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NZFOE BULLETIN

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CHANGES TO RULES OF NZFOE AND SFE CLEARING TO DOUBLE THE SIZE OF NEW ZEALAND 90-DAY BANK BILL FUTURES & OPTIONS CONTRACTS

Introduction

During 2001, Trading Permit Holders and the New Zealand Financial Markets Association approached SFE regarding the size disparity between the New Zealand 90-Day Bank Bill Futures & Options Contracts ("BB contract") listed on NZFOE and similar contracts, including the Australian 90-Day Bank Bill Futures & Options contracts listed on SFE. SFE undertook to increase the contract size from NZ$500,000 to NZ$1,000,000 once OM SECUR had been implemented.

In February 2002, SFE presented Trading Permit Holders with two alternative mechanisms for increasing the size. The first was to double the size of the existing BB contract and halve open interest in the same manner as the Australian 90-Day Bank Bill contract was converted by SFE in 1995; and the second involved launching a new NZ$1,000,000 contract. Overall, whilst acknowledging the pressure that would be placed on back-office processes for a short period of time, the market showed a preference for doubling the size of the existing BB contract.

Rule Changes

To effect the change in contract size, it will be necessary to change NZFOE Rules. Proposed changes to the Rules, (which must be approved by the NZ Securities Commission) include:

i. Changes to the Contract Specifications to replace 'NZ$500,000' with 'NZ$1,000,000' in the definitions of 'Unit Size' and 'Underlying Security' and appropriate changes to the calculation of the contract value and option premium value; and

ii. Transitional provisions to provide for dealing with existing contracts including:

- for each pair of contracts held by a Clearing Participant in the same contract month and on the same side to be matched up (house account and client account to be kept separate); and,
- for odd lots which cannot be matched to be randomly selected for cash settlement or replacement with a NZ$1,000,000 contract (with appropriate adjustments in margins) to ensure the market remains in balance.

Testing & Implementation

SFE will be testing all internal systems and conversion processes prior to implementation. Test data will then be made available to assist Participants and Vendors in preparing their systems and operational processes for the conversion.

It is critical to the success of the conversion process that all parties are made aware of how open positions will be treated. In particular, **Dealers and Participants should familiarise themselves with the conversion process so as to understand the benefits of ensuring that they hold an even number of contracts at the close of trading on the conversion date**. Attached as Annexure A is a brief outline of the conversion process, including the proposed treatment of odd lots. Following the completion of testing, SFE will provide more detailed procedures to Dealers and Participants including a timetable for the conversion weekend.

Dealers and Clearing Participants are asked to provide all clients who have open positions in the BB contract with a copy of this document.

Fee Incentive Scheme

In the Fees and Charges Schedule for 2002 it stated that at the scheduled change to the BB contract a new fee structure would be announced to coincide with the launch date. The new fee structure, including a fee incentive scheme designed to incentivise large volume users, will be announced in a separate Bulletin nearer to the launch date.

Market Making

To underpin the development of the market following the doubling of the Bank Bill contract, SFE will implement a market-making scheme to improve liquidity on the spreads between the New Zealand and Australian 90-Day Bank Bill contracts. Further details will be forwarded to Trading Permit Holders when finalised.

Should you have any queries please contact Greg Boland, General Manager, NZFOE on +64 9 309 8308 or greg@nzfoe.co.nz in relation to this matter.

GREG BOLAND
GENERAL MANAGER **12 APRIL 2002**

ANNEXURE A

BB CONVERSION PROCESS

Approach

This conversion approach is based on changing the current contract size of the NZ Bank Bill futures and options contracts (BB) from NZ$500,000 to NZ$1,000,000. This conversion will take place on a Friday and will impact open positions as at the close of the day session on the Friday (date still to be determined).

Timings

Subject to testing, the conversion will take place after the June quarter-month expiry, minimising the number of open positions subject to conversion. Every effort will be made by SFE Clearing to ensure that Trading permit Holders and Clearing Participants trade out all odd lots prior to the conversion date.

Open Positions

Any holder of an open position in either the Bank Bill futures or options contracts at the close of day session trading on the Friday will be affected by the conversion to the new NZ$1,000,000 contract.

For those who hold an even number of open contracts, the conversion will simply result in their open positions being halved. For example, a client who holds 50 bought futures contracts open in the September 2002 contract, will simply have those positions halved to form 25 of the new NZ$1,000,000 contracts, there will be no change in overall market exposure.

Any account which has an odd number of either bought or sold positions in any futures contract month or option series (either puts or calls) at the close of Friday will need to be randomly selected to either have that odd contract settled or have it converted to a new NZ$1,000,000 position. These adjustments will be made in accordance with Exchange and SFE Clearing rules dealing with the conversion of this contract. The need for this treatment of odd lots is set out below, as are the mechanics of the conversion process and its impact on the overall market exposure of a futures contract.

Odd Lots

Unfortunately, it is not possible to simply halve the number of NZ$500,000 open positions held and close out any odd lots which are left over. To do so, would result in the market becoming out of balance. An example has been detailed below to demonstrate this.

Participant ABC holds the following positions in their client account on behalf of different customers.

Participant ABC: Client Account	
Bought	Sold
20 contract	6 contracts
	12 contracts
	1 contract
	1 contract
Total bought = 20 contracts	Total sold = 20 contracts

If in the above example, all positions were simply halved and odd contracts were settled, Participant ABC's Client Account would be brought out of balance (i.e. the Participant would hold 10 bought contracts (20/2) and 9 sold contracts (18/2=9) with the remaining two one lot positions being closed out. However, its position with the SFE Clearing would remain 10 bought and 10 sold.

Therefore in order to keep the market in balance, one of the accounts with a single contract will have to be selected to have that position settled and closed out at Friday's daily settlement price, whilst the other account with a single NZ$500,000 contract will be selected to have that contract converted to a NZ$1,000,000 contract. This process will ensure that ABC's position is converted to half the original number of contracts (10 bought, 10 sold) and the market remains balanced. However, this conversion process for odd lots will result in the market exposure of accounts holding uneven numbers of contracts being modified, either through the receipt of an additional contract or through the settling of a contract originally held (prior to conversion).

For example, a client who holds a Bank Bill spread position consisting of one bought position in the September 2002 contract and one sold position in the December 2002 contract, may through the conversion process, have one of the sides of the spread settled while having the other side of the spread doubled. As a consequence, this client may inherit an outright futures position which is twice the position originally held.

Holders of open positions will be strongly encouraged to trade out of odd lots prior to the close of trading on the Friday to avoid uncertainty and to minimise the administrative impact of the conversion process described in this paper.

Accounts Affected by the Conversion

As described above, **any futures accounts which have an odd number of either bought or sold positions will be affected by the conversion process.**

Any market participant who holds an omnibus account with its Clearer or Broker but has sub-accounts in its own accounting system will need to ensure that odd lots in those sub-accounts are either settled or doubled in such a way that results in an overall position balance between the total of those sub-accounts and the omnibus account. If the omnibus account itself contains odd lots, these will be either settled or converted to a NZ$1,000,000 contract and Brokers should advise their clients accordingly.

Random Allocation Process

SFE Clearing, through using a random allocation utility, will randomly allocate any odd lots remaining to a close out or to a new contract.

Example

The following example illustrates how the conversion process used by SFE Clearing will take effect. This example related to SFE Clearing and Clearing Participants. A similar process will need to be undertaken between Participants and Brokers and any clients with omnibus accounts.

Participant DDD – Client Account	Participant BBB – Client Account
Gross Long: 2 contracts	Gross Long: 4 Contracts
Gross Short: 3 contracts	Gross Short: 5 Contracts
Final Settlement Price = 93.50 (end of trading on Friday)	

Following the random allocation utility process, SFE Clearing will settle one of the short lots held by Participant DDD (bringing positions from three to two contracts) and will give one short lot at the final settlement price to Participant BBB, thereby changing their gross short position to 6 contracts.

Post-SFE Clearing's random-allocation process

Participant DDD – Client Account	Participant BBB – Client Account
Gross Long: 2 contracts	Gross Long: 4 Contracts
Gross Short: **2** contracts	Gross Short: **6** Contracts

Final Settlement Price = 93.50 (end of trading on Friday)

Participant DDD will need to delete one short contract at Friday's daily settlement price within the appropriate client account. As Participant DDD has clients who are each long one contract (i.e. the two bought contracts held are for different clients, Participant DDD will randomly select one of its clients to receive an additional contract and another to settle one contract. These will both be done at the final settlement price and hence there will be no settlement cash flows within SFE Clearing arising from this.

Participant DDD will proceed to settle two short contracts and two long contracts. As the contracts are recorded in the back office system and client accounting systems at traded prices, the profit/loss realised on settlement should be processed in the normal course.

Participant BBB will need to add one long contract to the appropriate client accounts and will then proceed to settle six short and four long contracts. As detailed above, as the contracts are recorded in the back office system at traded prices, the profit/loss realised on settlement should be processed as per normal.

Once this process is complete, SFE Clearing will then finalise the conversion by halving the open positions and changing the contract size from NZ$500,000 to NZ$1,000,000, resulting in the following final positions held by SFE Clearing post-conversion.

Post-conversion status

Participant DDD – Client Account	Participant BBB – Client Account
Gross Long: **1** contract	Gross Long: **2** Contracts
Gross Short: **1** contract	Gross Short: **3** Contracts
Final Settlement Price = 93.50 (end of trading on Friday)	