

Key Notes

- Introduction
- Background
- Determining what is a conflict of interest is;
- Identifying, Monitoring and reporting potential conflicts of interest;
- Addressing conflicts of interest
- Record keeping
- Educating and training staff on the Market Participants conflicts of interest policies and procedures.
- Appendix I – guidelines for the establishment of conflict management procedures

Issued March 2007

Disclaimer

This guidance note has been issued to promote commercial certainty and assist market participants. It provides guidance to Market Participants and their advisors on NZX's interpretation of the NZX Participant Rules. 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. Guidance Notes do not constitute legal advice and are only a guide to NZX's policy & practice. NZX recommends that Market Participants take advice from qualified professionals.

GUIDANCE NOTE GN0013/07 – CONFLICT MANAGEMENT PROCEDURES

Introduction

This Guidance Note is published to provide guidance to Client Advising Participants on the interpretation of those NZX Participant Rules (“Rules”) that relate to conflict management policy. This Guidance Note outlines NZX's expectations in relation to both the standard required to comply with **Rule 11.10** and good practice with regard to conflict management procedures.

Rule 11.10.1 requires each Client Advising Participant to have:

“Written conflict management procedures in place to identify and manage any conflicts of interest which may arise between the Client Advising Participant, its Employees, Prescribed Persons, and/or any client of the Client Advising Participant”.

Rule 11.10.1A requires the conflict management procedures referred to in **Rule 11.10.1** to outline, without limitation:

- “(a) A process for Employees to disclose conflicts of interest to the Client Advising Participant;*
- (b) The method for disclosing and recording disclosure of conflict to clients of that Client Advising Participant;*
- (c) The procedure the Client Advising Participant will follow in the event an Employee fails to disclose their conflicts of interest to the Market Participant of a client; and*
- (d) The setting of an appropriate threshold for the Client Advising Participant to maintain registers of its Employee's Security holdings”.*

This Guidance Note provides Market Participants with guidelines on what to consider when establishing conflict management procedures to appropriately identify and manage conflicts of interests that they may face, or appear to face, in the course of their business activities. This includes:

- Determining what is a conflict of interest;
- Identifying and reporting potential conflicts of interest;
- Addressing conflicts of interest; and
- Educating and training their Employees.

Background

NZX recognises that the provision of financial and broking services can give rise to various potential conflicts of interest. Although the potential for conflicts to arise is likely to be greater in organisations providing a wide range of financial services, even those Market Participants offering a narrow range of services can have interests which conflict with those of their clients. It is therefore expected that Market Participants will identify and manage such conflicts of interest appropriately.

Characteristics of good practice which NZX expects to find in the conflict management procedures include:

- The Market Participant's senior management being fully engaged in conflict identification and management;
- The Market Participant's senior management taking an holistic view of conflict risk and conflict mitigation within the full range of business activities for which they are responsible and in a wider group structure where appropriate;
- The Market Participant regularly reviewing the types of conflicts it encounters and whether its procedures ensure that the conflicts are adequately disclosed to clients;
- The Market Participant regularly reviewing the types of mitigation it considers acceptable to address conflicts of interest; and

A well managed firm should have a culture of identifying and disclosing conflicts and the conflict management procedures should support the development of such a culture.

Guidelines as to minimum requirements for conflict management procedures are provided in Appendix 1.

What is a conflict of interest?

Conflicts of interest arise where an Employee's interests and/or the Market Participant's own interests or activities may be contrary to those of a client or where the Market Participant's interests or activities in relation to one client may be contrary to the interests of another client of the Market Participant.

It is not possible to set out all potential circumstances in which a conflict of interest may arise. Examples of situations where potential conflicts may arise are between:

- A Market Participant and a client of the Market Participant
- Two different clients of a Market Participant
- A Market Participant's Employee and a client of the Market Participant
- A Market Participant's Employee and the Market Participant
- A Market Participant and a Related Company

Identifying and reporting potential conflicts of interest

There is no 'one size fits all' approach to address how to identify the full range of potential conflicts that may arise in a Market Participant's business. However, to effectively manage conflicts of interest it is necessary (and a requirement of Rule 11.10.1) for each Market Participant to develop formal policies and procedures to identify and, where appropriate, report on conflicts of interest.

A Market Participants policy document must set out its overall approach to identification and management of conflicts of interest and should:

- (a) Set out the overall principles for conflict management – e.g. treating clients fairly and with integrity;
- (b) Identify conflicts that Employees have to the Market Participant;
- (c) Mandate certain actions to be taken by individuals or businesses of the Market Participant where a conflict is identified;
- (d) Outline a framework for internally escalating and resolving conflicts of interest;
- (e) The method for disclosing and recording disclosure of the conflicts to clients of the Market Participant;
- (f) Identify situations where specific disclosure is required to be made to clients rather than generic disclosure;
- (g) Set out relevant roles and responsibilities of individuals and/or management groups within the Market Participant for conflict identification, management, reporting, disclosure and consequences for failure to disclose;
- (h) The procedure the Market Participant will follow in the event an Employee fails to disclose their conflicts of interest to the Market Participant and/or clients; and

- (i) Set appropriate thresholds above which the Market Participant must maintain a register of Employees' Security holdings.

When setting the relevant appropriate threshold for any given Security, the Market Participant should consider:

- That Security's market capitalisation, free float, liquidity and normal trade size;
- The type and scope of any published research on the Issuer; and
- Whether the Market Participant's clients are advisory or Execution-Only Clients.

For example, the fact that an Employee may hold \$50,000 TEL shares and be advising a client about Telecom or taking an order in Telecom does not mean there is a conflict in providing this advice/taking this order. In this example the Employee's holding is irrelevant given the nature of the Security and its wide analyst coverage. Where the Security has limited research published or is a small cap Security which is relatively illiquid and the Employee has an interest, then the policy would dictate specific disclosure of that interest and the Security must be registered in the Employees Security holding register;

Addressing conflicts of interest

Some of the steps a Market Participant may reasonably take in response to a given conflict of interest are detailed below. It is not an exhaustive list as the appropriate response may depend on the facts and circumstances of each case.

Approaches for addressing conflicts may involve establishing specific structures or procedures, disclosure, or less commonly, refraining from engaging in certain conduct where a potential or actual conflict may arise. There are three key actions Participants can take in response to conflicts:

1. Controlling conflicts of interest

To demonstrate effective control of potential conflicts of interest a Market Participant must demonstrate it has, as a minimum, the following processes in place:

- (a) A process to report conflicts of interest

A Market Participant must have a process for Employees to disclose conflicts of interest to it and, where necessary, a process for Employees to seek that Market Participant's approval either prior to the conflict occurring or for the conflict to continue. For example, if an Employee holds outside business appointments that may conflict with the duties of the Employee to Market Participant and/or its clients that must be disclosed to the Market Participant or an Employee

holding in a Security may be considered to create a conflict due to the quantity held.

Each Market Participant should ensure that any processes are tailored to the nature, scale and complexity of its business.

Each Market Participant must also consider the requirement for that Market Participant to disclose relevant conflicts of interest to its Employees that those Employees will need to disclose to clients. For example, if the Market Participant has a significant principal position in a Security or other business arrangements that create a conflict.

(b) A process to monitor conflicts of interest

NZX would expect Market Participants to appropriately monitor adherence to its conflict management policy and other procedures. For example, monitoring:

- i) The effectiveness of formal Chinese Walls arrangements;
- ii) Trading - whether it is proprietary desk or agency trading;
- iii) Compliance with documented procedures and record keeping;
- iv) The appropriateness of generic and specific disclosures in use and where specific disclosure of conflicts are required to be made;
- v) Internal reporting structures – e.g. business review groups or conflict clearance committees or appropriate escalation of matters to senior management;
- vi) Related policies, for example personal account dealing, handling sales and trading conflicts, material interests, and disclosure of conflicts in research and other written material; and
- vii) The sequence of order receipt through to the trades occurring to detect front running research or other orders;

The policy document would not be expected to replicate all relevant procedures that exist within a Market Participant to manage conflicts, for example:

- Chinese Wall procedures required under Rule 3.23;
- Employee trading obligations under Rule A10.7;
- Breach reporting to NZX under Rule 17.10; and
- The specific and generic disclosures already separately provided for elsewhere in the Rules and other Guidance Notes.

However, it would be appropriate to reference these procedures as part of the overall conflict management process.

It is expected that a Market Participant would establish a framework to be applied where specific instances of possible conflicts arise. The framework would most likely be used to determine how to handle potential or actual conflicts of interest. If already existing procedures address the conflict satisfactorily then it would be expected that these would be followed – e.g. Chinese Walls, Employee trading restrictions etc. However, in circumstances where these procedures are not deemed adequate, additional processes and procedures may be required. The framework to be applied for conflicts where established procedures for the particular situation the firm faces do not already exist either through a legal obligation to disclose (for example, the Investment Advisers (Disclosure) Act 1996 / Part 4 of the Securities Markets Act 1988)), or NZX Participant Rule requirements (for example, Chinese walls).

Occasions may arise where other specific measures will need to be adopted to deal with the particular conflict – e.g. disclosure to clients of the conflict, consent by clients for the Market Participant to act despite the existence of the potential conflict or other mitigation measures which ensure the conflict is addressed through to ultimately declining to act if necessary.

2. Avoiding conflicts of interest

Some conflicts of interest may have such a serious potential impact on clients or be perceived to have a negative impact that there is no adequate way for the Market Participant to manage the conflict and continue to treat clients fairly. In these situations the mere disclosure and attempted control of the conflict may not be adequate.

Policies and procedures should give clear guidance as to the circumstances in which a conflict is unlikely to be effectively managed and where the Market Participant or other related entity should refrain from acting. The policies should detail the process a Market Participant should follow and the actions it should take when the circumstances change.

When deciding whether to refrain, relevant factors include the size and structure of the relevant parties and the intermediary, fiduciary or statutory obligations, and probability of harm or appearance of harm.

3. Disclosure of conflicts of interest

Market Participants are expected to make disclosures to clients as part of the Rules and relevant Securities Legislation. By itself this disclosure may not be sufficient depending on the nature of a potential conflict of interest identified. It is expected that Market Participants ensure clients are adequately informed about the relevant conflicts of interest that may affect the provision of the service and/or advice offered to them.

There will also be transaction specific situations where a Market Participant will require a particular disclosure or course of action in accordance with their policy. For example, a

stock may become “restricted” because of a Market Participant’s involvement in a corporate transaction, in which case there would be:

- Disclosure of the conflict;
- No proprietary/principal or Employee trading;
- No research; and
- Potentially, no advice able to be given about the merits or otherwise of a transaction.

This disclosure should focus on material conflicts not already covered under other legislation /regulations.

Where disclosure is used to address conflicts, such disclosure should be sufficiently complete and timely so that it is meaningful and comprehensible to the client. The Market Participant must have policies for occasions where specific disclosure is required to clients rather than relying on the generic disclosure.

Disclosure alone may not be enough to effectively address a conflict of interest; other approaches may be necessary or required.

Record keeping

A Market Participant should be able to demonstrate compliance with the conflict management procedures through its internal record keeping. These records may be requested by NZX as part of its regulatory oversight.

NZX also recommends that the Compliance Manager be able to demonstrate that he or she conducted independent reviews of the Market Participant’s and the Employees’ compliance with the procedures for managing conflicts of interest at appropriate intervals based on:

- The nature and the underlying risks of the firm’s activities; and
- The requirements of the conflict management policy.

Education and training

Ultimately, conflict management is dependent on the Employees of the Market Participant being alert to the issues conflicts of interest bring. An organisation’s culture shapes the manner in which it deals with issues. Compliance training supported by effective systems are important in embedding an appropriate culture.

Training will ensure all Employees understand the expectations of the Market Participant’s policies and procedures and how to apply them in the context of their work.

The annual declaration is a useful tool to ensure that Employees continue to be aware of their responsibilities and obligations.

Appendix 1 Guidelines

The following procedures represent the guidelines prescribed by NZX for the establishment of conflict management procedures for the purposes of **Rule 11.10**.

Written policy statement

A written policy statement should be developed outlining the Participants stance on conflicts of interest including:

- The principles behind the conflict of interest management requirements;
- Relevant Rules and Securities Legislation;
- Identification of conflicts;
- Ongoing monitoring of conflicts;
- Reporting conflicts;
- Addressing conflicts;
- Disclosure of conflicts including when specific disclosure is appropriate;
- Record keeping; and
- Consequences for not complying with the conflict management procedures.

Acknowledgement of Conflicts Management Procedures

The conflict management procedure should be provided to all staff.

All staff members must acknowledge annually that they have read, understood and have agreed to comply with the Market Participant's written policy on conflicts of interest. The Market Participant is to retain these acknowledgements.

New staff members are to:

- Be informed of their obligations with respect of conflict management;
- Be informed of related policies and procedures – e.g. Chinese Walls policies, Employee trading policies, client order precedence procedures, disclosure obligations etc.

Continuing Education

The Market Participant must ensure training and continuing education of Employees in relation to the written policy statement on conflict of interest management.

Monitoring and Detections of Breaches

Where the conflict management procedures are not followed (i.e. there is a breach) the Market Participant must immediately initiate steps to ensure that the breach is investigated and appropriate actions taken as per the Market Participant's Compliance Breach reporting procedures and **Rule 17.10**.