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**Disclaimer**

This practice note has been issued by NZX to promote market certainty and assist Market Participants. This practice 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. NZX may replace Guidance Notes and Practice Notes at any time and a Market Participant should ensure it has the most recent versions of those documents. This does not constitute legal advice. NZX recommends that Market Participants take advice from qualified persons.

## PRACTICE NOTE PN 09/05 – CLIENT FUND OVERDRAFT REPORTING

### Introduction

This Practice Note provides detail on the information requirements of NZX if an overdraft occurs in a Market Participant's Client Funds Bank or general ledger bank accounts. It is worth noting that if the information outlined in this Practice Note is provided in the initial notification to NZX, then further details will only be required in limited circumstances or if the information is not clear.

### Background

Guidance Note 'GN0008/05 – Client Assets' confirms the requirement at NZX Participant Rule 14.7.2 for a Market Participant to report all general ledger bank account and Client Funds Bank account overdraws to NZX immediately. Following feedback from Market Participants, it is appropriate to provide additional guidance on what information is required when reporting an overdrawn position to ensure consistency.

All Client Funds overdraws (in either the physical Bank account or the general ledger account) will be critically assessed by NZX Compliance for the material risks to clients, the actions which could have prevented the problem, and any action which needs to be taken to address the current situation and reoccurrences.

For the avoidance of doubt, disclosure to NZX of an overdraft pursuant to Rule 14.7.2 will not necessarily limit referral to NZX Discipline, but may be taken into consideration as a mitigating factor when NZX sets out the penalty it considers appropriate for the matter in its Statement of Case.

## Participant Rule - 14.7

Participant Rule 14.7.1(e) requires each Market Participant Accepting Client Assets to:

*“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 must immediately notify NZX if its bank book ledger balance or the physical Bank account balance for its Client Funds Account becomes overdrawn for any reason.”*

## Guidance Note ‘GN0008/05 – Client Assets’

Guidance Note GN0008/05 confirms the following requirements:

- Each Client Funds Bank account must be mapped to a single Client Funds ledger account and neither must go overdrawn;
- Each Client Funds ledger account must be mapped to a single Client Funds Bank account and neither must go overdrawn;
- There must be a Client Funds Bank and ledger account for each currency that a Market Participant accepts;
- The Market Participant must protect Client Funds until the client receives cleared funds or that the funds transmitted to the nominated bank account; and
- Cash should move simultaneously at the Bank and the ledger so that there is no delay in moving money to fund for presentation of cheques.

NZX considers that both the bank and the ledger accounts are important as a method of control. Key concerns include:

- Ensuring the true position of the bank once all pending transactions (for example cheques or forward dated foreign exchange transactions) have occurred is reflected the records of the Market Participant;
- An excessive and uncontrolled mismatch of bank and ledger records creates the risk of insufficient funds being available in the physical bank account. This is particularly relevant where two Client Funds Bank accounts are used;
- Bank controls within an organisation are a key indicator of the overall level and quality of internal control processes;
- Possible misstatements of client assets held if these are based on incorrect ledger balances; and
- Perceptions of lack of available funds in client bank accounts through reference to published financial statements.

Risks to Market Participants are reduced through ensuring that all physical funds transfers occur at the time of the booking of the transaction.

## Requirements of Market Participants

When notifying NZX of overdraft of a client funds bank account, the Market Participant Accepting Client Assets should provide the following information:

- The ledger account name(s) and number(s) of the overdrawn account(s);
- The Bank, branch, account name and account number of the overdrawn account(s);
- The amount and currency of the overdraft(s) and whether Client Funds were/are at risk;
- The amount of the error causing the problem, where an error has occurred;
- Details of the error – what happened, why it happened, and the parties involved, where an error has occurred;
- What has and is being done to resolve the problem;
- The time frame for resolution and any actions to be taken pending resolution; and
- The actions being taken to prevent such an overdraft from occurring again.

A reporting template is provided in Appendix 1.

In the event of an overdrawn Client Funds Account in the physical Bank account or in a general ledger bank account, the notification should be sent to [compliance@nzx.com](mailto:compliance@nzx.com) as soon as the overdraft is identified. If the information required will take a long time to collate then an initial notification should be sent with the basic information and an estimated time of when complete information will be sent to NZX.

## Assessment of overdrawn positions

When an overdraft is disclosed to NZX the following issues are considered as part of the assessment of the nature or the materiality of the position:

- The level of risk to the Market Participant's clients and whether client funds continue to be protected;
- The participants liquid capital position, including any Bank guarantees;
- The involvement of third parties in causing the error, if any; and
- The nature of the disclosure (i.e. Self disclosure by the Market Participant or discovery by NZX).

NZX, at its discretion, may require further investigation or explanation, particularly where there is a high frequency of occurrence. In addition, NZX may, at any time, refer either ledger or physical bank account overdraft instances to NZX Discipline. The Statement of Case may refer to past overdraft instances of the Market Participant. In either the general ledger bank accounts or physical bank account

## NZX's Statutory Reporting Requirements

When a Market Participant is referred to NZX Discipline in respect of breaches of the NZX Participant Rule overdraft provisions, NZX must report this referral to the Securities Commission under Section 36ZD of the Securities Markets Act 1988 as a "Notification of Disciplinary Actions and Suspected Significant Contraventions".

Consistent with the Memorandum of Understanding between NZX and the Securities Commission dated February 2002, NZX will send a report to the Securities Commission on a regular basis, of the overdrafts reported and/or discovered and any action NZX has taken. This will be information provided by NZX to the Securities Commission under Section 36ZL of the Securities Markets Act 1988 as "Disclosure of Information to Assist Commission in its Functions".

## Third Party Errors

NZX takes all overdraw positions very seriously but recognises that errors can occur that are outside the control of the Market Participant and there are occasions where a third party error, omission or activity causes a Market Participant's Client Funds Account to become overdrawn. Examples include Bank errors or a usually reliable counterparty not delivering the funds in accordance with normal practice.

Where these errors occur on an infrequent basis and the third party has accepted responsibility for the error, NZX will assess the materiality, case by case, based on the risk to overall Client Funds. However, it is the firm's responsibility to ensure that the counterparties and Banks they deal with have procedures in place to prevent errors occurring and to enable early detection of errors should they occur.

For the avoidance of doubt, a third party error which results in an overdraw, must be reported to NZX in the same manner as any other overdraw, even if the error will be corrected with good value.

If the error is caused by a third party (for example, a Bank) the Market Participant should ask that third party to produce a letter explaining the reasons for the overdraft occurring, confirming that the error was in their control and whether the NZX firm will receive good value for the deposit. The letter should be provided to NZX to allow the responsibility for the error to be recorded. This provides NZX with greater ability to judge the level of seriousness of the overdraw and to determine the level of responsibility allocated to the NZX Market Participant and the third party for the overdraw occurring.

Where there are regular problems arising as a result of the actions of a third party NZX expects that the Market Participant would discuss this with the third party to resolve the issues and to make changes to its processes and procedures to ensure that such errors do not continue to occur. Strategies that NZX firms may use to ensure that Bank accounts do not become overdrawn as a result of third party errors include:

- Exclusion of expected receipts from funding calculations where there is a risk of non-delivery by counterparties;
- Bank agreements providing for an account sweep from another Client Funds account should an overdraw occur overnight;
- Internal controls and processes which check for errors;
- Funding Foreign Exchange accounts at an appropriate level; and
- Reviewing input documents for formats which are prone to error.

## APPENDIX 1 – Report Format to NZX for all Client Funds Account overdraws

| Information required   | Information from the Market Participant |
|--|---|
| Firm Name<br><br>Date overdraft seen<br><br>Date overdraft reported  |   |
| Ledger name and number of the overdrawn account(s)   |   |
| Bank, branch, account name and account number of the overdrawn account(s)                                    |   |
| Amount and currency of the overdraft   |   |
| The amount of the error causing the problem, where an error has occurred                                     |   |
| Details of the error – what happened, why it happened, and the parties involved, where an error has occurred |   |
| What is being done to resolve the problem and is the firm being given backdated value for the funds?         |   |
| The time frame to resolution and any actions to be taken pending resolution?                                 |   |
| Actions being taken to prevent an overdraft occurring again  |   |