

Key Notes

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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 06/05 – CLIENT FUNDS FOR NZX ADVISING FIRMS

INTRODUCTION

This Practice Note has been developed in order to assist NZX Advising Firms interpret and comply with the requirements at Section 14 of the NZX Participant Rules (“Rules”).

This Practice Note should be read in conjunction with Guidance Note GN0008/05 – Client Assets.

BACKGROUND

Within the Market Participant base there are three distinct categories with respect to handling of monies on account for clients. There are:

- i) Full Delivery & Settlement – these firms provide a full service trading and settlement facility and handle client assets on account both in the form of funds and Securities (scrip);
- ii) Advising Cash Only – these NZX Advising Firms give-up the scrip settlement component to an accredited Delivery & Settlement Participant. They still maintain a client funds bank account for the purposes of settling directly with their clients and holding other monies on account; and
- iii) Advising Only – these NZX Advising firms give-up all of the settlement functions to a designated Delivery & Settlement participant. They do not handle client assets at all.

NZX Regulation considers that for category (ii) further guidance will prove useful to assist such firms in meeting their obligations under Section 14 of the NZX Participant Rules, particularly with respect to the scrip component of Client Assets.

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 the selling client’s FASTER Transfer Account as a result of direct instructions from that Trading Participant with whom that Delivery and Settlement Participant has a Post Trade Agreement for the settlement of that client’s securities. 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 client’s 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 receiving registration of the Securities which that client has purchased and to which those moneys related. This includes funds received by the Delivery and Settlement Participant prior to execution of an Order by a Trading Participant; 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 has not been applied (less reasonable brokerage or commission) for that purpose, these monies must be paid directly into the Market Participant Accepting Client Assets’ Client Funds Account.”*

As outlined in “Guidance Note GN0008/05 – Client Assets”, 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 addition this Guidance Note outlined that the calculation of 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 must 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.

APPLICATION OF SECTION 14

NZX Advising Participants passing orders to a Trading and Delivery & Settlement Participant **may** net off client DR and client CR balances with the net owing/payable from their Trading and Delivery & Settlement Participant provided that:

- i) The obligation to the NZX Advising Firm's clients form part of the Trading and Delivery & Settlement Participant's client funds Outstanding Obligations; and
- ii) The Trading and Delivery & Settlement Participant provides written declaration that its responsibility is for settlement of scrip directly to the Advising Participant's Client and Participant to Participant cash settlement.

Under this approach a client obligation for the NZX Advising Participant arises at the point at which:

- i) Cash is received from the client for a buy contract [extinguished at the point at which funds are passed to the Trading and Delivery & Settlement Participant];
- ii) Cash is received from the Trading and Delivery & Settlement Participant for delivered sell contracts [extinguished at the point at which the client receives clear funds]; or
- iii) Miscellaneous monies are retained on account with the NZX Advising Participant for any other purpose.

This approach recognises that the NZX Advising Firm provides registration details for each trade, but has no other control over or involvement in the registration of client Securities. This applies equally to trades on all exchanges.

CLIENT FUNDS RECONCILIATION OBLIGATIONS AND STANDARDS

A Market Participant Accepting Client Assets has the following obligation:

“14.4.1 Total Client Assets held in a FASTER Transfer Account, registered 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 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. Should this be the case, the reconciled bank balances must be used in this client funds reconciliation.

In short, for the NZX Advising Firm, Outstanding Obligations must be represented by segregated Client Assets in funds.

All other standards as to the completion of the reconciliation, daily submission, record keeping and adequacy of supporting information remain the same.