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Disclaimer

This Guidance Note has been issued by NZX to promote market certainty and to assist Market Participants. It sets out NZX's general approach to the interpretation of the NZX Participant Rules, but is not to be regarded as a definitive statement of the application of the Rules in every situation. NZX may replace Guidance Notes at any time and a Market Participant should ensure it has the most recent version. This does not constitute legal advice. NZX recommends that Market Participants take advice from qualified persons.

GUIDANCE NOTE GN0001/04 – KNOW YOUR CLIENT: SECTION 9

Introduction

This **Guidance Note** is published to provide guidance to Client Advising Participants in the interpretation of those **NZX Participant Rules (Rules)** that relate to obtaining the required client information under **Section 9** of the **Rules**.

Under **Section 1** of the **Rules** a Client Advising Participant is defined as:

...any Market Participant that provides investment advice and/or Securities recommendations to a client and may be responsible for that client's assets at any time and includes:

- (a) *An NZX Trading and Advising Firm;*
- (b) *An NZX Advising Firm;*
- (c) *A Bank Only Participant; and*
- (d) *Any Approved Organisation designated and approved as a Client Advising Participant from time to time by NZX pursuant to Rule 3.18*

In this Guidance Note we will cover the obligations of the “know your client” **Rules**, briefly look at the obligations of financial institutions under the Financial Transactions Reporting Act 1996, Discretionary and Hold Mail Accounts and client agreements.

Background

Rules in relation to “know your client” have been compulsory under the NZX Business Rules and Regulations (the Regulations) since 1997 and were introduced as a result of the client verification obligations under the Financial Transactions Reporting Act 1996.

During the drafting of the **Rules** introduced in 2004, one of the main areas of concern was the Regulations in relation to “know your client” and in particular the concern that a number of Market Participants were not meeting the requirements of the **Rules**. Another area of concern was the fact that the Regulations did not significantly address the different types of clients (e.g. a natural person vs. a company) and the information required from each of those different clients. As a result of this a significant amount of time was spent during the drafting process on ensuring that a standard and thorough set of minimum “know your client” rules were established that addressed the concerns of both the market and NZX.

These know your client rules have been further amended in the 2007 Rule Review to provide greater certainty and correct anomalies found through implementation of the 2004 Rule amendments.

(a) Purpose of Know Your Client Obligations

The purpose of **Section 9** is to ensure that all Client Advising Participants know their clients which will in turn:

- (a) Assist a Client Advising Participant in providing investment advice (where given) that meets the investment objectives and requirements of a client;
- (b) Reduce the likelihood of money laundering through the Client Advising Participant;
- (c) Reduce the likelihood that the Client Advising Participant will be a victim of fraud; and
- (d) Provide a layer of protection for the investing public against possible fraudulent activities.

Section 9 provides a set of minimum requirements that a Client Advising Participant must undertake before transacting business on behalf of a client. Providing a set of minimum requirements provides a minimum compliance standard that all Client Advising Participants must adhere to.

Section 9 is not an exhaustive list of the types of information a Client Advising Participant may wish to obtain from a client. Client Advising Participants are encouraged to obtain from their clients any additional information it considers beneficial to providing its clients with investment advice.

Section 9 of the **Rules** does not prescribe steps to be followed in respect of the identity of an Institutional Client. However, appropriate steps must be undertaken in relation to an Institutional Client under the Financial Transactions Reporting Act 1996.

(b) Financial Transactions Reporting Act 1996

Section 9 should be seen by Client Advising Participants as a supplement to their obligations under the Financial Transactions Reporting Act 1996 (the Act). New Zealand financial institutions (including Client Advising Participants) are required by the Act to:

- (a) Have procedures and systems in place to deter money launderers from using it as a conduit for their illegal activities;
- (b) Identify and report any suspicious transaction to the New Zealand Police Financial Intelligence Unit (NZPFIU); and
- (c) Keep an audit trail for use by any subsequent investigation into money laundering offences.

In addition to reading this **Guidance Note GN0001/04** the “Good Practice Guidelines for Financial Institutions” published by the NZPFIU in February 1997 contains a useful summary of the key obligations for compliance with the Act. (Refer to: <http://www.police.govt.nz/service/financial/guidelines.html>).

Penalties under the Act include:

- (a) A fine of up to \$20,000 (individuals) or \$100,000 (corporate) for failing to verify a client’s identity or to report suspicious transactions under the Act;
- (b) Fines as outlined in paragraph (a) for failing to keep records evidencing a client identity or transaction (irrespective of whether they involve cash);

- (c) A maximum of 2 years imprisonment for “tipping off” an individual on a potential investigation; and
- (d) A fine of up to \$10,000 for submitting false information or knowingly misleading reports to the New Zealand Police.

It is important to note that Client Advising Participants, Managing Principals and Responsible Executives are vicariously liable for the actions of their employees and agents.

NZX strongly advises that all Client Advising Participants and their employees remain conscious of their obligations under the Act when it comes to transacting business on behalf of a client.

Verifying Client Identity

Client Advising Participants must take all reasonable steps to ensure that the information received from a prospective client is genuine information. **Section 9** requires Client Advising Participants to verify the identity of a client from document(s) or information obtained from or relating to a reputable and identifiable source (where such information is capable of being obtained) or by way of reference from a reputable and identifiable party.

The type of information required to be obtained from different client types before any business is undertaken is prescribed in the following **Rules**:

- (a) Natural Persons – **Rule 9.2.2**;
- (b) Non-Natural Persons (that are not Trusts) – **Rule 9.2.3**;
- (c) Trusts – **Rule 9.2.4**;
- (d) Intermediaries – **Rule 9.2.5**;
- (e) Winding Up of Estates – **Rule 9.3**; and
- (f) One-Off Sales – **Rule 9.8**.

If a Client Advising Participant cannot obtain adequate authenticated information to verify the identity of the prospective client and source of funds, or if a Client Advising Participant doubts the veracity of the information provided, that Client Advising Participant must not undertake a transaction for that client until such time as the identity of the client can be established and verified.

If a client is reluctant to provide a complete set of information, e.g. reluctant to provide location details or authorised persons on an account, a Client Advising Participant should consider whether the actions of the client are suspicious and whether a report under the Act should be made. If an Advisor of a Client Advising Participant encounters such reluctance on the part of a prospective client he/she should discuss their concerns about that prospective client with that Client Advising Participant’s Compliance Manager.

Where copies of client identification are not retained centrally, they need to be held on a client’s file. Although the **Rules** do not prescribe how long such identification should be retained for, Client Advising Participants should note that the Act requires records to evidence verification of a client’s identity must be retained for at least **five years** from the date at which the relationship with the client ends. Furthermore, transaction records must be retained for at least **five years** after completion of a transaction.

The Act specifies that client records must indicate the nature of the evidence obtained and either comprise a copy of that evidence or such information that would enable that evidence or a copy of that evidence to be obtained or re-obtained. In order to demonstrate that a Client Advising

Participant has gone to **reasonable lengths** to verify the client's identity all documentation obtained to verify identity must be legible. Poor quality scanned or photocopied documents will not be acceptable for the purpose of new account opening. For example, blacked out passport or drivers licence photos are not acceptable.

In addition, Client Advising Participants must satisfy themselves that the documents they obtain to verify a client's identity are valid and genuinely relate to the account applicant.

In line with the FIU guidelines, NZX strongly recommends that Client Advising Participants only accept either:

1. Obtain certified copies of the documentation used to verify the identify of clients; and/or
2. Sight original documents and then make photocopies of those original documents for the Client Advising Participant's records.

Certified copies are photocopies that have been stamped and endorsed by a person who certifies that the copy is a true copy of the original. NZX expects that the person who certifies the copy would be a Justice of the Peace, a lawyer, or a court official. A signature is required on the document with the name and title of the certifier shown legibly below their signature.

A situation may arise where a prospective client arrives at a Client Advising Participant's office in person and wants to open an account but does not have two of the prescribed forms of identification. For example, a person may have a current and valid driver's licence and a bank cash card or credit card but not bank identification in the forms prescribed under the Rules. If the driver's licence photo is clearly that of the person in attendance and the signature of both the licence and the bank/credit cards match those of the client's name on the client agreement then, as a practical matter, NZX deems it reasonable in such circumstances for an account to be opened.

Similarly, a person might have bank ID in a prescribed form and photo identification but not hold a passport or driver's licence as required under **Rule 9.2.2(k)**. As outlined below under reference **Rule 9.2.2(k)(iii)**, provided that such a person has at least one other form of suitable identity such as, for example, correspondence from the IRD verifying the person's full name, address and IRD number it would be reasonable in the circumstances for the account to be opened. A Client Advising Participant's Compliance Manager (or a responsible delegate thereof) should **pre-approve** any such exceptions.

Duty of Care – Rule 9.1

Client Advising Participants must act in accordance with **Rule 9.1** at all times. NZX strongly recommends that these duties be appropriately outlined in the Client Advising Participant's client agreement.

Know Your Client Procedures – Rule 9.2

- (a) **Rule 9.2.1(b):** Verification of the information and documents received from a client can be performed internally. If performed internally, best practice dictates that this is done by two different people, that is someone independent from the Advisor or person who collected the information, for example a desk manager, persons responsible for administering new accounts or the Compliance Manager.

- (b) **Rule 9.2.2(a):** The full name of a prospective client must match and be checked against the documents and identification provided by that client.
- (c) **Rule 9.2.2(h):** If a prospective client does not have an IRD number two of the following forms of identification (which must be sighted and copied) will be accepted to apply for a CSN:
- (i) Drivers licence number;
 - (ii) Passport number;
 - (iii) Date of birth; or
 - (iv) Bank account details however the last two forms of identification combined will be insufficient on their own.
- (d) **Rule 9.2.2(j):** Birth certificates are only accepted as a form of identification for clients less than 18 years of age and are an alternative form of identification that may be obtained where the client is unable to provide a copy of one of the forms of photographic identification in Rule 9.2.2(k). As such identification can be readily obtained, Client Advising Participants must satisfy themselves that the document is valid and genuinely relates to the account applicant. A second form of suitable identification should ideally be obtained, for example that of the parent or guardian of the minor. In exceptional cases, when dealing with elderly clients who do not have suitable identification, a copy of the applicant's birth certificate may be accepted as one form of identification. This should be reconfirmed with the Client Advising Participant's Compliance Manager (or a responsible delegate thereof).
- (e) **Rule 9.2.2(k)(i):** If the applicant is an overseas resident additional tests should generally be conducted to ensure validity of the identification documents provided. For example, where a Client Advising Participant wants to confirm bank identification or has reason to doubt the veracity of the information provided it should usually be able to contact the relevant bank and get independent confirmation of the account name and number by citing the information provided by the prospective client. Experience has shown that a bank's fraud unit will usually help if frontline staff cannot. Generally a bank will assist in your enquiries on the basis that you are acting in the account holder's and the bank's best interests.
- (f) **Rule 9.2.2(k)(iii):** The current forms of photo identification recognised by the NZX are as follows:
- (i) current and New Zealand Police issue photo firearms licence;
 - (ii) New Zealand Police photo identity cards;
 - (iii) New Zealand Defence photo identity cards;
 - (iv) credit cards with the cardholder's photo embedded;
 - (v) current and valid national identity card; and
 - (vi) current and valid student identity cards,

Other suitable forms of identification include bank or credit cards with embedded cardholder's signatures, provided that the card holder countersigns their signature against that on the card and the Client Advising Participant is satisfied that the signatures match, and correspondence from the IRD verifying the name, address and IRD number of the account. In both cases the information should be pre-

approved as acceptable by the Client Advising Participant's Compliance Manager (or a responsible delegate thereof).

(g) **Rule 9.2.2(l):** A Client Advising Participant may receive written direction for an individual to act on behalf of a client. Such a written direction can be in the form of a power of attorney, written agreement, application or registration form or a letter, but must be signed (with the original signature provided to the Client Advising Participant) by both the client and the person(s) being granted the authority to transact the business on behalf of that client.

(h) **Rule 9.2.2(n) to (r):** It is not mandatory for a Client Advising Participant to receive the information requested in **Rule 9.2.2(n) to (r)**. A Client Advising Participant must however be aware of its obligation under this **Rule** to seek the information outlined in this Rule from a client (either verbally or in writing) and must keep a record on that client's file of whether or not that client agreed to provide the information requested.

The purpose of requesting the information contained in **Rule 9.2.2(n) to (r)** is to ensure that the advice provided by a Client Advising Participant in relation to the potential acquisition of securities or a financial instrument by a client meets the investment objectives and financial situation of that client.

The obligations of **Rule 9.2.2(n) to (r)** do not apply to execution-only clients.

(j) **Rule 9.2.3:** A Client Advising Participant must take particular care with regard to clients that are private companies (or private partnerships) established in an overseas jurisdiction. The increasing use of shelf companies to conduct money laundering (through providing the means to operate what are in effect anonymous accounts) is a concern for the New Zealand market. A Client Advising Participant should obtain satisfactory evidence of the identity of the beneficial owners, directors and authorised signatories of shelf companies. Primary reliance should be taken on such accounts with verification of bank identification provided by a Financial Action Task Force member country. In these cases NZX recommends that a Client Advising Participant's Compliance Manager or designate of that Compliance Manager should pre-approve or review all applications by prospective clients who are resident overseas.

(k) **Rule 9.2.3(h)(iv):** The full legal names of officers or persons authorised to place orders and give instructions on an account should be included in a client agreement.

(l) **Rule 9.2.3(i):** A copy of the relevant pages of the partnership deed or a copy of the partnership certificate must be obtained from a client if that client is a partnership. The partnership certificate must confirm the names and signatures of the partners authorised to act on behalf of the partnership.

(m) **Rule 9.2.4:** Trusts are regarded as potentially problematic situations, especially when the trusts are domiciled in poorly regulated countries. As a general rule, caution should be exercised along similar lines to those described at **Rule 9.2.3** above.

- (n) **Rule 9.2.4(a):** All Trustees must provide documentary evidence of identification. There are two exceptions to this:
1. When the Client Advising Participant has evidence that only certain Trustees are authorised to effect instructions, then only those Trustees are required to provide identification; and/or
 2. The Trustee is a Trustee Company as defined in the Rules.

Client Advising Participants must still ensure they comply with the Act at all times.

- (n) **Rule 9.2.5:** There are many legitimate reasons for the use of an intermediary. However any apparent unnecessary use of an intermediary in a transaction should give rise to further inquiry by a Client Advising Participant. A Client Advising Participant should take careful note of the verification of identity steps that must be performed in respect of a client who is an intermediary and the underlying investors.

For clarification, if a person does not provide a Client Advising Participant with its e-mail address (either because it does not have one or does not want to be contacted via e-mail) as required to be requested and recorded pursuant to **Rules 9.2.2(f) and 9.2.3(e)**, that Client Advising Participant is not prevented from setting that person up as a client and undertaking a transaction for that client.

With the exception of Rule **9.2.2(n) to (r)** as discussed above, it is important to note that the **Rules** do not distinguish a client by the services requested. For example, the same information is required to be obtained for a client under **Rule 9.2** regardless of whether the client is requesting the execution of a trade only or requesting advice on investing from the Client Advising Participant.

Intermediary or Institutional Relationships

Rules 9.2.5 outlines the “know you client” obligations for relationships between Client Advising Participants and intermediaries.

NZX is aware that in some situations a client may potentially fit within the definitions of an intermediary and that of an Institutional Client. For example, a situation may arise if a client is a custodian company acting for an intermediary which may be treated for the purpose of the **Rules** as either an intermediary or an Institutional Client. How a custodian company is treated for the purpose of the **Rules** will depend on the relationship that custodian company has with a Client Advising Participant and its Advisors. If the client relationship is limited to a relationship between the Client Advising Participant and the custodian company then that custodian company may be treated as an Institutional Client for the purpose of the **Rules**. On the other hand, if the relationship extends to include a Client Advising Participant, a custodian company and an underlying intermediary then that custodian company should be treated as an intermediary client pursuant to **Rule 9.2.5**. NZX would deem a relationship between a Client Advising Participant and a custodian company which involves a Client Advising Participant’s Advisors having direct and regular contact with the underlying intermediary as an intermediary relationship for the purpose of the **Rules**.

NZX does not propose to outline each different relationship that may arise between a Client Advising Participant and an intermediary. In each situation it is the responsibility of the Client Advising Participant to determine how a client is to be treated for the purpose of the **Rules**. It is strongly suggested that in such situations of uncertainty that a Client Advising Participant’s

Compliance Manager (or responsible delegate thereof) record the reasons supporting a Client Advising Participant's decision on the treatment of a client for the purpose of the **Rules**.

NZX considers that a Client Advising Participant either has a relationship with an intermediary or a direct relationship with an underlying client of an intermediary. Accordingly, there is one set of rules outlining the requirements for an intermediary. Where a Client Advising Participant transacts any business for or on behalf of an underlying client/receives instructions for an underlying client, the Rules apply to that client as a client of the Client Advising Participant. In other words, the Client Advising Participant must perform know your client on that underlying client.

Reliance on Group Records – Rule 9.2B

NZX recognises that there may be situations where a Client Advising Participant is a part of a Group structure that includes another company (e.g. a bank) that has already verified a potential client's identity in accordance with the Act. Rule 9.2B allows a Client Advising Participant to rely upon the records and other information maintained by another member of its Group to satisfy all or part of the Know Your Client requirements set out in Rule 9.2. This is subject to certain conditions, namely:

- (a) The information relied upon is capable of satisfying the relevant requirements of Rule 9.2 as if the information had been obtained, recorded or requested directly by the Client Advising Participant; and
- (b) The Client Advising Participant is able to:
 - (i) Readily access the information; and
 - (ii) Readily procure access to the information to NZX in accordance with the requirements of the Rules.

The information must either comprise a copy of the documents used to verify the client's identity or such information that would enable those documents or a copy of those documents to be obtained or re-obtained.

Winding Up Estates – Rule 9.3

Rule 9.3.5 requires all monies received from the sale of a deceased person's Securities (minus any reasonable brokerage) to be paid into the estate of that deceased person or to the trust account of the solicitor for the estate of that deceased person. Client Advising Participants will meet the obligations of Rule 9.3.5 by making a cheque out to the deceased person's estate or solicitor for the estate, crossing that cheque as non-transferable and mailing it to the address of the person(s) authorised to wind up the estate; or by paying the sale proceeds by direct credit into the bank account of the deceased person's estate or trust account of the solicitor.

Discretionary Accounts – Rule 9.4

What is Discretion?

Discretion is exercised where a Client Advising Participant has full authority to manage an account or portfolio and undertake transactions for the client of that account without prior reference, or direction from, that client.

Rule 9.4 requires a written authority to act to be signed and received from a client before discretion is exercised in the manner described above. The account parameters are set on the basis of the written authority to act and any directions outlined in that authority.

This requirement for a written authority applies even where discretion is exercised on a limited basis (e.g. where you are unable to contact a client concerning his or her account or where the client is away overseas).

Under Section 1 of the Rules a Discretionary Account is defined as:

...an account for which a Client Advising Participant buys and/or sells Securities and/or undertakes other transactions without prior reference to the client;

What is not “Discretionary”?

Exercising discretion in the above manner should not be confused with a situation where an NZX Advisor speaks to a client about a particular order and suitable authority is given by the client pursuant to **Rule 11.3** for that NZX Advisor to exercise his or her discretion as to when to execute an order. In such situations, the client has given a specific buy/sell instruction subject to the NZX Advisor’s judgment and discretion when to put that client’s order to market.

Beware of “loose” arrangements

Care must be taken to avoid situations that involve “loose” arrangements, which might lead to situations where an NZX Advisor exercises discretion without the required written authority. As well as breaching the **Rules**, the danger is that a client can dispute transactions that do not benefit that client at any time or claim that some or all of the trades undertaken by the Client Advising Participant on behalf of the client are unauthorised. This would leave the NZX Advisor and Client Advising Participant heavily exposed.

For example, when an NZX Advisor discusses strategy or ideas with a non-discretionary client, the NZX Advisor may believe that the client expects him/her to undertake various transactions at their discretion, without giving clear buy/sell instructions. Do not do so. If there is any expectation from the client as to the Client Advising Participant acting without specific instructions or exercising general discretion, a Discretionary Authority must be put in place before proceeding.

Portfolio valuations

NZX recommends that valuations not be produced manually or using software outside of the Client Advising Participant’s primary valuation system.

Discretionary client acting in execution only capacity

Situations may arise where a client who receives a full discretionary service decides to make his/her own investment decisions and gives instructions on the account, and by doing so may decline a Client Advising Participant’s recommendation or advice in relation to the particular transaction. If this happens regularly or it involves transactions that go against the Client Advising Participants account management policies, thus making the account difficult to manage, NZX recommends that a Client Advising Participant considers whether it is appropriate to continue running a discretionary account for that client. Before making such a decision NZX recommends that NZX Advisors speak to their desk manager or Compliance Manager for assistance.

NZX recommends that a record be kept to distinguish between discretionary transactions undertaken by an NZX Advisor on a client’s discretionary account and transactions where the client gives a direct instruction for its account. Where a direct client instruction is received to undertake a particular trade, even where advice is given in relation to that trade, an NZX Advisor needs to explain to the client that the Client Advising Participant will only accept the order on an execution-only basis. To evidence this fact a written record of the conversation should be made (for example if an order ticket is used a record of the conversation should be made on that order ticket and the ticket should be marked “execution-only”).

Rule 9.4.3 requires Discretionary Accounts to be designated as such and separated from any other non-Discretionary Accounts held by a Client Advising Participant for that client, any of its other clients or its Principal Accounts.

Time Period for Hold Mail Accounts – Rule 9.5.2(e)

Rule 9.5.2(e) does not prescribe a maximum period for which a hold mail account may be maintained for a client. However, NZX recommends that a hold mail account for a client should generally not be open for a period longer than 2 years.

During the period a hold mail account is open Client Advising Participants should provide (wherever practical to do so) a periodic report (which may be via e-mail) to the client for whom a hold mail account is held outlining the information contained in that client's account. NZX has not prescribed the exact content of the report or how often such a report should be provided to a client. Each Client Advising Participant will be expected to consider the specific requirements or requests of a client and to report to that client accordingly.

Client Agreement – Rule 9.6.3

Under **Rule 9.6.3** all new and existing clients of a Client Advising Participant must enter into a client agreement with that Client Advising Participant before transacting any trade on behalf of the client. The purpose of a client agreement is to ensure that the instructions of the client are recorded and the terms of business and specific activities of a Client Advising Participant in advising and facilitating a trade for a client are highlighted and agreed by both parties.

Such client agreements must outline the terms of business between the client and the Client Advising Participant and must be consistent with the requirements and obligations of the **Rules**.

For existing clients who already hold signed agreements, the Client Advising Participant is not required to enter into a new client agreement, but must provide the client (where appropriate) with a written update of the changes to the terms and conditions of those agreements as a result of the **Rules**.

An existing client is deemed by NZX to be an individual or entity who has been a client of a Client Advising Participant since **1 January 1999**. Although NZX recommends that all Client Advising Participants enter into client agreements with each of their clients, irrespective of when that individual or entity became a client of that Client Advising Participant, to meet the minimum requirements of **Rule 9.6.3** a client obtained prior to 1 January 1999 is not required to enter into a client agreement.

If an existing client agreement allows for the notification of changes to the terms and conditions of an existing client agreement by specific means as outlined in that client agreement then Client Advising Participants may inform its clients of changes to terms and conditions of existing client agreements in accordance with that agreement. For example, a client agreement may specify that notification of changes to the agreement will be done within 14 days of the intended implementation of the changes and notification may be by way of a newspaper advertisement.

NZX recognises the increasing use of the internet for means of affecting commerce as allowed under the Electronic Transactions Act 2002. However, NZX is concerned about the possibility of fraud by Client Advising Participants receiving client agreements via the internet or e-mail. NZX strongly recommends that Client Advising Participants obtain all original client agreements appropriately executed in ink. For the avoidance of doubt, a Client Advising Participant may obtain

a copy of an executed client agreement by fax and obtain the original copy of that client agreement at a later date.

Institutional Clients are exempt from entering into a client agreement under **Rules 9.6** and **9.7**. This reflects current practice in Australia. However, NZX recommends as a matter of best practice that Client Advising Participates enter into written agreements with Institutional Clients outlining both parties' obligations.

Existing Clients

The obligations of **Rule 9.2** relate to the procedures and resulting records kept on clients from the introduction of the **Rules** on 3 May 2004. NZX does not require Client Advising Participants to ensure that their existing records meet the obligations of **Rule 9.2** for clients established prior to 3 May 2004. However, each Client Advising Participant should ensure that its client records meet the legal requirements of the Act from the introduction of that Act (1 August 1996). NZX would be concerned if client records did not meet these legal obligations.