

## **5<sup>th</sup> Round Table on Capital Market Reform in Asia**

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### **Consolidation and Demutualisation – What Strategies should Exchanges Adopt for the Future?**

## **Report from New Zealand**

**Jane Diplock AO**

**Chairman, Securities Commission, New Zealand**

New Zealand investors have witnessed significant changes since the Fourth Round Table on Capital Market Reform in Asia in April 2002. Eighteen months is not a long time, but in New Zealand it has seen the passing of important new securities laws relating to stock exchanges, insider trading, continuous disclosure and directors' reporting, and new powers for the Securities Commission. The New Zealand Stock Exchange has demutualised and has recently listed on its own board. A new futures market is being developed by the New Zealand Stock Exchange and the Sydney Futures Exchange. There has been an increasing focus on corporate reporting and governance issues.

#### **New law**

New securities law come into force in New Zealand late last year. This legislation reflects the continuing commitment on the part of the Government to the New Zealand securities markets and to building investor confidence in those markets. The new laws seek to make the New Zealand market attractive to overseas investors and cost-effective for local and international firms. They aim to provide appropriate standards of regulation to protect the interests of investors.

The law gives the Securities Commission new functions and powers. Many of these are to enable the Commission to be more effective in its investigations and enforcement actions and to better target its resources against serious market malpractice. The Commission's powers to gather information have been strengthened, particularly its ability to obtain information for its overseas counterparts. The penalties for obstructing the Commission have been increased.

*Regulation of securities markets*

The legislation introduces a new regulatory structure for securities exchanges and markets operating in New Zealand. It gives the Securities Commission a specific function to review and comment on activities on securities markets.

The new law does not require the registration of all securities markets. Instead it provides a mechanism whereby market operators can choose to register, or, where their activities are significant, can be required to register by the Minister of Commerce. The government's intention was to ensure that the law could be applied where the interests of investors in the New Zealand market require this, but to avoid presenting a deterrent to the development of small and innovative trading platforms.

No organisation can say it is a registered exchange, or an exchange that is regulated under New Zealand law, unless it has been registered under the law. The Commission can prohibit statements by any organisation that breaches this rule, and require it to make corrective statements.

Registered exchanges are required to have conduct rules approved by the Minister on the advice of the Commission. Any changes to the rules are subject to a disallowance procedure. The registered exchange must operate its markets in accordance with its conduct rules.

The government can make regulations imposing a control limit on the ownership of registered exchanges. The New Zealand Stock Exchange has a control limit of 10%, meaning no person (and associates) can own more than 10% of the company.

In certain circumstances the Commission can give a binding direction to a registered exchange to suspend trading in securities of one or more issuers, or to take some other action in relation to trading in those securities. This can happen where an issuer or an exchange has breached continuous disclosure requirements, and where the Commission is satisfied that a direction is needed to protect people trading in the securities, and there is no other more appropriate course of action. In other cases the Commission can give directions where it believes this is necessary in the public interest to protect people trading the securities.

The Commission and registered exchanges have joint responsibilities under a new continuous disclosure framework. This framework gives statutory backing to the continuous disclosure rules that every registered exchange must have. The law sets out the continuous disclosure criteria, and requires registered exchanges to have rules that achieve the purpose of these criteria.

#### *Enforcement of market laws*

The Commission enforces the new continuous disclosure laws. It can require a public issuer to disclose information if it has breached a continuous disclosure obligation, and to publish any statements that are needed to correct the effects of the breach. Where a public issuer has breached a continuous disclosure obligation the Commission can take an action in Court for civil penalties. The maximum penalty is \$300,000.

The Commission can take court action against suspected insider traders. It can take up the right of action that a public issuer has against a suspected insider trader if it is in the public interest to do so. At the same time the existing rights of public issuers and shareholders to bring actions for insider trading themselves remain in place.

Another area of responsibility, soon to come in force, relates to disclosure by directors and officers of listed companies of trading in the shares of their company. This law needs regulations to be complete. When this new law comes into force the Commission will be able to require directors and officers to disclose trading if they fail to do so within the 5 days required under the law.

#### *Cross-border offers*

The new law also put in place a mechanism for the New Zealand government to make regulations for the cross-border recognition and application of laws for offers of securities. The regulations will be able to recognise specific jurisdictions, or specified products within a jurisdiction, and will enable offers to be made in New Zealand under the laws of the home jurisdiction, enforceable in New Zealand courts. Other regulations may extend the jurisdictional reach of New Zealand securities laws (with the agreement of the other jurisdiction), so that offers into other countries can be made by New Zealand issuers, using New Zealand law. Discussions are currently underway with the Australian government for a

mutual recognition regime, allowing complete recognition of securities offerings between our two countries.

This new legislation is the most important piece of securities law we have seen in New Zealand for some time. It is also a significant piece of law in terms of the relationship between the New Zealand Exchange and the Commission. It conferred on the Commission an oversight or monitoring role over the registered exchanges which did not formally exist before. The law now emphasises the “desirability of an effectively functioning framework of co-regulation of listed markets by registered exchanges and the Commission”.

### **New Zealand Exchange Limited – new name, new responsibilities**

We reported to the Fourth Round Table on Capital Market Reform in Asia in April 2002 that merger discussions between the New Zealand Stock Exchange and the Australian Stock Exchange had been undertaken, but had concluded with a decision by both parties not to proceed further. This year has seen the New Zealand Stock Exchange take important steps in its development as a commercial entity, and has seen corresponding developments in the law to strengthen the regulatory responsibilities of the exchange.

On 31 December 2002 the New Zealand Stock Exchange demutualised, following a vote of its members. The stock exchange, formerly a statutory corporation, became a limited liability company, called New Zealand Stock Exchange Limited.

In July 2003 the stock exchange took a further step when it listed on its own market, at the same time raising further capital via a public share offer.

On listing the stock exchange changed its name again, to New Zealand Exchange Limited – trading as NZX.

NZX had demutualised under a special Act of Parliament, which set out a mechanism for a vote by the members of the exchange. We reported last year on the protective measures added to this legislation, which recognise the important role of the stock exchange as a facilitator of investment in New Zealand business. We said at that time that wider reforms were expected. These have occurred, as outlined above. They recognise the importance of high standards of regulation for stock exchanges. It is particularly important for a small

economy, if it is to attract investment, that its market structures are seen to have integrity and to provide adequate protection for all market participants.

The new law sets up a “co-regulatory” structure, giving responsibilities to NZX to regulate its markets, and making these subject to the oversight of the Securities Commission.

NZX continues to regulate under its conduct rules. These rules are a matter of contract between NZX and market participants – NZX firms and stockbrokers in the case of the business rules, and listed issuers and directors in the case of the listing rules. The rules are subject to approval by the government.

The new law places certain obligations on the NZX, including obligations to:

- refer certain matters to the Commission, including disciplinary action taken under its conduct rules, and suspected breaches of the law;
- provide information, assistance, and access to its facilities to the Commission when requested;
- submit its conduct rules, and changes to these rules, to the Minister; and
- consult with the Commission about determinations (rulings and waivers) concerning its continuous disclosure rules;

The NZX and the Commission have agreed a memorandum of understanding, to enhance the certainty and efficiency of our dealings, and to make it clear to the market how we work together as co-regulators.

### **Memorandum of Understanding with the New Zealand Stock Exchange**

There has always been a relatively close working relationship between the New Zealand Stock Exchange and the Commission but new law has provided the impetus to formalise the relationship. The MOU sets out the framework for this.

In essence, the Stock Exchange is the frontline regulator concerned with breaches of its rules and performing a monitoring role in relation to trading activity. The Commission, as the statutory regulator, is concerned with responsibilities under the law, except the responsibility for prosecution of criminal breaches of securities law which rests with the Registrar of Companies.

The principle aim of the MOU is to co-operate for effective regulation of New Zealand's securities markets. Our shared goal is the optimal regulation of those markets.

To achieve this, the MOU sets out relationship principles:

- to communicate in an open, honest, and timely way,
- to respond promptly to requests;
- to exchange information and ideas to improve surveillance and regulation by each organisation;
- to recognise the importance of compliance costs for market participants;
- to promote the efficient use of resources by communicating well and minimising duplication of surveillance and regulatory operations; and
- to provide feedback following investigations to assist in the efficient use of resources.

Guided by these principles the MOU covers areas in which the Commission and the NZX have shared or complementary responsibilities including:

- referrals of disciplinary matters and suspected breaches of the law to the Commission from NZX;
- referrals of suspected breaches of NZX conduct rules to NZX from the Commission;
- consultation on waivers and rulings relating to the continuous disclosure provisions of the conduct rules;
- procedures (including prior consultation) relating to the Commission's power to give directions to NZX;
- procedures for approval or disallowance of the conduct rules.

The MOU does not cover certain things. Firstly it does not limit the assistance that we and the NZX can give each other. We are not bound by rigid statements that could cause this sort of limitation in practice.

Secondly the MOU does not limit or affect the independence of each organisation. In particular it does not limit the ability of the Commission to carry out its statutory functions and powers in the public interest.

Finally, the MOU does not simply repeat our statutory obligations. The MOU has been developed to supplement the statutory responsibilities for best effect on the markets and ultimately on investors.

The Commission and NZX both recognise that effective co-operation is vital if the co-regulatory framework set up under the Securities Markets Act is to succeed. We have a shared goal of achieving optimal regulation of New Zealand's securities markets through this co-operation. We aim to promote investor confidence by having a well-regulated market, including efficient enforcement of the rules and laws of the market, and efficient processes that recognise the costs of regulation for participants in the markets.

The result we want is a market that attracts more investors and more issuers. Both the Commission and NZX believe this agreement between us is beneficial to achieving that goal.

### **Futures markets**

The New Zealand futures markets undergone equally important changes in the past year. New Zealand currently has two authorised futures exchanges, Zealand New Zealand Futures and Options Exchange Limited (NZFOE), and Sydney Futures Exchange Limited (SFE). NZFOE has been a wholly owned subsidiary of SFE since 1997. Last year SFE decided to move trading in NZFOE products to Sydney. The great majority of trading on NZFOE has been by wholesale participants in interest rate products.

While the NZFOE and SFE are merged at a corporate level, until now the two exchanges were operated essentially as separate entities, each subject to dual regulation by Australian and New Zealand authorities. Traders on each exchange have been able to access products of the other, via the shared SYCOM® trading system.

The decision to move NZFOE's operations to Australia was a commercial one. With the majority of trading undertaken by wholesale participants, and with ready access to the electronic trading system for these participants, it is not expected that access to the products will be lessened. However, it was expected that the move would have implications for the New Zealand market, in particular the development of new futures products.

In addition, the Commission has in the past relied on the self-regulatory operations of NZFOE in authorising futures dealers. As a result of the decision to move trading, the Commission sought the industry's views on regulating futures dealers. Most responders preferred a self-regulatory model, with regulation by an entity involved in the market place,

but in the absence of NZFOE there was no readily identifiable industry body that could reliably perform this function.

Last month NZX, the registered securities exchange, concluded an agreement with SFE for listing and trading equity futures and options contracts for NZX listed securities. The agreement gives NZX an 8 year licence to develop and list equity derivative products based on NZX listed securities. The contracts will be listed and traded on the SFE market. The deal enables NZX to provide a range of futures and options contracts to New Zealand investors through the listing of these equity products on the Sydney Futures Exchange.

NZX had been exploring options for providing derivative products to investors. The agreement that has been concluded will see NZX being responsible for marketing the products, and for the trading of them by New Zealand dealers, with SFE providing the trading and clearing infrastructure, and regulation of its own participants.

The agreement between NZX and SFE illustrates one of the advantages for small exchanges of cross-border or regional alliances. New markets, particularly derivatives markets, are complex and costly to set up. The arrangement between NZX and SFE allows the development of a local market using the existing infrastructure of a developed overseas exchange. NZX says that this arrangement, worth around A\$1 million, was significantly cheaper than any option that NZX could develop itself for providing derivative products for New Zealand investors.

NZX will be responsible for the regulation of New Zealand dealers (other than SFE participants). This will include any NZX stockbrokers who wish to deal for clients in the new products. NZX already has in place business rules for the conduct of its stockbrokers, and should be able to leverage on its experience in this area to provide a comprehensive self-regulatory structure for futures dealing.

The NZX is currently developing its proposal to take a role in regulating exchange futures dealers in New Zealand.

The Commission will continue to work with the NZX on the structure for NZX's proposed regulatory role, including supervision and oversight, and rules of conduct and trading for futures dealers.

NZFOE contracts have been cleared through the Sydney Futures Exchange Clearing House for more than 10 years. As such, we have some experience in the challenges of cross-border regulation. As the NZX/SFE proposal is developed it will be important that the respective responsibilities of the New Zealand and Australian regulators, and the two exchanges, are both clear to regulators and participants alike. Essential to this are adequate provisions for the sharing of information among regulators and exchanges. Where possible, costs should be minimised by avoiding duplication of regulation. Equally importantly we must ensure that the shared responsibilities do not lead to regulatory gaps. The changes brought about by the recent law changes will provide a helpful framework for cooperation and information sharing between the Commission and the exchanges.

We think there are advantages for the industry and the market in having an effective self regulatory framework for futures dealers. There are advantages for New Zealand in having a locally promoted and developed derivatives market. The task ahead is to ensure that this new alliance can be provided within a structure that operates efficiently and provides adequate protection for investors in the market.

### **Conclusion**

Quite profound changes have occurred in the structure and regulation of New Zealand's capital markets in the past couple of years. These changes include an increasingly important role for the Commission in the regulation of our markets. The stock exchange has embarked on a phase of commercial development, and a new futures market is emerging. We see in these changes the development of both a domestic equities market and a cross-border alliance for the provision of equity products. Both models have advantages. Both bring regulatory challenges. Our overall goal continues to be to foster our securities markets so that they are attractive to investors, efficient and cost effective for operators and participants, and have standards of protection for investors that compare internationally.

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