



GENERAL OBLIGATIONS REVIEW OF NZX JUNE 2013

Financial Markets Authority

AUCKLAND

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

Website: www.fma.govt.nz

WELLINGTON

Level 2
1 Grey Street, Wellington
PO Box 1179, Wellington 6140

June 2013

ISSN 2324-4003 (Print)

ISSN 2324-4011 (Online)

CONTENTS

Context of this report	2
FMA's approach to regulation	2
Foreword	3
Executive summary and conclusion	5
Our conclusion	5
Key findings	5
Implementation of expected actions from the 2011 Report	5
Observations and recommendations	5
Summary tables	6
Section 1: NZX and its obligations	9
1.1 NZX	9
1.2 NZX's Statutory Obligations	10
1.3 Obligations on NZX to self-assess	11
1.4 NZX's Market Assessment Report	11
Section 2: FMA's assessment	12
2.1 Obligations on FMA to assess NZX	12
2.2 Approach to FMA's assessment	13
Section 3: Changes at NZX in 2012	14
3.1 Personnel changes	14
3.2 Business changes	16
Section 4: Expected actions – 2011 Report	17
4.1 Introduction	17
4.2 Progress against expected actions	17
4.3 Addressing recommendations	22
Section 5: Conclusion and key areas for continued focus	23
5.1 Conclusion - compliance with the Statutory Obligations	23
5.2 Key areas for continued focus	23
Section 6: General observations and recommendations	29
6.1 Introduction	29
6.2 Board oversight of NZX's compliance with the Statutory Obligations	29
6.3 NZX's wider infrastructure	31
Section 7: NZX business unit and Tribunal observations and recommendations	34
7.1 Introduction	34
7.2 Regulation	34
7.3 Issuer Regulation	37
7.4 Participant Compliance	39
7.5 Market Services	42
7.6 Client Market Services	44
7.7 Surveillance	46
7.8 Technology	48
7.9 The Tribunal and the Special Division	51
Appendix 1: Market conditions	54
Appendix 2: Glossary	57

CONTEXT OF THIS REPORT

This report summarises the Financial Markets Authority's (FMA's) assessment of compliance by NZX Limited (NZX) with its obligations under:

- section 36Y of the Securities Markets Act 1988 (*the Act*)
- clause 7(1) of the Authorised Futures Exchange (NZX Limited) Notice 2012 (*Futures Exchange Notice*)

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. This report therefore reviews NZX's operation of its Main Board (NZSX), Alternative Market (NZAX) and Debt Market (NZDX) and the Fonterra Shareholders' Market (FSM) (collectively *the Registered Markets*).

Although the Futures Exchange Notice does not place an express obligation on FMA to do so, this report also reviews NZX's operation of its authorised futures market, the Derivatives Market, since NZX's obligations under the Futures Exchange Notice are similar to those under the Act. It does not deal with other markets and activities operated by NZX, as they are not regulated by FMA under the Act.

This is the second assessment of NZX under amendments made to the Act in May 2011. The period under review was 1 January 2012 to 31 December 2012 (*the Review Period*).

Capitalised terms used in this report are defined in the glossary attached in Appendix 2.

FMA'S APPROACH TO REGULATION

FMA's principal objective is to promote and facilitate the development of fair, efficient and transparent financial markets. 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.

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

0,75 ▲

FOREWORD

In the past year the formal oversight regime for Registered Exchanges, introduced by amendments to the Securities Markets Act 1988 in 2011, has been embedded. FMA and NZX have developed a productive working relationship, with ongoing discussions and communication between both parties on matters relevant to the regulation of the securities markets, and to NZX's Statutory Obligations.

FMA's perception is that NZX has improved its approach to assessing its performance against the Statutory Obligations. This has been evident from general interactions between FMA and NZX, especially in the second half of the Review Period, and from the interviews specifically carried out as part of this review. There is a clear understanding of this change throughout the organisation.

FMA considers that NZX has committed itself to a programme of continuous improvement in all aspects of its operations that contribute to its delivery of fair, orderly and transparent markets – from its technology platforms, business processes and systems, to its front-line regulatory role. This commitment starts at the top of NZX and has been evident in our interactions with the NZX Board and Chief Executive Officer.

At a governance level, there is a greater appreciation that good processes and record-keeping are valuable regulatory resources, that can be mined for useful information to help achieve better-informed decisions and therefore better market outcomes, rather than regulatory costs.

The General Obligations Review assesses NZX's compliance with the Statutory Obligations, but it does not determine how NZX wishes to develop its Registered Markets and the Derivatives Market. For the second half of the Review Period, NZX's activities that contributed to compliance with the Statutory Obligations were dominated by responding to issues raised in the previous review, rather than attending to NZX's self-identified priorities. In NZX's most recent self-assessment, FMA has seen NZX being more forward thinking, identifying gaps and setting out its own focus areas for the coming year. This is consistent with its continuous improvement programme.

For this review, there was a readiness on NZX's part to accept that in some instances processes need more work, and a willingness to receive feedback in relation to them. There was also a willingness to admit where some areas of NZX's performance needed enhancing, most notably in the enforcement area.

The Review Period included FMA carrying out rolling file reviews for each quarter, so that NZX could gain feedback during the year as to FMA's views on its performance in certain areas. FMA envisages this ongoing interaction will increase over time, so that the General Obligations Review becomes less of a stand-alone project, and more like a summation of the previous period's interactions between NZX and FMA. To put it another way, the General Obligations Review should contain few surprises for either NZX or FMA, reflecting the continuous and productive engagement between the parties on an ongoing basis.

There are certain expected actions from the previous review that NZX has already taken significant steps to implement, but which steps, due in large part to the timing of their implementation, or because NZX is part way through their implementation, FMA considers have not yet completely addressed the expected action so as to achieve the intended outcome. As such, there are still key findings in respect of NZX's performance, most notably in enforcement, that will be closely observed by FMA in 2013, with an expectation that NZX will continue to improve its performance in the current period, so that it continues to be considered compliant with its obligations.

FMA's view is that there is a clear intent from NZX to continue improving performance in the operation of its Registered Markets and the Derivatives Market, even where a number of the changes made since the previous review have not yet had the opportunity to be operationalised and bedded in.



EXECUTIVE SUMMARY AND CONCLUSION

Our conclusion

FMA has concluded that, **during the Review Period**, NZX complied with the Statutory Obligations, with the **exception** of the adequacy of its arrangements for enforcing compliance with the relevant market rules, and the sufficiency of human resources allocated to the Regulation division.

FMA has concluded that, **by the end of the Review Period**, NZX was **fully** compliant with the Statutory Obligations, including these two requirements.

Our observations on the arrangements for enforcing compliance and the sufficiency of human resources allocated to Regulation are set out in sections 4.2.2 to 4.2.4.

FMA considers that NZX acted promptly to respond to the expected actions from FMA's 'Report on the NZX General Obligations Review dated 29 June 2012' (*2011 Report*). However, given the limited time NZX had to do so, it was to be expected that it would take NZX some time to become fully compliant.

Key findings

Notwithstanding our overall conclusion, FMA has identified areas where, although compliant, NZX should make improvements to ensure its ongoing compliance. Where relevant, FMA has included recommendations on how NZX could improve these areas.

Three key areas where FMA considers NZX needs to focus further efforts in 2013 are:

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

Our comments on these key areas are summarised in Table 1 and detailed in section 5.

Implementation of expected actions from the 2011 Report

This report includes an assessment by FMA of the implementation of the expected actions from the 2011 Report. FMA has concluded that NZX has implemented two of the four expected actions in full, although the benefits were not yet visible at the end of the Review Period. NZX is continuing to address the remaining expected actions in 2013 and FMA will work with NZX to monitor their implementation.

This assessment is detailed in section 4.

Observations and recommendations

FMA has made a number of general observations and recommendations that are relevant to compliance across NZX's Statutory Obligations. These observations and recommendations are summarised in Table 2 and detailed in section 6.

Finally, this report notes observations and recommendations specific to business units within NZX, as well as the New Zealand Markets Disciplinary Tribunal (*the Tribunal*) and the Special Division. These are summarised in Table 3 and detailed in section 7.

Summary tables

Table 1: Key areas of focus for 2013

Key area	Summary of recommendations
Managing potential conflicts of interest	<ol style="list-style-type: none"> 1. Consider potential conflicts that may arise from the positioning of Surveillance and Client Market Services (CMS) in Market Services 2. Consider whether the list of Related Entities supervised by the Special Division should be expanded
Enforcing compliance	<ol style="list-style-type: none"> 3. Develop an overarching Enforcement Policy to clarify NZX's enforcement objectives 4. Use the enforcement resource more efficiently and effectively 5. Consider whether NZX has the appropriate diversity of skills 6. Consider referring lower level rules breaches to the Tribunal 7. Consider ways of providing the market with information on enforcement activity
Board reporting and oversight	<ol style="list-style-type: none"> 8. Develop a mechanism for overseeing and assessing exercise of the regulatory delegations and the quality of regulatory decision-making

Table 2: General observations and recommendations

Area	Summary of recommendations
NZX Board oversight of NZX's Statutory Obligations	
Business continuity	<ol style="list-style-type: none"> 9. Obtain assurance of adequate business continuity, backup and disaster recovery plans
Monitoring of financial resources	<ol style="list-style-type: none"> 10. Continue to consider how to monitor financial resources for the operation of the markets
NZX's wider infrastructure that contributes to compliance	
Participant Rules	<ol style="list-style-type: none"> 11. Prioritise and complete the review of the Participant Rules
Processes	<ol style="list-style-type: none"> 12. Document processes for interactions between Market Services and Regulation 13. Ensure appropriate oversight by the Head of Regulation of regulatory functions carried out in Market Services 14. Continue to operationalise processes and demonstrate their effective implementation
Derivatives Market	<ol style="list-style-type: none"> 15. Review obligations under the Futures Exchange Notice in anticipation of growth in the Derivatives Market
Technological change	<ol style="list-style-type: none"> 16. Conduct planning and scenario testing prior to introducing new trading types 17. Perform a self-assessment against the IOSCO report on the impact of technological changes
Information for retail investors	<ol style="list-style-type: none"> 18. Maximise utility of the NZX website

Table 3: Observations and recommendations specific to business units, the Tribunal and the Special Division

Unit	Summary of recommendations
Regulation	19. Further develop the use of trend analysis
Issuer Regulation	20. Refine approach to recording decisions 21. Review guidance note on trading halts alongside other guidance note reviews 22. Further refine waiver procedures
Participant Compliance	23. Closely monitor human resources 24. Consider dedicating a specific resource to review work in this unit 25. Identify and develop tools for monitoring the Derivatives Market
Market Services	26. Keep positioning of CMS and Surveillance in this division under review
Surveillance	27. Devise guidelines and procedures for logging information not recorded in the case management tool
Technology	28. Incorporate recommendations from external review into testing processes 29. Independently test systems security to identify any security weaknesses

2,17%

1459,38	-0,02	▲	1,03%
2536,12	-4,56	▼	0,05%
856,25	-0,21	▼	0,02%
128,36	-0,01	▼	0,52%
4442,23	2,56	▲	0,37%
859,28	1,25	▲	0,18%
258,63	4,85	▲	0,09%
894,27	-0,20	▼	0,25%
1683,85	8,56	▲	0,02%
895,63	2,57	▲	0,41%
1749,23	9,25	▲	0,25%
258,36	-0,23	▼	0,25%
1857,95	-1,25	▼	0,02%
846,37	2,59	▲	0,53%
1284,64	3,57	▲	0,85%
2564,58	7,23	▲	0,02%
57,44	4,28	▲	1,03%
	1,28	▲	0,05%
	2,4	▲	0,02%
		▲	0,02%
		▲	1,01%
		▲	0,15%
		▲	0,52%
		▲	0,3%

SECTION 1: NZX AND ITS OBLIGATIONS

1.1 NZX

NZX is an information, markets and infrastructure company that operates securities, derivatives and wholesale energy markets in New Zealand. NZX builds and maintains the infrastructure on which these markets operate, and provides a range of information and data products. Information provided by NZX about market conditions during the period is attached in Appendix 1.

NZX's registered and authorised markets under the Act, which are included within the scope of this report, are as follows:

- NZSX
- NZDX
- NZAX
- FSM
- Derivatives Market

For each market, NZX acts as operator and regulator, to:

- set rules for the markets
- govern the admission and market conduct of Issuers of equity and debt securities
- govern the admission and market conduct of Market Participants
- monitor the market for transactions that potentially breach the Market Rules or legislation (for example, market manipulation and insider trading, which would breach the Act)
- investigate potential breaches of the Market Rules and, where it appears that a breach has occurred, take appropriate action, which may include referral to the Tribunal
- provide connectivity to and operate the technology systems and business processes required to operate the market
- supply accurate and timely data feeds and other data products, to enable market participants to trade on an informed basis
- calculate and supply index information, to enable accurate valuation of securities traded on its markets

Changes were made to NZX's organisational structure during the Review Period. They included the creation of the Market Services division, moving certain functions previously performed by Market Supervision into that function; the renaming of Market Supervision to Regulation; delegating to the Head of Regulation, solely, responsibility for the regulatory function; and the creation of the Head of Operations role to lead the Market Services division. These changes are described in section 3 of this report and illustrated in the organisation charts on page 15.

Within NZX's organisational structure, the functional areas of Regulation, Market Services and Technology contribute to the operation of the Registered Markets and the Derivatives Market. In addition, the Tribunal, an independent body, acts alongside Regulation in the enforcement of compliance. These business areas have been part of this General Obligations Review.

Regulation is led by the Head of Regulation. The Head of Regulation has direct delegation from the NZX Board (*the Board*) for the exercise of NZX's regulatory function. Within Regulation, Participant Compliance and Issuer Regulation are each managed by a Leader.

Market Services is led by the Head of Operations. The Head of Operations reports to the Chief Executive Officer (*CEO*) and is responsible for functions that contribute to the operation of the markets, including CMS and Surveillance. While the indices and data functions also report to the Head of Operations, and also contribute to fair, orderly and transparent markets, these functions have not been a focus of FMA's oversight for the Review Period.

Technology is led by the Head of Technology. The Head of Technology has responsibility for the Securities and Clearing Systems Delivery team, and is responsible for the delivery of projects as well as the daily operation, maintenance and monitoring of the trading and clearing systems used by the Registered Markets and the Derivatives Market. Accordingly this function is central to NZX meeting the Statutory Obligations.

The Tribunal is an independent adjudicative body that considers disciplinary matters referred to it by NZX in respect of the Registered Markets and the Derivatives Market. The Special Division is a division of the Tribunal responsible for administering and enforcing the Market Rules in respect of NZX and Related Entities, including Smartshares Limited, as Listed Issuers.

1.2 NZX's Statutory Obligations

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

General obligations in respect of registered markets

[NZX as] a registered exchange must, –

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

For the Derivatives Market, the Futures Exchange Notice, which came into effect on 3 February 2012, imposed similar obligations on NZX at clause 7(1):

Conditions relating to market supervision -

[NZX] must:

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

The Futures Exchange Notice superseded the Authorised Futures Exchange (NZX Limited) Notice 2010. The Futures Exchange Notice added the requirement at clause (b)(iv), bringing obligations for the Derivatives Market into line with obligations for the Registered Markets.

NZX is also subject to specific requirements pursuant to the Act, to provide FMA and the Takeovers Panel with information and assistance.

1.3 Obligations on NZX to self-assess

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

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

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

The Futures Exchange Notice includes a similar requirement:

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

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

1.4 NZX's Market Assessment Report

NZX provided FMA with the 'NZX Limited: Market Assessment Report' (*Market Assessment Report*), for the period 1 January to 31 December 2012, on 1 March 2013, in accordance with the requirements of the Act and the Futures Exchange Notice. 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 of the Act and in respect of the Derivatives Market against the requirements in clause 7(1) of the Futures Exchange Notice
- as the requirements of section 36Y and clause 7(1) are similar, the report was prepared on the basis that they were the same

NZX's assessment was that it had complied with all of its obligations during the Review Period. NZX concluded that it had done all things necessary to ensure that the Registered Markets and the Derivatives Market were fair, orderly and transparent markets, to the extent that it was reasonably practicable for it to do so. FMA agrees with this conclusion, with the exception of two elements of the Statutory Obligations, where FMA found NZX had become compliant by the end of the Review Period. FMA's conclusion is set out in full in section 5.1.

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

- changes to the organisational structure and delegations
- the documentation of processes
- improved Board reporting
- the introduction of trend analysis

The Market Assessment Report also noted a number of priorities for NZX for 2013. These included:

- further work on the review of the Participant Rules and the Listing Rules
- the review of certain guidance notes
- developing external publications detailing Regulation's enforcement policy and metrics
- a review of its conflict management arrangements against international standards
- further developing processes for interactions between Regulation and Market Services
- further education and up-skilling for staff involved in market operations

FMA was pleased that this year NZX engaged early with FMA to discuss how NZX should approach the Market Assessment Report, in order to provide a document that assisted FMA to assess NZX's compliance with the Statutory Obligations. NZX also provided FMA with a draft of the Market Assessment Report and welcomed comments from FMA in relation to certain elements of content and format.

SECTION 2: FMA'S ASSESSMENT

2.1 Obligations on FMA to assess NZX

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

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

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

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

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

The Futures Exchange Notice does not include an express obligation on FMA to produce a report on NZX's compliance with the obligations imposed by the Futures Exchange Notice. However, the obligations for the 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 obligations under the Act will, therefore, naturally reflect on NZX's compliance with its obligations under the Futures Exchange Notice.

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).

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

This approach was agreed with NZX.

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

2.2 Approach to FMA's assessment

FMA's mandate is to strengthen public confidence in New Zealand's financial markets, promote innovation and grow New Zealand's capital base. NZX, as New Zealand's only Registered Exchange, is an essential part of New Zealand's financial markets.

NZX's Statutory Obligations are ongoing, and whether it will comply with those obligations in the future cannot be judged merely by reference to its past compliance. The assessment process provides FMA the opportunity to report on the adequacy of the arrangements NZX had in place during a particular review period, with regard to the Statutory Obligations; and to identify issues that, in FMA's view, may need to be addressed to ensure NZX's continued compliance.

As with NZX's compliance with the Statutory Obligations, FMA's oversight needs to be ongoing. FMA therefore engaged with NZX throughout the Review Period, with the intent of raising issues as they occurred rather than after the end of the Review Period. Communication was open, with both parties contacting each other when discussion or consultation was required. Both parties have found this approach to be beneficial.

Methodology

FMA's ongoing oversight of NZX involved the following:

- frequent discussions about specific matters arising, as required
- regular meetings to discuss and address issues
- ongoing review of continuous disclosure and the practices of Issuers
- providing feedback on referrals made to FMA by NZX under the Act
- rolling on-site reviews of files and logs, followed by feedback to NZX after each review
- meetings between FMA and NZX to discuss FMA's expectations with regard to the Market Assessment Report
- a review of a working document from NZX reporting on the progress of actions arising from the 2011 Report, and supporting documentation, with feedback provided to NZX

This work contributed to FMA's assessment of whether NZX met its obligations under the Act during the Review Period. In addition, FMA reviewed the following:

- NZX's own assessment of its compliance with the Statutory Obligations contained in the Market Assessment Report, along with supporting information

- information obtained from interviewing NZX staff and members of the Board, the Tribunal and the Special Division. A list of people interviewed for the review process is set out in Table 4
- NZX Board papers and minutes relevant to the operation of the Registered Markets and the Derivatives Market
- relevant NZX procedures and policies

Table 4: List of interviewees

NZX area	Interviewee role during the Review Period
NZX Board	Chair
	Chair of the Audit & Financial Risk Committee
	Member of the Board Committee for the Market Assessment Report
Tribunal	Chair
Special Division	Chair
Senior management	CEO (since May 2012)
	Head of Regulation (Head of Market Supervision prior to 1 August 2012)
	Head of Technology
	Head of Operations (since November 2012)
Issuer Regulation	Leader
Participant Compliance	Leader
CMS	Leader
Surveillance	Leader
Enforcement	Enforcement solicitor

SECTION 3: CHANGES AT NZX IN 2012

A number of changes occurred at NZX in 2012 that were relevant to the operation of the Registered Markets and the Derivatives Market. These included changes in key senior personnel, a new organisational structure, the addition of a new registered market, technology infrastructure changes and, accompanying these changes, significant business process and system changes. These changes are summarised below.

3.1 Personnel changes

New Chief Executive Officer

A new CEO was appointed in January 2012, commencing in May 2012, following the resignation of the previous CEO after almost 10 years in the role.

Separation of commercial and regulatory roles

In June 2012, in order to address one of FMA's expected actions from the 2011 Report, to review the arrangements under the NZX Conflict Management Policy (*Conflicts Policy*), the Board approved a permanent change to the reporting structure and delegations in respect of regulation.

The changes included the delegation of the regulatory oversight function solely to the newly titled role of Head of Regulation (formerly Head of Market Supervision), and NZX ensuring compliance with its existing conflicts arrangements by appointing a new Corporate Counsel, separate from the Head of Regulation.

The Head of Regulation now reports directly to the Board in respect of Regulation and the CEO no longer has delegation of the regulatory power of NZX. The CEO and Head of Regulation have joint responsibility for regulatory policy and new listings, and the CEO has overall responsibility for the operation of the markets.

The Market Assessment Report stated, "The Board was of the view the delegations were appropriate to achieve the separation and confirmed that the Board would not be involved in regulatory decision-making."

Change in organisational and management structure

On 28 June 2012 NZX announced changes to its organisational structure. The changes included the establishment of two new senior roles, Chief Financial Officer and Head of Cash Markets; and the separation of the former Market Supervision area into the Regulation function and a newly formed Market Services division. Market Services would be led by the Head of Market Services, also a new role. (This role was later renamed Head of Operations.)

As set out above, the Head of Regulation and Corporate Counsel roles were separated, with the Corporate Counsel reporting to the Chief Financial Officer. The Chief Financial Officer role was introduced to provide enhanced levels of financial leadership and governance within the organisation. The new Chief Financial Officer commenced in this role in December 2012.

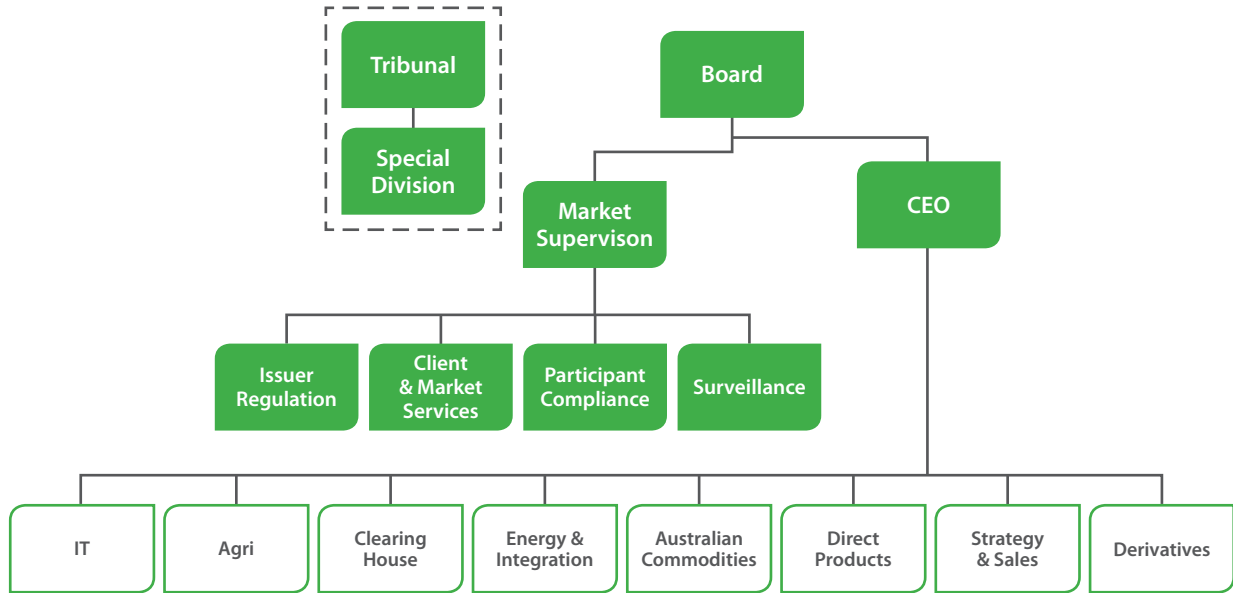
This new organisational structure was implemented on 1 August 2012. The organisation charts on the following page illustrate the changes.

Increase in resourcing

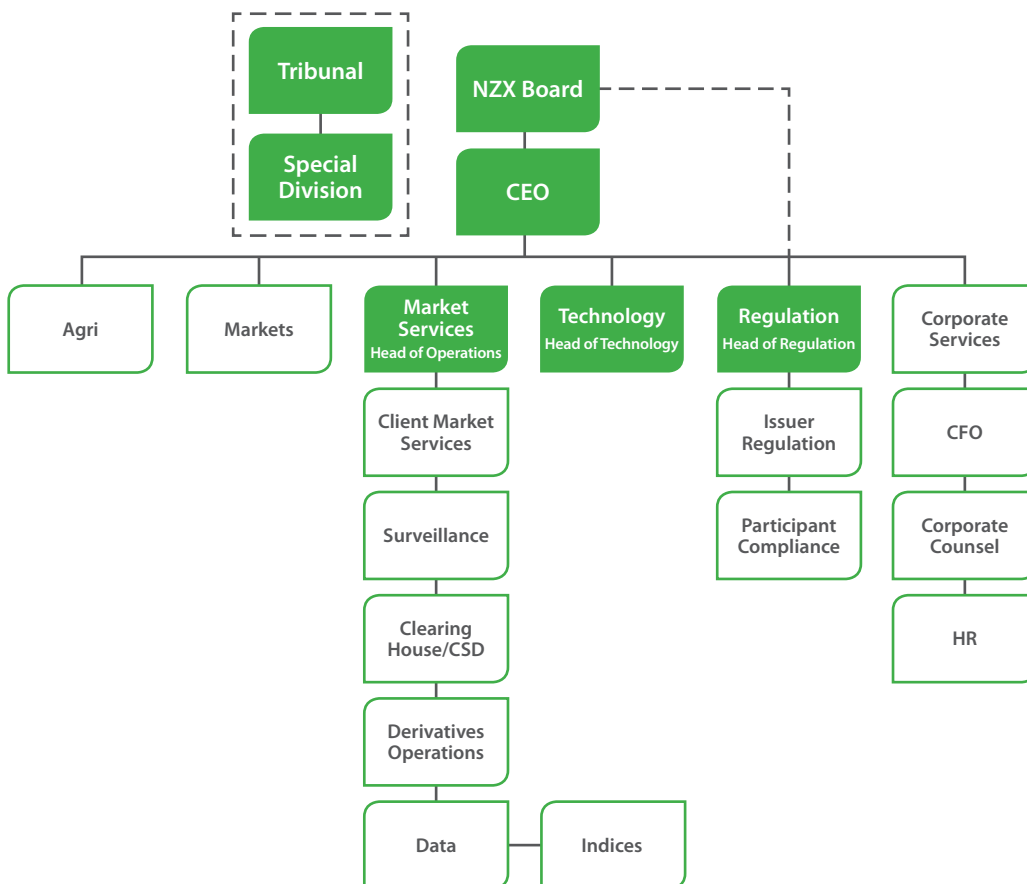
NZX increased its overall human resources in Regulation, Market Services and Technology during the Review Period, in particular in response to resource requirements for the new FSM. The number of staff in Regulation increased from 8.48 full-time equivalents (*FTE*) to 13.37 FTE. The number of staff in Market Services directly relevant to the day-to-day operation of the markets, being Surveillance and CMS, increased from 6 FTE to 8 FTE. One new solicitor in Regulation is focused solely on enforcement matters.

0,35%

NZX organisation chart at 1 January 2012



NZX organisation chart at 31 December 2012



3.2 Business changes

Addition of FSM

The FSM was launched on 30 November 2012, with NZX having been planning for this since 2009. NZX is the FSM market operator under the terms of an agreement with Fonterra Co-operative Group Limited (*Fonterra*). In order to register the FSM under the Act, NZX formulated the FSM Rules and made amendments to the Participant Rules and Tribunal Rules. These rules were considered and approved by FMA under the markets registration process set out in the Act. NZX added a supplement to its Conflicts Policy specifically relating to its commercial relationship with Fonterra.

Replacement of trading system

During the Review Period NZX completed a project to replace the Trayport GlobalVision trading system (*Trayport*) with the NASDAQ OMX X-stream trading system (*X-stream*). The new trading system went live in October 2012. This was a very significant event during the Review Period and the success of this project was key to NZX's ongoing compliance with the Statutory Obligations. NZX considers that the new trading system provides it with further capabilities to enhance the services it provides to participants. The project involved extensive interactions with Market Participants, data users and independent software vendors (*ISVs*) and was implemented on time and with no disruption to the markets.

-4,56 ▼

SECTION 4: EXPECTED ACTIONS – 2011 REPORT

4.1 Introduction

The 2011 Report was the first such report prepared under section 36YC of the Act, which came into force on 1 May 2011. It covered the period 1 July 2010 to 31 December 2011. (The 2011 Report is available on FMA's website. See 'Keep Updated/Reports and Papers'.)

FMA reached a qualified conclusion in relation to NZX's compliance with the Statutory Obligations for that period, finding that:

- NZX had adequate arrangements for operating its Registered Markets and the Derivatives Market, except for certain elements of the arrangements for handling conflicts and enforcing compliance
- NZX had sufficient 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 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, except as noted above

The 2011 Report set out FMA's key findings in support of this conclusion, along with specific expected actions required of NZX in order to address them. The expected actions were intended to ensure that NZX's approach was designed and operated so that NZX could be fully compliant with the Statutory Obligations into the future.

Prior to the publication of the 2011 Report, NZX advised FMA that it was implementing changes that would address all of the expected actions by the end of December 2012. FMA did not therefore require NZX to submit an action plan under the provisions of the Act. The 2011 Report noted that NZX's progress against the expected actions would be reported on in FMA's next report.

4.2 Progress against expected actions

This section details the expected actions stipulated by FMA in the 2011 Report; NZX's response on its progress to address those actions, as set out in the Market Assessment Report; and FMA's assessment of progress and the adequacy of NZX's response in relation to each expected action.

FMA is cognisant that, as the 2011 Report was published halfway through the Review Period, NZX had a constrained time period in which to address the expected actions before the next review by FMA. Many of the recording, reporting and operational procedures were not implemented until late in the Review Period, or the beginning of the current period (2013). As a result, for this review, FMA has been unable to assess whether these are operating effectively. Nevertheless, if these procedures operate as designed and intended, FMA is confident that the measures implemented will deliver the outcomes FMA and NZX are seeking.

FMA acknowledges that NZX has shown a high level of commitment to addressing the expected actions and recommendations from the 2011 Report, and has made significant efforts in the limited time available to introduce these new procedures.

4.2.1 Expected action 1: Conflict management

The NZX Board reviews the arrangements and controls under its Conflict 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 that conflicts, or perceptions of conflict, are appropriately managed. Sufficient senior resources should be allocated to the Head of Market Supervision role.

NZX identified in the Market Assessment Report that the following actions were taken to address this expected action:

- NZX reviewed the Conflicts Policy and amended the document in the following material respects:
 - NZX aligned the Conflicts Policy with the changes to internal delegations in respect of the NZX regulatory function
 - in light of the launch of the FSM, NZX added a supplement entitled 'Fonterra Co-operative Group Limited Protocol' (*Fonterra Protocol*), which contains conduct procedures and is applicable to all regulatory

activity, decision-making and information relevant to Fonterra in respect of the FSM, the Fonterra Shareholders' Fund (FSF) and trading of dairy futures

- The revised Conflicts Policy was implemented on 1 December 2012. NZX has scheduled a review of the Conflicts Policy against international practice, to be completed in the second quarter of 2013
- NZX has scheduled the following ongoing activities:
 - annual review of the Conflicts Policy by Head of Regulation, followed by a report to the Board
 - six-monthly training on the Conflicts Policy across NZX
 - regular audit of compliance with Personal Conflicts Policy in Market Services and Regulation
- NZX changed its organisational structure, by:
 - dividing the previous Market Supervision function into Regulation and Market Services
 - formally separating the roles of Corporate Counsel and Head of Regulation
 - delegating the regulatory oversight function solely to Head of Regulation and removing the previous dual delegation with CEO
 - increasing senior management oversight of the former Market Supervision areas from 1.0 FTE to 1.5 FTE

FMA's assessment of NZX response

NZX has gone some way to implementing this expected action. In particular, the amendments to the delegations to the CEO and Head of Regulation address FMA's key concerns about conflicts. FMA acknowledges NZX's prompt response in this respect.

FMA considers that *sufficient senior resources* [have been] *allocated* to the Regulation area, through the change in delegations and the separation of the Head of Regulation and Corporate Counsel roles. FMA is pleased to note this separation, which was required in order for NZX to comply with its existing conflict management arrangements. The Head of Operations also provides additional senior resources in this area, although FMA notes its comments in section 5.2.1 concerning the need to manage any conflict that might arise from having operational staff involved in regulatory activities.

NZX has carried out an overall review of, and made amendments to, the Conflicts Policy. The addition of the Fonterra Protocol recognised the important commercial relationship between NZX and Fonterra, and the increased potential for conflict due to the introduction of the FSM. Other amendments reflected the change in management structure and delegations. FMA therefore considers that NZX has *reviewed the arrangements and controls* under the Conflicts Policy.

However, the expected action has not yet been fully addressed. FMA notes that NZX is continuing to work on those elements of this expected action that are yet to be fully implemented, which are the arrangements that demonstrate that the Conflicts Policy is working as intended.

A review of the *adequacy of* [the Conflicts Policy] *against international best practice* was not undertaken during the Review Period. NZX stated in the Market Assessment Report that such a review was underway in the first quarter of 2013, to be completed by the end of the second quarter. FMA will seek an update from NZX at that time.

The Conflicts Policy stipulates that the Head of Regulation conduct an annual review to monitor the effectiveness of conflict management procedures and to ensure that they are adhered to. In the 2011 Report, FMA recommended that the annual review should provide information to the Board on compliance with the policy. Such a review would assist the Board to *ensure it could demonstrate that conflicts, or perceptions of conflict, are appropriately managed*.

NZX did not carry out a review during the Review Period, or in the preceding review period. The review indicated in the Market Assessment Report for the first quarter of 2013 has not occurred.

FMA considers that this expected action has not yet been fully addressed by NZX.

FMA expects that NZX will continue to address this action in 2013, through the following actions:

- a review of compliance with the Conflicts Policy
- a review of the Conflicts Policy against international best practice

FMA has not found evidence of any conflict of interest issues in the files and other material that has been reviewed. However, given the importance of the management of conflicts to a self-regulating organisation like NZX, there must be active efforts taken by NZX to monitor this.

FMA has further observations and recommendations in relation to managing conflicts of interest. These are set out in section 5.2.1 of this report.

4.2.2 Expected action 2: Enforcing compliance

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.

NZX identified in the Market Assessment Report that the following actions were taken to address this expected action:

- NZX created Enforcement Procedures and Service Levels during 2012, which were approved by the Board. Performance against the procedures is to be measured by reference to the Service Levels from 1 January 2013
- Reporting by Regulation to the Board was increased to monthly reporting. The format and content of this reporting were designed in consultation with the Board. This monthly reporting contains key operational metrics, including information on the number of enforcement matters underway and identifying where matters are more than three months old. A quarterly Enforcement Summary will also be provided to the Board
- An Escalation and Reporting Policy in Regulation has been included in NZX Regulation Procedures

FMA's assessment of NZX response

In December 2012, the Enforcement Procedures were endorsed by the Board, having been amended following a number of observations and comments from the Board. The Enforcement Service Levels were also endorsed by the Board, as a work in progress. The Enforcement Procedures require that the Board be notified if a matter is referred to the Tribunal, but do not explicitly require notification to the Board of other types of enforcement action that might be taken.

The Board provided input during the Review Period on the format of the revised reporting to the Board, and now receives monthly metrics on enforcement activities. These metrics contain information for the given month, and two previous months, on the number of possible breaches identified; investigations commencing, ongoing and completed; and referrals to the Tribunal. The Board has

therefore considered the *summary information it wishes to receive regarding cases that are not investigated or progressed to the Tribunal*.

Whilst the new format of reporting to the Board represents an improvement on reporting in the prior period, it is not clear to FMA how the Board gains confidence from the information provided that the right cases are being investigated from the breaches identified, and that the appropriate level of enforcement action is being taken for those matters that are not referred to the Tribunal.

The Enforcement Procedures contain a list of various factors that should be taken into consideration by staff when forming a view on whether a breach of Market Rules has occurred. However, there is no indication of the relative influence that each of those factors should have in the decision-making. For example, should the amount of resource required to investigate the breach have more or less influence on a decision to take no further action than if a loss were incurred by a client? Additionally, some of the factors seem more relevant to determining whether to carry out an investigation, as opposed to whether a breach has occurred.

When it has been established that a breach has occurred, NZX makes a decision as to whether enforcement action is required. Again, the Enforcement Procedures contain factors that the staff member should take into consideration in coming to that decision. In this case, there are three sets of criteria to consider, but again, there is no guidance as to which criteria should carry more weight than others in deciding the level of enforcement action that will be taken by NZX. For example, should the co-operation of the respondent with the investigation have more influence on the decision than the effect on the orderly nature of the market?

There is also no information in the Enforcement Procedures to indicate how a decision on whether or not to refer to the Tribunal is reached. The procedures state that NZX should consider the penalty bands outlined in the Tribunal Procedures as a guide to the seriousness of a breach. However, they do not elaborate to give direction as to the penalty bands into which a breach should fall in order to warrant a referral to the Tribunal as opposed to another form of enforcement action. Given that the Tribunal Procedures anticipate breaches in all penalty bands being referred to the Tribunal, FMA is unsure how reference to the penalty bands is relevant in deciding whether a referral will be made.

Accordingly, although the Board has *approved the criteria* in the Enforcement Procedures, FMA does not consider that the Enforcement Procedures as they are currently drafted *clarify the criteria for determining matters to be investigated, or for deciding the outcomes of investigations*.

Furthermore, the Enforcement Procedures do not appear to address *the role of the Market Rules in conferring investor protections, or guidance to the market*. NZX identified in the Market Assessment Report that it will develop external publications providing appropriate guidance to the market on the enforcement policy during 2013. This will address the latter part of the expected action.

The procedures do contain requirements *for recording assessments and decisions by people with appropriate delegation*.

FMA considers that this expected action has not yet been fully addressed by NZX.

The Head of Regulation, Board members and the CEO all agreed during interviews with FMA that further work was needed on the Enforcement Procedures. FMA acknowledges that NZX has put effort into developing the current draft of the Enforcement Procedures and this further work, which FMA expects NZX will undertake in 2013, will enable the specific outstanding requirements of the expected action and our comments above to be addressed.

In particular, FMA expects NZX to consider the relative importance of each of the decision-making factors listed at the different stages of the enforcement process, in order to provide employees with better clarity as to the priority that each factor should have in the decision-making.

FMA expects that the Board will use the summary information provided regarding cases that are not progressed to the Tribunal, to satisfy itself that decisions in these cases are appropriate, and made in accordance with the Enforcement Procedures. We also refer to our comments in section 5.2.3 regarding the quality of regulatory decision-making.

FMA has further observations and recommendations in relation to enforcement, set out in section 5.2.2 of this report.

4.2.3 Expected action 3: Progress of investigations

The progress of investigations is more formally tracked on an ongoing basis and reviewed by [the Head of Market Supervision]. 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.

NZX identified in the Market Assessment Report that the following actions were taken to address this expected action:

- NZX employed a solicitor to focus solely on enforcement matters (*the Enforcement solicitor*)
- An Enforcement Workflow Schedule has been developed and a fortnightly review of that workflow by the Head of Regulation has been scheduled. A monthly review of logs and registers will also take place
- Service Levels were developed. Monthly reporting to the Board against enforcement Service Levels began from 1 January 2013
- Increased monthly reporting by Regulation to the Board, as for expected action 2
- An Escalation and Reporting Policy in Regulation has been included in NZX Regulation Procedures, as for expected action 2

FMA's assessment of NZX response

FMA considers that the actions taken by NZX are sufficient to address the expected action. However, a more efficient progression of enforcement matters has not yet been achieved. During the Review Period, five enforcement matters were referred to the Tribunal, compared with four referrals during the previous 12-month period (which was itself a historical low).

The Enforcement Service Levels note that meeting the timeframes "will result in all suspected breaches of Market Rules having been resolved or referred to the Tribunal within four months" of the suspected breaches coming to the attention of NZX Regulation. However, the Service Levels also note that the progress of major investigations will depend on "the complexity of the matter and the ability of [Regulation] to obtain relevant information in a timely manner". Currently, the criteria for what is considered a

major investigation, or complex, and the regulatory tools that NZX can employ to ensure that information is obtained in a timely manner, are not addressed in either the Service Levels or the Enforcement Procedures. NZX might consider it useful to do this as part of its continued work on these documents and policies.

NZX intends that reporting to the Board against agreed Service Levels will provide more transparency around activity and resourcing in Regulation. Recording of work progress against the Service Levels will also provide a means of measuring performance, and assist in further standardising workflow processes in the area.

FMA is satisfied that the successful implementation of the procedures and reporting should result in a marked improvement in the progression of enforcement matters going forward, as the Service Levels are applied and employees within Regulation develop experience. The workflow monitoring and Service Levels were not put into effect until after the end of the Review Period. As a result, FMA expects the benefits flowing from these measures to be seen during the current period. FMA notes that three matters were referred to the Tribunal in the first quarter of 2013.

FMA expects NZX to use the information obtained through this additional monitoring to assist in identifying the reasons for any delays in progressing enforcement matters, and consider where further improvements can be made, in order to ensure timely and appropriate enforcement of the Market Rules. Board monitoring of investigations older than three months and enforcement activity not meeting the Service Levels, will be an important element in ensuring that investigations are not unduly delayed.

FMA is aware of certain matters that have been under investigation for more than six months, which have not yet been resolved. While it is unclear whether the Board had visibility of longstanding matters during the Review Period, prior to the changes to Board reporting now implemented, FMA is pleased to note that the CEO is actively managing these matters.

As the effectiveness of NZX's response to this expected action was not visible during the Review Period, FMA will continue to focus on this area in the current year.

Further relevant comments are set out in section 5.2.2 of this report.

FMA considers that this expected action has been addressed by NZX.

4.2.4 Expected action 4: Resourcing

NZX should consider the adequacy of the resources within Market Supervision. The approach to monitoring and planning workload 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.

NZX identified in the Market Assessment Report that the following actions were taken to address this expected action:

- The change in organisational structure separated the regulatory function
- Additional human resources were recruited for the November launch of the FSM. A review of resourcing was completed in November 2012, as part of 2013 planning
- Template work schedules have been prepared, to record work in Participant Compliance, Issuer Regulation, Enforcement and Policy. The Head of Regulation reviews these schedules fortnightly
- A Regulation compliance calendar has been introduced and a monthly review of this calendar is scheduled, including comparison against resources

FMA's assessment of NZX response

FMA considers that the actions taken by NZX are sufficient to address this expected action.

The changes in the organisational structure have provided an additional managerial resource within the former Market Supervision area. FMA also comments in section 5.2.1 about this change.

The number of staff within Regulation increased from 8.48 FTE to 13.37 FTE. This additional recruitment took place towards the end of the Review Period. NZX acknowledged in the Market Assessment Report, "The impact of the increased resourcing will therefore take some time to be evident."

FMA is satisfied that the implementation of the procedures described should result in better planning of resources

against workloads. In 2013, questioning by the Board of the Head of Regulation will be accompanied by Service Level reporting. Providing metrics to the Board, and Board monitoring against Service Levels, will also assist in measuring the adequacy of resources. FMA had concerns that, previously, questioning alone had not identified to the Board any insufficiency of resources.

As with other new procedures introduced by NZX, the work schedules and compliance calendar were not put into effect until after the end of the Review Period. FMA expects the benefits from these measures to be seen in the next review period, and FMA will continue to focus on the adequacy of resources in the current year.

FMA considers that this expected action has been addressed by NZX.

4.3 Addressing recommendations

In addition to the expected actions, FMA made a number of recommendations in the 2011 Report, where FMA considered improvements could be made to ensure NZX's continued compliance with its obligations.

FMA is generally satisfied that NZX has taken appropriate steps in the timeframe available to address many of our recommendations. Some recommendations have only been partially actioned, or not yet actioned. Where this is the case, NZX has indicated to FMA when it intends to take the required actions and FMA is satisfied with what is proposed.

NZX openly acknowledges that the implementation of the recommendations is still a work in progress, and NZX will need to continue to assess their implementation and operation. From interviews carried out as part of this review, it was evident that this is understood across NZX, at Board, management and staff levels. FMA finds this encouraging.

Progress towards implementing the expected actions and recommendations was the basis of a regular progress report by the Head of Regulation directly to the Board, ensuring that the Board was aware of, and could satisfy itself about, performance in relation to these matters. NZX has confirmed that, at each meeting, the Board discussed progress towards implementation, questioned the Head of Regulation on matters as appropriate, and provided feedback and guidance in relation to the format of the report and the actions themselves, to drive completion.

FMA **recommends** that NZX continue with this reporting to the Board. As well as updating the Board on the progress of the continuing implementation of an expected action or recommendation, the Board should be provided with information as to how the action has been embedded into the operation of the Registered Markets and the Derivatives Market by the relevant divisions of NZX.

0,02%

SECTION 5: CONCLUSION AND KEY AREAS FOR CONTINUED FOCUS

5.1 Conclusion – compliance with the Statutory Obligations

After making the assessments described in section 2, FMA has concluded that, in the Registered Markets and the Derivatives Market:

- For the period 1 January 2012 to 31 December 2012 in the Registered Markets and the Derivatives Market:
 - 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
 - NZX had adequate arrangements for operating its Registered Markets and the Derivatives Market, including arrangements:
 - for handling conflicts between the commercial interests of NZX and the need for NZX to ensure the markets operate in a fair, orderly and transparent way;
 - for monitoring the conduct of participants on or in relation to those markets; and
 - that ensure there is a sufficiently independent adjudicative body to adjudicate on contraventions of Market Rules that are referred to it
 - NZX had sufficient resources, except for human resources allocated to Regulation, to operate its Registered Markets and the Derivatives Market properly
- By the end of the Review Period:
 - NZX had adequate arrangements for enforcing compliance with the relevant Market Rules
 - NZX had sufficient human resources allocated to Regulation to operate its Registered Markets and the Derivatives Market properly

The Registered Markets and the Derivatives Market appear to have operated in a way that was fair, orderly and transparent during the Review Period. FMA notes there were no serious market failures or disruptions.

5.2 Key areas for continued focus

Notwithstanding its overall conclusion, FMA has noted three key areas in which NZX needs to have a continued focus in the current period, to ensure ongoing compliance with the Statutory Obligations. FMA considers that, should performance in these areas not improve in 2013, NZX may not be doing all things necessary to ensure that each of its Registered Markets and the Derivatives Market is fair, orderly and transparent. These three key areas are:

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

5.2.1 Managing potential conflicts of interest

Introduction

The quality of NZX's conflict arrangements is increasingly important as the commercial activities of NZX grow and become a greater proportion of NZX's overall activities. Therefore, it is important that NZX ensure that it has adequate safeguards to mitigate any real or perceived conflicts between its commercial and regulatory roles.

FMA considers it appropriate for NZX to refine these safeguards through adequate testing of the controls and arrangements underlying the policy, testing of compliance with the policy, and reference to international best practice.

FMA has the following observations and recommendations to make on this topic.

Observations and recommendations

Surveillance and CMS in Market Services

Ideally, all regulatory functions in an exchange should be exercised by the exchange's separate and independent regulation function, which is free from any input from the exchange's commercial operations.

Where a regulatory function at NZX is exercised by a team other than Regulation (which is ring-fenced from NZX's commercial operations), FMA expects NZX to have adequate controls and arrangements in place for handling conflicts between the commercial interests of NZX and NZX's obligation to ensure that the markets operate in a fair, orderly and transparent manner.

During the Review Period, the Surveillance and CMS business units were transferred from a purely regulatory division (formerly Market Supervision) to the newly created Market Services division, which is operational in nature. This is illustrated in the organisation chart on page 15. Interviews with staff from Surveillance and CMS established that this

change has not had any material effect on the day-to-day activities of Surveillance or CMS, or on their interactions with Regulation, and has in fact been beneficial in terms of the managerial oversight of the processes operated by the teams.

The Surveillance and CMS teams at NZX are essentially regulatory units that are operational in nature. They continue to carry out a number of regulatory functions that are key to NZX's compliance with the Statutory Obligations. For example, the CMS team identifies price-sensitive announcements and assists Issuers with understanding and navigating the Listing Rules; and the Surveillance team identifies potential market misconduct such as insider trading and market manipulation, carries out preliminary inquiries into these matters, and makes decisions on whether or not referrals to Regulation, or another party such as FMA, are required.

NZX updated its Conflicts Policy during the Review Period, but these changes did not take into account the movement of these regulatory functions to an operational division. A review of the policy in light of this change is needed. While FMA recognises that many of the functions in Market Services contribute to fair, open and transparent markets, there are nevertheless aspects of the Head of Operations role that are commercially driven. For example, Market Services is responsible for the accuracy of the commercial index calculations and the dissemination of NZX's market data and direct subscription products. Although Market Services is not responsible for the sale of these products, they are a major revenue contributor for NZX. The Head of Operations is also the relationship manager for one of NZX's commercial clients.

The current Conflicts Policy contains the following statements:

- commercial areas of the business and commercial interests will not be allowed to influence regulatory decision-making
- [the framework ensures] the quarantining of regulatory decision-making and information from the commercial part of the business
- regulatory employees are responsible for all regulatory decision-making, monitoring and investigation of potential breaches of the markets' rules and procedures

Managing business units that handle regulatory information and may contribute to regulatory decisions, when also responsible for activities with a more commercial focus, could create a perception of conflict. The Conflicts Policy recognises this and addresses it by quarantining these matters. New controls are required in circumstances where the regulatory functions carried out by Surveillance in particular, and CMS, that fall within the scope of "regulatory decision-making, monitoring and investigation of potential breaches", are being performed outside the Regulation division.

FMA **recommends** that, as part of the annual review of the Conflicts Policy during the current period, NZX considers the perception of a conflict of interest with regard to the regulatory functions that sit outside Regulation, and confirms its arrangements for managing conflicts that may arise because of this positioning. FMA also **recommends** that the review of the Conflicts Policy include consideration of whether there are adequate arrangements for the quarantining of regulatory information within the Market Services division, as the Conflicts Policy requires.

Related Entities

The Special Division of the Tribunal exists to foster market confidence that the Market Rules are applied to NZX or a Related Entity in an impartial and independent manner. The Special Division exercises the powers and functions of Regulation in relation to NZX, or a Related Entity, as a Listed Issuer.

The Tribunal Rules define a Related Entity as "any Participant in an NZX Market, or person who applies to NZX to become a Participant, which has a connection or relationship with NZX such that the Special Division is satisfied that in the circumstances there would be a reasonable apprehension or suspicion of bias by NZX in relation to that Participant or that person".

During the Review Period, the only entities subject to supervision by the Special Division were NZX and Smartshares Limited, a wholly owned subsidiary of NZX. Designating these entities as Related Entities is one way to manage the inherent conflict of self-regulation. However, the definition of a Related Entity allows for application beyond the NZX Group.

FMA **recommends** that NZX carry out a regular review of the list of Related Entities, in conjunction with the Special Division, considering the broad definition of Related Entity and extending consideration beyond NZX and its subsidiaries; for example, competitors to Smartshares exchange traded funds.

The addition of the Fonterra Protocol to the Conflicts Policy acknowledged the significance of the material commercial relationship between NZX and Fonterra, and the need to have adequate arrangements for dealing with the possibility of a conflict of interest between Fonterra's commercial relationship with NZX and NZX's role as regulator of Fonterra as a Listed Issuer. FMA **recommends** that NZX's annual review of the Conflicts Policy should examine whether Fonterra should be considered a Related Entity, making it appropriate to engage the Special Division in regulatory matters concerning Fonterra.

FMA considers that regular consideration, in conjunction with the Special Division, of whether any other entity should be considered a Related Entity, could enhance the current arrangements for the management of conflicts of interest and provide the market with an added level of assurance that regulatory decisions are taken independently.

5.2.2 Enforcing compliance

Introduction

The effective monitoring and enforcement by a market operator of its market rules are critical in ensuring that participants and investors can have confidence in the markets and make informed decisions. Having adequate arrangements for enforcing compliance is a key requirement of the Statutory Obligations.

In the 2011 Report, FMA identified potential resourcing concerns in this area of NZX's operations. As noted in sections 4.2.2 and 4.2.3, FMA expected NZX to take action in respect of its enforcement of compliance and the progression of investigations during the Review Period.

In response, NZX carried out three main actions:

- a. the employment of the Enforcement solicitor, to deal specifically with enforcement matters
- b. the development of Enforcement Procedures
- c. the development of Enforcement Service Levels

The Enforcement solicitor is responsible for carrying out inquiries and investigations into potential breaches of the Market Rules, with close support from the Head of Regulation and the Leader – Issuer Regulation. NZX has not previously employed a solicitor with a sole focus on enforcement. NZX intends that the Enforcement solicitor should co-ordinate activities and maintain oversight of the progress of enforcement matters, assisted by other solicitors within Regulation.

The introduction of the Enforcement Procedures and Service Levels is a positive development. However, further work on these documents is required, as set out in section 4.2.2, and this is recognised by NZX.

FMA acknowledges NZX's efforts in addressing FMA's expectations from the 2011 Report for this area. However, there have continued to be delays with the progress of major investigations, and some matters have not been dealt with in a timely manner. NZX acknowledged this in interviews.

In the Market Assessment Report, NZX commented that it is actively working to increase the work rate in the enforcement

area. The Market Assessment Report stated, "The goal, and plan for improvement in this area is over time to complete enforcement matters in a more timely and responsive manner, and to demonstrate that appropriate action is being taken in relation to breaches of the Market Rules."

FMA has a number of other observations and recommendations in relation to enforcement.

Observations

Low number of referrals to the Tribunal

The Tribunal's 'Annual Report 2012' states that the number of referrals to the Tribunal represents only around 10% of the total breaches of Market Rules identified by NZX. This indicates that NZX either determines that no action is required to be taken, or uses other methods of enforcing compliance, such as imposing conditions on the relevant party, or requiring a particular action by the party. FMA notes that, although there was some evidence in files reviewed that NZX follows up where conditions or required actions are imposed, the Enforcement Procedures do not document the need for this; nor do they record what the consequences will be should the required action not be taken. It may be helpful for NZX to document its policy in these cases.

The percentage of breaches dealt with through enforcement options other than the Tribunal indicates that NZX may be placing a high threshold on the level of breach that is referred. In the absence of clear decision criteria, as referred to in section 4.2.2, it is not obvious how NZX determines which cases will be referred, or whether breaches are being dealt with in accordance with any underlying policy.

Board oversight of enforcement decisions

Regulation increased reporting to the Board during the Review Period and provides the Board with information on enforcement activity. As we commented in section 4.2.2, it is unclear to FMA how the metrics provide the Board with appropriate oversight of the quality of enforcement decisions, particularly in relation to cases not investigated, or to the approximately 90% of breaches that are not referred to the Tribunal.

The metrics do include information on the length of time that enforcement matters have been underway, giving the Board greater oversight of delays in investigations. FMA notes that the number of investigations that have been open for more than three months is identified; however, no further detail is given on exactly how long the investigations have been underway. NZX agreed at interview that the metric on the duration of investigations needs refining and that NZX would do this.

Issuer compliance focus of the Enforcement solicitor

FMA notes that the Enforcement solicitor is predominantly focused on Issuer compliance, with the Participant Compliance area taking primary responsibility for its own enforcement. Three of the five matters referred to the Tribunal during the Review Period related to Market Participants. Although the Enforcement solicitor assisted with the investigations and referrals on two of these matters, it was confirmed at interview that she does not usually carry out Participant Compliance enforcement work. The Market Assessment Report stated, "One solicitor's time is devoted to enforcement work, focussing mainly on matters relating to Issuers."

FMA also notes that the Enforcement solicitor becomes involved very early where the possibility of a potential breach of the Listing Rules is raised, in particular when there is a possibility of a breach of continuous disclosure requirements. Issuer Regulation contacts Issuers when such a possibility arises, for example, when there is a sudden movement in a share price. During the Review Period, the Enforcement solicitor performed these preliminary inquiries.

External enforcement document

NZX identified in the Market Assessment Report its intention to produce a document for external publication in 2013, providing further information about Regulation's enforcement process. NZX also indicated that the Enforcement Procedures and Service Levels will continue to be developed as working documents.

Recommendations

Enforcement Policy

As noted in section 4.2.2, FMA expects NZX to continue developing the Enforcement Procedures with specific regard to the requirements of expected action 2 from the 2011 Report.

FMA **recommends** that NZX develop an overarching Enforcement Policy, clarifying NZX's enforcement priorities and goals and providing the market with clear expectations about how NZX approaches breaches of the Market Rules and enforcement decisions, and how the Tribunal will be used. Such a policy would guide the further development of the underlying Enforcement Procedures and Service Levels, which currently exist in isolation from any integrated philosophy of enforcement.

Use of the Enforcement solicitor

FMA **recommends** that NZX consider the point of an inquiry or investigation at which it is appropriate for the Enforcement solicitor to become involved. A number of solicitors carry out work in Issuer Regulation. Other solicitors could perform preliminary inquiries and refer a matter to the

Enforcement solicitor only if there has been a breach of the Listing Rules. This would help to achieve a balance between the Enforcement solicitor having adequate time to progress ongoing investigations, and becoming involved in new matters at an appropriate time.

It is also important to ensure that, whilst the Enforcement solicitor has responsibility for co-ordinating overall investigations, she can distribute enforcement work to other solicitors in Regulation as needed, in order to progress investigations at an appropriate pace.

Diversity of skills

NZX has to date hired predominantly solicitors in its Issuer Regulation function, and accountants in its Participant Compliance function. Noting that other regulators' enforcement functions have employees with a range of skills, such as forensic accountants and investigators, FMA **recommends** that NZX consider the appropriate skill sets in the team which are necessary to progress enforcement work efficiently and effectively. NZX could consider, for example, whether someone with experience in financial investigations might enhance the overall performance of the enforcement function.

Utilising the Tribunal

During the Review Period, NZX focused on completing investigations in a shorter timeframe, but the number of breaches referred to the Tribunal was still very low. The Chair of the Tribunal noted that the Tribunal Procedures are formulated in such a way as to allow for prompt consideration and determination of matters, and were envisaged for the use of the Tribunal for all levels of breaches. The Tribunal's Annual Report noted, "The summary hearing procedure is, in fact, designed to deal with minor breaches." FMA **recommends** that NZX consider the threshold for referral of matters to the Tribunal and more frequent use of the summary hearing procedure as an enforcement tool. Determinations by the Tribunal across a greater range of breaches of the different sets of Market Rules would assist in setting precedents and benchmarks, as well as give the market visibility of NZX's enforcement actions and intentions.

Updating the market

NZX has sometimes been the subject of criticism from the media and members of the public regarding a perceived lack of transparency surrounding its enforcement function and the lack of progress in certain enforcement areas. FMA considers that visible, proactive enforcement is an important element of encouraging investor confidence, as it shows the market that NZX is operating the Registered Markets and the Derivatives Market in a fair, orderly and transparent manner. The reality for any regulator is that a large amount of good work can be obscured by public articles querying why apparent market

misconduct is being ignored. Events relating to Blis Technology during the Review Period indicate this.

FMA **recommends** that NZX consider ways of updating the market with respect to enforcement. This could include information on current enforcement activities, as well as statistics on referrals, the outcomes of enforcement activities and any points of interest resulting from determinations of the Tribunal.

We note that information regarding Tribunal decisions in relation to Issuers is published on the NZX website under the Issuer code, and cannot be simultaneously published on the Tribunal page of the NZX website. This gives the appearance that the Tribunal page has not been updated for Tribunal decisions since July 2012. FMA understands that NZX is currently working to fix this and considers it would be useful for all Tribunal decisions to be available in one location. NZX could also consider issuing a brief educational announcement following Tribunal decisions, for the purpose of improving market practice.

5.2.3 Board reporting and oversight

Introduction

In the 2011 Report, FMA was concerned that there was insufficient monitoring of compliance with NZX's obligations by the Board. Relevant to this concern was the Board not being provided with regular, useful management information about the monitoring of risks and activities, the allocation of resources and the identification of trends relevant to the full scope of NZX's obligations.

Observations

Delegations

NZX made changes to the delegations during the Review Period in response to recommendations from FMA in the 2011 Report. The Board has now delegated all decision-making responsibility for regulatory matters solely to the Head of Regulation, with authorisation from the Board to the Head of Regulation to sub-delegate her authorities to members of the Regulation team. The Head of Regulation has sub-delegated some of these matters. The CEO no longer has joint delegation for regulatory matters.

This delegation to the Head of Regulation is made without conditions. No matters have been reserved for the Board and no constraint has been attached to the delegations made or sub-delegations the Head of Regulation can make.

The Board remains ultimately responsible for ensuring the quality of NZX's regulatory decision-making. This requires the Board to have in place appropriate arrangements to monitor the exercise of the delegations it has made.

Reporting

During the Review Period, changes were made to the information being presented to the Board. The Board received bi-monthly reports in the form of the 'NZX Regulated Markets and Regulated Infrastructure Report', for discussion at Board meetings, as well as monthly reporting on metrics across Regulation and other business units that apply to the operation of the markets. Reporting to the Board on policy matters relevant to the markets is on an occasional basis, as required. It was clear to FMA during this review that the Board, the CEO and senior management all regard the changes as an improvement to the past reporting arrangements.

FMA reviewed copies of Board reports from the Review Period, including the monthly metrics, as well as relevant sections of minutes from the Board meetings. We observed that the composition of the reporting to the Board was largely quantitative, and the nature of discussions regarding the operation of the Registered Markets and the Derivatives Market was not clear from the Board minutes.

In addition to the regular reporting to the Board, the NZX Regulation Procedures require escalation to the Board of, inter alia, "Any matter which has arisen or is reasonably likely to arise and which could reasonably be expected to affect materially the reputation of NZX or any of its markets or the performance and continued compliance by NZX with any of its obligations under legislation in respect of the markets". While this goes some way towards ensuring that the Board is made aware of serious matters under consideration in Regulation, FMA considers that the Board could enhance guidance as to the type of matter it wishes to have brought to its attention.

Recommendations

FMA **recommends** that the Board looks to enhance its oversight of the quality of decision-making in Regulation, to ensure that NZX is meeting the Statutory Obligations at all times.

The mechanism NZX chooses to oversee the performance of its regulatory delegations is a matter for it to consider. FMA's understanding is that the Board is considering options as to how best to do this. Possible mechanisms include:

- considering whether there are certain matters the Board regards of such importance that it might attach conditions to the exercise of its delegation. These may require additional oversight by the Board or special reporting to the Board
- developing the Regulation Procedures further, setting explicit parameters against which Regulation has escalation obligations

- focusing on issues that are of particular importance to the fair, orderly and transparent operation of its markets
- considering whether the Board should establish a Regulation Sub-Committee of the Board (which could include external members). Understanding that it is not possible for a disproportionately large amount of the full Board meeting time to be spent on these issues, given NZX's broad business base, a Regulation Sub-Committee could provide an effective means for the Board to ensure that it has sufficient focus on these matters
- enhancing qualitative reporting on the exercise of delegations

In 2013, FMA expects to see further demonstrable progress of effective Board oversight of regulatory delegations.

3,57 ▲

SECTION 6: GENERAL OBSERVATIONS AND RECOMMENDATIONS

6.1 Introduction

In addition to the key areas for continued focus identified in section 5.2, FMA has a number of observations and recommendations in relation to other areas of NZX's operations, where improvements could be made to ensure continued compliance.

The following observations and recommendations relate to Board oversight of NZX's compliance with its Statutory Obligations:

- risk identification
- business continuity
- monitoring of human resources
- monitoring of financial resources

The following observations and recommendations relate to NZX's wider infrastructure that contributes to compliance with the Statutory Obligations:

- review of Participant Rules
- documenting processes between Market Services and Regulation
- managerial oversight of regulatory functions of Market Services
- continuing process improvements
- completing projects
- Derivatives Market
- technological change
- information for retail investors

Our observations and recommendations on arrangements within the individual business units of NZX relevant to compliance with the Statutory Obligations are set out in section 7 of this report.

6.2 Board oversight of NZX's compliance with the Statutory Obligations

6.2.1 Risk identification

The reports from Regulation to the Board for Board meetings during the Review Period contained a section titled 'Top Risks in NZXMS' (the former NZX Market Supervision). These risks remained largely static throughout the entire Review Period, with no direct evidence of NZX addressing those risks or identifying new risks, or the Board actively engaging with NZX Market Supervision (or later, Regulation) in respect of mitigation strategies for those risks.

NZX acknowledged at interview with FMA that there was no formal process in place during the Review Period to identify risks to the operation of the markets, and the information on risks that was provided in the Board reports was not particularly useful for risk management purposes.

In the current period, NZX has begun to put in place a formal risk identification and management process across the entire business. NZX has informed FMA that this will record the various risks faced by NZX – operational, financial and regulatory – and the framework will include mitigation strategies, quarterly reviews of risks within the different business areas, and half-yearly reporting to the Board. The risk register will be built from the ground up, by people in the business.

FMA **agrees** that a formal risk management process is necessary for NZX. FMA will observe the implementation of this process in 2013.

6.2.2 Business continuity

Senior management in the relevant market operation areas confirmed that there are business continuity plans (BCPs) in place in their individual areas, to be used in the event of a business disruption or adverse event. NZX also confirmed that the core Market Services teams have access to laptops, technology systems and the necessary platforms to operate the Registered Markets and the Derivatives Market in case of such an event. NZX staff members are fully trained in the use of NZX technology from outside the office and a list of key personnel is kept by Market Services to access, if required, depending on the severity of a business disruption or adverse event.

The Technology division has responsibility for technological business continuity, and a full disaster recovery site exists for technological systems used by NZX. This is detailed further in section 7.8.4 of this report.

Although each area of NZX appears to have its own BCP, these are ad hoc and the level of knowledge of these plans varied between groups. The CEO acknowledged that

organisation-wide business continuity planning was not as cohesive as NZX would like it to be. He advised that this was a priority for 2013 and by the end of the year he expects that NZX will have the ability to operate the market from Auckland, in the event of a major business disruption to the Wellington offices. Clearing can already be undertaken from Auckland and a new senior Regulation resource is being hired for the Auckland office.

FMA considers that it is vital for NZX to have robust arrangements in place to ensure that critical business functions are available to stakeholders in the event of a disruption or outage. FMA **agrees** that an integrated BCP should be prepared for all of NZX and communicated to staff, with training provided if necessary.

FMA **recommends** that the Board obtain assurance of adequate business continuity, backup and disaster recovery plans for each of the systems and business units, including Regulation, that support the operation of the Registered Markets and the Derivatives Market. NZX should compare its current arrangements with international guidelines on effective business continuity management.

6.2.3 Monitoring of human resources

FMA's observation overall during the Review Period was that the business as usual (BAU) work of NZX, such as the issuing of waivers and trading halts, was largely done well, with improvements through the Review Period in terms of the documentation of those decisions. However, the non-BAU work, most notably the progress of enforcement actions and rule reviews, remains a concern.

In 2013, FMA expects NZX to demonstrate the effective monitoring of resources and the productive management of any gaps or shortfalls, in either skills or overall numbers. The completion of projects committed to by NZX for 2013, referred to on page 11 of this report, will be a key indicator. We also note our comments on diversity of skills in section 5.2.2.

6.2.4 Monitoring of financial resources

During the Review Period, FMA recommended that NZX give further consideration to how the sufficiency of financial resources for the Statutory Obligations can be more formally monitored. NZX stated in the Market Assessment Report that it had allocated significant financial resources to the markets, particularly in light of the launch of the FSF and FSM.

FMA is advised that a budget prepared by the Head of Regulation in respect of regulatory expenditure will assist in demonstrating the resourcing applied in this area in 2013. However, as the functions that relate to the operation of fair, orderly and transparent markets sit within three NZX divisions (Regulation, Market Services and Technology), budgeting by Regulation does not in itself address total financial forecasting and planning for the operation of the markets.

FMA **recommends** that NZX continue to consider how this obligation could be more formally monitored through specific forecasting or planning for its Registered Markets and the Derivatives Market.

1,03%

6.3 NZX's wider infrastructure

6.3.1 Review of Participant Rules

During the Review Period, Regulation undertook a review of the Participant Rules. The Market Assessment Report stated that "given the broad range of topics to be considered, the complexity of some of the changes and the need to engage with Participants at multiple levels, the review of the Participant Rules is continuing into 2013". A draft consultation paper detailing proposed amendments to the Participant Rules was released to the market on 28 March 2013.

It is disappointing to FMA that the review of the Participant Rules was delayed. FMA recommended in the 2011 Report, as did the Securities Commission in its 2010 report, that NZX complete its review of any changes to be made to the Participant Rules as a result of the dispute resolution provisions of the Financial Service Providers (Registration and Dispute Resolution) Act 2008. FMA notes that additional relevant legislation commenced in the interim, such as the Financial Advisers Act 2008; and anti-money laundering legislation that was passed in 2009 commences in June 2013. This legislation overlaps with and, in some cases, is inconsistent with, the Participant Rules, and will need to be taken into consideration when reviewing the Participant Rules.

FMA **recommends** that priority be given to completing the review of the Participant Rules in 2013, given the significant delays with the review thus far.

6.3.2 Documenting processes for interactions between Market Services and Regulation

A major change to NZX's organisational structure during the Review Period involved the formation of the Market Services function, and the renaming of Market Supervision as Regulation, to reflect the division of responsibilities of the two areas. The CMS and Surveillance business units, previously part of Market Supervision, became part of Market Services under the new structure.

CMS and Surveillance continue to interact extensively with Regulation on a real-time basis. For example, Regulation needs to communicate clearly with CMS, and vice versa, when a trading halt is required to be placed or removed for a security. Surveillance needs to confer with Regulation when there is a significant price movement in the absence of any material announcements and a price inquiry is required to be made of the Issuer.

CMS and Surveillance must therefore exercise judgement in deciding what information or events should be brought to the attention of Regulation.

From discussions with management and Leaders in Regulation and Market Services, it is apparent that the change in organisational structure has not hindered the day-to-day activities of CMS and Surveillance, or their interactions with Regulation. The Leader – CMS and Leader – Surveillance are confident that they can openly discuss with the Head of Regulation or other Regulation team members any matters with a regulatory focus, as required. Similarly, the Head of Regulation is satisfied that Regulation can approach CMS or Surveillance with a query.

Notwithstanding daily working regimes being unaffected, the change in reporting lines means that CMS and Surveillance now report to the Head of Operations on their activities, which includes reporting on matters that involve Regulation.

There is no documentation of the policies and procedures that should now be followed when CMS or Surveillance needs to escalate or refer a matter to Regulation, or when Regulation requires a Market Services function to carry out a task. There is also no documentation setting out which aspects of the CMS and Surveillance functions require regulatory oversight; when to make a referral to Regulation; at what stage referral or escalation should occur; or whether Market Services teams can conclude that no escalation is required, without consultation with Regulation.

Both Regulation and Market Services have acknowledged this and recognise the need for such documentation. FMA notes that it saw no evidence of any issues that have actually arisen in respect of the interactions between Regulation and Market Services.

FMA **recommends** that NZX document the processes for referral and escalation by CMS and Surveillance to Regulation, including decision criteria. These processes should give consideration to how both formal and informal interactions between the areas are recorded. While FMA recognises that much of the communication between Regulation and Market Services is, of necessity, ad hoc and sometimes time-sensitive, it can have an impact on decision-making and therefore should be recorded appropriately. Our recommendation in section 5.2.2 to develop an overarching Enforcement Policy is also relevant to setting decision criteria in these areas.

6.3.3 Managerial oversight of regulatory functions of Market Services

During the Review Period, Surveillance began using a case management tool for recording and tracking matters that require analysis and investigation by the Surveillance team. Once a matter is entered into the case management tool, the progress of inquiries can be followed. Some inquiries will result in a referral to Regulation. The Surveillance team

also uses the tool to record conclusions regarding matters that are not pursued further or referred. While the Head of Operations regularly reviews Surveillance activities recorded in the case management tool, the review is focused primarily on adherence to process and the timely progression of matters.

FMA **recommends** that NZX ensure there is appropriate oversight by the Head of Regulation of the regulatory functions carried out in Market Services and the decisions deriving from those functions. The Head of Regulation should satisfy herself as to the quality and appropriateness of the decisions being made by CMS and Surveillance, and ensure that all potential breaches have been correctly identified and referred to Regulation.

NZX could investigate whether decision criteria for referrals from Market Services to Regulation can be built into the processes in the case management tool.

6.3.4 Continuing process improvements

NZX has worked during the Review Period on the documentation of processes and procedures, in particular across Regulation, CMS and Surveillance. Additionally, and perhaps more importantly, NZX now carries out more self-review and identifies areas for improvement and change. This was evident in the Market Assessment Report, where NZX set out areas of focus for 2013 for various divisions, and it was also very evident during the interviews with staff and the Board.

As previously noted in this report, NZX had only six months of the Review Period during which to work on addressing the expected actions from the 2011 Report, as well as the many recommendations. At the same time, NZX was adapting to management and structural change, as well as inducting and training new staff members in various teams. FMA accepts that NZX has therefore not yet had time to embed all of the changes fully.

In embedding such significant processes and reporting changes, it is important that their essential purpose be kept front of mind by NZX. FMA encourages NZX to view processes and reporting as a means of helping people to carry out their roles effectively, and assisting NZX to identify issues or trends. Procedures and working documents should be kept under constant review as they are put into practice, and adapted and improved as needed.

FMA observes that many improvements made by NZX are driven by the timeliness of output, and notes that the quality of output from the processes also needs to be monitored and assessed. For example, adherence to Service Levels is a quantitative assessment of performance and a process that meets Service Levels in terms of timeliness does not necessarily mean that a good-quality decision has been

made. FMA encourages NZX to also consider the qualitative nature of decisions and have a means to monitor this. We refer to our comments in section 5.2.3 in this respect.

FMA notes that NZX recognised in the Market Assessment Report, that “the General Obligations are not a static requirement. Over time compliance requires enhancement and development to the Markets, the infrastructure on which they operate, and the Rules and legislation providing the regulatory framework in order to ensure that the Markets serve the needs of New Zealand, and continue to be competitive and keep abreast of local and international trends.” FMA agrees with this assessment and finds NZX’s approach encouraging.

FMA **recommends** that NZX operationalise the improved processes; be able to demonstrate that these improved processes are consistently being followed; and provide evidence that the changes are contributing to NZX’s compliance with the Statutory Obligations.

6.3.5 Completing projects

NZX has identified a number of areas of focus for itself for 2013. FMA is pleased to see NZX being proactive, assessing changes in the markets and identifying areas that require change or improvement, to keep up with a dynamic environment. Where NZX set out in the Market Assessment Report projects that will be undertaken during 2013, those projects should be progressed at an appropriate pace, with progress overseen by the Board, and be completed.

At interview, the CEO and members of the Board signified a commitment to applying resources as needed within the organisation, which could be external short-term resources, or further permanent resourcing, as needs become evident. FMA encourages NZX to take appropriate resourcing action to complete projects such as guidance note and rule reviews, rather than these projects becoming delayed due to changing priorities.

6.3.6 Derivatives Market

Trading in NZX’s Derivatives Market has remained relatively illiquid, although participation is growing and certain milestones were reached during 2012. As a result of inactivity in existing derivatives, NZX has not yet seen any need to implement separate compliance tools to carry out surveillance or to monitor the conduct of Derivatives Market participants. FMA has not seen evidence of any issues in respect of the operation of this market.

FMA observes that NZX plans to launch equity derivatives during 2013 and these are expected to attract far more liquidity than dairy futures. FMA also notes that NZX has identified the shift to on-market trading of over-the-counter

derivatives to be a global regulatory issue. In NZX's reporting to the Board during the Review Period, NZX identified the following risks with regard to the addition of new derivatives products:

- the potential to make BAU more complex, increasing the risks of error
- index futures contracts create the need for cross-market surveillance. Having an index future creates increased incentive to manipulate the price of component stocks particularly in the period near expiry (i.e. to minimise losses or maximise gains in the futures market)

With the potential for the dairy futures market to grow rapidly, and the impending launch of equity derivatives, FMA **recommends** that NZX review its obligations under the Futures Exchange Notice and consider what impact the potential growth of the futures market may have on NZX's ability to comply with its obligations. Interviews with both the Leader – Surveillance and the Head of Operations indicated that they regard the introduction of equity derivatives as a major focus for the current year. FMA further notes that the most recent employee hired in the Surveillance team has specialist derivatives experience.

6.3.7 Technological change

NZX noted in the Market Assessment Report that global regulatory issues such as high frequency trading and dark pools of liquidity are not yet prevalent in New Zealand: "While algorithmic trading has increased by approximately 35% during the Review Period, the relative lack of liquidity in the New Zealand market and the trading fee structure provide practical limits to automated trading." Algorithmic trading remains a very small proportion of overall trading on the Registered Markets.

FMA is aware of ways in which overseas regulators have responded to these issues. The unique regulatory structure in New Zealand, whereby NZX, not FMA, is responsible for real-time surveillance of the markets, means that NZX must have the means to identify and respond to these market events.

NZX has begun a market quality project to respond to changes in trading patterns in the market globally. At interview, the CEO noted that the project would look at the benefits of automated trading, as well as what type of algorithmic trading may be suitable for New Zealand markets. The project would also be looking at improving price discovery and liquidity. NZX will be involving a member of the Regulation team in the project, to provide input from a regulatory point of view.

FMA expects this project to incorporate FMA's **recommendation** from the 2011 Report, that NZX undertake appropriate advance planning and scenario testing to identify any risks or threats to compliance with the Statutory Obligations that the introduction of new trading types might pose. The NZX market quality project should provide comfort to investors that there is appropriate governance for automated trading. FMA would like NZX to keep it up-to-date on this project, given both parties' interest in this area.

FMA **recommends** that during 2013, NZX perform a self-assessment against IOSCO's report, 'Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency', which contains recommendations aimed at promoting market integrity and efficiency and to mitigate the risks posed to the financial system by the latest technological developments, including high-frequency and algorithmic trading.

6.3.8 Information for retail investors

The NZX website provides important market-related information to retail investors. FMA **recommends** that NZX review the way its website interacts with retail investors, and its completeness and currency, with a view to maximising its usefulness. For example, there is little information on the types of approved Market Participant and important factors to take into consideration when choosing a Market Participant. We also noted in section 5.2.2 the usefulness of making information in relation to determinations made by the Tribunal easily available on the NZX website.

0,03%

SECTION 7: NZX BUSINESS UNIT AND TRIBUNAL OBSERVATIONS AND RECOMMENDATIONS

7.1 Introduction

This section of the report contains FMA's specific observations and recommendations for the following NZX business units:

- Regulation and each business unit within Regulation:
 - Issuer Regulation
 - Participant Compliance
- Market Services and certain business units within Market Services:
 - CMS
 - Surveillance
- Technology

This section also contains our observations and recommendations in relation to the Tribunal and the Special Division. Although they are not business units of NZX, they are relevant to NZX's compliance with the Statutory Obligations.

The points set out in this section are more narrowly focused on the relevant business units than other comments elsewhere in this report. Where possible, we have not repeated matters dealt with previously.

7.2 Regulation

7.2.1 Introduction

NZX Regulation is made up of the Issuer Regulation and Participant Compliance teams.

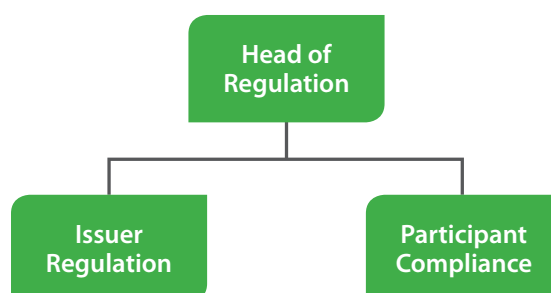
Regulation's core contribution to fair, orderly and transparent markets is through the demonstration of adequate arrangements for:

- monitoring the conduct of exchange participants on or in relation to the markets
- enforcing compliance with the relevant Market Rules

Regulation administers the Market Rules. The Market Rules provide the criteria for access to the markets and govern the operation and conduct of each of the markets. Appropriate market rules are key to the operation of a fair, orderly and transparent market. The Head of Regulation shares responsibility and delegation from the Board for the development of the Market Rules and other policy work with the CEO.

Regulation is also responsible for enforcing the Market Rules. This aspect of Regulation's work is carried out by the Issuer Regulation and Participant Compliance teams, led by the Head of Regulation. The Enforcement solicitor is devoted to enforcement work across both teams, but focuses mainly on matters relating to Issuers. The principal activities undertaken in enforcement involve investigating suspected breaches of Market Rules and taking action in accordance with the newly developed Enforcement Procedures.

7.2.2 Regulation team structure



7.2.3 Assessment process

In addition to FMA's general assessment of NZX described in section 2.2, FMA carried out an assessment specific to the overall Regulation division.

Documentation

FMA reviewed the following documentation:

- Board papers and monthly metrics
- NZX Regulation Procedures
- Solicitors' Handbook (updated September 2012)
- Enforcement Procedures and Enforcement Activity Log
- trend analyses of breaches and trading errors
- Service Levels
- internal checklists
- workflow schedules
- Regulation compliance calendar

FMA also considered notifications made by NZX to FMA during the Review Period, relating to significant contraventions of the Market Rules and enforcement actions for breaches of the Market Rules, as well as referrals to FMA in relation to possible breaches of the Act.

Interview

In our interview with the Head of Regulation, we focused on the following:

- the impact of the organisational changes on Regulation
- progress of actions following the 2011 Report
- reporting to the Board
- the identification and management of risks to the Registered Markets and the Derivatives Market
- resources and training
- the management of workflows and embedding processes
- investigation and enforcement

7.2.4 Observations

Enforcement

We have made substantial observations regarding enforcement in sections 4 and 5 of this report.

FMA notes that, during the Review Period, Regulation took steps to improve and formalise communications between Regulation and the Tribunal. Regulation consulted the

Tribunal regarding the Enforcement Procedures and Conflicts Policy. The Chair of the Tribunal noted that he has found this improved communication helpful and positive.

NZX also worked with FMA during the Review Period to improve liaison regarding cases notified to FMA, where it appeared that NZX and FMA may have overlapping jurisdiction, or might have been undertaking investigations on separate, but related, matters simultaneously. FMA has found this useful and will continue to liaise closely with NZX.

Human resources

During the Review Period, the number of staff in Regulation increased from 8.48 FTE to 13.37 FTE, which includes the Head of Regulation. The increase in resourcing largely occurred during the final quarter of 2012 and was linked to the launch of the FSM. FMA recognises this increase and also notes that NZX has put in place a means of monitoring human resources against workload going forward.

Although the addition of these resources is positive, the average experience level of staff has declined. NZX recognises this and has acknowledged that it will require a continuation of training of new staff and careful monitoring of work against workflow schedules and Service Levels, to determine if resource levels are appropriate. The Market Assessment Report stated, "as a result of historically high level of attrition, which reduced in the second half of 2012, the average experience levels of staff declined. The impact of the increased resourcing will therefore take some time to be evident".

We refer to our comments on page 26 on diversity of skills in the Regulation team.

NZX advises that recruitment is ongoing for a Senior Solicitor, whose role is intended as a second-in-command for the Head of Regulation. This proposed appointment should assist the Head of Regulation and the Regulation Leaders with their workload and complement the recent recruitment of new solicitors and advisers. This is an example of where NZX has identified a need and given thought to the particular level of skills and experience that might be appropriate, and FMA supports this recruitment.

FMA notes that the number of FTE employees counted in Issuer Regulation includes lawyers who act as the legal resource for Regulation, but are a shared resource between the Head of Regulation and NZX Corporate Counsel. These lawyers therefore carry out work across the areas of Regulation, corporate commercial, policy, market infrastructure support and Smartshares. The Board receives information about the allocation of this resource to each of the areas in the monthly reporting.

Changes to Market Rules

During the Review Period, Regulation undertook a review of the Listing Rules. NZX consulted on proposed amendments to the Listing Rules for NZSX and NZDX in March 2012. The proposed amendments included the introduction of a Diversity Rule. The Diversity Rule was implemented in late 2012 and a guidance note on the application of the Diversity Rule was also published. By the end of the Review Period, NZX had substantially completed its review of the submissions on the other proposed amendments and intends to release an exposure draft of the proposed amendments in 2013, for further public consultation.

NZX published the FSM Rules, and amendments to the Participant Rules and Tribunal Rules to accommodate the FSM, during the Review Period. Planned initiatives for 2013 include a proposal for NZX to review its 'Guidance Note – Process for Amending NZX Conduct Rules'; and a proposal to update guidance on continuous disclosure, following the release of ASX's 'Guidance Note 8 – Continuous Disclosure'.

FMA **agrees** that NZX should update its guidance note on amending Market Rules during 2013. The current guidance note was introduced in 2005 and states, "Each year NZX will facilitate two consultation rounds in which new conduct rules or changes to existing conduct rules will be considered." This has not been NZX's practice. While FMA does not necessarily consider that an annual review of the Market Rules is required, it considers that non-adherence to NZX's own published guidelines is a poor example to the market, and either the guidance note should be amended, or NZX should adhere to it. In amending the guidance note, due consideration should be given to international best practice.

Policy submissions

NZX made several submissions to public consultation on broader capital markets legislation or policy matters during the Review Period; for example, on the Financial Markets Conduct Bill and Issuer exemptions from the requirement to have a licensed auditor. FMA notes that NZX's inputs to these consultations – in particular, its comments on the exemptions paper – are sometimes driven by commercial considerations, taken from the point of view of either NZX as an organisation, which derives revenues through increased listings, or its Issuers; and seem to have insufficient regard for the broader interests and protection of investors. As the front-line regulator of New Zealand's capital markets, FMA reminds NZX to consider the full range of stakeholder views in all policy submissions.

7.2.5 Recommendations

Using information holistically

NZX has recently begun to carry out trend analysis. FMA gave feedback during the Review Period that NZX should make more use of its various logs and registers than it currently does. These resources can help to provide information about potential risks, or issues with particular Market Rules; and identify patterns of complaints, in respect of either individual participants or wider issues. FMA notes that NZX has used its initial trend analysis activity from 2012 to identify possible required changes to Market Rules.

NZX could improve analysis by using all the data available throughout the organisation to identify wider market knowledge and improvements – for example, data on market risks, rule reviews, the changing behaviour of Market Participants and Issuers, and market education. FMA **recommends** that the use of trend analysis be further reviewed and refined during the current period.

4,85 ▲

7.3 Issuer Regulation

7.3.1 Role of unit

The key responsibility of Issuer Regulation is monitoring and promoting the compliance of Issuers with the Listing Rules.

This includes considering applications for waivers from and rulings on the Listing Rules; approving notices of meetings; and reviewing offer documents produced by Issuers. Waiver and ruling decisions and notices of meetings are released through the Market Announcement Platform (MAP). This work is time-sensitive.

Issuer Regulation also monitors Issuers' compliance with the continuous disclosure requirements of the Listing Rules and considers applications for trading halts. The team works closely with both CMS and Surveillance in respect of this role.

Issuer Regulation investigates all alleged breaches of the Listing Rules and prepares statements of case for any referrals to the Tribunal. The Enforcement solicitor co-ordinates enforcement activities.

7.3.2 Assessment process

In addition to FMA's general assessment of NZX described in section 2.2, FMA carried out an assessment specific to the Issuer Regulation unit.

Documentation

FMA reviewed the following documentation:

- Issuer complaints files
- a sample of continuous disclosure inquiry files
- Issuer breaches logs
- trading halts logs
- files relating to applications for:
 - waivers from the Listing Rules
 - rulings on the application of the Listing Rules
 - notices of meetings
 - approval of appraisal reports
 - approval of listing on the Registered Markets

Interviews

In our interview with the Leader – Issuer Regulation, we focused on the following:

- the role of the unit in helping NZX to comply with the Statutory Obligations
- the impacts of the organisational changes on the unit and interaction with other teams

- the management of risks
- resourcing and training
- the management of workflows and embedding processes
- reporting and escalation procedures
- investigation and enforcement

FMA also interviewed the Enforcement solicitor with regard to the enforcement function.

7.3.3 Observations

General

The Leader – Issuer Regulation demonstrated an understanding of the Issuer Regulation unit's role in ensuring that the markets operated by NZX are fair, orderly and transparent.

Complaints process

During the Review Period, FMA provided feedback to NZX on its handling of complaints regarding Issuers. From file reviews, FMA noted that NZX was inconsistent in its approach to complaints, responses to complainants were not always informative and it was not always clear to complainants whether NZX was investigating matters, or the complaints were closed. In the Market Assessment Report NZX confirmed that it had made changes to its approach to complaints relating to Issuers during the Review Period as a result of recommendations received from FMA and feedback from complainants.

FMA observed, in the course of its on-site visits, the improvements made during the Review Period and encourages NZX's ongoing refinement of its approach to complaints relating to Issuers. By ensuring that there is a robust and transparent complaints process, NZX can demonstrate that it is able to act independently of its Issuers in enforcing compliance with its Listing Rules.

Education of and communication with the market

During the Review Period, NZX issued two guidance notes and three 'Issuer Updates'. These publications are useful tools for promoting and assisting compliance by Issuers. FMA observes that NZX is reviewing certain guidance notes and encourages this practice.

Continuous disclosure

Continuous disclosure is a critical part of ensuring that New Zealand's Registered Markets are fair, orderly and transparent. The Issuer Regulation team undertakes continuous disclosure inquiries of Issuers, to ensure that Issuers are meeting their continuous disclosure obligations at all times.

ASX has recently updated its guidance on continuous disclosure. A number of Issuers are dual listed on the NZSX and ASX. In the Market Assessment Report, NZX stated, "NZX proposes to develop guidance to aid these Issuers with compliance with the two sets of requirements." FMA encourages NZX to implement this action as soon as practicable.

7.3.4 Recommendations

Addressing 2011 Report recommendations

The key recommendation areas for Issuer Regulation from the 2011 Report related to:

- reinforcing the role of NZX to look at the merits of waiver applications from an investor perspective and formulating reasons referenced to that perspective
- 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

The Market Assessment Report stated that the following work was completed in Issuer Regulation to address those recommendations:

- revision of the policy for considering applications under urgency
- adoption of a procedure to expressly question Issuers as to why a proposal cannot be put to shareholders for approval, where a waiver from such a rule is sought
- implementation of a checklist to ensure that when a division is convened, that consideration is given as to whether at least one member of the division has been involved in an Issuer's previous application
- progress in ensuring that files better record how regulatory decisions are reached
- implementation of procedures to document the process for conducting quarterly trend analysis

Issuer Regulation also introduced workflow schedules to keep track of progress of matters underway, with regular reviews of these to be carried out by the Head of Regulation. Workflow for Issuer Regulation is documented on a team workflow list and a 'traffic light' list identifies applications where there are timing concerns.

The changes referred to above occurred largely during the last quarter of the Review Period. Accordingly, FMA is unable to comment as to the effectiveness of these changes. FMA **supports** the changes made by Issuer Regulation and will be observing how these are embedded, and their effectiveness, during 2013.

During the Review Period, FMA encouraged NZX to ensure that it retained records of its internal forums, analyses and decisions on matters that contributed to compliance with the Statutory Obligations. FMA **recommends** that further consideration be given to how Issuer Regulation can refine its approach, including training for NZX Solicitors about the level of detail needed in file notes.

Trading halts

In the Market Assessment Report, NZX acknowledged that its processes around the determination of trading halts within Issuer Regulation are not robust, and this was underlined during the Review Period by the inappropriate lifting of a trading halt on one occasion. The trading halt in question was lifted following an announcement regarding the Issuer's financial position, despite the announcement referring to material uncertainties with the Issuer. Following discussions between FMA and the Head of Regulation, the trading halt was reinstated, on the basis that the uncertainty surrounding the Issuer remained.

The decision to grant or lift a trading halt is a fundamental tool in ensuring fair, orderly and transparent markets. The Market Assessment Report stated, "As a result of this event, work has been completed and training undertaken to reinforce the procedures, in particular the escalation to Head of Regulation. An internal procedure is being developed in this area to improve process in this area." FMA **agrees** that more work needs to be undertaken in this area, regarding appropriate training for NZX Solicitors and documenting policies and procedures for the application of trading halts. In addition, FMA **recommends** that NZX review its guidance note on trading halts alongside its review of other guidance notes.

Issuer Regulation BAU

FMA notes that, for the most part, the Issuer Regulation unit's BAU activities are performed to a good standard, and in line with NZX's published processes and policies.

A core component of Issuer Regulation's BAU is considering applications for waivers from and rulings on the Listing Rules. During the Review Period, Issuer Regulation made changes to its procedures and introduced new checklists. FMA was pleased with the improvement in recording how regulatory decisions are reached and notified.

However, during quarterly file reviews, FMA observed certain waiver files where further challenges to the Issuers concerning the need for waivers would have been beneficial. For example, we reviewed a file where the Issuer had advised Regulation that it had not appreciated the decrease in its market capitalisation and therefore was unable to schedule shareholder consent for approval of a related party transaction (a loan from a director), before

that loan was required by the Issuer. Regulation provided the waiver subject to conditions.

FMA is of the view that an Issuer being unfamiliar with its market capitalisation is a poor policy basis for a decision. Issuers need to be given clear messages by NZX as to their responsibilities under the Listing Rules.

The conditions to this waiver included the receipt of confirmations from the Issuer's directors (excluding the related party) that the loan was on commercial and arm's-length terms, was in the best interests of the company and its shareholders, and was not influenced by the related party. The waiver decision also noted that Regulation had relied on precedent.

FMA also **recommends** that NZX use its preceding waiver decisions to help the team form decisions and apply consistency. However, NZX needs to consider the evolving policy behind the rules, and new market expectations around certain types of transaction, particularly related party transactions, in light of company failures in recent years. FMA considers that the failure of a company to be familiar with its market capitalisation should not be grounds for a waiver from the Listing Rules, even if similar waivers or conditions have previously been granted. NZX should not apply a precedent to a decision if that precedent conflicts with evolving policy.

In protecting the integrity of those rules that provide for shareholder consent, FMA **recommends** that NZX challenge the Issuer as to the reliability of the confirmations it has provided. For example, Regulation could query how the independent directors became satisfied in order to make their declarations.

7.4 Participant Compliance

7.4.1 Role of unit

The principal function of Participant Compliance is to supervise Market Participants and Derivatives Market participants for compliance with the Participant Rules and Derivatives Market Rules.

This includes the consideration of applications for accreditation, waivers and rulings; monitoring of client funds and capital adequacy reporting; on-site and prudential inspections; investigations of suspected rule breaches; and taking enforcement action where appropriate.

Certain regulatory oversight services for NZCDC are also performed by Participant Compliance.

The Participant Compliance team has a mixture of staff with legal and accounting backgrounds, reflecting the focus of the unit.

7.4.2 Assessment process

In addition to FMA's general assessment of NZX described in section 2.2, FMA carried out an assessment specific to the Participant Compliance unit.

Documentation

FMA reviewed the following documentation:

- Market Participant complaints files
- Market Participant breaches logs
- a sample of Market Participant inspection files
- files relating to applications for:
 - waivers from the Participant Rules
 - rulings on the application of the Participant Rules

Interview

In our interview with the Leader – Participant Compliance, we focused on the following:

- the role of the unit in helping NZX to comply with the Statutory Obligations
- the impacts of the organisational changes on the unit
- the management of risks
- resourcing and training
- the management of workflows and embedding processes
- reporting and escalation procedures
- the Market Participant inspection programme
- investigation and enforcement

7.4.3 Observations

General

The Leader – Participant Compliance demonstrated an understanding of the Participant Compliance unit's role in ensuring that the markets operated by NZX are fair, orderly and transparent.

Addressing 2011 Report recommendations

The key recommendation areas for Participant Compliance from the 2011 Report related to:

- 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

The Market Assessment Report stated that the following work was completed in Participant Compliance to address those recommendations:

- documentation of procedures for maintaining risk profiles of Market Participants
- documentation of procedures for completing a regular trend analysis of breaches of the NZX Participant Rules
- amendment of the On-site Inspection Procedure to reflect the process for considering a Market Participant's risk profile
- amendment of procedures to reflect the process for discussion and review with the Leader – Participant Compliance and the Head of Regulation

NZX also made changes during the Review Period for recording and monitoring the progress of work in Participant Compliance. Workflow is now recorded in a 'work in progress' spreadsheet. The spreadsheet is used by the Leader – Participant Compliance for weekly workflow management meetings with the team. The spreadsheet is also provided to the Head of Regulation on a weekly basis.

In response to FMA's recommendations in the 2011 Report, Participant Compliance completed a trend analysis of breaches that had occurred in the previous 18 months. As a result, Participant Compliance changed the way in which breaches are recorded, to ensure that the unit can easily extract better information from the breaches log.

The unit also completed a trend analysis of the volume and pattern of trading errors. As a result, NZX has planned initiatives to assess the need for amendments to the Participant Rules and NZX procedures.

On-site inspections

Participant inspections are carried out to provide assurance that Market Participants are complying with the Participant Rules, and that any non-compliance is detected and can be appropriately responded to by NZX. During the Review Period, the team carried out 12 on-site inspections and 4 desk-based capital and prudential inspections. No targeted, 'spot' inspections were carried out.

The Market Assessment Report stated that during the Review Period, Participant Compliance amended the On-site Inspection Procedure and supporting documentation. FMA noted an improvement in the standard programme for testing participants' compliance between the beginning and end of the Review Period, with better recording of findings and conclusions. NZX also introduced formal, internal pre-inspection meetings for on-site visits, with the meetings recorded on the inspection files. These meetings cover theme selection and involve senior management, including the Head of Regulation, and staff members attending the inspection.

The standard programme cross-references the Participant Rules. However, it does not provide comprehensive coverage for all obligations, and it is not clear why those obligations tested have been selected. A full assessment of compliance therefore relies on the inspector's knowledge of the Participant Rules and NZX procedures.

The Market Assessment Report stated that Participant Compliance is currently creating updated process documentation and checklists for specific areas of compliance, to better evidence sampling and record observations during inspections; and working to update the overarching On-site Inspection Procedure. NZX has begun its inspection programme for 2013 and the changed processes will be implemented and reviewed, with a view to further improvement.

Use of risk profiles

In the 2011 Report, FMA recommended that NZX consider how it could incorporate Market Participants' risk profiles more systematically into its supervisory programme and document this incorporation.

The Market Assessment Report stated that during the Review Period, Participant Compliance further incorporated risk profiles into Participant Compliance processes. Amendments to the On-site Inspection Procedure also allowed the involvement of senior management in determining themes for on-site inspections.

The Market Assessment Report also stated that, as part of further improvements, Participant Compliance has now developed a Participant Risk Profile Procedure to provide for regular updates of profiles and to ensure that follow-up actions are taken. FMA noted that pre-inspection preparation

involved a review and re-calculation of the Market Participant's risk profile. Despite these amendments, FMA understands that the on-site inspections during the Review Period were not always conducted on a thematic or risk profile basis. For example, the Leader – Participant Compliance noted that a large retail firm was visited for only one day, whereas an inspection of a firm of that size and nature should normally be a three-day visit, to ensure an adequate assessment. FMA notes that it does not consider even a very small firm could be meaningfully tested for compliance with all Participant Rules in a one-day visit.

Although all major trading participants were visited during the Review Period, it was not always apparent from the file how the risks identified by each Market Participant's risk profile had been incorporated into the inspection process; for example, how specific concerns identified for a particular firm had been tested. Instead, visits tended to focus on firms' entire obligations, and the inspections for all Market Participants appeared to have largely the same areas of focus. Accordingly, it seems that the pre-inspection meeting and revised processes, designed to help to identify particular risks posed by a firm and select themes for inspection based on these, are not operating as intended.

NZX staff confirmed that the current risk profiles quickly become out of date and the system is not working well. NZX has acknowledged that the existing risk profiling of Market Participants needs to be refined. The Market Assessment Report stated, "Through regular use of the risk profiles, Participant Compliance has determined that the risk weighting percentages used to rank Participants is overly complicated and would have greater utility if risk weighting was assessed as a comparison against all other Participants' risk profiles. ... In 2013, Participant Compliance will be considering alternative ways of recording the risk level associated with each Participant."

FMA acknowledges the work done by NZX to date to modify its programme, and its willingness to accept that further work is necessary, in order to effect the required improvements. FMA **agrees** with NZX that it needs to review its Market Participant inspection programme, particularly risk profiling and the matters to be included for on-site review.

FMA will observe what changes are made, and their effectiveness, during 2013. Consideration should be given as to whether a specific resource or skill is required to assist in this process. We make further comment on this in relation to resourcing below.

7.4.4 Recommendations

Resourcing

The Participant Compliance unit started the Review Period with 2 FTE and ended with 3.6 FTE, including the return of the Leader – Participant Compliance from parental leave. The Head of Regulation was involved in day-to-day aspects of the unit's activities while the Leader – Participant Compliance was on leave.

During the Review Period, one experienced Participant Compliance adviser resigned and two new Compliance & Risk Advisers were recruited. Therefore, although the number of resources was increased, the average level of experience in the team declined. Another experienced adviser moved to a different area of NZX in January 2013 and has not been replaced in the team. Although this occurred after the end of the Review Period, it was anticipated during the Review Period. FMA notes that there is also an open vacancy on the organisation chart in this area, for a General Assistant.

Participant Compliance fulfils NZX's obligation to provide regulatory oversight services to NZCDC, under the agreement for services. Although the amount of this work has decreased, it still reduces the time available for staff to undertake supervisory tasks in respect of the Statutory Obligations.

FMA understands that legal resources may be made available to Participant Compliance on request and that the Head of Regulation provides support on enforcement work. During the Review Period, NZX provided wider resource to assist in Participant Compliance enforcement activities, through the involvement of the Enforcement solicitor. However, we understand from the Leader – Participant Compliance that the enforcement matters in question reverted back to Participant Compliance, as there was concern about the progress made.

FMA observes that progress appears to FMA to be slow on Participant Compliance enforcement matters. Participant Compliance referred three matters to the Tribunal during the Review Period. In each case, the alleged breach had occurred more than nine months prior to referral.

During the Review Period, project work such as the review of the Participant Rules was delayed, despite recommendations from FMA and the Securities Commission in the previous two reviews regarding this. FMA also notes that two Market Participant inspection visits scheduled for 2012 were carried over into 2013, and those carried out were perhaps shorter than the Market Participants' risk profiles would have indicated was appropriate.

FMA is concerned about the overall allocation of resources to Participant Compliance, in light of the enforcement work continuing to be led by Participant Compliance staff; the continued delay to the Participant Rules review; and work such as scheduled Market Participant inspections not

being completed. We also note that departing resources in Participant Compliance have not been replaced. FMA has some concerns, as it appears to FMA that less priority is being afforded to Participant Compliance work than other work within Regulation.

FMA is also concerned that insufficient consultation took place between the Head of Regulation and the Leader – Participant Compliance with regard to planning resources against workload for the current year. The 2011 Report contained a recommendation to NZX about monitoring resources against plan.

FMA supports the focus by Participant Compliance on reviewing inspection processes, but is concerned that this review may come at the expense of BAU activities; alternatively, the important rules and inspection process review work may be postponed. NZX needs to consider how to resource these competing priorities.

FMA **recommends** that NZX consider how best to closely monitor staff resources in this unit in the current period as a matter of priority, given the level of turnover during the Review Period and the backlog of non-BAU work, as well as lengthy delays in referring enforcement matters to the Tribunal. If matters such as enforcement actions are suffering delays, resourcing should be adjusted to ensure that NZX continues to meet its obligations.

As noted in section 6.3.5, the CEO and the Board have signalled a commitment to resourcing workloads as required, including through the use of external resources if necessary. FMA **recommends** that NZX consider whether it could dedicate a specific resource to carrying out the review work in Participant Compliance.

Although there were some improvements in this unit during the Review Period, the work outstanding means that not all of the intended outcomes of the recommendations from the 2011 Report have been achieved. FMA will place focus in the current year on the performance of this unit and the completion of the review of the Participant Rules in particular.

Derivatives

Participant Compliance monitors compliance with the Derivatives Market Rules and procedures in the same way that it does for all Market Participants. Regulation of Derivatives Market participants is a small part of the unit's day-to-day activities.

FMA notes that NZX is preparing for the launch of equity derivatives and hopes that the dairy futures market will grow significantly. FMA **recommends** that NZX identifies and develops tools that may be valuable for the monitoring of Derivatives Market participants, as these markets grow and develop.

7.5 Market Services

7.5.1 Introduction

On 28 June 2012, NZX announced the formation of a new Market Services division, responsible for Registered Market and Derivatives Market operations, and customer service. The Head of Market Services at the time said, "In addition to having a strong customer focus, bringing together these critical functions in one team will enable us to identify where we need to make further investments in process improvements." The Head of Regulation noted, "We have decided to make the change in reporting lines to make the distinction between our regulatory and commercial roles more explicit. In turn, this will remove any perception of conflict between those roles."

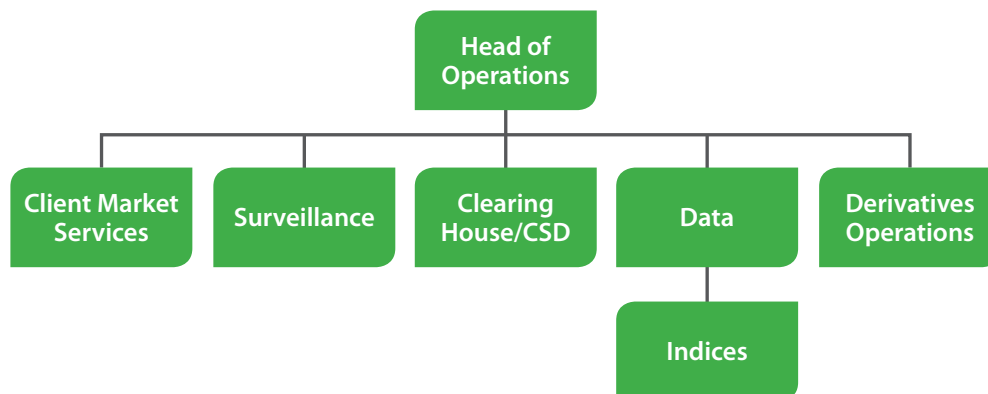
On 10 October 2012, NZX announced the appointment of a new Head of Operations to take charge of the Market Services division, effective 19 November 2012, following the resignation of the previous Head of Market Services.

The Market Services division comprises:

- Surveillance: monitoring of equity and derivative trading
- CMS: release and monitoring of market announcements and day-to-day operation of the trading system
- Clearing and Settlement: the operation of the Clearing House and Depository on behalf of NZCDC
- Indices: the calculation and publication of market data and direct subscription products
- Data: the dissemination of equity and derivative trading
- Derivatives: Derivatives Market operations

FMA's review focused on the business units in this area that contribute to the operation of fair, orderly and transparent markets, being CMS and Surveillance.

7.5.2 Market Services team structure



7.5.3 Assessment process

In addition to FMA's general assessment of NZX described in section 2.2, FMA carried out an assessment specific to the overall Market Services division.

Documentation

FMA considered referrals made by NZX to FMA during the Review Period relating to possible breaches of the Act, or where NZX had information that may have assisted FMA in discharging its functions.

Interview

In our interview with the Head of Operations, we focused on the following:

- the focus of the role and interactions with Regulation
- the management of regulatory functions within Market Services
- the management of workflows and embedding processes
- the identification and management of risks to the Registered Markets and the Derivatives Market
- resources and training
- reporting to the Board

7.5.4 Recommendations

Surveillance and CMS in Market Services

FMA has addressed its concerns regarding the impact of Surveillance and CMS being positioned in the Market Services division, with respect to the management of conflicts, in section 5.2.1 of this report. FMA **recommends** that NZX keep under review the positioning of these functions in Market Services. Given the considerable contribution of CMS and Surveillance to the Regulation function, FMA considers that NZX should demonstrate a clear benefit from the current structural arrangement.

FMA **recommends** that NZX compare this organisational structure with international best practice standards for the management of conflicts in demutualised exchanges.



7.6 Client Market Services

7.6.1 Role of unit

The primary role of CMS is to monitor announcements by Issuers and ensure the timely and accurate release of announcements on MAP.

The unit is central to the operation of the market itself. The identification of price-sensitive announcements in particular is critical, to ensure that trading halts are applied if necessary. Other functions of CMS include:

- inputting the data into NZX's systems that alters the session states of the market (for example, trading halts), 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)
- administering on-market offers of significant orders placed with trading participants (i.e. stands in the market)

CMS is a key point of contact between NZX and Issuers. Issuers regularly contact the CMS team with queries about particular requirements of the Listing Rules. The CMS team contacts Issuers directly to remind them of reporting requirements and when reporting dates are approaching.

CMS supports Regulation by monitoring announcements for compliance with the Listing Rules, such as reporting, corporate actions and notices of meetings. The team also monitors for lack of market information, which involves the identification of those Issuers that have made the required periodic announcements (for example, annual reports) but few, or no, other announcements. In addition, CMS reviews the annual reports of all Issuers, for compliance with the requirements of the Listing Rules. These activities may result in referrals from the CMS team to Regulation.

CMS also has considerable interaction with Surveillance. CMS updates Surveillance regarding announcements and other potentially market-sensitive information from Listed Issuers. It also informs Surveillance of any trading halts.

7.6.2 Assessment process

In addition to FMA's general assessment of NZX described in section 2.2, FMA carried out an assessment specific to the CMS unit.

Documentation

FMA reviewed the following documentation:

- the CMS procedures, updated in June 2012
- an additional update to the CMS procedures for price-sensitive announcements, dated December 2012
- the Issuer Risk List shared with Issuer Regulation
- the Market Services error log

Interview

In our interview with the Leader – CMS, we focused on the following:

- the role of the unit in helping NZX to comply with the Statutory Obligations
- the impacts of the organisational and operational changes on the unit
- the management of risks
- resourcing and training
- the management of workflows and embedding processes
- reporting and escalation procedures

7.6.3 Observations

General

The Leader – CMS demonstrated an understanding of the CMS unit's role in ensuring that the markets operated by NZX are fair, orderly and transparent.

The movement of the CMS team from the Regulation function to the Market Services function during the Review Period has not resulted in any change to the responsibilities of the team, nor has it had an impact on how the CMS team carries out its activities on a daily basis. The Leader – CMS commented that the addition of the Head of Operations provides a dedicated focus on process improvement and streamlining.

Addressing 2011 Report recommendations

The key recommendation areas for CMS from the 2011 Report related to:

- processes around trading halts and the identification of price-sensitive information
- thorough understanding of trading system functionality

The Market Assessment Report stated that the following work was completed in CMS to address those recommendations:

- CMS procedures were updated in June 2012, relevant to identification of price-sensitive announcements
- training of staff was carried out on the new trading system, prior to system go live
- a regular review of CMS procedures is scheduled

Changes to procedures

A high level of accuracy is essential in CMS and adherence to process is particularly important. The CEO, at interview, placed considerable emphasis on the need to automate processes in NZX going forward, particularly in Market Services, to eliminate errors as much as possible, in particular human errors such as the input of incorrect information.

During the Review Period, CMS processes and procedures were enhanced, in part to address recommendations arising from the 2011 Report. NZX reports that, although detailed procedures previously existed for each CMS activity, these were difficult to find and keep up to date. CMS procedures have now been centralised into a single document. This is in the process of being added to a centralised system, where it will be easier to locate and manage.

Procedures were also updated for changes arising from the introduction of the FSM and the X-stream trading system. The change from Trayport to X-stream in November 2012 affected the process for placing and removing trading halts. A problem was identified and raised by CMS during the testing phase and, as a result, custom software was written for NZX to process trading halts. NZX staff informed FMA that features of X-stream in relation to trading halts have made the processes easier for the CMS team.

In December 2012, a specific procedure on the identification of price-sensitive announcements was included in CMS procedures, in recognition of the potential consequences of failures to identify such announcements. NZX stated in the Market Assessment Report that this area will be further reviewed during 2013. The outcome of this review may be used to further train both the CMS and Surveillance teams.

Errors

Although CMS has always maintained an error log, during the Review Period Market Services introduced a new error log for errors that occur within Market Services, including CMS. The information recorded helps to determine the cause of an error, for example incorrect input; and identify how a similar error can be prevented, for example improved training, or an additional checking process.

One error with a market impact occurred within CMS during the Review Period. This involved the early removal of a trading halt. A number of trades occurred immediately after the release, and NZX received a complaint from a Market Participant. Following this error, the CMS team introduced a change to their trading halt procedures. The introduction of X-stream has also made the administration of trading halts easier.

A second error identified in the error log was an announcement being deleted in MAP before it was released. The log noted, "Given the nature of the Announcement, the impact was fairly low, but could have been much more significant." The Head of Operations has confirmed to FMA that she treats all errors, regardless of market impacts, in the same way, in order to assess what went wrong and how processes can be improved. FMA agrees with this approach.

Human resources

During the Review Period, the number of staff in the CMS team increased from 3 FTE to 4 FTE. The increased resource means greater cover is available for periods of annual leave or sickness, at which times the team would previously have been under pressure with workload. A further team member also began in the first quarter of 2013. Additionally, the unit now has a manager focused on its operational performance. With the additional staff in place, the Leader – CMS hopes to be able to spend more time on helping Issuers to understand the Listing Rules better.

There are particular periods of the year when CMS is especially busy, for example when Issuers are releasing annual reports. CMS has leave blackout periods at these times, to avoid resourcing problems.

The level of experience in CMS is relatively high. The Leader – CMS has been in the role for almost two years, as has one of the other team members. It is an area where every team member needs to be able to carry out all the tasks. The importance of cross-training and removing any 'key man' dependency issues is recognised by NZX.

FMA is satisfied that the level of resources in CMS is adequate.

Benefit of structural change

Owing to the process-driven nature of the work carried out by the CMS team, FMA considers that the CMS unit has possibly derived the most benefit from the change in the organisational structure. The creation of the Market Services team and the appointment of the Head of Operations have resulted in a strong focus on process improvement, with managerial resources to carry that out.

FMA looks forward to seeing further improvements in CMS during the current period.

7.7 Surveillance

7.7.1 Role of unit

The key responsibility of Surveillance is real-time monitoring of trading activity on the Registered Markets and the Derivatives Market, for compliance with the Market Rules. This monitoring may also raise issues concerning compliance with financial markets legislation, such as the Act or Takeovers Code, which NZX must then refer to the appropriate regulator. In addition, Surveillance is a key point of contact for Market Participants, Issuers and the public about trading activity of possible concern.

Key tools for performing real-time monitoring are the SMARTS surveillance system (*SMARTS*) and the trading system (previously Trayport, replaced by X-stream in October 2012). Surveillance also uses spreadsheets that update in real-time with securities movements and volume statistics, with information feeds from providers such as Iress and Bloomberg; as well as NZX's historical database of market activity.

SMARTS alerts are reviewed and investigated throughout the day as they occur. The unit also reviews trading in the context of significant events brought to its attention by announcements, CMS, or other sources. Surveillance carries out inquiries as necessary, where the information identified indicates a possible breach of Market Rules, or trading misconduct. Surveillance works closely with CMS to maintain the integrity of the Registered Markets and the Derivatives Market.

Surveillance maintains a watchlist of Issuers where there are factors indicating there may be an increased risk of improper trading. This list is discussed at weekly meetings that include staff members from NZX Regulation and CMS.

Surveillance supports the Special Division's monitoring of trading activity in securities issued by NZX and Related Entities. It refers all SMARTS alerts in securities issued by NZX, and alerts within certain parameters for Smartshares funds (the five funds managed by Smartshares Limited), to the Special Division. It also provides the Special Division with quarterly reports of trading in Smartshares funds.

Surveillance also conducts systems testing for applications to become NZX Dealers or Direct Market Access Dealers, before granting designation as such. This involves the simulation of trading scenarios based on test scripts, to ensure that applicants have the necessary competencies to operate the trading system.

In addition to monitoring for compliance with the Derivatives Market Rules, Surveillance was responsible for the following tasks for the Derivatives Market during the Review Period:

- managing price limits
- monitoring open positions
- approving wholesale trades
- the calculation and dissemination of daily settlement prices

Responsibility for the calculation and dissemination of daily settlement prices was transferred to the CMS team in the first quarter of 2013.

7.7.2 Assessment process

In addition to FMA's general assessment of NZX described in section 2.2, FMA carried out an assessment specific to the Surveillance unit.

Documentation

FMA reviewed the following documentation:

- the Surveillance Procedures Manual, updated in October 2012
- a sample of Surveillance weekly updates
- the Surveillance watchlist

Interview

In our interview with the Leader – Surveillance, we focused on the following:

- the role of the unit in helping NZX to comply with the Statutory Obligations
- the impacts of the organisational and operational changes on the unit
- the management of risks
- resourcing and training
- the management of workflows and embedding processes
- reporting and escalation procedures

7.7.3 Observations

General

The Leader – Surveillance demonstrated an understanding of the Surveillance unit's role in ensuring that the markets operated by NZX are fair, orderly and transparent.

The movement of the Surveillance unit from the Regulation function to the Market Services function during the

Review Period has not resulted in any change to how the Surveillance team carries out its activities on a daily basis. Staff feel there is now better clarity as to where the obligations of Surveillance end in the process of investigating possible breaches.

2011 Report recommendations

The key recommendation areas for Surveillance from the 2011 Report related to:

- 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 Market Assessment Report stated that the following work was completed in Surveillance to address those recommendations:

- Surveillance Procedures were updated in October 2012 to reflect the following:
 - the Head of Regulation must be notified of new trading types
 - the Head of Regulation must approve changes to parameters of SMARTS alerts
 - trading anomalies that are not triggered by SMARTS alerts must be escalated to the Head of Regulation in defined circumstances
- a quarterly review of risks to the markets is scheduled
- a SMARTS representative visited in October 2012, providing a forum for discussion, and planning is in place for attendance at the next SMARTS conference

Human resources

During the Review Period, the number of staff in the Surveillance team increased from 3 FTE to 4 FTE. The newest team member has a background in derivatives trading and options, which is a knowledge area that was previously not represented within the team and is a valuable addition, especially given the impending launch of equity derivatives.

Surveillance has an issue with staff retention, due to the nature of the work carried out and the type of recruit best suited to that work. Typically, recent graduates have been drawn to the roles, but after gaining one or two years of experience, they are inclined to move on to other jobs and organisations. With the recent departure of a more experienced analyst from Surveillance, currently the longest-serving member of the team (other than the Leader – Surveillance) has been in Surveillance for approximately one year.

NZX may wish to give consideration to the future resourcing of its Surveillance function, in light of changing trends in global markets. These include types of trading, such as algorithmic and high frequency trading; and the increasing complexity of products, such as derivatives. FMA notes that the surveillance function in other exchanges tends to be staffed by senior and experienced market professionals with significant analysis experience. Mathematicians are also often used in surveillance functions.

NZX has expressed a need for formalised training plans that would help people to progress within NZX and assist with retention. The need to cross-train and reduce key man dependency risk in Surveillance is recognised by NZX.

7.7.4 Recommendations

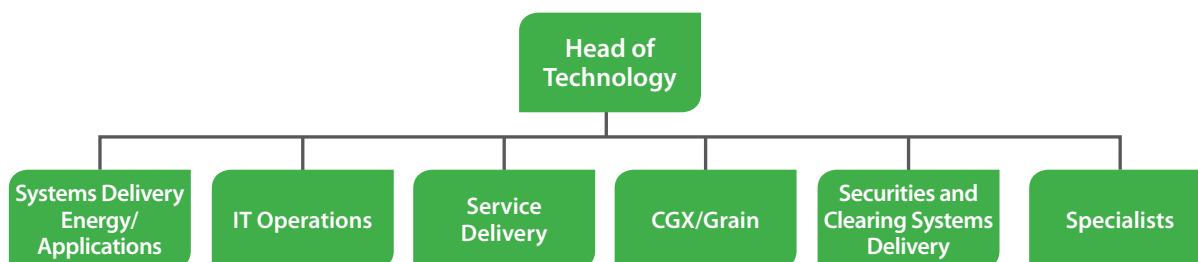
Logging all information

As referred to in section 6.3.3, during the Review Period Surveillance began recording inquiries in a case management tool. However, not all matters that are considered by the team are entered. In these cases, the matters are not recorded elsewhere. For example, Surveillance may receive a query from a participant, by telephone, about particular trading. The team will look into the trading in question and, if satisfied that the trading is reasonable, will inform the participant and there will be no further action. This type of interaction may not be recorded by Surveillance.

FMA **recommends** that the Surveillance team devise guidelines and procedures for logging queries that are not entered into the case management tool, but that could be relevant as part of NZX's overall data collection, and move towards more trend analysis. Although an individual query may not require further investigation, it may be indicative of a pattern. For example, NZX could be losing valuable information about market behaviour by not recording issues brought to the attention of Surveillance.

7.8 Technology

7.8.1 Technology team structure



7.8.2 Role of unit

Within the Technology group, the Securities and Clearing Systems Delivery team is responsible for the delivery of projects and the daily operation, maintenance and monitoring of the trading and clearing systems used by the markets. Technology is also responsible for system testing and implementation. The Market Assessment report stated, “The team works closely with Market Services to ensure that the infrastructure on which the trading system operates is fully redundant, robust, scalable and efficient.”

The team is made up of technology professionals, some of whom have been with NZX for a significant period of time.

The Technology unit has responsibility for the overall performance of NZX’s technological systems across both its regulated (by FMA and other regulators) and unregulated activities. The core function of this area is to ensure the availability, security, capacity and maintenance of its trading platforms and settlement systems, internal monitoring systems and general systems. The core systems that operate the markets include:

- the trading system that caters for all NZSX, NZDX, NZAX, FSM and Derivatives Market trading for NZX participants. The trading system integrates and connects with other systems using industry standard application protocol interfaces (APIs)
 - i. Trayport from 1 January 2012 to 28 October 2012
 - ii. X-stream since 29 October 2012
- the BaNCs clearing system, which facilitates the clearing and settlement of all transactions for the NZSX, NZDX, NZAX, FSM and the Derivatives Market. The clearing system also interfaces with other systems using industry standard APIs
- the System Knowledge Base – key information regarding all systems, including the core trading and clearing systems, is documented centrally. The information recorded includes system implementation procedures, system processes, hardware and software specification and licence information and troubleshooting processes, where applicable

- the NZX website, which provides real-time communication with the market
- MAP, the internet-based platform for disclosure of market announcements and corporate actions
- the market data feed, which provides a data feed of live announcements and prices on the relevant markets
- internal systems for monitoring the market, including SMARTS
- general systems, including server facilities and communications

NZX carries out daily, weekly and monthly housekeeping processes to ensure that system capacity and performance are optimal.

There were no trading system outages during the Review Period and both Trayport and X-stream recorded 100% up time. The Market Assessment Report noted that NZX experienced two major incidents that affected the market during the Review Period. These were:

- a BaNCs production outage: on 20 January 2012, the Clearing House system (BaNCs) stopped processing trade information from the trading system. This was successfully re-enabled by restarting a component of the Clearing House system
- a market data issue affecting day start trade messaging and downstream market data feed: on 13 November 2012, incorrect instrument data was entered in a source system that feeds the trading system. This affected the processing of some start-of-day bid and offer data distributed via the FIX trade messaging and the market data feed only. All trade messages created during the trading day were unaffected, and Market Participants were able to trade using the full bid and offer data available on the trading system. Some clients and data vendors were affected, but trading could proceed for the day. NZX confirmed that additional fail-safe mechanisms have been built into the software to prevent reoccurrence

During the Review Period NZX implemented a new trading system, which is discussed below in section 7.8.4. Other upgrades included:

- BaNCs clearing system upgrade
- Swift 2011 messaging changes
- technology infrastructure changes to facilitate the implementation of the new trading system

Technology also implemented processes to support the FSM. Certain system enhancements had to be made to facilitate the trading and clearing of the FSM specifically.

The Technology team provides business and technical support to the Market Services function, which includes trading, clearing, data, surveillance and client services, across all markets. This support is provided as and when required.

7.8.3 Assessment process

In addition to FMA's general assessment of NZX described in section 2.2, FMA carried out an assessment specific to the Technology division.

Documentation

FMA reviewed the following documentation:

- Board papers
- the 'NZX Trading System Update' provided to FMA
- incident reports sent to FMA during the Review Period
- a schedule of projects considered during the Review Period
- a third party report 'Test System Trading Review'

Interview

In our interview with the Head of Technology, we focused on the following:

- the identification and management of risks to the Registered Markets and the Derivatives Market
- resources and training
- the management of workflows and embedding processes
- the new trading system and the implementation process
- reporting to the Board

7.8.4 Observations

General

The Head of Technology demonstrated an understanding of the importance of technology in ensuring that the markets are fair, orderly and transparent.

In the Market Assessment Report, NZX stated, "The importance of IT governance to NZX is increasing as the use of technology in NZX's businesses grows. In this context, NZX's broad approach to IT governance is as a process of continual improvement, an endeavour to align IT to business strategy and to achieve identified beneficial outcomes."

Technology is a fundamental driver of New Zealand's Registered Markets and the Derivatives Market. With technology likely to be even more critical in the foreseeable future, this will be an ongoing focus of FMA's assessment.

The new trading system

During the Review Period NZX implemented a new trading system. The replacement was undertaken as the Trayport licence was expiring on 31 December 2012, and after an evaluation process, X-stream was chosen. Implementation of the new trading system began on 2 April 2012.

The project had a challenging implementation timeline, which included a system testing phase. This was in part driven by the fact that the Board had had poor visibility around the expiry of the licensing arrangement with Trayport and no rollover arrangement had been agreed.

In interviews with the Board, it was acknowledged that it was not until the beginning of 2012 that the Board became aware that Trayport's licence with NZX was expiring at the end of 2012. There was no real contingency plan, other than seeking an extension to the Trayport licence if the implementation was not on time or successful. The Board acknowledges the undesirability of this position and has put in place measures to ensure this does not happen again in the future.

The system testing process was planned in conjunction with NASDAQ OMX. Initially NASDAQ OMX believed that the implementation timetable was too short to achieve, but it gained comfort during the project. The test process involved Market Participants, ISVs and data vendors. The Market Participants had access to the relevant NZX test environments and ran their testing in parallel with NZX's internal test cycles.

The trading system went live in October 2012. NZX was satisfied with the implementation and stated in the Market Assessment Report, "The project, which involved extensive interaction with Participants, ISVs and data users, was implemented on time and with no disruption to the Markets."

NZX engaged with FMA with regard to the change of trading system and the process involved, although FMA notes that it was unaware that there were initial concerns expressed by the vendor about the implementation timeframe. NZX has informed FMA that the feedback from Market Participants on the process was very positive.

FMA notes that NZX has planned the implementation of further trading system updates for X-stream in 2013. FMA encourages NZX to keep FMA and Market Participants up to date about future technological changes.

Disaster recovery

NZX conducts annual fail-over and disaster recovery testing on the trading and Clearing House systems to ensure that the procedure can be commenced efficiently and operational knowledge remains current. The exercise tests the primary and secondary production site components for failure and the ability of core systems to continue working with little or no manual intervention.

NZX operates the markets from the disaster recovery site for the period of one week and then switches back to the primary site, effectively testing the fail-over scenario twice. As X-stream underwent extensive testing on its production infrastructure prior to launch, annual testing of the trading system will be carried out in the third quarter of 2013.

Reporting

The Head of Technology provides a Regulated System report as part of the quarterly 'Regulated Markets and Regulated Infrastructure Report' to the Board. This short report:

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

The Head of Technology attends the Board meetings to discuss his reports. In addition, the Head of Technology has a fortnightly meeting with the CEO, with discussions including projects, workflows and resources. With regard to major projects, for example the change of trading system during the Review Period, regular updates are also given to the Board to highlight progress, issues and risks. Any issue that comes up between Board meetings is escalated to the CEO via weekly project reviews.

Incident reporting

NZX has an incident management and incident reporting framework. The priority is to get the affected service restored as quickly as possible, while minimising the adverse effects on business operations. Where there is an external

impact, the market is notified and a formal incident report is distributed to the market once the incident has been resolved. The report provides details of the nature of the issue, the market impacts, the underlying cause and the actions that NZX has taken, or will take, to rectify the issue in the short and long term.

As noted earlier, NZX experienced two major incidents that affected the market during the period. In addition to these incidents, there was a number of incidents where an ISV that facilitates client connectivity to NZX for the Derivatives Market was unable to connect.

NZX was able to resolve the cause of the issues and has developed procedures or built fail-safe mechanisms to prevent reoccurrences.

Human resources

This division of NZX has a mixture of highly experienced, long-serving staff and newer employees. Technology is actively working to document the knowledge held by the long-serving staff members, in order to have that information available to all of NZX.

FMA is satisfied that the resources in Technology are adequate.

7.8.5 Recommendations

System testing processes

As part of the implementation of the new trading system, NZX requested an external review of the testing process and coverage. This was carried out prior to sign-off on final system readiness and the Board noted that this external review gave it comfort that NZX could go live on the new platform.

The key finding from the review was that there was no visibility of the testing process. There was uncertainty as to the accuracy of the test coverage and how much had been tested. The review also noted that the team involved in the testing had great business knowledge; however, there was little professional testing experience and this was evident when reviewing test documentation. The external review and NZX's own review observed that the test team all had full-time jobs and that resources were not always available.

Technology confirmed that the specific recommendations made by the external reviewer were implemented prior to go-live.

FMA **recommends** that NZX incorporate the external review's recommendations into its testing processes for regulated technology. It is critical that testing processes are appropriate and are adequately resourced for the new technologies that are being introduced. NZX should also

ensure that it manages contracts with key providers and is confident that changes can be effected without the pressures experienced in the implementation of X-stream.

Integrity of the trading system

The prompt resolution of IT issues and outages is crucial to NZX's Statutory Obligations to ensure fair, orderly and transparent markets. It is essential that the Technology unit has systems and processes relating to the capacity, integrity, resilience and security of its technology systems. In the Market Assessment Report NZX confirmed that it has implemented extensive monitoring to ensure any network, software or hardware problems are detected as early as possible.

A number of major overseas exchanges have suffered outages in recent years, caused by breaches of security arrangements. FMA **recommends** that NZX independently test its systems security, to identify any security weaknesses and how these might be mitigated.

7.9 The Tribunal and the Special Division

7.9.1 Assessment process

In addition to FMA's general assessment of NZX described in section 2.2, FMA reviewed the Tribunal and the Special Division.

Documentation

FMA reviewed the following documentation:

- 'NZ Markets Disciplinary Tribunal Annual Report 2012'
- correspondence between the Tribunal and NZX
- records of matters referred to and considered by the Tribunal and Special Division during the Review Period

Interviews

In our interviews with the Chair of the Tribunal and the Chair of the Special Division, we focused on the following:

- how the respective bodies operated during the Review Period
- the relationship with NZX
- the number and quality of referrals from NZX during the Review Period
- resources

7.9.2 Role of the Tribunal

The Tribunal is an independent adjudicative body established under the Tribunal Rules. The Tribunal's principal role is to determine and provide remedies for referrals made to it by NZX or New Zealand Clearing Limited, under the Market Rules or the Clearing House Rules. The jurisdiction of the Tribunal does not extend to reviewing decisions made by NZX in respect of approvals of listings, designations of Market Participants, changes to the Market Rules, published policy decisions, trading halts, or pricing schedules.

The Tribunal is required to be composed of various categories of member, representing different interest groups and relevant experience. It includes lawyers, Market Participant representatives, Issuer representatives, members with knowledge of clearing and derivatives, and members of the public. The full powers of the Tribunal are set out in the Tribunal Rules. Under Section 12 of the Tribunal Rules, the Tribunal is required to publish an annual report.

FMA is satisfied that the Tribunal is a sufficiently independent adjudicative body to adjudicate on contraventions of Market Rules that are referred to it.

7.9.3 Observations – the Tribunal

General

During the Review Period, changes were made in respect of the manner of engagement between Regulation and the Tribunal, including quarterly meetings between the Head of Regulation, the Enforcement solicitor and the Executive Counsel of the Tribunal. Both NZX and the Tribunal have found these changes to be positive, as they have resulted in improved communication and better co-ordination in relation to referrals. The Chair of the Tribunal stated in the Tribunal's Annual Report, "...the Tribunal's working relationship with NZX has strengthened over the course of this past year". FMA is pleased with the progress in this area.

Amendments to the Tribunal Rules dated 4 July 2012 came into effect on 30 August 2012. The amendments were a consequence of the introduction of the FSM, and extended the jurisdiction of the Tribunal to include determinations under the FSM Rules. The Tribunal was ultimately satisfied with NZX's consultation on the changes, although its view was that consultation could have been initiated earlier.

The Tribunal User Guide was updated in June 2012. This document is intended to assist parties appearing before it to understand the Tribunal Rules, the processes and policies of the Tribunal, and the procedures and timeframes that apply once a statement of case has been served.

2011 Report recommendations

The key recommendation areas for NZX in respect of the Tribunal from the 2011 Report were as follows:

- the need for timely and regular communication with the Tribunal on appointments, criteria and timeframes for referrals, and Market Rule changes

The Market Assessment Report stated that the following work was completed by NZX to address those recommendations:

- quarterly meetings between Regulation and the Executive Counsel of the Tribunal with a standing agenda have begun
- the review of the 'Guidance Note - Process for Amending NZX Conduct Rules' is to include consultation with the Tribunal
- dates of expiry of Tribunal members' terms of appointment are recorded in the Regulation Obligations Register. This register is reviewed quarterly

Resources

The Tribunal advised that it was adequately resourced by NZX, and had been provided with all the assistance required to perform its role. During the Review Period NZX secured the services of a second legal resource to support the Executive Counsel. This provides backup for periods of high volume or when the Executive Counsel is unavailable, as well as succession planning for the Tribunal.

Prior to 24 May, the Tribunal did not have the members required to ensure that it had the necessary composition to hear all cases; for example, there was no Clearing Appointee. At the end of the Review Period, the Tribunal comprised seven public appointees, six Issuer appointees, eight legal appointees, four Market Participant appointees and one member who qualified as both a Clearing Appointee and a Derivatives Market Appointee. Nine new Tribunal members were appointed during the Review Period; seven on 24 May 2012 and two on 11 July 2012.

The Tribunal will lose a number of its most experienced members, who must retire pursuant to the Tribunal Rules, at the annual meeting in June 2013. NZX has established a public nominations process and is currently seeking applications from suitably qualified candidates for both the Tribunal and the Appeals Panel.

FMA supports this process and will monitor the composition of the Tribunal and its compliance with the Tribunal Rules.

Referrals to the Tribunal

The processes of the Tribunal are designed to be efficient and expedient, in order to meet the requirements of the market for speed and certainty of interpretation in the administration of the Market Rules. The Tribunal commented in its Annual Report that this objective is frustrated when a significant period of time elapses between when NZX becomes aware of an alleged breach and when the matter is ultimately referred to the Tribunal.

At interview with FMA, the Chair of the Tribunal expressed concern in relation to this. In two cases referred, several months had elapsed between the date of NZX's last correspondence with the respondent and the referral of the matter to the Tribunal. The Tribunal's Annual Report also noted that the Tribunal is aware of a matter that has not been referred to the Tribunal, where it had taken more than a year from the time that NZX became aware of the breach until it was decided not to refer the matter to the Tribunal.

Regulation made five referrals to the Tribunal during the Review Period, compared with four during the period 1 January 2011 to 31 December 2011. Accordingly, while the 2012 performance was a slight improvement from the corresponding period, the number of referrals remains historically low and represents a small proportion of the breaches identified during the Review Period.

The Chair of the Tribunal noted that the Tribunal was “very much under-utilised”. In its Annual Report, the Tribunal commented on this issue: “The Tribunal is an equally effective forum for addressing more minor or technical breaches. The summary hearing procedure is, in fact, designed to deal with minor breaches.” The Tribunal’s Annual Report further stated, “... referral of minor breaches to the Tribunal may, on occasion, be beneficial, both to signal to participants that NZX is focused on particular breaches (especially where such breaches are occurring reasonably frequently) and to avoid the risk of participants becoming complacent in complying with what they may perceive to be less significant obligations under the Market Rules.”

7.9.4 Recommendations – the Tribunal

The Tribunal’s comments mirror FMA’s serious concerns in relation to the progress of investigations and the low number of referrals to the Tribunal, as set out in section 5.2.2. In particular, FMA expects NZX to be dealing effectively with recurrent breaches of a particular rule, or continued low-level breaches by a particular Market Participant or Issuer.

7.9.5 Role of the Special Division

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

7.9.6 Observations – the Special Division

Operational process

NZX and the Special Division operate under the Special Division Procedures. No amendments were made to these procedures during the Review Period.

Under procedures agreed with NZX, the Special Division receives:

- with respect to securities issued by NZX, all SMARTS alerts and instances of abnormal trading activity (in circumstances where no alerts have 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 instances of abnormal trading activity regarding units in a fund, whether or not an alert has fired

37 matters were dealt with by the Special Division during the Review Period. Approximately 80% of these were SMARTS alerts, of which the vast majority were attributed to general movements in the market. However, the Special Division did carry out further investigation on three matters. In two of these matters, the Special Division determined that no further action was necessary. It referred the third matter to FMA.

Resources

Two new appointments were made to the Special Division during 2012.

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

The Chair of the Special Division will retire in the current year, pursuant to the Tribunal Rules. The Tribunal has planned for his succession.

Referrals to the Special Division

The Special Division relies on NZX to identify unusual trading in its own, or Related Entities’, securities. The Special Division may also require NZX to carry out on its behalf, or assist with, inquiries, due to the fact that NZX holds the information and systems needed for those inquiries. There exists, therefore, an inherent conflict and risk, of which NZX must be constantly aware. NZX should ensure that controls for this risk, such as how it records referrals to and interactions with the Special Division, are up to date. It may be appropriate to take this into consideration during the annual review of the Conflicts Policy.

7.9.7 Recommendations – the Special Division

From FMA’s interview with the Chair of the Special Division, it is clear that, similar to the Chair of the Tribunal, he considers the function to be under-utilised by NZX.

We have made recommendations concerning the broader use of the Special Division in relation to managing conflicts of interest, in section 5.2.1 of this report.

APPENDIX 1: MARKET CONDITIONS

The following information is extracted verbatim from NZX's Market Assessment Report, and provides market context for this report.

Market Performance

The NZX 50 index (NZX 50) is the most common benchmark index of the New Zealand equities market.

During 2012 the NZX50 rose 778 points to 4066, a gain of 23.6%. Figure 1 shows a consistent rising track throughout 2012 with the rate of increase picking up in the second half of 2012. The performance of the NZX50 in 2012 outpaced many other international benchmarks notably the S&P500 (up 13%), S&P/ASX200 (up 11%), and the MSCI World Index (up 13%).

Volatility in 2012 was broadly flat. Figure 2 shows a rise in volatility in the middle of the year but without any significant spikes similar to what occurred in 2011.

Global factors influenced the course of NZX50 during the year. Despite the global backdrop, financial market sentiment improved in 2012, supported by global monetary policy and strong statements by policymakers in the US and euro area. In New Zealand the Reserve Bank held the OCR at 2.5%, which helped stimulate demand for higher yields.

The beginning of 2012 was characterised by a general improvement in financial market sentiment with the provision of longer-term liquidity measures in the European banking system. There was a flow-on effect through the New Zealand equity market in the early months of 2012 and the increase in investor confidence was reflected in the increase in the NZX50. After reaching a low of 3,211 on 16 January 2012, the index rose by 11% over the four months ending 30 April 2012 on 3,556.

In May and June, the index retreated slightly coinciding with news that economic activity in the euro area had contracted and the region continued to face considerable challenges in addressing the underlying issues related to the sovereign debt crisis. The NZX50 subsequently rose again after news of quantitative easing in the US, and the upward momentum carried through to the end of the year, with the NZX50 reaching a high of 4081 at the end of December 2012.

Algorithmic trading grew in 2012 but remains a very small component of the market (<1% of on-market) compared to overseas markets such as Australia (10-20%) and the US (50-70%). Moreover, NZX has not installed any co-location facilities to date which would be a key indicator that the growth of algorithmic/HFT trading was moving into line with international practice where such facilities are standard.

Market Volumes

Table 1 summarises trading volumes. Trading activity across the Markets increased in 2012 from the previous year with activity generally increasing as the year progressed. The highest value traded for the December month since 1988 was recorded in December 2012. Total value traded was up 5% in 2012 while the number of trades was up 23%. This latter reflects a rise in the extent of algorithmic and high frequency trading on the NZX Main Board.

NZX Derivatives Markets

Table 2 summarises NZX Derivatives Market volume in 2012. 2012 saw growth in Dairy Futures trading across all three product types. Total cumulative volume in NZX Dairy Futures surpassed 30,000 lots in September 2012.

Prices were highest at the start of the year before falling to a low mid-way through 2012 in line with movements in the underlying physical markets (i.e., Global Dairy Trade). By year-end prices had broadly recovered to levels seen at the start of the year.

There was no activity in the Options in 2012.

Figure 1: Performance of NZX50 2012

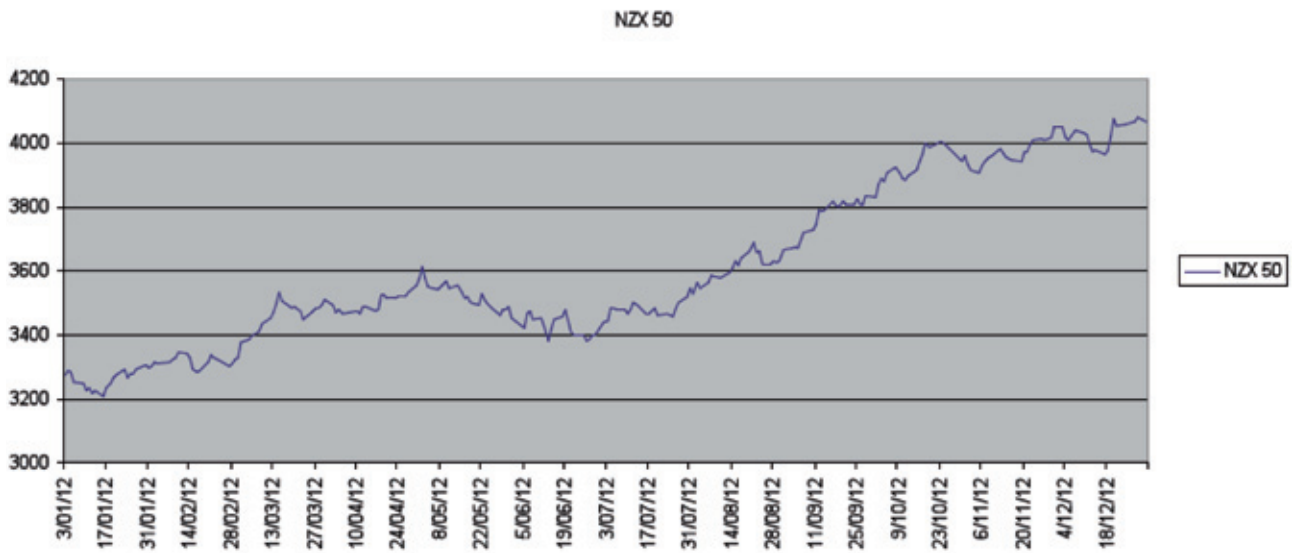


Figure 2: NZX50 30-Day Volatility 2012 (Source: Bloomberg)

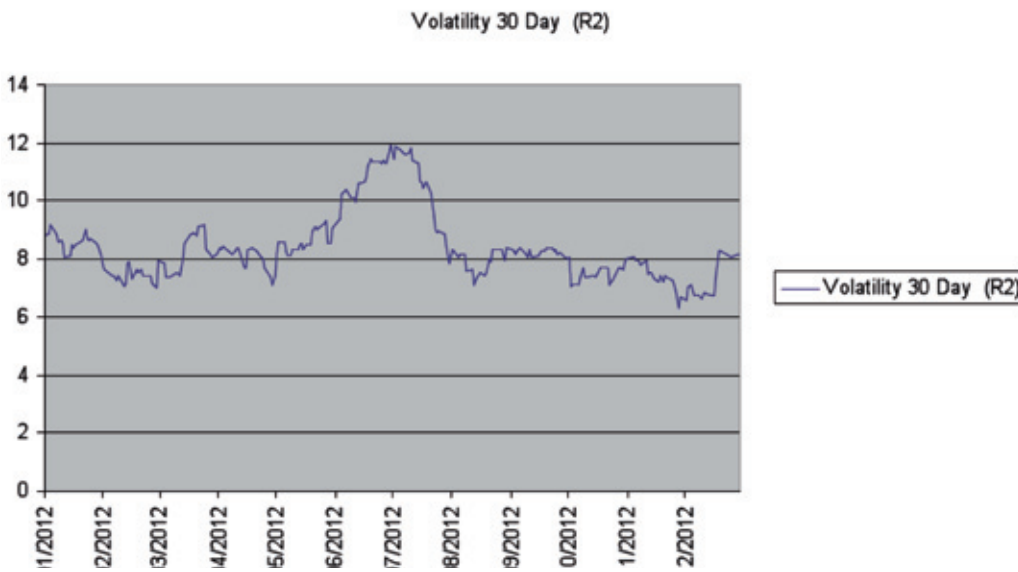


Table 1: Trading Volumes

	2012	2011	% Change
Daily Average Trades	3,427	2,775	23%
Daily Average Value (\$)	116,198,741	108,895,940	6.7%
Daily Average Volume	43,947,680	40,824,036	7.7%

Table 2: NZX Derivatives Dairy Futures Volumes (lots traded)

	2012	2011
WMP	17,562	7,349
AMF	5,521	3,500
SMP	1,100	280
Total	24,183	11,129

0,85%

APPENDIX 2: GLOSSARY

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

2011 Report	FMA's 'Report on the NZX General Obligations Review dated 29 June 2012'
Act	Securities Markets Act 1988
Alternative Market	NZX Alternative Market or NZAX
ASX	Australian Securities Exchange Limited
BaNCs	The core clearing and settlement system operated by NZX
BCP	Business continuity plan
Board	NZX Board
CEO	Chief Executive Officer
Clearing Appointee	Tribunal appointee with relevant Clearing House experience
Clearing House	The central counterparty clearing house operated by New Zealand Clearing Limited
Clearing House Rules	New Zealand Clearing Limited Clearing and Settlement Rules
CMS	The Client Market Services business unit of NZX
Conflicts Policy	NZX Conflict Management Policy dated December 2012
Debt Market	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
FMA	Financial Markets Authority
Fonterra	Fonterra Co-operative Group Limited
FSM	Fonterra Shareholders' Market
FSM Rules	NZX rules for the FSM
FTE	Full-time-equivalent staff
Futures Exchange Notice	Authorised Futures Exchange (NZX Limited) Notice 2012
General Obligations	The general obligations in respect of registered markets contained in section 36Y of the Act
General Obligations Review	A review carried out by FMA pursuant to section 36YB of the Act
HOMS	Head of Market Supervision. This position ceased on 31 July 2012
IOSCO	International Organization of Securities Commissions
Issuer or Listed Issuer	Any company that is or has been listed on any of NZX's Registered Markets
ISV	Independent software vendor: a connectivity partner that provides systems and software that allow brokers to connect to NZX's trading platform
Listing Rules	NZX rules for the NZSX, NZDX and NZAX

MAP	Market Announcement Platform
Market Announcement Platform	Electronic platform used by NZX to publish market announcements
Market Assessment Report	Report produced by NZX under section 36YA of the Act
Market Participant	A participant in the Registered Markets and/or the Derivatives Market who has been accredited and approved by NZX
Market Rules	Together, the Listing Rules, Participant Rules, Derivatives Market Rules and FSM Rules
Market Services	The Market Services division of NZX comprising Surveillance, CMS, Clearing, Indices and Data
NZAX	NZX Alternative Market
NZCDC	New Zealand Clearing and Depository Corporation Limited – a wholly owned NZX subsidiary that operates the clearing and settlement system that has been designated under part 5C of the Reserve Bank of New Zealand Act 1989
NZDX	NZX Debt Market
NZSX	NZX Main Board
NZX	NZX Limited
NZX Solicitors	Legal staff in NZX Regulation
Participant Rules	NZX rules governing its Market Participants
Registered Exchange	A person that holds a market registration under section 36F of the Act
Registered Markets	Registered markets of NZX as defined under the Act comprising the NZSX, NZAX, NZDX and FSM
Regulation	From 1 August 2012, the regulatory function of NZX, led by the Head of Regulation and comprising two functional areas – Issuer Regulation and Participant Compliance
Related Entity	Any participant in an NZX market, or person who applies to NZX to become a participant, which has a connection or relationship with NZX such that the Special Division is satisfied that in the circumstances there would be a reasonable apprehension or suspicion of bias by NZX in relation to that Participant or that person
Review Period	The period commencing on 1 January 2012 and ending 31 December 2012
Solicitors' Handbook	Internal NZX manual governing procedures and policies of 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
Statutory Obligations	The general obligations contained in section 36Y of the Act and the conditions contained in clause 7 of the Futures Exchange Notice
Surveillance Procedures Manual	Internal NZX manual governing procedures and policies of Surveillance
Trayport	Trayport GlobalVision trading system
Tribunal	New Zealand Markets Disciplinary Tribunal
Tribunal Rules	The rules governing the operation of the Tribunal
X-stream	The NASDAQ OMX X-stream trading system

