NZX
NEW ZEALAND'S EXCHANGE

NZX Participant Rule Consultation

10 April 2018

1. Introduction

As part of NZX's revised strategy, we are pursuing measures that support development of NZX's secondary market. A key aim is to promote increased liquidity in the secondary market and to support price transparency.

In December 2017, NZX communicated an intention to amend its current trade price structure to encourage greater liquidity and to align with global peers. Following further market engagement NZX has confirmed plans to introduce updated pricing later in 2018. The revised pricing structure replaces existing fixed cost fees related to transactions for trading and clearing with a value basis point charge, while the revised clearing structure will retain tiered cleared value charges to incentivise the amount of value cleared. Changes will see greater cost transparency and efficiency when executing NZX listed product.

To support these price changes NZX is consulting on potential rule amendments in relation to equities market trading to promote the long term development of NZX's markets i.e. these measures will not apply to the debt market or derivatives market.

Background

Although trading volumes on NZX have increased significantly in the past five years, market trading values are substantially lower when compared to other markets in the Asia Pacific region and those in the OECD that share similar market characteristics.

New Zealand institutional funds under management (FUM) has grown strongly. International investor participation in our market (particularly out of Australia) has provided valuable marginal liquidity. Despite these improvements in traditional indicators of liquidity, there appears to remain a degree of pressure on the trading environment. Retail participation has fallen, with the move to managed portfolios. Growing institutional participation means trading volumes are now made up of a smaller number of large parent orders. Per-trade execution values have also fallen as we observe a shift towards more electronic trade placement and management. The mix of these factors means the traditional methods of achieving order completion has arguably become more challenging for some participants. Some of the increase in volumes can also be linked to the increased participation of international passive or quantitative strategies (e.g. tracking the MSCI World index). This trading can be quite disruptive for the market and contributes to the slight disconnect between increasing volumes and the perceptions of some participants around decreasing market quality.

International investors have bought into New Zealand in recent years because of the search-for-yield, and it is important they continue to participate in the market if that investment story becomes less compelling. Many of these institutions want to transact in volume at what they can accept as a fair 'market' price (e.g. VWAP or mid-quotes). The same is increasingly true of New Zealand institutions given FUM growth through KiwiSaver and the need to transact for cash flow or liquidity reasons. That means the importance of a transparent price discovery process has increased, and will likely continue to heighten.

Over the past ten years the average value traded on market was 28% - in 2008, the average was 23%. Over the past five years the value traded on-market has improved to average 35% - in 2017, the average was 42% on-market. This improvement has continued this year, with average on-market value for year to date of 50.6% (i.e. until 31 March 2018). However, this still remains low by global standards. Local and global market stakeholders have offered consistent feedback on the perceived quality of the market as result of the lack of price transparency due to the number and overall value of trades performed off-market.

We understand that there are competing considerations when considering amendments to the current secondary market trading rules, but the price discovery process and the health of the market as a whole must be a priority. That means that at times NZX may introduce rules that serve to promote overall market health even when those rules may limit the ability of brokers to handle all orders in the ways that they traditionally have in some circumstances. The overall goal is to enhance the use of the market in relation to price discovery in order to improve it as a mechanism for achieving best execution in the longer term.

NZX is consulting on potential changes to the requirements in the Participant Rules for conducting crossings and for bringing orders to market. We are exploring options which can improve the levels of on-market activity to enhance the use of the central limit order book, also referred to as the lit-market, for price discovery. The aim is to improve the use of the lit market, over time to achieve best execution. NZX is not seeking to remove facilitation from the current market or to eliminate off-market activity but to make amendments which promote liquidity and price discovery. Facilitation is an important part of the New Zealand market and price risk as principal goes both ways. Successful facilitation provides institutional clients with certainty of execution that might not be possible on-market.

Process

11 May 2018	Feedback due on areas for review
June/July 2018	Rule approval process
Q3 2018	Introduce changes simultaneously with changes to trade pricing structure, subject to any necessary transition arrangements

2. Off-market crossings

A number of jurisdictions have minimum crossing thresholds. Under the Australian Market Integrity Rules implemented by ASIC, orders must generally be pre-trade transparent. This was introduced to harmonise minimum pre-trade transparency requirements across markets and to address ASIC's concerns about the growing use of dark pools of liquidity on the price formulation process on public markets in 2011.

In particular, for a trade in Australia to be conducted off-market it must either be:

(a) a block trade (similar to NZX's Crossings)

(b) a large portfolio trade (similar to NZX's Special Portfolio Crossing) or

(c) a crossing that results in a trade with meaningful price improvement.

The thresholds for block trades (i.e. category (a) above) in Australia are:

(i) $1m for Tier 1 Equity Market Products;

(ii) $500k for Tier 2 Equity Market Products; and

(iii) $200k or more for Tier 3 Equity Market Products.

NZX's current settings for Special Portfolio Crossings are $2.5m total consideration. The equivalent is AUD $5m in Australia. Separately, NZX also currently permits Special Crossings (i.e. a large crossing in a single stock) for amounts above $1m or 5% of the market capitalisation of the issuer.

There are comparable requirements in place in Canada under the Universal Market Integrity Rules, although the minimum thresholds are lower.

NZX understands its own market dynamics are different and that changes need to make sense for the local market. We are also conscious of the need to balance a desire to enhance on-market activity with ensuring that participants can adequately manage orders to achieve best execution for their clients. On this basis, we consider that if a minimum crossing threshold was to be introduced it could initially be set at a level which provides an incremental improvement in the levels of on-market activity and assists all participants in the market to utilise the lit-market for price discovery and to achieve best execution.

Based on our review of historical data, we estimate that around 5-7% of the value of off-market trades have been for amounts smaller than $50,000. We estimate that 9% of value in off-market trades has been in trades of less than $100,000. Introducing a minimum crossing threshold will result in a portion of these trades moving on-market. This will support the current positive trend in this area, particularly when coupled with the proposed trade pricing changes mentioned in the introduction above.

NZX would retain the ability within the rules to conduct Special Crossings and we seek feedback on whether to permit crossings below a minimum threshold size if it is a trade that results in meaningful price improvement.

We have suggested an initial minimum crossing threshold of $50,000 as a basis for seeking further feedback. This threshold is lower than for Tier 3 Equity Market Products in Australia.

This recognises the fact that the New Zealand market is less liquid than the ASX and more difficult to trade on screen. Even within the NZX50 there are some stocks that do not have significant institutional participation.

The NZX seeks feedback on whether this threshold is set at the right level, or whether any variations should be introduced based on liquidity or index inclusion. This includes whether a higher threshold could be justified for more liquid dual-listed stocks. However, we can also see the benefit of having a single threshold in terms of simplicity.

In order to ensure that all crossings are genuine, NZX also seeks feedback on a proposal to require that at least one side of a crossing relates to a single party i.e. you cannot bundle or accumulate both sides.

NZX is also considering whether additional measures are appropriate in relation to off-market crossings as principal with uninformed client orders i.e. execution-only orders from retail clients who do not get given, or granted access to, current market price information by the broker before placing their order. The concern is there is a potential risk for a mismatch of information between these parties in these situations, this risk requires active management.

Questions

1. Please provide feedback on the proposal to introduce a minimum crossing size.

    (a) Is $50,000 the right level if such an obligation was introduced? Should this be higher/lower? What would be the effect of a higher level, i.e. for example, $100,000?

    (b) Should NZX introduce minimum crossing tiers based on liquidity? If so, what should these tiers be? Is it necessary to align any such thresholds with ASIC/Australia in relation to dual listed securities?

    (c) What would be the operational impact (e.g. time or cost) of this change by participants?

    (d) Given our level of integration with Australia, would this change have an adverse impact on NZX-based trading activity in dual listed stocks?

2. Would you support the introduction of a mechanism to allow a trade to be carried out off-market below a minimum crossing threshold if it resulted in price improvement?

3. Do you agree that at least one side of a crossing should relate to a single party/client?

4. Should NZX introduce any additional measures in relation to off-market crossings as principal with uninformed client orders?

5. Do you have any other suggestions for improvements which could be made in relation to crossing rules – for example, the current Special Crossing and Special Portfolio Crossing thresholds?

3. Bringing orders to market

NZX is considering whether to make amendments to its requirements for bringing orders to market to reinforce the crossing measures noted above and considering the ability for orders to be delayed to accumulate or bundle orders in whole or in part to satisfy off-market crossings.

We understand it is important to balance the competing needs of improving price transparency for the market and participants meeting their fiduciary duties to clients.
Under the ASIC Rules a broker can delay bringing orders to market. In order to satisfy their broader fiduciary obligations to their clients, delays must be justified by either circumstances or client instructions. For small order sizes there is an expectation this should happen infrequently, given limited market impact. A broker must not attempt to limit their fiduciary obligations (for example allowing them to delay orders when not in the best interests of the client) through disclosure in the standard terms and conditions of a client agreement.

NZX has guidance in this area already but is seeking feedback on the current approach and whether it is operating effectively – see section 4.4 of NZX's guidance note on trading conduct available here.

Questions

6. Under what conditions is it acceptable for a broker to delay placement of an order to market?

7. Where an order has not been placed directly to the market should brokers be required to demonstrate how best execution has been achieved for client orders?

8. Where a client order has not been placed directly to market, and is subsequently crossed internally, should brokers be required to demonstrate the order lifecycle for both orders?

9. What rule amendments should NZX consider in this area? Should there be a different in treatment between retail and institutional orders?

4. International crossings and other

NZX recently made some amendments to its rules in relation to international crossings. We have received feedback to indicate we should re-consider these changes. Reporting of international crossings can provide a useful measure in relation to liquidity in NZX listed securities traded on overseas markets where that trading has been facilitated by an NZX participant (i.e. the broker has directly taken the order and arranged execution offshore with its local agent for execution). NZX seeks feedback on the recent changes and whether a reporting requirement should be reinstated to ensure that this trading is reported to NZX.

10. Should NZX reinstate a requirement for reporting of international crossings? If so, why and what should the criteria be?

11. Do you have any other suggestions on how NZX can increase the use of its markets for the purpose of price discovery, price transparency and achieve greater market integrity?