

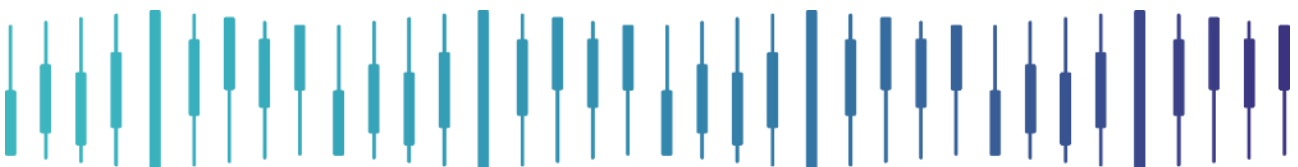
NZ RegCo

NZ'S LISTED
MARKET REGULATOR

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NZ RegCo Decision

Class Ruling on the application of NZX Participant Rule 18.2.1(b) in relation to client investments in registered Managed Investment Schemes



Ruling on the application of NZX Participant Rule 18.2.1(b) in relation to client investments in registered Managed Investment Schemes

Background

1. This Ruling applies to the NZX Participant Rules (**Rules**) dated 20 March 2024.
2. A Market Participant may hold Client Assets in the normal course of its business. Client Assets as defined in Rule 18.1 include client money and clients' Securities received and held by a Market Participant.
3. The term "Securities" is defined in Section 1 of the Rules. Under the definition the term covers a "financial product" as defined under the Financial Markets Conduct Act 2013 (**FMCA**).

Managed investment scheme as a regulated product under the FMCA

4. The meaning of financial product under section 7 of the FMCA includes a managed investment product.
5. A managed investment product is further defined as the interest in a managed investment scheme (**MIS**) in section 8(3) of the FMCA. The definition of MIS is set out in section 9(1) of the FMCA. Under the FMCA the manager of a MIS, other than a restricted scheme, must be licensed, and must have a licensed supervisor.
6. A MIS must be a registered scheme in order for a person to make a regulated offer of a managed investment product under section 125 of the FMCA.
7. A managed investment product in a registered scheme is a regulated product under section 41 of the FMCA.
8. A MIS is required to hold the scheme property on trust with a custodian under sections 156 and 157 of the FMCA. The scheme property in relation to MIS includes contribution of money to the scheme.
9. Under section 87 of FMCA, client money paid to an issuer or offeror of a regulated product to acquire that financial product, must be held on trust by that issuer or offeror. Section 87 permits an issuer or offeror to release money from trust in certain circumstances, including once the financial product is issued or transferred, or the money is otherwise applied for the purpose for which it is paid.

Client Assets obligations under the Rules

10. Section 18 of the Rules recognises the position of trust under which Client Assets are required to be held, and sets minimum standards for Market Participants in discharging their obligations.
11. In the normal course of its business a Market Participant Accepting Client Assets (**the Market Participant**) receives Client Funds, which are automatically defined as Client Assets under Rule 18.1.1. Rule 18.5.1 requires the Participant to hold Client Assets in trust at all times.
12. These Client Assets carry a corresponding Outstanding Obligation from the Participant to the client from the time they are received. Rule 18.4 requires a Participant's Total Client Assets held in certain accounts including a Client Funds Account together with any Buffer to at all times equal or exceed a Participant's total Outstanding Obligations.
13. Rule 18.2.1(b) defines Outstanding Obligations as an agreement or arrangement between the Participant and its client. Where the client who has paid the funds to the Participant is a buying

client, the Outstanding Obligation exists until the Securities purchased have been registered in that client's or its Nominee Company's name.

14. The client may instruct the Participant to acquire units in a registered MIS. The process involves the Participant sending an application for MIS units and client funds to the MIS manager. The MIS manager receives the unit allocation application and respective funds, and then issues units in the MIS and registers them in that client's or its Nominee Company's name. The process from sending the unit allocation application and client money to the MIS and the units being registered in client's name may take several days (the **Relevant Period**).
15. During the Relevant Period, the client funds are required to be protected by both the Market Participant under Rule 18.2.1(b) and by the MIS under section 87 of the FMCA.

Decision

16. NZX Regulation Limited (**NZ RegCo**) rules, pursuant to NZX Participant Rule (**Rule**) 21.3.1(c), and subject to the conditions set out in paragraph 17 below, that in relation to clients' money applied for the purpose of buying units in a registered MIS directly from the MIS manager, the Outstanding Obligation under Rule 18.2.1(b) ends for the Participant at the point when the Participant has provided an application for MIS units and client funds to the MIS manager on behalf of the client. At this point application money is not required to be captured as an Outstanding Obligation under the Rule 18.2.1(b).
17. The ruling in paragraph 16 above is provided on the conditions that:
 - a. the ruling does not apply to any listed Securities;
 - b. clients instruct the Participant to acquire units in a registered MIS, or such decision to acquire units is otherwise made on behalf of a client under a Discretionary Investment Management Service (**DIMS**) arrangement, and the Participant makes an application to an issuing MIS manager on behalf of the client to purchase units in the MIS, which is inclusive of the payment of application monies to the issuing MIS manager;
 - c. the MIS manager holds the Client Funds paid to the issuing registered MIS on trust for the client in accordance with the provisions of section 87 of the FMCA; and
 - d. this ruling is strictly limited to registered MIS products that are regulated products under the FMCA.
18. This ruling is effective until revoked by NZ RegCo. NZ RegCo reserves the right to revoke or vary this ruling at any time.
19. The Rules to which this decision relates are set out in Appendix One.
20. The sections of the FMCA to which this decision refers are set out in Appendix Two.
21. Capitalised terms that are not defined in this decision have the meanings given to them in the Rules.

Reasons

22. In coming to the decision set out in paragraph 16 above, NZ RegCo has considered that:
 - a. under section 87 of the FMCA, money paid to an issuer or offeror of a regulated product must be held in trust until the financial products are applied in the manner prescribed in section 87(2), which includes the financial products being issued or transferred;

- b. where funds are returned to the Participant as contemplated by section 87(2)(c) of the FMCA, this would automatically trigger a receipt of a Client Asset and therefore a new Outstanding Obligation;
- c. as such, client funds are protected once the application sent by the Participant on behalf of clients is received by a registered MIS manager;
- d. in addition, all scheme property must be held in trust for the scheme by the scheme custodian under section 157 of the FMCA, so the protection continues for the Client Assets throughout the process;
- e. the obligations prescribed to registered MIS managers under the FMCA provide protection similar to that afforded to clients of Participants under the Rules in this area;
- f. the ongoing Outstanding Obligation is currently met by Participants holding Buffer money to protect the Client Funds that have been sent to the registered MIS until the Participant receives confirmation from the MIS that the units have been registered for the client. This places a material financial burden on Participants in relation to money that is already subject to an equivalent statutory protection regime;
- g. applying this approach is not inconsistent with the regulations relating to the holding of client assets and the duties set out in Schedule 21C of the Financial Markets Conduct Regulations 2014,
- h. the shift in protection arising from the transfer of funds from the Market Participant to the registered MIS manager does not place undue risk on the protection of Client Assets once the funds have been applied by the Market Participant for the purpose of acquiring units in a scheme; and
- i. the Rules do not seem to adequately address when the Outstanding Obligation in relation to the client payment directly to a registered MIS to acquire an interest in a registered MIS is extinguished. This ruling intends to provide clear guidance on that.

Publication

23. This ruling will be published.

Appendix One

Participant Rule 1.1

Participant Rule 1.1 - Definitions

Security or **Securities** means, in all Sections of these Rules other than Section 19, any interest or right to participate in any capital, assets, earning, royalties, or other property of any Person; and includes:

- (a) a “financial product” as defined under the FMC Act;
- (b) an Equity Security;
- (c) a Debt Security;
- (d) an Option or a Right; and
- (e) any renewal or variation of the terms or conditions of any existing Security;

And, in Section 19 of the Rules means a “financial product” within the meaning of section 7(1) of the FMC Act and includes any right or option to acquire any Security or benefit of any kind, whether conditional or not and whether renounceable or not.

Participant Rule 18.2

Participant Rule 18.2.1 – Outstanding Obligations

Outstanding Obligations means an agreement or arrangement between a Market Participant Accepting Client Assets and its client where:

- (a) Securities of that client have been transferred into the Transfer Account of a Legal Title Transfer Depository Participant as a result of direct instructions from that client's Trading Participant and the funds owing for the transfer of those Securities to the buying client on the sale or proposed sale of those Securities have not yet been received by the Relevant Clearing Participant. Securities may not be transferred from a Transfer Account until such time as the Trading Participant has received an NZX confirmed Trade or BPOT; or
- (b) that client is a buying client and has paid money to the Market Participant Accepting Client Assets prior to those Securities being registered in that client's or its Nominee Company's name. This includes funds received by the Trading Participant prior to a Trading Participant entering that client's Order into the Trading System; or
- (c) that client has paid money to a Market Participant Accepting Client Assets for any other purpose, and the amount paid has not been applied (less reasonable brokerage or commission) for that purpose.

Participant Rule 18.10

Participant Rule 18.10.1 – Application of Funds

All Client Funds required to be paid into a Client Funds Account under Rule 18.7 must be held upon trust by the Market Participant Accepting Client Assets and applied:

- (a) for the purposes of the settlement of, or reimbursement in respect of the settlement of the purchase of Securities for a client;
- (b) in payment of the sale price for a Client's Securities transferred into a Market Participant Accepting Client Assets Transfer Account;

- (c) in payment to any other person for whom Client Funds have been held in the Client Funds Account; and
- (d) in payment of brokerage and other charges properly payable to the Market Participant Accepting Client Assets by its clients for transactions under Rules 18.10(a) and (b).

Appendix Two

Financial Markets Conduct Act 2013

Section 8 Definitions relating to kinds of financial products

...

(3) In this Act, subject to subsection (5)(a) and (b), managed investment product—

(a) means the interest in a managed investment scheme referred to in paragraph (b) of the definition of that term in section 9(1); but

(b) does not include—

- (i) an equity security; or
- (ii) a debt security.

...

Section 9 Definitions of financial benefit and of managed investment scheme

(1) In this Act, —

financial benefit means capital, earnings, or other financial returns

managed investment scheme means a scheme to which each of the following applies:

(a) the purpose or effect of the scheme is to enable persons taking part in the scheme to contribute money, or to have money contributed on their behalf, to the scheme as consideration to acquire interests in the scheme; and

(b) those interests are rights to participate in, or receive, financial benefits produced principally by the efforts of another person under the scheme (whether those rights are actual, prospective, or contingent, and whether they are enforceable or not); and

(c) the holders of those interests do not have day-to-day control over the operation of the scheme (whether or not they have the right to be consulted or to give directions).

(2) However, a managed investment scheme does not include—

Scheme only involves management of separate and direct interests in underlying property

(a) a scheme under which each participant takes part in the scheme only by holding 1 or more interests in property if, in respect of each interest, —

- (i) it is an interest in separately identifiable underlying property; and
- (ii) either the participant holds both the legal and beneficial interest in the property or the legal interest in the property is held on a bare trust for the participant; and
- (iii) the value of the interest is not substantially dependent on contributions being made by other participants or the use of other participants' contributions:

Discretionary investment management services

(b) a discretionary investment management service supplied by a DIMS licensee:

Insurance contracts

(c) a scheme that would be a managed investment scheme only because it involves pure risk contracts of insurance:

(d) a scheme that would be a managed investment scheme only because it involves life insurance policies (within the meaning of section 2(1) of the Securities Act 1978) that were issued before this section comes into force.

(3) In subsection (2), pure risk contract of insurance means a contract of insurance that does not, and never will, have a value on its cancellation or surrender that is greater than the sum of premiums paid to the insurer.

(4) A managed investment scheme as defined in subsection (1) also includes a scheme declared to be a managed investment scheme under subpart 3 of Part 9.

Section 41 Meaning of regulated offer and of regulated product

(1) In this Act, regulated offer—

(a) means an offer of financial products to 1 or more investors where the offer to at least 1 of those investors requires disclosure under this Part (regardless of whether or not an exclusion under Schedule 1 applies to an offer to 1 or more other investors); but

(b) does not include an offer of financial products to 1 or more investors if—

(i) the only investors who are able, under the terms of the offer, to acquire the products are investors to whom disclosure under this Part is not required; and

(ii) all of the investors who acquire the products under the offer are investors to whom disclosure under this Part is not required.

(2) In this Act, regulated product means—

(a) a financial product offered under a regulated offer; or

(b) a managed investment product in a registered scheme (whether or not there has been a regulated offer).

Section 87 Money for financial products must be held in trust

(1) This section applies to money paid to an issuer or offeror of regulated products if the money is paid by a person (A) —

(a) to acquire the financial products or an increased interest in the financial products; or

(b) as a further contribution or investment or a further deposit as referred to in section 11(2)(c).

(2) The issuer or offeror must hold the money in trust for A until—

(a) the financial products are issued or transferred; or

(b) the money is otherwise applied for the purpose for which it was paid (for example, to increase the extent of A's interest in a scheme or A's deposit or to pay a fee); or

(c) the money is repaid to A; or

(d) the money is applied in accordance with A's express instructions given after the application for financial products was made and the money was paid.

(3) The issuer or offeror must—

(a) deal with the money, while it is held in trust, in the prescribed manner (including ensuring that any prescribed requirements relating to the investment of the money are complied with); and

(b) if the money needs to be repaid, ensure the money is repaid as soon as practicable and, in any event, no later than 1 month after the obligation to repay arises.

(4) This section does not apply to derivatives (but see section 448, which provides for regulations relating to the holding and application of investor funds and property by derivatives issuers).

Section 125 Need to register managed investment scheme for regulated offer of managed investment product

(1) A person must not make a regulated offer of a managed investment product, or accept further contributions if there has been a regulated offer of a managed investment product, unless the managed investment scheme is registered.

(2) However, a managed investment scheme may be registered even if there is no regulated offer of a managed investment product in the scheme but, in this case,

(a) the managed investment products in the scheme are regulated products under section 41; and

(b) this Act applies accordingly (for example, in addition to this subpart, see section 87 (money for financial products must be held in trust) and subpart 4 of Part 3 (ongoing disclosure)).

(3) A scheme that is approved as a Schedule 3 scheme under Schedule 3 may not be registered under this subpart.

Section 156 Requirement to have supervisor or other independent person as custodian

(1) The supervisor of a registered scheme (A) must hold the scheme property or, if authorised by the governing document, contract the holding of the scheme property to another person (B) who meets the external custodianship requirements.

(2) If there is no supervisor for the scheme (for example, in the case of a restricted scheme), the scheme property must be held in 1 of the following ways:

...

by a person (B) who meets the external custodianship requirements and to whom the manager of the scheme (A), if authorised by the governing document, has contracted the holding of the scheme property.

(3) If a person contracts the holding of the scheme property to another person (the nominee) under this section, the person contracting out that function—

(a) must take all reasonable steps to—

(i) ensure that the function is performed by the nominee in the same manner and subject to the same duties and restrictions as if that person were performing it directly; and

(ii) monitor the performance of that function ...

Section 157 Custodian holds scheme property on trust

(1) The custodian for a registered scheme holds the scheme property on trust for the scheme.

(2) The custodian for a registered scheme must ensure that the scheme property is held separate from property held by any of the following persons on their own account:

(a) the custodian:

(b) any related party of the scheme.

- (3) The custodian must also comply with any other prescribed duties and other requirements in relation to the scheme property.
- (4) Scheme property—
- (a) is not available for the payment of the debts of the custodian or any other creditor of the custodian; and
- (b) is not liable to be attached or taken in execution under the order or process of any court at the instance of the custodian or any other creditor of the custodian.
- (5) Nothing in this section takes away or affects any lawful lien or claim that a custodian who holds scheme property has against the scheme property.

Schedule 21C Duties that apply when client money or property is held together with other money or property

This schedule sets out duties that must be complied with when client money or client property is not held separate from other money or property under regulations 229X to 229ZC.

2 Interpretation

- (2) In this schedule and regulations 229X to 229ZC, a practice or an action of an NZX provider or a non-NZX provider that involves client money or client property being held together with firm money or firm property is **reasonably necessary** if—
- (a) the provider has taken reasonable steps to investigate alternatives that would overcome or reduce the extent to which client money or client property is held together with firm money or firm property; and
- (b) the provider is satisfied on reasonable grounds either that, in the circumstances, there are no alternatives available or that any such alternatives—
- (i) would pose an undue risk to the prudent and orderly conduct of their financial product transaction business; or
 - (ii) are not able to be accessed or implemented without exposing the provider or their clients to an unreasonable level of cost or delay or risk; or
 - (iii) would be contrary to the best interests of their clients in being able to undertake financial product transactions in a timely and prudent manner.