

Report on the NZX General Obligations Review

29 June 2012




FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

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Structure of this Report

This report is comprised of the following sections:

An **executive summary** of FMA's key findings and the actions we expect NZX to take, together with FMA's other observations and recommendations

Section 1 describing NZX and the obligations imposed upon it during the review period

Section 2 describing how FMA assessed NZX's compliance with its obligations

Section 3 a detailed section setting out FMA's qualified opinion of NZX's compliance with its obligations and the reasons for this opinion

Section 4 identifying a number of other areas across NZX's business where FMA considers improvements could be made to NZX's compliance arrangements and our recommendations for these areas

Section 5 explaining in more detail our specific observations and recommendations in respect of those business units and functions that contribute to the performance of the obligations

Executive Summary

1. This report summarises the Financial Markets Authority ('FMA's') assessment of compliance by NZX Limited ('NZX') with its obligations under:
 - section 36Y of the Securities Markets Act 1988 ('the Act')
 - The Authorised Futures Exchange (NZX Limited) Notice 2010 ('Futures Exchange Notice').
2. The Act requires FMA to assess how well a registered exchange is complying with its obligations, which are designed to ensure that its Registered Markets operate in a fair, orderly and transparent way.
3. This report therefore deals with NZX's operation of its Main Board ('NZSX'), Alternative Market ('NZAX'), and Debt Market ('NZDX') (its 'Registered Markets'). It also deals with NZX's operation of its authorised futures exchange, the Derivatives Market. It does not deal with other markets and activities operated by NZX, as they are not regulated by FMA under the Act.
4. This is the first assessment since amendments introduced by the Securities Markets Amendment Act 2011 came into effect on 1 May 2011 and the Futures Exchange Notice came into force in September 2010.

FMA's assessment

5. FMA's principal objective is to promote and facilitate the development of fair, efficient and transparent financial markets. It does so in an environment that has fundamentally changed in the recent past.
6. Clarity of expectations and vigilant monitoring of the extent to which financial markets are successful are central to FMA's approach. FMA expects that as the impact of new regulatory obligations become clearer for participants, and as FMA develops as an organisation, standards of success will continue to develop.
7. For this first assessment, FMA considered, amongst other things:
 - NZX's own assessment of its compliance with its obligations in its private report to FMA and the Minister of Commerce, the Market Assessment Report dated 29 March 2012
 - information from interviews with NZX staff and members of the NZX Board the New Zealand Markets Disciplinary Tribunal ('Tribunal') and Special Division
 - NZX Board papers relevant to the operation of NZX's registered and authorised markets
 - a review of supporting information and a selection of NZX's procedures, policies, files and logs
 - steps taken by NZX in implementing the recommendations in the Securities Commission Previous Report.

Conclusions, key findings and expected actions

8. FMA has reached a qualified conclusion in relation to NZX's compliance with its statutory obligations.
9. With the exception of three specific areas, FMA has concluded that NZX is compliant with its obligations and has met its statutory requirements. The key findings leading to our qualified conclusion and the expected actions regarding these findings are summarised in Table 1. FMA's expected actions set out in the table are needed to ensure NZX's approach is designed and operated so it can fully comply with its obligations in future.
10. FMA has discussed these actions with NZX and NZX has advised that it is currently implementing changes that will address all of the expected actions by the end of December 2012. FMA welcomes this and on that basis FMA does not require NZX to submit any action plan under the provisions of the Act. NZX's progress will be reported on in FMA's next report.

Other observations and recommendations

11. In addition, the report identifies a number of other observations on how well NZX is complying with its obligations. They identify areas where, although NZX is compliant, improvements could be made.

General observations

12. General observations that are relevant to compliance across NZX's obligations relate to:
 - the NZX Board's monitoring of compliance with the obligations
 - the need for greater management information for, and oversight of Market Supervision
 - handling potential conflicts of interest in specific key areas (review of the Conflict Management Policy, registering interests of supervisory staff, and the basis for variable remuneration)
 - the composition of the Tribunal

Business Unit and Tribunal observations

13. The report also notes additional observations and recommendations to improve arrangements within the individual business units of Market Supervision, on Information Technology resources and on the Tribunal and its Special Division. These are summarised in Table 2, and set out in more detail in Part 5.
14. FMA has discussed these key recommendations with NZX and NZX has agreed to work with FMA to address these recommendations during the course of 2012.

Table 1: FMA’s qualified conclusion on NZX’s compliance with its obligations for the period 1 July 2010 to 31 December 2011

Qualified conclusion	Key findings influencing qualified conclusion	Expected actions
In the Registered Markets and the Derivatives Market:		
<p>NZX had adequate arrangements for operating its Registered Markets and the Derivatives Market, including arrangements:</p> <ul style="list-style-type: none"> a. for monitoring the conduct of exchange participants on or in relation to those markets <p>and, <i>except for elements of the arrangements as explained:</i></p> <ul style="list-style-type: none"> b. 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 c. for enforcing compliance with the relevant Markets Rules. 	<ul style="list-style-type: none"> • Potential conflicts of interest – dilution of the separation of the supervision and commercial activities of NZX as a result of appointing the Corporate Counsel to also act as Head of Market Supervision (HOMS). • Enforcing compliance – absence of documented criteria for consistent decision making, low number of referrals to the Tribunal and slow progress of investigations. 	<ul style="list-style-type: none"> • The NZX Board reviews the arrangements and controls under its Conflicts Management Policy. It should also consider the adequacy of its policy against international best practice for the management of conflicts in demutualised exchanges. The NZX Board should ensure that it can demonstrate that conflicts, or perceptions of conflict, are appropriately managed. Sufficient senior resources should be allocated to the HOMS role. • Policies and processes are put in place to clarify the criteria for determining matters to be investigated, for deciding the outcomes of investigations and for recording the assessments and decisions by people with appropriate delegation. We would expect the criteria to emphasise the role of the Market Rules in conferring investor protections and to provide appropriate guidance to the market. The NZX Board should consider whether it wishes to set or approve the criteria and what summary information it wishes to receive regarding cases that are not investigated or progressed to the Tribunal. • The progress of investigations is more formally tracked on an on-going basis and reviewed by HOMS. Consideration should be given to when information regarding delays should be escalated to the NZX Board, so that the NZX Board can monitor the adequacy of actions and resources.

Qualified conclusion	Key findings influencing qualified conclusion	Expected actions
In the Registered Markets and the Derivatives Market:		
<p>NZX had sufficient resources (including financial, technological and human resources) to operate its Registered Markets and the Derivatives Market properly, <i>except for the human resources allocated to Market Supervision</i></p>	<ul style="list-style-type: none"> An overall reduction in staff numbers and experience in Market Supervision set against a significant workload. 	<ul style="list-style-type: none"> NZX should consider the adequacy of the resources within Market Supervision. The approach to monitoring and planning work load and resources in Market Supervision should be reviewed to ensure there is more visibility of work compared with resources. Forward planning should include a consideration of the profile and likely movement of members of the team, and ensure all options for cover or temporary resources have been explored, including considering offering longer contracts than may be strictly necessary. Our general comments regarding monitoring against plan and management information on Market Supervision are relevant.
<p>NZX had, to the extent that it is reasonably practicable, done all things necessary to ensure that each of its Registered Markets and the Derivatives Market was a fair, orderly, and transparent market, <i>except as noted above.</i></p>	<ul style="list-style-type: none"> See comments above. 	<ul style="list-style-type: none"> See expected actions above
In the Registered Markets:		
<p>NZX had adequate arrangements for ensuring there is a sufficiently independent adjudicative body to adjudicate on contraventions of Market Rules that are referred to it.</p>		

Table 2: Summary of key recommendation areas to improve arrangements within the individual business units and the Tribunal

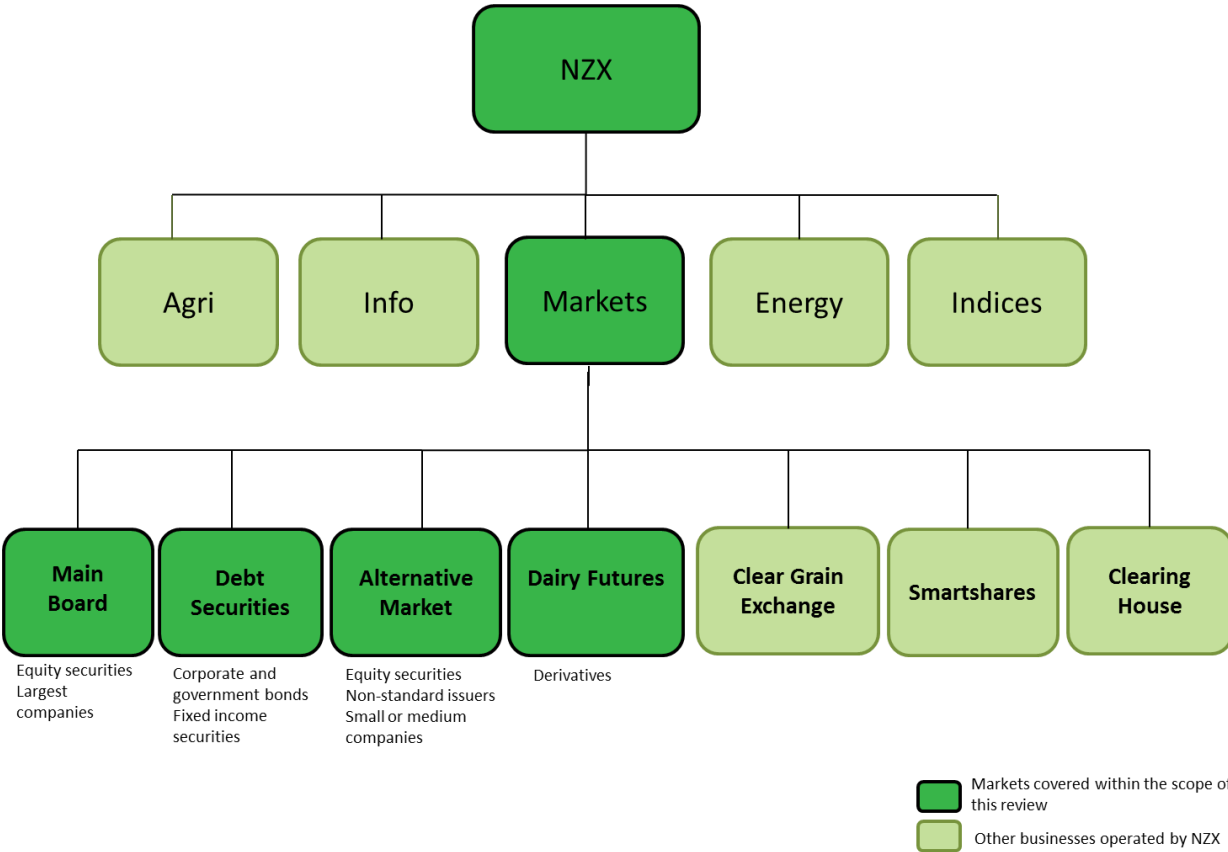
Unit	Summary of key recommendation areas
Market Supervision	
Issuer Regulation	<ul style="list-style-type: none"> • Re-inforcing the role of NZX to look at the merits of waiver applications from an investor perspective and formulating reasons referenced to that • Challenging repeat applicants to put transactions to shareholders, especially related party transactions • The importance of guidance notes for the market • Regular reviews of the Listing Rules
Client and Market Services	<ul style="list-style-type: none"> • Processes around trading halts and identification of price sensitive information • Thorough understanding of trading system functionality
Participant Compliance	<ul style="list-style-type: none"> • Updating of participant risk profiles and use of the risk profiles in the supervisory programme • Review of changes to Participant Rules • Robustness of the on-site inspection programme
Surveillance	<ul style="list-style-type: none"> • Planning and scenario testing prior to introducing new trading types • Processes around the SMARTS alert system and escalation of issues not detected through SMARTS • Training opportunities for Surveillance staff
The Tribunal	
The Tribunal and Special Division	<ul style="list-style-type: none"> • The need for timely and regular communication with the Tribunal on appointments, criteria and timeframes for referrals, and Market Rule changes

Section 1: NZX and its obligations

NZX

1. NZX Limited (“NZX”) is an information, markets and infrastructure company. It operates the New Zealand securities, derivatives and energy markets, builds and maintains the infrastructure on which they operate, and provides a range of information and data products. Information provided by NZX about the market context during the period is included at Appendix 1.
2. Figure 1 highlights the parts of NZX’s business, that are registered or authorised markets under the Securities Markets Act 1988 Act (“Act”) and are included within the scope of this report:

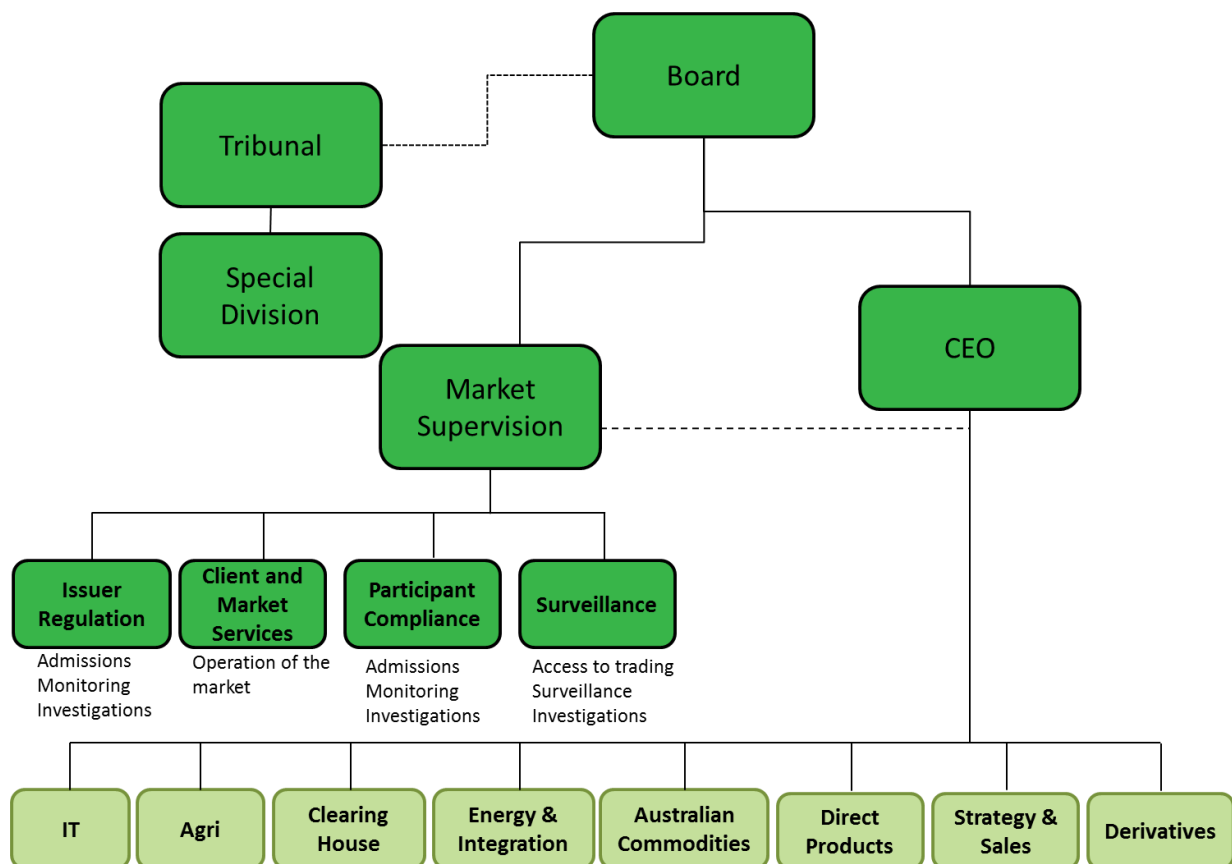
Figure 1: NZX businesses



3. For each market, NZX acts as operator and regulator to:
 - set rules for the markets, such as the Listing, Participant and Derivatives Market Rules
 - govern the admission and market conduct of issuers of equity and debt securities under the Listing Rules, including issuer announcements and reporting
 - govern the admission and market conduct of participants, under the Participant Rules or the Derivatives Market Rules. Monitoring of participants includes inspecting participants, monitoring capital adequacy, client funds requirements and technological compliance

- monitor the market for transactions that potentially breach Market Rules or legislation (for example market manipulation and insider trading)
 - investigate potential breaches of the rules and where it appears a participant has breached the rules, take appropriate action, which may include referral to the New Zealand Markets Disciplinary Tribunal ('Tribunal').
4. Within NZX's organisation structure, the business units in Figure 2 contribute to NZX's role as operator and regulator of the markets. These business units have been part of this report's review.

Figure 2: NZX organisation structure (April 2011)



5. Market Supervision is led by Head of Market Supervision ('HOMS'). HOMS has dual delegation with the Chief Executive Officer ('CEO') from the NZX Board for the operation of Market Supervision. Each unit within Market Supervision is led by a Business Leader.
6. The Tribunal is an independent adjudicative body that considers disciplinary matters in respect of the markets. Special Division is a division of the Tribunal responsible for administering (and enforcing) the Market Rules for NZX's own listing and to its related parties including the Smartshares funds.

Changes during the review period

- 7. This report covers the period from 1 July 2010 to 31 December 2011. During this period there were a number of relevant legislative changes and a new market was launched as summarised in Table 3.

Table 3: Summary of legislative changes during review period

1 July 2010	Period covered by this report begins
10 September 2010	Conditions relating to supervision of the Derivatives Market come into force (in the Authorised Futures Exchange (NZX Limited) Notice 2010 ('Futures Exchange Notice'))
8 October 2010	Launch of NZX's authorised futures exchange, the Derivatives Market
1 May 2011	New obligations on the Main Board ('NZSX'), Alternative Market ('NZAX'), and Debt Market ('NZDX') (together the 'Registered Markets') implemented (section 36Y of the Act)
1 May 2011	Financial Market Authority ('FMA') replaces the Securities Commission, assuming oversight of Registered Markets and the Derivatives Market
31 December 2011	Period covered by this report ends

- 8. This review is the first under the amended Act and the Futures Exchange Notice.

Obligations on NZX during the review period

- 9. At the start of the period, NZX's obligations (as a registered exchange under then section 36G of the Act) were to operate each of its markets in accordance with the NZX Listing Rules and NZX Participant Rules (together the 'Conduct Rules'), securing compliance with the Conduct Rules and performing any obligations on NZX under the Conduct Rules. The Securities Commission's oversight of NZX was conducted under sections 10(b), 10(ca) and 10(caa) of the Securities Act 1978. In assessing NZX's compliance with its supervisory functions under these provisions, it was necessary to consider matters broadly similar to those now found in section 36Y of the Act.
- 10. The revised Act carried obligations similar to those in section 36G and also imposed new obligations on NZX from 1 May 2011:

General obligations in respect of Registered Markets (Section 36Y)

[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.

11. For the Derivatives Market, the Futures Exchange Notice set similar obligations:

Conditions relating to market supervision (Clause 7(1))

[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 interest of the Company and the need for the Company 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
- (c) have sufficient resources (including financial, technological and human resources) to operate the Market properly and for the required supervisory arrangement to be provided.

12. These obligations were amended after the review period by the 2012 Futures Exchange Notice. An obligation was added to have adequate arrangements for ensuring there is a sufficiently independent adjudicative body to adjudicate on contraventions of the Derivatives Market Rules. This brought the overall obligations for the Derivatives Market into line with those for the Registered Markets.

13. NZX is also subject to specific requirements to provide FMA and the Takeovers Panel with information and assistance. Compliance with these obligations is relevant to NZX's arrangements for enforcing compliance.

Obligations on NZX to self-assess

14. The Act introduced a requirement for NZX to produce a Market Assessment 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.

15. 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 [FMA] on how well it has met its obligations under clause 7(1) of this notice in the preceding financial year.

16. Section 36YA(3) of the Act enables FMA and NZX to agree on the period to be covered by the first Market Assessment Report.

17. Although some of the obligations were new during the period, NZX was actively involved in commenting on the changes proposed in the Act. NZX's representatives have confirmed that NZX views the changes in the Act as a clarification and codification of its existing obligations. Because any review undertaken under sections 10(b), 10(ca) and 10 (caa) of the Securities Act 1978 would broadly consider similar matters to those imposed by changes to the Act, it was agreed by NZX and FMA that NZX's report and FMA's assessment, would be made under the Act as amended and would cover the 18 months since the Previous Report, being 1 July 2010 to 31 December 2011, noting that the obligations were not in effect for the entirety of that period. It was also agreed that a single report, would be provided for both the Registered Markets and the Derivatives Market.

18. Although this is NZX's first Market Assessment Report, in preparation for this obligation NZX prepared a self-assessment report for the Securities Commission for the period 1 January 2009 to 30 June 2010. A self-assessment report was also prepared for the period from the launch of the Derivatives Market to 31 December 2010.

NZX's Market Assessment Report

19. NZX provided its Market Assessment Report to FMA on 29 March 2012 in accordance with the requirements. The Market Assessment Report noted:

- it had been produced to satisfy the requirements of both the Act and the Futures Exchange Notice
- it had been prepared "against the requirements of section 36Y, notwithstanding that the requirements of section 36Y apply to only part of the Review Period"
- "as the requirements of section 36Y and condition 6(11) are similar, this report has been prepared in respect of the Derivatives Market on the basis that the requirements are the same".

20. NZX concluded that it had complied with its obligations.

21. The Market Assessment Report noted actions taken by NZX during the review period to further enhance its compliance with the obligations, including:
- the introduction of the NZCDC Settlement System¹, providing improved settlement certainty
 - rules development work, including work leading to consultation on rule changes in March 2012
 - arrangements for the distribution of Fonterra forecast volume information
 - enhanced monitoring activities, including a focus on participants' internal controls for monitoring and detecting improper trading conduct
 - enhanced enforcement activities.
22. The Market Assessment Report noted a number of actions to be taken following the review period, including:
- a review of the Conflict Management Policy
 - a review of the policy and fees for waivers considered 'under urgency' to determine whether there were adequate safeguards to ensure the quality of decision making
 - changes to the process for reporting to the NZX Board in respect of the markets.

¹ The NZCDC Settlement System is not covered by the Act, the Market Assessment Report or this report.

Section 2: FMA's assessment

Obligations on FMA to assess NZX

23. The Act introduced an obligation on FMA to review and report on NZX's performance of its 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 [by NZX] 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).
- (5) The first review of a financial year under subsection (2) may relate to the period covered by the first annual report provided [by NZX] under section 36YA.

FMA must make 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.

24. The Futures Exchange Notice does not include an express obligation on FMA to produce a similar report on NZX's compliance with the Derivatives Market's obligations. However, the obligations for Registered Markets and the Derivatives Market are similar. NZX's operational systems and approach for dealing with compliance with its obligations are generally similar and delivered by

the same teams. Comments about NZX's compliance with the Act obligations will necessarily therefore reflect on NZX's compliance with its Derivatives Market obligations.

25. In addition, FMA is required to monitor compliance with the Act and matters relating to financial markets (section 9 of the Financial Markets Authority Act 2011).
26. FMA's report therefore:
 - addresses NZX's compliance in respect of both its Registered Markets and the Derivatives Market
 - assesses these together holistically rather than separately, except for the obligation to have a sufficiently independent adjudicative body, which did not apply to the Derivatives Market during the review period
 - assesses compliance with the requirements for the review period, in line with the Market Assessment Report (and section 35YB(5)), noting that the Derivatives Market was launched during this period.

This approach was agreed with NZX.

27. In accordance with the Act, this assessment does not include the NZCDC Settlement System, which was introduced in September 2010. 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. Whilst outside the scope of this report FMA notes that the introduction of the NZCDC Settlement System is nevertheless relevant to the compliance by NZX with the obligations, as all trades executed on the Registered Markets and Derivatives Market settle on that system. It represents a significant structural change to the previous arrangements by introducing a central counterparty to all trades executed on NZX's markets, thereby fundamentally changing the trading risk of participants.

Approach to FMA's assessment

28. FMA is a new regulator. Its principal objective is to promote and facilitate the development of fair, efficient and transparent financial markets.
29. We seek to do this in an environment that has fundamentally changed in the recent past. For example:
 - New Zealand's financial market and investors' confidence in it have been significantly affected by the failure of finance companies and the global financial crisis
 - Parliament has legislated change to enhance investor and market confidence and investor participation
 - a new level of professionalism is required by law for a number of new market participants
 - the regulatory approach for those previously regulated has become more structured.
30. As a new regulator, 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 the market with scope to develop the way it meets these expectations. We seek to monitor vigilantly the extent to which the financial markets are successful, recognising that as financial markets mature and change and we develop as an organisation, standards of success will continue to develop.

Methodology

- 31. FMA engaged with NZX during the review period to raise issues and to undertake review work. FMA will seek to enhance this approach and its dialogue with NZX during the next review period.
- 32. Our work included:
 - meeting NZX staff on 20 July 2011 to discuss concerns about human resource levels
 - meetings to discuss the scope of the FMA oversight review of NZX in August 2011 with members of the NZX Board, and separately with NZX staff
 - providing guidance on FMA’s expectations and areas of focus for the Market Assessment Report in a letter on 8 September 2011 as anticipated by section 36YA(2)of the Act. Subsequently, FMA wrote to NZX regarding the Market Assessment Report, provided to the Securities Commission as part of its Previous Report, noting changes expected to the format and content of that report given the new statutory regime
 - carrying out two visits to review files and control logs in late December 2011/January 2012 and late February/March 2012. We provided comments on our initial findings following each review.
- 33. In carrying out its assessment FMA reviewed the following:
 - the NZX Market Assessment Report
 - the NZX assessment report to the Securities Commission for the Derivatives Market for the period to 31 December 2010
 - supporting information to the Market Assessment Report provided in letters, emails and in interviews
 - NZX Board papers relevant to the operation of the markets
 - relevant NZX procedures and internal policies
 - a selection of files and control logs, as set out in Section 5 of this report
 - the steps NZX had taken to implement the Securities Commission recommendations made in the previous reporting period.
- 34. FMA also interviewed NZX staff and members of the NZX Board, Special Division and Tribunal as described in Table 4.

Table 4: List of interviewees

NZX area	Interviewee role during the period
Tribunal	Chairman (since June 2011)
Special Division	Chairman
Board	Chairman Chairman of the Audit and Financial Risk Committee
Senior management	(Former) CEO HOMS Acting HOMS and Corporate Counsel Head of Information Technology

	Head of Corporate Office (in relation to Human Resources)
Issuer Regulation	Business Leader
Client and Market Services	Business Leader
Surveillance	Business Leader Analyst
Participant Compliance	Business Leader

Previous NZX oversight review report

35. The last oversight review of NZX was conducted by the Securities Commission. The Previous Report produced as a result of this review was dated April 2011 and covered the period 1 January 2009 to 30 June 2010. It took into account NZX's self-assessment report. It followed five previous oversight reviews. (The Previous Report is available from FMA's website, see Keep Updated/Reports and papers.)
36. The Previous Report was prepared under section 10 of the Securities Act 1978 requiring the Securities Commission to keep under review practices relating to securities, securities markets and law relating to securities.
37. The Securities Commission reviewed NZX's performance of its obligations under section 36G of the Act (before the 1 May 2011 amendments), requiring NZX to operate its securities markets in accordance with approved Conduct Rules.
38. It noted an overall conclusion that NZX was satisfying its obligations on its then regulatory functions.
39. The Securities Commission made the following recommendations.

General recommendations:

- (a) That NZX ensures that adequate resources are maintained at all times to enable essential supervisory functions, such as on-site inspections, to be carried out despite other competing matters requiring the attention of Market Supervision.
- (b) Because of the risk of potential conflicts of interest that might arise between the commercial and regulatory roles, the dual delegation of supervisory matters to the CEO and HOMS did not conform to international best practice and potentially left the supervision structure open to compromise. The Securities Commission recommended NZX consider removing the dual delegation structure and retaining a single delegation to the HOMS with a direct reporting line to the NZX Board.

Specific recommendations:

- (a) NZX carry out scheduled onsite inspections in accordance with its methodology.
- (b) NZX implement a means of recording actual human and other resources devoted to market supervision in order to increase transparency of resourcing.
- (c) NZX complete its review of any changes to be made to the Participant Rules and its communications as a result of the dispute resolution provisions contained in the Financial Service Provider (Registration and Dispute Resolutions) Act 2008 for consideration during 2011.

40. NZX Board members have confirmed that they discussed the Securities Commission's recommendations. NZX has actioned specific recommendation (a) – implementing its on-site inspection methodology. However, NZX has not actioned the other recommendations. Our comments on this are included with our findings in the later sections of this report. FMA notes that NZX did not engage with FMA concerning its views on those recommendations that NZX determined not to implement.

Section 3: Conclusion, key findings and expected actions

Compliance with the obligations

41. FMA notes there were no serious market failures or disruptions during the period. The Registered Markets and the Derivatives Market appeared to operate in a way that was fair, orderly and transparent.
42. After making the assessments described in Section 2, FMA concluded, that in the period 1 July 2010 to 31 December 2011 in the Registered Markets and the Derivatives Market:
 - NZX had adequate arrangements for operating its Registered Markets, and Derivatives Market including arrangements
 - a. for monitoring the conduct of exchange participants on or in relation to those markets and, except for elements of the arrangements as explained in paragraph 44 below,
 - b. for handling conflicts between the commercial interests of NZX and the need for NZX to ensure that the markets operated in a fair, orderly and transparent way
 - c. for enforcing compliance with the relevant Market Rules.
 - NZX had sufficient resources (including financial, technological and human resources) to operate its Registered Markets and the Derivatives Market properly, except for the human resources allocated to Market Supervision
 - NZX had, to the extent that it was reasonably practicable, done all things necessary to ensure that each of its Registered Markets and the Derivatives Market was a fair, orderly, and transparent market, except as noted above.
43. In addition, FMA concluded that, for the period 1 July 2010 to 31 December 2011 in the Registered Markets NZX had adequate arrangements for ensuring there was a sufficiently independent adjudicative body to adjudicate on contraventions of market rules that were referred to it.
44. NZX's assessment is that it complies with all obligations. FMA's assessment is a qualified one. The key findings influencing this assessment are described in detail below but in summary are:
 - (a) **arrangements for handling potential conflicts of interest** – the arrangements for the Corporate Counsel to also take on the role of acting HOMS from May 2011. These arrangements increased the possibility that supervisory decision making might be unfairly influenced by commercial considerations, and that supervisory work to ensure a fair, orderly and transparent market may not be prioritised. The arrangements appear contrary to NZX's Conflict Management Policy. This policy is not international best practice
 - (b) **arrangements for enforcing compliance** – the arrangements do not appear to include documented criteria for consistent decision making, a number of apparently serious matters have not been referred to the Tribunal and a number of investigations appear to have been underway for some time. This reduces the ability to demonstrate fairness of enforcement action and the number of public messages to the market demonstrating transparency and responsibility.

- (c) **human resources allocated to Market Supervision** – the number of Market Supervision full-time equivalent ('FTE') fell during the period, with a reduction in senior resources allocated and significant staff turnover. This occurred during a period of significant work. Other observations set out in this report indicate that the allocated resources are stretched. This reduces the ability of NZX to ensure a fair, orderly and transparent market.
- (d) **all things necessary have been done** – whilst NZX took some steps in respect of human resources, on this and the other matters, it was reasonably practical for NZX to have taken additional steps to address these matters.

Managing potential conflicts of interest

- 45. The Market Assessment Report recognised the potential for conflict between NZX's commercial interests, with its objective of generating long-term value for shareholders, and its obligations as a market operator to allocate sufficient resources to supervise its markets.
- 46. The Conflict Management Policy approved by the NZX Board, puts in place a structure designed to quarantine supervisory decision-making from the commercial business. The structure separates core supervisory functions into a separate division, Market Supervision. The policy "delegates regulatory strategy and activity jointly to the CEO and HOMS and provides a mechanism to ensure the independence of the HOMS and that no undue commercial pressures are brought to bear on the HOMS or her team".
- 47. The NZX Board safeguards in the policy include a requirement for the HOMS to meet with the NZX Board at each Board meeting without the CEO present, with the intention of excluding commercial influence and providing support to the HOMS if necessary.
- 48. Previous oversight reviews conducted by the Securities Commission noted that the dual delegation embedded an inevitable on-going source of conflict of interest between NZX's commercial and regulatory roles. In its 2008 report the Commission noted the structure was not consistent with the international best practice of formal separation of the commercial and regulatory functions of demutualised exchanges.
- 49. The 2009 oversight review also noted the dual delegation structure did not entirely mitigate the potential for conflict and was not international best practice. It suggested the NZX Board consider delegating supervisory matters to the HOMS alone with a direct reporting line to the NZX Board.
- 50. FMA agrees that NZX's conflict arrangements do not accord with international best practice.
- 51. The quality of NZX's conflict arrangements is increasingly important as the commercial activities of NZX grow and become a greater proportion NZX's overall activities.
- 52. Against that backdrop it is necessary that the arrangements the NZX Board has set out in its policy to manage conflicts are fully complied with.
- 53. During the period, the existing HOMS took parental leave. The NZX Board and CEO appointed the Corporate Counsel to cover the absence performing both the Corporate Counsel and acting HOMS roles. NZX Board members and the CEO commented that this ensured the person in the HOMS role had adequate knowledge of the market and had the advantage that the person had

the confidence of the NZX Board. NZX noted that it had experienced some difficulties with filling the HOMS role with external contractors in the past.

54. It is not clear that the impacts of the dual role on the arrangements under the Conflicts Management Policy were considered or that additional mitigating controls were put in place. Separation of the roles is pivotal given that some of the units reporting to HOMS also undertake both supervisory and commercial work. Within the NZX structure the HOMS is the key independent person.
55. The NZX Board continued to meet the acting HOMS separately from the CEO, and NZX Board members assured FMA that they had actively questioned the acting HOMS regarding the adequacy of resources for the supervisory role.
56. FMA accepts that, as noted in NZX's Conflict Management Policy, NZX's commercial and regulatory objectives are strongly aligned, but also that the perception of conflict can be damaging and must be managed accordingly. FMA has not found evidence that individual file decisions are being influenced by commercial considerations. The influence of competition for resource allocation for NZX's commercial legal work is less clear.
57. Having a joint HOMS and Corporate Counsel reduced the level of quarantine between supervisory and commercial decision making, and the independence of the review of the adequacy of supervisory resources. It reduced the adequacy of the arrangements for handling conflicts of interest. The NZX Board's separate meetings with the acting HOMS does not appear to FMA to be free from the commercial pressures anticipated by the policy, given the acting HOMS' dual role.
58. Because the dual role meant that less than all of the acting HOMS time was dedicated to supervisory activities, this had the effect of reducing the level of senior resource devoted to the supervision role. NZX has noted that there are currently a number of rules projects underway outside the existing regulated markets and the acting HOMS also contributes to these in the Corporate Counsel role.
59. The Market Assessment Report noted that the arrangements would be reviewed during the latter half of 2012 and "as part of that review, [NZX] will be considering the appropriate degree of separation of NZX's commercial from its regulatory functions" .
60. The HOMS resigned during May 2012. NZX has announced that the acting HOMS has assumed the HOMS role (while still also retaining her Corporate Counsel role) with effect from 21 May 2012. As NZX expands and pursues new opportunities, the areas of potential conflict will increase.
61. **FMA expects** the following actions to be taken to address these findings:

The NZX Board reviews the arrangements and controls under its Conflicts Management Policy. It should also consider the adequacy of its policy against international best practice for the management of conflicts in demutualised exchanges. The NZX Board should ensure it can demonstrate conflicts, or perceptions of conflict, are appropriately managed. Sufficient senior resources should be allocated to the HOMS role.

Enforcing compliance

Decisions on investigations

62. The Market Supervision unit prepares an annual report to the Tribunal, which is published with the Tribunal's annual report. The report for the year to 31 December 2011 showed a number of breaches of the Participant, Listing and Derivatives Market Rules. Of these, four cases were referred to the Tribunal (two related to Listing Rule breaches, two related to Participant Rule breaches and none related to the Derivatives Market Rules).
63. Of the matters not referred to the Tribunal, NZX judged 38 breaches of the Listing Rules significant enough to notify to FMA (under sections 36ZD and 36ZL of the Act). In addition, NZX identified 17 other matters that were less significant, or where a determination on referral to the Tribunal had not been made at the end of the review period. These matters not referred included failures by issuers to:
- disclose in a notice of meeting a related party was involved in an asset acquisition
 - meet board composition requirements, including not having the required number of independent directors on the board
 - have a correctly comprised Audit Committee
 - make the required announcement in respect of securities that it had bought back
 - provide all of the information required in its annual report.

Market Supervision did not include the number of Participant Rule breaches it had detected in its report to the Tribunal, but noted that a "number of breaches" had been identified.

64. NZX assured FMA that, in some of these cases, it had taken regulatory action to correct behaviour or information available by liaising with the issuer. For example, that the issuer had worked to appoint additional directors or had made additional announcements to the market. However, such actions were not obvious from the files.
65. FMA accepts that Market Supervision has a number of regulatory tools available to deal with breaches of the rules and referrals to the Tribunal will not be appropriate in many cases. However, the number of cases referred appears low compared with the seriousness of some of the breaches described. The numbers also seem low compared with the number of referrals historically made to the Tribunal. The Tribunal Chairman also commented on this. FMA would expect that even when immediate steps are taken to address breaches, matters may still be subject to referral to the Tribunal.
66. Market Supervision was able to explain generally its criteria for assessment of cases and these appeared reasonable. However, there is no written policy on the matters to be taken into account or records of the assessments made for individual cases. This makes it difficult to determine whether appropriate criteria have been used and consistently applied.
67. The HOMS has formal delegated authority to determine the types of action to be taken (including closing cases without action), but it was not clear from the files whether HOMS had made the decisions. In some cases decisions appeared to have been taken by the Market Supervision Business Leaders.

68. **FMA expects** the following actions to be taken to address these findings:

Policies and processes are put in place, to clarify the criteria for determining matters to be investigated, for deciding the outcomes of investigations and for recording the assessments and decisions by people with appropriate delegation. We would expect the criteria to emphasise the role of the Market Rules in conferring investor protection and to provide appropriate guidance to the market. The NZX Board should consider whether it wishes to set or approve the criteria and what summary information it wishes to receive regarding cases that are not investigated or progressed to the Tribunal.

Progress of investigations

69. The HOMS meets Market Supervision Business Leaders regularly to consider the progress of work and issues arising. It is not clear what information is used to monitor the progress of investigations. Some investigations appear to have taken some months to progress and in some cases it is not clear from the files whether decisions have been made not to progress the cases or if the cases are on-going.
70. We understand that the Tribunal has also experienced some delays in referrals, which have resulted in some operational difficulties. For example, competency, conflict and availability checks were undertaken to convene Tribunal divisions, but the referred matters were delayed, without explanation. In one case, expected to be referred in late 2011, the case had not been served at the end of May 2012.
71. As required, Market Supervision has notified to FMA a number of matters relating to breaches. Some matters potentially involve breaches of legal obligations (for example insider trading and market manipulation). However, a number of these matters involve breaches of Participant or Listing Rules, which FMA does not enforce.
72. **FMA expects** the following actions to be taken to address these findings:

The progress of investigations is more formally tracked on an on-going basis and reviewed by HOMS. Consideration should be given to when information regarding delays should be escalated to the NZX Board, so that the NZX Board can monitor the adequacy of actions and resources.

73. FMA will also work with NZX during the year to improve liaison regarding cases notified to FMA where it appears that NZX and FMA may have overlapping jurisdiction, or might be undertaking investigations on separate matters simultaneously.

Human resources in Market Supervision

74. The overall resource allocated to Market Supervision fell during the review period, with 17.5 FTE staff at the beginning of the period and 15.75 FTE at the close. Five FTE remained actively working in the team for the whole period (a further two remained employed, but were on parental leave for part of the period). All of the Market Supervision solicitors were also involved in commercial legal work. Three of the four Business Leaders were new to their role during the review period (all internal promotions), with the fourth Business Leader partly absent owing to

parental leave. In addition, as described above, the resource allocated to the HOMS role reduced, with the Corporate Counsel covering the role.

75. The adequacy of human resources is not simply about absolute numbers of people but also about the competency and skills of the persons employed. Therefore it is necessary to assess whether the anticipated workload is capable of being discharged by the number of competent and skilled resources available.
76. During the report period, NZX launched the Derivatives Market and the NZCDC Settlement System. It is also undertaking work to launch the trading among farmers market. NZX accepts that both of these activities absorbed significant resources from Market Supervision, although NZX note that its project work load did decrease once the Derivatives Market had been launched and the NZCDC Settlement System was operational. There was a rise in the number of regulatory applications received by NZX during the review period.
77. Interviews indicated that the NZX Board and management have been conscious of the level of staff turnover within Market Supervision. The NZX Board has questioned the HOMS regarding resource and has been clear that supervision work is the priority. Staff retention has been a focus for the HOMS. Management has used the results of exit interviews and compared pay rates in considering and addressing turnover. Temporary staff have been considered. In some areas management has found that replacement is difficult, as there are few candidates in the market with appropriate skill sets. It is evident that this is a focus for NZX.
78. HOMS meets regularly with the Business Leaders to prioritise work and monitor work load. Monitoring is largely by discussion rather than by reference to work logs, plans, or records of the proportion of time devoted to supervisory work. The workload has been managed, for example, by adapting the participant inspection timetable to take account of parental leave.
79. FMA accepts that recruiting appropriate skills can be difficult. However, we are concerned that the level of human resources has fallen, given a number of the observations in our report are likely to have been influenced by resource levels. For example, some investigations appear to have progressed slowly, some 'divisions' of staff debating recommendations to HOMS have comprised two rather than three staff, and there seems to have been a reduced focus on following processes and controls and on record keeping.
80. **FMA expects** the following actions to be taken to address these findings:

NZX should consider the adequacy of the resources within Market Supervision. The approach to monitoring and planning workloads and resources in Market Supervision should be reviewed to ensure there is more visibility of work compared with resources. Forward planning should include a consideration of the profiles and likely movements of members of the team, and ensure all options for cover or temporary resources have been explored, including considering offering longer contracts than may be strictly necessary. Our comments in Section 4 regarding monitoring against plan and management information on Market Supervision are relevant.

Section 4: Other general observations and recommendations

81. In addition to the areas highlighted in Section 3, FMA has identified a number of other areas where although NZX is compliant, improvements could be made to ensure continued compliance.
82. Our observations on arrangements within the individual business units of Market Supervision, on the Tribunal and its Special Division and on Information Technology resources are set out in Section 5 of this report.
83. In addition we have a number of observations relevant to the compliance approach across NZX's obligations. These general observations relate to:
 - NZX Board monitoring of compliance with the obligations
 - management information and oversight of Market Supervision
 - managing potential conflicts of interest.
 - the composition of the Tribunal.

Board monitoring of compliance with the obligations

84. The Market Assessment Report stated "NZX believes that its process for Board Reporting [...] would benefit from some review and in 2012 will refine the process for Board reporting and self-review in light of the [obligations]. ... The aim will be to provide evidence of compliance and self-review in a standard format that will include information on measured performance, relevant trends and measures taken to address trends and events as they arise. This will also provide the basis for reporting to the FMA within the statutory framework..."
85. Members of the NZX Board interviewed are keen to benefit from the views of the new CEO (who commenced in May 2012) in improving reporting to the NZX Board against the obligations and the process for preparing the Market Assessment Report.
86. We agree NZX should carry out a review of its NZX Board reporting, which should take into account our comments below.

Scope of information

87. The NZX Board monitors NZX's performance through written reports and discussions with senior management. In April 2011, a new report, the Quarterly Regulated Markets and Regulated Infrastructure Report was introduced. The NZX Board Chairman and CEO led the development of the report. It contains a section clearly setting out key operational statistics for Market Supervision's work. Information for the report is compiled by HOMS.
88. **We recommend** that further information be included in the written reports, to demonstrate that the NZX Board monitors key risks across the full scope of the obligations and the key controls operated by Market Supervision. For example, information on applications for listing, participant inspections, complaints and investigations (including progress and matters not referred to the

Tribunal). The information would benefit from more commentary on trends and issues, so that the NZX Board are informed but meeting time can concentrate on significant areas, as desired.

89. The HOMS should be a key stakeholder and adviser in this process. The requirements for reporting to the NZX Board set out in the NZX Board Regulatory Charter should be taken into account.
90. NZX has recognised the opportunity for a clear link between NZX Board information and the preparation of future market assessment reports. The Market Assessment Report under the new requirements did not comment on a number of areas where work has been undertaken that contributes towards meeting the obligations. **We recommend** that the scope of the next market assessment report be broadened, including to reflect the matters highlighted in our comments on NZX Board information.

Monitoring against plan

91. In discussions with FMA, the NZX Board Chairman and the Audit and Financial Risk Committee Chairman recognised that NZX Board reporting would benefit from more planning of key activities. For example, the plan could include proactive participant monitoring activities. It could also include the expected level of reactive activities in line with resource planning. Monitoring against plan would then provide a more objective measure of the adequacy of resources.
92. **FMA agrees that** more planning should be undertaken to allow progress and resources to be monitored.

Monitoring of financial resources

93. NZX monitors the financial resources for the company as a whole. It monitors financial performance by considering actual results against forecast for the company as a whole. It does not allocate budgets for business units, but operates a business case approach to the control of expenditure. However, since the company's operations are wider than the Registered Markets and the Derivatives Market, it is difficult for the NZX Board to monitor the level of financial resources allocated to the regulated activities and whether these are sufficient. In interviews, NZX Board members and the CEO assured FMA that the financial resources of NZX are available to ensure obligations are met and that, in monitoring overall financial performance, no pressure is brought to bear on Market Supervision to manage its costs down or to achieve a target for the income its activities contribute (such as fees for waivers).
94. **We recommend** that further consideration be given to how the sufficiency of financial resources for the obligations can be more formally monitored. This might include specific forecasting or planning. We understand the desire for such monitoring to be simple and reflect operating reality, preferably without complicated cost allocation if possible.

Management information and oversight of Market Supervision

95. At 31 December 2011, the Market Supervision unit included 15.75 FTE across four business units, including the NZX Solicitors. Market Supervision uses a number of logs to record items requiring action, such as logs of breaches, complaints received and applications made, which are available

to HOMS. HOMS monitors the activities of the units through a number of planned and ad-hoc meetings, including weekly meetings with Business Leaders. HOMS meets weekly with the CEO.

96. We recognise that the units are small and monitoring will often therefore be informal. However, **we recommend** that regular management information be produced. This will facilitate the monitoring of risks and activities, the allocation of resources and the identification of trends across the full scope of the obligations. The information could include for example: the time elapsed since receipt of trigger information for investigations; the progress of participant inspections compared with plan; trends from inspections; waiver requests considered under urgency and trends in waiver topics, applicants or advisers; and key decisions made by HOMS. Information should specifically consider the progress of matters without external deadlines, as well as monitor service levels to market participants.
97. The management information might not be collated into a formal report, but should be considered in discussions (between HOMS and Business Leaders and between the CEO and HOMS). It could build on existing logs. The production of management information in Market Supervision should, however, identify matters for further attention by the unit or HOMS, facilitate reporting to the CEO and assist with the identification of matters for inclusion in reports to the NZX Board. Evidence of the oversight should be retained, to demonstrate how the obligations are fulfilled.

Delegations

98. HOMS holds a delegation to take all operational decisions relevant to the supervisory area, for example, approvals of documents, waiver and rulings determinations and listing and delisting applications.
99. NZX has assured FMA that delegations have been exercised by the delegation holders, via the involvement of the necessary senior staff on files. However, this was not always apparent in the files reviewed by FMA.
100. **We recommend** that the exercise of delegations by the delegation holders be recorded to demonstrate appropriate oversight of activities in accordance with the NZX Board's requirements.

Managing potential conflicts of interest

Policy review

101. FMA notes that the Conflict Management Policy has not been subject to annual review, as the policy requires. The Market Assessment Report noted “The currency of the policy is a ‘front of mind’ matter for [the HOMS] and absent any need for change, maintenance of the status quo is not put to the NZX Board for endorsement. This element of the policy will be reviewed and is likely to be restated as an obligation to ensure that the policy remains current and appropriate and confirm the same or otherwise to the NZX Board no less than annually.”
102. **We recommend** that an annual review be carried out in accordance with the Conflict Management Policy. The policy sets the framework within which the NZX Board requires management to operate. Whilst management should undertake a review and recommend any changes necessary, the review should also allow the NZX Board to reconsider the policy and ensure that it remains appropriate. The review should provide information on compliance with the policy.

Market Supervision register of staff interests

103. The Conflict Management Policy requires Market Supervision staff to declare potential conflicts in a conflicts register. We understand the policy was discussed at a team meeting during 2011 and some training occurred. However, NZX was unable to locate the register or any signed returns dated after 2008. (Market Supervision staff must also notify NZX under the Share Trading Policy before trading.) NZX has moved quickly to obtain new declarations and has assured FMA that an improved process has been put in place. This should include consideration of the register when determining divisions to consider and make recommendations on matters such as waivers.

Variable remuneration

104. The staff bonus scheme for a regulated market should balance financial performance with the need to achieve the statutory obligations, so that fair, orderly and transparent markets are maintained. NZX operates a bonus scheme for management and staff. In the case of management 50% of the bonus is dependent on NZX’s performance and 50% on individual performance. In the case of staff 70% of the bonus is dependent on individual performance and 30% of the bonus is dependent on NZX’s performance.
105. We understand the criteria for achieving the bonus are deliberately not fixed, given the nature of NZX’s business and the need for individual flexibility. This allows NZX to react to market developments, issues and opportunities. The criteria for the element dependent on NZX performance, and whether they are attained, are determined by the judgement of the NZX Board and CEO. The CEO has assured FMA that the bonus scheme includes elements relating to satisfactory operational performance.
106. The bonus for HOMS is also determined by the NZX Board and the CEO. However, NZX were unable to provide FMA criteria or key performance indicators for the performance of HOMS for

the review period. The NZX Board Chairman has confirmed he is involved in performance discussions for HOMS.

107. We **recommend** that it be formally made clear to all staff that the achievement of the NZX performance element of the bonus is dependent on matters beyond financial performance, including matters relevant to the obligations. **We recommend** that there be a more formal record of the expectations of the HOMS.

Composition of the Tribunal

108. From October 2010 NZX operated its Derivatives Market. Any disciplinary cases for this market are heard by the Tribunal. The Tribunal Rules dated August 2010 require that the Tribunal have one Derivatives Market appointee, to ensure that the Tribunal has sufficient experience to consider relevant rule infringements. The Tribunal did not have a Derivatives Market appointee during the period. Had a case concerning the Derivatives Market participant been referred to it a division would have had to be convened without the specialist member, relying on the more general expertise of other Tribunal members, or on the Tribunal seeking external advice.
109. We note that the statutory obligation on NZX to ensure there is a sufficiently independent adjudicative body to consider contraventions of the Derivatives Markets Rules was not introduced until after the review period (by the 2012 Futures Exchanges Notice). We understand NZX has now appointed a Derivatives Market appointee. It has also appointed a Clearing appointee and new members to replace those members whose terms expire in 2012.

Section 5: NZX business unit and Tribunal observations

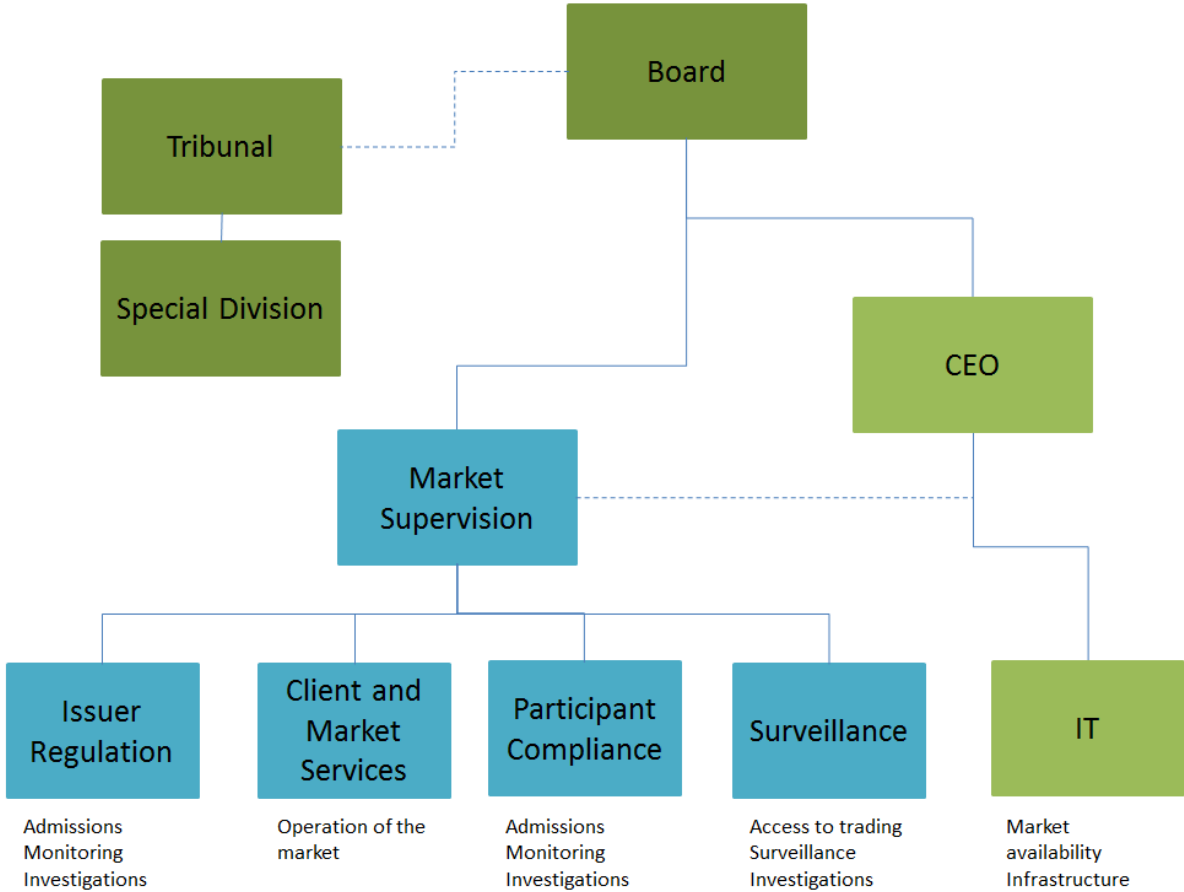
110. This section explains in more detail FMA's specific observations and recommendations about the NZX Market Supervision business units, Information Technology and the Tribunal and its Special Division.
111. The points set out in this section are more narrowly focused on the relevant business unit than our comments elsewhere in this Report. Where possible, we have not repeated matters dealt with in the general observations and recommendations in the front sections of this Report.

Introduction: NZX business unit and Tribunal observations

112. This section of the report contains FMA’s specific observations and recommendations for:

- each business unit within Market Supervision
 - Issuer Regulation
 - Client and Market Services
 - Participant Compliance
 - Surveillance
- Information Technology
- the Tribunal and Special Division

Figure 3: NZX areas addressed in this section



Issuer Regulation

Role of unit

113. The Issuer Regulation unit is staffed by lawyers (called NZX Solicitors), who act as the legal resource for Market Supervision and carry out work for NZX's commercial business units.
114. The key responsibility of Issuer Regulation is monitoring and promoting compliance of issuers with the Listing Rules. This includes:
- ensuring that the Listing Rules remain fit for purpose
 - considering applications for listing
 - approving various documents under the Listing Rules, for example notices of meetings
 - considering waiver applications made by issuers
 - reviewing offer documents produced by issuers
 - monitoring issuers conduct in the market
 - providing guidance to the market about obligations under the Listing Rules
 - inquiries and investigations into breaches and complaints and assessments of the actions necessary
 - preparing of Statements of Case for referrals to the Tribunal.
115. A proper discharge of the waiver function ensures that the integrity of the Listing Rules is maintained, whilst permitting sufficient flexibility for issuers to conduct their business without undue restrictions being imposed. This contributes to the orderly function of the market.
116. All applications for waivers and rulings are initially reviewed by the Issuer Regulation Business Leader. This allows the Business Leader to inform HOMS immediately of any significant or potentially problematic issues. Each application is then assigned to a division of three NZX Solicitors for assessment and determination. The Business Leader determines the seniority of the NZX Solicitors comprising the division based on the complexity of the application. In matters of significant complexity the Business Leader will form part of the division.
117. The Listing Rules allow NZX a maximum of 10 business days to consider a waiver or ruling application. An issuer may ask to have an application considered in a shorter period (referred to as consideration 'under urgency').
118. Some matters, for example, listing applications are considered by a single NZX Solicitor, but with the specialised input of NZX's Listing Sub-Committee, all three members to the Listing Sub-Committee has considerable capital markets experience. Other applications, for example, capital raisings are considered by an NZX Solicitor acting alone.
119. Issuer Regulation works very closely with both Client and Market Services ('CMS') and Surveillance, particularly in relation to trading halts and continuous disclosure inquiries, where there is a significant overlap between the roles of the units.

120. For day to day operational activities, the Issuer Regulation unit uses a Solicitor's Handbook. This documents the policies, procedures and checklists for operational supervision of the Listing Rules and also contains the Conflict Management Policy and Complaints Policy.

Assessment process

Documentation reviewed

121. FMA carried out an on-site review of a selection of NZX operational files, including:

- issuer complaints files
- files relating to applications for:
 - waivers from the Listing Rules
 - rulings on the application of Listing Rules
 - notices of meetings
 - approval of listing on the Registered Markets
 - approval of appraisal reports
 - continuous disclosure inquiry files

122. NZX's logs were also reviewed including:

- issuer breaches logs
- trading halt logs

123. In addition FMA reviewed:

- Solicitor's Handbook (last updated May 2011)
- NZX internal checklists
- NZX Board papers, including reports from HOMS and the quarterly Markets and Infrastructure Board reports.

124. FMA also considered the notifications made to it by NZX, relating to significant contraventions of its Market Rules, the Act or the Takeovers Code or enforcement actions for breaches of the Market Rules and other referrals which assist FMA in discharging its functions (under sections 36ZD and section 36ZL of the Act and the Futures Exchange Notice).

On-site visit

125. FMA interviewed the Issuer Regulation Business Leader. We focused on understanding:

- the management by Issuer Regulation of the key risks to NZX's general obligations
- the availability of resources in Issuer Regulation
- general work flow processes

- the interaction with other units with supervisory functions
- Issuer Regulation’s role in investigation and enforcement, including escalations to the Tribunal.

Observations and recommendations

General

126. The Business Leader demonstrated an understanding of the Issuer Regulation unit’s role in ensuring that the markets operated by NZX were fair, orderly and transparent.
127. FMA notes that, for the most part, the Issuer Regulation unit’s operational activities are performed to a good standard and consistently with NZX’s published processes and policies. Given the vast majority of this unit’s work is transparent to the market via the publication of its waiver and ruling decisions, this Unit is subject to public scrutiny, and the corresponding discipline that this brings.
128. Notwithstanding our specific comments below, FMA does not take issue with the overwhelming majority of work conducted by the unit on the files it reviewed. On the contrary, FMA considers that on some files NZX’s performance was to a very high standard.

Compliance with obligations

Urgency

129. NZX operates a variable fee schedule for the consideration of waivers and rulings under urgency. Fees range from \$862.50 per hour for two days’ urgency to \$632.50 per hour for three to five days’ urgency and \$460.00 per hour for six to ten days’ urgency. NZX advised that it introduced these variable fees to dissuade issuers from seeking urgency, unless necessary.
130. Of the 141 waiver applications reviewed during the six months to 31 December 2011, 55% were considered under urgency:

	Number	Percentage
0-2 days’ urgency	38	27%
3-5 days’ urgency	37	26%
6-10 days’ urgency	3	2%
Not urgent	63	45%
Total	141	100%

131. NZX has not analysed information on the use of urgency.

132. FMA is concerned that the variable fee schedule has ceased to become a means to dissuade issuers from seeking urgent waivers and has instead become an escape valve for issuers that have not been sufficiently engaged to submit their applications in a timely manner.
133. FMA's review of a selection of NZX's files did not find evidence that NZX was challenging issuers seeking urgency, even for planned events such as approval of notices of meeting or non-urgent capital raisings. In discussions, HOMS indicated that she is now actively encouraging NZX Solicitors to question the need for urgency. We support this initiative.
134. Urgency increases the risks that an NZX decision will not be fully considered, particularly where the team is handling multiple urgent applications. Often NZX is asked to consider very complex transactions in a short space of time. In FMA's view, issuers should be fully aware of their obligations to comply with the Listing Rules and urgency should only be sought, and permitted, in exceptional circumstances.
135. **We recommend** that NZX expand on work already commenced and revisit its policy on urgency, including its fees. We recommend that Issuer Regulation track the use of urgency and any trends in its use (for example by particular issuers and advisers).

Consideration of waiver requests

136. The Listing Rules constitute a contract between NZX and each issuer for the benefit of holders of that issuer's securities, and the Contract (Privity) Act 1982 applies. In considering any waiver application NZX should 'stand in the shoes' of the investor and consider the effects of any waiver decision.
137. During the review period NZX considered applications for waivers from the requirement to obtain shareholder approval for transactions involving parties with complex ownership arrangements.
138. From FMA's review of files relating to some of these applications where an issuer had made a number of applications over time from the same or similar Listing Rules, it was not apparent that NZX had considered the compliance history of the issuer or the cumulative impact of the waivers on investors over time.
139. In some cases it was also not clear from the file reviews whether NZX had considered whether having the matters put to meetings of shareholders was a viable alternative to granting waiver requests. Given that any waiver granted by NZX affects a shareholder's rights, and that the Listing Rules are for the benefit of investors, FMA considers that this alternative should be actively considered by NZX. This is particularly so in respect of those Listing Rules conferring key investor protections, such as rules concerning the dilution of interests and related party transactions.
140. In protecting the fairness of the market, NZX needs to have the interests of security holders 'front of mind'. Where multiple applications are made by an issuer for waivers of the same rule, and where waivers from rules conferring key investor protections, e.g. related party transaction rules, are sought, FMA **recommends** that NZX challenge why the issuer cannot put the transaction to its shareholders. FMA also considers it would be good practice for NZX to consider any patterns of waivers being sought by an issuer in its consideration of any given waiver application.

141. NZX does endeavour to use the same NZX Solicitors on divisions for related applications, so that divisions have the relevant background or history, but this is not always possible. This could mean that the division considering a matter is less familiar with the broader context of a particular transaction.

142. FMA **recommends** that, when convening a division, NZX endeavour to have at least one member who is or has been on other divisions considering applications from that issuer or parties related to that issuer or transaction.

Delegation

143. HOMS holds a delegation to take all operational decisions relevant to the supervisory area, for example, the approval of documents, waiver and rulings determinations and listing or delisting applications. HOMS involvement was not always apparent from the files reviewed by FMA. Our comments on the documentation of delegations are set out in Section 3.

Work processes

144. While the Business Leader meets with HOMS weekly, and in addition on an ad-hoc basis to discuss specific work, there is no formal management information prepared for those meetings.

145. Our observations and recommendations regarding management information and the oversight of Market Supervision are set out in paragraphs 95 to 97 of Section 4.

Education of and communication with the market

146. During the review period NZX issued only one update to a guidance note. These publications are tools to promote compliance.

147. FMA observes that NZX has now commenced consultation on two guidance notes and encourages this practice.

Review of the Listing Rules

148. Appropriate Listing Rules are key to the operation of a fair, orderly and transparent market. NZX's published policy on updating the Listing Rules, dated 12 April 2005, states that NZX will facilitate two consultation rounds each year on new rules or changes to existing rules. While matters in respect of any of the rules may be considered in either round, for the most part the policy expects to focus on changes to the Listing Rules in the first round and changes to Participant Rules in the second. The consultation rounds begin in March and August respectively each year.

149. Whilst the Listing Rules were updated in August 2010 to accommodate the launch of the NZCDC Clearing House, there was no other update of the Listing Rules during the 18 month review period.

150. To facilitate rule updates, Issuer Regulation maintains an on-going list of issues arising with the Listing Rules. This list is added to by the CEO, HOMS and NZX Solicitors on an on-going basis. NZX consults industry regarding the need for change. It has regular meetings with the Listed Companies Association and engagement with issuer advisers. However, NZX does not appear to have equivalent regularly scheduled engagements with investor representatives. Whilst NZX appears to be aware of developments occurring in Australia with respect to the ASX Listing Rules, it does not undertake any periodic reviews of international developments in rules generally.
151. **We recommend** that NZX re-commence, in accordance with its policy, regular scheduled reviews of the Listing Rules. In considering whether rule changes are necessary to maintain a fair, orderly and transparent market, NZX should actively seek the views of investors and should weigh these carefully against industry views. NZX should also consider overseas developments.

Enforcing compliance

Referrals to the Tribunal

152. Issuer Regulation has responsibilities for monitoring compliance. Where there are reasons to suspect non-compliance, Issuer Regulation investigates and files disciplinary proceedings with the Tribunal, if necessary. Issuer Regulation also considers, and responds to, complaints from members of the public, which may also reveal breaches of the Listing Rules.
153. Our observations and recommendations on enforcing compliance are set out in paragraphs 62 to 73 of Section 3.

Human resources

154. Issuer Regulation had 4.0 FTE solicitors at the start of the third quarter of 2011, excluding the HOMS. This was a reduction of 38% from the 6.5 solicitor FTEs during the last quarter of 2010 and first quarter of 2011. Four solicitors resigned from Issuer Regulation during the review period.
155. The Business Leader, internally promoted to the role in the second quarter of 2011, is part time. Her hours increased from 0.5 FTE to 0.75 FTE on her appointment.
156. Issuer Regulation's solicitors are shared across NZX's supervisory activities and its commercial business units.
157. In addition, during the second quarter of 2011, NZX was operating with its acting HOMS having the dual role of Corporate Counsel. This combination of roles had not occurred since NZX's listing in 2003, when NZX formally segregated the roles of Corporate Counsel and HOMS. Because of this dual role not all of HOMS time was spent on supervision, further lowering the level of resources available to this business unit.
158. Our observations and recommendations relating to human resources in Market Supervision are set out in paragraphs 74 to 80 of Section 3.

Client and Market Services

Role of unit

159. The primary role of CMS is to ensure that announcements from listed issuers are released to the market in a timely fashion through the Market Announcement Platform ('MAP'). An average trading day will see around 50 announcements released via MAP. At the end of every quarter, i.e. when half and full year financial reporting falls due, this number will increase considerably.

160. The unit is also central to the operation of the market itself. Amongst other things:

- it is responsible for inputting the necessary data into NZX's systems which alters the session states of the market (for example, trading halts) and the trade basis of securities (for example, 'ex' or 'cum' benefits and the details of the benefit itself (for example dividend price or yield price)).
- it administers on-market offers of significant orders placed with trading participants (i.e. stands in the market).

161. CMS supports Issuer Regulation by:

- checking issuer's periodic reporting and corporate action filings (in the form of Appendix 7 filings) for compliance with the Listing Rules
- reviewing corporate actions against previous actions for compliance
- contacting issuers to ensure they are aware of their regular reporting deadlines, and to provide feedback where errors have occurred
- updating Issuer Regulation on unusual market announcements.

162. CMS acts as an information conduit between the issuers and the wider Market Supervision group. CMS also has significant interaction with brokers.

163. As such there is considerable interaction between CMS and Surveillance and the smooth flow of information between these two units is important for the operation of fair, orderly and transparent markets.

164. CMS plays a part in deciding what information is passed to either Issuer Regulation or Surveillance. CMS updates Surveillance concerning announcements and other potentially market sensitive information from listed issuers and any trading halts. CMS must exercise judgement in deciding which pieces of information or events in the marketplace should be brought to the attention of NZX staff in other units.

165. FMA regards CMS as critical to the functioning of NZX as a whole. FMA notes that CMS has been staffed by new graduates or inexperienced staff. For that reason FMA regards the quality of managerial oversight as very important.

Assessment

Documentation reviewed

166. We reviewed the following CMS documents:

- Process Manual
- major incident/error checklists
- error reports
- annual reporting logs.

On-site visit

167. We interviewed the CMS Business Leader. We focussed on understanding:

- the key risks to NZX's general obligations
- the availability of resources
- general work flow processes, including appropriate escalation procedures
- the interaction with other units with supervisory functions
- CMS's role in investigation and enforcement.

Observations and recommendations

General

168. The Business Leader, who assumed the role in the second quarter of 2011, demonstrated an understanding of the key risks that CMS faced in ensuring that the markets were fair, orderly and transparent.

Compliance with obligations

Trading halts

169. During the review period, there was an issue involving the inadvertent removal of the halt in trading in Pike River Coal Limited ('PRC') securities. PRC was placed in halt on 22 November 2010 because of the mine disaster.

170. On 2 December 2010, NZX suspended trading in all of its markets for two minutes to join in the nationwide two minutes' silence at the beginning of the remembrance service for the 29 miners killed. When the market suspension was lifted, the trading halt that had been applied to PRC prior to that market suspension was also lifted. The volume and spread of orders in the order book meant that the value of PRC immediately fell from 88 cents to 20 cents, with the securities losing over 75% of their value very rapidly. NZX reversed all the trades with the effect that the share price was reinstated to 88 cents.

171. This issue was exacerbated when, later that same afternoon, NZX attempted a live fix of the problem that had caused the original halt to be lifted that morning. This 'fix' caused PRC to again, inadvertently, be taken out of halt.
172. NZX, as a market operator, should be familiar with how to suspend and lift the suspension of the entire market, without affecting halts that might be unrelated to the overall market suspension. It should have documented processes and controls to do this. Market suspensions may be required to be effected for a variety of reasons to ensure the proper operation of fair, orderly and transparent markets.
173. Whilst this particular suspension was not necessary for the operation of fair, orderly and transparent markets, it became apparent that NZX, at that time, was not readily able to undertake this action.
174. A full review was instituted by NZX, which led to new procedures being introduced. More process checklists have been introduced, including an escalation framework for significant market issues.
175. **FMA recommends** that NZX consider what functionality in the trading engine NZX may require to fulfil its statutory obligations and ensure that it is able to use this functionality competently and efficiently. This assessment is especially important as NZX plans to introduce a new trading system in the fourth quarter of 2012.
176. This situation also demonstrated that NZX was not fully familiar with the effects that a fix effected into the live trading environment would have. NZX should ensure that it has fully tested a fix or a change to operational procedures in a test environment prior to implementing that fix or those procedures in the live trading environment.

Errors

177. CMS maintains logs that are reviewed on a regular basis. Errors (whether made by the issuer or NZX) are recorded from detection to resolution. The Business Leader and HOMS identified that error rates in CMS had been a significant issue earlier in the review period, with errors in the weekly diary, announcements released under incorrect codes, coupon rates being data entered incorrectly into systems and other operational errors being at unacceptably high levels.
178. FMA notes that NZX identified this issue and in response significantly improved processes, and rationalised systems. These enhancements have markedly reduced data entry by the unit, which has served to reduce this error rate. The improvements made to the error rates are encouraging. NZX should continue to focus on maintaining the lowered error rate.

Identification of price sensitive information

179. CMS staff have an important role in ensuring orderly trading in securities through the release of market announcements. In particular CMS vets announcements for price sensitive information and will routinely halt trading to ensure that the market can consider price sensitive information before trading recommences. The CMS Process Manual identifies some (but not all) announcement types that may be price sensitive (for example full- and half-year preliminary announcements, or debt issuer decides not to pay interest). NZX has advised that in addition to the manual, CMS staff use internal documents to determine whether a halt is required. NZX has

also advised that the manual will be supplemented with further detail on potential price sensitive announcements.

180. The manual cannot, and is not expected to, comprehensively list all price sensitive information. This limitation makes the proper identification of price sensitive information an area where NZX should continue to exercise vigilance. The appropriate training in and management of, this area is of particular importance in this respect.
181. FMA did not identify any issues with the identification of price sensitive information. However, given the potentially significant consequences of a failure to correctly identify price sensitive information correctly, **FMA recommends** that NZX keep under review its policies and procedures and training opportunities to ensure that staff are correctly identifying potentially price sensitive information.

Human resources

182. As noted above, the Business Leader started her role at the end of April 2011. Both junior staff members of the CMS unit commenced in the review period, starting in April and August 2011 respectively. In effect, all of the personnel in the CMA unit turned over during the review period. FMA observes that as one staff member transitioned to another role in the broader Market Supervision team, his expertise remained available to the CMS unit.
183. **FMA recommends** that the retention of staff in this unit in the next year be considered a priority given the high level of turnover during the review period and the important front-line function they perform.

Participant Compliance

Role of unit

184. The principal function of the Participant Compliance unit is to supervise market participants and derivative participants for compliance with the Participant Rules and Derivatives Market Rules.
185. Under an agreement for services with New Zealand Clearing and Depository Corporation Limited, NZX provides the regulatory oversight services necessary to regulate the conduct of Clearing Participants, Lending Clearing Participants and Depository Participants (as defined in the Clearing and Settlement Rules and Depository Operating Rules), including:
- assisting with participant applications and reviews,
 - conducting on-going and periodic review of compliance with conduct related to the Clearing and Settlement Rules and Depository Operating Rules,
 - investigating potential rule breaches
 - reviewing and processing of waivers and rulings under the Clearing and Settlement Rules and Depository Operating Rules ('Regulatory Oversight Services').

These Regulatory Oversight Services are performed primarily by Participant Compliance. This work, undertaken since September 2010, necessarily reduces the time available for staff to undertake supervisory tasks in respect of the obligations under the Act.

186. Market participants and derivative participants were required to follow a new capital adequacy reporting regime with effect from September 2010, which included monthly reporting. Participant Compliance reviews the monthly returns based on a monthly returns checklist. The unit member who handles the financial aspects of participants' compliance is principally responsible for these reviews.
187. Regulatory supervision of relevant participant obligations is based on a risk-based model that includes:
- desk-based daily monitoring of client funds' reporting
 - desk-based monthly monitoring of participants' capital adequacy position reporting
 - scheduled on-site inspections to assess whether or not participant are, and have been, meeting all applicable obligations under the rules
 - targeted 'spot' on-site inspections
 - investigation of potential breaches of the Participant Rules and Derivatives Market Rules (solicitors in Issuer Regulation also assist in such investigations)
 - referrals of serious breaches of the Participant Rules and Derivatives Market Rules to the Tribunal.
188. This unit is also responsible for accreditation of all participant types under the Participant and Derivatives Market Rules. Where necessary, it is also involved in policy work.
189. Participant Compliance is staffed by accountants and compliance professionals. This reflects the focus of the unit on the monitoring of client funds, capital adequacy reporting and on the

evaluation of compliance with other participant obligations (through discussions and on-site reviews).

190. This unit also engages in outreach programmes to assist participants in their understanding of, and compliance with, applicable rules. During the period it published the Compliance Update. It also produced an 'Orientation Guide to NZX Derivatives Market Participants' to assist participants when the Derivatives Market was launched.

Assessment process

Documentation reviewed

191. We reviewed the Participant Compliance Handbook which contains detailed procedures for dealing with issues on a day-to-day basis.

192. During the review period, 18 on-site inspections were conducted by NZX. FMA selected seven on-site inspection reports and their associated files for review.

193. The unit also maintains a compliance log of:

- applications for waivers and rulings
- complaints
- guarantees and subordinated debts
- written permissions (for example. prescribed person trading through another trading participant)
- rule breaches
- monthly reporting spread sheet
- client funds' account overdraws.

194. Of these, FMA reviewed the applications for waivers and rulings, the complaints log and the breaches log.

On-site visit

195. We interviewed the Business Leader of Participant Compliance, covering the following topics:

- the key risks to NZX's general obligations
- the availability of resources
- general work flow processes
- reporting, including appropriate escalation procedures to HOMS
- investigation and enforcement.

Observations and recommendations

General

196. The Business Leader, who was on parental leave from August 2011, demonstrated an understanding of the unit's role in ensuring that the markets operated by NZX were fair, orderly and transparent.
197. The Participant Compliance unit did not accredit any new market participant during the review period. It accredited two Derivatives Market participants.
198. During the review period, 11 (nine in period to June 2011 and two thereafter) complaints were received by the Participant Compliance unit. The unit also considered a number of waivers and rulings. FMA did not see any work on trend analysis of waivers that had been granted or declined that would allow Market Supervision to decide whether any guidance or rule amendments were necessary.
199. No targeted 'spot' on-site inspections were conducted during the review period. (This tool would generally have been used if NZX had had significant concerns about a participant's compliance.)
200. The Business Leader met weekly with HOMS. At these meetings verbal updates were provided on current workload and issues that had surfaced. Policy issues, such as the need for amendments to the Participant Rules or for guidance notes/practice notes, were not regular agenda items, but were discussed on an "as required" basis.

Compliance with obligations

Updating of risk profiles

201. Prior to the review period NZX modified its risk based approach to monitoring participants. It redeveloped its process for scheduling and conducting onsite inspections and completed redesigned risk profiling of all of its participants. Scheduled on-site inspections were recommenced in October 2010 in accordance with this redeveloped process, after a hiatus of more than 12 months.
202. One of the reasons advanced by NZX for the hiatus in scheduled participant inspections during the Securities Commission's oversight review was the desire to complete redesigned risk profiling, with its consequent effects on the staging and scope of inspections. During this review we were advised that participants' risk profiles could be updated more frequently than is currently the case to reflect changes to participant risk profiles more accurately. If these risk profiles are intended to influence on-going supervisory choices, it is important that they remain current.
203. **FMA recommends** that NZX consider how it can best maintain the currency of its participant risk profiles.

Risk profiles and on-site inspections

204. During the last review period NZX undertook desk based capital and prudential inspections of participants. No scheduled on-site inspections occurred during that period.
205. The Business Leader advised that prior to beginning scheduled on-site inspections, trading and capital adequacy had been identified as the key risk themes.
206. Focussing on-site visits on high-risk themes is an efficient use of NZX's supervisory resources, and FMA supports this approach. However, it is not clear to FMA the extent to which the risk profiles completed by NZX were used to inform the frequency or focus of each on-site inspection or the identification of the risk themes chosen by NZX. Whilst a pre-planning meeting was undertaken for each inspection, it is not clear that there was any variance in the areas selected for more in-depth inspection at each participant. NZX had previously advised the Securities Commission that these profiles would be central to the on-site inspection programme.
207. FMA **recommends** that NZX consider how it can incorporate and document the incorporation of participants' risk profiles more systematically into its supervisory programme. HOMS should be actively involved in theme selection before incorporation into the on-site inspection programme, and the basis for theme selection should be documented.

Emerging trends

208. NZX identified a rise in algorithmic trading via Direct Market Access ('DMA') as an emerging trend in the second half of the review period and acknowledges that this development needs careful monitoring. It is pleasing to see that NZX is identifying such trends. This development places a greater burden on market participants to take responsibility for the activities of their clients.
209. FMA's recommendations concerning algorithmic trading and the adequacy of market participant arrangements for DMA are set out in Section 5, Surveillance.

Rules

Participant Rules' update including recommendations from the Previous Report

210. The Previous Report recommended that NZX complete its review of any changes to be made to the Participant Rules and its communications as a result of the dispute resolution provisions of the Financial Service Providers (Registration and Dispute Resolutions) Act 2008 during 2011.
211. This recommendation was not implemented during the review period. FMA **recommends** that NZX implement this recommendation as soon as practicable. Our comments under Issuer Regulation regarding review of the Listing Rules, also apply to the Participant Rules and the policy for their review.

Enforcing compliance

On-site inspections

212. FMA notes that NZX carried out scheduled on-site inspections in accordance with its methodology as recommended in the Previous Report.
213. Overall from its sample file review, FMA notes that the on-site inspection programme identified relatively few breaches of the Participant Rules. NZX had not collated information on inspection findings for trend analysis.
214. NZX advised that its population has now been subject to regulation under the Participant Rules since 2004. As such NZX is confident that the relatively low number of breaches identified is indicative of a compliant population base. NZX noted that the introduction of the clearing house also contributed significantly to increased levels of compliance. Participant Compliance advised that it had seen an increase in the level of self-reporting of breaches by participants which enabled the unit to monitor risk at an earlier stage. These are all positive developments.
215. Notwithstanding that overall compliance levels may have improved, FMA would nonetheless expect that a rigorous onsite inspection programme would continue to identify instances of non-compliance. As the regulated population matures, the breadth and depth of NZX's inspection programme will need to be tailored to ensure non-compliance continues to be identified.
216. FMA **recommends** that NZX should assure itself, in the current year's inspection programme that the overall number of identified breaches is properly attributable to improving standards of market conduct, and not due to a lack of depth of testing through its on-site inspections. NZX should collate findings and identify trends.

Referrals to the Tribunal

217. Participant Compliance monitors compliance with the Participant Rules and, where there are reasons to suspect non-compliance, investigates this non-compliance, and where necessary files disciplinary proceedings with the Tribunal.
218. None of the on-site inspection reports reviewed by FMA revealed breaches by participants that NZX considered required disciplinary action. When cases of non-compliance with the requirements of Participant Rules were identified, they were recorded as action points or good practice recommendations. Some of these were minor, while others were not (for example, client funds' account overdrafts).
219. FMA has made recommendations concerning the enforcement of NZX's Market Rules in Section 3.

Human resources

220. The unit started the review period with 3.0 FTE (the Business Leader and two compliance & risk advisers) and ended the period with 2.0 FTE, both advisers. The Participant Compliance Business

Leader took parental leave from August 2011. There were staffing fluctuations during the period, between three and two team members.

221. The Business Leader's position was unfilled during the parental leave period. NZX actively planned for appropriate cover but was not able to find a suitable replacement. In the end NZX discontinued looking for a suitable recruit to cover the position when it decided that temporary cover for the Business Leader's role was not necessary. NZX advised that this reasons for this decision included a combination of reduction of work in the Participant Compliance area, leverage across the Surveillance and Clearing House teams and good performance by remaining team members.
222. To prepare for the Business Leader's absence the unit managed its planned work so that the more complex inspections were undertaken prior to the commencement of the parental leave.
223. The unit operated with two advisors for the period from September 2011 to December 2011. By necessity this meant that the usual division of three members contemplated by NZX's procedures to consider waivers and rulings could not be convened and that matters were considered by a division of two instead. HOMS was one of the two division members in each case.
224. Furthermore, one team member is principally responsible for the financial aspects of participants' compliance. 50- 60% of this time involves reviewing participants' monthly returns.
225. NZX also had obligations under its agreement for services with New Zealand Clearing and Depository Corporation Limited to provide the Regulatory Oversight Services (as explained above).
226. This meant very few resources were available to undertake all other supervisory tasks, including on-site inspections.
227. FMA **recommends** that NZX consider the adequacy of the resources within the Participant Compliance unit. Other overall recommendations regarding human resources are set out in Section 3.

Surveillance

Role of unit

228. The key responsibility of Surveillance is to monitor, in real-time, trading activity on the markets for compliance with the Listing Rules and the trading rules within the Participant Rules and Derivatives Market Rules. This monitoring may also raise issues concerning compliance with financial markets legislation, such as the Act or the Takeovers Code, which are referred to the appropriate regulator.
229. Key tools to perform real-time monitoring are the SMARTS surveillance technology ('SMARTS') and the Trayport GlobalVision trading system. These are supplemented in real-time with securities movements and volume statistics from information providers such as IRESS and Bloomberg and regular reviews of the ASX website to ensure that dual listed and overseas listed issuers simultaneously disclose information to NZX and ASX.
230. Alerts are reviewed and investigated throughout the day as they occur.
231. Surveillance also conducts systems testing for dealers (including DMA dealers) before they are granted log on entry to the trading system. This involves the simulation of trading scenarios based on test scripts to ensure that people have the necessary competencies to operate the trading system.
232. Surveillance is also responsible for error trade cancellation. On-market error trades may be cancelled at the request of both parties to the trades or if NZX determines that an error trade may have a market impact or if cancellation is necessary for market or clearing system integrity.
233. In addition the unit reviews trading in the context of significant events brought to its attention via announcements and other potentially market sensitive information that it receives from CMS or other sources. Where necessary, issuers are questioned about their share price and participants on their trading activities.
234. Surveillance works closely with CMS to maintain the integrity of the Registered Markets and Derivatives Market. We understand that Surveillance can require a trading halt when anomalous trading activity is detected. Surveillance should also alert CMS when a price enquiry has been prepared for a listed security. CMS, on the other hand, advised that it informs Surveillance before releasing announcements containing price sensitive information. From our interviews with both Surveillance and CMS, much of this communication occurs verbally, which given the relatively small size of the units and close physical proximity of CMS to Surveillance appears effective.
235. Surveillance maintains a list of issuers where there are factors indicating there may be an increased risk of a breach of the Market Rules. This list is discussed at a weekly meeting that includes other members from Market Supervision.
236. Surveillance supports Special Division's monitoring of trading activity in securities issued by NZX. It refers all alerts in securities issued by NZX and Smartshare's funds and its related entities (being the five funds managed by Smartshares Limited) to Special Division. It also provides Special Division with quarterly reports of trading in Smartshares funds.

237. In addition to monitoring for compliance with the Derivatives Market Rules, Surveillance is responsible for the following tasks for the Derivatives Market:

- managing price limits
- monitoring open positions (at an underlying client level)
- approving wholesale trades
- the calculation and dissemination of Daily Settlement Prices.

Assessment process

Documentation reviewed

238. We reviewed the following documents:

- Market Surveillance Manual (last updated September 2011)
- a sample of Surveillance weekly updates, which are discussed at weekly Market Surveillance meetings.

239. We also considered referrals made by NZX to FMA under sections 36ZD and 36ZL of the Act and the Futures Exchange Notice. Referrals are where NZX has taken disciplinary action for a breach of the rules or where it knows or suspects that a contravention of its rules or financial markets legislation has occurred, or is about to occur, or where it has information that may assist FMA in discharging its functions.

On-site visit

240. We interviewed the Business Leader and an analyst. We focussed on understanding:

- the key risks to NZX's general obligations
- the availability of resources
- general work flow processes, including appropriate escalation procedures
- the interactions with other units with supervisory functions (especially their role in trade cancellations)
- Surveillance's role in investigation and enforcement
- its approach to emerging trends (for example, algorithmic trading).

Observations and recommendations

General

241. The Business Leader, who was appointed in the last quarter of 2011, demonstrated an understanding of the Surveillance unit's role in ensuring that the markets operated by NZX were fair, orderly and transparent.

Compliance with obligations

Integrity of trading system

242. Two market disruptions involving DMA trading through a single trading participant occurred during the period. On one occasion, the participant failed to put in place adequate filters. In the second incident, the participant's filters failed to detect unusual orders that entered the market and were executed. Since this, NZX has engaged more broadly with those participants with DMA access requiring assurances as to the adequacy of the filters.
243. Notwithstanding that the rules impose obligations on market participants to ensure the adequacy of their filters, FMA considers that the failure of filters can have significant impacts on NZX's obligations to run fair, orderly and transparent markets. FMA **recommends** that NZX test the adequacy of the filters of all market participants with DMA access. NZX should seek to assure itself that these market participants have appropriate arrangements in place.

SMARTS technology

244. The Surveillance unit exercises significant operational independence. The SMARTS alert system, functions within pre-set parameters to identify irregular trading patterns. The identification of these patterns then fires an alert, which is monitored across several units, but primarily by Surveillance, which has the responsibility for clearing or actioning the same.
245. The Surveillance Business Leader can make minor changes which would alter the pre-set parameters of the SMARTS alert system, thereby potentially altering the parameters and/or frequency of the alerts received by NZX. There is no oversight of or approval required for such minor changes, although no such changes were made during the Review Period.
246. Decisions to investigate or inquire into alerts and the extent of inquiry or investigation are left to the discretion of the Business Leader.
247. **FMA recommends**, that prior to any decision to alter the parameters of the SMARTS alert system, a recommendation to do so by the Surveillance Business Leader be approved by HOMS and the decision recorded. Where NZX decides to undertake investigations into alerts, we consider that either HOMS should be involved in these decisions, or a policy or criteria should be formulated, against which the Business Leader's decisions can be assessed by HOMS.

Algorithmic trading

248. During the review period, a number of algorithmic traders were given access to NZX's trading system via DMA. NZX noted both the international trend of increasing algorithmic trading and the liquidity benefits that it can provide.
249. NZX noted that algorithmic trading poses particular challenges in New Zealand given both the number of trades executed off market, with brokers not putting client orders to market, but instead working to find the other side of that order from the firms' other clients and crossing the stock, and the lack of overall liquidity for small and mid-sized issuers.
250. Algorithmic trading leads to a significantly increased number of much smaller orders being put to market. A number of participants have complained to NZX (including in one case, to FMA) about

the increase in trade execution costs as a consequence of this. A participant is required to pay NZX fees per trade. A high number of trades are required to be executed to fill client orders as algorithmic traders have multiple orders for very small parcels (one or two shares) in the market; this increases participant costs.

251. NZX is working to address the liquidity and off-market trading issues as part of a broader market quality project. The increase in execution costs is also to be considered as part of this work. While NZX is working to address these matters it acknowledged that there were some issues as a result of the introduction of algo trading during the review period.
252. FMA **recommends** that NZX undertake appropriate planning and scenario testing to identify any risks or threats to the performance of NZX's statutory obligations that the introduction of new trading types might pose. NZX should appropriately plan to mitigate those risks. NZX must also be careful to manage any perception of conflict of interest that arises from the per trade fees it earns against its responsibility to operate fair, orderly and transparent markets.

Enforcing compliance

Escalation and investigation of non-SMARTS trading anomalies

253. According to the Surveillance Manual, intra-day alerts exceeding 15% must be discussed with HOMS. There is no equivalent guidance regarding trading anomalies that are detected otherwise than through SMARTS. Some trading events that warrant enquiry may not fire alerts in SMARTS. Whilst NZX advise these matters are discussed at weekly meetings, it was not clear how many of these trading events were identified by Surveillance during the review period, or how serious they were.
254. We **recommend** that NZX consider documenting the process and criteria for escalating trading anomalies that are not triggered by SMARTS alerts to HOMS for consideration for further investigation.

Communication and documentation of supervisory decisions

255. Trade cancellations are not documented by Surveillance. Consequently, we were unable to assess these errors and whether they had any market impact. Proper documentation will demonstrate how an anomalous trading issue that NZX identifies is tracked, the work undertaken and its final outcome. Without records of the error being cancelled, NZX cannot assess trends. For example types of errors or participants with high error rates might necessitate heightened monitoring and possible disciplinary action. FMA considers that this might be useful to NZX.
256. We are aware that the unit operates in a dynamic environment where instant decisions have to be made. Some of these require discretion, for instance, in error trade cancellations. Nevertheless, we **recommend** that the decisions and rationales be documented. This can be done after the decisions have been taken.

Human resources

257. As noted above, the Business Leader started his role in the last quarter of 2011. At the time of his appointment, NZX resized the Surveillance Business Leader role and the management of CMS unit was moved to a separate position.
258. 1.0 Surveillance FTE was vacant for the final quarter of the review period. In addition an analyst resigned in the third quarter of 2011 and was replaced by a new unit member with no previous surveillance experience. The Business Leader advised at the interview that it took four to six months to train a new analyst.
259. The Business Leader advised that a number of new operational activities (described at paragraph 237) had been allocated to Surveillance upon the launch of the Derivatives Market. These new tasks, together with the responsibility for undertaking surveillance of the Derivatives Market itself, represented an overall increase in the workload of this business unit. While related to the monitoring role, they were different in nature. It was not clear to FMA that a staffing impact assessment had been undertaken before the new responsibilities were allocated particularly in circumstances where the team was down 1.0 Surveillance FTE at the time this market launched.
260. FMA **recommends** that NZX undertake an impact assessment of any additional operational responsibilities on supervisory duties before the new responsibilities are allocated, and consider the adequacy of the resources where additional supervisory duties are allocated.
261. Whilst none of the Surveillance unit had previous experience monitoring trading in commodity derivatives products, no external training opportunities or networking opportunities seem to have been sought for Surveillance staff. NZX advised that its Head of Derivatives, who had experience at LIFFE did provide support and training on derivatives products to the team. We also understand that NZX has previously attended SMARTS conferences, and is actively considering future attendance at such events. However no formal training was attended during this review period.
262. FMA **recommends** that NZX actively seek training opportunities for Surveillance staff when new products are introduced. This would help staff to identify the risks presented by new products or markets. Additionally, community of practice opportunities in respect of current markets should be explored.

Information Technology

Role of unit

263. The Information Technology ('IT') unit has responsibility for the overall performance of NZX's IT systems across both the regulated and unregulated activities. This includes the availability, security, capacity and maintenance of:

- the trading platforms and settlement systems, including Trayport GlobalVision and BaNCS, and including IT arrangements for DMA
- the NZX website, including real time communication with the market through both website updates and MAP
- internal systems for monitoring the market, including SMARTS
- general systems, including server facilities and communications.

264. The IT unit has disaster recovery plans for the systems and currently co-ordinates NZX's business continuity and pandemic planning.

265. The unit liaises with technology managers from key market participants to discuss relevant projects and any issues regarding market IT.

Assessment process

Documentation reviewed

266. We reviewed the following documents:

- a table detailing projects considered during the review period
- NZX Dealer Accreditation - Trading Test Script for NZX

On-site visit

267. We interviewed the Head of IT. We focussed on understanding:

- the key risks to NZX's general obligations
- the availability of resources
- general work flow processes
- reporting upwards within NZX against the above three areas.

Observations and recommendations

General

268. The Head of IT demonstrated an understanding of the importance of IT to ensuring that the markets were fair, orderly and transparent.

Reporting

269. The Head of IT provides a Regulated Systems report as part of the quarterly Regulated Markets and Regulated Infrastructure Report to the NZX Board. This short report:

- gives availability statistics for the trading and clearing systems
- comments briefly on risks and areas of operational focus
- lists key IT projects and comments briefly on workload.

270. The Head of IT attends the NZX Board meetings to discuss the reports.

271. In addition, the Head of IT has a weekly meeting with the CEO, with discussions including projects, work flows and resources.

Compliance with obligations

Disaster recovery and business continuity planning ('BCP')

272. Given the importance of IT to the markets, disaster recovery, including alternative servers and facilities, is an on-going focus area for the Head of IT.

273. BCP has been reviewed to take account of any lessons from the Christchurch earthquakes, considering both building loss and significant city-wide damage. For example, NZX has taken steps to minimise the reliance on telephone connectivity in the wake of a significant disaster.

274. The Head of IT has identified that BCP could be improved by the additional co-ordination of existing plans that are business unit focused.

Pike River Coal Limited trading halt

275. The Head of IT noted the one major IT related issue during the review period. This concerned the inadvertent cessation of the halt in trading of PRC securities, when the market resumed after the market wide halt to observe the Pike River remembrance service two minute silence.

276. The Head of IT advised that communications regarding the halt had been between individuals rather than the appropriate channels involving Business Leaders. This allowed the halt to be agreed without a formal assessment of the effects or any testing. The Head of IT advised that, as a result of this matter, processes have been implemented and formalised.

277. Further information, including FMA's concerns and recommendations are set out in the CMS section of this Section 5.

Systems upgrades

278. There were a number of significant projects during the review period. They included:

- the introduction of the NZCDC Settlement System. (The system is not within the scope of this report, but the Market Assessment Report noted that the system had assisted the Registered Markets by improving settlement certainty.)
- a trading system upgrade to a new version of Trayport GlobalVision. NZX facilitated discussions between the supplier and participants, to assist participants in their understanding of the new system version.

279. NZX has determined to replace its existing trading system, Trayport GlobalVision. The Head of IT was actively involved in considering the continued use of the Trayport system for the future during the review period. The replacement system will be implemented during 2012.

Processes and checks

280. There is a continual focus on monitoring the pinch points in the systems and working to mitigate these where possible. The systems operate with automatic alerts relating to availability and connectivity issues, and pro-active escalation policies.

281. The Head of IT identified a need for penetration testing of the security of the systems. A potential supplier has been identified.

282. The Head of IT focused, during the review period, on a more structured and dynamic approach to the documentation of processes, practices and checks across the IT infrastructure, so that information is captured and updated in real-time.

Human resources

283. There is no separate monitoring of the human (or financial) resources allocated to fulfilling NZX's obligations. Some of the unit's resources are dedicated to the development and operation of the trading systems, while other resources (for example programme office, or general operations) support the whole of NZX's activities.

284. The Head of IT reviews plans of the unit's workload with the unit Business Leaders and monitors progress on on-going projects with the programme office and the Business Leaders.

285. The Head of IT works with Market Supervision and the CEO to prioritise projects within the resources or to build a business cases for additional resources if necessary.

286. The Head of IT indicated that the IT unit was adequately resourced both in financial and human terms (30.0 FTE) during the review period. The Head of IT has analysed the skill mix of the unit compared with needs.

The Tribunal and the Special Division

Role

287. The Tribunal is an independent adjudicative body established under the Tribunal Rules.
288. The Tribunal's principal role is to determine whether there has been a breach of NZX's Market Rules and the Clearing House Rules in matters referred to it by NZX. In the event that the Tribunal finds a breach, its secondary role is to assess and impose penalties. The Tribunal's powers are set out more fully in the Tribunal Rules.
289. During the review period Stephen Kós QC resigned as Chairman of the Tribunal upon his appointment as a High Court Judge. Derek Johnston was appointed as the new Chairman in June 2011. In addition, a new listed issuer member, Jo Appleyard, and a new market participant member, Noeline Munro, were appointed to the Tribunal in June 2011.
290. The Special Division is an independent body established under the Tribunal Rules. It is a division of the Tribunal. The Special Division administers the Market Rules for NZX and its related entities. NZX's related entities are currently the five funds managed by Smartshares Limited. The Special Division has the same powers and functions as NZX under the Market Rules in respect of NZX and the Smartshares Funds, and in respect of persons trading in NZX or the Smartshares Funds.
291. There were no changes in the composition of the membership of the Special Division during the review period.

Assessment process

Documentation reviewed

292. We reviewed:
- the Tribunal's annual reports for the years ending December 2010 and December 2011
 - logs and records of all matters referred to and considered by the Tribunal in the review period
 - logs and descriptions of all matters considered by the Special Division during the review period.

Interviews

293. We interviewed the Tribunal Chairman, focusing on:
- how the Tribunal contributes towards the obligations
 - the Tribunal's relationship with NZX
 - the Tribunal's annual reports
 - the operation of the Tribunal
 - the quantum and quality of referrals

- the resources of the Tribunal.

294. We interviewed the Special Division Chairman, focusing on:

- how the Special Division contributes to the obligations
- the Special Division's relationship with NZX
- the applications and referrals considered by the Special Division
- general work flow processes
- the resources of the Special Division

Observations and recommendations – the Tribunal

Resources – general

295. The Tribunal advised that it was adequately resourced by NZX, and had been provided with all the assistance required to perform its role.

296. As at the end of the review period the Tribunal comprised five public appointees, four issuer appointees, eight legal appointees and four market participant appointees. Of these members the terms of four of the five public and one of the legal appointees expire in June 2012. In June 2013 the terms of three of the issuer appointees and the term of one further legal appointee expire.

297. The Tribunal Rules set out the process by which Tribunal members are appointed. The rules note that NZX will periodically call for nominations. The Tribunal wrote to NZX in November 2011 urging NZX to undertake a public nominations process in order to identify suitably qualified candidates for Tribunal membership and with the names of certain persons who the Tribunal considered might be appropriate for appointment, considering the function of the Tribunal and the criteria for appointment in the rules. NZX had not responded to this correspondence until April 2012.

298. Whilst members of the Tribunal have subsequently been appointed by NZX, FMA **recommends** that NZX prioritise responding to correspondence with the Tribunal, noting the Tribunal's especial importance and the impact of the Tribunal's composition on its on-going effectiveness.

Resources - Derivatives Market

299. In August 2010 the Tribunal Rules were amended to expand the Tribunal's jurisdiction. It now includes determining whether there has been a breach of the Derivatives Market Rules in matters referred to it by NZX, and in the event that the Tribunal finds a breach, assessing and imposing penalties.

300. The amended rules also require the Tribunal has one Derivatives Market appointee, to ensure that the Tribunal has sufficient experience to consider relevant rule infringements.

301. The Tribunal did not have a Derivatives Market appointee during the review period. The Tribunal advised they raised this deficiency in its composition with NZX on several occasions during the review period.

302. A Derivatives Market appointee was ultimately appointed in May 2012.
303. FMA **recommends** that NZX monitors the composition of the Tribunal to ensure that at all times it has the necessary composition to consider cases which might be referred to it.

Enforcing compliance

304. The Tribunal can only determine matters brought before it. The Tribunal relies on NZX to detect conduct breaching the Market Rules, and to bring cases before the Tribunal concerning that conduct. It is important that the market has confidence that conduct falling foul of the Market Rules is being detected and appropriately referred to a disciplinary body. The disciplinary body itself must also have confidence that it is receiving appropriate referrals.
305. In the period 1 January 2011 to 31 December 2011 four matters were referred to the Tribunal. The Tribunal also considered two matters referred to it on 24 December 2010 in 2011. This reflects a new low in terms of matters referred to the Tribunal. It represents a 50% reduction in referrals as against the previous low.
306. The Tribunal observed that NZX nevertheless appears to have identified a similar number of breaches of its Market Rules to previous periods, as reflected in the NZX report to the Tribunal, (contained within the Tribunal's annual report). NZX's categorisation of the breaches identified is also similar. Given this, FMA is concerned that matters that should properly be referred to the Tribunal are not being referred.
307. The Tribunal also observed that in 2009 it raised issues with NZX concerning the number of referrals made to the Tribunal and that less referrals were made during this period.
308. FMA's recommendations to NZX concerning its role in enforcing compliance with its Market Rules are set out in Section 3 of this report. FMA considers it may be helpful for NZX to discuss with the Tribunal the policy and criteria for the referral of cases to the Tribunal and the extent to which those criteria are being observed. This will also assist the Tribunal in being able to make informed comments in its own report on the topic of referrals.

Tribunal operations

309. NZX aims to inform the Tribunal shortly prior to the service of a case on a respondent and subsequent to its referral to the Tribunal. This enables the Tribunal to convene a suitably qualified, available and conflict-free division in time for the service of the matter.
310. During the review period the Tribunal received advice that matters were to be referred to it. In the event, the matters were either significantly delayed, or, as at the date of this report, not referred at all. The delays, and the causes of them, were not always communicated to the Tribunal.
311. The delays raised some operational difficulties for the Tribunal, especially in terms of the ongoing availability of the appointed division members.
312. This has been exacerbated in the current circumstances of the Tribunal, where division member's terms of appointment are due to expire, and the matter for which they were provisionally allocated have yet to be received by the Tribunal.

313. Providing advance notice of matters to be served enables appropriate forward planning to be undertaken by the Tribunal. However, the benefit of this notice is undone when the matters are not then served in the timeframe communicated.
314. FMA **recommends** that NZX proactively communicate with the Tribunal any changes to timeframes or expectations concerning matters to be referred to the Tribunal.

Policy and rules

315. The Tribunal noted in its 2009 annual report that NZX had advised it that policy formation and input into policy formation were not part of the mandate of the Tribunal. The Tribunal disagreed on the basis that it is a body established under the Tribunal Rules with the specific purpose of being independent of NZX and with the express power to “suggest to NZX and consult with NZX on the amendment of the Rules”. The background to this difference in view is set out in the Securities Commission’s Previous Report.
316. In that report, the Securities Commission noted its expectation that there will be on-going dialogue between NZX and the Tribunal in relation to this issue. The Securities Commission encouraged NZX to consider the unique and independent role and experience of the Tribunal in discussing these matters with a view to resolution.
317. The Tribunal advises that no further discussions have taken place between NZX and the Tribunal on this matter, largely because there have been no policy matters for the Tribunal to consider. FMA encourages NZX and the Tribunal to ensure there is mutual clarity as to the Tribunal’s role on policy.
318. The Tribunal has noted proposed rule changes contemplated by NZX, to accommodate the Trading Amongst Farmers market, would further expand the role of the Tribunal. The Tribunal notes that NZX did not seek any input from the Tribunal into these rule changes. NZX also had not sought to draw the Tribunal’s attention to its public consultation process on the proposed rule changes.
319. FMA **recommends** that NZX consult the Tribunal on any Market Rule changes that affect the role of the Tribunal. This consultation should occur prior to any public consultation.

Observations – Special Division

Resources – general

320. The Special Division is a division of the Tribunal. The Special Division’s membership is affected by the expiration of the term of two of its members, as set out in paragraph 296 above. Two new appointments to the Special Division will take effect in June 2012. In 2013 the Special Division’s Chairman’s term of appointment will expire.
321. Ensuring continuity of knowledge and skills will be a key focus for the Special Division during this period of membership change.

322. The Special Division advised that it is sufficiently resourced by NZX to exercise its powers and functions in a manner consistent with its objective.

Operational processes

323. In June 2010 the Special Division reviewed the procedures for the referral of SMARTS alerts by NZX. This review was undertaken to clarify when alerts and abnormal trading activity (where no SMARTS alert had fired) in units of the funds managed by Smartshares Limited should be referred to the Special Division. It resulted in amendments to the Special Division procedures.

324. Under procedures agreed with NZX, Special Division receives:

- with respect to securities issued by NZX, all SMARTS alerts and abnormal trading activity (in circumstances where no alert has fired)
- with respect to units issued by the funds managed by Smartshares Limited, SMARTS alerts for “High Long Term Volume” involving the creation or redemption of in excess of 20 baskets of units in a Smartshares fund and any abnormal trading activity regarding units in a fund, whether or not an alert has fired.

325. 25 alerts were referred to the Special Division during the year to 31 December 2011.

326. The Special Division noted its satisfaction with this changed process. NZX advised FMA that the referral of all SMARTS alerts to the Special Division occupied approximately 0.2 of an FTE time. The Special Division was surprised that the referrals absorbed this much resource. FMA encourages NZX and the Special Division to consider whether referrals of SMARTS alerts can be streamlined.

Inquiries

327. The Special Division noted that, where it and FMA have overlapping jurisdiction, enhanced communication is required to ensure that FMA and the Special Division are not duplicating effort.

328. FMA intends to enter into an memorandum of understanding with NZX to strengthen operational processes and efficiencies between them. This would include interactions between Special Division and FMA.

Appendix 1 Market context

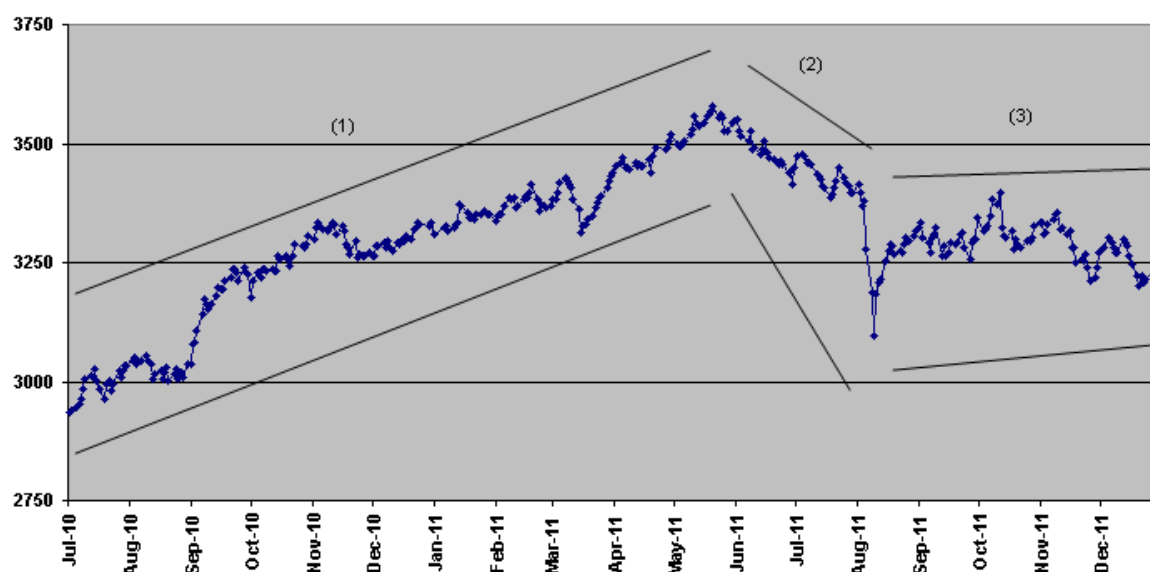
329. The following information is extracted verbatim from NZX's Market Assessment Report, and provides market context for this Report on the NZX General Obligations Review .

Market performance – Major trends in the NZX50 (1 July 2010 – 31 Dec 2011)

- The NZX50 Index is the most common benchmark index of the NZSX.
- The performance of the NZX50 over this 18 month period was characterised by 3 main trends: the market rally from July 2010 to May 2011; the market correction in August 2011; and following the correction, a period of higher than normal day-to-day volatility while remaining within a consistent range of upper and lower limits. These periods are highlighted in Figure 1.
- On 2 July the NZX50 reached its lowest point for 2010 (2,933). This heralded a run of unbroken month-on-month increases in the NZX50 through to 20 May 2011 (3,577) - a rise in the benchmark index of 22%. This mirrored gains in equities markets worldwide as global economies emerged from the widespread recession sparked off by the collapse of Lehman Brothers in 2009 and the resultant GFC. The major Christchurch earthquakes of 4 September 2010 and 23 February 2011 had no lingering effects on the overall upwards trend observed over the broader period with re-construction believed to provide a net stimulus to the NZ economy.
- Following a period of gradual decline beginning the end of May 2011, global equities markets underwent a substantial correction ("the global markets correction") in early August 2011. The proximate causes of these major market falls were the onset of the Greek sovereign debt crisis (plus escalating concerns over the unsustainability of ballooning Eurozone government debt), an unprecedented downgrade of the United States credit rating, and fears of a renewed global recession. Between 2 - 9 August 2011, the NZX50 plunged 300 points (9%). On 5 August 2011 the NZX50 fell 101 points – a daily points fall not recorded for over a decade.
- Following the global markets correction in August 2011, many major equity indices entered bear market territory (defined as a 20% fall in a 2 month period). The NZX50 was among few globally recognized equity indices that did not (the NZX50's largest 2 month decline, between June 10 and 9 August 2011, was 11%) and generally outperformed internationally on a relative basis. There were several plausible reasons for this relative outperformance, the high proportion of defensive stocks in the NZX50 (i.e, companies - such as utilities - that are less sensitive to the economic cycle), the lack of exposure of the NZ economy to the US and Eurozone economies, the comparative strength of the economies of New Zealand's major trading partners (Asia and Australia), and resilient export commodity prices.
- The period between August – December 2011 was characterised by 2 seemingly contradictory trends. An increase in the 30-day mean volatility (a measure of market risk) during a period in which the NZX50 stayed near-exclusively within a range of 150 points. Figure 2 shows that volatility was significantly higher in the aftermath of the global markets correction in early August 2011. Global markets were swinging wildly in response to the day's newsflow out of Europe and North America. It was a period of heightened investor nervousness when sentiment and risk appetite dominated over fundamentals and corporate earnings. Despite the day-to-day volatility the NZX50 found key support and resistance levels between 3200-3350 with the benchmark index closing between these values on 94 trading days out of 99 until the end of 2011.

- The NZX50 ended 2011 on 3,324, a fall of 35 points (1%) for the calendar year.

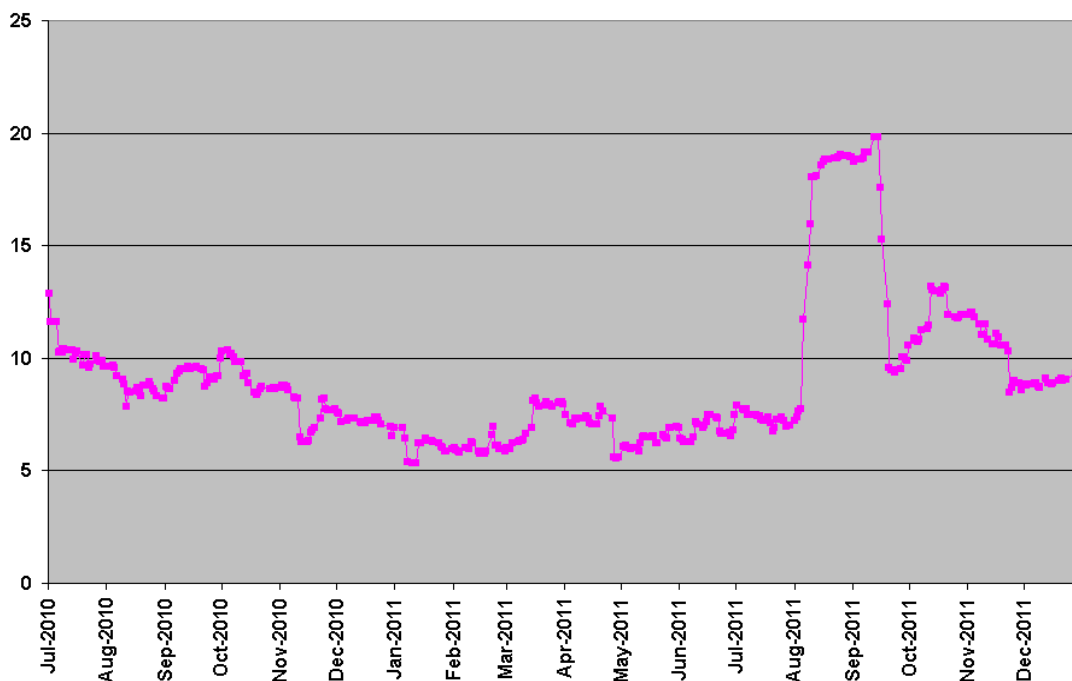
Figure 1: NZ50 Gross Index (July 2010 - December 2011)



Trading Volumes

- Trading volumes for 2011 were significantly up on 2010 (source: NZX Limited)
 - Total trades were up 37.1% to 740,601
 - Average daily trades were up 37.6% to 2,939
 - Total Value Traded was up 24.8% to \$28.6 billion
 - Daily Average Value Traded was up 25.3% to \$113 million
- Increased investor confidence following the GFC saw improved volumes in 2011.
- Other factors contributing to increased volumes include:
 - Following a successful trial in a few selected stocks, reduced price steps were implemented in stocks over \$2.50. The effect was to reduce spreads and aid liquidity.
 - An observed rise in the extent of automated trading strategies, or algorithmic (“alga”) trading during the second half of 2011 by overseas based institutional clients utilising Direct Market Access (“DMA”) via their NZX Trading Participant. High-frequency trading is one form of algo trading observed in which execution is achieved through a larger than normal amount of smaller trades. Orders activity in central order book was also seen to increase markedly in 2011.

Figure 2: NZX50 30-Day Historical Volatility July 2010 - Dec 2011
Source: Bloomberg



NZX Derivatives Markets

- NZX Dairy Futures Market began trading on 8 October 2010 with the introduction of Whole Milk Powder Futures. Anhydrous Milk Fat (“AMF”) and Skim Milk Powder (“SMP”) Futures were added on 18 Feb 2011.
- Options contracts on the first 6 WMP futures contracts were added on 30 November 2011.
- After low volumes for the first half of 2011 trading levels began to pick up in May 2011 and grew rapidly in September. Total lots traded surpassed 5,000 in October and passed 10,000 on 25 November 2011.
- Overall prices were higher in the first half of the year across the 3 futures contract types. In the 2nd half of the year prices levelled off along with reduced volatility consistent with the trends in the underlying physical markets (ie, gDT).
- There was no activity in the Options in 2011

Number of issuers	SX Domestic	SX Dual Full	SX Overseas	NZAX	NZDX	Equity	Debt
30-Jun-10	117	2	33	27	59	\$50.0	\$15.4
30-Sep-10	115	2	32	26	60	\$53.2	\$15.5
31-Dec-10	113	3	30	25	58	\$56.0	\$16.0
31-Mar-11	114	4	30	24	56	\$58.2	\$15.6
30-Jun-11	114	4	29	24	55	\$58.0	\$15.7
30-Sep-11	113	4	28	24	54	\$55.8	\$15.5
31-Dec-11	116	4	27	24	53	\$55.9	\$16.0

Capital Raised	Equity (m)	Debt (m)	Trades	Value (m)
3Q10	\$463	\$170	2,065	\$81
4Q10	\$317	\$425	2,150	\$103
1Q11	\$535	\$100	2,327	\$104
2Q11	\$646	\$361	3,195	\$124
3Q11	\$282	\$306	3,136	\$114
4Q11	\$1,436	\$272	3,039	\$109

Glossary

Act	The Securities Markets Act 1988
Alternative Market	NZX Alternative Market or NZAX
ASX	Australian Stock Exchange
BCP	Business continuity planning
CEO	Chief Executive Officer
Clearing appointee	Tribunal appointee with relevant Clearing House Experience
CMS Manual	Internal NZX manual governing procedures and policies of CMS
Compliance Handbook	Internal NZX manual governing procedures and policies of the Compliance Unit
Conduct Rules	Together the NZX Listing Rules and NZX Participant Rules
Dairy Futures Market	The New Zealand Dairy Futures Market
Debt Market	The New Zealand Debt Market or NZDX
Derivatives Market	New Zealand Derivatives Market authorised under the Futures Exchange Notice
Derivatives Market appointee	Tribunal appointee with relevant Derivatives Market experience
Derivatives Market Rules	Derivatives Market Rules dated August 2010
DMA	Direct Market Access
FMA	Financial Markets Authority
FTE	Full time equivalent staff
Futures Exchange Notice	The Authorised Futures Exchange (NZX Limited) Notice 2010
HOMS	Head of Market Supervision
Listing Rules	NZX rules for the NZSX, NZDX and NZAX markets
Market Announcement Platform	Electronic platform used by CMS to issue announcements regarding issuers
Market Assessment Report	Report produced by NZX under section 36YA of the Act dated 29 March 2012
Market Rules	Together, the Participant Rules, Derivatives Market Rules and Listing Rules

Market Supervision	the supervisory business units of NZX: Issuer Regulation, Participant Compliance, Surveillance, and Client and Market Services
NZAX	NZX Alternative Market
NZCDC	New Zealand Clearing and Depository Corporation Limited – a wholly owned NZX subsidiary which 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
NZX Solicitors	Legal staff in Issuer Regulation Unit
Participant Rules	The NZX rules governing its market participants
Policy	NZX Conflict Management Policy dated 20 January 2008
Previous Report	NZX Oversight Report produced by Securities Commission under section 10 of the Securities Act 1978 in April 2010
Registered Markets	Registered markets as defined under the Act comprising the NZAX, NZDX and NZSX markets
Solicitors Handbook	Internal NZX manual governing procedures and policies of Issuer Regulation NZX Solicitors
Special Division	A division of the Tribunal responsible for administering and enforcing the Market Rules for NZX’s own listing and to its related parties including the Smartshares funds
Surveillance Manual	Internal NZX manual governing procedures and policies of Surveillance
Tribunal	The New Zealand Markets Disciplinary Tribunal
Tribunal Rules	The rules governing the operation of the Tribunal