innovation and flexibility in the financial markets.

What's happening next?

19. We anticipate that policy decisions on the matters discussed in this paper will be made later in 2013, with any regulations being approved in the first half of 2014. However, these regulations may be subject to further transitional provisions, as discussed in Chapter 3.

1. Discretionary Investment Management Services

20. We have previously consulted on a number of specific requirements for FMC DIMS licensees that do not currently apply to DIMS offered under the FAA. These included licensing, disclosure, client agreements and periodic reporting requirements for DIMS.

21. The majority of these requirements will be prescribed through regulations under the FMC Bill. Cabinet recently made high level policy decisions on these regulations. The relevant Cabinet paper and Regulatory Impact Statement are available on our website: http://www.med.govt.nz/business/business-law/current-business-law-work/review-of-securities-law.

22. There would be benefits in applying substantially the same requirements to AFAs offering DIMS as will apply to FMC DIMS licensees. Ensuring that an equivalently robust regulatory regime applies to DIMS provided by AFAs should promote investor confidence in using these services and reduce the risk of regulatory arbitrage. The FMC Bill widens the regulation-making powers in the FAA to allow these requirements to be applied. We have not previously canvassed whether these requirements are necessary, or conversely problematic, for AFAs offering DIMS.

23. While we see there being benefits in having all DIMS providers subject to the same substantive requirements, we are conscious that the requirements for AFAs offering DIMS should reflect the nature of the service they are offering. Given that a personalised DIMS offered by an AFA may look different to a Class DIMS offered by an FMC DIMS licensee, the same requirements may not have the same benefits or may have higher relative compliance costs.

24. Other reasons for having different requirements for AFAs offering DIMS could include existing obligations under the FAA or the Code. The Code sets out standards for ethical behaviour, client care, competence and training that all AFAs are required to meet. In some areas, these standards may be more effective and flexible in regulating DIMS than requirements prescribed through regulation. Code breaches are referred to the Financial Advisers Disciplinary Committee. We are aware that the Code Committee is considering whether amendments to the Code are necessary in light of the changes proposed under the FMC Bill.

25. The FMA also may choose to propose new standard conditions for AFAs offering DIMS. It is worth noting that section 147A of the FAA will allow the FMA to apply these changes to the standard conditions for existing AFAs.[1]

26. In light of these factors, we would appreciate stakeholder views on whether the requirements proposed in this paper for AFAs offering DIMS are appropriate.

Issues for comment

1. Do you agree that AFAs who offer DIMS under the FAA should be subject to similar requirements to FMC DIMS licensees? If not, why not?
2. Are there any further requirements than those proposed that we should consider?

[1] As amended by clause 593A of the FMC Bill.

Eligibility requirements for AFAs who provide DIMS

27. AFAs are limited to providing the financial adviser services specified in their authorisation. Therefore some AFAs are only authorised to provide financial advice, while others are also authorised to provide investment planning services and DIMS. However, at present AFAs are not subject to additional eligibility criteria in order to be to be authorised to offer DIMS.

28. The current eligibility criteria for AFAs focus on competence and good character. While these requirements are appropriate for providing financial advice, we consider that the eligibility requirements for DIMS providers should ensure that the appropriate systems and processes in place provide the service effectively and minimise undue risks to investors.

29. Section 54 of the FAA will allow for further eligibility requirements to be prescribed for AFAs offering DIMS.[2] AFAs who wish to be authorised to offer personalised DIMS will need to satisfy the FMA that they meet these requirements.

Proposal

To be eligible to be authorised to provide personalised DIMS services, an AFA must satisfy the FMA:

- That there is no reason to believe that they will not comply with their obligations under financial markets legislation.
- That they are capable of effectively performing that service (having regard to the proposed conditions of their authorisation and the arrangements of any entity or other person involved in the provision of the service).

30. This is a higher standard that is currently required of AFAs under the FAA and is more closely aligned with the requirements that FMC DIMS licensees will have to meet, which have been generally supported by stakeholders. We consider that requiring AFAs to demonstrate that they have adequate systems and procedures in place to operate DIMS and for complying with their regulatory obligations provides an important level of protection for investors. It should mitigate the risk of client losses due to misappropriation, poor administration or inadequate record-keeping, and promote investor confidence in these services.

31. Although AFAs are authorised on an individual basis, a number of organisational factors are likely to be relevant in satisfying the FMA of the eligibility criteria. The proposal anticipates that the FMA will take these matters into consideration. As the authorisation is linked to the individual rather than their employer, the FMA may choose to reassess eligibility if an AFA moves to a different organisation.

32. There may be situations where it would be more appropriate for the personalised DIMS to be offered under an FMC DIMS licence. An example may be where the number of clients or the value of assets under management are such that entity-level licensing is likely to more accurately reflect how the service is offered. This would have the benefit of allowing the FMA to look at the organisation as a whole during the licensing process, applying liability and licence conditions at the entity level and licensing the organisation that provides the compliance procedures, rather than an individual who may move to another organisation.

33. While the FMA could limit DIMS offered by AFAs using a combination of the proposed eligibility test, licence conditions and its designation power under the FMC Bill, section 55 of the FAA will allow an objective limit to be prescribed on DIMS offered by AFAs.[3] This limit

[2] As amended by clause 583B of the FMC Bill.

could be expressed as a maximum value of assets under management, a maximum number of clients, or a combination of both. While we are not proposing to introduce such a limit at this point, we would appreciate stakeholder views on whether an objective threshold would be desirable and, if so, what an appropriate limit would be.

Issues for comment

3. Do you agree that AFAs providing DIMS should be required to demonstrate that they have adequate systems and procedures to operate a DIMS and for complying with their regulatory obligations? What would be the benefits and costs of the proposed approach?
4. Are the proposed eligibility tests appropriate? Should other matters be considered as well or instead of these tests?
5. Should there be a maximum limit to DIMS offered under the FAA? If so, what would an appropriate limit be (for example, a combination of funds under management, number of staff and number of clients offered DIMS)?

[3] As amended by clause 583C of the FMC Bill.

DIMS Disclosure for AFAs

34. Section 23 of the FAA will require AFAs to disclose any prescribed information relating to the provision of DIMS.[4]

> Proposal
>
> AFAs offering DIMS must disclose as part of their primary disclosure statement:
>
> - A prescribed statement outlining what a DIMS involves and what risks are associated with investing through a DIMS.
>
> AFAs offering DIMS must disclose as part of their secondary disclosure statement:
>
> - How custody over assets will be provided (including the name and details of the custodian) and whether the custodian is independent from the DIMS provider
> - How the client may give instructions on corporate actions relating to financial products in their portfolio
> - What will happen on the termination of the client agreement (whether the assets will be transferred to the client's control, or will be sold at the client's direction).

35. Unlike FMC DIMS licensees, AFAs are subject to existing disclosure requirements regarding fees, conflicts of interest, the basis of service and other matters through both the regulations and through the Code. While these requirements cover many of the matters that may be required for FMC DIMS disclosure, they do not include any DIMS specific matters such as details of custodial and termination arrangements.

36. AFAs are already required to disclose whether they are authorised to provide DIMS as part of their primary disclosure statement. This is a highly prescribed, up-front disclosure document that provides the key information a client would need to know to decide whether the AFA offers services that fit their needs. As DIMS are not necessarily well understood by retail clients, we propose requiring a short prescribed statement outlining what a DIMS involves and what risks are inherent to these services in the primary disclosure statement. This is consistent with the approach taken for equivalent services in Australia.[5]

37. We also consider details of custodial, corporate actions and termination arrangements to be information that a client would need in order to make an informed decision whether to invest through a DIMS. We expect that details of custodial arrangements would include whether the provider uses an independent custodian, and if so the name and details of that person. Termination arrangements may include whether the financial products held in the client's name would be liquidated or transferred to the direct control of the client at the termination of the service. These matters would also be covered by the client agreement, but we consider that inclusion in the disclosure statement would aid in highlighting these matters to the client.

38. Including this information in the existing disclosure statements would limit the number of documents that a client is expected to read prior to engaging the AFA. Alternatively, AFAs offering DIMS could be required to provide clients with a separate disclosure document for the DIMS. This may aid in comparability between DIMS offered by AFAs and those offered by FMC DIMS licensees. As AFAs will be limited to providing truly personalised DIMS, likely as part of a financial planning service, we see limited benefit in such comparability.

39. Requiring AFAs offering DIMS to amend their existing disclosure documents, rather than producing a separate disclosure document for their DIMS, would also minimise the additional

[4] As amended by clause 577 of the FMC Bill.
[5] http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ps179.pdf/$file/ps179.pdf.

costs of this proposal. Nevertheless, we are conscious that there would still be costs for AFAs associated with this requirement.

40. FMC DIMS licensees may also be required to disclose information relating to the risks of the DIMS' investment approach. While this is certainly essential information for all DIMS clients, the Code currently requires AFAs to ensure retail clients are aware of the principal benefits and risks of their services as part of their client care obligations, and must also ensure retail clients have sufficient information to make informed decisions about using the relevant services. Given the personalised nature of the AFA DIMS service, our initial view is that these matters are more effectively dealt with under the principle-based client care obligations in the Code, rather than prescribed disclosure requirements.

Issues for comment

6. Do you agree that AFAs offering DIMS should be required to disclose the proposed matters? If not, why not?
7. Are there any other further matters that AFAs offering DIMS should be required to disclose?
8. Should these matters be disclosed through the existing disclosure statements, or would a separate disclosure statement for DIMS be more appropriate?
9. What additional costs would AFAs incur in complying with these requirements?
10. Should risks of the investment approach be required as part of the disclosure statement?

Client Agreements

41. Section 42 of the FAA will require client agreements for DIMS to provide adequately for the prescribed matters.[6]

Proposal

Client agreements must provide adequately for the following matters:

- How custody over assets will be provided and the DIMS providers responsibilities in connection with any custodian
- How rights relating to the client's assets (e.g. corporate actions) will be exercised
- What will happen at the termination of a client agreement, including, where relevant, adequate arrangements for the transfer or disposal of any unregulated products (i.e. products offered on a wholesale basis) held on termination
- The client to be able to terminate the client agreement without penalty on a reasonable notice period to transfer or liquidate the assets.

42. Setting certain minimum standards for client agreements is a key tool for ensuring that DIMS have adequate governance and contractual arrangements. It is not intended that this requirement will outline all matters that should be addressed in a client agreement, only ensuring that the central issues for all DIMS are always dealt with. Due to the level of information asymmetry between a DIMS provider and a retail client, we do not consider it sufficient to rely on due diligence on the part of the client.

43. These requirements mirror those that are being considered for FMC DIMS licensees. Submitters on the FMC Regulations generally supported requiring these matters to be addressed in client agreements and we consider in principle that the same requirements should apply to AFA client agreements for DIMS. We would appreciate stakeholder feedback on whether there are situations where these requirements could cause difficulty or add cost, and on whether there are other matters that should also be provided for.

Issues for comment

11. Do you agree that the proposed matters should be required to be adequately provided for by AFAs' client agreements for DIMS? If not, why not?
12. Are there any other matters that DIMS client agreements should be required to provide for?
13. Would this proposal impose any additional costs on AFAs? If so, could you quantify these?

[6] As amended by clause 583A of the FMC Bill.

Periodic Reporting

44. Section 29A of the FAA will require further prescribed information to be disclosed to retail clients of DIMS at prescribed times.[7]

> Proposal
>
> AFAs providing DIMS must ensure retail clients are provided with a periodic report, setting out:
>
> - Portfolio valuations of all assets managed on behalf of the client at the beginning and the end of the reporting period
> - Total investment returns received and fees charged during the reporting period
> - Details of the individual assets managed on behalf of the client, including valuations and investment returns
> - A schedule of client asset transactions.
>
> These reports must be provided on a regular basis, taking into consideration the liquidity of the assets held.

45. Periodic reporting of the performance of DIMS is important in enabling clients to monitor the DIMS, including the provider's investment decisions and the overall effectiveness of the investment authority. We expect that a similar requirement will be prescribed for FMC DIMS licensees. We understand that such reporting is standard practice and consider these requirements should be standardised for all DIMS providers in order to ensure that clients are provided with comparable amounts of information and to discourage regulatory arbitrage.

46. An AFA would comply with the proposed approach if a periodic report including these matters is provided by another party, such as an independent custodian. The AFA would, however, be responsible for ensuring that the custodian provides reports that comply with these requirements. Some jurisdictions require both the DIMS provider and the custodian to provide periodic reports to clients, providing verification of both sets of information (where the custodian is independent from the provider). We would appreciate comment on whether such an approach would be justified in New Zealand.

47. We would appreciate stakeholder feedback on whether it would be appropriate to prescribe a particular minimum reporting period, or whether this would be dependent on the nature of the DIMS and the types of assets that are being invested in. We note that there may be classes of illiquid assets that it would be difficult or unduly costly to value on a very regular basis. We would also appreciate feedback on whether ensuring this information is provided on a substantially continuous basis would be an appropriate alternative.

48. Relevant considerations in determining an appropriate reporting period would include existing best practice and the requirements for similar services or products. We understand many DIMS providers report on a quarterly basis, which is consistent with our expected reporting period for managed investment schemes. NZX Participant Rules currently require performance reporting for DIMS providers on either a quarterly basis, or at a period agreed to with the client of six months or less.

49. We also understand that further information is typically provided to clients on an annual basis for tax and other purposes. We would appreciate feedback on whether a regulatory requirement for any further information to be provided on an annual basis is necessary or desirable.

[7] As amended by clause 580 of the FMC Bill.

Issues for comment

14. Do you agree that AFAs providing DIMS should be required to ensure clients are provided with a regular performance report? If not, why not?
15. Do you agree that the proposed matters should be included in the reports? Are there any other matters which should be included?
16. Would there be any practical difficulties in complying with these requirements? What additional costs would be incurred?
17. Should AFAs providing DIMS be able to rely on reports provided by the custodian or another third party?
18. What would be an appropriate reporting period? Would continuous access to this information through an electronic platform be a sufficient alternative?
19. Should any further information be required to be provided on an annual basis?

2. Regulation of custodians and other brokers

50. As part of the consultation on the FMC regulations, we asked whether there are any gaps in the current regulation of custodians. The majority of submitters did not consider the current regulatory requirements to adequately protect against risks to investors, such as the misappropriation of investor funds. While some submitters argued that custodians should be required to be licensed under the FMC Bill (which the Bill does not provide for), a number suggested that these risks could be mitigated through requiring independence of custody and regular audit, assurance and client reporting.

51. This discussion paper proposes standardising options to mitigate risks to investors through requirements for custodians under the FAA obligations for brokers. These proposals are based on suggestions from submitters on the FMC Regulations and on overseas regulatory requirements, with the aim of ensuring that custodians have appropriate control systems in place to minimise risks to clients' assets and that clients are provided with sufficient information to allow them to monitor their assets.

52. In recent years the role of custodians has been a focus of policy makers and regulators throughout the world. The International Organization of Securities Commissions (IOSCO) issued a number of draft principles against which the quality of regulation and industry practices concerning client asset protection can be assessed.[8] While these criteria are high level, they have helped to inform our proposals. In addition, we have taken into consideration recent work undertaken by the Australian Securities and Investment Commission and the Australian Treasury on aspects of custodial services.[9]

Summary of the existing law

53. The FMC Bill clarifies that all custodians are required to comply with the obligations for brokers under the FAA. There are a range of conduct obligations that apply to brokers at present and as refined by the FMC Bill:

    a. Brokers must exercise care, diligence and skill (s77K)

    b. Brokers must not engage in misleading or deceptive conduct (s77L)

    c. Advertisement of broker services must not be misleading, deceptive, or confusing (s77M)

    d. Brokers must not receive client money if offer contravenes financial markets legislation (s77O)

    e. Brokers must pay retail client money into separate trust accounts and hold client property on trust (s77P)

    f. Brokers must account for retail client money and property (s77Q)

    g. Brokers must keep records of retail client money and property (s77R)

    h. Brokers must only use or apply retail client money or property as expressly directed by the client (s77S)

    i. Retail client money and client property is not available for the payment of the debts of any other creditor of a broker (s77T).

54. The FMC Bill also introduces regulation making powers, allowing the Minister to prescribe:

[8] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD401.pdf.

[9] http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep291-published-5-July-2012.pdf/$file/rep291-published-5-July-2012.pdf; http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2011/Handling-of-client-money-in-OTC-derivatives.

a. Circumstances where a broker must report on client money and client property (s77RA)

b. Duties and other requirements in relation to client money and client property held on trust (s77P)

c. Requirements relating to the audit, review, or inspection of a broker's records (s77R(3)(b))

d. The extent to which the broker obligations in sections 77P to 77T apply to services provided to wholesale clients (s77J(3)(ac)).

Definition of custodial services

55. We are aware that the definition of a custodial service in s77B of the amended FAA may capture the activities of persons who would not ordinarily consider themselves to be custodians, for example, because they are transferring client assets, but in doing so fall within the definition of holding client assets.[10] Alternatively, there may be some forms of custody that are largely incidental to the offering of another service, where the costs associated with the proposed requirements would outweigh the benefits, or where the risks are addressed by other regulatory requirements.

56. We would appreciate stakeholder feedback on whether there are services that would be captured by the custodial service definition that should not be subject to the proposed requirements and what an appropriate scope of any exclusion would be.

Issues for comment

20. Are there services that would fall within the definition of a custodial service that should not be subject to some or all of the proposed requirements? What are these services and why would the proposed requirements be unnecessary or undesirable?

Obligations on licensees

57. FMC DIMS licensees and AFAs providing DIMS will have an obligation to use independent custodians, unless the use of a non-independent custodian is permitted under their licence/authorisation conditions. They will also need to believe, on reasonable grounds, that this custodian is appropriate to hold, and safeguard, the money or property. Additional requirements could be imposed under their licence/authorisation conditions.

58. These requirements will go some way to ensuring appropriate custody of client money and property and, at a minimum, require the provider to be satisfied that the custodian complies with the broker obligations in the FAA.

Market Participant Rules

59. A number of submitters on the FMC Regulations considered that the NZX Participant Rules provided sufficient protections for the custody of client assets. While this may be the case, not all custody is provided in relation to participation in the NZX. It is important that clients have a level of protection regardless of the nature of the transaction or the status of the provider. We therefore do not consider the NZX Participant Rules to provide an alternative to regulatory requirements that apply to all custodians.

60. In some areas under the FMC Bill we have provided exemptions on the basis that the relevant issue is already sufficiently addressed through the rules of a licensed market, such as NZX. We have done this in areas that we see as being central to the operation of a licensed market and where the approach taken in the market rules is an alternative way of

[10] Note that the s77A ensures that only a person carrying on the business of a broking service is defined as a broker.

meeting the same objective, for example by exempting listed entities from certain disclosure obligations where they are required to make continuous disclosure under listing rules.

61. Our provisional view is that NZX participants should not be exempted from these requirements, on the basis that the proposed requirements are consistent with (although not the same as) the NZX Participant Rules. We have taken the existing NZX Participant Rules into consideration when formulating these proposals, in order to limit any additional costs on those providers who already comply with these rules. We expect that the NZX Participant Rules may need to be modified to reflect the requirements in regulations. We would appreciate stakeholder views as to whether this is the correct approach, or whether there would be unanticipated costs associated with applying these proposals to NZX participants.

Issues for comment

21. Do you agree that any regulatory requirements for custodians should apply regardless of whether the custodian is subject to the NZX Participant Rules? Would there be any unanticipated costs associated with this approach?

Client Reporting

Proposal

Persons providing a custodial service must provide clients with:

- Details of all money and property held on behalf of that client at the time of reporting
- A schedule of all transactions during the reporting period.

This information must either be provided through a regular written report with ongoing access available at the client's request, or continuously through an electronic platform such as a website.

62. It is important that clients are provided with information about their asset holdings either on a regular basis or on a substantially continuous basis through a website or other electronic facility. It provides clients with a definitive and independent record of their holdings and allows them to effectively monitor their investments. We understand that this requirement is largely consistent with existing industry practice and the NZX Participant Rules. It is worth noting that written reports can be provided to clients electronically.

63. The proposed information requirements are a subset of the information that we propose to require DIMS clients be provided with. We anticipate that some custodians would provide further information in periodic reports, in order to meet the reporting obligations of the DIMS provider. We would appreciate feedback on whether this reflects current practice.

64. We understand that some custodians may not have an established relationship with their end client. While they may hold assets in trust for a client, the agreement may have been established by an intermediary, such as a financial adviser, using a power of attorney on behalf of the client. In these situations, periodic reporting may present practical difficulties and introduce costs for the custodian. However, depending on how widespread this practice is, these costs may be justified by the benefits of ensuring that all clients are receiving information directly from the custodian rather than through an intermediary.

65. We would appreciate stakeholder feedback on what an appropriate period for regular reporting might be for custodians who do not provide continuous electronic access. Our provisional view is that quarterly reporting would be appropriate, but, as previously noted, there are a range of different requirements that are currently in place for periodic reporting. We would appreciate information on what constitutes current industry best practice.

66. An alternative approach of requiring this information to be provided to clients periodically in writing, regardless of whether the information is available through a website, may have the benefit of periodically prompting investors to look at their asset holdings. However, our initial view is that these benefits would not justify the costs of this approach. The proposed periodic reporting requirement for DIMS providers could perform this function in some situations.

Issues for comment

22. Do you agree that custodians should provide clients with details of assets held on their behalf, either on a regular basis or continuously through an electronic facility?
23. Are there any other matters which should be mandated for custodian client reporting?
24. Would there be any practical difficulties in complying with these requirements? Would any types of retail custodial arrangements need to be exempted from such a requirement?
25. For custodians who do not provide continuous electronic access, what would be an appropriate reporting period?
26. Should regular reporting by custodians be required regardless of whether this information is continuously available through a website?
27. Can you give an indication of any additional costs that custodians would incur in complying with the proposed requirement?

Regular Reconciliation

Proposal

Custodians must have adequate procedures for the regular reconciliation of client assets, including the escalation and resolution of any variances that are identified.

67. Regular reconciliation of client accounts is an important safeguard against misappropriation of client assets, fraud, poor administration, inadequate record-keeping or negligence. These reconciliations should, where possible, be undertaken by a person who is not involved in the production or maintenance of these records. We consider that reconciliations are already required in order to comply with the current broking requirements, but the regulations would give detail to these requirements. We would appreciate stakeholder views on what level of detail should be prescribed for reconciliation procedures.

68. The NZX Participant Rules currently require custodians to reconcile client funds held in relation to trading on a daily basis and to reconcile client property at least monthly. Depending on the frequency of transactions that the custodian deals with, this frequency of reconciliation may not be appropriate for all custodians. We would appreciate stakeholder views on whether a minimum frequency of reconciliation should be prescribed, and if so, what an appropriate frequency might be for client funds and property.

69. In the United Kingdom, the Financial Conduct Authority requires firms that hold client assets to undertake reconciliations of their internal records as often as is necessary and additionally to conduct external reconciliations of their records with those of their sub-custodians on a regular basis. We would be interested in stakeholder views on whether there would be benefits prescribing specific requirements for internal and external reconciliation.

70. We expect that appropriate reconciliation procedures should be a standard part of industry practice and should not impose significant additional costs on custodians.

Issues for comment

28. Do you agree that all custodians should be required to undertake regular reconciliations of client assets?
29. What level of detail should be prescribed for reconciliation? If detailed requirements are warranted, what should such requirements be?
30. How prescribed should the timing of these reconciliations be? What would be appropriate time periods?
31. Would there be benefits in drawing a distinction between requirements for internal and external reconciliation?

Audit and Assurance

Proposal

Persons providing a custodial service must annually, within four months of the end of the custodian's financial year, have a person qualified to undertake company audits under section 199 of the Companies Act 1993 undertake:

- An audit of client assets at the period end; and
- A reasonable assurance engagement as to whether the custodian has adequate processes, procedures and controls for compliance with the broker requirements in the Financial Advisers Act 2008 and whether these have operated effectively during the period.

71. A number of submitters considered that requiring custodians to be subject to audit and assurance requirements would enhance safeguards on client money and property by providing an independent assessment of control environment and an independent check of clients' holdings.

72. Our intent is that these requirements would comply with existing industry best practices. We note that while the NZX Participant Rules require an audit of participants' financial statements, they do not require regular assurance engagements to be undertaken. However, we understand that many clients expect such engagements to be undertaken and that a number of custodians have them undertaken as a matter of course. We would appreciate information from stakeholders on how widespread this practice is.

73. Complying with the assurance component of the proposed requirement would be relatively costly for custodians that are not already obtaining these reports. We would appreciate feedback on what these engagements typically cost. If these engagements are not widespread industry practice and could not be justified as a baseline requirement for all custodians, an alternative might be for the FMA to require these assurance engagements where DIMS providers want to use an associated party as a custodian.

74. We understand that these engagements are typically undertaken in accordance with:

    - ISAE (NZ) 3402 *Assurance Reports on Controls at a Service Organisation*
    - ISA (NZ) 805 *Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*.

75. ISAE (NZ) 3402 applies when a service organisation makes assertions about the suitable design of controls. In order to meet the proposed requirement, the custodian would need to obtain a "type 2 report", which provides assurance that the organisation's controls have been implemented, are suitably designed to meet the control objectives, and have operated effectively throughout the past year. ISA (NZ) 805 sets out how the audit of financial information should be undertaken.

76. We also understand that these engagements are typically based on the Australian Guidance Statement GS 007 *Audit Implications of the Use of Service Organisations for Investment Management Services*. GS 007 provides guidance on what appropriate control objectives and processes are in the context of an investment management service such as a custodian. The New Zealand Auditing and Assurance Standards Board has recently consulted with audit practitioners on equivalent guidance for New Zealand. As the control objectives for custodians in this guidance align with the current and proposed broker obligations, we expect that many audit and assurance engagements would likely be based on this guidance.

77. We would also appreciate stakeholder views on the most effective way of notifying members of the public and/or the FMA that a custodian has complied with these requirements. One option could be to require custodians to publish audit certificates on their website and to highlight the availability of this certificate in client reports.

Issues for comment

32. Do you agree the proposed audit and assurance requirements would reduce the risk of misappropriation of client assets and help to ensure that custodians have systems in place to protect client assets? If not, why not?
33. Is the proposed level of audit and assurance requirement appropriate? To what extent would industry best practice already comply with these obligations?
34. What would be the costs associated with an assurance engagement in compliance with this proposal?
35. Is it appropriate to place assurance requirements on all custodians of client assets, as opposed to those providing custody for an associated party?
36. What would be the most effective way of notifying the public and/or the FMA of compliance with this proposal?

Requirements for wholesale assets

Proposal

The obligations for brokers relating to handling client money and client property should in principle apply to services provided for wholesale clients, subject only to limited exclusions where these requirements are not necessary or desirable.

78. While all custodians and other brokers are subject to general conduct obligations, only brokers who provide services to retail clients are currently subject to the obligations for handling client money and property in the FAA. These include the proposed regulations for custody outlined in this discussion document, along with the existing obligations:

    a. To pay client money in separate trust accounts and hold client property on trust (s77P)

    b. To account for client money and client property (s77Q)

    c. To keep records of client money and client property (s77R)

    d. To use or apply client money or property as expressly directed by the client (s77S)

    e. To not make client money and client property available for the payment of the debts to any other creditor (s77T).

79. Section 77J(3)(ac) of the FAA allows for some or all of these obligations to be applied to prescribed classes of wholesale brokers.[11] Other jurisdictions, such as Australia, impose requirements such as trust accounting and licensing on custodians of both retail and wholesale assets, with limited exemptions for certain wholesale arrangements.[12]

80. We see a benefit in applying these protections to wholesale assets where they are already part of industry best practice. While some wholesale clients will have sufficient knowledge and incentives to ensure that appropriate arrangements are in place to safeguard their assets, it is not evident that this will always be the case. For example, there is a risk that some individual wholesale investors may not have sufficient understanding of what appropriate custody arrangements are, or may not have sufficient incentives to get professional advice on these matters.

81. We understand that in general the existing obligations for handling client money and property are already standard industry practice (even for brokers dealing with wholesale assets), such as holding client assets in trust. Other requirements may be disproportionately costly in a wholesale context. We would appreciate feedback as to which obligations it would be beneficial to apply to wholesale broking and which obligations would be unnecessary or disproportionately costly.

82. We are also aware that none of these requirements may be necessary or desirable for some truly wholesale custody arrangements. These could include arrangements between an institutional investor and a custodian or between a custodian and their sub-custodian (although we note that the custodian would be responsible to the client for ensuring the sub-custodian complies with the custodian's obligations to retail clients). We therefore anticipate that certain types of arrangements would be excluded from the above proposal, and we appreciate stakeholder input on the most appropriate scope for these exclusions.

83. One option for minimising unnecessary costs would be to apply these obligations by default, but allow wholesale clients to opt-out. We would appreciate feedback on whether an opt-out

[11] As amended by clause 585 of the FMC Bill.
[12] Corporations Regulations 2001 7.6.01(k); ASIC Class Order 03/1110; ASIC Class Order 03/1112.

option would be appropriate and, if so, whether there are any particular protections that should not be able to be opted-out of, such as trust accounting.

84. By default, requirements on wholesale custodians would also apply when they are providing custody for managed investment schemes. However, there are also provisions in the FMC Bill to impose additional requirements for the custody of managed investment schemes that would not necessarily apply to custody of other wholesale client assets. Submissions on this proposal will help to inform these requirements.

Issues for comment

37. Do you agree that wholesale investors would benefit from the protections offered by the obligations for brokers relating to handling client money and client property? If not, why not?
38. To what extent would industry best practice already comply with these obligations?
39. What particular obligations, including those proposed in this discussion paper, would be inappropriate to apply to wholesale investors and why?
40. Are there any particular types of wholesale arrangements that should be excluded from these obligations? If so, what would be the appropriate scope of such an exclusion?
41. Would applying the obligations by default, but allowing wholesale clients to opt-out, provide the appropriate balance between protecting investors and imposing unnecessary obligations on certain wholesale arrangements? If so, are there any requirements that wholesale clients should not be able to opt-out of?
42. Are there requirements that should apply to the custody of managed investment schemes that should not apply to wholesale custody in general?

3. Transition and Implementation

86. As noted, we anticipate that any regulations resulting from this consultation process will be approved prior to the greater part of the FMC Bill coming into force around April 2014. We are, however, aware that some of the changes made by the Bill and the proposed measures under the regulations would involve significant changes to the procedures of AFAs and custodians and transitional provisions may be required.

FMC Bill Changes for AFAs Providing DIMS

87. After the FMC Bill comes into force only FMC DIMS licensees will be permitted to provide Class DIMS to retail clients. Changes to the definition of a wholesale client will also affect what type of licence or authorisation a DIMS provider will need. Some AFAs will therefore need to operate through an FMC DIMS licence or terminate the provision of Class DIMS.

88. AFAs providing DIMS will also need to ensure that client assets are held by an independent custodian, unless they are permitted to use an associated party as a custodian by their licence conditions.

Issues for comment

43. Is any transition period required for existing AFAs to change their operations so that they no longer provide Class DIMS or so that they do so through an FMC DIMS licence?

44. Should AFAs providing DIMS be given additional time to transfer their clients' portfolios to an independent custodian and if so how long?

Eligibility Criteria for DIMS

89. We would expect any changes to eligibility requirements to come into force in mid-2014, to align with the FMC Bill. Persons applying for authorisation from this date would need to satisfy the FMA of these matters.

90. Existing AFAs providing DIMS would be required to satisfy the FMA of these matters when they apply for renewal of their authorisation, unless the FMA chooses to assess these AFAs' eligibility prior to this time. The majority of AFAs were authorised in the first half of 2011 and will therefore need to renew their authorisation in 2016. Alternatively, the FMA may require existing AFAs to comply with the eligibility requirements from the date they come into force, in order to ensure a level playing field in the provision of DIMS.

91. We expect that the FMA would consider how many AFAs continue to offer DIMS under the FAA and its other licensing priorities in determining when to apply these criteria.

Issues for comment

45. Should existing AFAs be given additional time to comply with the eligibility requirements? If so, how long? Why would such a time period be appropriate?

DIMS Disclosure

92. The time and costs for AFAs in complying with the proposed DIMS disclosure requirements would be minimised by using the existing disclosure statements. We would appreciate feedback on whether the costs of providing this information to existing clients would be justified. Please note that the additional information could be provided electronically.

Issues for comment

46. Should new disclosure information be required to be given to an AFA's existing DIMS clients?

DIMS Client Agreements and Investment Authority

93. We would appreciate feedback on whether it would be appropriate to apply the proposed requirements to existing client agreements and, if so, what transitional provisions would be

appropriate. AFAs will be required to ensure that there is a written investment authority that contains clear limits and certain matters to be set out by the FMA.

Issues for comment

47. Should the requirements apply to existing client agreements? If so, what transitional provisions would be appropriate?

48. How long would it take for current AFAs to ensure that written investment authorities are in place which set out the matters required?

Periodic Reporting for DIMS

94. Depending on existing practice, AFAs providing DIMS may require some time to ensure that clients are being provided with the proposed information. We would appreciate feedback on an appropriate transition period, and whether there would be any problems with providing this information to existing clients.

Issues for comment

49. How long would AFAs providing DIMS need to transition to ensuring clients are provided with periodic reports and why?

50. Would it be appropriate for these reports to be provided to existing clients?

Client Reporting for Custodians

95. Depending on existing practice, custodians may require a transitional period to implement the necessary reporting systems. We would appreciate feedback on an appropriate transition period and whether this requirement should apply to existing clients.

Issues for comment

51. How long would custodians need to ensure that their client reporting systems comply with the proposed requirements and why?

52. Would it be appropriate for this requirement to apply to existing clients?

Regular Reconciliation of Client Assets

96. We expect that custodians will already be completing regular reconciliations. However, if particular reconciliation procedures are prescribed, custodians may require a transitional period to ensure that their procedures comply.

Issues for comment

53. If particular reconciliation procedures are prescribed, how much time should be provided to comply?

Audit and Assurance for Custodians

97. Depending on existing practice, custodians may require some time to obtain the proposed audit and assurance engagements. We would appreciate feedback on an appropriate transition period if this proposal is adopted.

Issues for comment

54. If audit and assurance requirements are introduced, would a transitional period be required, and if so how long would be needed?

Broking of Wholesale Assets

98. Depending on existing practice, custodians of wholesale assets may require some time to change their procedures to comply with the obligations relating to handling of client assets. We would appreciate feedback on an appropriate transition period if this proposal is adopted.

Issues for comment

55. If requirements relating to the handling of client assets are expanded to cover broking of certain wholesale assets, would a transitional period be required?