

NZX Participant Guidance Note

Client Assets

December 2017



The purpose of this guidance note is to provide guidance to Market Participants in relation to NZX’s interpretation of Section 18 of the NZX Participant Rules (**Rules**).

This guidance note replaces the previous Client Assets Guidance Note issued in December 2015, and the Bank Reconciliation Standards and Client Funds Overdraft Reporting Practice Notes issued in April 2011.

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



1. 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 18 of the NZX Participant Rules (Rules) recognises the position of trust under which these assets are held and sets minimum standards for Market Participants in discharging this fiduciary duty.

It is also recognised that it may be necessary for a Market Participant Accepting Client Assets to deposit its own funds in its Client Funds Accounts for the purposes of facilitating settlement and managing any shortfalls that may arise when carrying out such transactions.

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:

- 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, record keeping, and notification requirements.

1.1 Background

This Guidance Note has been developed to provide additional clarification of the key obligations under Section 18 of the Rules covering Client Assets. Key areas included in this Guidance Note are:

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

Custody (covered in Rule 18.15) is specifically excluded from this Guidance Note.

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

2. Key definitions

The purpose of this section of the Guidance Note is to explain certain key definitions used in Rule 18. It is essential that Market Participants fully understand the meaning of defined terms to understand the obligations imposed upon them.

2.1 Client Assets

18.1.1 “**Client Assets**” means:

- (a) *Client Funds received and held by a Market Participant Accepting Client Assets for undelivered buy contracts or received and held on account including, but not limited to, Margin Cover, funds on deposit, call accounts and application monies; and*

- (b) *Client's Securities received and held by a Market Participant Accepting Client Assets for delivered unpaid sell contracts.*"

NZXR 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 includes unlisted securities (debt and equity).

2.2 Buffers

"**Buffer**" is defined in Rule 18.3.3 as follows:

"Money belonging to the Market Participant Accepting Client Assets which is deposited into a Client Funds Account and retained for the purposes of facilitating settlement and to manage any shortfalls that may arise in respect of settlement."

NZXR recognises that it may be reasonably necessary for a Market Participant Accepting Client Assets to deposit its own funds in Clients Funds Accounts to ensure it is able to satisfy its daily settlement obligations where the Market Participant may not yet have received certain Client Assets, and also for example to mitigate against other unforeseen transactions outside the Market Participant's control.

A Market Participant Accepting Client Assets must calculate and maintain its Buffer on a daily basis in order to distinguish its property from that of its clients within its Client Funds Accounts.

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 18.15 and are not covered by this Guidance Note.

2.3 Client Funds Account

18.3.1 "Client Funds Account" means

- (a) *a trust account held by a Market Participant Accepting Client Assets solely for the benefit of its clients at a Bank approved by NZX; and*
- (b) *a Depository Account held by a Market Participant Accepting Client Assets solely for the benefit of its clients."*

Under this definition, a Client Funds Account represents a single trust account or Depository 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 18 of the Rules applies to each of these Client Funds Accounts (Rule 18.3.2). For the purposes of account operation each account must be treated individually and mapped to an individual ledger account and individually reconciled, but the accounts may be aggregated and converted to \$NZ in order to demonstrate that Total Client Assets held equal or exceed Outstanding Obligations.

3. Calculation of Outstanding Obligations

3.1 Outstanding Obligations

18.2.1 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 into the Transfer Account of a Legal Title Transfer Depository Participant as a result of direct instructions from that client's Trading Participant and 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 received by the Relevant Clearing Participant. Securities may not be transferred from a 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 to the Market Participant Accepting Client Assets prior to those Securities being registered into that client's or its Nominee Company's name. This includes funds received by the Trading Participant prior to a Trading Participant entering that client's Order into the Trading System; or*
- (c) That client 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.*

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 where:

- (a) Securities of a selling client have been transferred (legal title has passed) to a Legal Title Transfer Depository Participant for, or in advance of, sale or settlement, where that client is yet to be paid money;
- (b) A buying client has paid money to the Market Participant Accepting Client Assets 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 Outstanding Obligations, it is important to recognise that any Client Asset received by a Market Participant Accepting Client Assets will have a corresponding obligation. Accordingly, an obligation will not arise where the Market Participant Accepting Client Assets is yet to receive such Client Assets, regardless of whether a client's transaction has been executed on market as instructed by the client.

Given the definitions of Client Assets and Outstanding Obligations, NZXR notes that in the normal course of business (i.e. absent any errors) these two figures will equal each other. Therefore, it is essential that Market Participants have sufficiently robust systems and processes for calculating Outstanding Obligations to identify which assets in its possession are Clients' Assets, with the remaining assets belonging to the Market Participant (i.e. the Buffer).

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

3.2 Gross Segregation

The calculation of the Outstanding Obligations is based on gross segregation, therefore 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.

3.3 Trades on Other Exchanges

The obligations on a Market Participant under Rule 18 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 settlement date in Australia (currently T+3, however this is changing to T+2 in March 2016), 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 (currently T+3, however this is changing to T+2 in March 2016), 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.

3.4 Securities settled outside the Legal Title Transfer System

Market Participants may undertake transactions outside the Legal Title Transfer System when 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.

3.5 Delivery versus Payment (DVP)

DVP is defined 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.

3.6 Protection of Client Assets

“18.5.2 Each Market Participant Accepting Client Assets must protect Client Assets from the time of receipt of those Client Assets. 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, it is not discharged until the client's name is on the register.

4. Client Assets and reconciliation requirements

4.1 Client Assets, Buffers and Outstanding Obligations

A Market Participant Accepting Client Assets has the following requirement:

“18.4.1 Total Client Assets held in a Transfer Account of a Legal Title Transfer Depository Participant, Nominee Account and Client Funds Account by a Market Participant Accepting Client Assets (as the case may be) taken together with any Buffer must, at all times, equal or exceed that Market Participant's total Outstanding Obligations.”

The obligation under **Rule 18.4.1** is intended to recognise that during the course of a normal Business Day, circumstances may arise intra-day where, temporarily, a Market Participant Accepting Client Assets may need to rely on its Buffer to ensure that sufficient funds and Securities are held in Client Funds Accounts and a Transfer Account so that taken together Clients Assets and Buffers continually equal or exceed Outstanding Obligations.

This is a fundamental obligation, which expressed simply, requires Client Assets and any Buffer held in the Market Participant's Client Funds Account and Transfer Account to **equal or**

exceed Outstanding Obligations **at all times**. The purpose of this requirement is to ensure that a Market Participant Accepting Client Assets has sufficient Client Assets and Buffer to meet settlement obligations (on behalf of clients and itself as principal) as they fall due.

Where a Market Participant Accepting Client Assets is also a Clearing Participant, Client Assets transferred to the Clearing Participant's Settlement Account with CHO/CDO in anticipation of a clearing and settlement obligation may be included in Total Client Assets for the purposes of Rule 18.4.1.

4.2 The Client Assets reconciliation

A Market Participant Accepting Client Assets also has the following obligation in respect of daily reconciling, recording and reporting:

"18.4.2 Total Client Assets held in a Transfer Account of a Legal Title Transfer Depository Participant, Nominee Account and Client Funds Account by a Market Participant Accepting Client Assets (as the case may be) taken together but excluding any Buffer must, at the end of each Business Day, equal that Market Participant's total Outstanding Obligations."

The obligation under Rule 18.4.2 is monitored by Market Participants Accepting Client Assets being required to perform a daily "**Client Assets Reconciliation**" under Rule 18.6.1(h) for the previous Business Day, in order to:

- (a) Demonstrate that the Market Participant held sufficient Client Assets to meet its Outstanding Obligations; and
- (b) Identify, using its calculation of Outstanding Obligations, what money and Securities held in the Market Participant's Client Funds Account and Transfer Account are Client Assets;

as at the previous Business Day's close.

"18.6.1(h) Each Market Participant Accepting Client Assets must: Using data from Rule 18.6.1(g), perform reconciliations as required, in accordance with relevant Guidance Notes, Procedures and Good Broking Practice, in order to monitor compliance with Rule 18.4.2, including a reconciliation as at the end of each Business Day assessing and determining compliance with Rule 18.4.2;"

The underlying principle behind the requirement at Rule 18.4.2 and the accompanying reconciliation requirement is that, absent any errors, Client Assets and Outstanding Obligations should always equal each other.

Unless there are exceptional circumstances, the reconciliation should be completed **before 12pm** each Business Day (as at close of business the previous Business Day) using the Client Funds Account balances determined by the bank reconciliations required under Rule 18.6.1(g). The records of the bank balance for each Client Funds Account should be used in the Client Assets Reconciliation.

Unidentified items received on the bank statement but not yet receipted into the general ledger are deemed Client Assets until identified as non-client money, and should be factored into a Market Participant's Outstanding Obligations for the purposes of Rule 18.4.2.

4.3 Inclusion of Securities in Total Client Assets

In relation to inclusion of Securities in Total Client Assets, Rule 18.4.3 states:

“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 18.4.1 and 18.4.2. Securities belonging to the Market Participant Accepting Client Assets and client Securities that do not require protection that are held in either a Transfer Account of a Legal Title Transfer Depository Participant or Nominee Account may not be included in the calculation of Total Client Assets under Rule 18.4.1 and 18.4.2”.

In essence, client Securities held in the Market Participant’s Transfer Account 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. 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 where an Outstanding Obligation exists.

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

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

For the purposes of this Client Assets Reconciliation, Securities held in the 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.

4.4 Record keeping and reporting

In order to demonstrate compliance with the obligations under Rule 18.4.2, Client Assets Reconciliations must be recorded daily and retained for a minimum of three (3) years (in at least electronic format). Client Assets Reconciliations must be prepared according to the form set out in Appendix 1 and Appendix 2 of this Guidance Note. This information should be provided on a monthly basis, with Appendix 1 reflecting the last day of the month and Appendix 2 reflecting a daily log for that month.

4.5 Bank balances

In monitoring compliance with Rule 18.4.1, a Market Participant should use the current ledger balance of each bank account, provided that the ledger is kept current and accurately reflects all transactions.¹ In completing the Client Assets Reconciliation in accordance with 18.6.1(h) for the previous Business Day (as discussed under section 4.2 above), reconciled bank balances should be used from the reconciliations required under Rule 18.6.1(g).

¹ For the purposes of managing required funds under Rule 18.4.1, all unpresented cheques should be added back into the ledger balances due to the obligation not yet being discharged under Rule 18.5.2.



Bank reconciliation processes should take place on the morning following the current trading day; in order to prove that:

- All bank accounts have continued to hold the correct amount of funds as a result of overnight processing; and
- Client Assets have been adequately protected at all times.

4.6 Notifications

A Market Participant Accepting Client Assets must provide immediate notification to NZXR where:

- (a) Its bank book ledger balance, any physical Bank account or Depository Account balance for any of its Client Funds Accounts become overdrawn for any reason (Rule 18.6.1(e));
- (b) The Client Assets Reconciliation performed under Rule 18.6.1(h) reveals any non-compliance with Rule 18.4.2;
- (c) There has been any breach of Rule 18.4.1; and
- (d) There has been a breach of Rule 18.6.1(b).

Notifications should include an explanation of the events that caused the breach and details of the action taken to rectify the breach, along with a summary of the measures implemented to prevent reoccurrence in future.

In addition, a Market Participant Accepting Client Assets must periodically notify NZXR whether it intends to deposit Buffers in its Client Funds Accounts and advise NZXR of the basis on which such Buffers will be calculated. NZXR will seek these regular notifications as part of the annual inspection process.

NZXR expects that such Buffers will be calculated in accordance with the principles outlined in section 5 of this Guidance Note and in accordance with Good Broking Practice. These notifications should be provided to NZXR at least annually (which, following initial notification, will be achieved via requests for this information as part of routine pre-inspection requests for information), together with all situations when a Market Participant Accepting Client Assets materially amends the basis on which it intends to calculate its proposed Buffers.

4.7 Brokerage Sweep

NZXR recognises that common practice amongst Market Participants is to “sweep” accumulated brokerage and other charges the Market Participant levies its clients on a day-to-day basis with the Client Assets 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 sweeps would not cause Outstanding Obligations to exceed Client Assets. This proof must be able to be produced for NZXR to review immediately on request. Where a Market Participant conducts its brokerage sweep less frequently than daily, the brokerage that remains in the Client Funds Account should be accounted for within the Buffer.

5. Buffer Maintenance

Rules 18.3.3 and 18.3.4 provide:



“18.3.3 A Client Funds Account held by a Market Participant Accepting Client Assets may include a “Buffer”, being money belonging to the Market Participant Accepting Client Assets which is deposited into a Client Funds Account and retained for the purposes of facilitating settlement and to manage any shortfalls that may arise in respect of settlement.

18.3.4 Any Buffer deposited in a Client Funds Account by a Market Participant Accepting Client Assets must be reasonable in the circumstances and in accordance with relevant Guidance Notes, Procedures and Good Broking Practice.”

As clarified in previous sections of this Guidance Note, NZXR acknowledges that it may be reasonably necessary for a Market Participant Accepting Client Assets to deposit its own money in its Client Funds Accounts as a Buffer.² Where a Market Participant includes a Buffer in a Client Funds Account it is necessary for the amount of the Buffer to be reasonable based on the Market Participant’s circumstances, including the nature of the Market Participant’s business and its need to rely on buffers within its Client Funds Accounts in the past.

NZXR recognises that a Market Participant’s Buffer may fluctuate daily given a number of factors outside of its control, and as per the requirements of Rule 18.6.1(h), Market Participants will calculate this amount during the morning of each Business Day (for the previous Business Day).

NZXR appreciates that given the range of factors which may vary between Market Participants (such as settlement policies, processes, systems and differences in client bases), what is considered “reasonable in the circumstances” for the purpose of Rule 18.3.4 will differ between Market Participants. NZXR would expect a Market Participant’s procedure for determining and maintaining its Buffer at a reasonable level to at least consider (but not be limited to) the following factors:

- Its clients’ adopted method of settlement and the associated settlement risk (e.g. Retail vs. Institutional; Free-Of-Payment (FOP) vs. DVP, custodial vs. non-custodial clients);
- Historic settlement obligations, taking into account such items as past debit settlement obligations, proportion of client failure to pay or deliver;
- Upcoming settlement obligations (T+1, T+2, T+3) and current market activity (e.g. significant transactions or exceptional events);
- Potential internal or external (third party) errors and timing differences;
- Fees and charges, both periodic and unforeseen; and
- Mixed remittances and un-swept brokerage accumulation.

In the absence of an extraordinary transaction or circumstance, Market Participants Accepting Client Assets who wish to maintain a Buffer may want to establish a maximum level of Buffer for their business, to be determined as either a fixed amount or percentage of Outstanding Obligations.

6. Requirements for Bank Accounts

² NZXR notes that some Market Participants may have less need for a Buffer.



6.1 Client Funds Account Set Up

Although no prescriptive list of approved banks is set out in this Guidance Note, Client Funds Accounts in New Zealand 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 Prudential Regulation Authority in the United Kingdom, are acceptable to NZXR. 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 an 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 1 of the Rules are met in full), whereas a deposit with a finance company that is not a registered bank cannot. Market Participants should obtain clearance from NZXR 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 Market Participants Accepting Client Assets:

- Each Market Participant Accepting Client Assets must have a Client Funds Account of the type referred to in Rule 18.3.1(a) for each currency it accepts (*Rule 18.3.2*).
- With the exception of Depository Accounts, 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" (or similar words as required by legislation) appear in the bank account name. In addition, the written acknowledgement must be provided to NZX Compliance (*Rule 18.6.1(a)(ii)*). Refer to Appendix 3 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 18.6.1(b)*). No Client Funds can be deposited into any other account.
- Each Market Participant must ensure that the Client Funds Account is not overdrawn at either the general ledger or the physical bank account (*Rule 18.6.1(e)*).
- Each Market Participant must not use funds in the Client Funds Account for security (*Rule 18.6.1(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 18.6.1(g)*). NZX's expectations as to bank reconciliation standards are detailed below in section 6.4.

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.

6.2 Client Funds Account Overdrafts

Rule 18.6.1(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 18.6.1(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 18.6.2 requires each Market Participant Accepting Client Assets to notify NZX immediately, should the Client Funds Account become overdrawn for any reason. When notifying NZX of an overdraft, the Market Participant Accepting Client Assets must complete the template provided in Appendix 4.

NZXR is concerned primarily with any physical bank overdrafts, or any overdraft or understatement in a general ledger at the end of a Business Day (as highlighted by the reconciliations required under Rule 18.6.1(g)). NZXR understands that there may be timing issues in respect of the manner in which Market Participant’s accounting systems recognise transactions, which mean that a general ledger could be overdrawn for a short period of time intraday. NZXR would not expect notification of an intraday overdraft of the general ledger that has resulted from a timing difference of this nature and which had not resulted in the physical bank balance being overdrawn at any time.

All overdrafts (either physical or book) will be critically assessed by NZXR for possible disciplinary action. Disclosure to NZXR of overdraft pursuant to Rule 18.6.2 will not necessarily limit disciplinary action, but may be taken into consideration as a mitigating factor when NZXR recommends an appropriate penalty to the NZ Markets Disciplinary Tribunal for the matter. NZXR expects that the NZ Markets Disciplinary Tribunal will not look favourably upon a situation where a Market Participant fails to disclose an overdrawn account that is subsequently detected by NZXR on inspection or otherwise.

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

Market Participants should be aware that these requirements will require processes 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 overdraft 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.

NZXR recognises that errors can occur that are outside the control of a 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 (for example a Bank error).

Where these errors occur on an infrequent basis and the third party has accepted responsibility for the error, NZXR 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. As detailed above in section 5, Market Participants should also factor such considerations into the level of Buffer it holds within its Client Funds Accounts.

NZXR notes that a third party error which results in an overdraft must be reported in the same manner as any other overdraft, 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 confirm the cause of the overdraft occurring and that the error was theirs. This provides NZX with greater ability to assess the level of seriousness of the overdraft and to take into account circumstances that were outside of the Market Participant's control.

6.3 Application of funds

"18.10.1 All Client Funds required to be paid into a Client Funds Account under Rule

18.7 must be held upon trust by the Market Participant Accepting Client Assets and applied:

- (a) For the purposes of settlement of, or reimbursement in respect of the settlement of the purchase of Securities for a client;*
- (b) In payment of the sale price for a Client's Securities transferred into a Market Participant Accepting Client Assets Transfer Account;*
- (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 18.10 (a) and (b)*

18.10.2 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 18.4.1 continues to be met."

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

- (a) Fulfilling market settlement obligations or 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;

- (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; and
- (e) Reducing the Buffer held in the Client Funds Account, while remaining in compliance with Rule 18.4.1.

Payment of funds from a Client Funds Account for any purpose not listed above is likely to be 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.

NZXR 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 as soon as practicable. In the normal course of events, a Client Funds Account should not be used to receive operational income.

6.4 CFA Bank Reconciliations

With respect to the daily reconciliations required under Rule 18.6.1(g), NZXR expects that the controls over reconciliation processes that a Market Participant has in place should, at a minimum, include:

- (a) Documented processes and procedures, including a summary of all bank accounts and details of account signatories;
- (b) Appropriate segregation of duties between entry creation and reconciliation duties;
- (c) Assignment of responsibility for reconciliations at an appropriate level; and
- (d) Independent review at an appropriate level.

Independent review is the most critical element to ensuring the effectiveness of bank reconciliations as a key control. Critical components of this review include:

- (a) Reconciling items are valid and supported by sufficient explanation and supporting documentation;
- (b) Ensuring reconciling items clear within a reasonable time period;
- (c) Ensuring outstanding items are investigated and resolved;
- (d) Stale cheques are followed up with the client / vendor concerned;
- (e) Manual entries to the general ledger are valid.

NZXR recognises that both manual and system-generated reconciliations are common. There is no difference in the standards that apply. Keeping manual data entry to a minimum will help reduce the risk of human error or data manipulation. It is now common practice to automate the import of bank account transactions into a reconciliation programme.

Regardless of the method of preparation, there should be sufficient information available to demonstrate how the matching of items occurs.



Transactions within the reconciliation should be unalterable except for adding comments on the item to allow anyone to be able to pick up the reconciliation in the absence of the usual reconciler, for example:

- (a) Outstanding items should be explained along with action taken to resolve them if they are outstanding for an unreasonable length of time;
- (b) Any large or unusual items should be annotated; and
- (c) Differences awaiting correction should be annotated and not netted off.

Copies of all completed reconciliations must be kept as evidence of completion and to verify the calculation of Client Assets for each Business Day.

NZXR expects that, as a key control, bank reconciliations and associated records are kept for a minimum of 7 years in accordance with Participant Rule 3.27.1.



Appendix 2 – Client Assets Log



PARTICIPANT:
MONTH
ENDED:

Client Assets & Outstanding Obligations				
Date	Outstanding Obligations	Cash (CFA) and Clients' Securities	Client Assets	Buffer
1/12/2015				
2/12/2015				
3/12/2015				
4/12/2015				
7/12/2015				
8/12/2015				
9/12/2015				
10/12/2015				
11/12/2015				
14/12/2015				
15/12/2015				
16/12/2015				
17/12/2015				
18/12/2015				
21/12/2015				
22/12/2015				
23/12/2015				
24/12/2015				
29/12/2015				
30/12/2015				
31/12/2015				

Appendix 3 - Prescribed wording for inclusion in Bank Trust letters

“Re Bank Account XX-XXXX-XXXXXXXX-XXX

We acknowledge that in accordance with NZX Participant Rule 18.6.1, 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”.



Appendix 4 – Client Funds Account Overdraft Reporting

Information required	Information from the Market Participant
Participant	
Date of overdraft	
Date overdraft identified and reported	
CFA general ledger name and number of the overdrawn account(s)	
Bank, branch, account name and account number of the overdrawn CFA	
Amount and currency of the overdraft	
Details of the transaction causing the overdraft (date, amount, other party/account)	
Did the overdraft occur on the physical Bank account or the general ledger, or both?	
Did the overdraft occur intraday only, or was the CFA overdrawn at the end of a Business Day?	
Did the overdraft result in Client Assets being less than Outstanding Obligations?	
Details of the how the overdraft occurred – what happened, why it happened, and the parties involved	
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	
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Where reporting any CFA overdraft, please include:

- The CFA's Bank statement for the affected Business Days
- The CFA's general ledger statement for the affected Business Days
- The Client Assets Reconciliation in the form of Appendix 1

