

Key Notes

- Introduction
- Background
- Key Definitions
- Calculation of Outstanding Obligations
- Client Funds Reconciliation Obligations and Standards
- Requirements for Bank Accounts
- Application of Funds
- Protection of Client Assets
- Appendix I – Reconciliation Template
- Appendix II – Prescribed wording for inclusion in Bank Trust letters

12 July 2005

Reissued March 2007

Disclaimer

This guidance note has been issued to promote commercial certainty and assist market participants. It provides guidance to Market Participants and their advisors on NZX's interpretation of the NZX Participant Rules. This Guidance Note sets out NZX's general approach to the subject, but is not to be regarded as a definitive statement of the application of the Rules in every situation. Guidance Notes do not constitute legal advice and are only a guide to NZX's policy & practice. NZX recommends that Market Participants take advice from qualified professionals.

NZX may replace Guidance Notes at any time. Market Participants should ensure that they have the most recent version of the Guidance Note. Guidance Notes are posted to NZX's website at www.nzx.com

GUIDANCE NOTE GN0008/05 – CLIENT ASSETS

INTRODUCTION

A Market Participant may hold Client Assets in the normal course of its business. When it does so it will be in a fiduciary capacity, acting as agent for its clients. This requires high standards of custodianship and associated record keeping. Section 14 of the NZX Participant Rules (**Rules**) recognises the position of trust under which these assets are held and sets minimum standards for Market Participant's in discharging this fiduciary duty.

The management of a Market Participant is responsible for establishing and maintaining adequate accounting systems and records and effective internal controls that ensure that this fiduciary duty is met at all times. At a minimum this requires:

- The proper handling of client assets;
- Payments into and withdrawal from Client Funds Accounts being for authorised purposes in line with client instructions; and
- Compliance with reconciliation requirements.

BACKGROUND

This Guidance Note has been developed to assist in providing clarification of obligations under Section 14 of the Rules covering Client Assets. The guidance provided covers those areas where NZX Regulation considers NZX guidance would be useful to give Market Participants Accepting Client Assets greater clarity around meeting their obligations under the Rules.

Key areas included in this Guidance Note are:

- Key Definitions;
- Calculation of Outstanding Obligations;
- Reconciliation Requirements and Standards;
- Requirements for Client Funds Bank Accounts;
- Application of Funds; and
- Protection of Client Assets.

NZX Regulation advises that Custody (covered in Rule 14.14) is specifically excluded from this Guidance Note.

Please note that the capitalised terms used in this Guidance Note have the meaning given in the Participant Rules.

KEY DEFINITIONS

The purpose of this section of the Guidance Note is to provide some assistance to Market Participants in understanding certain key definitions used in Rule 14. It is essential that Market Participants fully understand the meaning of defined terms to understand the obligations imposed upon them.

Client Assets

Client Assets are defined in Rule 14.1 as follows:

“Client Assets means:

- (a) Client Funds received and held by a Market Participant Accepting Client Assets for undelivered buy contracts;*
- (b) Client’s Securities received and held by a Market Participant Accepting Client Assets for delivered unpaid sell contracts; and*
- (c) All funds received and held on account including but not limited to funds on deposit, call accounts and application monies.”*

NZX notes that Client Assets are **not** limited to funds or Securities received by a Market Participant for settling a share transaction, but include **all** assets of a Market Participant’s client that have been transferred to that Market Participant by that client or otherwise. However, it is expected that the most common type of Client Asset held by a Market Participant will be either Securities or funds.

“Securities” is defined in section 1.1 of the Rules and is not limited to FASTER settled Securities but includes unlisted Securities (debt and equity).

For the purposes of determining what is a Client Asset where a Market Participant operates a Nominee account for a client, only those Securities still requiring settlement, not all nominee holdings of that client, are considered Client Assets. The requirements imposed on Market Participants for longer term Nominee holdings (also known as Custody) are set out in Rule 14.14 and are not covered by this Guidance Note.

Although included in the definition of “Client Assets”, funds on deposit in client call accounts and/or other client deposit facilities held by the Market Participant on trust for clients are not considered when calculating a Market Participant’s Outstanding Obligations and are therefore not specifically covered in this Guidance Note.

Client Funds Account

“14.3.1 Client Funds Account means a trust account held by a Market Participant Accepting Client Assets for the benefit of its clients.”

Under this definition, a Client Funds Account represents a single trust account which has recognised status as being for the benefit of the clients of that Market Participant. In practice, multiple client funds bank accounts may be operated, such as foreign currency accounts and interest earning deposit and call accounts. Where multiple bank accounts are operated, Section 14 of the Rules applies to each of these Client Funds Accounts (Rule 14.6). For the purposes of account operation each account must be treated individually and mapped to an individual ledger account, but the accounts may be aggregated and converted to \$NZ in order to demonstrate that Total Client Assets held exceed Outstanding Obligations.

CALCULATION OF OUTSTANDING OBLIGATIONS

“14.2 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 by a selling client's Delivery and Settlement Participant, into its FASTER Transfer Account as a result of direct instructions from that client's Trading Participant. 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 paid by the buying client's Delivery and Settlement Participant. Securities may not be transferred from a FASTER Transfer Account until such time as the Trading Participant has received an NZX confirmed trade; or*
- (b) *That client is a buying client and has paid money into the selling client's Delivery and Settlement Participant's Client Funds Account prior to those Securities being registered into that client's or its Nominee's name. This includes funds received by the Delivery and Settlement Participant prior to a Trading Participant entering that client's Order into the Trading System; or*
- (c) *That client is a buying client and 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.*

The definition of Outstanding Obligations was amended when the rules were revised in May 2004 to reflect all Market Participant categories, but remains largely unchanged from the NZX Business Rules and Regulations, which prevailed prior to May 2004.

In essence, Outstanding Obligations reflects the aggregate of Securities or funds held by a Market Participant Accepting Client Assets as a result of an agreement or arrangement whereby:

- (a) Securities of a selling client have been transferred (legal title has passed) to a Delivery & Settlement Participant for, or in advance of, sale or settlement, where that client is yet to be paid;
- (b) A buying client has paid money to a Delivery & Settlement Participant for, or prior to a purchase of securities, prior to those securities being registered in that client's name; and
- (c) A client has paid money to the Market Participant Accepting Client Assets for any other purpose.

In calculating the level of Outstanding Obligations, the following should be noted:

Gross Segregation

The calculation of the Outstanding Obligations is based on gross segregation, in that a client's individual trades must be analysed for inclusion in the calculation of Outstanding Obligations. For example, a delivered but unpaid sell order should not be netted off against an unregistered buy order.

In addition, clients cannot be netted against one another. A Market Participant Accepting Client Assets must provide for Outstanding Obligations without the inclusion of client debtor balances.

Trades on Other Exchanges

The obligations on a Market Participant under Rule 14 are the same regardless of the exchange on which the transaction is executed. However, in practice it may be uncommon for a Market Participant Accepting Client Assets who is trading on other exchanges to hold Client Assets in the form of Securities and therefore the Market Participant may only need to protect cash.

For example:

- i) ***ASX Buy Transaction*** – a client provides money in advance of a settlement of a buy transaction. These monies are held by the Market Participant through to T+3 (fixed settlement date in Australia), then transferred to an Agent in Australia for settlement. In addition the Market Participant provides registration details of the underlying client to its Agent. The Market Participant must protect these client monies in its Client Fund Account from the point it received funds from the client until the Securities are registered in the client's name.
- ii) ***ASX Sell Transaction*** – a client places a sell order. This order is then passed to an Australian Agent of the Market Participant. The Market Participant also provides registration details for the client. On settlement (T+3), the Securities of that client are uplifted by the Australian Agent and exchanged for cash. These funds are repaid into the Market Participant's AUD Client Funds Account. The Outstanding Obligation arises once the Securities have been uplifted by the Australian Agent and are no longer registered in the client's name and is extinguished when the sale proceeds have been paid to the client.

Non-FASTER Settled Securities

NZX Regulation contemplates a Market Participant undertaking transactions in Non-FASTER Securities where the Market Participant is acting as Agent. Specific examples include unlisted Securities (Debt or Equity) and Government Stock. As with trades on other exchanges, it will be uncommon for such Securities to be held in the Market Participant's name and therefore the Outstanding Obligation may only arise in cash.

For example:

- i) ***Unlisted Debt Buy Transaction (counterparty is Institutional Bank Ltd)*** – a client provides cash to a Market Participant to transact a debt product purchase. Funds are then passed to Institutional Bank Ltd who registers the client's ownership of the specific debt product. The Market Participant must protect this client's assets in the form of cash from the point of receipt of funds into the Market Participant's Client Funds Account until such time as the debt securities are registered in that client's name.
- ii) ***Unlisted Debt Sell Transaction (counterparty is Institutional Bank Ltd)*** – a client provides a debt certificate and signed transfer form to a Market Participant to transact a debt product sale. These are then passed to Institutional Bank Ltd who de-registers the client's ownership interest in the specific debt product and passes cash back to the Market Participant in order to settle with the client. The Market Participant must protect this client asset from such time that Market Participant is provided with the signed transfer form and debt certificate until the client has received clear funds from that Market Participant.

Delivery Versus Payment (“DVP”)

DVP is defined in the Rules as “the contemporaneous exchange of Securities for funds on the settlement of a Trade or a transaction in Securities”. Transactions settled DVP with a client should not be included in the calculation of Outstanding Obligations because, as there is simultaneous settlement of Securities and cash, the Market Participant does not hold client assets at any point. This includes, for example, Institutional trades settled through Austraclear.

CLIENT FUNDS RECONCILIATION OBLIGATIONS AND STANDARDS

A Market Participant has the following obligation:

“14.4.1 Total Client Assets held in a FASTER Transfer Account, Nominee Account and Client Funds Account by a Market Participant Accepting Client Assets (as the case may be) must equal or exceed that Market Participant’s total Outstanding Obligations.”

This is a fundamental obligation, which expressed simply, requires Client Assets held by the Market Participant to **exceed** Outstanding Obligations at **all** times. NZX requires a formal “Client Funds reconciliation” to be performed in order to demonstrate that Client Assets held exceed Outstanding Obligations. This must take place at a minimum of once a day, at a consistent time each day.

For Trading Participants it is logical to perform this reconciliation at the end of day after settlement closes, so as to coincide with Market Participant’s general funding processes and Austraclear end of day cash settlement. Whilst FASTER provides for netted cash settlement intra-day, the funds move from NZX to the Market Participants at the end of each day.

For NZX Advising Firms it may be more practical for this Client Funds reconciliation to occur at the start of day in line with other key reconciliations such as bank reconciliations and scrip reconciliations.

Other points to note with respect to this Client Funds reconciliation:

Inclusion of certain items in the Market Participant’s FASTER Transfer Account in the Client Funds reconciliation

*“14.4.2 Each Market Participant Accepting Client Assets may only recognise those Securities that belong to clients in its calculation of Total Client Assets pursuant to **Rule 14.4.1**. Securities belonging to the Market Participant Accepting Client Assets and Clients Securities that are held in either a FASTER Transfer Account or Nominee Account may not be included in the calculation of total client assets under **Rule 14.4.1**”.*

Client Securities held in the Market Participant’s FASTER Transfer Account (“FTA”) may be included in the assessment of Client Assets held provided that they can be attributed to a client on a line-by-line basis. For the avoidance of doubt this requires that:

- The total balance of a specific Security must be able to be split by individual client; and
- There is a one to one match of a specific client’s Securities held by that Market Participant to an obligation arising through the pending transfer of those Securities.

Where Securities cannot be included in Client Assets, the equivalent amount must be held in cash.

Client Securities will be held in a Market Participant’s FASTER Transfer Account as a result of either:

- (a) A delivered, but unpaid sell contract; or
- (b) A paid, but unregistered buy contract.

For the purposes of this Client Funds reconciliation, Securities held in the FASTER Transfer Account should be valued in the same manner as the Outstanding Obligation.

In short, Outstanding Obligations must be represented by segregated Client Assets in either Securities or cash, but not both. In addition, the Securities or cash must relate to the client for which assets are to be protected.

Transfer

As a result of performing this Client Funds reconciliation, a transfer of cash to replenish the Client Funds Account may be required. This should only be necessary to cover timing differences between the receipt of cash from clients and the point in time at which the obligation arose, however from time to time it may be prudent for the Market Participant to deposit additional money in a Client Funds Account and such money will be classified as client monies from the point of its deposit.

Daily Submission

Summary information, namely total Client Assets Held, total Outstanding Obligations, and the resulting surplus must be submitted with daily liquid capital reports through the NZX Compliance reporting website (www.compliance.nzx.com). This should state the position as at the end of the previous trading day.

Record Keeping

In order to demonstrate compliance with the obligations under Section 14, the Client Funds reconciliations must be retained for a minimum of three (3) years (either in hardcopy or electronic format). NZX Regulation's required standard as to the format of this Client Funds reconciliation are set out in Appendix I.

Bank Balances

Where a Market Participant performs the Client Funds reconciliation at the end of day, that Market Participant should use the current ledger balance of each bank account, provided that the ledger is kept current and accurately reflects all transactions. Where the Client Funds reconciliation is completed at the beginning of the following day, reconciled bank balances should be used in the Client Funds reconciliation.

Bank reconciliation processes should take place on the morning following the current trading day. This is the opportunity to prove that:

- All bank accounts have remained in funds as a result of overnight processing; and
- Client Assets have been adequately protected at all times (Rule 14.4.1).

Immediate notification to NZX Compliance is required where the bank reconciliation processes indicate that these requirements have not been met (Rule 14.7.2). Notification should include an explanation of the events that caused the breach, along with a summary of the measures implemented to prevent such an occurrence arising again in the future.

Brokerage Sweep

NZX recognises that common practice amongst Market Participants is to "sweep" accumulated brokerage and other charges the participant levies its clients on a day-to-day basis with the Client Funds reconciliation determining the amount of funds to be protected in cash. This approach is acceptable, provided that the Market Participant can demonstrate that the aggregate of monies swept from the Client Funds Accounts is not more than the amount earned by the Market Participant in brokerage and other charges and such sweep would not cause Outstanding Obligations to exceed Client Assets. This proof must be able to be produced for NZX Compliance to review, immediately on request.

REQUIREMENTS FOR BANK ACCOUNTS

*“14.6 Each Market Participant Accepting Client Assets shall open and maintain a Client Funds Account at a Bank approved by NZX. If a Market Participant Accepting Client Assets has more than one Client Funds Account, this **Rule 14** shall apply to each of those Client Funds Accounts.”*

Although no prescriptive list of approved banks is set out in this Guidance Note, in New Zealand Client Funds Accounts must be held with a Registered Bank (which means a registered bank in terms of the Reserve Bank Act 1989). In overseas jurisdictions banks regulated by the recognised banking supervisor in that jurisdiction, such as Reserve Bank of Australia/Australian Prudential Regulatory Authority in Australia or the Financial Services Authority in the United Kingdom, are acceptable to NZX.

The designation of an interest bearing account as a Client Funds Account is acceptable, provided that:

- The account is in the name of the Market Participant Accepting Client Assets;
- All monies are deposited at call with a registered bank; and
- All other requirements for Client Funds Accounts are met.

For example, Client Funds held in a interest bearing deposit product offered by that Market Participant where deposits are held in a Registered Bank, can be designated as a Client Funds Account (provided all requirements as per Section 14 of the Rules are met in full), whereas a deposit with a Finance Company that is not a registered bank can not. Market Participants should obtain clearance from NZX Regulation if there is doubt as to whether a Client Funds Account meets this standard.

In addition, where a Market Participant Accepting Client Assets retains interest earned on client monies held, this must be disclosed to its clients.

The following are key prescriptive requirements for all Client Funds Bank Accounts:

- Each Market Participant Accepting Client Assets must have a Client Funds Account for each currency it accepts (*Rule 14.3*).
- Each Market Participant must obtain from the bank holding the Client Funds Account a written confirmation acknowledging the trust status of the bank account and ensure that the words “Client Funds Account” appear in the bank account name. In addition, the written acknowledgement must be provided to NZX Compliance (*Rule 14.7.1(b)*). Refer to Appendix II for standard wording of the acknowledgement. Market Participants must obtain the written acknowledgement from its bank before using the account as a Client Funds Account.
- Client Funds can only be deposited into a bank account if that account is designated a Client Funds Account (*Rule 14.7.1(c)*). No Client Funds can be deposited into any other account.
- Each Market Participant must ensure that the Client Funds Account is not overdrawn at any time, at either general ledger bank book or the physical bank account (*Rule 14.7.1(e)*).
- Each Market Participant must not use funds in the Client Funds Account for security (*Rule 14.7.1(f)*).
- Each Market Participant must reconcile the ledger records of each bank account with the Bank records on a daily basis. This covers all bank accounts, including foreign currency Client Funds Bank Accounts (*Rule 14.7.1(g)*). NZX’s expectations as to bank reconciliation standards will be issued by way of a separate Practice Note.

In addition, in order to demonstrate the segregation of client funds and Market Participant funds, recommended good practice is that Client Funds Accounts are set up under different bank account numbers as opposed to a different suffix.

Bank Account Overdraws

Rule 14.7.1(e) specifically states that each Market Participant Accepting Client Assets must:

“Ensure that each Client Funds Account is not overdrawn at any time, for the purposes of this Rule 14.7.1(e) this includes both the general ledger bank book and the physical Bank account. For the avoidance of doubt, a Client Funds Account in credit cannot be used to offset a deficit in another Client Funds Account;”

In addition, Rule 14.7.2 requires each Market Participant Accepting Client Assets to notify the NZX Inspector (NZX Compliance) immediately, should the Client Funds Account become overdrawn for any reason. When notifying NZX of an overdraw, the Market Participant Accepting Client Assets should advise the reason for that overdraw and when it was, or is expected to be, corrected.

All overdraws (either physical or book) will be critically assessed by NZX Compliance for possible referral to NZX Discipline. For the avoidance of doubt, disclosure to NZX of overdraft pursuant to Rule 14.7.2 will not necessarily limit disciplinary action, but may be taken into consideration as a mitigating factor when NZX sets out in its statement of case the penalty NZX considers appropriate for the matter. We expect that NZX Discipline will not look favourably upon a situation whereby a Market Participant fails to disclose an overdraw that is subsequently detected by NZX Compliance on inspection or otherwise.

It is not acceptable to seek to avoid general ledger overdraw by mapping two physical bank accounts to a single general ledger code.

Market Participants should be aware that these requirements will require process and policy to be in place, which may include the following:

- Daily Funding Requirements – where there is any uncertainty as to the likelihood of receipt of funds overnight, these monies should not be included in funding calculations. In determining whether uncertainty exists, Market Participants should consider the nature of the counterparty and past reliability.
- Removal of Netting – for the purposes of assessing an overdraw event, each bank account must be treated individually. For example, it is not acceptable for a Market Participant to operate two Client Funds bank accounts, one of which is in overdraft and the other in significant surplus (either physical or general ledger) for which the net of the two is positive. Therefore cash must move simultaneously in line with ledger bookings.
- Unpresented Bank Items - Market Participants Accepting Client Assets must not allow for presentation delay when deciding when to transfer funds between Client Funds bank accounts. For example, a situation where a cheque is written, but funds are not transferred to cover that cheque until 2 days later because it is not expected that the cheque will be presented is not acceptable. As outlined above, cash must move simultaneously in line with ledger bookings.

APPLICATION OF FUNDS

“14.10.1 All Client Funds required to be paid into a Client Funds Account under Rule 14.8 must be held upon trust by the Market Participant Accepting Client Assets and applied:

- (a) In reimbursing that Market Participant Accepting Client Assets for any amount paid by it in settling the purchase of Securities for a client including transfer to an intraday same day funds settlement account for that Market Participant Accepting Client Assets operated by NZX in the FASTER System for true DVP settlement where those funds are to be applied to the payment against the transfer of Securities purchased by that client to that Market Participant Accepting Client Assets FASTER Transfer Account;*
- (b) In payment of the sale price for Securities transferred into a Market Participant Accepting Client Assets FASTER Transfer Account by a client;*
- (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 14.10 (a) and (b).*

14.10.2 To the extent a Market Participant Accepting Client Assets has deposited its own funds into a Client Funds Account that Market Participant Accepting Client Assets may withdraw those assets provided that Rule 14.4.1 continues to be met.

”

In summary, valid transfers out of a Client Funds Account include:

- (a) Reimbursement of a settled purchase;
- (b) Payment of sale proceeds to a selling client;
- (c) Payment to any person, such as a third party. This must be based on an instruction from a client or authorised person on that client's account; and
- (d) Payment of brokerage and any other charges payable to the Market Participant by the client who has deposited funds into the Client Funds Account.

Rule 14.10.2 specifically allows for a participant to withdraw surplus monies previously deposited in a Client Funds Bank Account, provided that Client Funds held exceeds and will continue to exceed outstanding obligations

For the avoidance of doubt, payment of funds from a Client Funds Account for any purpose not listed above is a breach of the Rules, regardless of whether surplus Market Participant funds are held in that account. For example, a Market Participant Accepting Client Assets must not pay for business expenses from surplus Market Participant cash retained in a Client Funds Bank Account.

NZX Regulation recognises that mixed remittances to a Client Funds Account may occur. A mixed remittance is where a party may pay a combination of Client Funds and operational remittances into a Client Funds Account in a single payment. Where mixed remittances are identified, the Market Participant

Accepting Client Assets must transfer such operational monies to its own bank accounts within 24 hours. In the normal course of events, a Client Funds Account should not be used to receive operational income.

PROTECTION OF CLIENT ASSETS

“14.5.2 Each Market Participant Accepting Client Assets must protect Client Assets from the time of the receipt of those funds. Each Market Participant Accepting Client Assets obligations in relation to Client Funds are not discharged until:

- (a) That client has received clear funds from the Market Participant Accepting Client Assets; or*
- (b) The legal title of the Securities has been registered into that client’s name on the Issuer’s Securities Register.”*

The calculation of Outstanding Obligations must include unpresented cheques, as the obligation is not discharged until clear funds are received by the client. Similarly where transfer of title is being done via a securities transfer form, until the clients name is on register.

APPENDIX I – RECONCILIATION TEMPLATE

Client Funds Reconciliation Format

	NZD	AUD	USD	GBP	Total NZD
Client Assets Held					
Client Fund Cash Balances	x	x	x	x	xxxx
Cash Transfer	x	x	x	x	xxxx
Items in FASTER Transfer Account	x				xxxx
P1 Total Client Assets Held	xxx	xx	xx	xx	xxxx
Outstanding Obligations					
Items as per Client Funds Report	xx	x	x	x	xxx
Other Client Assets Held	x	x	x	x	xxx
P2 Total Outstanding Obligations	xxx	xx	xx	xx	xxx
P3 Surplus					x
Exchange Rates					
	NZD				
	AUD				
	USD				
	GBP				

APPENDIX II – PRESCRIBED WORDING FOR INCLUSION IN BANK TRUST LETTERS

“Re Bank Account XX-XXXX-XXXXXXXX-XXX

We acknowledge that in accordance with NZX Participant Rule 14.7.1, the above bank account is designated as a “Client Funds Account”.

- This is a trust account for the benefit of clients of XXXX and the bank is not entitled to combine the account with any other account(s), or to exercise any right of set-off or counterclaim against the money in this account in respect of any sum owed to it on any other account of XXXX, or that of any other person; and
- The title of the accounts sufficiently distinguishes the account from any other account that belongs to XXXX”.