## Summary





# GUIDANCE NOTE GN0003/04 – CAPITAL ADEQUACY

## Introduction

This Guidance Note is published to assist Market Participants Requiring Liquid Capital to interpret those NZX Participant Rules (**Rules**) that relate to capital adequacy.

Under **Section 1** of the **Rules** a Market Participant Requiring Liquid Capital is defined as:

> *"A Market Participant who must comply with the Liquid Capital requirements of Section 15 of these **Rules** as set out in Section 2 of these **Rules**".*

Liquid Capital means:

> *"the sum of Current Assets, reduced in accordance with the risk based provisions of Section 15, less Gross External Liabilities".*

Current Assets is defined in **Rule 15.2** and includes, among other things, and subject to certain parameters, subordinated loans and guarantees. External Liabilities is defined in **Rule 15.3** External Liabilities encompasses all liabilities (current and term, including contingent liabilities), but excludes the Market Participant Requiring Liquid Capital's own equity

## Background

NZX Firms (as they were known) were required under the NZX Business Rules and Regulations (Regulations) to meet a prescribed level of Liquid Capital. One of the primary reasons for the redrafting of the **Rules** was to bring the rules regulating the markets provided by NZX into line with international standards. The Liquid Capital requirements of the Regulations was a specific area which required redrafting to bring the NZX's market rules into line with international practice.

Under the **Rules** a Market Participant Requiring Liquid Capital must establish in-house policies and rules which monitor the capital level of a Market Participant Requiring Liquid Capital's Broking Business to ensure that that it complies with the capital requirements of the **Rules**.

It is important to note that a Market Participant Requiring Liquid Capital must at all times (intraday and overnight) maintain its Liquid Capital at or above the prescribed level.

## Reporting – Monthly

Under **Rule 15.9.5** a Market Participant Requiring Liquid Capital is required to provide NZX on a monthly basis the following documents:

(a) Trial Balance summary in the format of an NZX FF1 Report;

(b) Liquidity statement in the format of an NZX FF2 Report; and

(c) An internal control checklist of all of the Market Participant Requiring Liquid Capital's in-house monitoring, reconciliation's and Liquid Capital. This internal control checklist must be signed by the Managing Principal or the Responsible Executive of that Market Participant Requiring Liquid Capital.

The documents required for monthly reporting help to determine the following liquid capital indicators for a Market Participant Requiring Liquid Capital:

(a) Actual Liquid Capital; and

(b) Prescribed Liquid Capital.

**Rule 16.18** provides for a late filing fee as determined by NZX from time to time for a Market Participant failing to supply, by the specified date, any returns or records required by NZX under these Rules.

**Actual Liquid Capital** is the amount of Liquid Capital (as determined under the **Rules**) that is held in the Market Participant Requiring Liquid Capital's Broking Business for meeting their commitments and is calculated in Part 2 of the NZX's FF2 Report.

**Prescribed Liquid Capital** is the minimum Liquid Capital level required by a Market Participant Requiring Liquid Capital to conduct business in the markets provided by NZX and is linked to the Gross External Liabilities of that participant's Broking Business. For the purpose of the Rules and Part 3 of the NZX's FF2 Report the Prescribed Liquid Capital of a Market Participant Requiring Liquid Capital is:

(a) For a Market Participant Requiring Liquid Capital which has been a Market Participant Requiring Liquid Capital for a consecutive period of **12 months or more**; the sum of:

(i) $100,000;

(ii) 5% of Gross External Liabilities; and

(iii) 5% of the outstanding net underwriting, sub-underwriting or firm allocation value; or

(b) For a Market Participant Requiring Liquid Capital which has been a Market Participant Requiring Liquid Capital for a consecutive period of **less than 12 months**; the sum of:

(i) $250,000

(ii) 5% of Gross External Liabilities; and

(iii) 5% of the outstanding net underwriting, sub-underwriting or firm allocation value.

## (A) Trial Balance Summary – NZX's FF1 Report

A Trial Balance Summary contains data obtained directly from the Market Participant Requiring Liquid Capital's in-house back-office accounting system. The summary incorporates the balances of all accounts in their "raw" state (i.e. in the currency the transaction took place in) and presents those balances in New Zealand dollars using the exchange rate at the reporting date of the FF1 Report.

## (B) Liquidity and Equity Statement – NZX's FF2 Report

The NZX's FF2 Report is broken into the following 7 parts:

(1) Part 1: Trial Balance;

(2) Part 2: Calculation of Actual Liquid Capital;

(3) Part 3: Calculation of Prescribed Liquid Capital and resulting surplus;

(4) Part 4: Adjustments in assessing Liquid Capital;

- (i) Adjustments to Current Assets; and
- (ii) Adjustments to Current Liabilities;

(5) Part 5: Movements in Retained Earnings;

(6) Part 6: Underwriting/sub-underwritings/firm allocations;

(7) Part 7: Log of Client Funds Accounting and Log of Liquid and Prescribed Capital.

### *(1) Part 1: Trial Balance*

Part 1 of the FF2 Report takes the New Zealand dollar equivalent data from the FF1 Report and categorises it into Current, Non-Current or Equity.

It is important to note that Client and Advisor balances in the FF1 and FF2 must be recorded as "gross" amounts and not netted-off, except where there is a legal right of set-off. This principle also applies to all other debit and credit items in Part 1. As a result, while including items under a particular account heading, a Market Participant Requiring Liquid Capital must ensure that items can be netted-off only in cases where there is a sufficient legal basis reason for the netting and the netting meets with the relevant accounting standard.

### *(2) Part 2: Calculation of Liquid Capital*

Part 2 relates to the calculation of Liquid Capital as required under the **Rules** (i.e. Adjusted Current Assets less Adjusted Current Liabilities). For details about the calculation of Adjusted Current Assets and Adjusted Current Liabilities refer to Part 4.

### *(3) Part 3: Prescribed Liquid Capital and the surplus of Actual Capital over Prescribed Liquid Capital*

(i) Prescribed Liquid Capital is the minimum capital level required by a Market Participant Requiring Liquid Capital to conduct business in a market provided by NZX and is linked to the Gross External Liabilities of that participant's Broking Business. For the purpose of the **Rules** and Part 3 of the NZX's FF2 Report the Prescribed Liquid Capital of a Market Participant Requiring Liquid Capital is:

(a) For a Market Participant Requiring Liquid Capital which has been a Market Participant Requiring Liquid Capital for a consecutive period of **12 months or more**; the sum of:

(i) $100,000;

(ii) 5% of Gross External Liabilities; and

(iii) 5% of the outstanding net underwriting, sub-underwriting or firm allocation value; or

(b) For a Market Participant Requiring Liquid Capital which has been a Market Participant Requiring Liquid Capital for a consecutive period of **less than 12 months**; the sum of:

(i) $250,000

(ii) 5% of Gross External Liabilities; and

(iii) 5% of the outstanding net underwriting, sub-underwriting or firm allocation value.

(ii) Liquid Capital Surplus is determined by deducting the Prescribed Liquid Capital in accordance with (i) above from the Liquid Capital as required under the **Rules** in Part 2. The **Rules** place an obligation on the Market Participant Requiring Liquid Capital to inform NZX in the event that its Liquid Capital falls below 120% of its Prescribed Liquid Capital level.

*(4) Part 4: Adjustments in Assessing Liquid Capital*

Part 4 is a worksheet used to calculate the risk-based adjustments (Haircuts) necessary in assessing a Market Participant Requiring Liquid Capital's Liquid Capital. These adjustments are broken into (i) adjustments to Current Assets and (ii) adjustments to Current Liabilities.

(i) Adjustments to Current Assets

Risk-based adjustments are detailed in **Rule 15.6**. Reference should also be made to **Rule 15.2(b)** which lists specific assets, which must be excluded from the Current Assets calculation.

The underlying principle of these adjustments is to determine whether there is a sufficient element of liquidity in the balance sheet of the Market Participant Requiring Liquid Capital. Even though an item may meet the definition of Current Assets under Generally Accepted Accounting Practice, it may need to be reduced/eliminated from the Current Assets in the FF2 Report if there is no ready market for that item or that item cannot be easily liquidated.

Any receivables outstanding for more than 10 Business Days from clients will be subject to a 100% risk based reduction from Current Assets. Similarly, receivables from related parties if included in the Current Assets would have to be reduced in the adjustments in Part 2 of the FF2 Report.

For all other cases and in **cases where there is any doubt as to whether a risk-based reduction is necessary the following test should be applied:**

*Do the Rules provide for a specific reduction in this Current Asset?*

If the answer is "Yes" the Market Participant Requiring Liquid Capital needs to take the Haircut from the Current Asset.

*Can this current asset be converted into cash in the next 10 Business Days?*

If the answer is "No" then the Market Participant Requiring Liquid Capital needs to take a 100% reduction from the Current Asset as that item fails the liquidity test.

**If there is still some doubt, the matter should be referred to NZX for consideration.**

(ii) Adjustment to Current Liabilities

Gross External Liabilities include current, long term and contingent liabilities. They do not include shareholder funds (paid-up capital, retained earnings or subordinated loans).

The net level of any underwriting or firm allocation commitments of a Market Participant Requiring Liquid Capital must be added to its Gross External Liabilities in addition to any contingent liabilities. For example if a Market Participant Requiring Liquid Capital has legal proceedings against it, where the decision could lead to financial liabilities, it should add the expected value of these liabilities to the Gross External Liabilities. Where the value of such claims cannot be easily quantified NZX will determine the appropriate amount (if any) that should be added to the Market Participant Requiring Liquid Capital's Gross External Liabilities.

*(5) Part 5 Movements in Retained Earnings*

Part 5 of the NZX's FF2 Report presents the profit or loss recorded for the reporting month, along with any adjustment movements which have a material affect (e.g. dividends paid). Where the Opening Balance of Retained Earnings for the reporting month does not equal the Closing Balance of Retained Earnings per the previous months FF2 Reports, the difference between the two figures should be reconciled and explained in the current return.

*(6) Underwriting/Sub-Underwritings/Firm Allocations*

Part 6 of the NZX's FF2 Report provides details of the net underwriting/sub-underwriting/firm allocation commitments undertaken by a Market Participant Requiring Liquid Capital. It is important to note how these commitments are accounted for in the FF2 Report.

The net level of these commitments must be added to the liabilities section of the FF2 Report. This has the effect of increasing the level of Prescribed Liquid Capital by 5% of the net underwriting/sub-underwriting/firm allocation commitment outstanding at the time of the Liquid Capital calculation. To off-set this, the net level of the commitments can be added (if appropriate) to the Shares in the Listed Companies section of the FF2 Report, although this will be subject to the risk based reduction contained in Part 4 in the Report.

It is important to note that in an underwriting/firm allocation a Market Participant Requiring Liquid Capital's commitment is deemed to be applicable from the point in time that participant signs an undertaking/contracts to take on that commitment. The appropriate risk based reductions must be taken by that Market Participant Requiring Liquid Capital from that point onwards.

The following is an example of how underwriting commitments should be treated in the FF2 Report:

**Assumptions:**

Current Assets (before underwriting) are $3,500

Gross External Liabilities (before underwriting) are $3,000

The Market Participant is a Market Participant Requiring Liquid Capital (and has been for greater than 12 consecutive months) and has a net underwriting commitment of $600 in a company which is expected to be ranked between 16 and 50 in the NZSX50 Index, which will require a risk based reduction of 10%.

| | **Before** | Underwriting Adjustment | **After** |
|---|---|---|---|
| Current Assets | 3500 | 600 | 4100 |
| Adjustments: | | | |
| Underwriting | | | -60 |
| Adjusted Current Assets | 3500 | | 4040 |
| GEL | -3000 | -600 | -3600 |
| Liquid Capital Per Rules | 500 | | 440 |
| Prescribed Capital | 250 | | 280 |
| Liquid Capital Per Rules | 500 | | 440 |
| Liquid Capital Surplus | **$ 250** | | **$ 160** |

The difference between the Before and the After amounts (i.e. $90) is made up of the risk based adjustment (Haircut) on the underwriting commitment (i.e. $60 – being $600 x 10%) and the increase in the level of Prescribed Capital (i.e. $30 – being $600 x 5%)

*Part 7: Log of Client Funds Accounting and Log of Liquid and Prescribed Capital*

(1) Client Funds accounting (CFA) Log

The CFA Log records the daily level of Client Assets, Outstanding Obligations and the Surplus/Shortfall during the reporting month.

(2) Liquid Capital Log

The Liquid Capital Log records the daily levels of Actual Liquid Capital, Prescribed Level of Liquid Capital and the Liquid Capital Surplus expressed as a percentage of the Prescribed Liquid Capital during the reporting month. This should be greater than 120% at **all times.** If the Liquid Capital Surplus at any time falls below a threshold of 20% in excess of the Prescribed Level, the Market Participant Requiring Liquid Capital **must** notify NZX immediately.

## Reporting – Daily

Market Participants Requiring Liquid Capital are also required under **Rule 15.9.1** to:

(a) Provide NZX with a full calculation of its prescribed and actual Liquid Capital levels on a daily basis for each Trading Day. Daily Liquid Capital calculations must be filed with NZX no later than 11am on each Trading Day for the close of the previous Trading Day and must be in the format of an NZX FF3 Summary Report; and

(b) Provide a Principal Position Report in support of the FF3 which must be generated each morning for all open principal positions for the close of the previous Trading Day and must include for each principal position:

(i) All securities;

(ii) Long and short positions held by the Market Participant Requiring Liquid Capital;

(iii) Contract price; and

(iv) The mark to market value of the Market Participant Requiring Liquid Capital's principal position.

Daily returns must be provided to NZX on each Trading Day irrespective of regional Anniversary Day holidays in New Zealand or public holidays in other countries, unless otherwise agreed in advance with NZX.

## Current Assets and Subordinated Loans - 50/50 Ratio

A new requirement under the **Rules** relates to a limit on the aggregation of a Market Participant Requiring Liquid Capital's calculation of its Current Assets and subordinated loans and prevents them from exceeding a ratio of 50/50 of the Market Participant Requiring Liquid Capital's Current Equity.

**(1) The calculation of Current Assets**

**Rule** 15.2 states that

> "C*urrent Assets means all current assets of a Market Participant Requiring Liquid Capital … … provided that the aggregate of assets calculated in accordance with* ***Rule*** *15.2(a)(i) and (ii) does not exceed the ratio of 50/50 of the Market Participant Requiring Liquid Capital's Current Equity unless the aggregate of assets calculated in accordance with* ***Rule*** *15.2(a)(i) and (ii) is for a loan, guarantee, bond, facility or arrangement for a period of 3 months or less and for a specific transaction of that Market Participant Requiring Liquid Capital's Broking Business and that Market Participant requiring Liquid Capital has been granted a waiver …"*

It is in NZX's complete discretion as to whether a waiver from the requirements of **Rule** 15.2 will be granted. Furthermore it is important to note that as part of any waiver granted NZX may require a Market Participant Requiring Liquid Capital to apply any additional risk based reduction that NZX considers in its complete discretion as reasonable and appropriate.

**(2) Subordinated Loans**

**Rule** 15.5 (and specifically **Rule** 15.5.3) limits the aggregate value of subordinated loans of a Market Participant Requiring Liquid Capital to no more than a ratio of 50/50 of the Market Participant Requiring Liquid Capital's Current Equity. A Market Participant Requiring Liquid Capital may request a waiver from the requirements of **Rule** 15.5 under **Rule** 15.10.

Current Equity is defined as:

> *"the sum of a Market Participant Requiring Liquid Capital's shareholder funds and reserves (including retained earnings)".*

## Valuation of Positions

The **Rules** do not directly address the valuation of securities or financial instruments and accordingly NZX wishes to provide some guidance as to how a Market Participant Requiring Liquid Capital should approach valuations.

Market Participants Requiring Liquid Capital must value a position at the closing market price for that security or financial instrument. Where a security or financial instrument is illiquid, it is suggested that that security or financial instrument be valued at its current Bid price (long position) or at the security's or financial instrument's current Offer price (short position). Positions must be valued on a prudent and consistent basis having regard to the liquidity of the securities or financial instrument concerned and any special factors that may adversely affect the closure of the position. Where there is uncertainty as to the most appropriate price to take into consideration, a Market Participant Requiring Liquid Capital should use the price giving the most conservative valuation for the security or financial instrument.

If a Market Participant Requiring Liquid Capital is also a Market Maker it should use its own Bid or Offer prices. In this instance the Market Makers own price should generally reflect its exposure to the market as a whole and its view on the future pricing of the security or financial instrument. The valuation in such circumstances should be the most prudent. If the Market Participant Requiring Liquid Capital is solely a Market Maker then the Bid or Offer price used for a valuing a security or financial instrument must be the most prudent in all circumstances.

## Approval for Temporary Non-Compliance

If a Market Participant Requiring Liquid Capital is unable to comply with the Liquid Capital requirements **Rules 15.8.1** and **15.1.2** it may request a waiver under **Rule 15.10** for a particular transaction. It is important to note that when applying for a waiver under **Rule 15.10** it is important to provide NZX Compliance with the full details of the proposed transaction and the involvement of the Market Participant Requiring Liquid Capital in that transaction. For example information could include:

(a) The maximum $ commitment;

(b) In the case of an underwrite or firm allocation, what actions have been taken to assess client demand;

(c) Actions being taken to assess credit worthiness of large client counterparties to deliver stock or cash

(d) Details of current outstanding firm allocations/underwriting for other securities. This should include the security, amount originally allocated, and amount remaining outstanding at the time the application is made;

(e) A revised FF2 (parts 1 to 4 i.e. trial balance, ALC calculation, PLC calculation, and risk reduction calculations) for the previous day reflecting the position bid for and the resulting ALC/PLC ratio;

(f) Any other information considered relevant in order for NZX to assess the application.

It is also important to note that it should not be assumed that a wavier from **Rules 15.8.1** and **Rule 15.1.2** will be granted in every situation. Approval for non compliance with **Rules 15.8.1** and **15.1.2** must be obtained before a Market Participant Requiring Liquid Capital makes a firm commitment to be involved in a particular transaction that will result in that participant not meeting it's liquid capital obligations under the **Rules**.