



Consultation Paper

Derivatives Market

Third-Party Clearing and Direct Margining

November 2024



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This Consultation Paper has been prepared by NZX to seek comment on the proposals contained in the paper, with a view to ensuring that the proposals will enable NZX to operate its markets on a fair, orderly and transparent basis. The proposals set out in this paper do not reflect NZX's concluded views of the matters raised. Capitalised terms which are not defined in this Consultation Paper have the same meanings given to them in the NZX Derivatives Market Rules, New Zealand Clearing Limited - Clearing & Settlement Rules, and New Zealand Depository Limited - Depository Operating Rules (together the **Rules**), as appropriate. The glossary also defines how capitalised terms should be interpreted in this Consultation Paper, as we have slightly modified some of the Rules definitions for the purposes of this paper to aid interpretation.



Background

Since 2020, NZX has been looking to refresh the S&P/NZX 20 Index Futures Contract (**NZX 20 Futures**). The refresh aligns with the vision of sustainable market development outlined in the Growing New Zealand's Capital Markets 2029 Report¹, and will help drive growth in New Zealand's capital markets by expanding the suite of financial products offered by NZX.

In order to support the preferred clearing and settlement arrangements for participants in relation to the relaunch of NZX 20 Futures, NZX has been considering its regulatory settings relating to third-party clearing for the Derivatives Market.

Third-party clearing occurs when a Trading Participant is not itself a Clearing Participant and instead utilizes the services of a Clearing Participant in relation to the clearing and settlement of Trades.

NZX is proposing various amendments to the following regulatory documents, which are attached as exposure drafts to this Consultation Paper, to better facilitate preferred third-party clearing structures for the settlement of Trades executed on the NZX Derivatives Market in relation to NZX 20 Futures:

- NZX Derivatives Market Rules (**Derivatives Rules**)
- NZX Derivatives Market Procedures (**Derivatives Procedures**)
- New Zealand Clearing Limited Clearing & Settlement Rules (**C&S Rules**)
- New Zealand Clearing Limited Clearing & Settlement Procedures (**C&S Procedures**)
- New Zealand Depository Limited Depository Operating Rules (**Depository Rules**)
- New Zealand Depository Limited Depository Operating Procedures (**Depository Procedures**)
- Capital Adequacy Guidance Note (**Guidance Note**)
(together referred to as the **Exposure Drafts**)

NZX considers that these changes will promote innovation and flexibility in NZX's markets, by encouraging confident and informed participation by investors and Participants. These changes will continue to enable NZX to operate its markets on a fair, orderly, and transparent basis, consistent with NZX's obligations under the Financial Markets Conduct Act 2013 (**FMC Act**).

Consultation Process

We invite interested parties to provide their views on the proposals contained in this paper by emailing a written submission to policy@nzx.com. Alternatively, if you would prefer to provide a verbal submission, please email NZX Policy to arrange a time to speak with us.

The closing date for submissions is **Friday, 29 November 2024**.

¹ [Growing New Zealand's Capital Markets 2029](#)

NZX may publish the submissions it receives, so please clearly indicate if you do not wish for your submission to be published, or if part of your submission contains confidential information.



Introduction

NZX has been engaging with current and potential NZX Derivatives Trading and Advising Firms (**Trading Participants**) and Clearing Participants in relation to the relaunch NZX 20 Futures. Some of these entities wish to utilise third-party clearing arrangements to manage the clearing and settlement obligations that will arise from Trades in NZX 20 Futures.

While the current regulatory settings contemplate third-party clearing being undertaken for the NZX Derivatives Market, NZX is taking the opportunity to refine some of the rule requirements to better accommodate these entities preferred contracting structures, which we understand are accepted structures internationally.

These arrangements include settings to accommodate a Clearing Participant directly margining an underlying Client of a Trading Participant, rather than making a margin call on the Trading Participant to be passed on to an underlying Client. While this is accommodated to some degree through the current settings, we are taking the opportunity to further clarify and refine the requirements in this area.

The Schedule to this paper depicts the clearing and settlement arrangements that we are seeking to accommodate through our regulatory settings, being:

- **Conduit Model:** in which a Clearing Participant passes a margin call to a Trading Participant which is then passed to the Trading Participant's Client.
- **Direct Clearing Model:** in which a Clearing Participant passes a margin call directly to a Trading Participant's Client.
- **International Model:** in which a Clearing Participant passes a margin call directly to a Customer who then passes the margin call to the Trading Participant's Client.

The Derivatives Rules contain settings that govern the standard terms that must be included in a Client Agreement between a Trading Participant and its Client, while the C&S Rules contain settings that govern the standard terms that must be included in a C&S Agreement between a Customer (who may be a Trading Participant, Client or other Person) and a Clearing Participant. These settings have been the focus of the review, along with the requirements under the Derivatives Rules for a Trading Participant to have appropriate clearing and settlement arrangements in place in relation to the settlement of its Trades.

It is important to note that under all three models a Trading Participant utilising a third-party clearing model must have a C&S Agreement in place with a Clearing Participant to ensure that there is a Clearing Participant who is responsible for the Settlement of all Trades on the NZX Derivatives Market. Where a Trading Participant allocates a Settlement Transaction to a Customer Account other than its own, the Trading Participant will not be responsible to its Clearing Participant for meeting margin calls in relation to that position. However, if a Settlement Transaction is allocated to the Trading Participant's Customer Account, it will remain responsible to its Clearing Participant for meeting margin calls in relation to that position.

Design principles

We have considered both NZX's obligations as a market operator under the FMC Act, and CHO's obligations under the Financial Market Infrastructures Act 2021 when designing the proposals contained in this paper.

We have also applied the following design principles in developing the proposed settings:

- **flexibility:** the Rules only regulate certain aspects of the contractual arrangements between Clients, Trading Participants, Customers and Clearing Participants. It is appropriate for these entities to have flexibility to determine the commercial nature and terms of their arrangements.
- **disclosure:** it is appropriate for the rules to ensure that appropriate disclosure is made to a Client and Customer in relation to the clearing and settlement terms of a Trade, and the client funds protections that apply to Client assets.
- **Clearing Participant act as principal:** Clearing Participants act as principal in all of their activities with CHO and are responsible and liable to CHO as principal.
- **CHO is agnostic as to Customer identity:** while CHO wishes to ensure that each CP has a C&S Agreement with a Customer that is responsible for margin calls, CHO is agnostic as to the Customer's identity.

Scope of the proposals

This paper contains proposals relating to third-party clearing arrangements for Contracts on the NZX Derivatives Market (other than Options to which unique requirements apply). As there is currently no active trading in NZX's exchange traded options, the third-party clearing and settlement arrangements for Options fall outside the scope of this paper.

The proposals in this paper do not enable direct margining to be undertaken on NZX's securities markets which are governed by the NZX Participant Rules. Some of the proposed amendments to the C&S Agreement obligations under the Clearing Rules will be applicable to Clearing Participants who provide clearing and settlement services in relation to transactions on NZX's securities markets, and may require minor amendments to be made to C&S Agreements.

The following sections of this paper summarise the material changes that are proposed to the Rules that are set out in the accompanying Exposure Drafts.

Contractual Arrangements

Client Agreement requirements under the Derivatives Rules

Derivatives Rule 9.6 requires a Trading Participant to enter into a Client Agreement with each client with which it has a direct relationship, setting out the terms of the Trading Participant's relationship with its client. A Client is defined in the Derivatives Rules as a counterparty to the Client Agreement.

Derivatives Rule 9.5 also requires a Trading Participant to provide a written disclosure statement to a Client relating to the clearing and settlement arrangements for the Client's Trade. As part of the work to streamline the contracting arrangements to better accommodate third-party clearing, we propose to require the relevant provisions of the clearing and settlement disclosure statement to be included in the Client Agreement. Trading Participants will no longer be required to provide Clients with a separate written disclosure statement.

Derivatives Rule 9.6 requires certain terms to be included in a Client Agreement. We are proposing to make certain amendments to the required terms for a Client Agreement, including amendments:

- to require a description of the clearing and settlement model that applies to the settlement of the Client's Trades including whether or not the Trading Participant is utilizing third-party clearing, and confirmation as to whether or not the Client has made its own clearing and settlement arrangements (i.e. where the Direct Clearing Model or International Model will be utilised). (Derivatives Rules 9.6.1(e) and (f)).
- to modify the limitation which restricts the Client's rights and obligations to those in respect of the Trading Participant, so that the limitation only applies to the Client's rights and obligations under the Client Agreement. This change will enable a Client to have rights against and obligations to a Clearing Participant under the Direct Clearing Model and International Model where it has elected to utilise its own clearing and settlement arrangements, and has direct contractual obligations to the Clearing Participant (Direct Clearing Model) or Customer (International Model). (Derivatives Rule 9.6.1(i)).
- to require a statement as to whether or not the Trading Participant has obligations under the Client Funds Regulations in relation to Client Funds it receives from the Client, and a statement that where the Client pays Client Funds to a person other than the Trading Participant in relation to the clearing and settlement of the Client's Trades that the protections under the Client Funds Regulations may not apply. These amendments are designed to provide appropriate disclosure to Clients who elect to use the Direct Clearing Model or International Model, noting that overseas entities who are not participants in NZX's markets may not be subject to the Client Funds Regulations by virtue of clause 239(6)(b) of the FMC Regulations 2014. (Derivatives Rule 9.6.1(j) and(k)).

We also propose to make minor drafting amendments to the required terms and conditions to be included in the Client Agreement to better accommodate the differing third-party clearing models.

Advising Participants who are not Trading Participants must enter into a Trading Agreement with a Trading Participant under Rule 6.4 and a Client Agreement under Rule 6.5. We have made conformance amendments to the required content for these agreements, to reflect the changes made to Derivatives Rule 9.6.

C&S Agreement requirements under the C&S Rules

C&S Rule 2.14 requires a Clearing Participant to enter into a C&S Agreement with every person for whom it will provide clearing and settlement services, and prescribes certain terms that must be included within a C&S Agreement.

The prescribed terms that are set out in C&S Rule 2.14.1 broadly accommodate the third-party clearing models that we have been considering through this review. We are proposing to make certain amendments to the required terms for a C&S Agreement, including amendments:

- to require the Customer to acknowledge that it has included certain terms in relation to its agreement with an underlying Client. We have also introduced a new requirement for

a Customer providing clearing and settlement services in relation to Derivatives Contracts to confirm in the C&S Agreement that the Customer has provided disclosure in relation to the client funds protections applying to client assets provided to the Customer in relation to the clearing and settlement of such Transactions. The proposed amendment accommodates the International Model, where the Client Funds Regulations do not apply to the Customer. This disclosure is not required for the settlement of Securities Transactions, as the International Model is not available in relation to NZX's cash markets. The C&S Rules already require certain disclosures to be made by a Customer to an underlying client. These include the disclosures relating to clearing and settlement that are required by the Derivatives Rules, and disclosures in relation to novation along with those that limit the liability of CHO and Affected Persons, and the introduction of the client assets disclosure is a natural extension of these provisions to better accommodate the International Model. (C&S Rule 2.14.3(c)).

- to better reflect the contemplated models, by amending the references to 'Settlement Transactions resulting from Transactions *entered into* by the Customer' to refer to 'Transactions that *relate to* the Customer'. This approach is consistent with the obligations in C&S Rule 3.17.1 that require a Clearing Participant to make a margin call from a Customer in relation to Settlement Transactions arising from Derivatives Contracts that relate to a Customer. (C&S Rule 2.14.3(m)).

We are also taking this opportunity to clarify the effect of the termination of a C&S Agreement, in order to enable the C&S Rules to operate as intended.



Capital Adequacy

We propose amendments to the Guidance Note to clarify the extent to which a Positive Credit Exposure arises under the Direct Clearing Model and International Model for a Trading Participant.

In the Direct Clearing Model, the Settlement Transaction arising from a Client's Trade will be allocated to the Settlement Account of the Customer who is also the Client. In the International Model the Settlement Transaction arising from a Client's Trade will be allocated to the Settlement Account of the non-member international entity Customer.

Under these models, the Trading Participant will continue to be required to have a C&S Agreement in place with a Clearing Participant. That agreement will include an obligation for the Trading Participant to pay amounts to the Clearing Participant for margin calls made by the Clearing Participant under C&S Rule 3.17.1. However, under the Direct Clearing and International Model the Settlement Transactions arising from a Client's Trades will not be allocated to the Trading Participant's Customer Account. Therefore, the Clearing Participant will not be calling margin from the Trading Participant in relation to those Settlement Transactions and so from a capital adequacy perspective the Trading Participant will not be regarded as having a Positive Credit Exposure.

Give-Ups

C&S Rule 3.6 sets out the arrangements for Clearing Participants who wish to undertake give-up transactions. These transactions allow a Clearing Participant to 'give-up' its clearing and settlement obligations in relation to a Settlement Transaction to an alternative Clearing Participant who wishes to accept responsibility for the clearing and settlement of that transaction, when such an arrangement has been approved by CHO.

CHO currently only accommodates give-up transactions being undertaken between Clearing Participants through the BaNCS settlement system on an individual transaction basis. CHO does not currently accommodate 'auto give-ups' whereby there is a standing arrangement for a Trading Participant to effect an allocation to a Transferee Clearing Participant with whom the Trading Participant does not have a C&S Agreement. We may consider whether auto give-ups can be accommodated in the future.

We are aware that there is market practice for participants to enter into the ISDA master give-up agreement² whereby the clearing broker to whom settlement responsibilities are allocated can elect not to accept those responsibilities. The terms of this agreement are not consistent with NZX's market structure whereby a Trading Participant must identify a Clearing Participant that is responsible for the clearing and settlement of the Trade at the time of Order entry. That Clearing Participant can only transfer those responsibilities by following the Give-Up process set out in Rule 3.6.

² [2005 ISDA Master Give-Up Agreement – International Swaps and Derivatives Association](#)

NZX has been engaging with Clearing Participant entities who may wish to utilise give-up arrangements for the clearing and settlement of Trades in the NZX20 Futures.

Under the current settings CHO's notification of its acceptance of a give-up transaction is the trigger for novation to occur. We are proposing technical amendments to clarify the intended application of the current rules where a Credit Event occurs in relation to the Transferee. The amendments clarify that should a Credit Event occur in relation to the Transferee prior to CHO notifying the Clearing Participants of its acceptance of a give-up, then no novation of the Settlement Transaction to the Transferee will occur. In the event the Transferee Credit Event occurs post novation, the Transferee is responsible for the settlement of the Settlement Transaction, despite the occurrence of the Credit Event.

In the Derivatives Rules we are also proposing provisions to cater for circumstances in which give-ups are entered into in relation to a Client of an Advising Participant who is not a Trading Participant.



Ancillary Amendments

End of Day Cash Refunds

We are proposing to provide additional flexibility in relation to the management of cash in the Depository, to allow further flexibility for Depository Participants.

Specifically, we are proposing amendments to Depository Rule 3.3.6 to allow a Depository Participant to request that CDO not refund Money at the close of each Business Day. The amendment will enable CDO to determine an alternative time for repayment, on the acceptance of such a request.

We are also proposing an amendment to Depository Procedure 3.3.3, which defines when the close of business occurs for the purposes of Rule 3.3.6, to relocate it within Procedure 3.2 which contains the arrangements for the treatment of Monies in the Depository. We also propose amending the standard close of business time from 4.30pm to 7.30pm NZST. The delayed close of business time reflects that New Zealand banks allow CDO to complete transactions up until 7.30pm and provides additional flexibility for CDO and Participants in relation to the treatment of Monies.

Daily Settlement Price Methodologies

NZX is also proposing an amendment to Derivatives Procedure 8.3, to provide NZX with more flexibility in relation to the methods used to calculate the Provisional Daily Settlement Price and Final Daily Settlement Price of the contracts quoted on the NZX Derivatives Market,

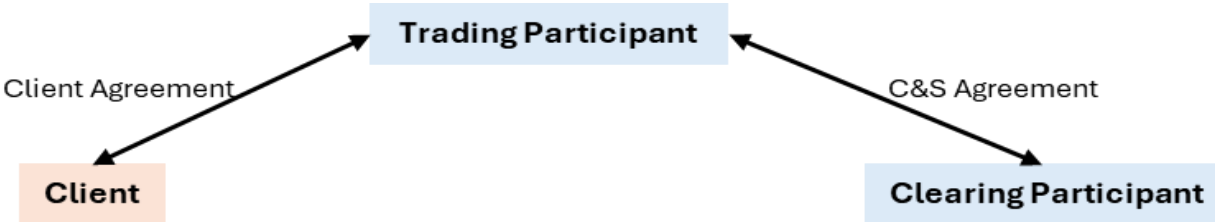
NZX intends to publish a Daily Settlement Price policy document which sets out the intended methods for calculating Daily Settlement Prices. In relation to NZX's Exchange Traded Options (Contract No. 7) NZX intends to use the Cox-Ross-Rubenstein method, and in relation to NZX 20 Futures (Contract No. 5) NZX intends to use the cost of carry model. NZX will retain its discretion to calculate Daily Settlement Prices using an alternative method to enable NZX to be satisfied that the Daily Settlement Price is a fair reflection of the market for the relevant Contract.

These amendments remove methods from the Derivatives Procedures that were used in relation to NZX's dairy derivatives suite which are no longer quoted on the NZX Derivatives Market. These amendments also allow NZX to tailor Daily Settlement Price calculation methods to new contracts in the future, without the need to amend the Derivatives Procedures.

Schedule

Third Party Clearing Models for the Derivatives Market

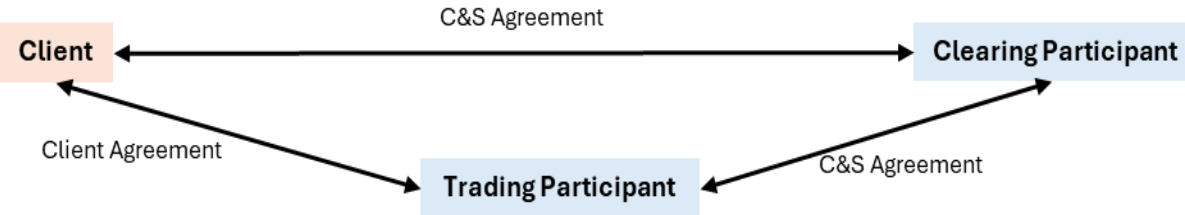
Conduit Model



Key points:

- the Clearing Participant makes a margin call on the Trading Participant who conduits that margin call to the Client.
- the Trading Participant is the Clearing Participant’s Customer under the C&S Rules.
- the Settlement Transaction arising from the Trade executed by the Trading Participant for the Client is allocated to the Clearing Participant’s Customer Account that relates to the Trading Participant.

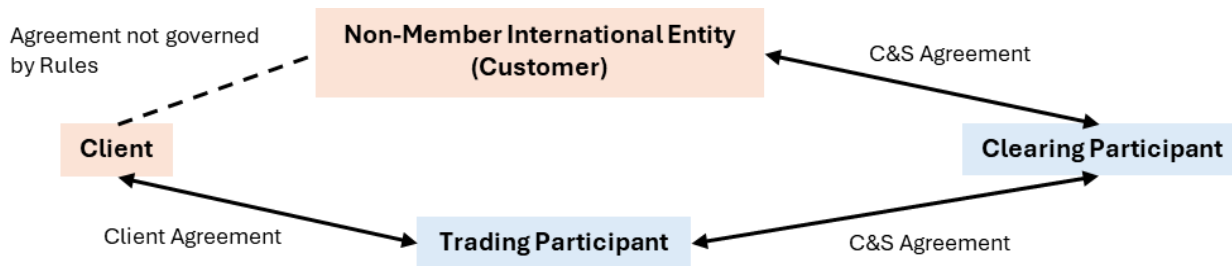
Direct Clearing Model



Key points:

- the Clearing Participant makes a margin call on the Client rather than the Trading Participant
- the Client is the Clearing Participant’s Customer under the C&S Rules.
- the Settlement Transaction arising from the Trade executed by the Trading Participant for the Client is allocated to the Clearing Participant’s Customer Account that relates to the Client.
- post-Trade the Trading Participant has no continuing responsibility for the settlement obligations in relation to the Trade (and no Positive Credit Exposure in relation to the Settlement Transaction).

International Model



Key points:

- the Clearing Participant makes a margin call on the Customer rather than the Trading Participant or Client.
- the Non-Member International Entity will usually be an international sister entity of the Clearing Participant, and under the C&S Rules is the Clearing Participant's Customer.
- the Settlement Transaction arising from the Trade executed by the Trading Participant for the Client is allocated to the Clearing Participant's Customer Account that relates to the Non-Member International Entity.
- post-Trade the Trading Participant has no continuing responsibility for the settlement obligations in relation to the Trade (and no Positive Credit Exposure in relation to the Settlement Transaction).
- the Non-Member International Entity has an agreement with the Client through which the Client accepts responsibility for the settlement obligations of the Trade to the Non-Member International Entity, the C&S Rules require this to contain certain provisions.

Glossary

The terms used in this Consultation Paper bear the following meanings, which may differ from the manner in which these terms are defined in the Rules, for ease of interpretation.

Advising Participant	means a Person accredited as such under the NZX Derivatives Rules who provides only advising services, and for the purposes of this consultation paper excludes a Trading Participant.
C&S Agreement	means a clearing and settlement agreement between a General Clearing Participant and a Customer for provision of clearing and settlement services.
CDO	means New Zealand Depository Limited.
CHO	means New Zealand Clearing Limited.
Clearing Participant	means a Person that CHO has allowed to be a participant in the Clearing House in accordance with the C&S Rules.
Client	means a Person who has executed a Client Agreement with a Derivatives Market Participant (Trading Participant or Advising Participant).
client	means a Person to whom a Customer provides clearing and settlement services, who may also be a Client.
Client Funds Regulations	means regulations 238 to 250 of the Financial Markets Conduct Regulations 2014.
Customer	means a Person who has executed a C&S Agreement with a Clearing Participant.
Customer Account	means a Clearing Participant's Settlement Account held for the purpose of effecting the settlement of Settlement Transactions relating to a Customer of that Clearing Participant
Trading Participant	means a Trading and Advising Firm accredited under the NZX Derivatives Market Rules.