

Market Maker Eligibility

Consultation Paper

June 2024

CONTENTS

Introduction	3
Objectives of the review.....	3
How can I contribute to this consultation?	3
Provide a submission.....	3
Background	5
Proposed obligations applying to Designated Market Makers	6
Market Maker specific obligations.....	6
Market making activity to be entered via DCOP	6
Conflict management arrangements.....	7
Market maker activity requirements.....	7
Appointment of a Market Making Representative.....	8
Administrative matters	8
General conduct obligations	8
General conduct requirements	8
Market manipulation	9
NZX supervision and powers.....	9
Trading Participant obligations	11
Access to Trading System and responsibility for Orders	11
Capital adequacy.....	12
Incidental amendments.....	14
Clearing and Settlement Rules.....	14
Trading Conduct Guidance Note	14
Derivatives Market Procedures.....	14
NZ Markets Disciplinary Tribunal Rules.....	15

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 Listing Rules.

Introduction

As a result of recent developments in the macro environment that have arisen in relation to the proposed relaunch of the S&P/NZX20 Index Futures Contract, NZX is consulting on proposed amendments to the market maker eligibility requirements and ongoing obligations contained in the NZX Participant Rules (**Participant Rules**) and NZX Derivatives Market Rules (**Derivatives Rules**, together the **Rules**).

The existing settings only allow NZX Trading Participants to be designated by NZX as a market maker (**Designated Market Maker**). We consider that more permissive market making eligibility settings will encourage greater participation in NZX's markets and support increased liquidity and market efficiency.

We are therefore proposing to remove the requirement that a Designated Market Maker be a NZX Participant. Instead, a Designated Market Maker will be able to access NZX's markets as a Direct Market Access (**DMA**) Authorised Person through an existing NZX Trading Participant. NZX Trading Participants may also continue to be Designated Market Makers.

As described further in this document, our view is that the proposed structure of NZX's market making programme, and the interplay between the obligations applying to a Designated Market Maker and its Trading Participant will provide a structure that encourages a wider breadth of participation, while still ensuring there are appropriate safeguards in place.

Objectives of the review

NZX is undertaking this review with the objectives of ensuring that NZX's regulatory settings:

- promote innovation and competition in NZX's markets;
- encourage participation and enhance efficiency;
- are fair and consistent across NZX's markets; and
- apply appropriate obligations on market participants relative to their activities, avoiding unnecessary compliance costs.

These objectives have been designed to enable NZX to continue to operate its markets on a fair, orderly, and transparent basis, consistent with NZX's obligations under the Financial Markets Conduct Act 2013.

How can I contribute to this consultation?

Provide a submission

We invite interested parties to provide their views on the proposals described in this consultation paper, and contained in the Exposure Draft of the Participant Rules and Derivatives Rules and Derivatives Procedures, by emailing NZX Policy with a written submission. We are interested in general feedback in relation to the proposals, and have raised specific consultation questions to prompt feedback in certain areas.

Alternatively, if you would prefer to provide a verbal submission, please email NZX Policy to arrange a time to speak with us.

You can contact NZX Policy at: policy@nzx.com

The closing date for submissions is Friday 19 July 2024.

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

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

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Background

NZX's existing requirements relating to market makers differs across the cash and derivatives markets. The Participant Rules provide that a Trading Participant may apply to be designated as a market maker in particular securities,¹ and section 16 of the Participant Rules provides the obligations specific to market makers. The Derivatives Rules require a market maker to be a Participant and allow NZX to approve a Market Maker Programme at its discretion,² although no such programme has been established.

The proposed changes to the Participant Rules and Derivatives Rules amend the existing settings to allow entities who are not currently NZX Participants to apply to NZX to be designated as Market Makers, and to adopt equivalent provisions in the Derivatives Rules.

We have considered the wider international context when re-designing the eligibility requirements. While international practice regarding market making participation is inconsistent, we found examples of exchanges who do not accredit market makers but allow market making activity to occur. We also identified an example where the exchange accredits the market maker without requiring a trading participant status, being SGX who uses this model for certain products.

One of the purposes of this review is to align the approach to market makers across NZX's markets. NZX currently has Trading Participants that are designated as Market Makers under the Participant Rules. The proposed changes will not alter the obligations of these existing Market Makers, instead there will be additional obligations applied to Designated Market Makers that are not also Trading Participants.

¹ Participant Rule 16.1.

² Derivatives Rule 14.3.

Proposed obligations applying to Designated Market Makers

The proposed changes to the Rules provide for two main categories of obligations that will apply directly to Designated Market Makers:

- (a) **specific market maker conduct obligations:** there will be a section in each rule set with obligations specific to market makers (section 16 in the Participant Rules and section 17 in the Derivatives Rules); and
- (b) **general conduct obligations:** certain other parts of the Rules will be incorporated by reference (these are set out in section 2 of the Participant Rules and section 17 of the Derivatives Rules).

In addition, NZX supervision and enforcement powers will apply.

These obligations take into account the Trading Participant's trading conduct obligations in relation to the Designated Market Maker as a DMA Authorised Client, and that the Designated Market Maker will not be a Client Advising Participant.

Market Maker specific obligations

A separate section will be included in each Rule set providing the specific obligations relating to market making activities. These are largely based on the existing section 16 of the Participant Rules. Additional requirements apply if a Designated Market Maker is not also a Trading Participant.

Market making activity to be entered via DCOP

Designated Market Makers that are not NZX Trading Participants, will be required to be registered on the relevant Trading Participant's DMA Authorised Person register,³ and to enter all market making Orders via Direct Client Order Processing (**DCOP**). These Designated Market Makers will also be required to enter into a DMA agreement⁴ and, for Designated Market Makers in the Derivatives Market, a Client Agreement⁵ with the relevant Trading Participant.

This requirement ensures that NZX has the ability to direct the relevant Trading Participant to suspend, limit, or prohibit the Designated Market Maker's ability to use DCOP, in the case that a Designated Market Maker's trading activity is putting the integrity of NZX's markets at risk.⁶ NZX considers that this power is integral to the maintenance of fair, orderly and transparent markets as it enables NZX to prevent a Designated Market Maker trading.

³ NZX Trading Participants providing DMA to clients are required to maintain a DMA Authorised Person register under Participant Rule 10.10 and Derivatives Rule 8.6.

⁴ In accordance with Participant Rule 10.9.2, and Derivatives Rule 8.5.2.

⁵ In accordance with Derivatives Rule 9.6.

⁶ In accordance with Participant Rule 10.10.2 and Derivatives Rules 8.6.2 and 8.6.3.

We have also proposed a clarification in Participant Rule 10.10.2, to ensure that NZX can direct a Trading Participant to suspend, limit, or prohibit a Designated Market Maker's access to DCOP in the case that the Designated Market Maker itself has breached any applicable Rules, directions, or Good Broking Practice. This clarification was not required for Derivatives Rule 8.6.2, as that Rule is drafted more broadly to include a breach by any person accessing the Trading System via DMA.

Conflict management arrangements

A Designated Market Maker will be required to separate market making activities from its other business activities, which includes:

- (a) ensuring that authorised access, such as a designated trader workstation, is used exclusively for its market making activities; and
- (b) ensuring that any Employees performing market making activities are not also executing client Orders.

These conflict management requirements currently apply to Market Makers designated under the Participant Rules. They are intended to ensure that NZ RegCo can readily identify market making activity and suspend access to the Trading System in relation to the Designated Market Maker's market making activities if required. Additionally, requirement (b) is aimed to mitigate the conflicts that may arise where a Designated Market Maker also executes client orders. We note that point (a) is not intended to require a Designated Market Maker to have a separate person conducting market making activity from other as Principal activity.

An entity applying to be designated as a Market Maker will need include in its application a description of how its conflict management arrangements and controls are sufficient to enable it to meet its requirements under these Rules, including (if it executes client orders) separating client order flow from market making activity, and notify NZX if these arrangements change.

Market maker activity requirements

The Rules contain requirements for Designated Market Makers to:

- (a) buy and sell the designated securities on its own account, and on a continuous basis;
- (b) enter and maintain Bids and Offers in the designated securities during the hours agreed in its Market Making Agreement;
- (c) satisfy all Orders delivered to its posted quotes;
- (d) adjust and reinstate two-sided quotations within the period agreed upon in its Market Making Agreement following an executed Trade; and
- (e) ensure that all Orders submitted in its capacity as a Designated Market Maker are flagged as Market Making Orders.

NZ RegCo will monitor whether a Designated Market Maker is meeting these obligations using its existing SMARTS surveillance technology.

Additionally, Designated Market Makers will be required to ensure that all market making Orders are appropriately flagged. This is discussed in more detail in the Trading Participant section below.

Appointment of a Market Making Representative

Entities applying to be designated as a Market Maker who are not also Trading Participants will be required to appoint a Market Making Representative.

This requirement will ensure NZX is able to contact the Designated Market Maker directly in relation to its activities (rather than having to direct queries through the relevant Trading Participant).

Designated Market Makers who are also Trading Participants are not required to appoint Market Making Representatives, as the Participant Rules and Derivatives Rules require Trading Participants to appoint a Managing Principal or Responsible Executive, which provides NZX with a direct contact point.

Administrative matters

In addition, NZX is proposing administrative requirements specific to Designated Market Makers and their market making activity. These include:

- (a) the application process for Designated Market Makers;
- (b) processes around trading halts and applications for withdrawing quotations;
- (c) processes for NZX to suspend or withdraw a Market Maker's designation; and
- (d) processes for resigning as a Designated Market Maker.

There is also an ability for NZX to require periodic reporting from Designated Market Makers.

Currently, as a condition of designation, NZX requires Market Makers to report on whether or not they have met their obligations under their Market Making Agreement (for example, spread requirements). It is intended that NZX will require similar periodic reporting under the new regime, along with an additional confirmation that the Designated Market Maker has complied with all its obligations under the Rules.

General conduct obligations

In addition to the specific requirements proposed in section 16 of the Participant Rules and section 17 of the Derivatives Rules, we propose incorporating key conduct requirements found in other sections of the Rules by reference. The Rules being incorporated by reference are included in Rule 2.9 of the Participant Rules and Rule 17.2 of the Derivatives Rules.

General conduct requirements

The proposed amendments apply Participant Rule 8.1 and Derivatives Rule 4.4 to Designated Market Makers. These provisions require a Designated Market Maker to ensure that it, its Directors, and its Employees:

- (a) observe proper ethical standards and act with honesty, integrity, and due skill and care;
- (b) refrain from conduct that is, or is reasonable likely to be, detrimental to the integrity of NZX's market or discredit or bring into disrepute NZX or any of its markets or Participants;
- (c) comply with applicable Rules and directions of NZX, and follow Good Broking Practice;
- (d) co-operate with NZX when NZX is exercising its powers; and

- (e) comply with all relevant laws and regulations.

These sections contain general conduct obligations that are integral to the maintenance of fair, orderly, and transparent markets. We note that these Rules will apply only in relation to a Designated Market Maker's market making activities, given the scope of the designation and not its broader business activities.

Market manipulation

The proposed amendments incorporate Participant Rule 10.2 and Derivatives Rule 4.3, which contain the prohibition on market manipulation. The Financial Markets Conduct Act 2013 (the **FMC Act**) also contains a prohibition on creating a false or misleading appearance of trading⁷.

We considered whether it was sufficient that the prohibition in the Rules will apply to a Designated Market Maker's Trading Participant who is responsible for all Orders submitted into the Trading System. This allows NZX to take action against a Trading Participant if the Designated Market Maker was placing Orders via the Trading Participant in a way that triggered this provision. However, NZX considers that the prohibition on market manipulation should apply directly to a Designated Market Maker to allow NZ RegCo to take action directly against the Designated Market Maker, in addition to the existing ability to refer cases to the Financial Markets Authority, if necessary to properly safeguard the integrity of NZX's markets.

NZX supervision and powers

The proposed amendments incorporate various parts of sections 20 and 21 of the Participant Rules, and parts of section 14 in the Derivatives Rules.

These sections are specific to NZX's supervision powers over its markets, and its enforcement powers in certain scenarios. These functions are undertaken by NZ RegCo, an independently governed entity responsible for monitoring and enforcing NZX's market rules. The sections we are proposing to incorporate include sections that provide NZ RegCo with broad powers to carry out this function, as well as other key powers for NZX, including:

- (a) the power for NZ RegCo to determine compliance with the relevant Rules;
- (b) broad powers for NZ RegCo to inspect, verify, and request information if it considers this information is necessary to allow it to determine compliance with the relevant Rules;
- (c) power to refer matters to the New Zealand Markets Disciplinary Tribunal;
- (d) powers to set fees and levies;
- (e) an obligation to apply to Designated Market Makers to supply any information requested,
- (f) obligations applying to NZX around handling confidential information; and
- (g) the Designated Market Maker being liable for NZX costs.

Incorporating these supervision and enforcement powers, will ensure that Designated Market Makers who are not Trading Participants are still subject to the full suite of NZX's enforcement

⁷ Section 265 of the Financial Markets Conduct Act 2013.

and surveillance powers should they conduct their market making activity in a manner that puts the integrity of NZX's markets at risk.

We also note that we are proposing to incorporate a number of Rules which are administrative in nature, including interpretation, definition, grouping provisions and assignment. While the full suite of Rules will not apply to Designated Market Makers directly, we note that these Rules still apply to Trading Participants with Designated Market Makers as clients in the same way as they currently apply to Trading Participants with DMA Authorised Persons as clients. This is discussed in more detail in the next section.

Consultation questions

1. Do you consider that it is appropriate to require Designated Market Makers who are not also Trading Participants to enter all Orders relevant to its market making activity via DCOP, noting that by doing so NZX is ensuring that it has the power to terminate a Designated Market Maker's market access in relation to its market making activity?
2. Do you consider the obligations contained in the market maker specific sections of the Rule sets are sufficient to ensure market making activity does not put the integrity of NZX's markets at risk?
3. Are there any additional obligations that you consider should apply directly to a Designated Market Maker?
4. Are there any obligations we have proposed applying directly to a Designated Market Maker that you consider should not apply?
5. Are there any additional requirements above what NZX is proposing that you consider should apply to an entity who is not a Trading Participant to be designated as a Market Maker?

Trading Participant obligations

The Rules place a number of obligations on Trading Participants regarding the activity and conduct of its DMA Authorised Persons, and orders being placed via DCOP. These obligations will apply to a Trading Participant whose client is a Designated Market Maker, creating an extra regulatory overlay in relation to this activity.

Access to Trading System and responsibility for Orders

The Rules place a number of requirements on Trading Participants to ensure that allowing their clients to access the Trading System by DMA, and place orders by DCOP, doesn't threaten the integrity of NZX's markets. These requirements include that the Trading Participant is responsible for:

- the security and control of access to the Trading System, including ensuring that only authorised persons submit Orders;⁸
- ensuring that use and access to DMA does not interfere with the efficiency and integrity of NZX's markets, or the proper functioning of the Trading System;⁹
- ensuring that appropriate filters, screens, and security measures are established and maintained, and that any orders submitted into the Trading Participant's order entry system by DMA Authorised Persons which do not pass directly through its filters are rejected outright or referred to a Dealer for review and decision before being allowed to pass into the Trading System;¹⁰
- having procedures in place to ensure that DMA Authorised Persons are made aware of the appropriate use of the order entry system of that Trading Participant, and the Rules applying to Trading;¹¹ and
- ensuring a written agreement is in place with all clients that are DMA Authorised Persons providing that the client must be able to provide details of who placed each order submitted by that client via DCOP.¹²

In addition to the obligations above, Trading Participants are responsible and liable for the accuracy of Orders entered and submitted into the Trading System, including those submitted by DCOP.¹³

These obligations will apply to Trading Participants who have Designated Market Makers as clients, making them responsible for the Designated Market Maker's access to the Trading

⁸ Participant Rule 10.7.1; Derivatives Rule 8.3.3.

⁹ Participant Rule 10.8.1(b), Derivatives Rule 8.4.2(c).

¹⁰ Participant Rule 10.8.1, Derivatives Rule 8.4.1.

¹¹ Participant Rule 10.9.1(b), Derivatives Rule 8.5.1(b).

¹² Participant Rule 10.9.2, Derivatives Rule 8.5.2.

¹³ Participant Rule 10.8.2, Derivatives Rule 8.4.3.

System in the same way Trading Participants are responsible for their DMA Authorised Persons' Trading System access.

We note that we are proposing to apply an obligation on Designated Market Makers directly to require such entities to ensure the Market Maker flag is applied appropriately to all market making Orders submitted via DCOP. It is our view that, as Designated Market Makers will be submitting market making Orders directly into the Trading System via DCOP, rather than placing such order with Trading Participants, it makes sense for this obligation to be placed directly on the Designated Market Maker.

Capital adequacy

We are not proposing to impose capital adequacy requirements on Designated Market Makers, as the relevant Trading Participant will account for the positions of the Designated Market Maker in its capital adequacy requirements. The existing capital adequacy calculations will apply to Trading Participants who have clients who are Designated Market Makers in the same way that they apply to all other DCOP clients of the Trading Participant.

We understand that the amount of a Trading Participant's Total Risk Requirement (**TRR**) will differ depending on whether its market making positions are held:

- (a) directly as Principal because the Trading Participant itself is a Designated Market Maker;
or
- (b) on behalf of a client who is a Designated Market Maker.

In situation (a), positions will be held as Principal positions and will sit within the Position Risk component of the TRR calculation. In situation (b), positions will be held as client positions and will sit within the Counterparty Risk component of the TRR calculation.

The capital adequacy requirements under the Rules measure a Participant's current financial health by assessing its liquidity against the risks to which it is exposed. The TRR calculation represents the level of liquid capital a Participant is required to hold, to cover its business risks.

While there are many variables included in the TRR calculation, generally speaking where a position is held of exactly the same size in exactly the same securities, if that position is held as Principal (and included in Position Risk) a Participant will be required to hold more liquid capital than if that position is held by a client (and included in Counterparty Risk). This reflects the higher level of exposure that a Participant faces when a position is held on its own books compared to that position being held by a client.

NZX is not proposing to amend the capital adequacy methodology which is calibrated to ensure that NZX has appropriate oversight of a Participant's financial wellbeing and to provide suitable confidence to investors in relation to a Participant's liquidity. NZX does not regard the trading strategy that has given rise to a position (e.g. market making, arbitrage, portfolio management) to be relevant to a Participant's risk exposure to a position.

Consultation questions

1. Do you agree that the obligations placed on Trading Participants with Designated Market Makers as clients should align with the obligations that exist currently in relation to DMA Authorised Persons? Are there any other obligations you consider should apply to a Trading Participant with a Designated Market Maker as a client?
2. Do you agree that the capital adequacy requirements, including the TRR calculation, correctly take into account the risks associated with market making positions held as either Principal or client positions?

Incidental amendments

As part of the wider NZX20 relaunch project, a few incidental amendments have been required to support the introduction of a Designated Market Maker in the NZX20.

Clearing and Settlement Rules

The Clearing and Settlement Rules (**C&S Rules**) currently define “Customer Account” as:

a Clearing Participant’s Settlement Account Held for the purpose of effecting the settlement of Settlement Transactions arising from Transactions of a Customer of that Clearing Participant and includes a Settlement Account held for recording the Settlement Transactions arising from Transactions of a Market Maker.

The definition of Market Maker in the C&S Rules is:

a Trading Participant acting as a market maker in accordance with the rules of an NZX Market.

We propose to remove the underlined section in the definition of Customer Account, and remove the definition of Market Maker from the C&S Rules. We consider that transactions arising from market making activity should be held on the relevant account depending on who undertook the transaction (whether customer or house).

Trading Conduct Guidance Note

As part of the wider relaunch of the S&P/NZX20 Index Futures Contract we are proposing amendments to the Trading Conduct Guidance Note to provide additional guidance in relation to examples of circumstances where NZX’s policy is to not take any action where a legitimate transaction occurs, even if that transaction does not result in a change of beneficial ownership.

These amendments include adding the situation where an “accidental” Trade arises due to a Designated Market Maker trading on its own account as principal in addition to its market making activities. This change will be specifically consulted on in the wider consultation in relation to the NZX20 relaunch, along with other changes to the Trading Conduct Guidance Note.

Derivatives Market Procedures

The Derivatives Rules currently require Trading Participants to ensure that all Orders entered or submitted into the Trading System are entered with the trading flags required by the Derivatives Market Procedures (**Derivatives Procedures**).¹⁴ This requirement is equivalent to Participant Rule 10.1.5, which refers to Participant Rule Procedure 2.1.

The Derivatives Procedures do not currently specify trading flags that must be entered with certain Orders. We propose to add Derivatives Procedure 8.17 which provides for the equivalent trading flags to the Participant Rules, aside from the short-selling flag which is not required for derivatives trading.

¹⁴ Derivatives Rule 8.7.7.

NZ Markets Disciplinary Tribunal Rules

The NZ Markets Disciplinary Tribunal Rules (**NZMDT Rules**) give NZMDT the ability to impose certain orders on Market Participants and Derivatives Participants in relation to a breach of a Participant Rule or Derivatives Rule respectively.

We have included Designated Market Maker in the definition of Market Participant and Derivatives Participant for the purposes of the NZMDT Rules, to ensure that NZMDT has the ability to hear cases and impose penalties on Designated Market Makers.