



JUNE 2014

NZX GENERAL OBLIGATIONS REVIEW

Financial Markets Authority

Website: www.fma.govt.nz

Auckland Office

Level 5, Ernst & Young Building
2 Takutai Square, Britomart
PO Box 106 672
AUCKLAND 1143

Wellington Office

Level 2
1 Grey Street
PO Box 1179
WELLINGTON 6140

June 2014

ISSN 2324-4003 (Print)
ISSN 2324-4011 (Online)

Contents

Context of this report	5
NZX's obligations	5
FMA's obligations	5
Approach and methodology	6
FMA's approach to regulation	6
FMA's approach to this review	6
Reporting format	7
References	7
Executive summary	9
NZX	11
NZX	11
NZX's Market Assessment Report	12
Actions from the 2012 Report	13
Review of compliance with the Statutory Obligations	15
Introduction	15
Arrangements for handling conflicts	16
Arrangements for monitoring conduct	25
Arrangements for enforcing compliance	29
Ensure there is a sufficiently independent adjudicative body	34
Have sufficient resources to operate the markets	36
Financial resources	36
Technological resources	37
Human resources	40
Fair, orderly and transparent markets	42
Conclusion	45
Appendices	47
Appendix 1: Statutory framework	47
Appendix 2: Market conditions	49
Appendix 3: Glossary	50



Context of this report

NZX's obligations

The Securities Markets Act 1988 (*the Act*) imposes the following obligations on a Registered Exchange in respect of the registered markets it operates (*the General Obligations*):

General obligations in respect of registered markets

A registered exchange must, –

- (a) to the extent that it is reasonably practicable, do all things necessary to ensure that each of its registered markets is a fair, orderly and transparent market; and
- (b) have adequate arrangements for operating its registered markets, including arrangements –
 - (i) for handling conflicts between the commercial interests of the registered exchange and the need for the registered exchange to ensure that the markets operate in the way referred to in paragraph (a); and
 - (ii) for monitoring the conduct of exchange participants on or in relation to the markets; and
 - (iii) for enforcing compliance with the relevant market rules; and
 - (iv) that ensure there is a sufficiently independent adjudicative body to adjudicate on contraventions of market rules that are referred to it; and
- (c) have sufficient resources (including financial, technological, and human resources) to operate its registered markets properly.

The General Obligations are designed to ensure that registered markets operate in a fair, orderly and transparent way.

NZX Limited (NZX) is currently New Zealand's only Registered Exchange. NZX operates the following registered markets (collectively referred to as the *Registered Markets* in this report):

- NZSX (Main Board)
- NZDX (Debt Market)
- NZAX (Alternative Market)
- FSM (Fonterra Shareholders' Market)

NZX is also authorised by the Authorised Futures Exchange (NZX Limited) Notice 2012 (*the Futures Exchange Notice*) to operate its futures market, the NZX Derivatives Market (*the Derivatives Market*). The Futures Exchange Notice places conditions on NZX in relation to market supervision of the Derivatives Market (*the Derivatives Market Conditions*), which mirror the General Obligations, and are designed to ensure that the Derivatives Market also operates in a fair, orderly and transparent way. The Derivatives Market Conditions are set out in Appendix 1.

The Act requires NZX to report to the Financial Markets Authority (FMA) annually on the extent to which it has complied with the General Obligations in the preceding financial year. The Futures Exchange Notice includes a similar requirement in relation to the Derivatives Market Conditions. The self-assessment provided by NZX to FMA is intended to meet NZX's reporting obligations under both the Act and the Futures Exchange Notice.

The General Obligations and the Derivatives Market Conditions are jointly referred to in this report as the *Statutory Obligations*.

FMA's obligations

The Act requires FMA to carry out a review, at least annually, of how well a Registered Exchange is meeting the General Obligations, and to publish a written report on that review (*the General Obligations Review*). The period under review for this report was 1 January 2013 to 31 December 2013 (*the Review Period*).

Although the Futures Exchange Notice does not expressly require FMA to report on NZX's compliance, NZX's operational systems and approach to dealing with compliance with the Derivatives Market Conditions are generally similar, and delivered by the same teams, as for the General Obligations. This report therefore also refers to NZX's compliance with the Derivatives Market Conditions during the Review Period.

In accordance with the Act, this assessment does not include the New Zealand Clearing and Depository Corporation Limited (NZCDC) Settlement System. This system and its operators are subject to the supervision of the Reserve Bank of New Zealand and FMA, as joint regulators of that system, pursuant to the Reserve Bank of New Zealand Act 1989.

This is FMA's third General Obligations Review of NZX.

NZX LIMITED (NZX) IS
CURRENTLY NEW ZEALAND'S
ONLY REGISTERED EXCHANGE



Approach and methodology

FMA's approach to regulation

FMA's principal objective is to promote and facilitate the development of fair, efficient and transparent financial markets. We have a mandate to strengthen the public's confidence in New Zealand's financial markets, promote innovation and grow New Zealand's capital base. Our approach is to work with financial market participants in an open and educative way, to achieve best standards of compliance. We seek to be clear about FMA's expectations, while providing market participants with scope to develop the way they meet these expectations.

FMA monitors market participants' compliance with the obligations imposed upon them. Our monitoring activities are designed to facilitate voluntary compliance by market participants, and are one of the ways through which we communicate our expectations and work to raise standards. Our expectations of regulated participants increase over time, as regulatory regimes are embedded.

FMA's approach to this review

NZX, as New Zealand's only Registered Exchange, is an essential part of New Zealand's financial markets. The General Obligations Review provides FMA with the opportunity to report on the adequacy of the arrangements NZX had in place to comply with its obligations during a particular review period, and to identify issues that, in FMA's view, would assist NZX to ensure its continued compliance. FMA is also mindful of the need to promote confidence in New Zealand's financial markets, and a significant component of this relates to the way in which NZX explains and publicly demonstrates the effectiveness of its regulatory functions and structure.

FMA's oversight is not confined to the General Obligations Review. Matters may also be identified by FMA during a review period that are relevant to NZX ensuring continuous compliance with its obligations. FMA and NZX therefore engaged in an ongoing dialogue throughout the Review Period, dealing with issues as they occurred. NZX also invited FMA to comment on a number of policies and other initiatives, such as guidance note updates and certain waiver decisions. FMA hopes that this engagement will develop further over time.

FMA'S PRINCIPAL OBJECTIVE IS
TO PROMOTE AND FACILITATE
THE DEVELOPMENT OF FAIR,
EFFICIENT AND TRANSPARENT
FINANCIAL MARKETS

Methodology

FMA’s oversight of NZX during the Review Period involved the following:

- discussions about specific matters arising, as required
- meetings as required
- ongoing review of continuous disclosure and the practices of Issuers
- providing feedback on referrals made to FMA by NZX under the Act
- onsite reviews of files and logs
- consultation on NZX policies and guidance notes, where appropriate

This work contributed to FMA’s assessment of whether NZX met its Statutory Obligations during the Review Period. In addition, FMA reviewed the following:

- NZX’s assessment of its compliance with the Statutory Obligations contained in the ‘NZX Limited: Market Assessment Report’ for the period 1 January to 31 December 2013 (*the Market Assessment Report*), along with supporting information
- information obtained from discussions with NZX management and members of the NZX Board (*the Board*), the NZ Markets Disciplinary Tribunal (*the Tribunal*) and the Special Division of the Tribunal (*Special Division*). A list of the people interviewed by FMA in relation to the review is set out in Table 1
- NZX Board papers and minutes relevant to the operation of the Registered Markets and the Derivatives Market
- relevant NZX procedures and policies

NZX and FMA met during the preparation of this report, to discuss FMA’s key findings and determine how they might be addressed. This led to the formulation of a number of Agreed Actions that NZX will take during the current review period, to strengthen its arrangements in relation to some of the Statutory Obligations. These are discussed in the relevant sections of the report.

Reporting format

In this report, FMA describes its review of and conclusion on how NZX complied with each of the Statutory Obligations during the Review Period.

For each obligation we provide a summary description of the areas or activities within NZX that contribute to the obligation; describe any relevant changes made by NZX during the Review Period; and identify actions that NZX has agreed to take to facilitate NZX’s ongoing compliance with the Statutory Obligations.

References

Full details of the statutory framework for this report are contained in Appendix 1.

Capitalised terms used in this report are defined in the glossary in Appendix 3.

Table 1: List of interviewees

NZX AREA	INTERVIEWEE ROLE DURING THE REVIEW PERIOD
NZX Board	Chair (also Chair of the Regulatory Governance Committee (RGC))
Tribunal	Chair
Special Division	Chair
Senior management	Chief Executive Officer (CEO) Head of Regulation Head of Technology Head of Operations



Executive summary

Conclusion

FMA has concluded that, during the Review Period, NZX was compliant with all of the Statutory Obligations.

Agreed Actions

During the end-of-year review process, FMA raised a number of matters where it considered NZX could make improvements to its existing arrangements. These related in particular to the obligations 'Arrangements for handling conflicts' and 'Arrangements for enforcing compliance'.

Conflict management

NZX spent considerable time on its conflict management arrangements during the Review Period and implemented a number of changes. FMA is satisfied that NZX's conflict management framework is adequate for the identification and management of any potential conflicts that exist between NZX's commercial interests and its role as frontline regulator, and we have seen no evidence to suggest that the framework is not working as intended.

However, FMA has seen evidence of a growing public perception that NZX's regulatory decision-making may be vulnerable to undue influence from conflicts of interest. A credible perception that NZX's regulatory decision-making could be influenced by NZX's commercial interests, or other affiliations of NZX, could undermine NZX's effectiveness as the market regulator and erode market confidence in the regulatory framework.

FMA and NZX have therefore considered a number of ways in which NZX's conflict management arrangements might be enhanced, in order to provide the market with greater assurance that NZX's conflict management arrangements are working as intended, and that NZX is carrying out its regulatory function in an impartial manner.

Whilst being confident as to the robustness of the existing framework, NZX has agreed to take a number of actions to strengthen the current arrangements and deepen confidence in the operation of its regulatory function. These Agreed Actions are summarised in Table 2 and full details are set out in the section 'Arrangements for handling conflicts'.

Enforcing compliance and monitoring conduct

Matters raised by FMA in relation to improving NZX's 'Arrangements for enforcing compliance' were focused on achieving greater efficiency in the Enforcement function, and giving the market more visibility of NZX's enforcement activities. This is to increase public confidence in NZX's willingness to take decisive action and enforce compliance with the Market Rules. NZX has agreed to take certain actions to address FMA's concerns.

NZX has also agreed to take one action in respect of its 'Arrangements for monitoring conduct'.

FMA will monitor progress towards the completion of the Agreed Actions, and will review the effectiveness of changes made as part of our oversight of NZX in the current review period.

**FMA HAS CONCLUDED THAT,
DURING THE REVIEW PERIOD,
NZX WAS COMPLIANT WITH ALL
OF THE STATUTORY OBLIGATIONS**

**Table 2: Summary of Agreed Actions**

OBLIGATION	SUMMARY OF AGREED ACTIONS
Arrangements for handling conflicts	<ul style="list-style-type: none"> NZX will revise the process for regulatory decision-making in circumstances where particular conflicts may arise, or there could be a significant market impact
	<ul style="list-style-type: none"> NZX will establish a Conflicts Committee of the Board to oversee NZX's arrangements for managing conflicts
	<ul style="list-style-type: none"> NZX will appoint independent members to the RGC
	<ul style="list-style-type: none"> NZX will expand the scope of the RGC to include reviewing regulatory policy changes
Arrangements for monitoring conduct	<ul style="list-style-type: none"> NZX will improve visibility of its conflict management arrangements
	<ul style="list-style-type: none"> NZX will revise its communications policy in relation to public comment, for greater transparency
Arrangements for enforcing compliance	<ul style="list-style-type: none"> NZX will amend the guidance note on amendments to NZX's rules
	<ul style="list-style-type: none"> NZX will enhance visibility of regulatory matters and enforcement activities
	<ul style="list-style-type: none"> NZX will amend internal service levels to reflect the nature and complexity of different investigations, and the variety of possible outcomes
	<ul style="list-style-type: none"> NZX will improve communication with complainants
	<ul style="list-style-type: none"> NZX will review the penalty structure for minor and unambiguous breaches of its rules

NZX IS AN INFORMATION,
MARKETS AND
INFRASTRUCTURE
COMPANY THAT OPERATES
SECURITIES, DERIVATIVES
AND WHOLESALE ENERGY
MARKETS IN NEW ZEALAND

NZX

NZX

NZX is an information, markets and infrastructure company that operates securities, derivatives and wholesale energy markets in New Zealand. NZX builds and maintains the infrastructure on which these markets operate, and produces a range of information and data products. Information provided by NZX about market conditions during the period is attached in Appendix 2.

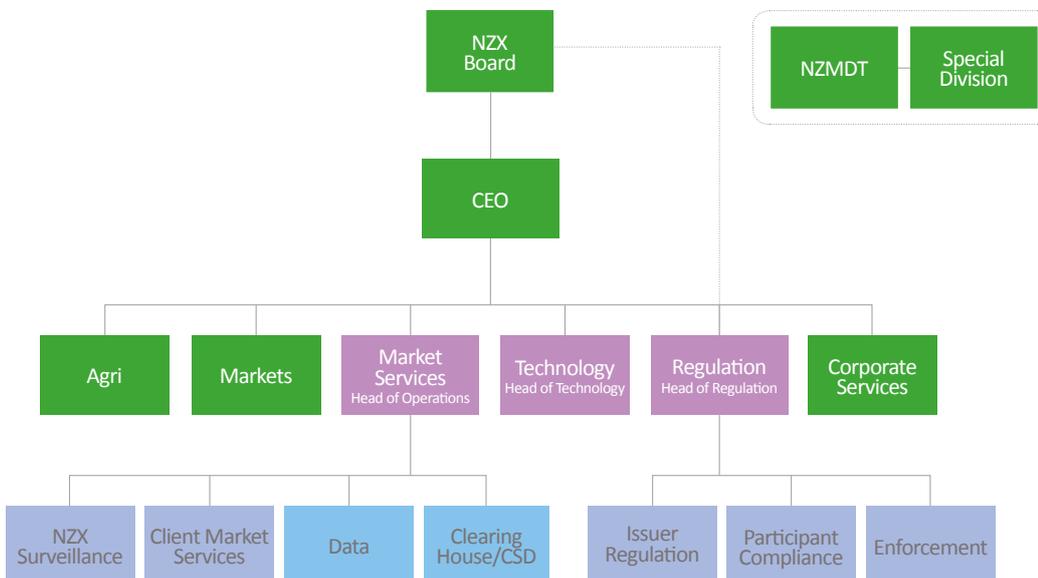
NZX is a Registered Exchange under the Act, and is also authorised to operate a futures market. As such, NZX acts as operator and regulator of the Registered Markets and the Derivatives Market. NZX's role includes:

- providing the technology systems and business processes required to operate its markets, and ensuring connectivity to, and the availability of, those systems
- supplying accurate and timely data feeds and other data products, to enable exchange participants to trade on an informed basis
- calculating and supplying index information
- setting rules for the markets
- governing the admission and market conduct of Market Participants and Issuers of equity and debt securities
- monitoring the market for transactions that potentially breach the Market Rules or legislation (for example, market manipulation and insider trading, which would breach the Act)
- investigating potential breaches of the Market Rules and taking appropriate enforcement action when breaches are determined

Within NZX's organisational structure, the functional areas of Regulation, Market Services and Technology contribute to the operation of the Registered Markets and the Derivatives Market. In addition, the Tribunal, an independent adjudicative body, acts alongside Regulation in the enforcement of compliance with the Market Rules. Special Division is an independent division of the Tribunal that acts as the regulator of NZX and Related Entities as Listed Issuers, in the same way that Regulation acts as the regulator of other Listed Issuers. These functions have been part of FMA's review and are highlighted in the organisation chart below.

The Board has ultimate responsibility for ensuring that NZX complies with the Statutory Obligations, and for discharging NZX's regulatory function. The Board delegates all decision-making responsibility for regulatory matters solely to the Head of Regulation, with authorisation to sub-delegate authorities to employees in the Regulation function. Whilst the Head of Regulation sits on NZX's executive team, the role reports directly to the Board in respect of the regulatory function. The CEO has delegation of approvals of new listings and certain products, but otherwise has no authority for regulatory decision-making.

NZX organisation chart





NZX's Market Assessment Report

The Act and the Futures Exchange Notice require NZX to produce a report for each financial year, assessing its own performance against the General Obligations and the Derivatives Market Conditions.

NZX provided FMA with the Market Assessment Report on 31 March 2014, in accordance with these requirements. The Market Assessment Report was produced to satisfy the requirements of both the Act and the Futures Exchange Notice.

NZX's assessment was that its activities during the Review Period had met the required standard for NZX to comply with the Statutory Obligations. NZX concluded that it had done all things necessary to ensure that the Registered Markets and the Derivatives Market were fair, orderly and transparent markets, to the extent that it was reasonably practicable for it to do so.

The Market Assessment Report noted actions taken by NZX during the Review Period to enhance its compliance with the Statutory Obligations, including:

- enhanced rigour in enforcement processes and increase in enforcement action
- increased resources in Regulation
- a review of NZX's conflict management arrangements and the creation of the RGC
- a review of Market Rules
- major process improvement embedded

The Market Assessment Report also noted a number of priorities for NZX for 2014. These included:

- continuing NZX's market quality project, focusing on algorithmic trading and off-market activity
- developing and implementing an organisation-wide business continuity plan (*BCP*)
- responding to domestic and international regulatory changes
- ongoing improvements to regulatory governance, organisation and process
- a comprehensive review of participant monitoring and enforcement
- launching a new market for smaller, high-growth companies

THE ACT AND THE FUTURES EXCHANGE NOTICE REQUIRE NZX TO PRODUCE A REPORT FOR EACH FINANCIAL YEAR, ASSESSING ITS OWN PERFORMANCE AGAINST THE GENERAL OBLIGATIONS AND THE DERIVATIVES MARKET CONDITIONS

Actions from the 2012 Report

The most recent General Obligations Review report prepared by FMA was published on 4 June 2013 and covered the period from 1 January to 31 December 2012 (*the 2012 Report*). FMA found that, by the end of that period, NZX was fully compliant with the Statutory Obligations. The 2012 Report is available on FMA's website, under 'Keep Updated/Reports and Papers'.

Following the previous review by FMA, as contained in the 2011 Report, FMA expected NZX to take certain actions in order to be fully compliant with the Statutory Obligations, and the 2012 Report assessed NZX's progress in addressing those Expected Actions. FMA found that elements of two of the Expected Actions remained outstanding at that time, being:

- conflict management:
 - » NZX had not carried out a review of compliance with its Conflict Management Policy (*Conflicts Policy*)
 - » NZX had not completed a review of the Conflicts Policy against international best practice
- enforcing compliance:
 - » NZX's Enforcement Procedures required further development

FMA expected NZX to complete the implementation of those actions and identified the following three key areas of focus for NZX for 2013:

- managing potential conflicts of interest
- enforcing compliance
- Board reporting and oversight

FMA also made a number of other observations and recommendations in the 2012 Report, which in FMA's view would help to ensure NZX's continued compliance with the Statutory Obligations.

NZX is not obligated to adopt or respond to specific recommendations from FMA. However, FMA notes that NZX has taken steps to address the majority of the recommendations from the 2012 Report. Progress towards addressing the Expected Actions and recommendations was the basis of a regular progress report by the Head of Regulation to the Board, ensuring that the Board was aware of, and could satisfy itself about, performance in relation to these matters.

Work undertaken by NZX towards the completion of the Expected Actions is discussed in the sections 'Arrangements for handling conflicts' and 'Arrangements for enforcing compliance'.



Review of compliance with the Statutory Obligations

Introduction

FMA's review of how well NZX complied with the Statutory Obligations during the Review Period is reported on as follows in this report:

Page 16: NZX must have adequate **arrangements for handling conflicts** between the commercial interests of NZX and the need for NZX to ensure that the markets operate in a fair, orderly and transparent way

Page 25: NZX must have adequate **arrangements for monitoring the conduct** of exchange participants on or in relation to the markets

Page 29: NZX must have adequate **arrangements for enforcing compliance** with the Market Rules

Page 34: NZX must have adequate arrangements that **ensure there is a sufficiently independent adjudicative body** to adjudicate on contraventions of the Market Rules that are referred to it

Page 36: NZX must have **sufficient resources** (including **financial, technological, and human** resources) to operate the Registered Markets and the Derivatives Market properly

Page 42: To the extent that it is reasonably practicable, NZX must do all things necessary to ensure that each of the Registered Markets and the Derivatives Market is a **fair, orderly and transparent** market

The legislation is set out in full in Appendix 1.

The obligation to ensure that the Registered Markets and the Derivatives Market are fair, orderly and transparent underlies all of the other obligations. A Registered Exchange that is not meeting one of its other obligations is also unlikely to be meeting this obligation. Many of NZX's activities and functions involved in operating its markets meet one of the other, more specific, obligations. Accordingly, FMA has chosen to review how NZX has met the requirement to do all things necessary to ensure that its markets are fair, orderly and transparent after assessing NZX's compliance with all of the other, more definitive obligations.

In reporting on compliance with each obligation, FMA has focused on those changes made by NZX during the Review Period that demonstrate an undertaking from NZX to seek continuous improvement and ensure ongoing compliance with the Statutory Obligations. We may not describe all activities carried out by NZX that are relevant to the obligations.



Arrangements for handling conflicts

A registered exchange must have adequate arrangements for handling conflicts between the commercial interests of the registered exchange and the need for the registered exchange to ensure that the markets operate in a fair, orderly and transparent way

Introduction – regulatory background

NZX is the frontline regulator of the Registered Markets and the Derivatives Market. It is also a demutualised exchange, with securities listed on the markets that it both operates and regulates. NZX is therefore a for-profit, self-regulatory organisation (SRO). Globally, the trend over the last decade has been away from for-profit exchanges being responsible for regulatory functions, and towards basing some or all regulatory functions in the relevant securities regulator.

Papers released in 2001 and 2006 by the International Organisation of Securities Commissions (IOSCO) outlined a number of regulatory issues, including conflict of interest issues, for demutualised exchanges with regulatory functions. In 2006 IOSCO highlighted 'risks to the maintenance of a proper balance between an exchange's public interest obligations and its commercial interests; the potential misuse of regulatory powers for commercial purposes; and conflicts of interest due to self-listing'¹. The business structures of most exchanges that are SROs (*Exchange SROs*) increase the potential conflicts, because regulation functions depend on funding from business operations.

Securities exchanges that responded to IOSCO's 2006 report generally took issue with the report's suggestion that a 'for-profit exchange may be tempted to lower standards to try to generate additional revenue'². The international trend has been for exchanges' regulatory responsibilities to be reduced, to manage such conflicts effectively and to address other issues, for example the introduction of alternative trading venues.

IOSCO has established standards that Exchange SROs should be required to meet, and maintain, as conditions of authorisation by the regulator³. Although not focused exclusively on conflict management by for-profit Exchange SROs, these standards are relevant to those organisations. Of particular significance to an Exchange SRO's conflict management are requirements that an SRO must:

- treat all members of the SRO and applicants for membership in a fair and consistent manner
- develop rules that are designed to set standards of behaviour for its members and to promote investor protection
- submit to the regulator its rules for review and/or approval and ensure that the rules of the SRO are consistent with the public policy directives established by the regulator
- co-operate with the regulator and other SROs to investigate and enforce applicable laws and regulations
- enforce its own rules and impose appropriate sanctions for non-compliance
- avoid rules that may create uncompetitive situations
- avoid using its regulatory role to allow any market participant unfairly to gain advantage in the market

Whilst the New Zealand legislative regime expressly permits the Exchange SRO model, the General Obligations have been introduced, and are designed on the basis that innate conflicts exist between the commercial and regulatory functions of Exchange SROs. Controls must therefore be put in place to manage those conflicts.

¹ 'Regulatory issues arising from exchange evolution – Final report', IOSCO, November 2006

² 'The Role of Stock Exchanges in Corporate Governance', Hans Christiansen and Alissa Koldertsova, OECD, 2008

³ 'Methodology for assessing implementation of the IOSCO Objectives and Principles of Securities Regulation', IOSCO, February 2008

A REPORT SPONSORED BY THE WORLD BANK⁴ SUMMARISED THE CONFLICTS OF INTEREST FACING DEMUTUALISED EXCHANGES WITH FRONTLINE REGULATION RESPONSIBILITIES

Types of conflict

A report sponsored by the World Bank⁴ summarised the conflicts of interest facing demutualised exchanges with frontline regulation responsibilities, including:

Conflicts between exchange's business and regulation mandates:

- an exchange's business interests and duty to its shareholders to maximise profits may conflict with its duties as a regulator
- directors face conflicts in reconciling their duties to shareholders with their public interest responsibilities in overseeing a regulator
- regulation of trading participants produces tensions between business interests and regulation responsibilities
- regulation of listed companies produces tensions between business interests and regulation responsibilities
- funding of regulation may suffer because of competition for resources between business and regulation needs and because efforts to reduce costs put pressure on non-revenue-producing areas like regulation

Conflicts in the integrity of self-regulation programs:

- high standards in rules may have a negative effect on attracting trading or listings business
- maintaining high standards of supervision may negatively affect business development and relationships with customers
- pressure from big customers could result in biased administration of rules
- customer pressures could compromise the independence of investigations and enforcement programs

FMA also notes that, when the board of an exchange has members who are also directors or executive management of regulated exchange participants, potential conflicts of interest exist for those individuals between their respective roles. These conflicts also need to be robustly managed, in particular if the board of the exchange is involved in regulatory oversight.

NZX's conflict management framework

NZX considers its commercial interests to be aligned with its regulatory interests, as the effective operation of its regulatory function contributes positively to its commercial reputation and brand. It believes that proper regulation of its markets engenders confidence, which increases participation in the markets.

NZX accepts that it is important to manage conflicts of interest that arise because NZX operates a self-regulating, demutualised exchange. Accordingly, NZX has a number of policies and procedures in place that are designed to satisfy the obligation imposed by the Act to have arrangements for handling conflicts and, in particular, to ensure the separation of its regulatory function from the rest of the business. These include:

- delegation of the regulatory function solely to the Head of Regulation
 - » the Head of Regulation reports directly to the Board in respect of the regulatory function, and is given time at each Board meeting to address the Board without the CEO being present
 - » the CEO has no delegation of the regulatory function, other than shared delegation with the Head of Regulation to approve new listings and certain products, and develop regulatory policy. Any disagreement is escalated to the Board
- Special Division
 - » ensures that the Market Rules are applied in respect of NZX as a Listed Issuer, or in respect of a Related Entity, in an impartial and independent manner

⁴'Self-Regulation in Securities Markets', John Carson, January 2011



- Conflicts Policy (available on NZX's website at <https://www.nzx.com/market-regulation>)
 - » the primary policy which sets out the responsibilities of NZX and its employees, including the CEO and the Board, in managing potential conflicts
 - » includes the Regulatory Charter of the NZX Board, Regulatory Code of Conduct, Personal Conflicts Policy, Associated Entity Protocol and Fonterra Co-operative Group Limited Protocol
 - » the 'NZ Markets Disciplinary Tribunal Conflicts Policy' applies to the Tribunal and Special Division
- Interests Register
 - » maintains a record of individual conflicts of directors, such as shareholdings and other directorships
- Securities Trading Policy (available on NZX's corporate website at www.nzxgroup.com/investor-centre/corporate-governance)
 - » requires that all NZX employees, officers and directors request and obtain approval before trading any securities traded on the Registered Markets or the Derivatives Market, or issued by NZX

In addition, we note that NZX is subject to the oversight of FMA. The annual General Obligations Review includes a review of NZX's conflict management practices, and FMA must approve any changes NZX proposes to make to the Market Rules or the Tribunal Rules.

Changes during the Review Period

Review of compliance with the Conflicts Policy

The Conflicts Policy states that the Head of Regulation will carry out an annual review of NZX's compliance with its conflict management procedures. However, by 2011, no such review had been undertaken since the Conflicts Policy had been put in place in 2008. One of the Expected Actions in the 2011 Report required NZX to carry out the review contemplated by the Conflicts Policy, as it was incumbent on NZX to be able to verify and demonstrate that its conflicts were appropriately managed. This part of the Expected Action was carried over from 2012 and completed during the Review Period.

The scope of the review was to evaluate NZX's compliance with, and the effectiveness of, the arrangements in place to manage potential conflicts for NZX. The objective was to ensure that sufficient arrangements and controls were in place to manage identified conflicts; staff and management were aware of their obligations; the arrangements and controls were being complied with; and a process was in place for identifying and managing new conflicts.

Although the Conflicts Policy stipulates that the Head of Regulation will carry out the review, the Head of Regulation is also obligated to comply with conflict procedures. The review was therefore carried out by a contractor in the Corporate Services area, with the scope agreed between the reviewer and the Chief Financial Officer, and the review process designed by the reviewer. The Audit and Risk Committee of the Board was briefed on the progress of the review and was presented with the findings.

FMA agrees that any audit of compliance with the Conflicts Policy should be carried out by a person who is independent of the regulatory function and not subject to the Conflicts Policy. NZX has agreed to formalise this approach by updating the Conflicts Policy.

A report on the results of the review identified some 'best practice' recommendations for relatively minor improvements. It also recommended that NZX schedule regular reviews of various elements of the conflict management framework, and include these reviews in the compliance calendar, to ensure they take place. The Audit and Risk Committee confirmed with the CEO that these recommendations would be implemented.

Update of Conflicts Policy

The Conflicts Policy sets out the responsibilities of NZX and its employees in managing potential conflicts. During the Review Period, NZX updated the Conflicts Policy to reflect the fact that work carried out by employees in the Market Services function is often regulatory in nature, in particular within the Client Market Services (CMS) and Surveillance teams. The updated Conflicts Policy requires employees in Market Services to comply with the Regulatory Code of Conduct and the Personal Conflicts Policy, similar to employees in the Regulation function. This followed changes made to NZX's organisational structure during 2012, which changed the reporting line for CMS and Surveillance from the Head of Regulation to the Head of Operations.

Updates were also made to the Conflicts Policy to reflect the creation of the RGC.

Review of Conflicts Policy against international best practice

Internationally, demutualised exchanges and their regulators have adopted different models for managing conflicts, whether actual or perceived, to assure the public that an exchange's regulatory role continues to serve its public interest objectives. Approaches to managing conflicts of interest between an Exchange SRO's regulatory role and commercial interests include:

- prescriptive corporate governance arrangements
- organisational separation of business and regulation
- committees with responsibility for the identification of conflicts and supervision of conflict management
- involvement of the government regulator in conflict management
- regulation responsibilities transferred to an independent SRO, or the government regulator

FMA acknowledges that there is no single, 'best', model for Exchange SROs, and that each exchange needs to reflect the circumstances of its particular market and the range of powers and functions assigned to it by the relevant legislative framework.

In the 2012 Report, FMA identified conflict management as a key focus area for NZX for the Review Period. This followed an Expected Action in the 2011 Report, requiring NZX to consider the adequacy of the Conflicts Policy against international best practice for the management of conflicts in demutualised exchanges, and to ensure that it could demonstrate that conflicts, or perceptions of conflict, were appropriately managed. The Expected Action was carried over and completed during the Review Period. A paper on the review of NZX's conflict management arrangements against other international exchanges was presented to the Board in July 2013.

In its review, NZX compared its conflict management practices with the practices of four international exchanges that have some frontline regulatory functions: Singapore Exchange (SGX), Bursa Malaysia, the Australian Securities Exchange Limited (ASX) and Hong Kong Exchanges and Clearing Limited (HKEx). FMA notes that these exchanges do not all have the same breadth of regulatory responsibility as NZX. For example, SGX's and HKEx's responsibility for supervising the market conduct of trading participants is more limited. ASX does not have a market surveillance mandate; this is carried out by the government market regulator, the Australian Securities and Investment Commission (ASIC).

NZX chose these exchanges for comparison as they, like NZX, follow the Exchange SRO model. NZX highlighted the following three areas where NZX's arrangements differed from those of the exchanges reviewed:

- board composition
- separation and supervision of the regulatory function
- committees

For example, regarding board composition, NZX identified that three of the exchanges are required to have a certain proportion of the board that is appointed by a government agency and/or that meets particular independence requirements. Regarding committees, NZX noted that, 'All of the exchanges surveyed, have one or more committees that supervise the in-house regulatory function. These committees are made up of persons that are independent of the exchange, and have a role to oversee the work of the regulatory function.'

Following the review, NZX decided to establish the RGC. The Terms of Reference for the RGC were approved and adopted by the Board in August 2013, and set out that the purpose of the RGC is to '...assist the Board in fulfilling its governance responsibilities relating to NZX's regulatory function for its registered markets, and any other matters referred to it by the Board'. The Terms of Reference for the RGC are available on NZX's corporate website at www.nzxgroup.com/investor-centre/corporate-governance.

FMA considers that the establishment of the RGC is relevant to FMA's recommendation in the 2012 Report, that the Board should seek to enhance its oversight of the quality of regulatory decision-making, and we view the RGC as a suitable mechanism for this oversight. NZX agrees that, whilst the RGC originated from NZX's review of its conflict management arrangements, the RGC's primary purpose is to provide the Board with greater assurance as to the quality of regulatory decision-making.



Regulatory tasks carried out in Market Services

In the 2012 Report, FMA expressed some concern about the positioning of CMS and Surveillance in the Market Services function. In the Surveillance team in particular, although an operational focus on improving processes and operational efficiency is important, in FMA's view the tasks are largely regulatory in nature and often require exercising considerable judgement when deciding whether or not a matter needs to be escalated.

CMS is a largely operational function that is process-driven. Whilst the proper performance of all of its tasks contributes to the satisfaction of the Statutory Obligations, in CMS the key task that involves an element of regulatory decision-making is identifying if a market announcement is price-sensitive.

FMA recommended the following:

- that the structure be kept under review
- that the processes for referral by CMS and Surveillance to Regulation be documented, including decision criteria
- that NZX ensure the Head of Regulation had appropriate oversight of the regulatory decisions being made in Market Services, to ensure potential breaches were being correctly identified and referred

NZX carried out a review of the structure and presented a paper to the Board in July 2013. The paper demonstrated real operational benefits resulting from structural changes, such as eliminating the duplication of certain processes, improved error identification and prevention, cross-training of staff to provide additional cover, and full documentation of CMS processes.

In this Board paper, NZX noted two key areas where the potential for conflicts between its commercial and regulatory interests could be reduced: demonstrating that all alerts⁵ are appropriately reviewed by Surveillance; and showing appropriate review of all cases, including those referred to Regulation and those closed without referral.

The tool currently used by Surveillance to log enquiries provides a record of each enquiry and a reason for the related decision, i.e. whether to close the enquiry, or refer the matter to Regulation or another party such as FMA. The Head of Regulation has access to this tool and can review decisions made by Surveillance. However, the system does not retain a record of any review, therefore NZX cannot demonstrate whether and how it is taking place. There is also minimal (if any) recording of matters reviewed by Surveillance where no enquiry or other action is taken.

During the Review Period, NZX began the process of identifying a system that could address outstanding concerns about record-keeping and information-sharing, and in March 2014, NZX announced that it had selected Wynyard Group Limited to supply NZX with investigative case management software. This new system will be used by Regulation and Market Services and NZX expects it to enable better workflow management, improved tracking and recording of activities in both areas, and information-sharing across the two functions. A number of employees from Regulation and Market Services have been involved in the scoping and design of the new system.

NZX intends that the software will be used to record all activities and interactions, including activities that may not currently be recorded, such as minor queries from Surveillance to Market Participants. Information will be accessible to NZX to carry out trend analysis on market activity. The system will provide the Head of Regulation with oversight of activities being carried out in CMS and Surveillance, and will record when reviews have been carried out. NZX hopes to have this software in place by mid-2014. FMA regards this as a noteworthy enhancement to NZX's monitoring and enforcement processes and capabilities.

⁵ NZX's principal market-monitoring system, SMARTS, produces alerts when market activity breaches parameters set in the system, such as percentage price or volume moves. Hundreds of alerts can be produced in one day. During the Review Period, the Surveillance team reviewed almost 16,000 SMARTS alerts

Public perception of conflicts

FMA considers that NZX's conflict management framework is adequate for the identification and management of any actual or potential conflicts that exist between NZX's commercial interests and its role as frontline regulator. Under NZX's policies, only staff within the Regulation function should be involved in making regulatory decisions; decisions should be made in line with documented policies and procedures; decisions should not be subject to any undue influence; no employee, manager or director with an identified conflict regarding a specific entity is allowed to be involved in any regulatory decision concerning that entity; and regulatory employees should be able to bring any attempt to influence decisions to the attention of management or the Board. FMA has seen no evidence to indicate that this framework is not working as intended.

Notwithstanding the framework that NZX has in place, FMA believes that there is a growing public perception that the Regulation function may not always be seen to be impartial when investigating complaints or potential breaches concerning entities that have a significant association with NZX outside the normal Issuer or Market Participant relationship. This view is based on a growing number of queries and complaints to FMA, as well as media commentary, about conflicts that may arise for NZX and how these are managed.

FMA emphasises that it has not, either in this review or otherwise, seen any instances of undue influence on NZX's regulatory decisions. Nonetheless, a credible perception that NZX's regulatory decision-making is open to influence could undermine NZX's effectiveness as the market regulator and erode market confidence in the regulatory framework. This confidence is critical to encouraging broader participation in New Zealand's capital markets.

It is understandable that the Board of NZX should comprise individuals from the business community, who have a range of backgrounds and expertise that is required to govern a listed company, as well as being relevant to overseeing the operation of a Registered Exchange. The size and nature of the New Zealand markets means that associations between members of the business community, and the entities that participate in the Registered Markets and the Derivatives Market, can be difficult to avoid. It is therefore imperative that NZX not only has in place a robust framework for the management of conflicts, but is able to demonstrate the effectiveness of those controls to the market.

FMA and NZX have discussed a number of measures that might further strengthen NZX's conflict management arrangements, in order to provide the market with greater assurance of their effectiveness. The measures considered included:

- involving the Tribunal in regulatory decision-making in prescribed circumstances
- creating an additional governance committee to consider conflict matters, which committee might include independent members
- appointing independent members to the RGC
- expanding the scope of the RGC to include policy review
- introducing independent reviews of compliance with the Conflicts Policy
- giving the market greater visibility of NZX's conflict management policies and procedures

As a result of this engagement, NZX and FMA have arrived at a number of Agreed Actions that NZX will take, in order to address FMA's residual concerns regarding this obligation.



Agreed Actions

Revise the process for regulatory decision-making in prescribed circumstances

Central to the discussions between FMA and NZX was the need to address the perception that NZX's regulatory decision-making could be inappropriately influenced, when the decision involves persons or entities with whom NZX, or the Board, have relationships. FMA and NZX agreed that introducing access to a further level of independence in NZX's decision-making in these circumstances would be beneficial.

NZX has **agreed** to amend regulatory policy, to require that the Head of Regulation will consult with the Chair of the Tribunal (or an appointed delegate) prior to granting rulings and waivers and making enforcement decisions which, in the Head of Regulation's view, could have a significant market impact, or which concern an Issuer or Market Participant that presents a specific conflict for NZX.

FMA notes that NZX already has in place the following arrangements to ensure that conflicts of interest do not influence regulatory decision-making:

- neither the Board nor the RGC is involved in regulatory decision-making. The RGC reviews a selection of regulatory decisions after their completion, to assess the quality of the decisions and their appropriateness to the particular circumstances, as well as adherence to NZX's processes and policies. The RGC cannot reverse or alter any decision
- Special Division acts as the regulator of NZX and Related Entities as Listed Issuers. Going forward, a new Conflicts Committee will consult with Special Division in identifying Related Entities

Establish a Conflicts Committee of the Board

NZX has **agreed** to establish a Conflicts Committee of the Board, to satisfy the Board that any perceived or actual conflicts between NZX's commercial interests and regulatory responsibilities are addressed.

The Conflicts Committee will comprise members of NZX's Board and independent persons from outside the Board who are appropriately skilled and qualified.

The Terms of Reference for the Conflicts Committee will be reviewed by FMA prior to being settled and will include the following:

- assessing the adequacy of NZX's arrangements for managing potential and actual conflicts between its commercial and regulatory interests
- carrying out regular review of the adequacy of the plans, budget and resources of NZX Group in relation to its regulatory function
- approving changes to the Conflicts Policy, or NZX's other conflict management policies and procedures, prior to submission to the Board
- identifying Related Entities, in consultation with Special Division
- overseeing the annual review of NZX's compliance with the Conflicts Policy, which might be carried out by a party independent of NZX, reporting to the Conflicts Committee

The review of compliance with the Conflicts Policy carried out during the Review Period tested the existence of controls for managing conflicts, but did not explicitly test whether those controls had operated as designed when Regulation dealt with matters concerning identified conflicts for NZX. NZX has also **agreed** that the scope of this annual review will be expanded to include this testing.

Appoint independent members to the RGC

The RGC is currently composed solely of members of the Board. NZX has **agreed** to appoint new members to the RGC who are independent of NZX and the Board. Members with relevant skills and expertise in capital markets will be selected. The presence of independent members is intended to introduce a greater level of independence and transparency to reviews of regulatory decisions. This change will be reflected in amendments to the Terms of Reference for the RGC.

NZX has also **agreed** to consider whether it would be appropriate to appoint an independent member to act as Chair of the RGC, and will report to FMA on the outcome of that consideration.

Members of the RGC are subject to the Conflicts Policy and NZX's Regulatory Code of Conduct in their reviews of decisions, and members must excuse themselves from reviews or discussions concerning any matter in respect of which they have a personal interest or other potential conflict. This requirement is contained in the Terms of Reference.

One current member of the RGC has a relationship with a Market Participant. NZX does not provide that member with information on regulatory decisions concerning any Market Participant, and the member is excluded from all RGC discussions relating to Market Participants. FMA regards this practice as apt, given the small number of Market Participants, but the requirements of the Conflicts Policy are not broad enough to imply this rule.

NZX has **agreed** to amend the Terms of Reference for the RGC to be explicit on this requirement for matters concerning Market Participants.

Expand the scope of the RGC

NZX has an important role in helping to grow and develop New Zealand's capital markets. NZX must entice companies to list on NZX's markets, and encourage new investment in existing Issuers, to give New Zealand companies access to growth capital. NZX is also expanding its suite of markets, to offer investment opportunities in companies at different stages of development and growth, and its range of products, for example offering equity derivatives.

As the regulator of the Registered Markets, one of NZX's primary roles is to protect investors, which in turn helps to increase investor confidence in the securities markets and encourage further investment.

Regulatory policy plays a key part in achieving each of these goals. Market rules must achieve a balance between being rigorous enough to provide adequate investor protection, but not so restrictive that companies are discouraged from raising money in the capital markets by the burden of compliance.

NZX has **agreed** to amend the Terms of Reference for the RGC, to include a requirement for the RGC to review changes to NZX's regulatory policy prior to changes being submitted to the Board for approval. This review is aimed at ensuring that regulatory policy balances the competing commercial and regulatory interests of NZX, and in particular that NZX's policy settings appropriately consider the interests of investors. The paper presented to the RGC and the Board should be required to include discussion on how the interests of investors are addressed in the proposal. Any concerns of the RGC that are not addressed by changes to the policy under consideration will be referred to the Board.

Improve visibility of NZX's conflict management policies and procedures

FMA considers that greater visibility of how NZX manages potential conflicts between its regulatory responsibilities and commercial interests would help to increase market confidence in NZX's regulatory function.

NZX's conflict management framework incorporates a number of policies, of which some are available on either one or other of NZX's websites: www.nzx.com, the markets website, and www.nzxgroup.com, the corporate website. However, they exist on different pages of the sites and it is not always obvious where to find the information.

NZX has **agreed** to implement improved communication in respect of its conflict management policies and procedures, to better inform the public on how NZX manages conflicts between its regulatory responsibilities and commercial interests. This Agreed Action is already underway.



Revise communications policy

FMA receives queries, and requests to carry out investigations, from investors and commentators who see what they perceive as unexplained movements in the trading volumes or prices of particular securities. We also receive queries about trading prior to material announcements – it is not uncommon for the market to speculate whether insiders have been trading when an announcement leads to a material change in the price of a security, and when there appears to have been a change in normal trading patterns ahead of the announcement. This type of trading is also frequently the subject of media comment, which can draw conclusions without access to all available and relevant facts.

NZX carries out the frontline role of market surveillance, identifying and investigating anomalous market behaviour, and NZX has systems and processes in place to carry out that role. NZX routinely examines trading prior to announcements that have resulted in material price or volume changes, as well as investigating alerts generated by the SMARTS surveillance tool when trading patterns change. NZX refers matters to FMA when there is evidence to suggest that insider trading or market manipulation may have occurred. When asked about anomalous trading, either by individuals or the media, NZX's policy has always been to not comment on any specific company or investigation, at least partially to avoid unfair prejudice to the relevant company or its share price.

However, in a situation where changes in trading have been noticed and there is public speculation as to the reasons, FMA considers that it would reassure the market if NZX were to confirm whether the trading is being, or has been, investigated. If NZX has determined that the trading does not require investigation, it would benefit the market to understand the reasons for that determination, as this type of query is frequently made with only some of the relevant information available to the broader market. For example, a research report may create increased trading in a security, but the entire market may not be aware of the existence of that report.

NZX has already taken steps to change its approach to responding to enquiries about trading, in an effort to be more transparent and to give the market more information about NZX's activities in this area. FMA acknowledges and encourages this change. Although the question is not necessarily one of conflict in these

cases, we consider that an absence of information and understanding about NZX's identification of, and response to, potential market misconduct can be detrimental to investor confidence. There is a danger that the market and the public may view a lack of comment as a lack of action on NZX's part. We have found NZX to be prompt and proactive in reviewing unusual trading activity, but have seen instances where the market perception is different.

NZX has **agreed** to change its existing 'no comment' policy, to provide the public with more detailed information when it is in the public interest to do so, or if it is already public knowledge that NZX is considering an issue.

We also note the Agreed Action in relation to the visibility of enforcement activities, in the section 'Arrangements for enforcing compliance'.

Conclusion

FMA is satisfied that, during the Review Period, NZX had adequate arrangements for handling conflicts between the commercial interests of NZX and the need for NZX to ensure that the markets operate in a fair, orderly and transparent way. During the Review Period, NZX undertook activities to update its policies and procedures, and to verify compliance with them. FMA saw no evidence to suggest that NZX's conflict management arrangements are not operating as intended.

FMA concludes that NZX was compliant with this obligation during the Review Period.

The effective management of NZX's conflicts is essential to market confidence in NZX as a regulator. It is clear to FMA that the Board and management take these issues seriously and have devoted significant time to them. Nonetheless, given the importance of this particular obligation to market confidence, and FMA's views of the market perception concerning NZX's existing arrangements, FMA considers that further improvements could be made to NZX's conflict management arrangements.

NZX has agreed that enhancements can be made, and has committed to taking certain Agreed Actions, in order to help strengthen confidence that NZX is carrying out its regulatory function in an impartial manner, and provide assurance that its conflict management arrangements are working as intended.

FMA CONCLUDES THAT NZX WAS COMPLIANT WITH THIS OBLIGATION DURING THE REVIEW PERIOD

Arrangements for monitoring conduct

A registered exchange must have adequate arrangements for monitoring the conduct of exchange participants on or in relation to the markets

Introduction

This obligation requires NZX to have systems, processes and people in place to monitor the conduct of exchange participants, including Issuers, Market Participants and investors. NZX must ensure that participants meet the conventions and standards of behaviour that are expected on a Registered Exchange, including operating within the bounds of legislation and the Market Rules. NZX must ensure that those rules remain appropriate and relevant and are kept up to date with, for example, a changing market environment or changes to legislation.

NZX has a number of rule sets, to govern different types of exchange participants (Issuers, trading and advising participants, derivatives participants, clearing participants) and NZX's different markets. NZX also has a number of business processes and system-driven rules, relating to access to, and the use of, its trading system by Market Participants and their clients.

The conduct of NZX exchange participants is monitored by Regulation, Surveillance and CMS. NZX's Technology function also plays a role in ensuring the appropriate use of NZX's technological systems.

NZX functions relevant to the obligation

Regulation monitors the conduct of exchange participants through many of its business-as-usual (BAU) activities. Issuer Regulation is primarily responsible for monitoring and promoting the compliance of Issuers with the Listing Rules. BAU activities include reviewing offer documents and new listing applications; considering waivers and rulings; approving notices of meeting; monitoring Issuers' compliance with continuous disclosure requirements; and considering applications for trading halts.

The Participant Compliance team is responsible for supervising Market Participants for compliance with the Participant Rules and Derivatives Market Rules. BAU activities include considering applications for accreditation, waivers and rulings; monitoring client funds and capital adequacy reporting; and onsite and desk-based inspections. Certain regulatory oversight services for NZCDC are also performed by Participant Compliance.

Surveillance's BAU activities are focused almost entirely on monitoring conduct. Surveillance has the role of monitoring trading activity on the Registered Markets and the Derivatives Market for potential breaches of the Market Rules, or secondary markets

legislation such as insider trading and market manipulation. The team therefore monitors the activities of Market Participants, Issuers and anyone placing orders in the Registered Markets through Market Participants. Where potential misconduct is identified, a referral is made to Regulation or another relevant party such as FMA.

CMS monitors market announcements from Issuers, submitted through the Market Announcements Platform (MAP), and reviews annual reports for compliance with the Listing Rules. Matters are referred to Regulation when any potential breaches are identified. CMS and Regulation maintain an 'Issuer Risk List' to identify Issuers with a history of non-compliance. CMS regularly contacts Issuers to assist with compliance, for example to remind them when their financial reporting is due.

NZX has information technology (IT) security and access procedures that ensure only appropriately authorised users can access NZX's technological systems. The Technology function's monitoring systems enable NZX to detect any attempts at unauthorised access.

Special Division is an independent division of the Tribunal, established under the Tribunal Rules. Special Division has the same powers and functions as NZX Regulation under the Market Rules, in respect of NZX as a Listed Issuer and Related Entities. The objective of Special Division is to foster market confidence that the Market Rules are applied to NZX and Related Entities in an impartial and independent manner. NZX's Related Entities are currently the five funds managed by Smartshares Limited.

The Market Services and Regulation teams follow documented policies and procedures for completing tasks and recording information. NZX uses information obtained through its monitoring activities for trend analysis, to assist in identifying when action may need to be taken, such as market guidance, issuer education, rule changes, or changes to its monitoring activities.

Historically, Regulation has had responsibility for developing regulatory policy and amending the Market Rules. During the Review Period a new Policy team was created. This is described below under 'Increased resources for policy development'.



Changes during the Review Period

Increased resources for policy development

In the recent past, NZX has tended to review and amend the Market Rules and associated guidance notes when prompted by an external event. For example, some recent rule changes have been necessary to align rules with changes in financial legislation.

During the Review Period the Board expressed a desire for NZX to be more proactive in the area of policy and rule reviews, but identified that the resourcing within Regulation was not sufficient to encompass this work. As a result, a Policy team was created within the Regulation function. Some internal staff movements occurred, and overall resources were increased to staff the Policy team and fill vacancies created from internal movements.

Rules amendments

NZX amended four rule sets during the Review Period:

- Tribunal Rules: minor administrative changes were made. Amendments were approved by FMA in April 2013
- FSM Rules: amendments were made to introduce the Diversity Rule, to align the FSM Rules with the Listing Rules. Amendments were approved by FMA in June 2013
- Listing Rules: a number of amendments were made, on which consultation had begun in March 2012 and was continued in May 2013. Amendments were approved by FMA in October 2013
- Participant Rules: amendments were made to take into account financial legislation that came into force in 2011. Amendments were approved by FMA in November 2013

NZX has begun a review of the corporate governance provisions of the Listing Rules, and during the Review Period set up a working group, including external interested parties, to look at what changes may be desirable.

NZX also began a review of certain guidance notes during the Review Period: continuous disclosure, trading halts and market manipulation. NZX consulted FMA on the first two of these and we welcomed the opportunity to comment. When reviewing the continuous disclosure guidance note, NZX took into account recently updated guidance from ASX and consulted dual-listed issuers. FMA looks forward to NZX's wider market consultation on these guidance note reviews.

The amendments to the Listing Rules and the Participant Rules took some time to complete and FMA commented on this in the 2012 Report. The review of the guidance notes has also been underway for some time. Accordingly, we are pleased to see an increased focus by NZX on this area and more resources applied to policy and rules development.

Process changes

During the Review Period, NZX sought to embed process improvements made in 2012 and improve on these further where possible. Files reviewed by FMA for the Review Period demonstrated that Regulation is using templates and checklists to record decisions and how those decisions are reached, for example when assessing waiver applications and carrying out investigations into potential breaches. These process changes are resulting in more complete and accurate recording of information, and consistency of decision-making across the Regulation team. Robust analysis and managerial review were also evident.

FMA notes that we saw some instances on waiver files where NZX had taken information provided by Issuers at face value, but where FMA thought further questions could have been asked of Issuers' motivations or need for the waiver, and to ensure that appropriate investor protection was present. The Listing Rules are intended to afford protection to investors in listed entities. Accordingly, alternative investor protection arrangements, or the consequences for investors, need to be considered by NZX when granting a waiver.

NZX began trend analysis of regulatory information during 2012 and developed its approach further during the Review Period. Changes included involving wider Market Services and Regulation teams in trend identification; including analysis of information held by Market Services; and developing reports of trends identified and NZX's responses to them. In its reporting on the analysis, NZX determined actions to address emerging trends, where necessary. FMA encourages NZX to continue developing the use of analysis of information gathered through its regulatory activities to identify trends, to help inform its monitoring and enforcement activities, as well as policy and rules development.

FMA was informed that there was a focus during the Review Period on carefully documenting processes for all tasks carried out in CMS, and ensuring they were written in a way that did not assume prior knowledge. These processes are available to all staff in a centralised 'wiki'.

NZX sought to increase collaboration between Regulation and Market Services. Monitoring activities in the CMS team support Issuer Regulation, and during the Review Period a revised method for reviewing Issuers' annual reports was introduced by CMS with the help of Regulation. A centralised register of non-compliant reports, which Regulation can access, is maintained by CMS. Surveillance adjusted the content and format of the weekly update between Market Services and Regulation, to broaden the interest in and increase the relevance of the update.

NZX also increased liaison with FMA with regard to the identification and investigation of potential market misconduct. NZX's Surveillance team carries out the frontline role of monitoring market trading activity, while the legislation prohibiting market misconduct is enforced by FMA. When possible insider trading or market manipulation is detected, Surveillance carries out an initial investigation, and makes a formal referral to FMA if there is evidence that market misconduct may have occurred.

During the Review Period members of staff from NZX and FMA met a number of times, to discuss general approaches to these enquiries, and to jointly examine information relating to specific matters. Communication between Surveillance and FMA both before and following formal referrals has increased, and NZX frequently assists in gathering information required for FMA's enquiries and investigations. FMA has welcomed this increased collaboration, which has resulted in greater efficiency in dealing with these matters.

Price-sensitivity training

When a market announcement is deemed price-sensitive, it is denoted with a 'P' symbol on the NZX website and an administrative trading halt is placed for 10-15 minutes, in order to allow the market to absorb the information and ensure that an orderly market is maintained.

During the Review Period, price-sensitivity training sessions were held for the CMS team. Market Services also began a 'Monthly Announcement Review'. The team reviews announcements from a specified period that have had material impacts on the market, and check if price-sensitive flags were correctly applied to all of those announcements when released. The team also reviews announcements where price-sensitive flags were applied, but the market did not react as expected. The reasons for decisions about price-sensitivity are discussed and indicators of price-sensitivity are recorded. These initiatives should increase knowledge of price-sensitive indicators and accuracy in identifying price-sensitive announcements. CMS also consults Regulation if there is uncertainty about the price-sensitivity of an announcement.

Issuers currently have the option of marking announcements as price-sensitive when submitting them to MAP. However, Issuers do not always make use of this function and, when it is used, NZX verifies the designation before releasing the announcement.

FMA considers that Issuers are best placed to understand the price impacts of their own market announcements, and NZX should consider ways in which to encourage Issuers to indicate the potential price impact of their announcements when submitting them to MAP.

Changes in Participant Compliance

In the 2012 Report, FMA commented on the need for NZX to review how the risk profiles of Market Participants are arrived at, and how they are used to guide NZX's onsite inspection programme. NZX had made some changes during 2012 and expressed an intention to continue reviewing and enhancing procedures during 2013. FMA also expressed concern about the level of resourcing within Participant Compliance, and recommended that NZX consider dedicating a resource to carry out project-based work in this area.

FMA reviewed NZX files from the onsite inspection programme and saw an obvious change from early 2013 to the end of the Review Period. Participant Compliance amended the method for assessing a Market Participant's risk profile, incorporating significantly more data and drawing on historical compliance information held by NZX. Quantitative analysis must be overarched by qualitative assessment, and this was evidenced by reports from pre-assessment meetings involving the Head of Regulation, the Participant Compliance team leader, the Head of Operations representing the Clearing House, and members of the inspection team, who are drawn from each of those areas as well as Surveillance. Comprehensive discussions were held, from which notes were recorded on file, and particular focus areas were identified for individual inspections. The resulting inspections were more targeted.

As noted previously, the review of the Participant Rules was completed during the Review Period. In December 2013 a contractor was employed to progress 'a number of important projects'⁶ in Participant Compliance. These included continuing work on further amendments to the Participant Rules relating to direct market access and client custody services, and updating the guidance note on market manipulation. NZX is also continuing the development of risk profiling and risk-based monitoring of Market Participants. The Market Assessment Report noted, 'The increase in trading volumes and values ... and the planned introduction of equity derivatives make a comprehensive review of participant monitoring and enforcement timely.'

The Participant Compliance team leader resigned at the end of the Review Period and the contractor was appointed permanently to that role during the first half of 2014. FMA encourages NZX to maintain momentum on these projects and recruit further in this area as necessary.

⁶From the Market Assessment Report



Advances in trading types

NZX has been undertaking a market quality project, focused in particular on off-market trading and algorithmic-like trading. The project has found that, given the size and structure of the New Zealand market, an increase of smaller, automated trades would improve liquidity in the market. NZX identified an increase of approximately 10% in algorithmic trading during the Review Period.

The level of algorithmic trading as a percentage of all trading is still low in New Zealand relative to other countries. Nonetheless it is important to ensure that monitoring and surveillance activities adapt to the changing environment. The Market Assessment Report stated, 'During 2013, NZX scoped and began work on reviewing algorithmic trading practices and whether any amendments are required to the Participant Rules in order to ensure that algorithmic trading activity is appropriately regulated. This work will be continued into 2014.' FMA supports this focus.

NZX launched equity derivatives on the Derivatives Market in June 2014. The Market Services team prepared for the launch by sharing knowledge from the derivatives sales team with the Surveillance team, building understanding of derivatives products. A member of staff trained in dairy derivatives spent some time in the Surveillance team. The Head of Operations also visited the Surveillance function of ASIC, and ASIC offered to send a representative to speak to NZX staff once the equity derivatives were launched.

In its review of Market Participant monitoring and enforcement procedures, FMA encourages the Participant Compliance team to consider changes needed in order to supervise these new products.

Agreed Actions

Amend the guidance note on rule amendments

In the 2012 Report, FMA recommended that NZX update the guidance note on the process for amending NZX Conduct Rules. The current guidance note states that NZX will consult on rule changes each year. This practice is not followed and FMA regards it as a poor example to the market that NZX does not comply with its own guidance.

With the new Policy team in place, NZX is now better resourced to carry out regular rule reviews. NZX has **agreed** to review this guidance note, to reflect NZX's planned timetable for the revision of the Listing Rules and the Participant Rules.

A number of NZX's other guidance notes have been in existence for several years. The Market Assessment Report noted an intention for NZX to update the guidance notes on reverse and backdoor listings and share purchase plans during 2014. We encourage NZX to determine whether other guidance notes also need updating.

Conclusion

FMA is satisfied that, during the Review Period, NZX had adequate arrangements for monitoring the conduct of exchange participants on or in relation to the markets. NZX developed processes further to improve the quality and consistency of its monitoring activities. NZX has been proactive in identifying and preparing for market developments, has dedicated resources to advancing policy, and has progressed significant projects.

FMA concludes that NZX was compliant with this obligation during the Review Period.

**FMA CONCLUDES THAT NZX
WAS COMPLIANT WITH THIS
OBLIGATION DURING THE
REVIEW PERIOD**

Arrangements for enforcing compliance

A registered exchange must have adequate arrangements for enforcing compliance with the relevant market rules

Introduction

This obligation requires NZX to have systems, processes and people in place to determine whether breaches of the Market Rules have occurred, and take appropriate action when breaches are identified. Effective enforcement supports the operation of fair, orderly and transparent markets by contributing to improved compliance. Visibility of enforcement is important to give the markets confidence in the effectiveness of the regulator, and give confidence that the markets are operating in a fair, orderly and transparent manner.

NZX functions relevant to the obligation

The Enforcement function is overseen by a senior lawyer who was recruited to Regulation during the Review Period, and one other solicitor is dedicated to enforcement (*the Enforcement Solicitor*). The Enforcement function, assisted by solicitors in Issuer Regulation, considers complaints regarding Issuers and carries out investigations of potential breaches of the Listing Rules, as well as taking responsibility for developing enforcement procedures and policy. The Enforcement Solicitor co-ordinates investigations and enforcement actions.

Team members in Participant Compliance handle complaints about Market Participants and carry out investigations into potential breaches of the Participant Rules. If a referral is to be made to the Tribunal, the Enforcement Solicitor prepares the Statement of Case.

Where Surveillance or CMS has reason to be concerned with Issuer or Market Participant behaviour, an initial investigation is conducted and the matter is referred to Regulation if a potential breach of the Market Rules is identified. Surveillance is responsible for real-time supervision of all trading activity on the Registered Markets and the Derivatives Market. Specifically in regard to enforcing compliance, Surveillance is responsible for administering price enquiries to Issuers when significant changes in trading activity occur that cannot be explained by information in the market. These price enquiries are published under the Issuers' codes on MAP and NZX's website. Surveillance is also responsible for referring matters to FMA when possible insider trading or market manipulation is detected.

The RGC was set up during the Review Period, to facilitate the Board's governance responsibilities in relation to NZX's regulatory function. The prime focus of the RGC is the monitoring of the quality of regulatory decision-making.

The Tribunal is an independent body set up to determine whether there has been a breach of the Market Rules in matters referred to it by NZX; and, in the event that a breach is determined, to assess the appropriate penalty. The Tribunal is discussed in relation to the next obligation, to ensure there is an independent adjudicative body.



Changes during the Review Period

Efficiency of the Enforcement function

The Market Assessment Report stated, '... during the Review Period NZX took steps to improve the efficiency of [the Enforcement] function, and to complete a number of investigations that had been outstanding. There was a particular focus on reducing the time taken to form a view as to whether a particular matter evidenced a breach of Rules and reach a decision as to the appropriate regulatory action to take as a consequence. The Board focused on this aspect when reviewing the Head of Regulation Monthly Report, and the number of matters outstanding more than three months reduced over the Review Period.'

NZX has reported to FMA that approximately 90% of the enquiries and investigations carried out during the Review Period were completed within the service levels. Matters that were not completed within the requisite timeframes were generally identified as more complex, for example continuous disclosure enquiries. The Market Assessment Report stated that, during the Review Period, a streamlined approach was developed for the consideration of potential breaches of the Listing Rules in relation to the omission of information from Issuers' annual reports.

FMA recognises the efforts that NZX has made in the Enforcement function and the improvements that have been achieved, and hopes to see further advancement in this area. We note the Agreed Actions in this section regarding amending internal service levels and improving communication with complainants.

Introduction of the Enforcement Policy

During the Review Period, NZX documented an Enforcement Policy in response to FMA's recommendation from the 2012 Report that NZX should 'develop an overarching enforcement policy, clarifying NZX's enforcement priorities and goals and providing the market with clear expectations about how NZX approaches breaches of the Market Rules and enforcement decisions, and how the Tribunal will be used'. NZX consulted the Tribunal and FMA on the policy and published it in November 2013. The Enforcement Policy is available at <https://nzx.com/files/static/cms-documents/NZXEnforcementPolicy.pdf>.

FMA considers that the published Enforcement Policy conforms to our recommendation and assists the market to understand NZX's approach to regulatory decision-making, in particular when choosing which of the various enforcement options to use in a particular situation. NZX should ensure that this document is kept up to date if NZX's enforcement priorities change.

During 2012, NZX documented Enforcement Procedures and implemented service levels. These were intended to address an Expected Action arising out of FMA's 2011 Report, relating to the slow progress of investigations and the low number of matters being referred to the Tribunal. FMA considered that the Enforcement Procedures required further development, and in the Market Assessment Report, NZX stated an intention to review the Enforcement Procedures during 2014 to ensure that they conform to the Enforcement Policy. We encourage NZX to refer to FMA's comments in the 2012 Report in relation to the Enforcement Procedures.

Enforcement of the Participant Rules

The Market Assessment Report noted that Issuer Regulation considered 90 potential breaches of the Market Rules during the Review Period, while Participant Compliance considered 42. The Participant Compliance team currently carries out its own enquiries, while all solicitors in Regulation may be available to carry out enquiries into potential Issuer breaches. At the end of the Review Period, there were two enquiries in Issuer Regulation that had been open for more than three months, while in Participant Compliance there were four. Additionally, of nine cases referred to the Tribunal during the Review Period, only one related to a Market Participant.

The Market Assessment Report stated, 'While performance has improved significantly in enforcement work in respect of breaches of the Listing Rules, further improvement is required in the area of breaches of the Participant Rules.' NZX has advised that changes have been implemented since the end of the Review Period, such that the Enforcement function is now more closely involved in the investigation of potential breaches of the Participant Rules and is responsible for taking enforcement action that involves a referral to the Tribunal.

FMA has not seen these changes in practice. Accordingly, this will be an area reviewed by FMA in the current period, to assess if the changes advised by NZX have been successfully implemented and are achieving better outcomes.

Board oversight of Regulation

The origin of the RGC has been discussed in the section on conflict management arrangements. We noted in that section that we regard the RGC as an effective mechanism for the Board to review the quality of regulatory decision-making, including adherence to process and policy, and thereby assure itself of the effective discharge of the delegation of the regulatory function.

The RGC reviews enforcement decisions that have been concluded by Regulation and assesses the quality of the decision-making for logic and appropriateness; consistency with the Market Rules and any policy or guidance issued by NZX; and compliance with NZX processes. The RGC will discuss any issues identified in its work with the CEO and/or the Head of Regulation, as appropriate, and may refer such issues to the Board if considered necessary. The RGC also reviews performance against the service levels. The RGC has no delegation to make regulatory decisions, nor any authority to reverse or alter any decision made⁷.

Regulation provides the RGC with a schedule of all regulatory decisions made for a specified period. The RGC selects particular decisions to review in full, obtains the related documentation, and then meets to discuss its view of the decisions. Decisions are not included in the schedule until they have been concluded and a determination has been reached by Regulation, or the Tribunal where applicable. Decisions chosen for review include decisions to take no regulatory action. The RGC met once during the Review Period and has met twice in 2014 prior to the publication of this report.

The Terms of Reference for the RGC contain a responsibility to review the 'arrangements for referral by Market Services to Regulation of matters for investigation and enforcement action by Regulation and adherence to these arrangements'. To date, the RGC has not included regulatory decisions made in Market Services in its reviews of regulatory decisions. In FMA's view, this is necessary in order to ensure that the arrangements for referral are being adhered to. The RGC should ensure that its reviews include a selection of materials relating to regulatory activities being carried out in Market Services, in particular those matters that do not result in referrals to Regulation, to fulfil this responsibility.

⁷From RGC Terms of Reference



Revised reporting

During the Review Period, Regulation further developed the format and content of reporting to the Board on Regulation's activities, begun in 2012. Regulation now provides the Board with comprehensive monthly metrics on the different activities undertaken across the Regulation teams, including the number of activities ongoing at the end of the month. The report must specifically identify when activities have not been completed within the timeframes required by the service levels, and explain any delays. These reports also provide metric information from CMS and Surveillance.

The Board determined what information would be reported and, during the Review Period, actively sought to obtain more detailed information from Regulation in relation to the length of time taken to complete investigations. Minutes from Board meetings demonstrate that the Board is actively monitoring the progress of investigations and the adequacy of resources in Regulation. NZX informed FMA that the increased focus on Regulation's activities and adherence to service levels has resulted in greater accountability for decisions in Regulation, leading to improved performance and quality of decision-making.

During the Review Period, Regulation also began publishing key quarterly metrics to the market on regulatory activities. These are published under NZX's stock code on the NZX website and MAP.

Increased referrals to the Tribunal

FMA has commented in previous reviews on the low number of referrals from Regulation to the Tribunal, as well as the practice in the past of referring only matters where clear breaches of the Market Rules could be determined by Regulation.

During the Review Period Regulation referred nine cases to the Tribunal. In the Tribunal's Annual Report for 2013⁸, the Chair of the Tribunal noted that, although that number represented only around 10% of all breaches identified, the majority of breaches identified during the Review Period were minor in nature, such as a large number for failing to include information in annual reports. Nonetheless, NZX has shown a willingness to refer more minor breaches to the Tribunal, such as administrative breaches, as well as a case where NZX and the relevant party were in dispute as to whether a breach had occurred.

FMA encourages NZX to continue to make more frequent use of the Tribunal as an enforcement tool. In particular, we support the use of the Tribunal to arbitrate where clarity on the interpretation of the Market Rules would be of benefit to the market.

Additional resources

A senior resource was recruited to Regulation during the Review Period and was given particular responsibility for the Enforcement function. This assisted the advancement of enforcement work in compliance with the service levels, the development of the Enforcement Policy, and the conclusion of some matters that had been outstanding for a long period of time.

Agreed Actions

Improve visibility of enforcement activities

In the 2012 Report, FMA commented on the lack of external visibility of NZX's Enforcement function, which had resulted in criticism of NZX in the past. FMA recommended that NZX consider ways of updating the market with respect to enforcement, as market confidence in NZX's willingness to take decisive enforcement action against its participants is eroded by the lack of visibility of its enforcement decisions and actions. Currently, the only enforcement actions visible to the market are those that result in the imposition of public penalties by the Tribunal.

In the Tribunal's Annual Report for 2013, NZX provided more detailed information than previously in relation to NZX Regulation's enforcement activities. NZX outlined the nature of the breaches and complaints that had arisen; detailed the enforcement action taken by NZX in each case, if any; and provided an explanation as to the choice of that particular enforcement action. This assisted in providing a better view of the range of actions NZX takes in respect of rule breaches, in addition to referring cases to the Tribunal for determination.

FMA views this additional information as useful in providing the market with greater transparency regarding NZX's regulatory function and how NZX's Enforcement Policy is implemented, and we encourage this type of reporting to the Tribunal going forward. However, we think it likely that the level of exposure of the Tribunal's Annual Report is relatively narrow, and the general public may not be alert to the existence of the information.

NZX agrees that this type of information is useful to the market, and extending the reporting of this type of information outside the limits of the Tribunal's Annual Report is desirable. NZX has therefore **agreed** to enhance its communication with the market on regulatory matters and enforcement activities, to give the market greater confidence that NZX is enforcing compliance with the Market Rules, using a number of enforcement tools.

⁸ Available at https://www.nzx.com/files/documents/regulators/DISP/79_NZMDT_2013_ANNUAL_REPORT.pdf

Amend internal service levels

NZX's published Enforcement Policy states, 'NZX Regulation will aim to provide formal notice of its intention to refer a matter to the NZ Markets Disciplinary Tribunal within four months of commencing an enquiry where NZX Regulation determines that referral is appropriate. For all other matters, NZX Regulation will aim to conclude any enforcement action within three months of commencing an enquiry (noting that enforcement action will not be taken in all cases).' However, the Enforcement Policy also notes that Regulation's ability to meet the indicated timeframes will depend on access to evidence in relation to an enquiry.

FMA recognises that the Enforcement function has increased the efficiency with which regulatory decisions are made. We acknowledge that some investigations take longer than others, for example when facts are in dispute, or when respondents request additional time to provide information. However, NZX does not have a maximum timeframe within which it will endeavour to complete matters where this is the case. Enquiries that are more complex or difficult to investigate can therefore remain ongoing for some time, with no further stated service levels to meet.

Similarly, when it is determined that a matter is to be referred to the Tribunal, there is no specified timeframe within which NZX must prepare the Statement of Case and make the referral. This means the respondent does not know when a conclusion to the matter may be reached, and it seems at odds with the arrangements in the Tribunal Rules that require the respondent to respond to allegations in a Statement of Case within a reasonably short period once served.

NZX has **agreed** to modify its internal service levels, to better reflect the nature and complexity of different types of investigation and the end-to-end process, such that there are specified targets for even the more complex matters that NZX may undertake. Service levels will be implemented for completing Statements of Case and referrals to the Tribunal.

Improve communication with complainants

In the 2012 Report, FMA noted that NZX had made improvements to its handling of complaints regarding Issuers, but encouraged ongoing refinements of NZX's approach. During the Review Period, however, FMA received complaints about a lack of communication from NZX to complainants on the progress of investigations, as well as the length of time that it sometimes took NZX to complete investigations.

We note the Agreed Action to amend service levels, which should help to improve efficiency in Enforcement. Investigating complaints expediently is important to investor confidence in NZX's Regulation function, and providing information to complainants aids the transparency of the process.

NZX has **agreed** to implement changes to its complaints process, including enhancing communication with complainants. NZX will set expectations with complainants about the length of time an enquiry might take NZX to complete, and will commit to communicating with complainants during the course of prolonged investigations.

Review penalties for clear breaches

Four of the cases referred to the Tribunal during the Review Period were for breaches of the rule that requires an Issuer to provide an annual report to NZX within three months of its financial year end. Another case concerned the failure of a Market Participant to provide contract notes to clients within one day, as required by the Participant Rules. Breaches of this nature are unambiguous. Other market rules exist that can also be breached clearly and definitively, for example the requirement to have a minimum number of independent directors on an Issuer's board, and the requirement to provide information to NZX at the same time as it is provided to shareholders.

Ideally, NZX should be able to take disciplinary action quickly and easily for clear breaches. A refined process for preparing Statements of Case should help in this regard. During the Review Period, Regulation and the Tribunal discussed undertaking a review of the current penalties and penalty bands, which have not changed since the Tribunal was established in 2004.

NZX has **agreed** to review the penalty structure for minor and unambiguous breaches of its rules.

Conclusion

FMA is satisfied that, during the Review Period, NZX had adequate arrangements for enforcing compliance with the Market Rules. NZX showed a readiness to improve in this area, applying additional resources and continuing to document processes, as well as utilising the Tribunal more. The publication of the Enforcement Policy gives the market greater visibility of NZX's approach to enforcement.

FMA concludes that NZX was compliant with this obligation during the Review Period. However, NZX has acknowledged that further improvements could be made in this area and has therefore undertaken to carry out the Agreed Actions.

FMA CONCLUDES
THAT NZX WAS
COMPLIANT
WITH THIS
OBLIGATION
DURING THE
REVIEW PERIOD



Ensure there is a sufficiently independent adjudicative body

A registered exchange must have adequate arrangements that ensure there is a sufficiently independent adjudicative body to adjudicate on contraventions of market rules that are referred to it

Introduction

This obligation requires that an independent adjudicative body be in place. Having adequate arrangements to ensure the body is available when required includes having rules and procedures in place relating to the composition, the operation, the scope of responsibility, and the powers of the body; applying sufficient financial resources to fund the operation of the body; and providing adequate information to the body, to enable efficient and effective adjudication on matters referred to it. Using the independent adjudicative body effectively is implicit in the obligation to have adequate arrangements for enforcing compliance with the relevant market rules.

NZ Markets Disciplinary Tribunal

The Tribunal is an independent adjudicative body, established under the Tribunal Rules, that considers disciplinary matters referred to it by NZX in respect of the Registered Markets and the Derivatives Market.

The Tribunal's principal role is to determine whether referrals made to it by NZX or NZCDC, under the Market Rules, the Clearing and Settlement Rules, or the Derivatives Market Rules, demonstrate breaches of the rules in question; and to impose penalties for any breaches determined. The jurisdiction of the Tribunal does not extend to reviewing decisions made by NZX in respect of approvals of listings, designations of Market Participants, changes to the Market Rules, published policy decisions, trading halts, or pricing schedules. In certain circumstances the Tribunal can review decisions on waivers and rulings in respect of the Market Rules.

The Tribunal is required to be composed of various categories of member, representing different interest groups and relevant experience. It includes lawyers, Market Participant representatives, Issuer representatives, members with knowledge of clearing and derivatives, and members of the public with particular expertise.

The full powers and responsibilities of the Tribunal are set out in the Tribunal Rules. The Tribunal Rules are supplemented by the Tribunal Procedures and Tribunal User Guide.

Independence

The operation of the Tribunal in relation to cases referred by NZX Regulation is independent of NZX. The Tribunal ordinarily acts by Division, with Divisions comprising three or five non-conflicted members who are selected by the Chair of the Tribunal, in accordance with the Tribunal Rules and subject to relevant experience.

Monetary penalties imposed by the Tribunal go into a Discipline Fund. This fund may be used to meet the costs of the Tribunal and for certain other purposes specified in the Tribunal Rules. NZX must fund any costs of the Tribunal not met by the Discipline Fund.

Members of the Tribunal are appointed by NZX, but must be confirmed by FMA. Consultation between NZX and the Tribunal is required for certain matters, for example when proposing amendments to the Tribunal Rules, and appointing new members. During the Review Period, NZX also consulted the Tribunal on other matters pertinent to the Tribunal, such as NZX's Enforcement Policy and the Terms of Reference for the RGC.

A good working relationship between NZX and the Tribunal is necessary to ensure that the Tribunal is used effectively, and that the Tribunal Rules and procedures remain current. FMA considers that the Tribunal is sufficiently independent to adjudicate on contraventions of the Market Rules.

Activities relevant to the obligation

Appointments to the Tribunal

NZX is responsible for appointing members to the Tribunal. During the Review Period, five members of the Tribunal were required to retire in accordance with the Tribunal Rules. NZX, in consultation with the Tribunal, undertook a public nominations process in the first half of 2013 to identify suitable candidates, in preparation for the forthcoming retirements. This process resulted in the appointment of six new members to the Tribunal during the Review Period. FMA confirmed the appointments, as required by the Tribunal Rules.

Amendments to the Tribunal Rules

In March 2013, NZX applied to FMA for the approval of some minor changes to the Tribunal Rules. The majority of the changes were administrative in nature, for example removing references to the discontinued NZX Futures and Options Rules, and correcting typographical errors. An amendment was also made to allow retiring Tribunal members to complete their determinations on any open matters, if they retire before a determination is made. NZX consulted the Tribunal on the proposed changes, which were approved by FMA in April 2013.

Appeal Panel structure

The Appeal Panel of the Tribunal is established under the Tribunal Rules. Where a party wishes to appeal a determination made by the Tribunal at a full hearing procedure, application is made to the Appeal Panel.

During the Review Period, NZX requested the Rules Sub-Committee of the Tribunal to consider the structure of the Appeal Panel and assess whether changes were desirable. All of the Appeal Panel's members were required to retire at the end of 2013, and since its inception, the Appeal Panel had only been called upon once. The Rules Sub-Committee made recommendations to NZX and NZX agreed with the proposed changes. A public consultation document was released on 31 January 2014, and NZX applied to FMA for approval of the proposed changes in April 2014.

In the interim, NZX appointed five new members to the Appeal Panel for a period of six months, until 30 June 2014. FMA confirmed the appointments.

Reporting to the Tribunal

The Tribunal Rules require NZX to provide a report to the Tribunal, for each calendar year, with information regarding breaches identified, complaints received, and the use of the Disciplinary Fund during that year. The report from NZX is included in the Tribunal's Annual Report to the public.

As noted earlier in this report, NZX changed the format of its reporting to the Tribunal for the most recent Annual Report, to include more detailed information than previously in relation to Regulation's enforcement activities. In his report, the Chair of the Tribunal thanked NZX for the new format.

The Tribunal's Annual Report for 2013 is available at <https://www.nzx.com/regulators/DISP/announcements/249706>

Conclusion

FMA is satisfied that, during the Review Period, NZX had adequate arrangements to ensure that the Tribunal was a sufficiently independent adjudicative body to adjudicate on any contraventions of NZX's rules that were referred to it. NZX took actions to ensure that the Tribunal had sufficient suitably qualified members, and to update the Tribunal Rules in order to maintain the continued effectiveness of the Tribunal and the Appeal Panel.

FMA concludes that NZX was compliant with this obligation during the Review Period.

**FMA CONCLUDES THAT NZX WAS
COMPLIANT WITH THIS OBLIGATION
DURING THE REVIEW PERIOD**



Have sufficient resources to operate the markets

A registered exchange must have sufficient resources (including financial, technological, and human resources) to operate its registered markets properly

Financial resources

Introduction

This obligation requires NZX to make sufficient financial resources available, to ensure the adequacy of all other resources required to operate the Registered Markets and the Derivatives Market in a fair, orderly and transparent manner. This includes both annual expenditure on the operation of the markets, and having sufficient capital resources in the balance sheet.

NZX does not allocate capital to lines of business, except where those businesses are operated as separate subsidiaries. NZX states that this reflects the fact that the capital requirements and financial variability of the non-markets businesses will ultimately affect the markets businesses. NZX does not therefore account separately for the operation of the markets, and does not forecast separately for the regulatory and non-regulatory aspects of the business. However, the individual business functions prepare annual budgets and the Head of Regulation prepares a budget for expenditure in Regulation independently of the CEO. The Market Assessment Report stated that the budget presented to the Board in December 2013, for the current period, was refined to provide greater visibility of the business units that support the markets.

The Board reviews and approves the annual budgets, then receives monthly reporting tracking performance against budget. Management provides the Board with detailed papers as required, when significant changes to planned expenditure are proposed.

Financial resources

NZX has no term debt. The Market Assessment Report stated, 'This provides [NZX] with substantial ability to absorb financial shocks or a sustained downturn in financial performance or cash flows without adverse impact on the operation of the Markets'. Operations are primarily funded from internally generated cash flows, and operating cash flows increased in 2013 compared with 2012. NZX also maintains a large overdraft facility to assist with the management of working capital needs. At the end of the Review Period NZX had not drawn on this facility.

Expenditure

During the Review Period, the Board focused on monitoring the adequacy of human resources available to operate the markets, and demonstrated a willingness to increase expenditure in this area as necessary. Details of changes in human resources are discussed later in this section under 'Human resources'.

NZX also continued to invest in enhanced infrastructure, including updates to the technological systems required to operate the markets, hardware upgrades and system security enhancements. These changes are discussed below under 'Technological resources'.

FMA considers that NZX's current financial position should enable NZX to continue to operate the markets in a fair, orderly and transparent manner, and the Board appears committed to applying resources as necessary to the operation of the markets.

ALL MARKET TRANSACTIONS ARE ELECTRONIC, FROM PLACING CLIENT ORDERS THROUGH TO SETTLING TRADES

Technological resources

Introduction

This obligation requires NZX to have technological systems in place on which to run the markets, and to support the operation of the markets, to ensure that the Registered Markets and the Derivatives Market operate in a fair, orderly and transparent manner. Technological systems are central to the operation of NZX's Registered Markets and Derivatives Market. All market transactions are electronic, from placing client orders through to settling trades. Material information is provided to NZX electronically and distributed via the NZX data feed to the NZX website and data vendors, at which point it is deemed to be generally available to the public. NZX communicates with Market Participants via the trading system, and with Issuers via MAP.

Stable, secure, accessible, and up-to-date technological systems are therefore essential to the operation of fair, orderly and transparent markets, as the failure of any element of a system within the group of systems could lead to a lack of fairness, orderliness or transparency.

NZX functions relevant to the obligation

The Technology function of NZX has responsibility for the overall performance of NZX's technological systems, across both its regulated and unregulated activities. This area's core function is to ensure the availability, security, capacity and maintenance of NZX's trading platforms and settlement systems, internal monitoring systems, and general systems.

The technological systems must operate as intended and be accessible to all users when required. The key technological systems for operating the market include:

- X-stream, the trading system
- TCS BaNCs, the clearing system
- MAP, for the disclosure of market announcements and corporate actions
- SMARTS, the core market surveillance system

Additionally, NZX employs a number of other technological resources, such as its websites, a market data feed of live announcements and prices, and general systems, including server facilities and communications. NZX has a primary production site and a secondary disaster recovery site, with real-time data synchronisation between the sites.

NZX continuously monitors its systems to ensure that any network, software or hardware problems are detected as quickly as possible, and team members receive text and email alerts from the monitoring application when exceptions occur, on a 24-hour basis. The trading system allows NZX to monitor client connectivity to the market, which is logged. Daily, weekly and monthly housekeeping processes are carried out, to ensure that system capacity and performance are optimal. Specifically for the Derivatives Market, NZX must conduct a semi-annual self-assessment of the trading system against a particular IOSCO principle for screen-based trading systems for derivatives products, and provide a report to FMA.

When problems occur with any of the technological systems, the priority for the Technology team is to get the affected service back up and running as quickly as possible, with minimal disruption to business operations and the markets. The Head of Technology, Head of Operations and Head of Regulation are immediately notified. If the problem affects the market, the market is notified of issues via communications from the CMS team. An analysis of the cause occurs after the service capabilities have been returned. A formal incident report is distributed to the market after an incident has been resolved, and these reports are also sent to FMA.

During the Review Period, a paper titled 'NZX Technology State of Play' was presented to the Board. This paper set out the changes and improvements in the overall technological framework in the previous two years, and plans for continuing those improvements. The Technology team has been focussing on planning for the future: moving away from short-term, custom-made solutions, towards applications and infrastructure that will help to ensure stability and will be easier to maintain, enhance and secure in the longer term.



Events during the Review Period

INCIDENTS

There were no disruptions to the trading system during the Review Period. However, there were three incidents affecting system availability to the market, as follows:

- on 1 January 2013 (a non-business day), a domain name system outage resulted in no access to NZX's systems from external sources. The outage continued through to 2 January, which was a Dairy Futures trading day. The market impact was minimal because the Registered Markets were closed and no participants sought to place orders on the Derivatives Market
- on 23 April 2013, a market data feed issue affected the markets website and third-party data vendors using the market data feed. This resulted in market announcements being available on the X-stream trading system, but not on the website or all third-party systems. A decision was made to allow the market to trade, but NZX implemented a plan to place a trading halt on any securities for which price-sensitive announcements were submitted to NZX, until the issue was resolved. Market connectivity and order and trade data were not affected
- on 1 July 2013, the NZX website was affected by a bug in the network time protocol service on the primary site, which had an impact on a number of downstream systems, including the trading system and MAP. Trading was halted on all markets at 12:51 pm. Following issues with restarting systems on the primary site, NZX failed all systems over to the disaster recovery site and the market re-opened at 3:00 pm

In the case of each of these incidents, Market Participants, data vendors, and all other key stakeholders were kept informed of relevant matters while NZX sought to identify and resolve the issue. Detailed incident reports were subsequently prepared and distributed. NZX investigated the cause of each issue fully and, where necessary, has put a long-term solution in place to avoid a recurrence

FAIL-OVER AND DISASTER RECOVERY TESTING

Fail-over and disaster recovery testing is conducted annually on the trading and clearing systems, to check that the markets can be operated through either the primary or secondary site, that the switch between the sites can be carried out efficiently with little or no intervention, and that external parties such as Market Participants can connect to the secondary site. Testing involves 'failing over' the system from the primary site to the secondary site. The market is operated from the secondary site for one week then switched back.

The trading system fail-over and disaster recovery testing for the Review Period was carried out in October 2013. The fail-over to the secondary site was successful; however, one Market Participant was unable to connect to the secondary site. The system was therefore failed back to the primary site later that evening and was not run on the secondary site for a week, as is usually done. NZX and the Market Participant subsequently determined there was an issue on the Market Participant's network. The disaster recovery testing was re-run successfully in March 2014.

Changes during the Review Period

PENETRATION AND SECURITY TESTING

During the Review Period, NZX began penetration testing of its technological systems and commissioned an external review of the security of its systems. A bottom-up threat model analysis was carried out, with a particular focus on threats from outside NZX, and NZX is taking actions to address the results of that analysis in order of priority.

FMA considers it would be inappropriate to publish details of the results of the testing, or the actions being taken by NZX. We are satisfied that NZX is highly focused in this area and is taking appropriate measures to minimise risks to its technological systems, as well as scheduling regular external security reviews of its systems.

NZX also outsourced a review of its IT policies and contracted an online framework for IT policies, which is cross-referenced to international standards and tailored to NZX's needs. The new policies will cover how, what, where and when NZX uses technology, and ensure that everyone within NZX understands what is expected. NZX hopes to roll out these new policies around June 2014.

TECHNOLOGY UPDATES

NZX made a number of technological updates during the Review Period. The releases of phases 2 and 3 of the X-stream trading system software were successful. These releases included minor bug fixes, and enhancements required for the launch of the equity derivatives market in June 2014. A major upgrade of the BaNCs clearing system database and operating system was undertaken, to ensure that BaNCs continues to operate on supported underlying software. NZX reported that the upgrade process, including testing and co-ordination, is now well understood by Market Participants.

NZX also updated hardware, acquiring some new equipment and decommissioning or re-deploying older hardware, and began the process of moving all staff members to a virtual desktop infrastructure. Remote access will be possible from almost anywhere, which will greatly enhance business continuity capability. Desktops will be standardised, enabling ease of management for the Technology team. This process is expected to be completed for all staff during 2014.

The Technology team has also been preparing for the operation of NZX's planned new market for smaller, growth companies. This market will operate on the existing trading and clearing systems, but will have a dedicated website, which is under development.

BUSINESS CONTINUITY PLANNING

BCP and disaster recovery are essential to the orderliness of NZX's markets. Although the individual teams each have measures in place, NZX began developing a more co-ordinated, organisation-wide BCP during the Review Period. The earthquakes affecting Wellington in July and August emphasised the need for BCP, but also brought to light certain planning needs that had not previously been identified. The project was therefore expanded and is ongoing. The Technology team has responsibility for this project and reports regularly to the Board on progress.

NZX expects that, were a large event such as an earthquake to take place in Wellington, the markets would most likely be closed for a period of time. However, NZX has sufficient systems in place to allow the markets to continue operating, should a lesser adverse event prevent access to its main offices in Wellington. The Technology systems delivery teams have remote access to the primary and secondary production sites. These teams can also monitor and operate the markets via a secure internet connection from outside the Wellington office.

Market Services must also have access to core IT systems and the necessary platforms to operate the markets. The Surveillance and CMS teams have dedicated disaster recovery laptops with 3G access, which are kept charged and available at all times, and staff are fully trained in the use of technology from outside the office. Other employees have remote access to NZX's general systems via a secure virtual private network.

NZX has established a larger office in Auckland and expects to have full trading capability from Auckland by mid-2014. NZX also has backup office space for up to 10 people in the Wellington region, in the event that access to the main offices is lost in an isolated case (as distinct from a Wellington-wide event).

FMA agrees that NZX should retain a strong focus on designing and implementing a comprehensive plan for business continuity as soon as possible.



Human resources

Introduction

This obligation requires NZX to employ enough people across the organisation to carry out all of the tasks required to operate the markets in a fair, orderly and transparent manner. It also implies that those people should have the appropriate skills to carry out those tasks, and that there should be substitute resources available to ensure consistent standards of service at all times.

In the Market Assessment Report, NZX identified the following drivers of human resource requirements for the operation of the markets:

- **the volume and nature of the work:** for example, the number and complexity of waiver applications being considered at any time varies
- **the scalability of the function:** for example, Technology resources are largely scalable (within a range), whereas Regulation resource requirements vary with the volume of work
- **the skill and experience base of staff operating the function:** this affects the capacity of business functions to manage increases in volume effectively without proportionate increases in the number of staff. As experience grows, capacity increases

The average tenure of staff in Regulation and Market Services increased during the Review Period, which meant the overall level of experience in these areas was greater and key person dependencies were reduced. It also enabled senior staff to be less involved in BAU activities and more focused on the supervision and development of newer staff.

Changes during the Review Period

BOARD MONITORING OF RESOURCES

In the 2012 Report, FMA recommended close monitoring of resources in the Participant Compliance area, as well as a consideration of whether a specific resource was needed to progress non-BAU projects. We also made recommendations regarding resources and skills in Enforcement.

Monthly reporting to the Board on activities in Regulation contains information designed to allow the Board to monitor the adequacy of resources across Regulation and Market Services. Regulation reports on the volume of activities undertaken for the month, whether internal service levels have been met, and how long investigations have been underway. The information is segregated between Issuer Regulation and Participant Compliance to give visibility of resourcing in each team. Activity metrics are also provided for Surveillance and CMS.

Minutes from Board meetings demonstrated a strong focus on resource levels during the Review Period, particularly in Regulation. The revised reporting and increased monitoring led to the recognition that BAU activity was increasing, and resources were inadequate to allow NZX to be proactive on policy and rules development. The Board sought a solution to address this gap, resulting in the creation of the Policy team.

BAU activities in Regulation appeared to be adequately resourced in the Review Period. NZX reported that internal service levels in Enforcement were met for approximately 90% of enquiries and investigations. We have commented earlier in this report on the Agreed Actions to be taken by NZX to continue to improve efficiency in Enforcement.

INCREASED RESOURCES AND EMPLOYEE MOVEMENTS

NZX has increased the overall resources in Regulation through a number of internal staff movements and external recruitment. A senior lawyer was recruited in July and assigned largely to the Enforcement area. An additional resource was also contracted to the Participant Compliance area in December, to progress projects.

In the Technology function, two new employees joined the Securities and Clearing Service Delivery team at the beginning of the Review Period. NZX reports that this recruitment has removed key person dependencies from the team.

Where more experienced employees have changed roles within NZX, FMA encourages NZX to continue to draw on their experience to support and develop newer employees, or employees who have moved into different roles. This will help to ensure consistency in approach and the quality of decision-making.

TRAINING AND RETENTION INITIATIVES

During the Review Period NZX initiated a three-year graduate recruitment programme, which gives university graduates the opportunity to work across a range of functions within NZX, in particular Market Services. This initiative should assist with staff retention and cross-training gives NZX greater scope to fill gaps in resources. At the end of the Review Period recruitment was also underway for two graduates in Regulation.

In preparation for the launch of equity derivatives, a member of the Derivatives team spent time working in Surveillance, helping Surveillance to build knowledge in this area.

Internal promotion also assists with the retention of staff and institutional knowledge.

Conclusion

FMA is satisfied that, during the Review Period, NZX had sufficient financial, technological, and human resources to operate the Registered Markets and the Derivatives Market properly. The Board focused on monitoring human resources and NZX applied additional resources where necessary.

FMA concludes that NZX was compliant with this obligation during the Review Period.

FMA CONCLUDES THAT NZX WAS COMPLIANT WITH THIS OBLIGATION DURING THE REVIEW PERIOD



Fair, orderly and transparent markets

A registered exchange must, to the extent that it is reasonably practicable, do all things necessary to ensure that each of its registered markets is a fair, orderly and transparent market

Introduction

In this section, we discuss activities and functions within NZX that may not correspond directly to any of the more defined obligations, but are relevant to the overarching obligation to ensure that the Registered Markets and the Derivatives Market operate in a fair, orderly and transparent manner. As noted earlier in this report, this obligation underlies all of the other obligations, and therefore the activities and functions previously discussed are also relevant to compliance with this obligation.

Other NZX activities and functions relevant to the obligation

Information

The timely, accurate, and non-discretionary dissemination of market information is a cornerstone of fair, orderly and transparent markets. Investors need access to material information about listed companies, in order to assess the value of securities and make informed investment decisions. Information about market bids and offers must be available, to give investors a view of the supply of and demand for a security, and at what prices. Post-trade information must also be published, to reflect the market prices of securities and the level of trading activity.

NZX provides the market with relevant, timely information in a number of ways:

- NZX provides Market Participants and market information system providers, such as Iress and Bloomberg, with real-time trading information from its trading system. Investors gain access to this information through broker relationships
- MAP allows Issuers to release information to the market, in particular material information that requires immediate disclosure under the Listing Rules
- www.nzx.com, NZX's markets website, gives real-time access to announcements from MAP and also provides information on trading activity and the prices of securities, on a delayed basis

Information about the operation and regulation of the Registered Markets is also of relevance and interest to the market, and NZX provides a range of information on its markets website. Examples of the operational information available are trading statistics for individual securities and the overall market, and index compositions and performance. Examples of regulatory information include the Market Rules, Tribunal determinations, and some of NZX's policies and procedures. Quarterly regulation metrics are released on MAP under NZX's stock code. NZX also uses its markets website to provide information that may be of use to investors, for example links to business news headlines.

Client Market Services

As noted in the section 'Arrangements for monitoring conduct', the CMS team plays a role in NZX's monitoring activities, and refers matters to Regulation as required. CMS carries out a number of other activities that contribute to the operation of fair, orderly and transparent markets, for example:

- releasing market announcements under the correct headings and with the correct Issuer authority
- identifying and flagging price-sensitive announcements
- processing corporate actions
- updating the trading status of securities in the trading system (e.g. ex-dividend)
- administering trading halts and suspensions
- providing assistance to Issuers in understanding and meeting continuous disclosure requirements and deadlines
- notifying Issuers and Market Participants of market events
- assisting Issuer education by publishing Issuer Updates in conjunction with Regulation

Processes and procedures

Effective processes and procedures, which are documented and easily accessible to staff across the organisation, help to ensure consistency and accuracy in carrying out tasks, and reduce errors. They also facilitate the induction of new employees, and cross-training for covering periods of holiday and sick leave.

In Market Services particularly, accuracy and efficiency are vital. Information must be released to the market as quickly as possible after being submitted to NZX. Processing errors can have negative market impacts; for example, if a trading halt on a security is inadvertently lifted, or an incorrect date is entered on a corporate action. Investors may also base decisions on factors such as the composition of a securities index; therefore it is important that this information is correct and up to date.

Changes during the Review Period

Information

During the Review Period, NZX increased the information it provides to the market in a number of ways.

Some design changes were made to the markets website and NZX began using an icon to highlight price-sensitive announcements.

As noted earlier, NZX published its Enforcement Policy and began publishing quarterly metrics on its regulatory activities on the markets website, which help to give the market a view of the nature and volume of tasks that Regulation undertakes. Regulation also provided summary details of its investigations from the Review Period in the Tribunal Annual Report for 2013, published in April 2014.

During the Review Period, CMS and Regulation worked on significant changes to the design, format and content of the Issuer Updates that are circulated periodically to Issuers and are available on MAP. The first Issuer Update in the new format was published in January 2014.

Process improvements

As noted earlier in this report, NZX focused during the Review Period on documenting processes for all tasks carried out in CMS, and ensuring they were written in a way that did not assume prior knowledge. NZX has also focused on removing duplication of processes and preventing errors. The Market Services Error Log is used to identify the reasons for any errors and help prevent recurrences.

Also previously noted, better processes and the use of templates in Regulation have led to more consistent decision-making in Regulation and improved the recording of decisions.

Board oversight

The Board has ultimate responsibility for ensuring that NZX's markets operate in a fair, orderly and transparent manner, and should assure itself of overall compliance with the Statutory Obligations. From FMA's review of the minutes from Board meetings, as well as our discussion with the Chair of the Board, it was evident that greater emphasis was placed on the Board's duties in this regard during the Review Period. The Board proactively addressed FMA's recommendations from the 2012 Report, not only focussing on oversight of the regulatory delegations, but also ensuring that progress was made in other areas where the Board felt changes were necessary. A focus on the efficiency of investigations, the identification of deficiencies such as resourcing for policy development, and the establishment of the RGC, have been discussed in other sections of this report and are all relevant to Board oversight of compliance with the Statutory Obligations.

Conclusion

FMA is satisfied that, during the Review Period, to the extent that it was reasonably practicable, NZX did all things necessary to ensure that each of its Registered Markets and the Derivatives Market was fair, orderly and transparent.

FMA concludes that NZX was compliant with this obligation during the Review Period.

**FMA CONCLUDES THAT NZX WAS
COMPLIANT WITH THIS OBLIGATION
DURING THE REVIEW PERIOD**



Conclusion

Compliance with the Statutory Obligations

After making the assessments described in this report, FMA has concluded that, in the Registered Markets and the Derivatives Market:

- For the period 1 January 2013 to 31 December 2013:
 - » to the extent that it was reasonably practicable, NZX did all things necessary to ensure that each of its Registered Markets and the Derivatives Market was a fair, orderly and transparent market
 - » NZX had adequate arrangements for operating its Registered Markets and the Derivatives Market, including arrangements:
 - › for handling conflicts between the commercial interests of NZX and the need for NZX to ensure the markets operate in a fair, orderly and transparent way
 - › for monitoring the conduct of participants on or in relation to those markets
 - › for enforcing compliance with the relevant market rules
 - › that ensure there is a sufficiently independent adjudicative body to adjudicate on contraventions of market rules that are referred to it
 - » NZX had sufficient resources, including financial technological and human resources, to operate its Registered Markets and the Derivatives Market properly.

The Registered Markets and the Derivatives Market appear to have operated in a way that was fair, orderly and transparent during the Review Period.

Agreed Actions

NZX has agreed to take a number of Agreed Actions to address matters raised by FMA in the course of this review, in particular regarding arrangements for managing conflicts of interest and arrangements for enforcing compliance. These areas will continue to be a focus of FMA's oversight of NZX in the current review period and FMA will monitor NZX's progress towards completion of the Agreed Actions.



Appendices

Appendix 1: Statutory framework

NZX's Statutory Obligations

NZX's obligations as a Registered Exchange under section 36F of the Act are set out at section 36Y of the Act, as follows:

General obligations in respect of registered markets

[NZX as] a registered exchange must, –

- (a) to the extent that it is reasonably practicable, do all things necessary to ensure that each of its registered markets is a fair, orderly and transparent market; and
- (b) have adequate arrangements for operating its registered markets, including arrangements –
 - (i) for handling conflicts between the commercial interests of the registered exchange and the need for the registered exchange to ensure that the markets operate in the way referred to in paragraph (a); and
 - (ii) for monitoring the conduct of exchange participants on or in relation to the markets; and
 - (iii) for enforcing compliance with the relevant market rules; and
 - (iv) that ensure there is a sufficiently independent adjudicative body to adjudicate on contraventions of market rules that are referred to it; and
- (c) have sufficient resources (including financial, technological, and human resources) to operate its registered markets properly.

For the Derivatives Market, the Futures Exchange Notice imposes similar obligations on NZX at clause 7(1):

Conditions relating to market supervision

[NZX] must:

- (a) to the extent that it is reasonably practicable, do all things necessary to ensure that the Market operates in a fair, orderly and transparent manner;
- (b) have adequate arrangements for supervising the Market, including arrangements:
 - (i) for handling conflicts between the commercial interests of [NZX] and the need for [NZX] to ensure that the Market operates in a fair, orderly and transparent manner;
 - (ii) for monitoring the conduct of Participants;
 - (iii) for enforcing compliance with the Rules and Procedures; and
 - (iv) that ensure there is a sufficiently independent adjudicative body to adjudicate on contraventions of the Regulations that are referred to it; and
- (c) have sufficient resources (including financial, technological, and human resources) to operate the Market properly and for the required supervisory arrangements to be provided.

Obligations on NZX to self-assess

The Act requires NZX to produce an annual report assessing its own performance against the obligations:

Registered exchange must give annual report to FMA (section 36YA)

- (1) A registered exchange must, within 3 months after the end of its financial year, give a report to the FMA and the Minister on the extent to which it has complied with its obligations under section 36Y in the preceding financial year.

The Futures Exchange Notice includes a similar requirement:

Conditions relating to reporting obligations (Clause 6(10))

[NZX] must, within three months after the end of its financial year, give a report to Financial Markets Authority on how well it has met its obligations under clause 7(1) of this notice in the preceding financial year.



Obligations on FMA to assess NZX

The Act requires FMA to review and report on NZX's performance of the General Obligations:

FMA may carry out general obligations review (section 36YB)

- (1) The FMA may, at any time, carry out a review of how well a registered exchange is meeting any or all of its obligations under section 36Y.
- (2) The FMA must carry out a review of how well a registered exchange is meeting all of its obligations under section 36Y at least once in respect of each financial year of the registered exchange.
- (3) The FMA –
 - (a) may, in carrying out the review, take into account the most recent annual report and other information provided under section 36YA and any other information it considers appropriate; and
 - (b) must, after carrying out the review, provide a draft written report on its review to the registered exchange and take into account any submissions made by the exchange within the reasonable period for submissions specified by the FMA.
- (4) The FMA must not carry out a review of a designated settlement system (within the meaning of section 156M(1) of the Reserve Bank of New Zealand Act 1989) of a registered exchange under this section (but nothing in this subsection prevents a review under that Act being carried on in conjunction with a review under this section).

FMA must make written report on general obligations review (section 36YC)

- (1) The FMA must give a written report on a review under section 36YB to the Minister and the registered exchange –
 - (a) as soon as practicable after carrying out the review; and
 - (b) in any case, within 3 months after the exchange has provided an annual report to the FMA under section 36YA.
- (2) The FMA must also publish the written report on the review on an Internet site maintained by or on behalf of the FMA.
- (3) However, the FMA may, in publishing the written report of its review, omit from the published report any information for which it considers there would be a good reason for withholding under the Official Information Act 1982 if a request for that information were made under that Act.

Appendix 2: Market conditions

The following information is extracted verbatim from the Market Assessment Report, and provides context for this report regarding activity in the Registered Markets and Derivatives Market during the Review Period.

New Listings and Sell Downs

There were 10 new listings in 2013 ranging from partial privatisations of SOEs (Mighty River Power, Meridian) to small cap technology firms (e.g., SLI Systems, Snakk Media). These new listings raised total capital of approximately \$7.5 billion. A further \$4.024 billion was raised by existing issuers (equity \$3.7 billion, debt \$292 million), taking the total funds raised for 2013 to approximately \$11.5 billion. Several strategic investors sold interests in a number of listed companies; approximately \$2.5 billion in aggregate.

Market Volumes

Trading activity in 2013 increased from the previous year. Table 1 summarises activity. Highlights of the trading activity in 2013 include:

- Total number of trades up 32.62% to 1.19 million.
- Average daily trades increased from 3,598 to 4,772.
- Total value traded up 41.12% to \$41.72 billion.
- Average value traded per day increased from \$120.6 million to \$170.21 million.
- Market capitalisation of NZX50 up 29.7% to \$55.04 billion.
- Single largest day by value: \$1,045,740,858 (5 May 2013, included SKT sell down by News Corp of \$800m).
- Single largest day by volume: 12,050. (26 November 2013, an all-time record.)

Table 1. Trading Volumes (All Markets)

	2013	2012	% Change
Daily Average Trades	4,772	3,598	32.6%
Daily Average Value (\$)	170,217,026	120,612,982	41.1%
Daily Average Volume	48,117,296	43,947,680	9.4%

DMA/Algorithmic Trading

2013 saw a significant shift in the proportion of trading via Direct Market Access ("DMA") as the year progressed. An increase in the estimated amount of algorithmic trading was also observed.

- Approximately 28% of the total trades were via DMA (no 2012 data for comparison).
- DMA trading increased significantly from September 2013 through to December 2013 with approximately 39% of all trades via DMA in this period.
- DMA value traded as percentage of total value traded increased from 1.62% in January 2013 to 7.05% in December 2013.
- Average estimated monthly algorithmic trades increased during 2013. The total number of estimated algorithmic trades in 2013 was approximately 10% greater than the number of estimated algorithmic trades in 2012 (2013: 286,553, 2012: 260,785).

Proportion of On-Market Trading

2013 saw an increase in the proportion of value of trades executed on-market to \$42.7 billion or 29.19% of total value (compared to \$30.3 billion or 25.78% in 2012).

NZX Derivatives Markets

Table 3 summarises NZX Derivatives Market volumes. Total volume across all dairy futures product categories was up 52% in 2013 with exceptional growth in SMP in particular. AMF volumes fell from 2012.

Table 3: Trading Volumes (NZX Dairy Futures)

	2013	2012	% Change
WMP	21,058	17,562	19.9%
SMP	11,371	1,100	933.7%
AMF	4,382	5,521	-20.6%
Total	36,811	24,183	52.2%

On 23 August 2013, NZX amended the trading hours of the NZX Dairy Derivatives Market, with the market now opening at 2.00am NZT, four days a week. Traded volume in these extended hours (between 2.00am-8.00am) was 7,033 lots from 23 August 2013 to 31 December 2013.



Appendix 3: Glossary

In this report, the following terms have the following meaning, as the context requires:

2011 Report	FMA Report on the NZX General Obligations Review published 29 June 2012
2012 Report	FMA Report on the NZX General Obligations Review published 4 June 2013
Act	Securities Markets Act 1988
Appeal Panel	Appeal Panel of the Tribunal
ASX	Australian Securities Exchange Limited
BaNCs	The core clearing and settlement system operated by NZX
BAU	Business-as-usual
BCP	Business continuity plan
Board	NZX Board
CEO	Chief Executive Officer
Clearing and Settlement Rules	NZX rules governing clearing and settlement with New Zealand Clearing Limited
Clearing House	The central counterparty clearing house operated by New Zealand Clearing Limited
CMS	Client Market Services business team
Conflicts Policy	NZX Conflict Management Policy
CSD	Central Securities Depository
Derivatives Market	New Zealand Derivatives Market authorised under the Futures Exchange Notice
Derivatives Market Conditions	Conditions contained in clause 7(1) of the Futures Exchange Notice
Derivatives Market Rules	NZX rules governing the Derivatives Market
Exchange SRO	A registered exchange that is self-regulating
Expected Action	An action imposed by FMA on NZX that is required to be undertaken
FMA	Financial Markets Authority
Fonterra	Fonterra Co-operative Group Limited
FSM	Fonterra Shareholders' Market
FSM Rules	NZX rules governing the FSM
Futures Exchange Notice	Authorised Futures Exchange (NZX Limited) Notice 2012
General Obligations	General obligations in respect of registered markets set out in section 36Y of the Securities Markets Act 1988
General Obligations Review	A review carried out by FMA pursuant to section 36YB of the Securities Markets Act 1988
HKEx	Hong Kong Exchanges and Clearing Limited
IOSCO	International Organisation of Securities Commissions
Issuer or Listed Issuer	Any company that is or has been listed on any of NZX's markets
IT	Information technology
Listing Rules	NZX rules governing the NZSX, NZDX and NZAX markets



MAP	Market Announcements Platform
Market Announcements Platform	Electronic platform used by NZX to publish market announcements
Market Assessment Report	Report produced by NZX under section 36YA of the Securities Markets Act 1988
Market Participant	A participant in the Registered Markets and/or the Derivatives Market who has been accredited and approved by NZX
Market Rules	Together, the Listing Rules, Participant Rules, Derivatives Market Rules and FSM Rules
Market Services	The Market Services division of NZX comprising Surveillance, CMS, Derivatives Operations, Clearing, Indices and Data
MAS	Monetary Authority of Singapore
NZAX	NZX Alternative Market
NZCDC	New Zealand Clearing and Depository Corporation Limited – a wholly owned NZX subsidiary that operates the clearing and settlement system that has been designated under part 5C of the Reserve Bank of New Zealand Act 1989
NZDX	NZX Debt Market
NZSX	NZX Main Board
NZX	NZX Limited
Participant Rules	NZX rules governing Market Participants
Registered Exchange	A person that holds a market registration under section 36F of the Securities Markets Act 1988
Registered Markets	Registered markets of NZX as defined under the Securities Markets Act 1988, comprising the NZSX, NZDX, NZAX and FSM
Regulation	The regulatory function of NZX, led by the Head of Regulation and comprising three functional areas – Issuer Regulation, Participant Compliance and Enforcement
Related Entity	Any Participant in an NZX Market, or person who applies to NZX to become a Participant, which has a connection or relationship with NZX such that Special Division is satisfied that in the circumstances there would be a reasonable apprehension or suspicion of bias by NZX in relation to that Participant or that person
Review Period	The period commencing on 1 January 2013 and ending 31 December 2013
RGC	Regulatory Governance Committee of the Board
SGX	Singapore Exchange
Special Division	A division of the Tribunal responsible for administering and enforcing the Market Rules in relation to NZX's own listing and Related Entities
SRO	Self-regulatory organisation
Statutory Obligations	The General Obligations and the Derivatives Market Conditions
Tribunal	New Zealand Markets Disciplinary Tribunal
Tribunal Rules	The rules governing the operation of the Tribunal
X-stream	The NASDAQ OMX X-stream trading system

