Review of NZX Participant Rules

Discussion Document

23 November 2015

Contents

1. Introduction

NZX is required to have adequate arrangements for monitoring the conduct of participants in relation to its markets, including advising, trading, sponsor, distribution and underwriting, and clearing participants (NZX Participants). NZX imposes these obligations via the NZX Participant Rules (the Rules).

NZX is aware from application of these rules, and from feedback received, that areas of these rules are in need of review. Accordingly, NZX proposes to conduct a targeted review of the Rules (and, where relevant the associated procedures and guidance). NZX seeks feedback from interested parties as part of this review process. The key areas of review are as follows:

- Reducing overlap between NZX's Rules and legislation
- Reviewing specific areas of the Rules where they are not currently operating effectively
- Conducting a targeted review of the existing capital adequacy requirements
- Considering proposals to introduce additional surveillance tools

Some of the matters proposed for review require only minor, straight forward amendments. Other areas are likely to require more feedback so we plan to receive that feedback in two stages, commencing with publication of this discussion document. Depending on the feedback received, amendments may be required to other rule sets, such as the Clearing and Settlement Rules and the Derivatives Market Rules. All proposed changes will be detailed at the next stage of the review and implemented simultaneously. The proposed timeline for the review is as follows:

- Publish discussion document — 23 November 2015
- Deadline for feedback to discussion document — 18 December 2015
- Publication of proposed specific amendments — Q1 2016
- Deadline for feedback on proposed rule amendments — Q2 2016
- Proposed implementation of amended rules[1] — Q3 2016

Request for comments

In order to receive feedback, NZX seeks answers to the questions outlined in Sections 2-6 of this discussion document. NZX may publish comments received. Please indicate in your submission if you have any objection to the release of information contained in your submission. Please provide comments in electronic format.

Please send your submission before Friday, 18 December 2015 to consultation@nzx.com

If you have any queries in relation to this consultation document, please contact:

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[1] This will include a period for approval of proposed rule amendments by the Financial Markets Authority under section 331 of the Financial Markets Conduct Act 2013

2. Overlap between NZX's Rules and legislation

Financial advice

NZX is considering whether the NZX Advisor regime should be maintained in its current form given that the provision of financial advice is also governed by legislation, specifically the Financial Advisers Act 2008.

Depending on the answer to this broad question, a number of sub-issues have been raised in relation to the operation of the current NZX Advisor regime. For example:

- Are the current accreditation requirements (i.e. the Kaplan exams) fit for purpose?
  - Should the process for accreditation of experienced 'Authorised Financial Advisers (AFA)' be stream lined i.e. reduced requirements if an AFA has a certain number of years of experience?
- Are two levels of advisor status (i.e. NZX Advisor and NZX Associate Advisor) still required?
- Are the pathways from NZX Associate Advisor to NZX Advisor appropriate i.e. are there sufficient incentives/paths to graduate to NZX Advisor status?
- Are the Rules sufficiently clear in relation to the activities for which accreditation is required i.e. is it only when giving advice, or more broadly when transacting on NZX-listed securities?

Background and discussion

The Rules outline criteria for individuals to achieve the status of NZX Advisor or NZX Associate Advisor and place obligations on such individuals when acting in either capacity.[2] These individuals are also subject to obligations under legislation in relation to the provision of financial advice, in particular the Financial Advisers Act 2008 i.e. these individuals will also typically be Authorised Financial Advisers or Registered Financial Advisers, and subject to the requirements of legislation.

This raises the broad question of whether NZX should retain a role regulating the provision of financial advice given that this is primarily regulated by legislation.

NZX notes that the legislation in relation to regulation of financial advisers is currently being reviewed by the Ministry of Business, Innovation and Employment (MBIE) – see here. Given the current review of legislation, it is also appropriate to consider whether NZX should retain an ongoing role in relation to the regulation of financial advice. MBIE's review is due to continue through until mid-2016 with amended legislation likely to come into effect in 2017. NZX is participating in the MBIE review but in the meantime we seek preliminary feedback on whether NZX should continue to regulate the provision of financial advice.

For example, it may be appropriate for NZX simply to regulate the trading conduct in respect of any activities undertaken by these individuals and for those aspects of conduct in relation to the provision of financial advice to be governed by legislation and therefore be regulated by the Financial Markets Authority (the FMA). This would allow NZX Participants to retain a point of difference while also reducing potentially unnecessary compliance burdens.

[2] For example, Participant Rules 5.6, 5.7, 5.8 – 5.13 and section 9

NZX will be in a better position to determine this issue following the outcome of the current review of legislation but seeks preliminary views on this matter in the meantime.

NZX can revisit the sub-issues noted in the introduction above if NZX determines it is necessary to continue to regulate the provision of financial advice. If not, and NZX no longer regulates the provision of financial advice, these sub-issues with the regime will fall away.

Feedback sought

1. Where are the key areas of overlap between the Rules and legislation in relation to the provision of financial advice?
2. Do NZX's Rules offer any useful protections beyond those set out in legislation?
    a. What are the additional costs for NZX Participants in maintaining NZX Advisor and NZX Associate Advisor accreditations?
    b. Do NZX Participants benefit from having advisors who have separate NZX Advisor status (over and above RFA or AFA status, for example)? If so, what are these benefits?
3. What role, if any, should NZX retain in relation to regulating the provision of financial advice?
4. What amendments should NZX make to its Rules to address these issues?

Operation of discretionary accounts

NZX is considering whether it should continue to regulate the operation of discretionary accounts given that this is also governed by legislation.

Background and discussion

The Rules place obligations on Client Advising Participants who operate 'Discretionary Accounts'.[3] Discretionary Accounts are defined as accounts for which a Client Advising Participant buys and/or sells securities and/or undertakes other transactions without prior reference to the client. The Rules require Client Advising Participants who operate Discretionary Accounts to do the following:

- Maintain a register recording certain basic information
- Ensure appropriate written authority has been obtained from the client
- Ensure that discretionary accounts are appropriately designated and separated from non-discretionary accounts
- Review the accounts half yearly
- Prepare and send to clients written reports setting our prescribed matters
- Maintain adequate internal records in relation to the account

Separately, the Financial Markets Conduct Act 2013 (the FMCA) and the Financial Advisers Act 2008 impose obligations in relation to the provision of discretionary investment management services (DIMs).

Under section 388(c) of the FMCA, a person acting as a provider of DIMs must hold a market services licence, subject to certain exemptions such as a person providing the service under sections 17-20 of the

[3] Section 9.9 of the Participant Rules

Financial Advisers Act 2008.[4] Once licensed, sections 433-443 of the FMCA outline a number of duties and obligations of DIMs licensees.

Feedback sought

5. Where are the key areas of overlap between the Rules and legislation in relation to the provision of DIMs?
6. Do NZX's Rules offer any useful protections beyond those set out in legislation?
    a. What are the additional costs for NZX Participants in meeting NZX's separate requirements in relation to the operation of discretionary accounts?
    b. Do NZX Participants receive any incremental benefits from meeting the NZX requirements in this area over and above the legislative requirements? If so, what are these benefits?
7. What role, if any, should NZX retain in relation to regulating the provision of discretionary investment management services?
8. What amendments should NZX make to its Rules to address these issues?

Custody of client assets

NZX is considering whether it should continue to regulate the custody of assets given that this is also governed by legislation.

Background and discussion

The Rules impose a number of obligations on Market Participants Accepting Client Assets when providing custody services.[5] These are summarised as follows:

- Obtaining written authority outlining the rights and obligations of each party in relation to operation of the custody account
- Establishment of a separate nominee account for the purposes of operating the custody account
- Maintenance of a day to day record of movements within the custody account
- An obligation to advise the client of material changes in securities or funds held in the custody account
- Monthly reconciliations
- Obtaining lien letters from sub-custodians

The Rules also outline reporting requirements, which can be summarised as follows:

- Quarterly (or 6 monthly, if agreed) reporting in relation to the custody accounts, covering prescribed matters
- Such reports must be provided not later than 20 business days following the end of the reporting period to which it relates
- An obligation to prepare and send to clients an end of year summary of income and dividends

[4] Section 389 (2) of the FMCA

[5] Section 18.15 of the Rules

The Financial Advisers Act 2008 also governs the conduct of individuals or entities offering or providing a 'broking service' (defined as 'brokers' under that act), which includes the holding of client money or client property in trust for others.[6] The Financial Advisers Act 2008 therefore also regulates the conduct of parties providing custody services, including the general conduct obligations within that Act.

The Financial Advisers (Custodians of FMCA Financial Products) Regulations 2014 also regulate the provision of custody services. The FMA has recently published an Information Sheet in relation to these requirements – see here. Under these regulations, a custodian is not required to forward custody information to clients on a specified periodic basis if that information is available to clients through an electronic facility on a substantially continuous basis and:

- The client agrees to the information being provided in that way; and
- The client has been given access to the facility.[7]

Given these separate legislative obligations, it has been suggested that the custody reporting requirements in Rule 18.15 should be updated for the use of such a facility (possibly online) where clients can access their own statements and reports.

Feedback sought

9. Where are the key areas of overlap between the Rules and legislation in relation to custody of client assets?
10. Do NZX's Rules offer any useful protections beyond those set out in legislation?
11. What, if any, role should NZX retain in relation to regulating the provision of custody services?
12. What amendments should NZX make to its Rules to address these issues?

Know your client obligations

NZX's Rules also outline requirements in relation to "knowing your client" for Client Advising Participants. NZX Participants will also be subject to separate requirements under legislation. NZX seeks feedback on whether it is necessary to retain its own requirements in this area.[8]

13. Where are the key areas of overlap between the Rules and legislation in relation to 'know your client' obligations?
    a. Do NZX's Rules in this area offer any protections over and above legislation?
14. Should NZX amend its own requirements in light of this overlap? If so, how?

[6] Sections 77A and 77B of the Financial Advisers Act 2008

[7] Section 6 Financial Advisers (Custodians of FMCA Financial Products) Regulations 2014

[8] Section 9 of the Participant Rules

3. Review of other specific obligations

Control of broking offices

NZX is reviewing the obligations on NZX Participants in relation to control of Broking Offices.

Background and discussion

The Rules currently distinguish between Broking Offices and Principal Broking Offices. Principal Broking Offices are required to be under the control of a Managing Principal or Responsible Executive. Currently, Broking Offices are required to be under the control of an NZX Advisor or NZX Associate Advisor.[9]

NZX has published a guidance note which discusses this requirement. This guidance states that "NZX's policy is that direct full time control involves an appropriately qualified person being located in that office". However, it is not clear that the status of NZX Advisor or NZX Associate Advisor is sufficient to establish that the individual will be "appropriately qualified" to run the office, or whether it is necessary at all to retain a requirement in this area.

The obligations of NZX Advisors or NZX Associate Advisors under the Rules do not have any particular relevance in relation to controlling a Broking Office, so it is unclear why it should be necessary for such designated individuals to perform this role.

Given that NZX does not place any additional obligations on individuals who have control of a Broking Office, whether or not they are NZX Advisors or NZX Associate Advisors, it should be acceptable to allow a broader range of individuals to fulfil this role, provided they have the necessary skills and expertise. If it is still deemed appropriate to have a designated individual perform such role while physically located on site, NZX considers that the key point should be to ensure that there is a named individual who has responsibility for the Broking Office – both from an operational perspective and in order to engage with NZX where necessary. Regardless of any amendments NZX makes in this area, the Managing Principal of an NZX Participant would continue to have overall responsibility for an NZX Participant's obligations under the Rules.

In Australia, ASX's Operating Rules and ASIC's Market Integrity Rules require participants to name authorised signatories/Responsible Executives but there do not appear to be equivalent provisions to NZX in relation to control of Broking Offices in terms of requiring this role to be fulfilled by advisors.[10]

NZX notes that its guidance note in this area will also need to be updated depending on the outcome of the current review.

Feedback sought

NZX seeks feedback on whether Rule 3.8.3(a) should be amended to allow a broader range of individuals to have full time control of a Broking Office i.e. non-Principal Broking Offices. NZX considers that an amended rule should address two matters:

[9] Participant Rule 3.8.3(a)

[10] ASX Operating Rule 6510 & ASIC Market Integrity Rules 2.1.1 and 2.1.3

- NZX Participants should be required to provide a named individual who has responsibility for a Broking Office
- That individual should have appropriate skills and experience to fulfil this role and the NZX Participant should explain to NZX Regulation why this is the case

An amendment as proposed would allow the NZX Participant to determine the appropriate individual but ensure that this is notified to NZX and to explain the reasons for the appointment.

More broadly, NZX also seeks feedback on whether the requirement to have a separate named individual physically located on the premises to control an individual Broking Office remains necessary at all.

15. Should NZX broaden the range of individuals who can have full time control of a Broking Office under the Rules?
16. Do you agree that an amended requirement in this area should seek to address the two matters identified above (i.e. require a named individual with appropriate skills and expertise)?
17. Alternatively, is it necessary for NZX to retain requirements in this area i.e. for an individual physically located on site to control separate Broking Offices?

Contract notes

NZX is reviewing whether Client Advising Participants should be required to send contract notes to clients, particularly institutional investors.

Background and discussion

Client Advising Participants are required to send written contract notes to a client's postal address as recorded and verified on the Client Advising Participant's records no later than the day following the completion of that client's instruction, if that client is an institutional client.[11] There are some permitted exceptions to this requirement as follows:

- The client has entered into a Hold Mail Agreement under Participant Rule 9.10; or
- The client is a Discretionary client and has entered into a written agreement authorising the Client Advising Participant not to send contract notes, provided that the agreement meets certain requirements.

NZX has received feedback suggesting that written contract notes should not be required to be sent where the institutional client receives the same notification already in another form (e.g. a Notice of Execution) and has elected not to receive contract notes, or alternatively has not positively elected to receive contract notes.

NZX considers this proposal has the potential to reduce unnecessary compliance costs. Institutional clients will still receive the information which is contemplated by the existing requirement and would retain the right to either 'opt in' or the ability to 'opt out' of receiving a written contract note. NZX's preference is to require institutional clients to 'opt in' to receive contract notes but seeks feedback on this point.

[11] Participant Rule 15.17

NZX notes that this proposal is similar to the position in Australia where participants are not obliged to send contract notes to non-retail clients.[12]

NZX also seeks feedback on whether retail clients should continue to receive contracts notes under the Rules or whether to consider similar amendments for all clients. NZX notes that if feedback indicates that a change is also appropriate in this area that it may be appropriate for amendments to make this an "opt out" regime i.e. the default position would be that retail clients continue to receive contracts notes unless they opt out of continuing to receive these.

Feedback sought

NZX proposes to introduce an additional limb to the current exceptions within Rule 15.17 outlining circumstances in which written contract notes are not required to be sent to institutional clients. NZX seeks feedback on whether to introduce a similar amendment for all clients (ie including retail clients).

18. Do you agree that written contract notes should not be required to be sent to institutional clients who receive the same notification already in another form (e.g. a Notice of Execution) and have elected not to receive contract notes (or alternatively have not positively elected to receive contract notes)?
    a. Should the saving provision be an "opt out" or "opt in" regime?
19. Should any distinction be drawn for retail clients or should NZX also consider allowing this approach for contract notes for all clients (potentially on the basis that retail clients would have the ability to "opt out" of receiving contract notes, as opposed to making it the default situation that they do not receive contract notes)?
20. Are any other amendments required to Rule 15.17 in relation to sending contract notes to clients?

Reporting of international crossings

NZX is reviewing the current obligation under the Rules for Trading Participants to report International Crossings via the Trading System.

Background and discussion

All Crossings, including International Crossings, are required to be reported through the Trading System.[13] The requirement to report International Crossings impacts trades by Trading Participants in Dual Listed Issuers and Overseas Listed Issuers on Recognised Securities Exchanges. In practice, the majority of the International Crossings which are reported relate to trades on ASX.

The definition of an International Crossing has four components:

- it must be a Crossing (as defined under the Rules);
- the transaction must be carried out on the regulated market of a Recognised Securities Exchange;

[12] See ASIC Market Integrity Rule 3.4.3

[13] Participant Rule 13.1.1(a) and definition of 'Crossing' and 'International Crossing' within section 1 of the Participant Rules

- the security traded must be listed on the regulated market of a Recognised Securities Exchange; and
- at least one party to the trade must be resident outside New Zealand.

NZX is concerned that this requirement is being applied inconsistently by Trading Participants. A particular problem relates to the first limb. Crossings are defined in the Rules as trades where a Trading Participant acts as buyer and seller on the transaction in an agency capacity or as buyer or seller on one side of that transaction in an agency capacity and as a Trading Participant Acting as Principal on the other side. However, a large proportion of activity reported as International Crossings are aggregates of individual trades in the same security over the course of the day on ASX's order matching system. In these situations, NZX expects that the counterparty will almost always be a different Trading Participant and therefore will not meet the definition of a Crossing (or International Crossing). .

The correct application of the Crossings requirement (the first of the four limbs listed above) will likely result in a substantial reduction in the amount of activity eligible to be reported under the current International Crossings requirement.

There are also concerns with the second limb of the definition outlined above. The transaction must be carried out on a regulated market of a Recognised Securities Exchange. A transaction "on a regulated market" is not defined but if on-market refers to trades that result from orders being matched in the Trading System of the Recognised Securities Exchange, then this contradicts the definition of a Crossing because the reporting Participant will not be acting on both sides of the transaction.

An off-market trade between a New Zealand client as buyer and Australian client as seller will be reported as a Crossing on NZX and a Crossing on ASX. The next day the Participant will report the trade originally reported on ASX again on NZX as an International Crossing. A specific concern which has been raised in this context is where the crossing takes place the morning after the trade and the security is ex dividend on ASX but cum dividend on NZX (or vice versa) – what price should be reported?

Feedback sought

21. Should NZX amend its current requirements to address these issues? If so, how should NZX amend the current requirements?
22. What concerns do NZX Participants have with the current reporting requirements for International Crossings?
23. Alternatively, should NZX continue to permit reporting of International Crossings but remove all recognition from reported data?

Authority to act as Primary Market Participant

NZX is reviewing the requirements for Primary Market Participants requesting assurance of authority to act when bringing an issue of securities to market and/or distributing and underwriting an offer.

Background and discussion

Rule 7.2.2 requires each Primary Market Participant to seek authority to act as advisors, or distributors and underwriters, to an initial or subsequent public offer. NZX has received feedback that some Primary

Market Participants had understood that only the Organising Participant was required to seek authority to act.

NZX considers that Rule 7.2.2 is sufficiently clear, and queries whether Rule 7.2.4 is being incorrectly interpreted to reduce the obligations under Rule 7.2.2. If this is the case, NZX proposes to clarify Rule 7.2.4 to indicate that nothing in Rule 7.2.4 reduces the requirements set out in Rule 7.2.2.

Separately, Rule 7.3 lists a number of things that a Primary Market Participant accepts, confirms or agrees to by receiving authority to act. However, there is no reference to these matters in Appendix 6A or 6B (the appendices), which are required to be used when seeking authority to act. NZX proposes to amend the appendices to include a confirmation of these matters. The proposal to amend the appendices will remove the requirement for NZX to separately seek confirmation of these matters and will reduce the time taken to obtain assurance of authority to act.

Feedback sought

24. Do you agree with NZX's proposal to amend Rule 7.2.4 to clarify that it does not reduce the requirements of Rule 7.2.2.?
25. Do you agree with NZX's proposed amendments to the appendices?
26. Do you consider any other amendments are required to Rule 7.2 or the appendices?

Margin cover requirements

NZX is reviewing whether Client Advising Participants should be required to obtain Margin Cover in respect of all short sales by clients or whether there are circumstances that should be excluded from this requirement.

Background and discussion

Rule 15.8 requires a Client Advising Participant to obtain margin cover from a client before making a short sale on behalf of the client. Additional margin cover may be required in certain circumstances, for example if there is an increase in the price of the security which has been short sold.

NZX has received feedback that many clients make their own securities borrowing arrangements, and deliver securities to settle the short sale as if it were a long sale from the perspective of the NZX Participant. As the client simply delivers securities to settle the sale, without the need for the participant to borrow or arrange borrowing, the client is paid for the securities at settlement and the NZX Participant has no ongoing exposure.

Requiring margin cover in these circumstances seems unnecessary so amending this requirement has the potential to reduce unnecessary compliance costs. The current rule does not adequately address the actual risk to the participant that is associated with the short sale in the circumstances described above.

Feedback sought

27. Do you agree that NZX introduce an additional limb to Rule 15.8 outlining circumstances in which margin cover is not required?
28. What circumstances would you suggest need to be captured by any changes to Rule 15.8?

Client and principal order records

When reviewing principal trading by Trading Participants during NZX's routine compliance monitoring activities, NZX has found that it is often difficult to determine the basis for decisions to trade, the specific timing for decisions to trade and to identify the individual within the Trading Participant who made the decision.

NZX is also reviewing its current requirements in relation to voice recording by Client Advising Participants.

Background and discussion

Currently Rule 15.13 does not apply in respect of order records for a Trading Participant trading on its own behalf i.e. as principal. Rule 10.6 requires records to be maintained by Trading Participants setting out the date and time of receipt of all orders, but it does not specifically refer to trading as principal.

To address these concerns, NZX proposes to enhance the record keeping requirements for principal orders by adding a requirement to Rule 10.6.1 to keep and maintain records of the date, time and basis of each decision for the Trading Participant to trade as Principal, including the name of the person who made the decision.

NZX considers that this proposal will enhance the ability for both NZX and Trading Participants to monitor principal trading without creating an unreasonable burden for Trading Participants.

In addition, Rule 15.12 sets out requirements for voice recording by Client Advising Participants. However, there is no requirement currently for NZX Participants to record calls and NZX considers this would be useful information to be able to access. NZX seeks feedback on the most appropriate way to amend the Rules to require NZX Participants to record calls in relation to client orders (for example, to amend Rule 15.12) and the appropriate extent of a new obligation in this area. This would allow NZX (and FMA) to access a broader range of information when considering potential market misconduct issues. NZX would also like to understand the practical implications of introducing such a proposal.

Feedback sought

29. Do you agree NZX should amend Rule 10.6.1 as proposed above in relation to principal orders?
30. Should NZX amend Rule 15.12 to require Client Advising Participants to record client telephone calls? If so:
    a. What forms of communication should be required to be recorded? (e.g. landlines, mobile phones, internet calls, video conference etc)
    b. Should this apply to all clients or just institutional clients?
31. Would either of the proposed amendments at 29 or 30 above create any specific difficulties for you?
32. Separately, should NZX introduce a requirement for principal traders to be physically separated from client desks, as per international guidance?

Disclosure of interests

Under Rules 10.3, 10.4 and 15.11, a Client Advising Participant must disclose:

- When it is acting as principal in a transaction for the sale or purchase of securities prior to releasing a communication to a client;
- Where there is a conflict of interest identified through the conflict management procedures required under Rule 15.11;
- On a contract note when it is acting as principal in a transaction; and
- On a contract note when it is acting as agent for the buyer and seller in a transaction and is earning income from both parties to that transaction.

Guidance Note 02/04 – 'Trading on behalf of a client' effectively reduces these requirements by permitting a generic disclosure in client agreements and/or contract notes.[14]

Background and discussion

NZX considers that generic disclosure may not be sufficient to adequately disclose the potential conflicts of interest that arise in some of these circumstances e.g. when an NZX Participant is acting as principal in a transaction.

Feedback sought

NZX proposes to amend Guidance Note 02/04 to limit the circumstances in which generic disclosure is considered adequate.

33. Which circumstances do you think generic disclosure may not be sufficient to adequately disclose the potential conflicts of interest that might arise?
34. Would the proposed amendments create any specific difficulties for you?

Employee and Prescribed Person trading rules

The current trading requirements for employees and "Prescribed Persons" as defined in the Rules of a Trading Participant, NZX Advising Firm and a Distribution and Underwriting Sponsor are set out in Rule 10.5.

Rule 10.5 requires Employees and Prescribed Persons of these NZX Participants to obtain written authority from an appropriate party before dealing in any securities on their own personal account. The Rules also place restrictions on employees and prescribed persons from participating in initial public offers ("IPOs") and from disposing of securities prior to the expiry of a 10 business day holding period (Holding Period). These requirements seek to detect and deter market misconduct (or the perception of this occurring) and aim to balance the personal investment interests of employees with the responsibilities of market participants to ensure that conflicts of interest are managed appropriately.

However, NZX is concerned that the current definition of Prescribed Person within the Rules is too broad and is leading to unintended consequences. In addition, NZX is reviewing whether it is appropriate for the Rules as drafted to seek to impose obligations directly upon Employees and Prescribed Persons, as opposed to focusing on the conduct of NZX Participants.

[14] See the following statement on page 6 of the Guidance Note 02/04: "To satisfy these Rules, a Client Advising Participant may make a generic statement in its client agreements (including any amendments to these) and/or contract notes ... and may be earning income from both parties to that transaction."

Definition of Prescribed Person

The definition of Prescribed Person in the Rules captures a wide group of people and entities, particularly in respect of people or entities that are closely connected and/or associated with a person that falls within the "Restricted Group".[15] The scope of the definition has caused issues for a number of NZX Participants, as discussed below.

The definition of Prescribed Person applies to a person, identified as part of the Restricted Group and to any person or entity if a person within the Restricted Group has influence in respect of that person's or entity's investment decisions, except in the ordinary course of a client advising relationship (Limb (b)(ii)).[16] For example, a charitable organisation could be captured by this limb if an Employee of an NZX Participant was on the board or appointed a trustee of a charitable organisation. This is because a member of the board would have the ability to contribute to the overall investment decisions of that organisation. Assuming the organisation exists exclusively for charitable purposes, this would appear to be an unintended consequence of the current definition. Limb (b)(ii) of the definition of Prescribed Person also captures a person who has appointed someone within the Restricted Group as an attorney in respect of that person's property affairs under an enduring power of attorney. NZX questions whether this limb goes beyond what is a necessary control in this area.

Limb (b)(iii) of the definition of Prescribed Person also includes any person where one of the Restricted Group has a direct or indirect beneficial interest in that person's property, even if a person falling within the Restricted Group has no control or influence over the person.[17] For example, this will capture a discretionary trust where an Employee of a NZX Participant is a discretionary beneficiary of that trust because that employee would have a beneficial interest in the assets of the trust, even though this interest is not vested and is dependent upon the trustees exercising their discretion to distribute any assets to that particular beneficiary. Concerns have also been raised that a person within the Restricted Group may not actually be aware that they have been named as a discretionary beneficiary of a trust. NZX is also concerned that this creates a situation where a Prescribed Person cannot be easily identified by an NZX Participant, making compliance difficult.

The definition of Prescribed Person also includes a Market Participant. It is not clear whether this is intended to capture the Market Participant acting on its own behalf. The reference to Market Participant in the context of Rule 10.5 has the potential to create unintended consequences. For example, if a Market Participant is unable to allocate all IPO securities to clients, is it required to notify NZX under Rule 10.5.4 of the shortfall amount that will be retained? Or if a Market Participant acts as principal, is it required to seek written authority as per Rule 10.5.1 or hold the securities for 10 business days as per Rule 10.5.9? NZX seeks feedback on whether a Market Participant should be captured as a Prescribed Person, noting that if it is removed there will be consequential amendments required in respect of Rules 15.11, 15.16 and the definition of Acting as Principal.

[15] The term "restricted group" is included within the definition of a "Prescribed Person" and includes a director, a partner, a Managing Principal or Responsible Executive, shareholder or Employee of a Market Participant.
[16] "Prescribed Person" means; ...."(b) (ii) any person over whom any one of the restricted group has influence for that person's investment decisions except in the ordinary course of a client advising relationship;..."
[17] "Prescribed Person" means:...."(b)(iii) any person where any one of the restricted group has a direct or indirect beneficial interest in that person's property..."

NZX notes that the supervision of employee trades in Australia is governed by ASIC's Market Integrity Rules and that the definition of prescribed person is much narrower than NZX's.[18]

Obligations and restrictions in respect of Employee and Prescribed Person trading

The Rules place the following restrictions and obligations on employees and Prescribed Persons:

I. A requirement to obtain written authority to deal in securities on their own behalf or on behalf of a Prescribed Person;
II. A restriction on participating in certain activities such as IPOs; and
III. A requirement to hold all securities purchased for any account over which that employee or Prescribed Person has a controlling interest, discretion or controlling influence on investment decisions, for a minimum of 10 business days.

NZX is concerned that the Rules seek to impose obligations and responsibilities on Employees and Prescribed Persons without a sufficient basis in law to do so (i.e. the Rules form a contractual relationship with NZX Participants, but it is not clear this extends to employees in this context). On that basis, it is not clear that NZX would be able to take disciplinary action against an employee or Prescribed Person of a Market Participant for a purported breach of the Rules. NZX therefore queries whether these Rules should be reframed to impose obligations directly on NZX Participants only.

Prescribed Person of any other Trading Participant or NZX Advising Firm

Rule 10.5.11 restricts a Trading Participant or NZX Advising Firm from buying or selling securities for a Prescribed Person of any other Trading Participant or NZX Advising Firm. NZX has received feedback that this rule could be breached by factors beyond the control of that Trading Participant or NZX Advising Firm. For example:

- a Prescribed Person or an Employee may open an account with another NZX Participant without the NZX Participant's knowledge;
- an account holder of a Trading Participant or NZX Advising Firm is subsequently employed by another Trading Participant or NZX Advising Firm and that account holder fails to advise this information to the Trading Participant or NZX Advising Firm;
- an entity or person may not be aware that it is classified as a Prescribed Person due to broad definition;

NZX queries whether it should amend this rule to impose a specific obligation that a Trading Participant or NZX Advising Firm has appropriate processes and policies in place to ensure that Employees and Prescribed Persons are aware of this restriction. For example, a client agreement should clearly request the person opening the account to confirm whether they are a Prescribed Person of another NZX Participant and explain the consequences that would follow if they failed to disclose such fact, such as immediate closure of account. In addition, NZX queries whether it should include an obligation on NZX Participants to takes steps to ensure that their Employees and Prescribed Persons only deal in securities

[18] ASIC Market Integrity Rules (ASX Market) 2010, rule 5.4.2 –which captures an employee, a company controlled by an employee and a controlled trust (as defined)

through their employing participant. This appears to be the intention of Rule 10.5.11 currently but no obligations are imposed directly on the employing NZX participant.

Feedback sought

32. What persons/entities should be captured by the employee trading rules?
33. In light of responses to the question above, is it necessary for the definition of "Prescribed Person" to capture the following :
    a. any one of the Restricted Group that is acting under a discretion given by the immediate family of a Market Participant or a person in the restricted group, family company and a family trust of a Market Participant or a person in the restricted group or a body corporate or other entity controlled by that body corporate?
    b. any person or entity if any one of the Restricted Group has influence for that person's or entity's investment decisions (except in the ordinary course of a client advising relationship)?
    c. any person or entity if one Restricted Group has a direct or indirect beneficial interest in that person's or entity's property?
34. Is it realistic to impose obligations on Employees and Prescribed Persons or should obligations be imposed directly on the NZX Participant?
35. Do you agree that it should not be a breach for a Trading Participant or NZX Advising Firm to buy or sell securities for a Prescribed Person of any other Trading Participant or NZX Advising Firm where they have adequate processes and policies in place to minimise the risk of this occurring?
    a. What would adequate processes and policies look like?
36. Do you agree that the Rules should include a requirement on participants to take steps to ensure that their Employees and Prescribed Persons deal in securities through them?
37. Is the current scope of the restrictions on Employees and Prescribed Persons appropriate i.e. in relation to IPO participation and Holding Periods?

4. Review of capital adequacy requirements

NZX prescribes capital adequacy requirements in section 19 of the Rules. Similar requirements are imposed on NZX Participants via NZX's other rules sets depending on their designation, including the Clearing and Settlement Rules and Derivatives Market Rules. The discussion below will focus on references to the requirements in the Participants Rules, but any amendments will need to be considered in the broader context of NZX's market rules.

NZX has received feedback that the capital adequacy provisions of the Rules should be reviewed. In particular, concerns have been raised that the requirements applicable to NZX Advising Firms not accepting Client Funds are too onerous. NZX has also noted concerns in relation to the application of the capital adequacy requirements in the following areas:

- Application of requirements to different participant categories
- Appropriate minimum Net Tangible Current Asset requirements for participant categories
- The reporting requirements, including movement notifications
- Calculation of factors relating to the Total Risk Requirement
- Minor amendments to clarify application of existing requirements

Each of these topics is discussed in more detail below and feedback is sought.

Background and discussion

Application of requirements to different participant categories

All categories of NZX Participants are subject to the same formula and methodology for calculation of capital adequacy requirements, with the only distinction being in relation to the minimum Net Tangible Current Asset (NTCA) requirements outlined in Rule 19.2.1. For example, the minimum NTCA requirement for an Advising Firm not accepting Client Funds is $250,000 whereas for a Trading Participant it is $500,000 and for a General Clearing Participant it is $5,000,000.[19] However, the minimum capital required is the greater of this minimum NTCA amount or the participant's total risk requirement (TRR) and the TRR calculation is the same for all participant categories.

Minimum NTCA requirements for different participants

The minimum NTCA requirements outlined in Rule 19.2.1 do not include a minimum NTCA requirement for Distribution and Underwriting Sponsors, which NZX proposes to add. In addition, no separate minimum NTCA is included for Principal Only Participants as they are captured as a category of Trading Participant. NZX seeks feedback on whether it is appropriate for Principal Only Trading Participants to have a lower minimum NTCA than Trading and Advising Participants.

In addition, NZX seeks feedback on whether the minimum NTCA requirements for other participant categories remains appropriate, in particular whether $250,000 is an appropriate level of minimum NTCA for Advising Firms not accepting Client Funds. NZX has observed that these participants tend to be smaller in scale and it may not always be appropriate for a fixed monetary figure to calculate the expected minimum NTCA. NZX wishes to explore whether other generally accepted accounting

[19] Under the Clearing and Settlement Rules

practices (e.g. “debt to equity ratio” or “current ratio”) may be a more appropriate measure in these cases.

The reporting requirements, including movement notifications

The reporting requirements within Rule 19.3 do not state the timing for when notifications must be provided. A prescriptive requirement in Rule 19.3.1 to perform the calculation (and report, if necessary) the following business day to which the reporting relates would provide more clarity in this area.

In addition, NZX considers that the notification requirements for material changes in the capital ratio (at present movements greater than 50% between two days) do not allow for adequate supervision of market participants with lower capital ratios and are unduly onerous for market participants with high capital ratios. NZX considers that amending these reporting thresholds may allow for better identification and monitoring of participants operating at lower capital ratios.

At present, participants with the highest levels of excess liquid capital provide notifications on most days e.g. moving from 1100% to 1300%. These notifications are of little value to NZX with respect to its capital monitoring. Alternately, higher risk participants operating at lower levels of liquidity tend to have smaller movements in their capital ratio and in certain circumstances can move to low levels of liquidity without being required to notify NZX e.g. 3 or 4 consecutive negative movements each less than 50% has in the past resulted in a NZX Participants falling below 200% without NZX being notified.

NZX considers that the following movement ‘reporting thresholds’ may be more appropriate for NZX to assess the relative changes in capital adequacy movements of participants i.e. if a participant falls below such threshold: 100%, 120%, 150%, 200%, 300%, 500% and 1000%.

NZX also seeks feedback on whether this will adequately address significant capital movements for NZX Participants with strong capital positions or whether any additional thresholds should be considered e.g. if an NTCA position reduces by half.

Calculation of Net Tangible Current Assets

NZX proposes to provide more clarity on what is considered “any asset which, in the normal course of business is not capable of being realised within 12 months” for the purpose of Rule 19.4.3 because NZX has received a number of queries in respect of the meaning of this requirement. NZX seeks feedback on whether this should be clarified in the procedures, guidance or in the Rules.

Calculation of factors relating to the Total Risk Requirement (TRR)

NZX is also considering whether it is appropriate to apply the same TRR calculation method for all NZX Participant categories or whether different TRR calculation methods should be applied to the different participant categories depending on the nature of the risk associated with that type of business. In particular, concerns have been raised that the existing requirements on Market Participants not accepting Client Assets are too onerous.

NZX also seeks feedback on how the Counterparty Risk Requirement (CRR) is applied to different participant categories under Rule 19.7, in particular Advising-only Firms and Advising-only Firms that do not accept Client Assets. The main area of concern raised by NZX Participants seems to be whether a risk

weighting of 4% for “transactions unsettled but not overdue” is appropriate, or if counterparty risk should be applied at all when the Positive Credit Exposure for these transactions is also accounted for in the executing broker’s calculation.

In addition, NZX has received feedback that the method of calculating Counterparty Risk to derivative transactions in 19.7.4(b) is too broad and does not clearly set out how initial margin is to be determined across different types of margined transactions. NZX seeks feedback on whether to add a definition of initial margin for the purposes of the TRR calculations.

Given the additional derivative products offered by NZX (Index Futures, Single Stock Options, etc), NZX is also reviewing whether the methodology applied under Rule 19.9.1 for the Position Risk Requirement should be amended to appropriately account for participants who use these instruments as hedging tools. NZX seeks feedback on whether participants who use derivatives contracts to hedge a position in the matching underlying financial instrument (or vice versa), should be permitted to offset the derivatives against the physical when calculating their position risk.

NZX also seeks feedback on the risk weighting used to calculate the Counterparty Risk Requirement. Under clause 8.2 of the appendix to the Clearing and Settlement Rules, the positive credit exposure used to derive the Counterparty Risk Requirement is calculated as 4% of the value of unsettled transactions and 10% of the initial margin requirement for all clients in respect of margined transactions. NZX has received feedback indicating that this is inconsistent with the calculation of the risk weighting used for cash transactions. The risk weighting used for computing the Counterparty Risk Requirement on derivative transactions is also significantly different from the one used for calculating the Position Risk Requirement on derivative positions, which is twice the initial margin requirement. NZX seeks feedback on whether these requirements should be amended.

Minor amendments to clarify expectations of current requirements

NZX also proposes to amend Rule 19.13.7 to require the use of the prevailing spot rate as at the end of the previous business day when performing calculations under this rule.

Feedback sought

38. Should the Rules continue to operate so that all market participants are subject to the same capital adequacy requirements?
39. Noting that the current requirements applying to participants are addressed in a number of rule sets, should NZX consider consolidating these requirements into a single rule set?
40. Should NZX amend the current minimum NTCA requirements in Rule 19.2.1 to cover Distribution and Underwriting Sponsors and Principal Only Trading Participants? If so, what minimum NTCA should be applied in respect of each?
41. Are the minimum NTCA requirements for other participant categories within Rule 19.2.1 appropriate?
42. Would other generally accepted accounting practices (e.g. “debt to equity ratio” or “current ratio”) be a more appropriate measure for minimum NTCA in the case of smaller participants, rather than using a fixed monetary figure?

43. Do you agree with the requirement to calculate (and report) the Capital Adequacy Calculation under Rule 19.3.1 each Business Day for the previous Business Day?
44. Do you agree with NZX's proposal to amend the current notification and reporting requirements as proposed above? If not, do you have an alternative solution?
45. Are there any other amendments or updates you think are required to the reporting requirements in the Rule and Procedures in respect of capital reporting?
46. Should NZX clarify the application of Rule 19.4.3 within the procedures, guidance or Rules?
47. Is it appropriate to calculate CRR differently in respect of the different NZX Participant categories? For example, in respect of transactions executed by an Advising-Only Firm through another Trading and Clearing Participant should a risk weighting of less than 4% for "transactions unsettled but not overdue" be applied, or should counterparty risk be applied at all when the Positive Credit Exposure for these transactions is also accounted for in the executing broker's calculation?
48. Do you agree that there is a need for greater clarity in respect of Rule 19.7.4(b)?
    a. Do you agree that adding a specific definition of initial margin in respect of capital calculations would improve the clarity of Rule 19.7.4(b)? Do you have any suggestions for details to be included in the definition?
    b. Is the specific reference in Rule 19.7.4(b) to "for all clients" required given the definition of counterparty already includes clients?
    c. Is any further clarification required in respect of Rule 19.7.4(b)?
49. Do you support a change to Rule 19.9 that, in situations where a participant has used derivatives contracts to hedge a position in the matching underlying financial instrument (or vice versa), the participant could offset the derivative against the physical when calculating their position risk?
50. More generally, is further guidance required in relation to the application of the capital requirements in respect of derivatives?
    a. In particular, should NZX amend the CRR and PRR calculations applying to derivatives participants? If so, how?
51. Do you have any other suggestions for improving the calculation of TRR in respect of derivatives?
52. Do you agree that the spot rate used for the purpose of Rule 19.13.7 should be the one from the end of the previous business day?

5. Review of surveillance arrangements

NZX seeks feedback on proposals to enhance its existing surveillance tools. NZX's surveillance function is an important front line tool for the surveillance and detection of potential market misconduct and to monitor and detect real time market issues, such as disclosure issues or error trades.

NZX Participants are required to input certain information into the Trading System when entering orders or reporting trades. NZX proposes to review these requirements to enhance real-time surveillance capabilities. NZX considers that this is also likely to cut down on the number of routine requests of NZX Participants for client information.

Background and discussion

NZX seeks feedback below on a number of areas which are intended to reinforce existing surveillance tools. The changes proposed are not new but are simply intended to extend the current requirements to areas where gaps have developed since these reporting obligations were initially introduced (e.g. identifiers for wholesale clients, User IDs for Dealers via 3rd party systems). These proposed changes are intended to supplement NZX's existing surveillance tools and ensure that NZX's surveillance function can carry out its duties efficiently. These proposals should also improve the quality of real-time information available to NZX surveillance function.

In terms of other impact of these proposals, Dealers will be required to input additional information into the Trading System, which could slow down manual processes. There may also be some one-off IT work required (e.g. passing through 3rd-party system IDs). The substantial benefit will be a significant reduction in the number of routine surveillance queries seeking to identify clients and or accredited dealers/advisors behind trades and an enhancement to NZX's real time surveillance capabilities.

Reporting of underlying client CSNs

A key source of information for NZX's surveillance function is the client CSN details which NZX Participants are required to enter into the trading system for retail client orders. This information allows NZX to identify parties to a trade in order to monitor and detect potential market misconduct. However, the ability to effectively utilise this information relies on it accurately identifying the correct parties to a trade.

Currently NZX has published guidance requesting NZX Participants to enter custody CSNs rather than underlying client CSNs when a client's securities are held in a nominee account.[20] NZX proposes to amend this guidance to make it clear that a client's underlying CSN should be entered, where known. This is consistent with the policy intention of Rule 15.5, which is to ensure that NZX has information which allows it to detect potential market misconduct.

Although NZX has the ability to request this information from market participants, it is far more efficient for this information to be entered into the trading system (or reported via the trading system) as part of normal processes. This has the potential to significantly reduce the number of requests for information of NZX Participants by NZX's surveillance team.

NZX seeks feedback on this proposed updated guidance (or whether to address via a rule change).

Flagging employee trades

Dealers entering orders into the Trading System can specify that the client is an Employee or Prescribed Person in the account field. This is useful information for NZX's surveillance function because Employee (and Prescribed Person) trading carries additional risk because Employees potentially have access to information such as client order flow, research opinions, trading mandates (e.g., buybacks), major transactions (e.g. strategic sell-downs) which is not necessarily generally available to the public.

[20] Guidance Note GN0002/004 "Trading on behalf of client", page 6 of the guidance note. The concerning statement reads: "For the avoidance of doubt, if a client's securities are held in a nominee account the CSN for that nominee account (not the underlying client's CSN) is required to be entered into the Trading System."

In general, Employees of trading participants have access to more information than members of the investing public and therefore trading by these individuals requires a heightened level of oversight. To illustrate this point, there are a number of additional controls and restrictions on employee trading in the Rules, which are also currently the subject of review. Therefore NZX proposes to introduce a requirement that all trades on behalf of Employees and Prescribed Persons are flagged when entered into (or reported via) the Trading System.

By flagging Employee trades in the Trading System, NZX can do additional monitoring of this trading. NZX Participant Compliance also reviews employee trading in the lead-up to annual on-site inspections. This will also make it easier to extract this information.

Although trades by Employees and Prescribed Persons are often flagged, it is not a requirement and is not consistently completed. NZX seeks feedback on whether to make this a mandatory requirement.

Enter Financial Service Provider (FSP) numbers/identifiers for all wholesale trades in CSN field

NZX is considering whether to introduce a requirement that FSP numbers are entered for all orders on behalf of wholesale/institutional clients. This would harmonise the requirement to identify wholesale/institutional clients with the requirement for retail clients (Rule 15.5). For New Zealand regulated entities, their FSP number provides a ready-made regulatory register from which to populate the CSN field with a similar identifier. The FSP register is maintained by the Companies Office. A full explanation of the FSP register can be found here. NZX also seeks feedback on what might be an appropriate similar expectation in this area in relation to overseas entities.

Provision of reference codes for all DMA clients

As part of maintaining their DMA Authorised Person's register (see Rule 10.11), NZX Participants are required to record details of any DMA Authorised Persons and any clients on whose behalf the DMA Authorised Person acts. Rule 15.13.2 (d) requires all order records to include details of the natural person who placed the order. To meet these requirements, a client reference code must be entered against that DMA client's orders when trading via Direct Client Order Processing.

NZX therefore seeks feedback on whether it is necessary to reinforce the existing requirement under Rule 10.11.1(a) to record the underlying client of any DMA Authorised Persons and Rule 15.13.2(d) to record the natural person who placed each order – possibly by requiring a unique identifier to be applied to each natural person who enters orders via the DMA system. NZX has concerns that the current requirement is not being complied with consistently.

NZX has also received feedback that some DMA Authorised Persons who act as agent for underlying clients are reluctant to provide details of their underlying clients to participants, but are willing to provide this information directly to NZX if required. NZX anticipates that similar objections may arise in respect of allocating a unique identifier to each person who enters orders and is willing to accept details of the unique identifiers directly.

Identify dealers who access the Trading System through Iress or Securitease

NZX Dealers/DMA Dealers are issued with access to the Trading System with a unique user ID to allow for real-time identification and monitoring of Dealer conduct. However, when Dealers access the

Trading System via a 3rd-party order entry system (Iress, SSS, CQG) their identity is hidden. The majority of orders and trades entered by Dealers on NZX is via third party systems. These systems require Dealers to log on with a unique user ID but NZX understands that the systems themselves then connect to the Trading System via single FIX connections, meaning that different Dealers at one participant will appear to NZX as a single user (e.g, 'XZYIOS', 'XZWIOS').

NZX therefore seeks feedback on whether Dealers accessing the Trading System via a third party system should be required to use a unique identifier so that individual Dealers can be identified.

Feedback sought

NZX seeks feedback on its proposals to introduce additional surveillance tools as proposed above.

53. Should NZX should amend its current guidance note (GN 02/04) to clarify that NZX Participants should enter the underlying client's CSN details, where known, as opposed to the CSN for a nominee account?
54. Should NZX introduce a requirement for all employee trades to be flagged in the account field when entered into the Trading System?
55. Should NZX require FSP numbers of NZ Business Numbers (NZBN) to be entered for all orders on behalf of NZ wholesale/institutional clients? If so, which is the preference between and FSP number and NZBN? What would be an appropriate similar requirement for non-NZ based wholesale/institutional investors?
56. Should NZX introduce any additional requirements in relation to the provision of reference codes for all DMA clients e.g. by requiring a unique identifier to be applied to each person who enters an order via a DMA system?
57. Should Rule 10.11.1 be amended to include a note that NZX Participants can meet (a) and (c) by contractual arrangement, which is enforceable, that allows them to access this information from the DMA Authorised Person /that requires the DMA Authorised Person to supply this information directly to NZX?
58. Should Dealers accessing the Trading System via a third party system be required to use a unique identifier so that individual Dealers can be identified?
59. Would any of these proposals cause you any particular difficulties?

6. Minor drafting amendments

NZX intends to include minor drafting amendments to correct and/or update the rules as part of the consultation on the proposed specific amendments (i.e. at the second stage of this review). This will include a review of the appendices and application forms. Stakeholders will have an opportunity to provide feedback on these proposed specific amendments at the next stage of the review.

NZX welcomes any preliminary feedback on any specific changes which should be made as part of this process, noting that there will be an opportunity to comment on proposed specific amendments (and suggest items that may have been missed) at that stage. This will include a consideration of appropriate amendments to related rule sets, such as the Clearing and Settlement Rules and Derivatives Market Rules.