



NZX Regulatory Agenda 2016



NZX Regulatory Agenda — 2016

NZX plays a critical role in supporting the development of New Zealand's capital markets. The equity and debt markets which NZX operates provide access to capital that support the growth and expansion of New Zealand businesses.

As a licensed market operator, NZX is required to regulate the conduct of issuers and participants on its markets. In order to be an effective regulator, NZX pro-actively addresses market trends, changes in technology and law, and developments in international best practice.

Each year NZX develops a regulatory agenda based on changes in the marketplace and the key risks, and legislative and economic factors, which currently influence NZX's regulatory role.

This document sets out NZX's regulatory agenda for 2016. The agenda focuses on three key areas:

- ▶ **Market infrastructure**
- ▶ **Orderly markets**
- ▶ **Market engagement**

The agenda guides the regulatory team's priorities and resourcing, and the outcomes we seek to achieve.



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NZX Regulatory Agenda

NZX's regulatory agenda for 2016 focuses on three key areas:

Market
infrastructure

Orderly
markets

Market
engagement

These areas, and the objectives for each, reflect NZX's statutory obligations, the current economic environment, and NZX's observation of the risks and trends that are impacting or will impact operation of NZX's markets.

Market Infrastructure

NZX's objectives:

- ▶ NZX's market rules balance the need for informed, confident participation in NZX's markets, and the efficient operation of those markets. An imbalance in NZX's approach to regulatory oversight may adversely affect participation and liquidity in the markets.

NZX's regulatory infrastructure is the rules, technology and processes – effectively the market “architecture” – that NZX uses to operate its markets. Key to this architecture are NZX's market rules.

NZX's regulatory infrastructure supports the fair, transparent and orderly operation of NZX's markets. Informed, confident participation by investors in NZX's markets is facilitated by effective and appropriate standards of conduct that apply to issuers and market participants.

AREAS OF FOCUS FOR 2016

Review of corporate governance

In 2015, NZX began consultation on its corporate governance reporting framework for issuers. International examples show that enhanced corporate governance reporting can deliver value for shareholders and stakeholders, with the additional information allowing investors to better assess issuers and make informed investment decisions.

NZX will revise the corporate governance reporting framework for listed issuers to more closely align it with the governance principles set out in the FMA's Corporate Governance Handbook. This should ensure consistency between NZX's requirements and other guidelines and expectations targeted at listed issuers.

NZX is conscious that any changes to its corporate governance reporting requirements will need appropriate materiality thresholds to be applied, and should strike a balance between effective disclosure and the cost to issuers. NZX's corporate governance arrangements need to appropriately reflect New Zealand's market size, and that NZX has a diverse range of listed issuers on its markets.

NZX has sought preliminary feedback on proposals relating to a range of governance principles. It is intended that the market will be further consulted on specific rule changes in Q3 2016, with implementation of amended reporting requirements targeted for Q4 2016.

Review of NZX Main Board/Debt Market Rules

In 2016, NZX intends to commence a review of the NZX Main Board/Debt Market Rules. It is expected that a listing rules review will span 2016–2017. That review will be an opportunity to consult

on a range of issues relating to the scope and application of those rules, including:

- ▶ The implications of domestic and international trends in capital markets and financing
- ▶ Simplifying the rules, so that they can more readily be used as a tool to support issuers' compliance programmes
- ▶ Responding to domestic and international legislative trends and changes in the regulatory environment in which New Zealand's capital markets operate
- ▶ Considering changes to the corporate governance requirements, to support the proposed changes to the reporting framework made under the separate corporate governance review project noted above
- ▶ Considering changes to address where NZX frequently grants routine waivers in order to reduce unnecessary compliance costs

Any rules review will need to ensure that an appropriate balance is maintained between the interests of investors and market participants, key oversight priorities, and the effective and efficient operation of NZX's markets. This needs to take into account the size, scope and complexity of NZX's markets, in the context of the New Zealand economic environment.

Review of NZX Participant Rules

NZX is currently conducting a review of NZX's Participant Rules. The review reflects recent market developments and trends, the activities of participants, and matters consequential to recent legislative changes.

The key areas of review include:

- ▶ Reducing overlap between the NZX Participant Rules and legislation: Areas of overlap include the regulation of financial advice, operation of discretionary accounts, custody of client assets and the requirements of "know your client" obligations for client advising participants. These are all subject to parallel regulation under either the Financial Markets Conduct Act 2013 (FMC Act), Financial Advisers Act or other regulation.
- ▶ Improving the effectiveness of rules: NZX considers that various rules are unduly onerous, relative to the benefit to the market. Further, NZX considers that other rules could be revised to enhance NZX's oversight and inspection processes.
- ▶ Application of the capital adequacy requirements for participants: NZX imposes capital requirements on participants, depending on their role and their relative risk exposures. NZX is considering amending the scope of those capital requirements to better reflect the risk profile of each participant and to consolidate requirements contained in difference rule sets.
- ▶ Proposals to introduce additional surveillance tools: NZX is also proposing amendments that will improve the quality of the real time information available to support NZX's surveillance activities. These proposals will enhance NZX's ability to detect market misconduct and real time market issues.

Following its review of submissions on the discussion document, NZX will consult with the market on detailed rule change proposals in Q3 2016, with implementation of rule changes targeted for Q4 2016.



Orderly Markets

NZX's objectives:

- ▶ Comprehensive and effective frontline monitoring and enforcement of trading misconduct on NZX's markets.
- ▶ Market participants clearly understand the scope of permissible trading conduct on NZX's markets.
- ▶ Market participants effectively monitor and mitigate risks associated with potential market misconduct at an operational level.

NZX's supervisory functions include frontline monitoring of trading conducted on NZX's markets. NZX also has a responsibility to educate market participants on the rules and best practice expectations. Together, these support the detection and prevention of potential market misconduct, and maintaining the orderliness of NZX's markets.

AREAS OF FOCUS FOR 2016

Trading conduct guidance

NZX and the Financial Markets Authority (FMA) established a trading conduct working group in 2015.

The objective of the working group is to provide greater clarity to the broker and funds management industries on the parameters of permissible trading conduct. As part of this, NZX and the FMA will highlight practices that they consider are, or may be, indicative of potential market misconduct.

During 2016, NZX and the FMA are continuing to engage with participants in the broker and funds management industries on current trading practices. Following this, NZX and the FMA will collaborate on guidance to the securities industry clarifying the scope of permissible trading conduct.

This will include NZX publishing a revised edition of its market manipulation guidance note.

The guidance note will provide examples of conduct that NZX considers may be manipulative. It will also highlight measures that brokers should implement to ensure compliance with their market manipulation obligations.

NZX will actively engage with participants in 2016, and facilitate compliance training workshops, on practical implications of that guidance.

Refine inspection process and risk profile procedures

As part of NZX's ongoing monitoring programme, accredited market participants are subject to annual risk assessments, and on-site or desk-based inspections.

NZX intends to further enhance its risk assessment methodology in 2016. This includes transitioning to "real time" risk assessment. In late 2015, NZX imposed additional reporting requirements on brokers for trading activities, client assets and capital positions. In 2016, NZX will integrate this additional information into its risk assessment

process, together with additional monthly risk data from NZX Surveillance and NZX Clearing. This will enhance the quality and relevance of data received about participants.

NZX's 2016 inspection programme will include, among other things, in-depth investigation of a number of matters that contribute to identifying and preventing market misconduct, including reviews of brokers' compliance monitoring plans, Direct Market Access (DMA) arrangements, and trade monitoring. NZX will proactively work with participants to recommend and implement best practice improvements it identifies.

NZX will continue to collaborate with the FMA on inspection processes in 2016. This will include considering additional mechanisms to reduce duplication, given the joint regulatory roles in relation to brokers.

ISG membership and access to information

In December 2015, NZX was approved as a member of the Intermarket Surveillance Group (ISG).

The ISG is an association of international securities exchanges and regulators. It provides a framework for the sharing of information and the coordination of regulatory efforts to address potential intermarket manipulations and trading abuses.

NZX's membership of ISG will contribute to the maintenance of fair, orderly and transparent markets. It will enhance NZX's access to information about anomalous market conduct that might not otherwise be available to NZX. This is important given the rise of DMA trading and overseas participation in NZX's markets. Membership of ISG will allow NZX to better monitor trading that is initiated from overseas or which has been intermediated through overseas brokers.

In 2016, NZX will look to leverage its membership of the ISG to support its frontline investigation of offshore order origination. NZX will also utilise ISG best practice, and the work of ISG's committees and working groups, to support NZX's broader surveillance work.

Market Engagement

NZX's objectives:

- ▶ Support and facilitate the development of issuer and participant compliance frameworks, addressing their approach to organisational culture and conduct.
- ▶ Enhance NZX's risk-based regulatory approach. That approach supports market development through applying and enforcing clear and balanced obligations and standards to existing and prospective issuers, new financial products, and existing and prospective market participants.

AREAS OF FOCUS FOR 2016

Investor information and issuer disclosure practices

Investors need access to full, timely and accurate information in order to make informed investment decisions.

Confident participation in NZX's markets also requires confidence in the transparent operation of those markets and of the price discovery process – where the pricing accurately reflects underlying demand and information generally available to the market. This applies to new issues of securities and secondary trading.

In 2016, NZX Regulation will increase its focus on the quality of issuer disclosures, and practices relating to the timing of release of announcements to the market.

Increased issuer engagement

In 2015, NZX Regulation worked closely with the NZX's markets and operations teams to provide compliance training for issuers and their advisers.

NZX will continue to develop and implement its issuer engagement strategy in 2016. This will involve better understanding issuers' approaches to compliance. NZX will also use its ongoing trend analysis to identify key risks for issuers and will target market education accordingly. The focus of this engagement will be on continuous disclosure, corporate governance issues, and best practice relating to the content and timing of market announcements.

NZX will also focus on issuer maturity, and enhance engagement on matters that are particularly relevant to new and prospective issuers.

Engagement will be tailored to reflect the particular needs, size and experience of issuers operating in the listed issuer environment. It will include:

- ▶ Direct one-on-one engagement with key management
- ▶ Issuer workshops on key regulatory themes and issues
- ▶ Additional written guidance on best practice

Increased broker engagement

In connection with NZX's increased focus on engagement, NZX will also increase its interaction with brokers outside of the annual inspection process. This will focus on personnel in brokers' compliance and trading teams.

In 2016, NZX intends to undertake:

- ▶ Workshops on the standards and guidance to be issued following the outcome of the trading conduct working group process (described elsewhere in this document), and the revised NZX market manipulation guidance note
- ▶ Engagement on the amendments made to the NZX Participant Rules
- ▶ Education of newly accredited overseas participants in relation to functional compliance issues

Risk-based offer document reviews

NZX Regulation has a role in reviewing offer documents for primary and secondary capital raisings on NZX's markets. NZX has increased its collaboration with the FMA on offer document reviews, given the FMA's role in relation to securities offers under the FMC Act.

In 2016, NZX will take a more risk-based approach to reviews of offer documents, to ensure that those documents meet prescribed content requirements and effectively and adequately disclose material offer information to potential investors.

Appendix: Introduction to NZX's Regulatory Functions

A summary of NZX's regulatory functions is set out below. The summary also includes commentary on current trends and factors that influence, and provide the context for, NZX's regulatory agenda for 2016.

REGULATORY FUNCTIONS

NZX has two key regulatory functions in respect of the operation of NZX's markets:

- ▶ **Regulating market conduct:** NZX is responsible for monitoring and enforcing the rules under which NZX's markets operate. This applies directly to issuers and market participants and indirectly (through market participants) to investors. This function is undertaken by the NZX Regulation team.

- ▶ **Market rules and policies:** NZX is responsible for developing and enhancing the market rules, practices and policies under which NZX's markets operate. This function is undertaken by the NZX Policy team.

These functions are supported by NZX Market Services, which provides operational support to NZX's markets and conducts frontline trade monitoring.

NZX Regulation

NZX Regulation is led by the Head of Market Supervision who reports directly to the NZX Board. It covers three broad areas of regulatory focus:



The Issuer Regulation team administers the NZX Listing Rules, and supervises compliance by listed issuers with those rules. The team:

- ▶ engages with Listed Issuers concerning continuous disclosure and market releases
- ▶ considers applications for new listings
- ▶ considers applications for waivers and rulings in relation to the NZX Listing Rules
- ▶ reviews documents for compliance with the NZX Listing Rules
- ▶ manages trading halt applications
- ▶ refers suspected rule breaches to the Enforcement team for investigation and enforcement as appropriate

The Participant Compliance team administers the NZX Participant Rules and NZX Derivatives Market Rules, and supervises compliance with those rules by market participants. The team:

- ▶ considers applications for accreditation as a market participant
- ▶ considers applications for waivers and rulings in relation to the NZX Participant Rules, if there exist commercial and policy reasons why a market participant will not be able to comply
- ▶ performs capital and prudential inspections and risk profiling of participants
- ▶ investigates suspected NZX Participant & Derivatives Market Rules breaches, and refers suspected rule breaches to the Enforcement team for enforcement as appropriate

The Enforcement team investigates suspected breaches of NZX's market rules and takes action in accordance with NZX's Enforcement Policy.

NZX Policy

NZX sets the rules for trading on NZX's markets, including the NZX Main Board / Debt Market and NZAX Listing Rules, NXT Market Rules, NZX Participant Rules and NZX Derivatives Market Rules. The rules are enforceable as a contract between NZX and each participant or issuer, and the continuous disclosure provisions are also enforceable under the FMC Act. NZX publishes guidance to assist those subject to NZX Rules to meet their regulatory requirements.

The NZX CEO is responsible for NZX's regulatory policy, and the work is led by the Head of Policy and Legal.

Market Services

In addition to the core regulatory functions undertaken by NZX Regulation and NZX Policy, market operations are monitored by NZX's Market Services team, namely:

- ▶ Surveillance
- ▶ Client and Data Services (CDS)

The Surveillance team performs real time and post-trade monitoring. This includes analysis of abnormal market conduct or trading, and allegations of market misconduct on NZX's markets.

The Surveillance team uses market-monitoring software (SMARTS), market information from the NZX's trading system (X-stream), databases that update in real time with securities movements and volume statistics from information providers such as IRESS and Bloomberg, as well as NZX's historical database of market activity.

The CDS team monitors and processes market announcements, and monitors for compliance with issuers' periodic reporting requirements.

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RISK AND TRENDS CONTEXT

Capital markets inherently involve risk and are impacted by market trends. These include macroeconomic risks, market activity and capital inflows and outflows, as well as other risks which may directly or indirectly impact on the financial product markets NZX operates.

These risks are a factor for NZX in setting its regulatory agenda, as they are often drivers of conduct.

Some of the key drivers of risk and key trends affecting NZX's regulatory environment are set out below.

Participation in NZX's markets

Issuers and brokers are key drivers of conduct on NZX's markets. Their resources, experience and governance shape their compliance culture and their approach to compliance with NZX's rules.

NZX's issuers are a diverse group. Although there are a number of large, sophisticated listed issuers, a key feature of NZX's markets is the number of smaller and medium-sized companies. There has also been a significant growth in the number of new issuers on NZX's markets in recent years. NZX has observed that these dynamics can sometimes present challenges to those issuers, their compliance frameworks, and how they respond to market events that have implications under NZX's market rules.

There has also been an increase in the number of issuers who have dual listings on NZX's Main Board together with a primary or secondary listing on another overseas exchange. This includes issuers who have adopted "foreign exempt issuer" status on the ASX. Dual listings result in issuers being subject to multiple sets of listing rules, and have compliance obligations in multiple jurisdictions. This can increase the risk of information asymmetry on the different exchanges where an issuer is listed, different regulatory

and operational approaches being taken by the relevant exchanges, and opportunities for trading arbitrage between listing venues.

NZX accredits brokers and advisors to undertake certain services on NZX's markets. The composition of this group of market participants is evolving.

There has been a notable increase in the number of overseas entities seeking accreditation as derivatives trading participants. This reflects the growth of NZX's dairy derivatives market as a developing global leader in tradable dairy futures and options. This follows NZX's registration in 2014 as a foreign board of trade by the U.S. Commodities and Futures Exchange Commission. That registration means accredited US-based derivatives market participants can directly access dairy derivatives products quoted on NZX's Derivatives Market.

Increased participation by overseas-based broking firms will affect NZX's approach as the regulator of participant conduct on its markets. This reflects the potential impacts of newly accredited participants not having a working knowledge of applicable market rules and legislation, or the expectations and best practice standards imposed by NZX. Logistical constraints may also apply where participants' compliance functions are based overseas, rather than in New Zealand.

Technological innovation

The regulation of exchanges is increasingly being impacted by technology.

Innovations relevant to NZX's markets include developments in electronic trading, and increased integration of global markets.

▶ ***Developments in technology can directly benefit NZX's regulatory function. They can, for example, create electronic trading audit trails, enhance order and trade transparency, allow for the development of automated risk controls and for regulators such as NZX to monitor how those controls are being used.¹***

A number of technology innovations are increasingly prevalent on NZX's markets. These include:

- ▶ Algorithmic and high frequency trading, which use computer trading programmes to execute trades.
- ▶ "Dark pool" arrangements, which involve direct off-market trading, usually between market participants and institutional investors.
- ▶ Direct Market Access (DMA), which allows clients to directly access and place orders in NZX's trading system.

These innovations have resulted in improved efficiency and cost effectiveness in order execution.

However, if trading technologies do not operate as intended, or operate with inadequate oversight, they can potentially result in abnormal

trading. That trading can pose risks to market efficiency and integrity, and to the transparency of liquidity in the market and price discovery.

Market manipulation

A fundamental component of fair and orderly markets is price transparency which reflects genuine supply and demand. NZX actively supervises trading on its markets to support this objective.

Manipulative behaviour poses risks for NZX. It can damage the integrity of the markets and undermine investor confidence, by creating a false or misleading appearance as to the extent of trading, supply or demand, or the price of securities.

NZX's surveillance function, together with the NZX's market rules and guidance, is integral to the monitoring for potential market manipulation on NZX's markets and for enforcing the rules.

Information quality

Investors in NZX's markets must have access to full, timely and accurate disclosure to make informed investment decisions.

The quality of disclosures and disclosure practices varies significantly between issuers on NZX's markets. Inadequate disclosure practices can adversely impact confident participation on NZX's markets, particularly if it means that trading occurs where there is an asymmetry of information in the market.

¹ Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency, Final Report of the Technological Committee of IOSCO, FR09/11, page 10.

Regulatory coordination

NZX and the FMA have “joint regulatory” responsibility for a number of regulatory issues, including:

- ▶ Continuous disclosure
- ▶ Surveillance and investigation of insider trading and market manipulation
- ▶ Investigations and complaints concerning brokers
- ▶ Approval of market rules
- ▶ Review of offer documents for regulated offers of securities under the FMC Act

These require coordination and collaboration between NZX and the FMA to ensure that oversight is efficiently managed.

In addition, other government agencies have roles that directly impact NZX’s markets. These include the Ministry for Business, Innovation, Industry and Employment, the Reserve Bank of New Zealand, and the Takeovers Panel.

Measures introduced by these agencies can impact participants in NZX’s markets, and affect NZX’s regulatory functions. This requires NZX to be proactively involved in relevant policy debates, and to coordinate with those agencies on relevant matters.

LEGISLATIVE CONTEXT

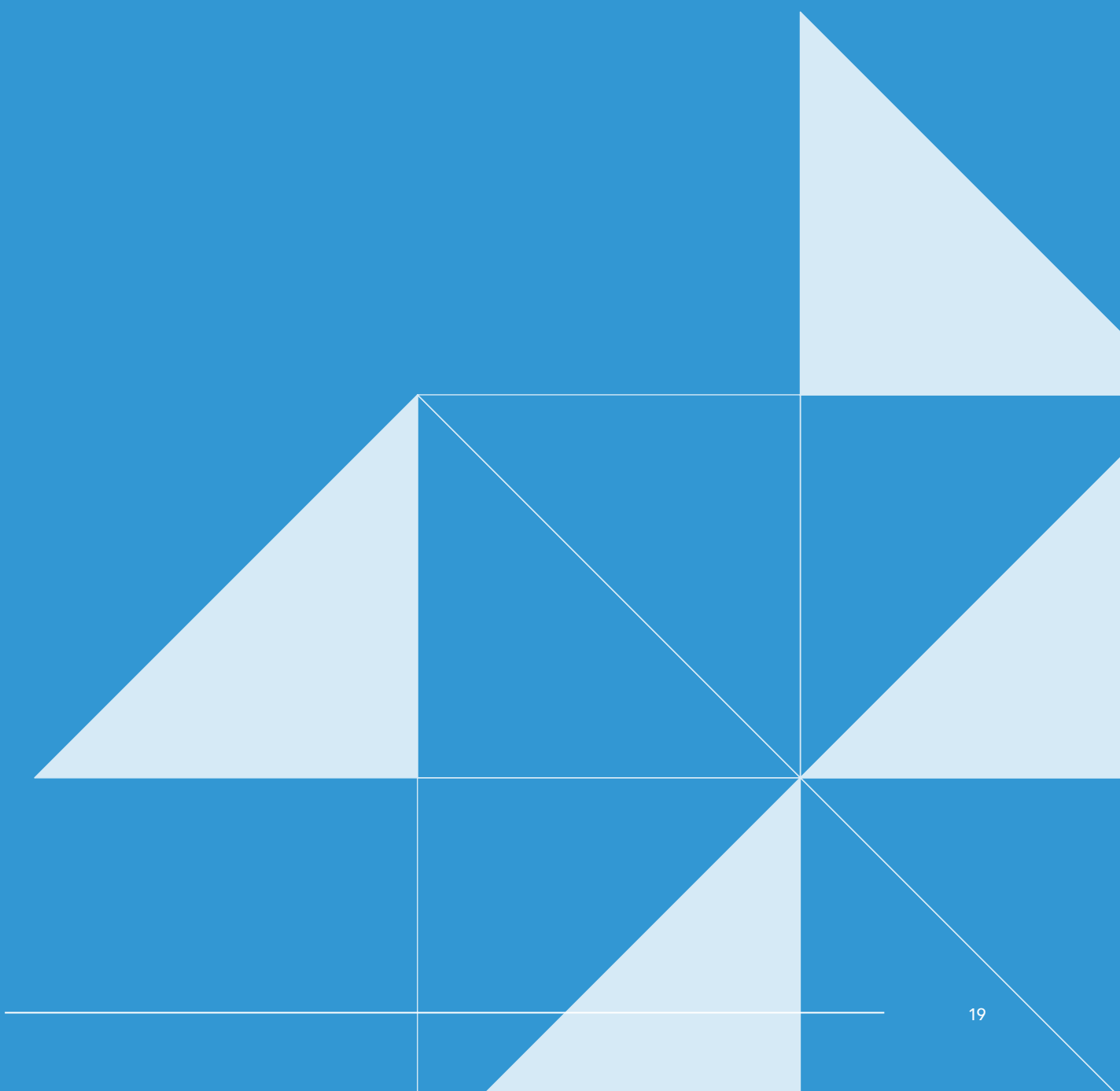
The legal framework that underpins New Zealand’s capital markets activity is subject to ongoing change.

This has included recent implementation of the FMC Act, review of the financial advisers and financial service providers’ regime, and continued changes in international financial services legislation and audit requirements.

These changes, and the policy drivers that influence them, will continue to affect the way in which NZX performs its oversight function, delivers on its regulatory policy strategy, and is assessed on the discharge of those functions.

The FMC Act is key to the operation of New Zealand’s public financial markets. It imposes obligations on NZX as a licensed market operator. This includes requiring NZX to do all things, to the extent that it is reasonably practicable, necessary to ensure that its markets are fair, orderly, and transparent. NZX is assessed annually by the FMA on its compliance with those requirements.







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