NZX Participant Guidance Note

Trading Conduct

January 2025

The purpose of this Guidance Note is to provide guidance to NZX Participants in relation to Good Broking Practice in the areas of trading conduct encompassed by the Participant Rules and Derivatives Market Rules (**Rules**).

This Guidance Note replaces the previous Market Manipulation Guidance Note issued in May 2021.

Contents

1. Introduction

The purpose of this Guidance Note is to provide information for participants in respect of trading on NZX's markets, including:

- the key principles that NZX considers underpin the role of participants who trade on those markets;
- describing acceptable market practices, best practice and recommendations on procedures relevant to order execution; and
- details of the types of conduct or behaviour that may potentially breach NZX market Rules or result in regulatory scrutiny.

Good trading conduct practices underpin fair, orderly and transparent markets and promote market integrity. This increases public confidence in the operation of NZX's markets. Public confidence in turn enhances market liquidity and efficiency.

1.1 Scope of this Guidance Note

This Guidance Note addresses considerations relating to trading conduct under both the Participant Rules and the Derivatives Market Rules (the **Rules**). This Guidance Note includes guidance relating to trading on NZX Dark which is a voluntary venue that Market Participants may elect to use for trading financial products quoted on the NZX Main Board.

Parts of this Guidance Note relate to areas where NZX and the FMA have overlapping regulatory roles, for example market manipulation. Where there are areas of overlap, NZX and the FMA work cooperatively and will, where possible, endeavour to jointly engage with NZX Participants.

Where relevant, examples of conduct are set out in this guidance. Please note that the examples set out in this Guidance Note have been provided for illustrative purposes, are limited and are not designed to cover all eventualities. All investigations by NZX into trading conduct are considered on a case by case basis, and determined based on their particular facts.

References to NZX Participants in this Guidance Note include:

- Participants, NZX Derivatives Advisers, Dealers, and Designated Market Makers, as defined in the Derivatives Market Rules and specified in each relevant Rule; and
- Market Participants, Advisers, Dealers, and Designated Market Makers as defined in the Participant Rules and specified in each relevant Rule.

Capitalised terms which are not defined in this Guidance Note have the same meanings given to them in the Rules.

Under Participant Rule 21.4.1 and Derivatives Market Rule 14.14.1, NZX may act by and through NZX Regulation Limited (**NZ RegCo**) in performing any function or discharging any power set out in the Rules. References in this Guidance Note to NZX therefore also include NZ RegCo in relation to any regulatory activity or discretion.

2. Key principles

The key principles NZX considers underpin NZX Participants' role in trading conduct are set out below:

- conflicts of interests must be appropriately managed;
- NZX Participants should always place the interests of their clients before their own interests;
- markets should be fair, orderly and transparent;
- NZX Participants should have systems and controls in place in order to meet their requirements under NZX's Rules and legislation; and
- NZX Participants should follow good broking practices.

Where possible NZX Participants should endeavour to trade on-market, as this will lead to a deeper and more liquid market with greater transparency.

3. Orderly Markets

As a licensed market operator, section 314 of the Financial Markets Conduct Act (**FMCA**) requires that NZX, "*to the extent that is reasonably practicable, do all things necessary to ensure that each of its licensed markets is a fair, orderly, and transparent market*."

For the purpose of this Guidance Note, orderly market considerations relate to orderliness of trading across the market as well as in relation to specific securities.

In this respect, the key characteristics of an orderly market are that participants can determine, with an appropriate degree of certainty, the volumes and prices at which they can deal by using NZX Central, and in which unreasonable price variations between trades are avoided.

Participant Rule 8.8 and Derivatives Market Rule 8.2 require NZX Participants to ensure their conduct promotes and helps maintain an orderly market, including when giving effect to any Orders placed by clients. Designated Market Makers are required to ensure that they enter and maintain quotations that are reasonably related to the prevailing market of the Security or Contract that it is marking markets in. In respect of trading conduct, NZX considers that a key factor in maintaining the orderliness of NZX's markets (in the absence of any new information), is the steady (i.e. not unusually volatile) movement in the price of a financial product being traded.

In ensuring their trading conduct promotes and helps maintain an orderly market, NZX Participants consider a range of circumstances relevant to the current conditions of the market for any financial product. Accordingly, in allowing each Order to proceed through to the market, NZX Participants must first determine (among other things):

- Whether the execution of that Order is consistent with the recent trading activity in the relevant financial product; and

- Whether the execution of that Order will materially affect the price or market for the relevant financial product.[1]

Key considerations for NZX Participants in relation to maintaining an orderly market, particularly with respect to less liquid products, include the impact of simply crossing the spread, or placing “at market” or limit Orders that will trade through the best bid or offer, or placing a series of Orders and apply equally to DMA Orders. Further detail in respect of each of these potential impacts is set out below.

While NZX Participants are required to ensure the orderliness of the market, they also have obligations to promote a market that accurately reflects the supply and demand of a financial product. NZX acknowledges that there are financial products traded on NZX’s markets that are relatively illiquid. However, simply following client instructions on order execution is not a valid ground for NZX Participants to disregard the impact an Order will have on the market generally.

NZX is unlikely to have concerns if an NZX Participant submits an Order that will, or is likely to, result in a significant price movement, particularly in a less liquid financial product, provided the NZX Participant has first taken appropriate measures to ensure the market for that financial product remains orderly. For example, if (in the absence of any material information about the financial product) an NZX Participant proposes to execute an Order at a price significantly higher or lower than the last traded price for a financial product, the NZX Participant should, where possible, take steps to discover buyers or sellers at a price between the last price traded and the significantly higher or lower price before executing with the current best price. This could involve placing bids (offers) at a price close to the last traded price, then amending the price incrementally (in increments that are consistent with usual trading in that financial product) to reveal any potential sellers (buyers) at prices that would result in a less material price change and a better price for the client. When placing Orders that will incrementally alter the price of a financial product as a price discovery mechanism, it is only necessary to leave each incremental Order in the market for a short period – NZX recognises that the specific period will vary from seconds to a couple of minutes depending on the liquidity of the financial product.

Participants should treat all Sweep Orders (which will traverse NZX Dark, before progressing to NZX Central if they do not fully execute) as if they are being sent solely to NZX Central, when considering their obligations in relation to maintaining an orderly market.

Example 1:

The current spread of XYZ is $0.34/$0.41, with a last traded price of $0.34. Recent trading in XYZ has ranged between $0.30 and $0.35. Participant 111 receives a client Order to buy 1,500 XYZ at $0.41. Entering the Order to buy directly at $0.41 would cause a material price impact (due to the price increase of >20%), and be likely to be viewed by NZX as trading in a disorderly manner. However, entering the Order to buy at $0.35, then increasing the price in 1 or 2 cent increments and leaving each amended bid in the market for a short period would not be viewed as disorderly, even if the end result was that the buy Order traded at $0.41.

In the above example, the incremental price improvements demonstrate to NZX that the NZX Participant has taken steps to minimize the risk of a disorderly market, even if the Order may ultimately trade at a price materially higher or lower than the last traded price (i.e. trading at $0.41 after seeking any potential price improvements is more likely to be viewed as orderly than trading at $0.41 after a ‘careless’ market order).

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[1] See section 9 of this Guidance Note for further details regarding the required considerations when accepting an Order.

A disorderly market can arise where an NZX Participant enters an Order to trade "at market" or at a limit price (that is lower than the best bid or higher than the best offer price), if the volume of that Order causes a material price movement by immediately trading against a number of available Orders in the market at escalating or reducing prices. NZX Participants must consider the overall impact (i.e. both price and volume) of all Orders before entering them into the market to ensure they do not cause a disorderly market.

Example 2:

The current spread of XYZ is $0.35/$0.37, with a last traded price of $0.35. The current bids in the order book are:

475 @ $0.35
1,000 @ $0.34
4,000 @ $0.32
2,000 @ $0.30
15,000 @ $0.29

Entering a sell Order for a volume of 10,000 either "at market" or at a price that is lower than the best bid (e.g. $0.30) would immediately trade against the first four or five bids and leave the spread as $0.29/$0.30.

This would result in a material price impact (due to the price decrease of >14%), and be likely to be viewed by NZX as trading in a disorderly manner.

A series of Orders entered into the market that cause a material price move by trading against a number of available Orders in the market at escalating prices can also be viewed as a disorderly market. Even though each new Order may only have a small impact on the price, if the overall trading in a short space of time has a material impact on price that is inconsistent with recent trading in the relevant financial product, the series of Orders will be considered together (see also point (g) in section 9 of this Guidance Note). This is a particular risk associated with NZX Participants who use, or whose clients use, algorithms to enter Orders.[2]

The orderly market requirements apply equally to Orders received via an NZX Participant's DMA system. NZX Participants are required to have adequate filters in place in their DMA systems in respect of the throughput and execution of DMA Orders. NZX Participants that offer DMA must also have controls and procedures for ensuring Dealers give due consideration to the potential impact of an Order before allowing an Order that has been referred to them as it is outside the filter parameters to enter the Trading System. Where possible, trade monitoring should consider all trading by a person irrespective of the order entry method.

4. Client Orders

4.1 Client Order Priority

Participant Rule 15.15 and Derivatives Market Rule 9.8 prohibit NZX Participants from buying or selling Securities/Contracts on their own behalf or on behalf of a Prescribed Person when they hold an unexecuted client Order on the same terms. In addition, NZX Participants are

[2] See, for example, NZX Limited v Macquarie Securities (NZ) Limited (NZMDT 01/2016), which can be found here

prohibited from allocating sales and purchases of Securities/Contracts to fulfil all or part of an Order from a Prescribed Person or on their own behalf[3], when they have an unfilled client Order on the same terms.

A reference to an NZX Participant giving priority to an Order of a client over an Order on its own behalf or on behalf of a Prescribed Person, means that from the time of receipt of the Order until it is fully executed, the NZX Participant does not enter into, on its own behalf or on behalf of a Prescribed Person, a trade for the same financial products on the same terms.

NZX expects NZX Participants to have clear procedures and controls to manage this requirement. These should include specific processes and controls for transactions where the NZX Participant is Acting as Principal or acting on behalf of a Prescribed Person. For example, an NZX Participant's allocation policy and procedure should prevent the allocation of trades to fulfil all or part of an order for its own account or the account of a Prescribed Person when it has an unfulfilled Order on the same terms for those trades from a client. NZX Participants' monitoring processes should include ongoing monitoring of principal and Prescribed Person trading to ensure client Orders are given priority.

Participant Rule 15.15.7 permits NZX to set out in a Guidance Note any additional conditions under which Participant Rule 15.15 - Client Order Priority will not apply. The primary purpose of this is to allow NZX to recognise the difficulties that arise in meeting this obligation for Participants that have genuine segregation of their principal trading from agency trading. Where a Participant wishes to implement a segregation model that will allow Rule 15.15 to not apply to that part of the Participant's business, it may do so where such a model:

- includes appropriate segregation of its principal trading; and
- includes adequate controls and monitoring to restrict access to clients' trading information; and
- has been expressly permitted and approved in writing by NZX.

See also NZX Conflicts Management Guidance Note here.

4.2 Indications of Interest

Indications of Interest (IOIs) are conditional non-binding expressions of interest to trade financial products, which may be provided by an NZX Participant in electronic, written or verbal form (including through email, FIX messages, voice or direct messaging).

IOIs are used by Participants to advertise potential crossing opportunities to potential counterparties. While IOIs may contain information such as the name of the financial product, trade direction (buy or sell), volume and price indications, they are not an Order and are usually

[3] For the purposes of Participant Rule 15.15 an NZX Participant acting on its own behalf includes where the NZX Participant does so on behalf of any person which controls, or is controlled by, that NZX Participant.

also not a contractual offer, although in some circumstances, they can be. Whether an IOI is an offer will depend on how the IOI is phrased and is further impacted by the time that has passed and any market movements since the IOI was issued.

IOIs are used by NZX Participants to advertise Institutional Client or Principal flow, and are seldom used in respect of Retail Client Orders. To the extent that NZX Participants disseminate or communicate IOIs, such indications must be genuine and not be misleading.

Participant Rule 9.1.1(c) and Derivatives Market Rule 6.8.1(c) require an NZX Participant to respect and ensure the confidentiality of client information and to ensure the use of this information is limited to the purposes for which it was provided.

Conduct expectations for advertising IOIs

When advertising an IOI, NZX Participants should have controls and procedures in place to:

- manage the risks of an actual or perceived conflict of interest arising from the advertisement (therefore, we expect that to the extent a Participant's procedures require that Dealers who are executing Trades for a Participant who is Acting as Principal should be precluded from viewing client flow, that the Participant's procedures should also preclude the Dealer from viewing client flow IOIs);

- address information imbalances that may result in a worse outcome for the client. Participants should be cognisant that the disclosure of Trading intentions in respect of large volumes in less liquid securities may be price sensitive, and may deliver a worse outcome for the client;

- manage the risk of the potential front-running of a client Order. Participants should be cognisant of the possibility of a worse outcome for the client as a result of information being used by recipients of an IOI to trade ahead of the Participant; and

- prevent non-genuine IOIs being used to gather and exploit information about genuine Trading intentions. Such activity could be viewed as misleading and deceptive conduct under Part 2 and/or Part 5 of the FMCA and be contrary to Good Broking Practice and the conduct requirements for NZX Participants (Participant Rule 8.1 and Derivatives Market Rule 4.4).

NZX Participants should also ensure that IOIs, particularly in electronic IOI dissemination systems, are kept up-to-date, by, for example, cancelling an IOI which has subsequently been traded. NZX Participants should also consider their obligations under Participant Rule 15.11 to maintain records of Relevant Employee Communications in respect of disseminated IOIs.

Flagging IOIs

NZX recommends that NZX Participants consider whether it would be appropriate to 'flag' whether an IOI represents:

1) "client", "potential", or "principal" flow; and

2) "natural" or "non-natural" flow.

NZX suggests that Participants consider adopting the AFME/IA framework (or a similar international framework to flag their IOIs). The AFME/IA framework sets out a "Class: Subclass" system, using the following letter and number codes:

Class	Sub-class
C = Client	1 = Natural, can deal as a block
P = Potential	2 = Natural, need to work the order
H = House	3 = Non-natural

NZX notes that, because the AFME/IA framework is becoming the de facto global standard for advertising IOIs, many of the electronic IOI dissemination providers include the ability to send IOIs in this "class: subclass" format.

Client/Natural

A "natural" IOI is one in which a Participant has an "agency" Order in hand, able to be traded in some way (eg VWAP (C:2), Participate (C:2), at a price (C:1), etc).

Potential

A "potential" IOI is one in which a Participant has a reasonable expectation of interest from a client. For example, a client may say to a Participant "I am a buyer of financial product X, show me any size selling you see". This IOI would be flagged as "Potential/Natural" (P:1, or (maybe) P:2).

House /Natural

An IOI flagged in this way (H:1, H:2) would represent a Principal position which a Participant is prepared to Trade – either unwinding, or adding to, an existing position or initiating a new position - and which the Participant will NOT then unwind in the market in potential competition with any on-going Order from the client, without that client's express permission.

House /Non-Natural

A "House/Non-Natural" IOI (H:3) would tell the client that the Participant is prepared to Trade the Order, under the terms specified in the IOI (VWAP, at a price, etc), but that it will then be active in looking to unwind any resulting Principal position, on-market, and/or via IOI advertisements. One example would be a Participant buying financial products arising from a non-natural/principal IOI, and then unwinding the position by selling it in the market.

Example 1:

IOI detail	IOI detail with "class:subclass" codes	Description
BUY 200k ZEL 5.77, natural, agency, would	Buy 200k ZEL 5.77, C:1	This IOI says the Participant has an agency Order in hand ("natural, agency"; "C:") to buy 200k ZEL and would trade them in one line ("would"; ":1"), assuming the price is $5.77 or lower.

Example 2:

IOI detail	IOI detail with "class:subclass" codes	Description
SELL 100k FPH, natural, agency, vwap	SELL 100k FPH, C:2, vwap	This IOI says the Participant has an agency Order in hand ("natural, agency"; "C:") to sell 100k FPH and would trade them at the day's VWAP ("VWAP"; ":2").

Example 3:

IOI detail	IOI detail with "class:subclass" codes	Description
SELL 250k SKL, natural, agency, ITW	SELL 250k SKL, P:1	The Participant is in touch with ("ITW"; "P:1") a seller of 250k SKL and feels confident that, should she find a buyer, she would be able to access 250k from this seller, subject to a pricing negotiation. Obviously, there is scope for abuse of this designation, but a Participant using it, and failing to deliver too often will find clients treating all her IOIs sceptically.

Example 4:

IOI detail	IOI detail with “class:subclass” codes	Description
BUY 200k FBU, non-natural, principal, would	BUY 200k FBU, H:3, would	The Participant is indicating they will buy 200k FBU from a client in one line, but if transacted, they retain the right to immediately look to either unwind this position in the market, and/or advertise it via IOI.

Example 5:

IOI detail	IOI detail with “class:subclass” codes	Description
SELL 150k CEN, natural, principal, would	SELL 150k CEN, H:1	The Participant is either long (“natural, principal”; “H:”) 150k CEN, which they would sell to a client in one line (“would”; “:1”) at a price to be negotiated, or they are prepared to short the financial product and undertake not to seek to cover (or advertise) the position in the market immediately. They can, however, use this position to respond to unsolicited client Orders.

4.3 When is it an “Order”?

An Order is an instruction to purchase or sell financial products (or an instruction to amend a previous Order), whether for a client or as Principal. Certain specific information must be recorded in respect of any client or principal Orders received, including the date and time of receipt of the Order. Further details of the Order record requirements can be found in Participant Rule 15.12 and Derivatives Market Rule 9.7. While Participants are not required to obtain a specific instruction from a Client in order to place an NZX Dark Order, to the extent such an instruction is received it should be recorded in accordance with the requirements of Participant Rule 15.12.2(m).

An Order arises when the NZX Participant has received a client instruction to trade. An IOI is not itself an Order for the purposes of this Guidance Note. However, where an IOI is based on instructions held by the NZX Participant, those instructions are an Order. Similarly, where an NZX Participant receives a response to an IOI that agrees to trade at the price and volume indicated as firm by the NZX Participant in its IOI, that response would be considered an Order.

When dealing with Institutional Clients, it is common practice for one or more discussions to take place between the client and the NZX Participant regarding that client's trading intentions prior to an actual Order being placed.

Although these discussions with Institutional Clients are indications of trading intentions rather than Orders, NZX expects NZX Participants to retain, and to be able to provide details of, information of the discussions, timing and specific nature of the information available to the NZX Participant in respect of these clients' trading intentions leading up to the receipt of the actual Order. Information of this nature, that is required to be maintained under the Rules, is likely to be requested in respect of any trading conduct investigations. These records may, subject to any specific Rule requirements, be in multiple formats, including voice recordings, written records, email, system records (e.g., Iress or Bloomberg), etc.

4.4 Bringing Orders to market

Participant Rule 15.4.1 and Derivatives Market Rule 9.4.2 require NZX Participants to submit Orders, which are at market or at a fixed price limit, straight to market via the Trading System. The Rules then prescribe the circumstances in which an NZX Participant may delay - and in respect of the Participant Rules, accumulate or bundle - an Order, which is at market or at a fixed price limit, rather than submitting it straight to market via the Trading System. These requirements apply to all NZX execution venues. If one of these prescribed circumstances applies, the NZX Participant is able to execute an Order for a client at that NZX Participant's discretion. However, NZX Participants cannot exercise this discretion in order to avoid the obligations in the Rules, or any direction issued by NZX or if to do so would be contrary to Good Broking Practice.

One of the circumstances prescribed in the Rules that would permit an NZX Participant to delay, accumulate or bundle Orders, is through the inclusion of standing instructions in a client agreement as contemplated by Participant Rule 15.4.2 and Derivatives Market Rule 9.4.3. If such standing instructions are to be included in client agreements, the agreement should:

- set out any such terms clearly and prominently;
- allow the client to override the standing instructions at the time the Order is placed;
- set out how the NZX Participant will allocate trades executed in respect of any bundled Orders, particularly where there may be a price variation or where they are unable to complete all of the combined volume of the bundled Orders; and
- disclose the circumstances in which client Orders may be bundled with Principal Orders, including Prescribed Person Orders and how client Orders will receive priority in any subsequent allocation.

When exercising a discretion to delay, accumulate or bundle an Order NZX Participants must ensure there is a clearly identifiable benefit, or a reasonable expectation of one, to that particular client in the circumstances. The NZX Participant must be able to provide evidence of this if requested by NZX or the client. NZX anticipates that NZX Participants will exercise this discretion infrequently and when doing so, will ensure that client Orders are entered and allocated fairly and in due turn.

Another situation where it would be appropriate to delay entering a client Order is where execution of that Order is likely to have a material impact on the price of the financial product. In such case, the NZX Participant can delay entering the Order to allow them to contact the client to obtain alternate instructions or to enter the Order undertaking a price discovery process by incrementally amending the price so as to maintain an orderly market (see also Section 3).

Bundling Orders that are on the same terms and are received at approximately the same time can provide benefit to the relevant clients in respect of gaining equal priority and potential to access volume. However, it is more difficult to demonstrate a clear benefit to each client when Orders on the same terms are received at different times and then bundled.

When considering whether to exercise a discretion to delay, accumulate or bundle an Order, NZX Participants should start with the base requirement of the Rule which is to "submit Orders, which are at market or at a fixed price limit, straight to market via the Trading System". Where the NZX Participant is of the view that a particularly long delay, or in some cases a need to complete the transaction over multiple days, is necessary, this should be discussed with the client.

Example 3:

The current spread for XYZ is $0.35/$0.38. Participant 111 receives an Order to buy 1,500 XYZ at market from Client A at 10:35am, an Order to buy 5,000 XYZ at market from Client B at 10:37am, and an Order to buy 11,800 XYZ at market from Client C at 10:40am. Participant 111 considers it in the interests of the clients to bundle these Orders and places a bid into the market for 18,300 XYZ at $0.36. During the morning, this Order has been partially executed and 7,500 remain to be done. The Order is the priority bid and two additional bids have been entered into the market by other Participants at $0.36. At 13:56pm Participant 111 receives an Order to buy 8,000 XYZ at market from Client D.

The Order from Client D cannot simply be added to the combined Orders for Clients A, B and C. To do so would risk the earlier bundled Order losing priority and can create an allocation issue if there is a price variation in the execution of the Orders or an inability to complete all the desired volume. If Participant 111 elects to increase the previously bundled Orders by this new amount, it will need to be able to clearly demonstrate how this approach is in the best interests of each of Clients A, B, C and D.

Example 4:

The current spread for XYZ is $0.35/$0.37, with a last traded price of $0.36 and there are a total of 4,000 XYZ available on offer at $0.37. Participant 111 receives an Order to buy 2,500 XYZ at market from Client A at 10:35am. Participant 111 determines not to enter the Order straight into the Trading System, but instead to facilitate the Client A's Order, along with three other Client Orders. While Participant 111 is arranging the crossing, the spread for XYZ changes to $0.38/$0.40. At 11:04am, Participant 111 reports a crossing (which includes the purchase of 2,500 XYZ for Client A) of 10,000 XYZ at $0.39.

The Order from Client A could have been executed on-market immediately without any adverse market impact and in accordance with the client's instructions. It would be difficult for Participant 111 to demonstrate a clear and readily identifiable benefit to that particular client in the circumstances. This is made even more difficult by the conflict that arises because Participant 111 is acting as principal in the transaction.

5. Principal Trading

Principal Trading refers to an NZX Participant trading on its own behalf or Acting as Principal. Principal Trading can take several different forms, although it primarily falls into two broad categories:

- proprietary trading; and

- client facilitation.

NZX recognises the value that Principal Trading, particularly client facilitation, brings to the New Zealand market, including through improved execution certainty, increased liquidity and reduced signalling risk.

Whichever category it falls into, Principal Trading introduces additional risks of actual or perceived conflicts of interest for NZX Participants. Controls and procedures are required to manage these risks. NZX Participants that engage in Principal Trading must address trading conflicts, and how they are managed, in their conflicts management policies. In particular, conflict management policies should:

- be approved internally by persons with the appropriate delegated authority;
- be subject to regular internal compliance review; and
- set out how the NZX Participant manages the conflicts between agency and Principal Trading (including both facilitation and proprietary trading, and where a Participant elects to utilize NZX Dark the user permission arrangements that the Participant has applied) and in which circumstances a conflict can be managed by effective disclosure and which require avoidance (e.g. segregation).

See also NZX Conflicts of interests Guidance Note here.

In all cases where an NZX Participant deals as principal with one of its clients, this should be disclosed to the client as required by the Rules, and where possible before execution of the transaction.

There are different regulatory expectations in respect of these categories.

5.1 Proprietary trading

Proprietary trading generally refers to situations where an NZX Participant is trading on its own behalf and includes trading:

- to take or exit a position in order to make a profit;
- to exit an underwriting position;
- to hedge an exposure;
- as part of a market making arrangement; or
- to manage an error position to avoid or limit a loss.

When engaging in proprietary trading, an NZX Participant may be competing with its clients to acquire or dispose of financial products. It is therefore inappropriate for the individuals conducting this trading on behalf of the NZX Participant to also have visibility of client trading information in relation to the same financial products.

In these situations the NZX Participant's interests have the greatest potential to conflict with those of its clients. As a result, stricter controls, oversight, monitoring and clearly documented procedures are expected. A Designated Market Maker should ensure it has implemented controls to maintain the separation of any client related trading in the specified Securities or Contracts that it is market making in, and associated oversight, and monitoring arrangements. It is not a mandatory requirement under the Rules for an NZX Participant's proprietary trading function to be segregated from the client facing areas of the NZX Participant's business, but NZX considers that this is best practice. NZX considers that such segregation should include access to systems and information (such as directories, and any form of meeting or electronic communication used to discuss client Orders and trade ideas), as well as physical separation (with no access to trading areas occupied by client traders). Where the only proprietary trading conducted by an NZX Participant is in respect of managing error positions, NZX considers it is unlikely that grounds exist to warrant segregation of the Dealer.

5.2 Facilitation

Facilitation (sometimes referred to as “flow trading”) refers to situations where an NZX Participant trades as principal in order to assist its clients to complete their Orders.

When undertaking facilitation, an NZX Participant may agree to buy financial products directly from its client, or to sell financial products directly to its client, as principal before reporting these transactions to the market as Crossings. This is often to provide liquidity and/or execution certainty for clients wanting to execute large transactions or to provide execution and price certainty to clients who need to achieve completion of an entire order at a specific price (for example at the closing price for the day or at the Volume Weighted Average Price (**VWAP**)).

As a result of the inherent potential conflicts associated with acting both as principal and as agent in a transaction, NZX will likely review facilitation transactions which appear to have been conducted with the intention of, or to have the effect of, impacting the price, volume or market for a financial product for the benefit of the NZX Participant.

Facilitation can be either passive (sometimes referred to as reactive) or active (sometimes referred to as proactive).

Passive facilitation

Passive facilitation is client initiated - where a client requests a trade on specific terms which results in the NZX Participant taking a principal position as counterparty to the trade to assist the client to achieve their desired result.

Active facilitation

Active facilitation is initiated by the NZX Participant - this can include the NZX Participant:

- trading or indicating a willingness to trade with one or more clients (to exit a position taken in response to earlier client requests); or
- trading to build a position so it has sufficient securities available to respond to anticipated client demand.

When engaging in active facilitation, there is an increased risk that the NZX Participant may be competing with clients to buy or sell a financial product. NZX Participants will need additional controls and monitoring in respect of active facilitation to manage this increased risk, which could include, among other things:

- mandatory disclosure to the affected client that the NZX Participant is Acting as Principal (in accordance with the Rules);
- keeping contemporaneous records of the basis for anticipating receipt of an Order;
- additional mechanisms for managing client Order priority requirements;
- ensuring access to any information in relation to Retail Client Orders is appropriate;

- having a clear facilitation policy with limits applied and monitored; and
- conducting regular reviews of facilitation trading to ensure client interests remain the purpose of the trading.

Confidentiality

When offering facilitation services to clients, NZX Participants need to have suitable arrangements in place to manage the confidentiality of information surrounding clients' trading intentions, to ensure that the NZX Participant, its Employees or others are not able to use this information improperly to try to gain a benefit or advantage, for example through front running a large client Order. These should include controls, oversight, monitoring and clearly documented procedures.

NZX will review trading if it appears that an NZX Participant may have used knowledge of the trading intentions of its clients to enter into active facilitation transactions where the NZX Participant benefits from the ancillary transactions. For example, trading to move the spread or to set a different last traded price or closing price, whether to allow reporting or to influence the facilitation price for the benefit of the NZX Participant.

6. Insider Trading

The legislation also prohibits insider trading. The Rules require NZX Participants to report instances of suspected insider trading to NZX.

As a licensed market operator, NZX's frontline monitoring of trading occurring on its markets includes monitoring for possible insider trading. Trading that may be indicative of insider trading is referred to the FMA, the regulator responsible for enforcing the insider trading prohibitions in legislation.

Examples of areas of an NZX Participant's business that are more at risk of Employees being exposed to information that will be subject to the insider trading prohibitions primarily include investment bankers and research analysts, but can also include Advisers and Dealers, particularly where they advise or deal for clients who are officers of a listed company and are therefore more likely to be exposed to such information.

The relevant Rules are Participant Rule 15.6 and Derivatives Market Rule 4.21. They require NZX Participants to have policies and procedures that require all instances of suspected insider trading to be referred to the NZX Participant's Compliance Manager, who must record, investigate and report them to NZX.

The legislative requirements in respect of insider trading are set out in the FMCA sections 231-234 and 240-261.

A person is an information insider in respect of a listed issuer where they:

- have access to material information in relation to the listed issuer that is not generally available to the market; and
- know (or should know) that the information is material; and
- know (or should know) that the information is not generally available to the market.

A person is an information insider in respect of a quoted derivative where they:

- have access to material information in relation to the derivative, the underlying, or the issuer of the underlying that is not generally available to the market; and
- know (or should know) that the information is material; and
- know (or should know) that the information is not generally available to the market.

Where a person is an information insider, as defined in section 234 of the FMCA, they are prohibited from trading, advising or encouraging others to trade or disclosing the inside information.

NZX Participants should have policies and procedures in place to manage situations where they or any of their Employees have access to inside information, which may include Chinese Walls. Policies and procedures should also cover situations where an Employee has reason to suspect a client may be an information insider and should include regular training for all Employees.

For example:

- in relation to NZX Participants that conduct research, it is best practice to have policies in respect of:
  - segregation of the research team;
  - specific trading limitations for research team members, particularly in respect of companies that they cover; and
  - specific trading requirements in the period prior to the release of a research report.
- in relation to situations where an Employee suspects a client may be an information insider, a policy that sets out how to deal with the client and their Orders and the escalation path the Employee should follow.

7. Market Manipulation

A fundamental component of fair, orderly and transparent markets is that they reflect genuine supply and demand and support accurate price discovery.

As a licensed market operator, NZX undertakes frontline monitoring of trading occurring on NZX's markets. A key aspect of this is monitoring for trading that may be indicative of market manipulation or other market misconduct.

Broadly speaking, the Rules describe market manipulation as conduct that creates a false or misleading appearance of the trading activity, the price/yield of, or the market for (including supply and demand) a quoted financial product. Both trading that is intended to create this impression and trading that has the effect of creating this impression (whether intended or not) can be considered manipulative.

Manipulative conduct can either directly influence the price or appearance of trading in a financial product through the transactions undertaken, or indirectly influence the price of another asset or investment. For example, a person may trade in a way that impacts the price of a listed Security to gain a benefit in a Derivative that they hold such as an equity option or a contract for difference.

Trading in a manner that is designed to set a specific price (setting a price) or to ensure a price does not go below (or above) a specific level (maintaining a price), such as price support or marking the Close, would be likely to be considered to create a false or misleading appearance of the price of a quoted financial product.

It is important to note that setting or maintaining a price or creating an impression of active trading does not need to be the sole purpose for the conduct in order for it to be considered market manipulation. In other words, having a purpose of setting the closing price would still be considered manipulative, even if the person also had a legitimate commercial purpose for the transaction. In addition, conduct that has the effect of setting or maintaining a price or creating an impression of active trading, whether or not it was intended to, can also be considered market manipulation.

In *Financial Markets Authority v Warminger*, Venning J held that:[4]

> Under s 11B the purpose behind the transaction in issue is a relevant factor in determining whether the trade has affected the genuine supply and demand in the market. Each trade in the market has the potential to impact on the price of the security traded and, depending on the volume transacted and the timing of the trade, may impact on the supply of or demand for the securities. A manipulative transaction may seem the same as a non-manipulative one in terms of its impact on the price, the supply of, demand for or the extent of the active trading in the security. The purpose of the trade may be the key factor which distinguishes culpable manipulation from a trade made for genuine reasons.

Venning J cites *Siddiqi (Re)*:[5]

> As is clear from these authorities, a person manipulating the market might use a variety of tools to do the job. Some of these tools are not inherently illegitimate trading practices – they only become so when employed with the intention of manipulating the market. It is also necessary to consider the conduct of the alleged manipulator as a whole. Some trading and order activity may not seem manipulative when viewed in isolation, but is clearly so when considered along with all of the manipulator's other conduct.

It is therefore important for NZX Participants to remain cognisant of the two limbs of the market manipulation requirements. The first is concerned with the intention of the NZX Participant (or its client). Accordingly, the actual effect of the Order is not relevant. The second is concerned with the actual or likely effect of an Order and therefore intention is irrelevant, and an objective assessment of whether a false or misleading impression will be created is necessary together with an assessment of whether a false or misleading impression is a likely effect.

New Zealand law and the Rules prohibit market manipulation on NZX's securities and derivatives markets.

[4] *Financial Markets Authority v Warminger* [2017] NZHC 327 [3 March 2017], at 61.

[5] At 70, referencing *Siddiqi (Re) 2005 BCSECCOM 575* at 118

7.1 Legislation

Market manipulation is prohibited under the FMCA – see sections 262-269.

Specifically, section 265 of the Financial Markets Conduct Act 2013 provides that:

A person must not do, or omit to do, anything if –

(a) the act or omission will have, or is likely to have, the effect of creating, or causing the creation of, a false or misleading appearance -

(i) with respect to the extent of active trading in quoted financial products; or

(ii) with respect to the supply of, demand for, price for trading in, or value of those financial products; and

(b) the person knows or ought reasonably to know that the person's act or omission will, or is likely to have, that effect.

7.2 Rules

Participant Rule 10.2.1 provides that:

Every Trading Participant, NZX Advising Firm, Dealer, Adviser and Employee who provides services in relation to Execution Only Orders is prohibited from placing an Order for, or dealing in, any Securities:

(a) either when Acting as Principal or placing that Order has the effect, or in the opinion of NZX is likely to have the effect, of creating a false or misleading appearance:

(i) of active trading in any Securities;

(ii) with respect to the market for, or the price/yield or, any securities; or

(iii) the Trading Participant, NZX Advising Firm, Dealer, Adviser or Employee who provides services in relation to Execution Only Orders intends to create the effect of any of the circumstances in Rule 10.2.1(a)(i) or (ii); and

(b) on behalf of a client or any other person where that Trading Participant, NZX Advising Firm, Dealer, Adviser or Employee who provides services in relation to Execution Only Orders intends to create, or is aware that that client or other person intends to create, or that Trading Participant, NZX Advising Firm, Dealer, Adviser or Employee who provides services in relation to Execution Only Orders should reasonably suspect that the client or other person intends to create the effect of any of the circumstances in 10.2.1 (a)(i) or (ii).

Derivatives Market Rule 4.3.1 provides that:

Each Participant is prohibited from placing an Order for, or Dealing in, any Contract when Dealing in that Contract or placing that Order might reasonably be expected to have an adverse effect on the operations of the Market or result in unfairness to its Clients or other Participants:

(a) including when Acting as Principal or placing that Order has the effect, or in the opinion of NZX is likely to have the effect, of creating a false or misleading appearance:

(i) of active trading in any Contract; or

(ii) with respect to the Market for, or the price of, any Contract,

(iii) or the Participant intends to create the effect of any of the circumstances in Rule 4.3.1(a)(i) or Rule 4.3.1(a)(ii);

(b) including when acting on behalf of a Client or any other Person where:

(i) that Trading Participant intends to create;

(ii) that Trading Participant is aware that that Client or other Person intends to create;

(iii) that Trading Participant should reasonably suspect the Client or other Person intends to create,

the effect of any of the circumstances in Rule 4.3.1(a)(i) or Rule 4.3.1(a)(ii); and

(c) including manipulating the Market and in particular creating a condition in which prices do not or will not reflect fair market value either by the manipulation of the Market or manipulation of a Contract's Underlying Market

Participant Rule 10.2.1 and Derivatives Market Rule 4.3.1 prohibit the placing of an Order for, or dealing in, any Securities or Derivatives Contracts quoted on NZX markets:

(a) either as Principal or for clients, which have the effect, or in the opinion of NZX are likely to have the effect, of creating a false or misleading appearance:

(i) of active trading in any Securities/Contracts;

(ii) with respect to a market for, or price or yield, of any Securities/Contracts; or

(iii) where the NZX Participant intends to create the effect of any of the circumstances in (i) or (ii); and

(b) on behalf of a client or any other person where that NZX Participant intends to create, or is aware that that client or other person intends to create, or that NZX Participant should reasonably suspect that the client or other person intends to create, the effect of any of the circumstances in a) (i) or (ii).

Derivatives Market Rule 4.3.1 also prohibits placing Orders or dealing where doing so might:

- reasonably be expected to have an adverse effect on the operations of the Market or result in unfairness to clients or other Participants; or
- create a condition in which prices do not or will not reflect fair market value either by the manipulation of the Market or manipulation of a Contract's Underlying Market.

The Rules impose obligations on NZX Participants before accepting an Order for execution, to consider the impact of that Order on the market, whether there is a legitimate commercial reason for the Order and whether the client, or another related person, may have an interest in creating a false or misleading market. These requirements are covered in more detail in section 9 of this Guidance Note.

A number of other Rules support the prevention and detection of manipulative activity, for example:

- NZX Participants are required to conduct and report Trading and dealing in accordance with Good Broking Practice, and must enter Orders in accordance with the requirements of the Trading System and the Rules;

- NZX Participants are required to maintain Order records and provide information concerning Orders to NZX on request;

- Off-market transactions, including Crossings and Block Trades must be reported through the NZX Trading System, and must be within parameters prescribed in the Rules; and

- NZX Participants who permit clients to use Direct Market Access, are required to ensure those clients comply with all applicable Rules, and are liable for Orders directly entered into the NZX Trading System via the NZX Participant's order entry system.

7.3 Types of conduct that may be manipulative

Set out below are examples of trading activity that NZX considers likely to be of concern given the prohibition on manipulative conduct under the Rules and FMCA. If NZX observes conduct that is described below, this will be likely to result in further regulatory scrutiny. Where NZX seeks further information with respect to trading, NZX Participants and their clients need not immediately assume that the trades in question are considered manipulative or otherwise outside of acceptable trading conduct practices. Information is requested to allow NZX to give due consideration to the context of the conduct and assess the validity of trading that, on first look, appears unusual.

Trading with no change in Beneficial Ownership

Participant Rule 10.13.9 and Derivatives Market Rule 8.7.10 prohibit trading that does not result in a change in beneficial ownership when trading either as Principal or on behalf of clients.

Section 267 of the FMCA deems those who enter into trades in quoted financial products of a listed issuer which do not result in a change in beneficial ownership to be treated as contravening the false or misleading appearance of trading prohibition, subject to certain specific exclusions. NZX Participants should have controls in place to prevent and detect transactions which will not result in a change in beneficial ownership, including for DMA Orders and Orders received via an intermediary. Where NZX Participants engage in principal trading, they should have controls to prevent, detect and manage any accidental house crossings.[6]

[6] These should be reported as errors and cancellation sought where this is possible under the Rules. Next day or delayed identification and cancellation (ie, in BaNCS) is likely to be insufficient as a false impression of active trading may have been created and will be outside the parameters for cancellation within the Rules.

NZX acknowledges that there are legitimate circumstances where a transaction is effected by an NZX Participant when there is no resulting change of beneficial ownership. It is NZX policy not to take action in such circumstances, for example:

- a fund manager may change the legal owner of financial products held between funds, but which does not result in a change in beneficial ownership. To enable such a transaction to be reported, a put-through trade flag must be used to detail the nature of the transaction.
- certain inadvertent Crossings – for example, the matching of:
  - as Principal Orders[2] entered by different divisions of an NZX Participant that are segregated for conflict management purposes (for example a client facilitation desk and a proprietary trading desk). This includes algorithmic or programme Orders; or
  - as Principal Orders entered by different DMA Authorised Employees.

  In respect of these inadvertent Crossings, NZX does not consider that the trades create a false or misleading appearance of active trading even though they do not result in a change in beneficial ownership, provided (as applicable):

  - the trades have not been pre-arranged;
  - the same DMA Authorised Employee has not entered each side of the trade;
  - the orders originated from segregated areas of the NZX Participant's business or from a defined programme; and
  - the NZX Participant's Crossing can be shown to be "accidental".
- "accidental" Trades in the S&P/NZX 20 Index Futures that arise from implied Order functionality
- where an NZX Participant effects such transactions when it can prove that there was no reason for that NZX Participant to suspect that a change in beneficial ownership would not occur.

NZX expects that NZX Participants will actively monitor such trades to ensure that they remain "accidental" in nature, and NZX Participants should notify NZ RegCo of such trades, and request that the trade be cancelled where possible and if cancellation is permitted in accordance with the Rules.

Abnormal client Orders

NZX Participants should be wary of instances of abnormal trading by clients. In these circumstances, NZX Participants should seek to understand the motivation for trading in a particular way, especially where the client is trading in a way that does not appear to be in their best interests or which is unusual in light of previous patterns of trading by the client.

Placing Orders on both sides of the market

Buying and selling on the same day is not a conclusive indicator of manipulative conduct. However, if this activity appears to be used to maintain trading at a particular level in order to obtain a better outcome on a larger transaction, it may be indicative of manipulative conduct. NZX will scrutinise trading in which an NZX Participant as Principal or a client trades on one side of the market to complete a transaction, but also enters small periodic Orders on the other side of the market, particularly where that follows a price movement that would otherwise be

[2] Principal Orders are Orders which are placed when a Participant is 'Acting as Principal'.

disadvantageous to the larger Order.

Example 5

Client A is selling a large parcel of XYZ intraday. Sell orders have traded in a price range of $2.39 to $2.37. The volume traded results in the price of XYZ moving downwards, so the price is $2.35 and appears likely to fall further. Client A enters a relatively small buy Order at $2.36 and is happy for that Order to trade. Client A is still a large seller on the day. Each time the price goes down to $2.35 or lower, Client A enters another buy Order at $2.36. While an argument could be made that Client A is a genuine buyer as they do not attempt to prevent the buy Orders from trading, Client A appears to be engaging in price support. If Client A's purpose for entering the buy Orders includes preventing the price from falling while they are selling their large parcel (or as a result of their selling), this could be viewed as manipulative.

Similarly, NZX will scrutinise trading in which an NZX Participant as Principal, or a client, trades on one side of the market to complete a "market on Close" transaction, but also enters small periodic Orders on the other side of the market during the day, particularly where those Orders have the effect of moving the price in a direction that is advantageous to their larger closing price Orders. NZX Participants should have mechanisms for monitoring all trading by a client, particularly where the client is known to trade through multiple accounts with that NZX Participant.

NZX recognises that there are legitimate strategies that include having Orders on both sides of the market, however execution of these strategies should not be considered a basis to disregard the other trading conduct requirements.

Number of Orders

Entering multiple orders at various price levels (also referred to as 'layering") on the buy or sell side of the market can indicate an attempt to create an appearance of additional volume and therefore demand. Orders placed in this manner may not represent genuine supply or demand, so should be queried by NZX Participants. This is of particular concern where, for example, a person enters multiple Orders on the buy side at increasing prices, then when a third party enters a buy Order at these higher prices, the first person enters a sell Order to match that buy, then removes their earlier buy Orders.

NZX Participants should consider such Orders in light of the requirement that all Orders must be entered with a genuine intent to trade. Circumstances which should be carefully reviewed by NZX Participants include where there is a particularly high ratio of order to trade volume or a record of actively entering and amending orders on both sides but only trading on one.

Placing Non-genuine Orders

Entering Orders and then withdrawing them before they can trade can indicate an attempt to create an appearance of more supply or demand with respect to the Security. Orders placed in this manner may not be genuine Orders.

NZX Participants should consider such Orders in light of the requirement that all Orders must be entered with a genuine intent to trade.

Placing Orders around the Close

When entering Orders during the Pre-Close session, particularly Orders that are likely to influence the closing price and/or volume, NZX Participants should enter them as early as possible in the session. This allows time for the market to respond to any additional volume or price changes. Where Orders are entered late in the Pre-Close session that have the appearance of influencing the closing price, or the volume traded, and then withdrawn immediately afterward, these are likely to be investigated. NZX recognises that there are many legitimate reasons to withdraw an Order from the Pre-Close, but notes that it will likely question the withdrawal of Orders that have the appearance of having been placed to influence the closing price.

NZX Participants are not precluded from trading towards the end of the day or accepting closing price Orders, but care needs to be taken to ensure that trading around the Close does not contravene the Rules or relevant legislation.

The following are examples of matters that should be taken into consideration:

- Whether the size of the transaction to be undertaken will materially affect the closing price. In this case the NZX Participant should consider whether entering or accepting the Order is appropriate in the circumstances and whether the client may have an interest in impacting the closing price;

- Where an NZX Participant executes a "market on Close" Order whereby it benefits through purchasing Securities at a lower price during the day then enters Orders into the Pre-Close that set the price at Close higher, this may give the impression that the NZX Participant could have motivation to materially affect the closing price; and

- Transactions that appear to include a purpose of attempting to manipulate or set the closing price. NZX Participants should be particularly vigilant in monitoring trading activity around corporate events or milestones, for example at month or quarter end.

Example 6

At 9:30am Participant 111 receives an Order from Fund Manager B to buy 250,000 XYZ at "market on Close". Participant 111 agrees to facilitate the transaction. In order to manage the risk it has agreed to take, Participant 111 buys XYZ during the course of the day, so its facilitation book has sufficient XYZ to sell to Fund Manager B on the Close. Participant 111 manages to buy 220,000 XYZ during the day at an average price of $1.64. During the Pre-Close, the indicative closing volume and price for XYZ is 47,500 at $1.64. Near the end of the Pre-Close, Participant 111 enters a further buy Order for 30,000 at $1.87 for its facilitation book, which changes the indicative closing volume and price to 79,300 at $1.68. The closing price for XYZ is set at $1.68. Participant 111 then reports a Crossing between Fund Manager B and its facilitation account of 250,000 XYZ at $1.68.

Participant 111's execution approach has increased the closing price of XYZ by 2.4% and has also resulted in a benefit to Participant 111 of $8,800, which would cause NZX to question the trading.

A common indicator of marking the Close in the NZX Dairy Derivatives market is the entering of small orders into the trading system late in the session which has the effect of changing the Daily Settlement Price (**DSP**). The DSP is used in the calculation of margin requirements each day, so changes to the DSP have an economic impact on holders of open positions. This conduct will be investigated by NZX.

For example, the previous day's DSP for NZX Jan 2016 WMP Futures was $2,550. During the next session the quotations for this contract range between $2,525 to $2,550 for the bids and $2,650 to $2,675 for the asks. At 15:59:30 an NZX Participant enters a small bid at $2,625 so that at the Close the quotations are $2,625 / $2,675. As there were no trades that day the DSP changes from $2,550 to $2,625 (up 2.9%).

Trading to achieve VWAP

If an NZX Participant receives an Order at VWAP to be executed over one day or part day and that NZX Participant will facilitate the trade, the NZX Participant may be able to benefit through purchasing the relevant financial products at a lower price (or selling at a higher price, as the case may be) during the day. In this situation, the NZX Participant should consider its execution approach, particularly with respect to the effect the execution may have on the VWAP. In this situation the NZX Participant benefits from setting the VWAP price as high (or low) as possible and therefore could have motivation to affect the VWAP.

Example 7

At 9:30am Participant 111 receives an Order from Fund Manager B to buy 250,000 XYZ at "VWAP over the day". Participant 111 agrees to facilitate the transaction at the end of the day. In order to manage the risk it has agreed to take, Participant 111 buys XYZ during the course of the day as Principal, so its facilitation book has sufficient XYZ to sell to Fund Manager B on the Close. Participant 111 manages to buy 170,000 XYZ during the day at an average price of $1.64. The VWAP for the day immediately prior to the Pre-Close is $1.644.

During the Pre-Close, the indicative closing volume and price for XYZ is 47,500 at $1.64. Near the end of the Pre-Close, Participant 111 enters a buy Order for 80,000 at $1.87, which changes the indicative closing volume and price to 129,300 at $1.69. The final VWAP for XYZ for the day is $1.675. Participant 111 then reports a Crossing between Fund Manager B and its facilitation account of 250,000 XYZ at $1.675.

Participant 111 has benefited from its execution approach, which would cause NZX to question the trading with particular emphasis on the trading that has occurred just prior to the reporting of the VWAP (end of day and intra-day).

NZX Participants should be aware that VWAP orders (or in fact any order where the price is determined by traded market data generally rather than the prices traded for the client in the market) create a conflict of interest for the NZX Participant, because they create an incentive for the NZX Participant to move the traded market price in order to set the price the client will receive. These conflicts need to be recognised and monitored by the NZX Participant.

Trading for volume or unnecessary facilitation

Principal trading to facilitate client instructions promotes liquidity and in itself is not considered manipulative. In this situation, an NZX Participant may take varying degrees of risk and use its balance sheet to facilitate client trading activity. There are, however, situations when facilitation could be viewed as manipulative. For example, an NZX Participant which uses its principal book in order to unnecessarily facilitate two client agency trades would, prima facie, be considered to be trading for volume. This conduct is considered by NZX to be misleading as it creates a false impression of trading activity, which may be a breach of both the Rules and legislation.

A key determinant for considering whether an NZX Participant is in fact providing a facilitation service, rather than unnecessarily interposing itself between the clients, will be whether or not the NZX Participant assumed actual risk as a result of the transaction, in addition to there being a change in beneficial ownership.

Factors giving rise to principal risk include the NZX Participant assuming price risk (i.e., the buying as Principal and the subsequent unwinding, or selling, are at different prices), differences in timing of receipt of client buy and sell orders, etc. Whether Principal risk existed in a transaction will be determined on the facts of each instance. However, simply booking a transaction through a Principal book is not considered sufficient justification for classifying a transaction as facilitation.

Another example is when two matching trades entered at the same price and approximately the same time – usually within minutes of each other – with the NZX Participant interposed as Principal. Where a transaction is able to be crossed directly between the buying and selling clients, these should be reported as a single transaction to avoid double reporting. NZX acknowledges the tension in this situation that is created by the requirement to report Crossings “immediately”, which some NZX Participants apply literally even where waiting only a few seconds would be sufficient to receive the confirmation from the client on the other side. NZX would apply a practical and reasonable approach to “immediately” in this context as “promptly and without delay” because it is understood that some practical steps will need to be taken in order for the Crossing to be reported.

Another example of trading for volume is when an NZX Participant has a large Order from a client that is volume restricted. In this case, the NZX Participant has an interest in seeing higher volume traded in the stock that is sufficient to allow the Order to be completed. Where an NZX Participant uses its facilitation account to increase the volume traded on market, this creates a conflict for the NZX Participant that must be managed, increases the risk of a client order priority issue arising and increases the likelihood that the trading will be questioned by NZX.

Example 8

Participant 111 receives an Order to buy 200,000 XYZ at $1.85 from Client A. The current spread of XYZ is $1.83/$1.85 and there are a total of 147,500 XYZ on offer at $1.85. Participant 111 accepts the buy Order as done, effectively guaranteeing the completion of the full 200,000 at $1.85.

If Participant 111 buys the available 147,500 XYZ at $1.85 as Principal and reports a crossing of 200,000 XYZ at $1.85 between Client A as buyer and its principal account as seller, this could be viewed as unnecessary facilitation. As Participant 111 was not actually on risk in respect of the 147,500 XYZ that was readily available, the on-market purchase should be done on behalf of Client A and the remaining balance of 52,500 XYZ crossed as Principal.

Example 9

Participant 111 has received an Order from Client B to sell 250,000 XYZ at $2.62, subject to verbal confirmation based on available volume, and is in discussion with Client C who is looking to buy 225,000 XYZ at $2.62. At 11:27:29am Participant 111 receives a confirmed Order to buy 225,000 XYZ at $2.62 from Client C. While calling Client B to obtain verbal confirmation to proceed with their Order to sell 250,000 XYZ at $2.62, Participant 111 reports a crossing of 225,000 at $2.62 between Client C and its principal account. At 11:28:24am Client B confirms its sell Order and Participant 111 reports a crossing of 250,000 at $2.62 between Client B and its principal account.

Given the imminent confirmation of the sell Order, NZX would consider the most suitable approach in this case to be to call the seller for confirmation and then (assuming the seller is contactable) report a single crossing of 250,000 XYZ at $2.62, with Client B as seller and Client C and its principal account as buyers.

Example 10

At 3:15pm Participant 111 receives preliminary Orders from Fund Manager F, which has multiple funds, detailing the estimated volumes of XYZ required to be purchased or sold for each relevant fund. The estimated volumes are that Fund 1 will need to buy approximately 721,450 XYZ and Fund 2 will need to sell approximately 645,900 XYZ. Participant 111 agrees to complete the final volumes (once known) at the Closing Market Price that day.

At 17:08pm, once the Closing Market Price is known, Participant 111 receives the final instructions from Fund Manager F. The final volumes are that Fund 1 will need to buy 721,391 XYZ and Fund 2 will need to sell 646,124 XYZ.

During the Adjust Session, Participant 111 reports two crossings of XYZ at the Closing Market Price, as follows:

- Fund 1 buying 721,391 XYZ with Participant 111's facilitation account selling; and
- Fund 2 selling 646,124 XYZ with Participant 111's facilitation account buying.

In this case, Participant 111 knew the approximate volumes and had agreed that both the buy and sell would be done at the Closing Market Price, the only potential risk Participant 111 was exposed to was that of a small variation in both sides' volume. NZX would consider reporting the transactions as set out to overstate the traded value of XYZ and that it would create a false impression to the market of active trading in XYZ, as the Participant acted unnecessarily as middle-man. NZX would also not consider the manner in which Participant 111 reported the Crossings to be truly reflective of the risk it was exposed to. The appropriate method that would have correctly reflected Participant 111's risk and the actual trading activity conducted in XYZ would have been for:

- The volume that could be matched between Fund 1 and Fund 2 to be reported as an *Agency Crossing* between the two Funds (as a Put Through); and
- The balance to be reported as a *Principal Crossing*, with Fund 1 as buyer and Participant 111 Acting as Principal on the other side.

Moving the spread

Placing Orders into the market with the objective of moving the spread for a Security to facilitate the reporting of a Crossing could constitute manipulative conduct. This is particularly the case where an NZX Participant enters Orders as principal, then Acts as Principal on the opposite side of the reported crossing. Where the circumstances of the transaction require that an on-market trade is executed in order to report the off-market trade, the client should receive the benefit of any better price obtained in the on-market trade.

<u>Example 11</u>

Participant 111 receives an Order to buy 175,000 XYZ at $2.85 from Client A and agrees to facilitate the order. The current spread of XYZ is $2.81/$2.83 and there are a total of 4,500 XYZ on offer at $2.83 and a further 10,500 XYZ on offer at $2.84. Participant 111 enters a buy Order into the market for 15,000 XYZ at $2.84 on its principal account, which trades immediately (4,500 at $2.83 and 10,500 at $2.84). This changes the spread to $2.81/$2.85. Participant 111 then reports a crossing of 175,000 XYZ at $2.85 with Client A as buyer and its principal account as seller.

In this case, NZX would expect to see Client A as the buyer of the 15,000 on-market at lower prices and the crossing being reported for 160,000 XYZ at $2.85.

<u>Example 12</u>

Participant 111 receives an Order to buy 75,000 XYZ at $2.20 from Client A and an Order to sell 75,000 XYZ at $2.20 from Client B. The current spread of XYZ is $2.18/$2.19, with best bid volume of 1,200 and best offer volume of 2,500. Participant 111 enters a buy Order into the market for 2,500 XYZ at $2.19 on its principal account, which trades immediately and changes the spread to $2.18/$2.20. Participant 111 then reports a crossing of 75,000 XYZ at $2.20 with Client A as buyer and Client B as seller.

In this case, NZX would expect to see Client A as the buyer of the 2,500 on-market at the lower price and the crossing being reported either for 72,500 with a remaining balance for the sell Order or for 75,000 at $2.20 with its principal account buying 2,500 at $2.20.

Trading to set the price for an off-market transaction

If an NZX Participant and a client are negotiating a large off-market transaction, entering Orders into NZX Central for the purpose of trading to set the current market price to use in pricing the off-market trade (by either party) could be considered manipulative and also a misuse of client order flow information.

Although reasonable to base the price negotiation on the current on-market traded price and/or current spread, where one (or both) of the parties to the off-market transaction trades to influence the current on-market price and then goes on to benefit from a higher / lower price in the off-market trade, this is not genuine price discovery. Instead, a conflict arises as the party has directly brought about the price "discovered".

Example 13

Client A wishes to sell a large parcel of 1,200,000 XYZ. Participant 111 is willing to facilitate the trade for the entire volume as Principal, and is negotiating a price with Client A. The current spread of XYZ is $2.32/$2.34, with a last traded price of $2.34. Both parties are referring to the current market price as a reference for the agreed price on the off-market transaction.

While both parties can monitor any activity in the market to determine the appropriate price at which to conduct the off-market trade, if either party attempts to influence the current market price as an important determining factor for the price of the larger off-market price, this could be viewed as manipulative. For example, if either:

- Participant 111 places an Order to sell 8,000 XYZ at $2.32, which partially trades immediately, moving the spread to $2.31/$2.32, with a last traded price of $2.32; or

- Client A places an Order to buy 10,000 XYZ at $2.35, which partially trades immediately, moving the spread to $2.35/$2.36, with a last traded price of $2.35.

Either could potentially argue that they were attempting “price discovery”, however, this would be questionable since they would be directly bringing about the “discovered” price in the absence of any further contribution to the price discovered from the market.

As Venning J said in *Financial Markets Authority v Warminger* [2017]:[7]

> While not determinative, the market price shown on the screen must be a relevant consideration, particularly when the market appears to be moving in a particular direction. Further, in terms of effect on the market it is important to note that the market is not restricted to institutional or fund managers.

Index Replication Orders

NZX Participants should be conscious of Orders replicating an index, or purchases for clients who operate index funds. While there may be a valid commercial purpose for these trades to be transacted at market Close, the obligations to maintain an orderly market apply and clients that insist on tracking an Index may not be as sensitive to price. Care should be taken to ensure that

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[7] *Financial Markets Authority v Warminger*, above n6, at 144.

this activity does not create a disorderly market or a material and potentially misleading price impact.

NZX recognises that passive funds are an increasing feature of the market and "market on Close" orders are likely to continue to occur. NZX also recognises that price movements on rebalancing dates are likely in some cases and, where relevant, will account for this. However, these rebalancing dates are not a basis to simply disregard the orderly market requirements.

In addition, NZX Participants should be aware that "market on Close" orders (or in fact any order where the price is determined by traded market data generally rather than the prices traded for the client in the market) create a conflict of interest for the NZX Participant, because they create an incentive for the NZX Participant to move the traded market closing price in order to set the price the client will receive. These conflicts need to be recognised and monitored by the NZX Participant.

Trading to correct the market price after an Error

Where an Error occurs, a Market Participant can seek to have the trades cancelled in accordance with Participant Rule 10.14 or Derivatives Market Rule 8.8. Where the Error results in a Market Impact (e.g. a move of 10% or more from the last traded price) the Error must be reported to NZX and the resulting transactions may need to be cancelled. Where an Error results in a price impact, it is inappropriate for an NZX Participant to place an Order into the market with the objective of restoring the price of the impacted Security or Contract to correct the Error and such action could constitute manipulative conduct or could be considered an aggravating factor in respect of a breach of other requirements of the Rules. An example of such trading being considered an aggravating factor in respect of an orderly market matter was considered by the NZMDT in 2015 and the public censure in relation to the matter can be found here.

8. Trade reporting

The Rules require that off-market trades, including Crossings, are reported through the Trading System.

Depending on the nature of the specific transaction, the Rules may prescribe price limitations (such as "within the spread"), time limitations in which to complete the reporting (such as "immediately"), or may require the inclusion of a specified "flag" in the reporting (such as a "special crossing" flag). Any price and time limitations or flag requirements in respect of reporting are set out in the Rules and any relevant Procedures or Guidance.

9. Considerations when accepting an order

Participant Rule 10.2.2 and Derivatives Market Rule 4.3.2 set out factors that an NZX Participant must consider when determining whether it is appropriate to accept an Order. These Rules embody a key requirement for an NZX Participant to actively consider the nature and impact of instructions.

The requirements apply to all Orders received by an NZX Participant.

Before executing an Order, NZX Participants must consider the factors in those Rules, and where necessary, make further inquiries of their clients, to satisfy themselves that entering the Order will not result in a breach of the Rules. NZX Participants should include in their processes a requirement for Advisers and/or Dealers to consider whether there is anything about the client, the financial product or the circumstances surrounding the Order that may require further questions to be asked to ensure compliance with the Rules. NZX Participants providing DMA access to clients must design their processes and filters to ensure compliance with these Rules, as these Rules apply equally to Orders submitted via DMA.

It is not necessary for there to be suspicious circumstances in existence under each area of consideration for an NZX Participant to make further enquiries. One or two areas is sufficient to warrant an NZX Participant making further enquiries to confirm whether the Order has been placed for legitimate purposes.

In circumstances where an NZX Participant has made additional enquiries with respect to an Order, the additional information should be clearly recorded, including reference to the NZX Participant's consideration of the information provided in determining whether or not to proceed with executing the Orders. This will be important in establishing that the relevant factors under the Rules have been considered, particularly to explain the reasons for particular trading, which might otherwise seem unusual or irregular.

Where the considerations required to be made under Participant Rule 10.2.2 and Derivatives Market Rule 4.3.2 raise any concerns with respect to an Order, NZX Participants must determine whether or not it is appropriate for that Order to proceed through to the market.

The areas for consideration in respect of all Orders as required by Participant Rule 10.2.2 and Derivatives Market Rule 4.3.2, both for clients and as Principal, are set out below with additional commentary (noting that (e) and (h) are specific to Derivatives Rule 4.3.2):

(a) Whether that Order, or the execution of that Order, is consistent with recent trading in that Security/Contract, taking into account current market conditions

This requires an NZX Participant to exercise judgement, based on its experience and knowledge of trading in the financial product, and consider whether the Order or its execution is consistent with recent trading. Considerations of recent trading should include information relevant to both recent prices and usual trading volume.

(b) Whether that Order, or the execution of that Order, will materially affect the market for, or price/yield of, any Security/Contract

NZX Participants must consider the impact an Order may have on the market for the financial product.

Larger volume Orders may significantly affect the price and market for financial products, particularly if those products are less liquid.

In addition, a movement of even one or two price steps may be material for low priced financial products. NZX Participants should consider the price impact an Order may have on a financial product in the context of recent trading (including intraday trading ranges) before placing Orders.

Examples of circumstances where an NZX Participant should query an Order include, but are not limited to:

- Receiving instructions to buy up, or sell down, to a specified price that will materially affect the price of the relevant financial product, or which appears to have no regard to the volume that may be traded;

- Receiving instructions to sell financial products while at the same time receiving instructions to enter large disclosed or undisclosed bids just below the priority bid. Particular attention should be paid to instructions to enter bids during the Pre-Opening Session and then withdraw those orders prior to the commencement of Normal Trading; and

- Receiving instructions to buy or sell at “market” where the volume of the Order can only be achieved by moving through several price steps.

If the NZX Participant considers that the Order would materially affect the market for or the price/yield of a financial product, the NZX Participant must assess the purpose of the Order to determine whether it is genuine and whether it should be executed. Clients will generally want to obtain the best price, however from time to time there may be genuine reasons why a client might be satisfied with a lower/higher price, e.g. the need to sell/buy quickly. In all cases NZX Participants must also consider the orderly market requirements – see section 3 of this Guidance Note.

When assessing whether conduct may be indicative of market manipulation in breach of Participant Rule 10.2.1 or Derivatives Market Rule 4.3.1, NZX will consider, among other things, the timeframe in which Orders to trade are given, or transactions undertaken, and the impact of those Orders on the market price. Orders which lead to a sudden price change that is subsequently reversed, may be evidence of manipulative conduct.

(c) Whether that Order is received during Trading Hours or after the market has closed, and whether instructions about when that Order is to be entered have been received from the client

NZX Participants must always consider the timing of receipt of an Order, and the instructions for the timing of execution of the Order.

Particular care and attention is required when receiving instructions to place an Order at or near the Close, to ensure they are not being placed in an effort to influence the closing price for a financial product.

An NZX Participant that receives an Order with instructions to execute at or near the Close should enquire as to why the client wants the Order executed at that time. NZX expects all NZX Participants to be able to distinguish Orders that are intended to influence the closing price from Orders where the client is seeking to achieve the closing price for a valid commercial purpose.

NZX Participants should also give particular consideration in respect of Orders placed with instructions to execute at or near the Close on the last trading day of a month, quarter or year, where such Orders may move the price when executed. An NZX Participant must consider whether the person may be seeking to influence the closing price in these circumstances. For example, a fund manager may benefit from trading near the Close on the last day of a quarter, if the price of a Security or an index may impact a fee payable.

When acting on behalf of clients who track or benchmark an index, NZX Participants must consider the impact of Orders to trade in financial products joining or leaving that index where the Order may materially move the price for that particular Security. NZX Participants are required to maintain an orderly market in such circumstances.

Other examples of conduct that may be designed to impact the price of a financial product include where clients instruct an NZX Participant to obtain a specific closing price, or ask what volume would be required to be bought or sold to achieve a specific price.

(d) Whether the client who has entered/submitted that Order, or any other person who the Trading Participant, NZX Advising Firm or Advisor knows to be a Related Party of that client, may have a beneficial interest in creating a false or misleading market in, or the price/yield of, any Security/Contract

When receiving an Order, NZX Participants must consider whether the client, or parties related to the client, may benefit from the creation of a false market for, or price/yield of a financial product. NZX recognises that NZX Participants will not always be aware that a client may have such an interest, so expects further inquiries to be made where the NZX Participant could reasonably be expected to be aware of the client's beneficial interest.

NZX Participants should generally be aware of significant connections their clients may have with Issuers.

Circumstances in which NZX Participants should consider (and, if appropriate, enquire as to) the purpose of a Client's trading, include where:

- Orders are placed by a large holder of the financial product who may have an interest in artificially inflating or deflating the price of that holding, for example an Order placed for shares of an Issuer that is a takeover target, with the possible intention of obtaining a better price in the takeover;
- Orders are placed that impact the price during the qualifying period for a corporate action, or a conversion (for example, preference shares converting to ordinary shares);
- Orders are placed in a financial product that are likely to impact a related Derivatives Contract or a corporate action outcome to the client's benefit;
- Orders are placed by a known Director or Officer of an Issuer; and
- Orders are placed by a fund manager and may be relevant to meeting performance targets, for example Orders that are likely to impact the quarter or year-end price of a Security that is a material holding of the fund.

(e) Whether an Order received appears to be 'out of character' for a particular Client

An NZX Participant must ask a client further questions if an Order is out of character with their usual trading behaviour. This requires the NZX Participant to exercise its judgement, based on its experience and knowledge of the client's usual trading behaviour.

(f) Whether there are any additional unusual requests in relation to that Order, including but not limited to requests in relation to settlement and delivery

Unusual requests in relation to Orders, such as requests for non-standard settlement or delivery, should be queried to ensure they are not indicative of an underlying strategy that may result in a false or misleading appearance of active trading.

(g) Whether that Order appears to be one in a series of requested Orders and whether that series of Orders has any of the effects outlined in this Rule

A client who requests that an NZX Participant places a number of Orders into the market in small quantities over an extended period of time; or places Orders in the same financial product over a number of days should be queried as to their strategy, where these Orders appear to impact either the price or market for that financial product. Likewise, a consistent pattern where a client forgoes a better price intra-day to trade around the end of day should be questioned. Small volume orders are not necessarily manipulative, but may be indicative of a manipulative strategy, such as maintaining a price level.

(h) Whether an excessive Order, or a number of smaller related Orders, has been received in respect of a Contract that is unusual for that Contract

NZX Participants should consider recent trading in the Contract to determine if the Orders received are consistent with usual trading for that Contract.

(i) Whether there is a clear legitimate commercial reason for that Order being placed, which is unrelated to the intention to create a false or misleading market in respect of the market for, or price/yield of, any Securities/Contract.

Many Orders that impact the market for or price/yield of a Security may have been placed for legitimate commercial reasons, and may be executed by NZX Participants.

Where there is a legitimate commercial reason for an Order, an NZX Participant must consider whether there may also be an intention to create a false or misleading impression, or if that could be the effect of the Order or could be viewed as the effect, and if there is a concern that there may be manipulative conduct, NZX recommends that NZX Participants should not accept the Order.

Orders that have a genuine commercial reason may be acceptable, even where they may have a price impact, provided that the NZX Participant considers any additional intentions that may exist and executes the Order in an appropriate way bearing in mind its market obligations, including the requirement to maintain an orderly market.

10. Cross product considerations

Cross product manipulation is where a person trades in one product to influence the price of another product or to benefit from information regarding a related product.

For example, a person with knowledge of pending large orders in a listed security, may enter into transactions in derivative products (such as CFDs or Equity Options) that will benefit from the price impact that the large order will have. A specific example of this type of conduct can be found here.

Another example could be where a person buys a WMP Call Option that is “out of the money” (i.e. it gives them the right to buy WMP Futures at a price higher than where the Futures Contract is currently trading). The person then trades WMP Futures in such a way as to increase the DSP, thereby moving the WMP Options so that they become “in the money”. The person then closes out the WMP Option at a profit.

While not strictly a different product, another way this type of conduct may manifest itself is where a person trades to impact the price of a listed security (often by pushing the price down) so that they can benefit from the lower price in a pending corporate action.

When considering whether a person may have a beneficial interest in creating a false or misleading market in, or price/yield of, a financial product, NZX Participants should take into consideration any related products that the person may hold, where this is known.

11. Investigation considerations

When assessing trading conduct that has occurred, each case will need to be determined based on its particular facts and the context in which the trading took place. In the absence of a specific scenario being described in this Guidance Note, NZX may apply any or all of the following factors in assessing whether trading by an NZX Participant or their client is in accordance with the Rules and Good Broking Practice:

- the manner in which the trading was entered into or carried out;
- the form and substance of the trading;
- the time at which the trading was entered into and the length of the period during which the trading was carried out;
- the result achieved by the trading;
- the market context at the time of the trading, both generally and in respect of the specific product;
- whether the trading and the timing of the trading were rational in terms of the release of positive/negative information;
- the manner in which any potential conflicts of interest have been managed;
- any benefit to the relevant NZX Participant or their client that has resulted, will result, or may reasonably have been expected to result from the trading;
- any benefit to any person who is a connected person of the relevant NZX Participant or their client, that has resulted, will result, or may reasonably have been expected to result, from the trading; and
- any other consequence that occurred as a result of the trading having been entered into or carried out.

These considerations are not an exhaustive list of the factors that NZX can take into account when determining whether market misconduct has occurred. Further information in respect of how NZX approaches enforcement can be found here.