



NEW ZEALAND'S EXCHANGE
TE PAEHOKO O AOTEAROA

NZX Derivatives Market Rules Conformance Amendments

Consultation Paper

February 2020



CONTENTS

Introduction	3
Consultation Process	3
Background	4
Description of the Proposed Amendments	4
Financial Advice	4
Operation of discretionary accounts (DIMS)	5
Know your client procedures/ required client information	5
Contract notes	6
Voice Recording	6
Disclosure of Interests - Acting as Principal	6
Employee and prescribed person trading	7
Surveillance tools	8
DMA trading	9
Further Amendments and request for submissions	9

This Consultation Paper has been issued 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.

Introduction

Over 18 months during 2016 and 2017, NZX conducted a review of the NZX Participant Rules, which included extensive consultation with the industry and stakeholders. As a result of that review, NZX amended the NZX Participant Rules on 1 December 2017.

At that time, NZX noted that it intended to amend certain aspects of the NZX Derivatives Market Rules (**Rules**), to reflect the changes to the NZX Participant Rules. NZX is therefore, now proposing minor and technical changes to the Rules.

This Consultation Paper provides further detail in relation to the key changes that are currently proposed. An Exposure Draft of the proposed Rule amendments (**Draft Rules**) has been contemporaneously released with this Consultation Paper. The Exposure Draft of the Draft Rules is available here.

In completing the current review, we have also noted a number of substantive matters which we consider warrant further consideration. We intend to consult further on these matters later in 2020.

Consultation Process

NZX is seeking responses on the proposed amendments set out in the Draft Rules.

We invite interested parties to provide their views on the proposals raised in this paper by emailing a written submission to policy@nzx.com. The closing date for submissions is **31 March 2020**.

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

If you have any queries in relation to the review, please contact:

Jody Taylor
Leader Participant Compliance, NZX Regulation
Email: jody.taylor@nzx.com
DDI: +64 4 498 0035

Kristin Brandon
Head of Policy and Regulatory Affairs
Email: kristin.brandon@nzx.com
DDI: +64 4 495 5054

Background

NZX is proposing conformance changes to the Rules to appropriately reflect the amendments that were made to the NZX Participant Rules in 2017. These changes are designed to reflect the policy matters that were determined through the NZX Participant Rule review process. The changes will promote consistency across the rule sets that govern trading on NZX's markets.

The proposed changes are contained in the Draft Rules which are available [here](#).

This Consultation Paper, provides further explanation of the changes we are proposing to the following areas of the NZX Derivatives Rules:

- Financial advice
- Discretionary accounts
- Know your client procedures/ required client information
- Contract notes
- Voice recording
- Disclosure of interests
- Employee and prescribed person trading
- Surveillance tools
- DMA trading.

Description of the Proposed Amendments

Financial Advice

We have simplified the definition of "Advisor" and renamed this category "NZX Derivatives Adviser".

We have retained the existing requirements in relation to client agreements at Draft Rules 6.5 and 9.6. We are not proposing to exclude Institutional Clients from the know your client information obligations or client agreement obligations, unlike the approach taken in the NZX Participant Rules. We consider that NZX Derivatives Participants will need to enter into client agreements and obtain information from Institutional Clients accounting for factors specific to dealing in Derivative Contracts, for the purposes of making margin calls and managing their ongoing relationship.

We have included a broad requirement to have adequate arrangements for the management of conflicts of interest that may arise in relation to a Participant's business. We note that these requirements now extend to Independent Directors.

References:

- Draft Rule 1.1 – amended definitions
- Draft Rule 6.5 and 9.6 relating to client agreements
- Draft Rule 4.21.1 in relation to conflict management procedures

Discretionary accounts

We have removed NZX's current requirements for the operation of discretionary accounts given the regulation of retail DIMS under the current financial markets conduct legislative regime.

References:

- Deleted Draft Rules 11.5, 11.6, 11.7 and 11.8
- Draft Rule 1.1 – definition of Discretionary Account

Know your client procedures/ required client information

The submissions that NZX received through the NZX Participant Rule review recognised that much of the information required under the Rules is useful from an operational perspective, for both NZX and NZX Participants. However, submitters expressed concern that the requirements were at times, inconsistent and/or duplicative with the requirements of the AML/CFT legislation and the financial market services legislation.

We have streamlined the requirements in the Draft Rules, to acknowledge the information that NZX Derivatives Participants are required to obtain under legislation. We have retained obligations in respect of additional key information that Advising Participants should know about their clients to manage their relationship, and information which NZX may need to access for the purpose of monitoring compliance under the Rules.

We also propose removing the requirement for Advising Participants to obtain evidence of the identity of a prospective Client or Intermediary, as this duplicates existing anti-money laundering requirements.

We propose changing who is responsible for obtaining information under the 'Know Your Customer Obligations' from the Advisor (now NZX Derivatives Adviser) to the Advising Participant. We consider that it is more appropriate for the Advising Participant to bear the responsibility for ensuring that appropriate client on-boarding and other information is obtained.

We have amended Draft Rule 6.13 to require bank account details and disclosure documents to be obtained from persons who are Intermediaries. We have also amended the definition of Intermediary so that these requirements may operate as intended.

References:

- Draft Rules 6.9 to 6.13 (KYC requirements)
- Draft Rule 6.13 (Intermediaries)

Contract notes

Following the approach taken to the amendments to the NZX Participant Rules, there will no longer be a requirement to send written contract notes to wholesale clients (as defined in the financial markets conduct legislative regime) who have agreed to receive an alternative transaction confirmation.

We have amended the delivery method for contract notes so that electronic delivery is the primary method of delivery (although all Clients will continue to have the option to elect to receive hard copy contract notes). We have not proposed amendments to any of the content requirements for contract notes.

Reference:

- Draft Rule 9.9.

Voice Recording

We have clarified that the records of the conversations, communications and instructions that are currently required to be recorded, must include voice-records or records of electronic communications, as relevant. We expect such records to be maintained as part of an appropriate recording system.

We have clarified that where voice records forms part of an Order record, such records must be maintained for two years. This is to help NZX and other regulators better perform their enforcement functions.

Reference:

- Draft Rule 4.22

Disclosure of Interests

We have amended the definition of 'Acting as Principal'. This term has been narrowed so that it no longer includes trading where an Associated Person holds a beneficial interest in a Contract. An entity that falls within the grouping provision contained in Draft Rule 3.22, that holds a beneficial interest, will continue to be captured by the definition. We consider that this amendment appropriately excludes the very narrow pool of entities who are Associated Persons but who do not fall within the grouping provision.

The definition has also been amended to refer to a 'transaction' rather than a 'Trade'. This broadens the scope of the definition so that it extends beyond placing an Order. This is appropriate because the prohibitions on market manipulation contained in Draft Rule 4.3 apply to a Participant who is 'Acting as Principal' and extend to a broader range of activity than Order placement.

The proposed definition has been narrowed to refer to a Contract so that the definition only relates to contracts that are tradeable on the NZX Derivatives Market. This is consistent with the way in which the term 'Acting as Principal' is used in the remainder of the Rules.

Reference:

- Definition of 'Acting as Principal'
- Definition of 'Associated Person' in Draft Rule 1.2.3
- Draft Rule 3.22

Employee and prescribed person trading

We have amended the requirements that currently apply to trading by Employees and Prescribed Persons. The 'Employee Trading' section is renamed 'Prescribed Person Trading'.

Scope of the requirements

In order to support the refresh of these requirements, we have amended the definition of 'Employees' to clarify that it includes Partners and Directors (but not Independent Directors). We have also included new definitions of the terms 'Directors' and 'Independent Directors' (someone who is not an executive officer or employee involved in the everyday Broking Business of the Participant).

We have also amended the definition of Prescribed Person so that it is limited to: (1) Employees of an Advising Participant; (2) the Immediate Family of Employees; (3) Family Companies or Family Trusts of Employees or their Immediate Family; and (4) any companies 'controlled' by such persons.

We have broadened the nature of the financial products to which the Prescribed Person rules apply, to include underlying securities quoted (or to be quoted) on a Recognised Securities Exchange (which includes NZX). This will implement appropriate controls relating to trading in the underlying financial product for equity derivatives contracts. We have also clarified that the requirements apply when a Prescribed Person arranges for an order to be executed through an entity other than an Advising Participant who employs the Prescribed Person.

We propose to retain the current permission requirements where a Prescribed Person places an Order through the employing Advising Participant.

NZX has published guidance under the Participant and Derivatives Market Rules Guidance

Note [‘Prescribed Person Trading’](#) about what it views as “reasonable steps” at section 3.

Prescribed Person Trading through another Participant

We have amended current Rule 4.20 to require Participants to take reasonable steps to ensure:

- (a) they do not operate an account for an Employee or Prescribed Person of another Participant; and
- (b) where they employ staff, they take reasonable steps to ensure that their Employees and Prescribed Persons do not have accounts with other Participants.

We have amended the requirement for NZX to provide permission for Prescribed Person trading, to a requirement that NZX is notified where the employing Participant has agreed to allow the Prescribed Person to trade through another Participant (refer to Draft Rule 4.19 (d)).

We have also amended the client order priority rules to captures trading conducted on behalf of a Prescribed Person, or by a Participant Acting as Principal (or trading on its own behalf, including anyone who controls or is controlled by the Advising Participant).

References:

- Definition of ‘Prescribed Person’
- Draft Rule 4.19
- Draft Rule 9.8

Surveillance tools

We have included with Draft Rule 8.7, a requirement that each Trading Participant must ensure that all Orders entered or submitted into the Trading System are entered or submitted with the trading flags and data required by Procedures. This Rule extends to all Orders entered or submitted into the Trading System by a Trading Participant's Dealers and by DMA Authorised Persons.

We will require that all NZX Dealers accessing the Trading System, whether directly or via third party systems, such as Iress or CQG, are clearly identifiable as specified in 8.3.4. This will allow NZX to identify all trading linked to particular NZX Dealers in order to monitor for potential market misconduct. See proposed amendments to Rules 8.3.4

Reference:

- Draft Rule 8.3.4
- Draft Rule 8.7

DMA trading

We have also removed the concept of a DMA Dealer, as there is no practical distinction between a Dealer and DMA Dealer.

We have removed the concept of Direct Principal Order Processing from the Rules and instead imposed an obligation in Draft Rule 8.4.2(d) that any DMA Orders that are intercepted by a filter must be either rejected outright, or referred to a Dealer.

We have updated Rule 8.5 to require Trading Participants to ensure DMA Authorised Persons are made aware of how the order entry system operates, the relevant Rules, the requirements of Good Broking Practice and applicable Guidance Notes.

We have amended the requirements for written agreements with DMA Authorised Clients. These agreements must provide that DMA Authorised Clients will provide information relating to the identity of their underlying client, where NZX requests this information from the Trading Participant. We have also added a requirement for Trading Participants to maintain a DMA Authorised Person Register and specified content requirements for that register in Draft Rule 8.6.1. These obligations will support NZX's surveillance activities.

References:

- Definition of DMA Dealer and Dealer
- Draft Rules 8.4 to 8.6

Further Amendments and request for submissions

We note that we will need to appropriately conform the Guidance Notes and NZX Derivatives Procedures to reflect the proposed changes as set out in the Draft Rules.

As noted above, later in 2020, NZX intends to undertake a holistic review of the Rules, to determine whether the scope of the Rules remains fit for purpose.

We intend to consider the following matters as part of that review:

- whether trading of derivatives products that are not quoted on the NZX Derivatives Market should be regulated by the Rules;
- whether the current Participant categories contained in the Rules remain appropriate, in particular whether the category of "Technology Connecting Facility" should be retained; and
- whether the requirements relating to accepting and holding client funds remain appropriate.

We welcome submissions on the proposed amendments outlined in the Draft Rules, and the matters that should form part of next year's review.