



NZX Participant Guidance Note

Trading Conduct: Consultation Draft

Section 4.2: Indications of Interest Amendments

August 2020



4. Client Orders

4.2 Indications of Interest

Indications of Interest (**IOIs**) are non-binding, usually electronic expressions of trading interest ~~that are used to identify~~ used by Participants to advertise potential crossing opportunities to potential counterparties ~~to a large transaction~~. While IOIs may contain information such as the name of the financial product, trade direction (buy or sell), ~~capacity (agency or principal),~~ volume and price indications, they are not an Order and are usually also not a contractual offer, although in some circumstances, they can be. ~~However, an IOI may represent an Order that is held by the NZX Participant and, in some circumstances, can be a contractual offer.~~ 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. For example:

~~an IOI stating that the NZX Participant is a seller of 100,000 XYZ @ \$4.50 would generally be considered an offer;~~

~~an IOI stating that the NZX Participant is a seller of 100,000 XYZ @ \$4.50 (subject to confirmation) would not be considered an offer; and~~

- ~~• an IOI stating that the NZX Participant is a seller of 100,000 XYZ @ \$4.50 issued at 9:30am where the market price had changed by 10:30am to \$4.70, would no longer be considered an offer (although this IOI should be updated or removed).~~

IOIs are ~~generally used as a mechanism to identify potential counterparties where there is a large volume of securities to trade and are usually distributed by an NZX Participant to selected clients. They are used in respect of trading by the NZX Participant as principal or on behalf of~~ used by NZX Participants to advertise Institutional Client or Principal flow,s 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(e) requires 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.

~~Some of the risks that can be associated with the use of IOIs include:~~

- ~~• the potential for IOIs to be misused as a means of gathering and exploiting information regarding the genuine trading intentions of others;~~
- ~~• the use of non-genuine IOIs — i.e. not backed by a genuine intention to trade either for a client or as Principal. Such activity could well be viewed as misleading and deceptive conduct under Part 2 and/or Part 5 of the FMCA and contrary to Good Broking Practice and the conduct requirements for NZX Participants (see Participant Rule 8.1 and Derivatives Rule 4.4);~~
- ~~• a conflict can arise when an NZX Participant trades as Principal in the knowledge of the trading intentions of others;~~
- ~~• there is a possibility that clients with genuine trading intentions end up with a worse outcome as a result of information being used by recipients of an IOI to trade ahead of~~

them; and

- there is a possibility that disclosure of trading intentions in respect of large volumes in less liquid securities, may be price sensitive.

When using an IOI, NZX Participants need to have controls and procedures in place to manage the risks of an actual or perceived conflict of interest arising, information imbalance that may result in a worse outcome for the client or potential front running of a client Order, as well as to prevent non-genuine IOIs being used to gather and exploit information about genuine trading intentions.

Conduct expectations for advertising IOIs

When advertising an IOI, NZX Participants must 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 (NZX Participant Rule 8.1 and Derivatives Market Rule 4.4).

NZX Participants must 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 must also keep records of all disseminated IOIs, be able to link these to client orders when the IOI is advertised with a "client (C:x)" flag, and provide such records to NZX on request.

Flagging IOIs

NZX expects all IOIs disseminated by NZX Participants to contain two "flags" to indicate whether the IOI represents:

- 1) "agency/client", "potential", or "principal/house" flow; and
- 2) "natural" or "non-natural" flow.

NZX suggests that Participants adopt the AFME/IA framework to flag their IOIs in the Trading System. This framework sets out a "Class: Subclass" system, using the following letter and number codes:

Class

Sub-class

<u>C = Client</u>	<u>1 = Natural, can deal as a block</u>
<u>P = Potential</u>	<u>2 = Natural, need to work the order</u>
<u>H = House</u>	<u>3 = Non-natural</u>

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.

NZX expects that the Participant’s Principal book will be precluded from transacting in the financial product on-market, or advertising the Principal flow arising from this transaction until five times the volume of the transaction has traded on-market on an NZX market, or three complete Trading Days have passed, whichever occurs earlier. The record of three complete Trading Days or five times the trading volume would begin from the point at which a Trade was completed and reported to the market as a result of these IOIs. The Participant’s Principal book can, however, respond to any unsolicited interest in the stock from its clients.

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 before 5 times the volume of the Trade has Traded on-market subsequent to the Trade being agreed.

Example 1:

<u>IOI detail</u>	<u>IOI detail with "class:subclass" codes</u>	<u>Description</u>
<u>BUY 200k ZEL 5.77, natural, agency, would</u>	<u>Buy 200k ZEL 5.77, C:1</u>	<u>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.</u>

Example 2:

<u>IOI detail</u>	<u>IOI detail with "class:subclass" codes</u>	<u>Description</u>
<u>SELL 100k FPH, natural, agency, vwap</u>	<u>SELL 100k FPH, C:2, vwap</u>	<u>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").</u>

Example 3:

<u>IOI detail</u>	<u>IOI detail with "class:subclass" codes</u>	<u>Description</u>
<u>SELL 250k SKL, natural, agency, ITW</u>	<u>SELL 250k SKL, P:1</u>	<u>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 skeptically.</u>

Example 4:

<u>IOI detail</u>	<u>IOI detail with "class:subclass" codes</u>	<u>Description</u>
<u>BUY 200k FBU, non- natural, principal, would</u>	<u>BUY 200k FBU, H:3, would</u>	<u>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</u>

		<u>position in the market, and/or advertise it via IOI.</u>
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Example 5:

<u>IOI detail</u>	<u>IOI detail with "class:subclass" codes</u>	<u>Description</u>
<u>SELL 150k CEN, natural, principal, would</u>	<u>SELL 150k CEN, H:1</u>	<u>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 until the expiration of the volume/time moratorium. They can, however, use this position to respond to unsolicited client Orders.</u>