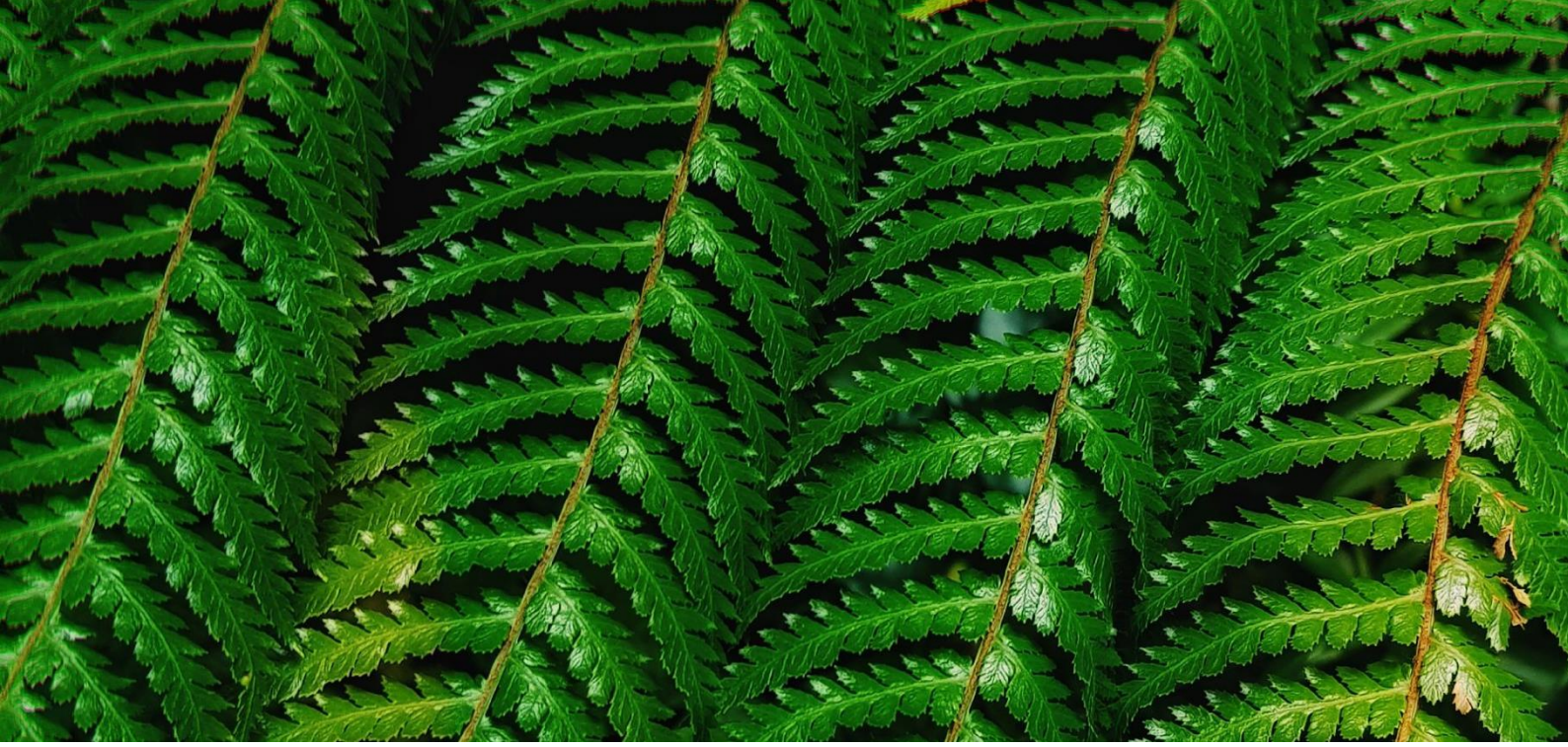

OCTOBER 2023

Lessons learned from the Barry Kloogh Ponzi scheme

Report on the FMA's enquiries into regulatory settings and practices of financial services used by Barry Kloogh to commit fraud

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TĀTAI HOKOHOKO

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Executive summary

In 2019, the Financial Markets Authority – Te Mana Tātai Hokohoko (**FMA**) became aware of fraudulent activities carried out by Barry Kloogh (**Kloogh**). We referred the matter to the Serious Fraud Office (**SFO**) at a very early stage and after we had completed a preliminary investigation into the flow of funds within Kloogh's Ponzi scheme.

Kloogh used companies he controlled, Financial Planning Limited (**FPL**) and Impact Enterprise Limited (**IEL**), as a "front" for his Ponzi scheme (see page 6 for more details). As has been publicised, the SFO investigation ultimately led to Kloogh's conviction and sentence of eight years and ten months' imprisonment. Kloogh admitted charges of:

- false accounting
- false statements by promoters
- theft by person in special relationship
- obtaining by deception; and
- forgery.

We carried out further enquiries into how Kloogh was able to exploit the trust and goodwill of his clients utilising services provided by FNZ Limited and FNZ Custodians (collectively '**FNZ**'), Consilium NZ Limited (**Consilium**) and Bank of New Zealand (**BNZ**).

Purpose of this report

This report concerns our enquiries into what services were provided to Kloogh by these third parties (collectively '**the entities**').

The purpose of this report is to record the FMA's views and findings on the conduct that was the subject of these enquiries, the law that applies to that conduct, and our actions as a result of our findings.

Our findings

We identified opportunities for custodians to improve how they meet obligations to provide custody reporting to end investors under the Financial Advisers Act 2008 (repealed) (**FA Act**).[1] We did not identify contraventions by FNZ of its broker and custodian obligations.

We identified that Consilium did not receive or hold client money or client property on behalf of advisers or their clients, and therefore did not have obligations under the FA Act and was not a reporting entity under the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 (**AML/CFT Act**).

[1] The laws governing financial advice in New Zealand have changed. The Financial Markets Conduct Act 2013 (FMC Act) now sets out the duties that apply to providers.

We had concerns around BNZ's review of transaction behaviour on Kloogh's account. We have provided this information to BNZ's AML/CFT supervisor, the Reserve Bank of New Zealand. We found no evidence to suggest that BNZ knew or should have known that Kloogh was operating a Ponzi scheme.

Our response

The FMA has identified a range of actions that market participants can take to strengthen protection for consumers. We are publishing this report to raise awareness of these, and to strengthen understanding of relevant obligations.

To support this, we will also publish a guidance note that includes details of custodians' responsibilities with regards to custody reporting to clients.

We have already enhanced our monitoring and risk framework to increase scrutiny of client money handling processes and to better identify risk factors that may indicate misconduct. Recent legislative reforms have also bolstered our resources for regulation of financial advisers.

We have identified potential law changes that we believe would support consumer protection relating to custodians, and have referred these to the Ministry of Business, Innovation and Employment (MBIE).

Fraud of the type committed by Kloogh is sophisticated and preys on the trust that clients place in their financial adviser. History shows that such fraud is difficult to detect. However, regulatory settings, regulatory oversight and vigilance on the part of market participants can create layers of protection that make such fraud more difficult to commit and more likely to be detected.

We encourage, and expect to see, increased vigilance in the systems and processes financial service providers and their support services (e.g. wrap platforms) deploy to detect and monitor fraud. The surge in fraudulent activity experienced around the globe recently shows that this vigilance is necessary.

Background to the Ponzi scheme

A Ponzi scheme is a form of fraud characterised by the use of funds from new investors to pay interest or repay capital to earlier investors. Such schemes generally collapse when the operator can no longer find sufficient new funds to satisfy the existing investors.

Key parties

- Mr Kloogh was an authorised financial adviser (**AFA**) under the FA Act. As an AFA, Mr Kloogh was authorised to provide personalised financial advice and investment planning services. He used companies he controlled, FPL and IEL, as a "front" for his Ponzi scheme.
- Consilium provides a wrap platform (i.e. an online portal for advisers and clients to access and manage their investments) to individual financial advisers and firms. FPL had a platform agreement with Consilium for the purposes of using the wrap platform to manage clients' investment portfolios (including recording clients' external investments onto their online account). Consilium in turn holds a custody services agreement with FNZ Limited.
- FNZ Limited was contracted by Consilium to provide custody services. FNZ Limited provides the custody service through FNZ Custodians Limited, which holds investments on behalf of an adviser's underlying client(s) as bare trustee. These investments are held in a pooled account, with FNZ responsible for maintaining accounting and custody records that enable investments to be readily identified.
- BNZ provided banking services to Mr Kloogh's business IEL.

Nature of the fraud

Mr Kloogh was in the business of providing financial advisory services to clients. Apart from his own companies, Kloogh used (or purported to use) the services of other entities such as Consilium, FNZ and BNZ to run his business.

Mr Kloogh was not a registered broker and custodian (nor were his companies), and he was not permitted to receive or handle client monies. Some of Mr Kloogh's clients were instructed to deposit funds into a bank account that they believed to be owned and/or operated by Consilium, on the understanding that Mr Kloogh would invest their monies in the investment products as set out in their respective client instructions. These accounts, controlled by Mr Kloogh, were designated with trading names (e.g. "Consilium") to look as though they were held by other independent entities such as Consilium. Funds in these accounts were co-mingled and misappropriated for other purposes, including for Mr Kloogh's personal expenses, business expenses, or to pay out other clients.

Mr Kloogh utilised various other methods to maintain his Ponzi scheme. For instance, he recorded and maintained fictitious external investments of clients in the Consilium platform to corroborate his misappropriation of funds. In addition, Mr Kloogh had been authorised to create and operate Consilium accounts on behalf of his investment clients, with clients being able to access their own accounts if they wished. However, Mr Kloogh did not provide all of his clients access to their respective accounts, and in at least one instance would not give the client password access to their account.

Mr Kloogh also nominated addresses associated with himself to receive FNZ's mandatory custody reports meant for some of his clients. To further conceal his Ponzi scheme, Mr Kloogh provided clients with false or forged documents (including false statements on a client's investments).

In March 2020 Mr Kloogh pled guilty to 11 charges brought by the Serious Fraud Office relating to the Ponzi scheme. The charges include false accounting, false statement by a promoter, forgery, theft by a person in a special relationship, and obtaining by deception. He was sentenced to eight years and ten months' imprisonment (with a minimum period of imprisonment of five years and four months).

Summary of key dates

1983

- Mr Kloogh started his financial services career in 1983.

1995

- It was noted in the judgement that Mr Kloogh offended over a period of at least seven years, but it also acknowledged his offending began in 1995, over 20 years ago.

June 2011

- Mr Kloogh started practising as an Authorised Financial Adviser (AFA) on 20 June 2011.

September 2016

- Mr Kloogh switched over to Consilium. Prior to that he used Discovery Portfolio Services to provide custodial services.

December 2018

- The accountant Mr Kloogh engaged to prepare accounts and tax returns for his businesses discovered discrepancies in the BNZ bank statements of IEL that Kloogh had provided to him.

May 2019

- The FMA referred the matter to the Serious Fraud Office on 13 May 2019, after conducting an initial investigation.
- The SFO executed search warrants on Mr Kloogh's home and business premises on 23 May 2019.
- Mr Kloogh had approximately 2000 'active clients' in May 2019, of whom approximately 200 were categorised as investment clients. The fictitious "external investments" totalled approximately $15,000,000 on or about May 2019.

July 2019

- Interim liquidators from Deloitte were appointed to maintain the assets and investigate the affairs of FPL and IEL, after an application by the FMA.

August 2019

- The Official Assignee was appointed as liquidator.

September 2019

- FMA cancelled Mr Kloogh's AFA authorisation, as a result of concerns regarding compliance with his broker obligations under the Financial Advisers Act 2008.

Other points of note

- Mr Kloogh stated in his interview that he had operated the Ponzi scheme for 20 years or more and had misappropriated approximately $18,000,000.

FMA's enquiries and findings

FNZ and its obligations under the FA Act

FNZ broker obligations

FNZ, as a broker and a custodian, had obligations under the FA Act[2]. The relevant broker obligations were as follows:

- not engaging in misleading or deceptive conduct (s77L)
- pay client money into separate trust account and hold client property on trust (s77P)
- account for client money and client property (s77Q)
- keep records of client money and client property (s77R)
- report on client money and client property (s77RA)
- exercise care, diligence, and skill that a reasonable broker would exercise in the same circumstances (s77K).

FNZ acted only on authorised instructions. Underlying clients authorised their financial adviser to give authorised instructions to FNZ on their behalf. Kloogh was one such financial adviser.

FNZ relied on financial advisers to facilitate the onboarding and create the wrap client account on the Consilium platform. This included entering the client's details (including the chosen delivery method for custody reporting) on the platform.

Clients typically made deposits into their wrap accounts for the purpose of making investments. Once the funds were applied, financial advisers then placed orders on the wrap client accounts for financial products, in line with the client's investment strategy. Under the FA Act, only financial advisers with authority to act on behalf of clients had permission to place orders.

The client funds could only be withdrawn to the bank account entered on the Consilium platform. However, FNZ's policy did not deem it to be unusual to accept deposits into the client wrap account from a range of sources. Additionally, FNZ did not verify the source bank account from which the funds were paid into the client wrap accounts. Funds received only had to be referenced with the wrap client number.

Enquiries undertaken by the FMA showed that Kloogh gained access to client funds:

a) by having clients pay funds directly into bank accounts belonging to his companies;

b) by depositing client cheques (made out for investment purposes) into his company bank accounts;

c) by making withdrawal requests to Consilium on behalf of clients who had funds deposited with FNZ. These withdrawals were paid to the client, but Kloogh would immediately contact the client saying a mistake had been made and request they pay the funds back to a bank account with details that purported to be Consilium's (but instead was a bank account belonging to his companies, as in point a) above).

[2] The FA Act and associated regulations were repealed when the new financial advice regime came into force on 15 March 2021.

Kloogh typically deposited funds into a client wrap account when an investor requested a withdrawal of funds. Kloogh would transfer money to FNZ's custodial account with the client wrap account as reference. Once FNZ matched the funds to the client wrap account, he would instruct FNZ to pay the money to the client's bank account.

FNZ did not typically query these types of instructions received from Kloogh. FNZ stated that, as it has no direct relationship with the end investor, it depends on the apparent legitimacy of an authority to act. Unless something about the instruction suggests irregularity or lack of authority, FNZ considered it did not have a practical ability to second guess (nor was it obligated to check) authorised instructions. FNZ relied on the apparent lawful authority of the agent giving the authorised instruction.

FNZ custody-specific obligations

As a custodian, FNZ was required to comply with the following obligations:

- to pay client money into a separate trust account and hold client property on trust (s77P)
- to account for client money and client property (s77Q)
- keeping records of client money and client property (s77R)
- reporting on client money and client property (s77RA)
- restrictions on use of client money and client property (s77S)
- protection of client money and client property held on trust (s77T).

As mentioned above, Kloogh was responsible for setting up the end investor accounts on the Consilium platform. This included entering the investor's chosen method for receiving custody reporting.

Reporting on custody assets

FNZ reported to end investors on custody assets (custodial investments) held on their behalf every six months. The report included details of transactions carried out during the reporting period. FNZ was required to send information to the end investor's address registered on the Consilium platform.

FNZ confirmed that as of 23 May 2019, 92 of Kloogh's 118 clients had an address associated with Kloogh for purposes of custody reporting; and 26 clients had an alternative residential or postal address not associated with Kloogh, or had elected to receive custody reporting via email.

FNZ confirmed that no sample testing of custody reporting processes was carried out. FNZ relied on the information provided by the authorised adviser on behalf of the client and did not verify the client's address.

Our view

In carrying out our enquiry and considering the facts above, we found no evidence that FNZ breached its obligations as a broker and a custodian.

However, we did identify the practice of sending client custody reports to addresses other than the client's own verified address (such as their financial adviser's address). We are aware that FNZ's approach is the same or similar to other custodians in New Zealand, and across the sector there are variable and inconsistent interpretations of "client address" for the purposes of determining where client reports should be sent.

It is our view that custodians must send a custody report directly to a client's physical or electronic address every six months, detailing transactions relating to the client's money and property during the reporting period. In our view, the address specified by the client must be the client's own address. In the case of Kloogh, addresses specified by him were not the clients' addresses but his own. Our view is that sending client reports to an adviser may facilitate the potential for fraud, as clients do not have an independent record of transactions relating to their money and property, and must rely on information from the adviser.

We are currently developing guidance on best practice for custodians to ensure clients are being directly given the mandated custody reports and information.

Ensuring individual clients receive their portfolio information every six months allows clients to do their own due diligence on how their money is handled and their authorised transactions are being processed.

FNZ has informed us that over the last several years it has invested considerably in making enhancements to its internal processes, including a move towards custody reports being sent to end investor addresses.

FNZ and its obligations under the AML/CFT Act

FNZ is a reporting entity under the AML/CFT Act. One of the purposes of the AML/CFT Act is to detect and deter money laundering and terrorism financing.

FNZ is required to carry out customer due diligence (**CDD**) when onboarding a new customer and thereafter to perform ongoing CDD and account monitoring for all its clients[3]. FNZ contracted with Consilium to perform CDD on FNZ's behalf.

FNZ also has account and transaction monitoring obligations under the AML/CFT Act, and is required to file a suspicious activity report (SAR) with the NZ Police Financial Intelligence Unit (**FIU**) for any suspicious activities found during monitoring by no later than 3 working days after forming a suspicion. Section 46 of the AML/CFT Act prohibits the FMA from disclosing information relating to SARs.

Our view

Our view is that FNZ can appoint an agent under section 34 of the AML/CFT Act, but FNZ retains responsibility to ensure that CDD is properly completed.

[3] S31 of the AML/CFT Act requires a reporting entity to conduct ongoing customer due diligence and account monitoring.

Consilium and its obligations under the FA Act

Consilium did not receive or hold client money or client property on behalf of advisers or their clients. Consilium's role in relation to the platform is holding the agreements with adviser firms that allow them to access the platform. Consilium entered into an agreement with Kloogh, who acted on behalf of FPL, signed and dated on 20 July 2016 (the Consilium Platform Agreement).

Our view

In our view, because Consilium did not receive or hold client money or client property on behalf of advisers or their clients, it did not have obligations under the FA Act.

Consilium and its obligations under the AML/CFT Act

Prior to Consilium receiving its Discretionary Investment Management Service licence in August 2018, Consilium did not consider itself a reporting entity, as defined in section 5 of the AML/CFT Act. In relation to Kloogh's offending, Consilium explained that it did not perform any of the activities listed in the definition of financial institutions, in the ordinary course of business. The activities listed are performed by the financial advisers (who are Consilium's clients) and by FNZ, which are reporting entities.

Our view

Our view is that Consilium was not a reporting entity in this instance. Although Consilium was appointed (for and on behalf of FNZ) to conduct CDD in respect of new customers and ongoing CDD, FNZ ultimately remained responsible for ensuring that CDD was done properly.

BNZ and its obligations

Other than fair dealing obligations under Part 2 of the Financial Markets Conduct Act 2013 (**FMC Act**), BNZ does not have any specific conduct obligations under the FMC Act. Our enquiry focused on understanding how BNZ's banking systems may have been exploited by Kloogh and/or if those systems identified the Ponzi scheme. BNZ provided information to us under section 25 of the FMA Act.

Our view

The profile and account details provided for Kloogh and IEL were limited. BNZ held information regarding Kloogh's gross income and employer, and information about IEL was limited to the industry in which it operated and its beneficial owner/controlling person, being Kloogh. The only documentation held on file for both Kloogh and IEL was the Insolvency Notice dated 30 September 2019 in relation to IEL. BNZ could not provide:

- copies of account opening forms
- any documents in the customer files for Kloogh and IEL (such as customer onboarding forms including photo identification and certificate of incorporation in relation to IEL)
- internal documents or reports that record BNZ's understanding of IEL and the nature of that business, and details of insights into the operation of that business.

BNZ stated that IEL was managed in the retail segment and not in its business banking area. This meant that the account was unmanaged, no regular customer account management or reviews were conducted, and no business relationship manager had been assigned.

The bank explained that the transactional behaviour identified on Kloogh's account was consistent with Kloogh's customer profile, being a business operating in the capacity of 'Services to Finance and Investment'. In one of the alerts triggered by BNZ's monitoring system, it was noted that Kloogh was registered on the Financial Service Providers Register (FSPR) as a Financial Adviser and thus the transactions were deemed consistent with his profile and the alert was closed.

It appears that BNZ reviewed the alerts and considered the transactions not to be suspicious. In our view, BNZ's review of the alerts was limited and we consider further enquiries or information could have been sought to better understand the nature of Mr Kloogh's business and the transactions made.

As part of enquiry, we received information from BNZ that has been provided to the Reserve Bank of New Zealand as BNZ's AML/CFT supervisor. We found no evidence in this to suggest that BNZ knew or should have known that Kloogh was operating a Ponzi scheme.

Reporting on external investments (non-custodial assets)

The Consilium platform provided additional functionality that enabled financial advisers to add into the end investor's online account any assets that the end investor held directly or elsewhere, and investments in products other than financial products or cash (external investments). These external investments were recorded in the end investor account but were not held in custody. FNZ (as custodian) did not report on these external investments and did not validate or monitor them, nor was it required to do so. The responsibility for verifying these external investments sat with the financial adviser.

Mr Kloogh inputted fictitious 'investments' that clients believed they held into the clients' online accounts so that he could 'keep track' of the funds he misappropriated in running his Ponzi scheme. This appears to have given some clients a misleading impression that investments were held in custody.

Regulatory response

This enquiry has prompted a number of actions to improve market conduct, oversight and understanding of relevant obligations. These are set out below.

- We are currently finalising a guidance note that includes details of custodians' responsibility to ensure custody reporting is done in a way that enables the client to receive a definitive and independent record of their holdings, to allow them to effectively monitor their investments. Our guidance aims to provide clear expectations on custodians' reporting requirements.
- Under the FA Act regime, we reviewed the way we generated ranking and profiles for monitoring and supervision of AFAs. This included introducing additional data points from regulatory filings, and the identification of additional risk factors associated with the use of wrap platforms, custodial services, and investment planning services.
- The new financial advice regime came into force in 2021. As a result of increased regulatory funding associated with the introduction of the new financial advice regime, we now have a dedicated financial advice monitoring team, and have increased the resources available to monitor the conduct of financial advisers. Enhancements to the FMA's monitoring approach and risk frameworks are ongoing, including for financial advice providers and financial advisers who provide custodial services (now known as 'client money and property services' under the FMC Act). All financial advice providers are asked whether they provide client money and property services in their licence application to the FMA, and must register for this service on the FSPR. Financial advice providers must also complete regulatory returns from 2024, which will capture data on an ongoing basis about which providers are offering client money and property services. This data, alongside other information, will help us develop regulatory intelligence to target our monitoring approach for financial advisers who provide client money and property services.
- We have identified and referred to MBIE potential law changes that can be made to improve consumer outcomes. If made, these would improve our ability to intervene in similar circumstances and clarify the expectations related to custodians and assurance reports.
- We have asked MBIE to consider whether the regulatory settings for custodians in New Zealand should be reconsidered, including whether or not potential harms in this area indicate that increased regulation such as licensing is appropriate.[4] This case highlighted the very limited role that the custodian considered it needed to perform in overseeing transactions made on behalf of clients; we note there is also a minimal level of regulatory controls and standards that apply to custodians. Wilful and sophisticated fraud and the carrying on of Ponzi schemes is difficult to detect, monitor, and legislate against. However, where fraudulent activity is able to occur through the systems of intermediaries such as custodians, their conduct and the obligations on them under law to protect the interests of underlying investors, along with increased vigilance, should affect the risk of fraud being successful or persisting over a long period of time.

[4] This gap in regulatory settings compared to other jurisdictions was identified in the International Monetary Fund's 2017 report on New Zealand as part of its Financial Stability Assessment Programme.

AUCKLAND – Level 5, Ernst & Young Building | 2 Takutai Square, Britomart | PO Box 106 672 | Auckland 1143
WELLINGTON – Level 2 | 1 Grey Street | PO Box 1179 | Wellington 6140

fma.govt.nz