



IOSCO thematic review: recommendations for the regulation of custodians

Finance Update

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In our May 2017 update we discussed the International Monetary Fund's (**IMF**) 2017 report on New Zealand's financial sector. One of the IMF's notable recommendations was for the New Zealand Government to require custodians to be subject to licensing and supervision, within a timeframe of 1 to 3 years.

The regulation of custodians was front and centre in the International Organisation of Securities Commissions' (**IOSCO**) recently released report. In its report, IOSCO completed a review of member countries' (including New Zealand's) adoption of legislation, regulation and other policies following from its 2014 recommendations regarding the protection of client assets.

IOSCO observed that it was unable to find any evidence of New Zealand fully implementing steps to adopt the following three recommendations pertaining to custodians:

- maintaining adequate records of clients' assets ("principle 1");
- implementing appropriate arrangements to safeguard clients' rights in their assets and minimise the risk of loss and misuse ("principle 3"); and
- disclosing client asset protection arrangements and underlying risks to clients ("principle 5").

IOSCO found that, while New Zealand custodians were required to maintain records of client assets, custodians met only partially the reconciliation requirement under principle 1. IOSCO noted that brokers who are not custodians under the Financial Markets Conduct Act 2013 or "NZX participants" are not required to reconcile client asset records on any particular frequency. Instead, they are subject to a general duty of care under the Financial Advisers Act 2008 to reconcile on an 'appropriate' frequency only.

With regards to principle 3, IOSCO expected holistic and ongoing due diligence of custodians' businesses, a forecast of any corporate actions which may complicate the return of client assets, and an assessment of the risks and consequences of a custodian's default. While it acknowledged that New Zealand brokers conduct a 'reasonable level' of due diligence on their custodians and their outsourcing arrangements, IOSCO noted that these due diligence requirements do not generally apply to client monies placed with a bank, as this would not be considered outsourcing. As a result, IOSCO concluded that New Zealand regulation requires a lower level of due diligence from brokers on their custodians than had been recommended.

Although the report stated that principle 5 hadn't been adopted in New Zealand, it didn't provide any further explanation of why that might be.

With both the IMF and IOSCO recommending that New Zealand impose more regulation on custodians, this is a topic to watch. Although it hasn't specifically mentioned the regulation of custodians, the Financial Markets Authority has stated in its Strategic Risk Outlook that its regulatory perimeter is on its risk radar. Accordingly, it seems that some form of increased supervision for custodians, including potentially licensing, is likely.

If you would like to discuss the IOSCO's report, or the potential for custodian licensing and its implications on your business, please contact one of our experts.

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