

NZX CONSULTATION MEMORANDUM
XXX Market Derivatives Rules

OCTOBER 2009



I. Introduction

Over the past year, NZX has been working on the XXX Market Rules (“Rules”) and XXX Market Procedures (“Procedures”) in anticipation of the introduction of a new derivatives market. Throughout this period NZX has undertaken consultation with market participants. NZX now wishes to consult with the wider public in respect of these Rules and Procedures, so as to provide an opportunity for all interested parties to provide feedback.

NZXR encourages all those interested in the development of New Zealand’s derivatives markets to consider the information provided in this paper, the Rules and Procedures and welcomes any comments on those matters.

Feedback is sought by 30 October 2009. NZX would prefer submissions to be provided in electronic format. Submissions should be addressed to:

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Those providing feedback are asked, as part of their response, to specifically identify the section and Rule or Procedure number on which they are commenting.

II. Background

NZX is New Zealand's sole registered exchange and is licensed under section 36F of the Securities Markets Act 1988 (the "Act"). NZX intends to apply to the Securities Commission to be authorised to operate a futures exchange under the Act in order to operate a derivatives market in New Zealand. Initially, NZX plans to launch a whole milk powder future that will enable dairy industry participants worldwide to hedge price risk in the whole milk powder market. Over time NZX anticipates that the types of Contracts tradeable on its derivatives market will expand.

NZX is seeking comment on the Rules and Procedures that will regulate the derivatives market it intends to operate. As a branding decision has yet to be made, the proposed derivatives market is referred to as the XXX Market in the Rules and Procedures, and Participants in that market are referred to as XXX Participants.

NZX is implementing a clearing and settlement system that aligns with international best practice, in order to promote confidence and participation in NZX's markets. The new clearing and settlement system must be operational for derivatives trading to commence, as the clearing and settlement system currently used for the cash markets (being the NZSX, NZDX and NZAX) cannot be used for clearing and settling derivatives. NZX's model comprises a clearing house (the clearing house operated by New Zealand Clearing Limited ("CHO")) and depository (the Depository operated by New Zealand Depository Limited ("CDO")). NZX's consultation on its proposed clearing and settlement system can be found on the NZX website at <http://www.nzx.com/market-supervision/rules-consultation/>. NZX invites submissions on those Rules as they relate to the clearing and settlement of derivatives as part of this consultation on the XXX Market Rules and Procedures.

The Rules have derived from the trading provisions of the NZX Participant Rules ("Participant Rules") (including the proposed updates to those Rules to reflect the changes necessary for the new clearing and settlement model) and the NZX Futures and Options Rules ("FOX Rules"). NZX engaged Clifford Chance LLP in London was engaged by NZX to review the Rules and Procedures prior to this release to ensure that they reflect international best practice.

Changes are also required to the NZ Disciplinary Markets Tribunal Rules so that XXX Participants in the XXX Market fall under the jurisdiction of the NZ Disciplinary Markets Tribunal.

III. Proposed new XXX Market Rules

This memorandum sets out a description of each section of the XXX Market Rules, the key provisions contained in each section and the policy reasons behind the key provisions.

1. Section 1 – Definitions and Interpretation

This section is a typical introductory section defining key terms used elsewhere in the Rules and containing standard amendment and interpretation provisions.

International participants should note that the Rules are governed by New Zealand law and require submission to the jurisdiction of the New Zealand courts.

2. Section 2 – Classes of XXX Participant

Section 2 sets out the types of XXX Participant that may participate in the XXX Market and describes what each XXX Participant is able to do in the XXX Market.

Section 2 includes a description of the XXX Technology Connecting Facility (“TCF”). The TCF is a new category of participant for NZX’s markets, that does not deal in the XXX Market but acts as a conduit to provide a connectivity solution for international clients that are subject to the oversight of an Alternative Regulator (or have the benefit of an appropriate exemption). This is a liquidity initiative designed to facilitate worldwide access for qualified persons to the XXX Market. The Rules that apply to XXX Trading Participants also apply to a TCF unless they are inappropriate. For example, as a TCF does not have Dealers the Rules relating to an XXX Trading Participant’s Dealers do not apply.

3. Section 3 – Application and Designation

This section specifies the requirements for becoming an XXX Market Participant and establishes specific criteria for various XXX Participant classes.

This section contains provisions giving NZX a wide discretion to approve or decline an application for XXX Participant status; provisions relating to the jurisdiction of NZX following a XXX Participant’s resignation and provisions regulating any change of Control of a Participant.

Section 3 also requires XXX Participants to disclose details of their ownership structure, to notify NZX of changes in senior management, to institute Compliance Managers and contains the requirements that apply to Overseas Applicants. This section also provides that no XXX Participant may transfer or assign its rights.

4. Section 4 – Business Conduct of XXX Participants

This section requires all XXX Participants to comply with the Rules, to notify NZX of key events, to provide NZX with information on request and contains other general business conduct requirements.

Note that section 4 also includes requirements as to employee trading and prescribed persons reflecting those provisions contained in section 9 of the FOX Rules.

5. Section 5 – Additional Requirements for TCFs

Section 5 establishes additional requirements for TCFs. Rule 5.1 requires the TCF to maintain a register of its DMA Authorised Persons and TCF Clients that records details of those persons, a copy of any written authorisation held by a DMA Authorised Person to act for a TCF Client and details of the security arrangements between the TCF and the DMA Authorised Person. Rule 5.2 clarifies that a TCF is required to enter into Client Agreements with its Clients, as are all XXX

Trading Participants under Rule 4.25. The intent of section 5 is to ensure appropriate regulation of XXX TCF Participants.

6. Section 6 – Business Conduct of XXX Advising Participants, XXX IBs and XXX Advisors

Section 6 contains certain specific requirements for XXX Advising Participants, XXX IB Participants and XXX Advisors, including know your client requirements. Note that pursuant to Rule 6.1.1, an XXX Trading Participant is regarded as an XXX Advising Participant if it otherwise meets the definition of an XXX Advising Participant.

NZX previously set prescribed forms of Client Agreements and Trading Agreements. NZX has moved away from prescribing a standard form Client Agreement and Trading Agreement in line with international best practice. Each XXX Participant that deals directly with clients must now have a signed Client Agreement with its client(s) that complies with the Rules in their entirety and contains the provisions specified in the Rules. The provisions specified in the Rules include an acknowledgement by the client that neither CHO nor CDO are liable to the Client except as such liability may arise under the C&S Rules or Depository Rules. NZX is empowered to waive the content requirements that apply to a Client Agreement, in its sole discretion. It is likely that XXX Participants' Client Agreements will need to be updated to reflect these requirements.

7. Section 7 – Clearing and Settlement

Section 7 stipulates that XXX Trading Participants must satisfy NZX that they have in place appropriate clearing and settlement arrangements.

Section 7 ensures that Clearing and Settlement occurs through the Clearing House, in accordance with the Clearing & Settlement Rules (“C&S Rules”) and reflects amendments proposed to the NZX Participant Rules. The C&S Rules and Depository Rules that govern the clearing and settlement system that will be used to clear derivatives can be found on the NZX website at <http://www.nzx.com/market-supervision/rules-consultation/>. NZX invites submissions on those Rules as they relate to the clearing and settlement of derivatives as part of this consultation on the XXX Market Rules and Procedures.

The new Rule 7.1 requires all XXX Trading Participants to have arrangements in place for the clearing and settlement of all Trades (including, if the XXX Trading Participant is not a Clearing Participant, third party clearing arrangements that comply with Section 7 and the C&S Rules).

Rule 7.2 establishes the basic requirements for third party clearing arrangements including an acknowledgement by a XXX Trading Participant that, under the C&S Rules, the clearing and settlement obligations relating to all Trades will be novated to the Relevant Clearing Participant who will clear and settle all Trades for that XXX Trading Participant.

Rule 7.3 establishes the content requirements for a C&S Agreement, including a requirement that each XXX Trading Participant is bound by each term that the C&S Rules require to be included in the C & S Agreement (whether or not they are included). The Rule also requires NZX approval for any amendments to a C&S Agreement.

Rule 7.5 provides for suspension of an XXX Trading Participant's ability to trade if CHO takes action against that XXX Trading Participant's Relevant Clearing Participant that prevents the clearance of the XXX Trading Participant's Trades.

Rule 7.6 details the process for the termination of a C&S Agreement (including prior notice requirements) and the effect of that termination.

8. Section 8 – XXX Trading Participant General Obligations

Section 8 places particular obligations on XXX Trading Participants including prohibitions on Unprofessional Conduct and Market Manipulation. Section 8 reflects the provisions of section 10 of the Participant Rules.

Rule 8.3 allows NZX to set Price Limits and Position Limits for the XXX Market. This practice will help NZX to ensure market integrity and reflects international best practice.

The requirement contained in the Participant Rules for XXX Trading Participants to maintain a DMA Authorised Person register has not been carried over into the Rules (other than in respect of TCFs as specified in Rule 5.1). As XXX Trading Participants retain their responsibility for Trades on the XXX Market this level of oversight is unnecessary.

The new Rule 8.10 provides for the cancellation of Trades and Cross Transactions where there has been an error, and differs from existing Participant Rule 10.17. The main difference between the existing Participant Rule 10.17 and the new Rule, is that the new Rule recognises that, with anonymous settlement of transactions, Participants will need NZX's intervention to cancel on-market Trades. NZX is proposing to make a similar amendment to the Participant Rules and has undertaken public consultation in that regard.

8. Section 9 – Trading with a Client

Section 9 reflects requirements contained in section 11 of the NZX Participant Rules concerning bringing orders to market, recording client instructions and reporting to clients.

Rule 9.6 requires XXX Trading Participants to enter into a Client Agreement with a client. As noted above in respect of Section 6, NZX has moved away from prescribing a set form of Client Agreement.

Rule 9.9 requires XXX Participants other than a TCF, to use voice recording to record client instructions. The existing Participant Rules do not require mandatory voice recording. However, given the nature of derivatives trading this is appropriate as an anti-market manipulation device and reflects international best practice.

10. Section 10 – Requirements for Trading on the XXX Market

Section 10 is a new section containing specific requirements for the new derivatives market. It allows NZX to specify session times, order types, common trade facilities and contract specifications by Procedure and regulates cross transactions.

The Procedures provide for Block Trades, Exchange for Physical, Exchange for Swaps and Cross Transactions to be entered into on the XXX Market. Contract Specifications will dictate whether a particular Contract may be traded by way of a Block Trade, Exchange for Physical, and/ or Exchange for Swap facility and, in respect of Cross Transactions, the minimum time period that is applicable.

The Procedures do not yet include detail of the trading times for the XXX Market. In addition NZX is finalising the Contract Specifications and the underlying Contract for the whole milk powder derivative. NZX has not yet resolved how Block Trades, Exchange for Physical and Exchange for Swap transactions are to be reported to the XXX Market. NZX welcomes submissions on these areas of the Procedures along with submissions regarding the calculation of the Daily Settlement Price described in section 2 of the Procedures.

11. Section 11 – Accepting and Holding Client Funds

Section 11 sets requirements for the acceptance and holding of Client Funds and reflects the provisions of section 8 of the FOX Rules. There are no material changes from the existing FOX Rules in this respect.

12. Section 12 – Capital Adequacy

Section 12 sets capital adequacy requirements for XXX Participants and reflects the changes NZX is proposing to the calculation of capital adequacy in the NZX Participant Rules, following NZX's consideration of international best practice in this regard.

The new provisions are consistent with the capital adequacy requirements for Clearing Participants under the Clearing and Settlement Rules, although the minimum amount of capital required is less.

Rule 12.1 generally requires an XXX Participant Requiring Capital to maintain its Net Tangible Assets at a level at, or greater than, its Prescribed Minimum Capital Adequacy (which is the higher of its Minimum NTA (which is an adjusted net tangible asset calculation) or its Total Risk Requirement). The current requirement in the Participant Rules and FOX Rules is for a prescribed level of liquid capital. The new requirement takes into account the change in location and profile of market risk as a result of the introduction of the central counterparty clearing house. The new Rule 12.1 also permits NZX to exempt an XXX Participant Requiring Capital from this requirement if NZX is satisfied that it is subject to, and complying with, an equivalent level of supervision by an Alternative Regulator (either in New Zealand or overseas).

Rule 12.2 provides for the reporting requirements relating to Capital Adequacy. The Rule provides for daily and monthly reporting, with more frequent reporting under certain circumstances as set out in Rule 12.2.

Rule 12.3 provides for the basis on which an XXX Participant Requiring Capital's NTA is calculated, generally by reference to NZ GAAP as modified by Procedure.

Rule 12.4 provides for the basis on which an XXX Participant Requiring Capital's Total Risk Requirement is calculated. This calculation is the aggregate of 7 individual requirements, calculated in the manner determined by Procedure.

Rule 12.5 specifies the circumstances in which Subordinated Debt can be excluded from an XXX Participant Requiring Capital's liabilities for the purposes of the Rules or Procedure.

Section 7 of the Procedures provides detail as to how the various calculations are made.

13. Section 13 – Facilitating Trades Off-Exchange

Section 13 regulates “over the counter” trading of contracts tradable on the XXX Market and reflects the appropriate provisions of section 9 of the existing FOX Rules.

14. Section 14 – Accounts, Audits and Inspections

Section 14 sets out the accounting record requirements for XXX Participants and empowers NZX to inspect XXX Participants. It replicates the requirements contained in section 11 of the FOX Rules.

15. Section 15 – NZX Powers

Section 15 provides NZX with broad powers to give effect to the Rules and loosely reflects requirements contained in Section 12 of the FOX Rules.

IV. Timetable

The table below sets out the anticipated timetable for this review of the XXX Market Rules.

Action	Date
Consultation Paper containing proposed changes and explanation of new XXX Market Rule Book released for public consultation	9 October 2009
NZX to receive and consider submissions made in response to individual Consultation Papers	30 October 2009