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NZX review 2016

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Executive summary

Purpose of this report

We are required to report at least annually on how well NZX is meeting its licensed market operator obligations¹. This is our fifth review of how NZX is complying with its obligations, and covers the 2015 calendar year.

Our review of how NZX met its market operator obligations in 2015 was carried out throughout the year, through regular interactions and coordination. We did an end-of-year review to look at key changes in NZX's business and markets over the year, and how NZX regulates participant firms' compliance. This is a focus for us, given the important role NZX participants play in driving good trading conduct in the markets.

For more information about how we carried out this review, please see the Appendix.

Key findings

From our oversight, we are satisfied that NZX:

- ensured, to the extent reasonably practicable, that each of its licensed markets was fair, orderly and transparent
- had adequate arrangements for notifying disclosures from participants in its markets, and for continuing to make them available
- had adequate arrangements for handling conflicts between its commercial interests, and the obligation to ensure its markets operate in a fair, orderly and transparent manner
- had adequate arrangements for monitoring the conduct of participants in its markets
- had adequate arrangements for enforcing compliance with market rules
- had sufficient resources (including financial, technological and human resources) to operate its licensed markets properly.

NZX had two key changes to its business and markets in 2015 that were relevant to its market operator obligations: it acquired SuperLife, and launched the NXT market. We are satisfied from our review that NZX considered how these developments would affect its regulatory responsibilities, and responded with appropriate changes. These included new regulatory procedures, and additional arrangements to manage potential conflicts of interest.

We are also satisfied that NZX's participant compliance function is effective. Its files demonstrated good processes and appropriate regulatory responses to breaches. NZX is targeting participant inspections to focus on current trends in breaches and market developments. Compliance matters identified by the participant compliance team have also been taken into account in an update of the participant rules, expected to be completed in 2016.

Overall, NZX complied with its market operator obligations in 2015. We do not require it to take any specific actions following this review.

¹ The market operator obligations are set out in the Appendix.

Future focus

NZX plays a crucial role in helping to achieve capital market growth and market integrity. It is essential investors are confident that NZX complies with its obligations in operating, monitoring and regulating its markets.

We believe the market may still interpret low levels of visible action to mean NZX does not respond appropriately to potential or actual non-compliance. This is particularly evident in commentaries made when the market experiences an event such as a large price movement.

Much of NZX's regulatory work is not obvious to the public. Activities such as monitoring for market misconduct and enquiries into issuers' material disclosures are generally unseen. These are a significant part of the work NZX does to maintain fair, orderly and transparent markets. When breaches occur, enforcement action taken by NZX is usually only reported if the case is referred to the NZ Markets Disciplinary Tribunal (NZMDT). However, NZX has a variety of other enforcement options for addressing non-compliance, set out on its website and in its enforcement policy². It also works with issuers and participant firms to improve standards and prevent breaches of its rules, reducing the need for enforcement action.

NZX publishes quarterly regulation metrics to show levels of activity, and has published a regulatory agenda setting out its areas of focus for 2016³. Detailed information about its enforcement activities in 2015 can be found in NZMDT's annual report⁴. We encourage NZX to continue to improve public visibility of its regulatory function. For example, it could consider publishing its participant updates, and report on the use of its new infringement notice power for minor breaches. We comment on these later in this report.

NZX has significantly developed its regulatory framework since our first annual review in 2012⁵. As its markets grow, in particular NXT and the derivatives market, it will continue to face regulatory challenges. We are assured NZX is committed to reviewing and improving its operations to keep up with these changes.

In our view, NZX is carrying out its regulatory role effectively, and its markets are well regulated. We will continue to work closely with NZX to promote fair, orderly and transparent markets.

² Available at www.nzx.com/regulation/ensuring-quality

³ Available at www.nzx.com/regulation/publications

⁴ Available at www.nzx.com/NZMDT/annual-reports

⁵ Previous reports are available on our website at www.fma.govt.nz/compliance/role/market-operators/nzx-notices-and-reports/

Market conditions

NZX's equity markets have doubled in value since the FMA's first review in 2011. During 2015, their total value grew 14.2% to \$110.2 billion.

The listed debt market's capitalisation rose a significant 50% to \$19.8 billion during 2015, from \$13.2 billion. The listing of \$5.6 billion of Local Government Funding Agency (LGFA) bonds represented almost 70% of the new debt. LGFA was set up as a way to reduce local government borrowing costs.

The fall in global initial public offerings (IPOs) affected the local market, with only four IPOs in 2015, raising \$1.7 billion of new capital. This compared with a record of \$4.7 billion raised in 2014 from 13 IPOs.

The amount of secondary capital raised grew to \$12.9 million from \$2.4 million in 2014. In particular, issuers made use of the exemption from having to produce a full product disclosure statement (PDS) when they offer quoted securities of the same class ('same class offers')⁶.

NZX's dairy derivatives market continued to grow, with lots traded rising 111.5% from the prior year due to more interest from Asia-based traders.

In June 2015, NZX launched the NXT market, a stepping-stone market for small and mid-sized firms. At the end of 2015, NXT had one compliance listing and one company which moved from the NZX Alternative Market (NZAX).

⁶ Clause 19, schedule 1 of the FMC Act.

Business developments

Launch of NXT market

NZX is NZX's market for small- and medium-sized businesses. It was officially launched in June 2015. NZX's systems, including the trading system, markets announcement platform and clearing and settlement system, were configured ahead of the launch. Although only two issuers were listed on NXT at the end of 2015, this has allowed the procedures and technology to be tested. There were no technological issues with the launch.

The main features of the market are periodic disclosure against key operating milestones, independent research on all issuers, and arrangements to ensure liquidity. NXT issuers must also use an approved NXT adviser for at least three years after listing, to help them meet their obligations. Investors wanting to trade shares listed on NXT must acknowledge a risk warning.

NZX's approach to regulatory decision-making for NXT is generally similar to its approach for its other markets. However, staff members were trained in the specific NXT rules and market procedures to ensure they are consistently applied. NZX also developed a suite of templates and checklists for new listings and ongoing compliance matters. NZX will continue to engage with issuers, their legal advisers, and NXT advisers to assess the appropriateness of NXT rules, guidance and templates in practice. This will help it decide whether these need to be changed over time.

NZX also developed processes for monitoring the firm that helps provide liquidity for the NXT market (known as the 'market maker'). In 2015 this included a targeted inspection of the firm to review how it carries out its role, and its arrangements for handling any potential conflicts.

We reviewed NZX's activities relating to the NXT market and we are satisfied that NZX is monitoring NXT appropriately for the current level of market activity.

NZX will keep its monitoring procedures under review and adapt them as this market grows. We will keep up to date with progress through our regular operational discussions with NZX.

Acquisition of SuperLife

During the year, NZX acquired SuperLife, a funds management business with investment options, including KiwiSaver and superannuation funds. SuperLife has relevant interests⁷ in listed issuers held by its managed funds due to the management relationship. NZX's board and the conflicts committee considered whether the purchase would require changes to its conflict management arrangements.

NZX decided that when it and any of its subsidiaries, individually or together, have a 5% relevant interest or more of any issuer⁸, it will apply the associated entity protocol to manage the potential conflict⁹. This protocol introduces extra

⁷ As defined in section 235 of the FMC Act.

⁸ A substantial holding as defined in section 274(2) of the FMC Act.

⁹ Available at <https://www.nzx.com/regulation/conflicts-management>

safeguards to avoid potential conflicts for NZX when exercising its regulatory responsibilities. NZX has implemented processes to ensure associated entities are correctly identified.

NZX consulted us about its intended approach. We also reviewed documentation from the board's, and the conflict committee's discussions on the matter. We believed the purchase of SuperLife could lead to potential conflicts, but are satisfied that NZX has appropriate measures to address this.

We are satisfied that NZX continues to have adequate arrangements for handling conflicts of interest between its commercial interests and its regulatory role.

Participant compliance

The participant compliance team within NZX's regulation function is responsible for overseeing NZX participant firms. Activities include ongoing monitoring through desk-based and onsite inspections, investigating suspected rule breaches, and working with the enforcement team to take action against a participant firm if necessary. This activity influences decisions of whether rules or guidance need to be updated to remain in line with market trends and risks.

One of our strategic priorities is to encourage market growth and support market integrity. This is important for promoting confidence in New Zealand's capital markets.

A key focus for us is improving trading conduct, particularly detecting and responding to insider trading and market manipulation. Trading misconduct has a direct impact on the integrity and reputation of our markets, and the confidence of people investing in them.

NZX participants play an important role in driving good market conduct. They are the gateway to NZX's markets. They are responsible for ensuring that when they and their clients trade, their conduct complies with legislation and NZX's rules. Effective monitoring of their compliance, and dealing appropriately with non-compliance, are crucial to improving standards of trading conduct.

Findings from our file review

We inspected NZX's inquiry logs and selected several participant compliance inquiry files for review. We chose files where the response was either 'no further action' or an 'obligations letter'¹⁰ to the participant firm.

Our focus was on appropriate levels of inquiry and professional scepticism, as well as consideration of participant firms' overall compliance when deciding an outcome. We also looked for consistency in enforcement responses for similar circumstances. This file review supplemented ongoing information provided to us about regulatory decisions.

We were satisfied with the quality of inquiry on the files we looked at, and the files demonstrated good processes. Decision-making requires the team member to consider a participant firm's compliance history, as well as previous decisions by NZX on similar breaches by other NZX participants. NZX considers several other factors when assessing the seriousness of a breach, and the appropriate regulatory response. The approach is set out in its enforcement policy.

Dealing with breaches

Three of the files we looked at concerned different breaches by the same firm. All three breaches were different. Two were relatively minor or technical. The third concerned the timeliness and priority of placing client orders into the market. The firm was required to modify its processes, undertake training and report back to NZX. We considered the responses reasonable for each breach, in isolation. However, as breaches of different rules could indicate a wider issue with a firm's compliance, we reviewed NZX's approach to dealing with recurring non-compliance.

¹⁰ Check NZX's website <https://www.nzx.com/regulation/how-we-regulate> to see when an obligations letter is used.

We are satisfied that the participant compliance team takes into account appropriate factors when investigating breaches, including the overall compliance history of the firm. Broader concerns about a firm's compliance are correctly identified, and regulatory action is escalated in these cases. For example, NZX may carry out a targeted inspection, increase ongoing monitoring, require the firm to take corrective action, or refer cumulative breaches to NZMDT. This will depend on various factors, including the extent and type of breaches.

All regulatory responses must be approved by the leader of participant compliance and the head of market supervision, to ensure a participant firm's overall compliance is supervised. The NZX regulatory governance committee's (RGC) review of decisions also helps to ensure possible wider compliance issues are addressed appropriately. Minutes from RGC meetings show the committee is mindful of the compliance history of both NZX participants and issuers, and monitors actions taken by NZX regulation when the committee has concerns about non-compliance.

Inspection programme

NZX implemented a targeted inspection programme in 2015. These inspections, focusing on fewer areas in greater depth, will be run between broader inspections of participants, which will be done every third year. The focus areas for targeted inspections will be based on trends in breaches, as well as market developments and changes in trading activity. In 2015 they included participants' controls around direct market access (DMA) trading and algorithmic trading by their clients, as well as trading resulting in no change in beneficial ownership, for which there is a presumption of market manipulation. Potential issues in these areas had been identified from NZX's surveillance activities. These market trends were also considered for the current review of the participant rules¹¹.

NZX's participant compliance team and the FMA's supervision team collaborate at the planning stage and share feedback after the inspection, where possible, in the inspections of NZX participant firms. This reduces duplication of monitoring activities and helps to reduce participant firms' compliance costs. We are continuing this joint approach.

Improving visibility for dealing with compliance issues

NZX communicates with participant firms through periodic compliance updates. The participant compliance team uses these updates effectively to remind participants of their obligations, and of NZX's expectations about specific issues or breaches they have seen through inquiries and inspections.

We encourage NZX to publish the participant updates¹². This would give the wider market visibility of relevant matters, and improve market confidence by demonstrating how NZX is taking action to deal with participant compliance issues.

Improving trading conduct

From our ongoing interaction and our end-of-year review, we note that NZX is developing a stronger focus on participant firms' trading conduct, and assessing whether firms are complying with the rules that are designed to maintain fair, orderly and transparent trading in NZX's markets. Enforcement referred four matters concerning these rules to NZMDT in 2015. Two were for breaches of good broking practice, one was for breach of employee trading

¹¹ Full details of proposed changes are contained in a discussion document, available at www.nzx.com/regulation/consultation

¹² NZX already publishes its issuer updates on its website at www.nzx.com/regulation/issuer-update

permissions requirements, and the fourth was for short-selling when an issuer was under takeover¹³. This compared to one referral in 2014 for breaches of rules regarding employee trading.

Focus on access to markets

NZX continues to monitor the level of algorithmic and high-frequency trading on its markets. This was steady in 2015, but has increased since the beginning of 2016. Trading in NZX's markets by international traders also appears to be growing. These types of trading are commonly executed through DMA accounts, which allow participant firms' clients to enter orders directly into NZX's trading system, provided they meet the firms' system controls.

As trading grows, it is increasingly important that NZX participants' controls for DMA access by their clients are adequate to maintain orderly markets and prevent market misconduct. Participants should also be able to identify the source of orders, as the participant is responsible for all trading executed through its accounts.

As noted above, these areas were incorporated into NZX's participant inspection programme in 2015, and we understand they will remain a focus in the current year. The current review of the participant rules also seeks to improve NZX's tools for monitoring trading. If the proposed changes go ahead, participant firms will be required to enter more information into the trading system, to help NZX identify clients without reverting to the participant. NZX has also proposed introducing unique identifiers for wholesale traders and underlying clients of DMA traders. NZX's membership of the Intermarket Surveillance Group (ISG)¹⁴, confirmed in early 2016, should further enhance its ability to access information about people trading in its markets.

Focus on market misconduct

The FMA has taken enforcement action against suspected market manipulation three times in the past two years, following referrals from NZX.

In 2015, NZX and the FMA initiated discussions with the Securities Industries Association on trading practices and conduct. This is continuing. When it concludes, NZX will issue revised guidance clarifying the scope of permissible trading conduct, together with the FMA.

¹³ Details of NZMDT's decisions are available in its annual report at www.nzx.com/NZMDT/annual-reports, pages 16, 22, 24 and 35.

¹⁴ The ISG is an international group of frontline market surveillance bodies, with two main purposes: coordinating and developing programs and procedures to identify possible fraudulent and manipulative activities across markets; and information sharing. More information is available at www.isgportal.org/home.html

Regulation, enforcement and policy

One of our strategic priorities is to ensure frontline regulators are effective in their role. NZX's market monitoring and enforcement activities help ensure fair, orderly and transparent markets for a more competitive and productive economy.

From our regular interaction, we are confident that NZX is committed to continuously reviewing how it operates, and adapting to changes and developments in the markets. It has actively improved its regulatory and enforcement activities over recent years, as reported in our previous reviews, and continued to do so in 2015. During the year, activities in this area included:

- working closely with issuers on best practice compliance, particularly the timing, quality and context of market announcements
- improving interaction with NZX's surveillance function on trading inquiries and referrals
- engaging with ASX on issues affecting dual-listed issuers
- working with NZX's policy function on rules reviews.

Rules reviews

An important element of NZX's arrangements for monitoring the conduct of participants in its markets is ensuring market rules remain appropriate for current market conditions and trends.

Completed reviews

We approved changes to NZX's market rules in 2015 to:

- align them with the *Financial Markets Conduct Act 2013* (FMC Act)
- align them with an FMA exemption from the *Financial Advisers Act 2008*, which addresses the use of buffers in client funds accounts
- change the standard settlement from three trading days to two trading days.

There were also changes to the NZMDT rules and procedures, following a review of the penalty provisions and the process for imposing penalties. From February 2016, NZX regulation has had the ability to issue infringement notices. This should enable NZX to address minor breaches more efficiently. We encourage them to consider how the application of this regime can be reported to the market, to help deter non-compliance by others.

Ongoing work

NZX is continuing work on a review of the participant rules. The review reflects recent market developments and trends, the activities of participants, and matters resulting from recent changes in legislation. A review of the corporate governance reporting requirements in the main board listing rules is also underway. NZX hopes to complete these reviews in 2016, following further public consultation.

Governance

The NZX board has ultimate responsibility for NZX's compliance with its obligations. Sub-committees help the board to ensure delegated responsibilities, including the regulatory function, are being exercised appropriately.

Oversight of regulation

We reviewed meeting minutes of the board and the RGC.

Meeting minutes demonstrate that the RGC thoroughly tested the appropriateness and consistency of decision-making. We believe the RGC is operating effectively to ensure the board has appropriate oversight of how NZX is carrying out its regulatory function.

Conflict management

The conflicts committee of NZX's board, established in late 2014, was fully functional in 2015. NZX added a requirement for the committee to have at least one independent member who was appointed in October 2015.

The committee's duties include reviewing the adequacy of NZX group's conflict management arrangements. It commissioned Buddle Findlay to review how conflict management arrangements had worked during 2015. Buddle Findlay found that the arrangements had been effective, processes were well managed, and the policy was well understood. Also, all material recommendations made by EY in a similar report for the previous year had been implemented. This included the introduction of a protected disclosures policy, enabling employees to confidentially raise concerns about conflicts.

During 2015, the committee also reviewed the adequacy of resources for regulation, and assessed potential conflicts from the purchase of SuperLife and the proposed response, as discussed earlier in this report.

NZX also created a head of compliance role during the year, whose responsibilities include ensuring compliance with internal policies and training employees in the conflicts management policy. The head of compliance is secretary to the conflicts committee, and supports the committee's management of its obligations under its terms of reference. The creation of this role enhances NZX's overall compliance and conflict management arrangements.

Other matters

Other obligations

The FMC Act added a new general obligation, requiring NZX to have arrangements for notifying disclosures made to it and for continuing to make them available. NZX makes disclosures available on its website, with the lesser of 50 announcements or six months' historical announcements currently visible for each issuer. All other announcements continue to be available, but through paid subscriptions.

We discussed this new obligation with NZX, and we understand that NZX intends to amend the format of its website to make more historical announcements available free of charge. This may be done in stages and we will continue to work with NZX on this issue.

Other activities

These are additional activities from 2015 that have contributed to fair, orderly and transparent markets.

Monitoring equity derivatives

Equity futures and options were first launched on NZX's derivatives market in 2014. To date there has been minimal trading in these products. However, NZX has been developing processes to ensure effective monitoring, particularly cross-market surveillance of derivatives and the underlying shares. It has identified key risks and designed surveillance alerts.

NZX is reviewing current participant rules about capital requirements for derivatives market participants, to accommodate growth in this market, taking into account participants applying hedging strategies between shares and derivatives.

Reducing errors

There were eight operational errors by the client and market services team (CMS) at NZX during the year. None of these had any impact on the market. NZX analysed the reasons for the errors and CMS has amended processes. Technological systems and alerts are now being used, where possible, to reduce the risk of error.

NZX automated 90% of manual data processes during 2015.

Appendix: Our review

Our role

Under the FMC Act, we are required to review, at least annually, how well a licensed market operator is meeting its market operator obligations, and to publish a written report. This review supports the priorities, outlined in our *Strategic Risk Outlook 2015*, which focus on capital market growth and integrity, as well as ensuring frontline regulators are effective in their role.

We had regular meetings with NZX in 2015. Our memorandum of understanding, signed in January 2015, sets out the principles for engagement and co-operation, and provides for regular operational meetings. This means we are kept up to date on NZX's key initiatives and developments throughout the year. We also communicate based on an agreed set of protocols for dealing with normal business activities that concern both regulators. These include continuous disclosure inquiries and reviewing offer documents.

This regular interaction and coordination meant our review of how NZX met its market operator obligations in 2015 was carried out throughout the year.

We also did an end-of-year review to look at key changes in NZX's business and markets over the year, and the impact on its governance and operations. We looked closely at how NZX regulates its participants' compliance, given the important role NZX participant firms play in driving good trading conduct. This is essential to our strategic priority of supporting market integrity, and is therefore a focus for us.

NZX's markets

NZX is licensed to operate the following markets:

- NZX main board
- NZX debt market
- NZX alternative market
- Fonterra shareholders' market
- NZX derivatives market
- NXT market

Details of NZX's licences are available on our website at www.fma.govt.nz/compliance/lists-and-registers/licensed-market-operators.

The FMC Act explicitly excludes NZX's wholly owned subsidiary, New Zealand Clearing and Depository Corporation (NZCDC), from our review. NZCDC operates a designated settlement system and is regulated jointly by the FMA and the Reserve Bank.

Market operator obligations

In the FMC Act, 'market operator obligations' mean:

- the general obligations contained in section 314 of the FMC Act:
 - to ensure, to the extent reasonably practicable, that each of the licensed markets is fair, orderly and transparent
 - to have adequate arrangements for notifying disclosures from participants in its markets, and for continuing to make them available
 - to have adequate arrangements for handling conflicts between its commercial interests and the obligation to ensure its markets operate in a fair, orderly and transparent manner
 - to have adequate arrangements for monitoring the conduct of participants in its markets
 - to have adequate arrangements for enforcing compliance with market rules
 - to have sufficient resources (including financial, technological and human resources) to operate its licensed markets properly
- an obligation to respond to a request from the FMA to make changes to market rules (*section 333*)
- an obligation to give the FMA an annual self-assessment of compliance with its obligations (*section 337*)
- an obligation to act on the directions of the FMA or the Minister, if the operator is found to be failing to meet any of its obligations (*sections 340 to 342*)
- any obligation imposed as a condition of a market operator's licence.

Information reviewed

Our ongoing oversight of NZX throughout 2015 included:

- periodic operational meetings
- receipt of quarterly documentation under the memorandum of understanding
- discussions about market matters arising as required
- consultation on NZX policies and proposed rule changes where appropriate
- liaison on market misconduct matters
- feedback on referrals made to the FMA by NZX under the FMC Act.

The following was also taken into account for this report:

- NZX's self-assessment of performance against its statutory obligations, provided in March 2016 in compliance with section 337 of the FMC Act
- an onsite review of participant compliance documentation
- NZX board and committee papers and minutes
- NZX procedures and policies, particularly new procedures.

Glossary

CMS	NZX's client and market services team.
DMA trading	Direct market access trading, which allows clients of participant firms to enter orders directly into NZX's trading system, unless the firm's system controls disallow the order.
FMA	Financial Markets Authority
FMC Act	Financial Markets Conduct Act 2013
Issuer or listed issuer	Any company that is or has been listed on any of NZX's markets.
Licensed markets or NZX's markets	Financial product markets NZX is licensed to operate under the FMC Act.
Listing rules	NZX rules governing issuers on NZX's licensed markets.
Market operator obligations	Obligations imposed on a licensed market operator as a condition of its licence or under sections 314, 333, 337, 340, 341 and 342 of the FMC Act.
Market rules	All the rules governing NZX's licensed markets, including listing rules, participant rules and NZMDT rules.
NXT	The NXT market, a stepping stone market for small- and mid-sized businesses.
NXT adviser	A person or firm authorised by NZX to provide advice and support to NXT issuers.
NZMDT	NZ Markets Disciplinary Tribunal, an independent regulatory body for determining potential breaches of NZX's market rules.
NZMDT rules	Rules governing the operation of NZMDT.
NZX	NZX Limited
NZX participant or participant firm	A participant in the licensed markets who has been accredited and approved by NZX under the participant rules.
Participant rules	NZX rules governing participant firms.
Regulation or NZX regulation	The regulatory function of NZX, led by the head of market supervision. It has three functional areas – issuer regulation, participant compliance, and enforcement.