

NZX

COMPANY

FINANCIAL MARKETS AUTHORITY

NZX GENERAL  
OBLIGATIONS  
REVIEW **2015**

SELL



FMA

FINANCIAL MARKETS AUTHORITY

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FMA — NZX General Obligations Review  
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## EXECUTIVE SUMMARY

The Financial Markets Conduct Act 2013 (FMC Act) requires the FMA to carry out a review, at least annually, of how well a licensed market operator is meeting the market operator obligations contained in section 314 of the FMC Act, and to publish a written report. This is our fourth review of NZX's obligations.<sup>1</sup>

### Our conclusion

We have concluded that, during 2014, NZX complied with all of its statutory obligations.

### Agreed actions from 2013

As part of the *2013 General Obligations Review*, published in June 2014, NZX agreed to several actions relating to arrangements for managing conflicts of interest, arrangements for monitoring conduct, and arrangements for enforcing compliance. Progress towards completing the agreed actions is overseen by the NZX board and NZX has completed all but one of the agreed actions. The final agreed action, to review the penalty structure within the tribunal rules for minor and unambiguous breaches of the market rules, is underway.

We are satisfied that the actions taken have further strengthened NZX's arrangements for handling conflicts, monitoring conduct and enforcing compliance. They also allow greater visibility and market awareness of NZX's regulatory activities and outcomes. We believe this will help increase market confidence in NZX's effectiveness as the operator and frontline regulator of New Zealand's licensed financial products markets.

### Activities during 2014

NZX has continued to focus on improving internal processes across the business functions that contribute to the operation of its markets. Changes have included introducing a case management system for market services and regulation, which enables information-sharing, internal referrals and managerial oversight and reporting. The market participant inspection

programme has been revised and updated, resulting in more focused inspections and better allocation of resources. More work has also been done to ensure the accurate identification and labelling of price-sensitive announcements.

Efficiency in regulation and enforcement has also been a focus, with amendments made to internal service levels and several legacy investigations completed. The regulatory governance committee of the board, introduced in the latter half of 2013, was fully operational in 2014 and the regulation team has found the extra oversight and analysis of regulatory decision-making helpful.

Resourcing is monitored by the board, the regulatory governance committee, and individual teams. There was a higher workload in the regulation and policy teams during 2014, largely due to more listings and the development of the NXT market, and NZX employed extra resources as necessary.

Technological issues with the trading system in the first half of 2014 were thoroughly investigated, root causes determined, and permanent solutions implemented. There have been no disruptions to the trading system since 27 June 2014.

We do not require NZX to take any specific actions following this review. Interactions with management and the NZX board during 2014 showed that NZX is focused on compliance and on developing its systems, processes and activities to benefit all stakeholders. Its responses to key concerns raised in previous reviews have resulted in effective arrangements for operating fair, orderly and transparent markets, and its activities during 2014 demonstrated a commitment to continuous improvement, ensuring its ongoing compliance with the statutory obligations. As the markets grow and develop, our continuous engagement with NZX will enable us to address any changes we consider necessary in the future.

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<sup>1</sup> NZX was a registered exchange under the Securities Markets Act 1988 (SMA) until 1 December 2014. The obligations under the FMC Act are equivalent to the obligations under the SMA. Previous reviews of NZX's compliance with its obligations were carried out under the SMA.

## PURPOSE OF THIS REPORT

### NZX's obligations

The period under review for this report is 1 January 2014 to 31 December 2014. For most of this period, NZX Limited (NZX) had the following general obligations under the Securities Markets Act 1988 (the SMA):<sup>2</sup>

1. NZX must have adequate **arrangements for handling conflicts** between its commercial interests and the need to ensure that the markets operate in a fair, orderly and transparent way.
2. NZX must have adequate **arrangements for monitoring the conduct** of exchange participants on, or in relation to, the markets.
3. NZX must have adequate **arrangements for enforcing compliance** with the market rules.
4. NZX must have adequate arrangements that ensure there is **a sufficiently independent adjudicative body** to adjudicate on contraventions of the market rules that are referred to it.
5. NZX must have **sufficient resources** (including financial, technological, and human resources) to operate the registered markets and the derivatives market properly.
6. To the extent that it is reasonably practicable, NZX must do all things necessary to ensure that each of the registered markets and the derivatives market is **fair, orderly and transparent**.

### Markets operated by NZX

NZX was New Zealand's only registered exchange under the SMA<sup>3</sup>, and operated the following registered markets:

- NZSX (main board)
- NZDX (debt market)
- NZAX (alternative market)
- FSM (Fonterra shareholders' market)
- NXT (a market for emerging small and mid-sized companies, conditionally registered on 29 September 2014).

NZX was also authorised to operate a futures market, the NZX derivatives market. This placed conditions on NZX which mirrored the general obligations, and were designed to ensure the derivatives market also operated in a fair, orderly and transparent way. The general obligations and the derivatives market conditions are jointly referred to in this report as the statutory obligations.<sup>4</sup>

### FMA's obligation to review

The FMC Act requires the FMA to carry out a review, at least annually, of how well a licensed market operator is meeting its obligations, and to publish a written report. NZX's operational systems and approach to compliance with the derivatives market conditions are generally similar, and delivered by the same teams, as for the general obligations. We therefore refer to NZX's compliance with the derivatives market conditions in our general obligations reviews.

This review 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 the FMA as joint regulators of that system, under the Reserve Bank of New Zealand Act 1989.

<sup>2</sup> On 1 December 2014, the second phase of the FMC Act came into force, superseding the SMA. As this was towards the end of the review period, this report refers to obligations under the SMA and any other relevant legislation that preceded the FMC Act.

<sup>3</sup> Under the FMC Act, NZX is a licensed financial product market operator.

<sup>4</sup> The FMC Act contains obligations for licensed market operators which are equivalent to the general obligations. NZX's market operator licence permits NZX to operate the registered markets and the derivatives market collectively as financial product markets.

### How we did this review

NZX's obligation to ensure that its markets are fair, orderly and transparent underlies all of the other obligations. A registered exchange that does not meet one of its other obligations is also unlikely to meet this obligation. Many of NZX's activities and functions involved in operating its markets meet one of the other, more specific, obligations. We have reviewed how NZX has met the requirement to do all things necessary to ensure that its markets are fair, orderly and transparent after assessing NZX's compliance with all of the other, more definitive obligations.

In reporting on compliance with each obligation, we have focused on activities undertaken by NZX during 2014 that demonstrate a commitment to continuous improvement and ensure compliance with the statutory obligations. We may not describe all activities carried out by NZX that are relevant to the obligations.



REVIEW OF  
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## ARRANGEMENTS FOR HANDLING CONFLICTS

NZX is the frontline regulator of the registered markets and the derivatives market. It is also a demutualised exchange, with securities listed on the markets that it both operates and regulates. Potential conflicts of interest facing demutualised exchanges with frontline regulation responsibilities include conflicts between an exchange's business and regulation mandates, and conflicts in the integrity of self-regulation programmes. For these reasons, legislation places an express obligation on registered exchanges to ensure any potential or actual conflicts are managed appropriately.

### Agreed actions from 2013

NZX's conflict management framework was a key focus of the *2013 General Obligations Review*. We considered that NZX's existing conflict management framework was adequate for the identification and management of any actual or potential conflicts of interest between NZX's commercial interests and its role as frontline regulator. While we had not seen any evidence to indicate that framework was not working as intended, it seemed there was a growing public perception that NZX's regulatory decisions may not be impartial for organisations with a significant association with NZX outside the normal issuer or market participant relationship. NZX therefore agreed to the following actions, to provide the market with greater assurance regarding the effectiveness of the framework:

- to revise the process for regulatory decision-making where particular conflicts may arise, or there could be a significant impact
- to establish a committee of the board to oversee NZX's arrangements for managing conflicts
- to expand the annual review of compliance with the conflict management policy to include testing whether the controls had operated as designed
- to appoint independent members to the regulatory governance committee (RGC)

- to consider the appropriateness of appointing an independent chair of the RGC
- to be more explicit in the terms of reference for the RGC on when committee members would be excluded from receiving review material or participating in discussions
- to expand the scope of the RGC to include reviewing regulatory policy changes
- to improve visibility of its conflict management arrangements
- to revise its communications policy on public comment, for greater transparency.

### Conclusion

We are satisfied all these agreed actions have been met and that NZX complied with this obligation during 2014. The improvements made demonstrate NZX's commitment to increasing market confidence in its role as regulator and operator of the registered markets and the derivatives market. The changes should also provide the market with greater assurance of the effectiveness of NZX's conflict management framework and the quality of its regulatory function.

We are satisfied that, during 2014, NZX had adequate arrangements for handling conflicts between its commercial interests and its need to ensure the markets operate in a fair, orderly and transparent way.



NZX has policies and procedures in place that satisfy this obligation and, in particular, ensure the separation of its regulatory function from the rest of the business. These include:

- delegation of the regulatory function solely to the head of market supervision
  - the head of market supervision reports directly to the board on the regulatory function, and is given time at each meeting to address the board without the CEO being present
  - the CEO has no delegation of the regulatory function, other than shared delegation with the head of market supervision to approve new listings and certain products
- special division
  - ensures the market rules are applied to NZX as a listed issuer, and to related entities, in an impartial and independent manner
- NZX's conflict management policy (available on NZX's website at [www.nzx.com/regulation/conflicts-management](http://www.nzx.com/regulation/conflicts-management))
  - the primary policy which sets out the responsibilities of NZX and its employees, including the CEO and the board, in managing potential conflicts
  - includes the regulatory charter of the NZX board, regulatory code of conduct, personal conflicts policy, associated entity protocol and Fonterra Co-operative Group Limited protocol
  - the NZ markets disciplinary tribunal conflicts policy applies to the tribunal and special division
- interests register
  - maintains a record of individual conflicts of directors, such as shareholdings and other directorships

- securities trading policy (available on NZX's corporate website at [www.nzxgroup.com/investor-centre/corporate-governance](http://www.nzxgroup.com/investor-centre/corporate-governance))
  - requires all NZX employees, officers and directors to obtain approval before trading any securities on the registered markets or the derivatives market, or securities issued by NZX.

We also note that the annual *General Obligations Review* includes a review of NZX's conflict management practices, and we must approve any changes NZX proposes to the market rules or the tribunal rules.

#### **Agreed action – process for regulatory decision-making**

NZX has amended the regulation procedures to require the chair of the tribunal to be consulted by the head of market supervision before NZX grants rulings or waivers or makes enforcement decisions which the head of market supervision believes could have a significant market impact, or could present a specific conflict for NZX. This change introduces a further level of independence to regulatory decision-making in circumstances where there could be a perception of conflict for NZX, and should mitigate the perception that it can be inappropriately influenced when the decision involves particular people or organisations.

This new procedure has been used for two waiver decisions about periodic disclosure during 2014. The additional consultation has been useful for the regulation team, allowing critical assessment of the rationale for the proposed decisions and the relevant conditions. For transparency, the published waiver decisions each included a statement that the chair of the tribunal had been consulted.

### Agreed action – conflicts committee

In November 2014, NZX established a conflicts committee as a sub-committee of the board. We approved the terms of reference for the committee, which include the specific terms set out in the *2013 General Obligations Review*, including that the committee will undertake an annual review of related entities with special division. NZX has published the terms of reference on its website at [www.nzx.com/regulation/conflicts-management](http://www.nzx.com/regulation/conflicts-management).

The 2013 review stated that the committee would comprise members of NZX's board and *'independent persons from outside the board who are appropriately skilled and qualified'*. The final terms of reference for the committee allow for all members (no less than three) to be selected from the board, provided they are *'deemed by the board to be sufficiently independent of conflicts in relation to NZX Group activities'*. The board will seek to appoint external, independent members for the committee if it is unable to fulfil the required membership criteria from within the board.

NZX made a formal request to the FMA for this variation, and we approved it on the basis that we were satisfied the terms of reference met the purpose of the agreed action.

With our agreement, NZX implemented the conflicts committee with two initial members, and sought to appoint a third member who met the independence criteria. At a board meeting on 21 May 2015, NZX appointed two new members to fill the vacancy created by the retirement of Simon Power and the third seat. We look forward to observing in 2015 how the committee contributes to NZX's arrangements for handling conflicts.

### Agreed action – conflict management policy

NZX's conflict management policy has been amended to require that the conflicts committee oversee an annual review to *'monitor the effectiveness of conflict management procedures and to ensure that they are adhered to'*. This review must include an *'assessment*

of the existence of controls for managing conflict and testing of whether those controls had operated as designed when dealing with matters concerning identified conflicts'. The terms of reference for the committee include a responsibility to annually review the adequacy of the arrangements within the NZX Group for dealing with any potential or actual conflict for NZX.

NZX engaged EY Limited (EY) to conduct this review, for the period from 1 December 2013 to 30 November 2014. EY concluded that NZX has robust processes and controls in place to effectively manage actual and potential conflicts of interest, that these processes and controls are being complied with, and that NZX has appropriate processes in place to ensure staff and management are aware of their obligations. EY also verified that the three minor observations that had arisen out of this review in 2013 about the conflict management policy had been implemented by NZX.

### Agreed action – changes to the regulatory governance committee

The prime focus of this committee is monitoring the quality of regulatory decision-making. Its terms of reference have been amended in the following ways:

- It has introduced independent members, to bring a greater level of independence and transparency to its oversight of the regulatory function. The amended terms provide for at least one, and up to two, independent, non-director members. Derek Johnston, former chair of the tribunal, was appointed as an independent member in October 2014. As was agreed, NZX considered whether it would be appropriate to appoint an independent member to act as chair, and has appointed Mr Johnston as the independent chair, effective from May 2015. The amended terms stipulate that the chair of the committee may not be the chair of the board.
- Any member who has a relationship with a market participant will not receive material or participate

in committee discussions regarding other market participants. Similarly, any member who has a relationship with a listed issuer, including an advisory relationship, will not receive material or participate in committee discussions regarding that listed issuer. This requirement is additional to an underlying obligation on members to declare conflicts of interest and excuse themselves from the committee when appropriate.

- It will review changes to NZX's regulatory policy that require approval of the board, before they are submitted to the full board. This was aimed at ensuring balance between the commercial and regulatory interests of NZX when implementing policy.

#### **Agreed action – visibility of policies and procedures**

This was aimed at improving public information about how NZX manages conflicts between its regulatory responsibilities and its commercial interests, therefore helping to increase market confidence in the impartiality of its regulatory function.

NZX has updated the 'regulation' page of its website, [www.nzx.com](http://www.nzx.com), to include substantially more information about the legislative framework that applies to NZX, its regulatory function, and its approach to managing potential conflicts and ensuring quality regulatory outcomes. The website now includes information about internal systems, procedures and policies relevant to these areas, including its conflict management and enforcement policy. Oversight arrangements are described and links are provided to the terms of reference for the RGC and the conflicts committee.

#### **Agreed action – communications policy**

In the past, NZX has adopted a 'no comment' policy when asked about specific market events and possible inquiries. It has amended that policy and has begun providing information to the public about inquiries or investigations when it would be in the public interest to comment, or when it is already public knowledge that it is considering an issue. It has revised its internal enforcement procedures accordingly.

It has demonstrated its commitment to this change on several occasions. This included commenting on continuous disclosure matters concerning Gentrack Group, BLIS Technologies, and Motor Trade Finances. Examples in 2015 include its comments about trading in SkyCity Entertainment Group and Xero.

We also note actions taken for communicating with complainants, described in the section 'Arrangements for enforcing compliance'.



## ARRANGEMENTS FOR MONITORING CONDUCT

This obligation requires NZX to have systems, processes and people in place to monitor the conduct of exchange participants, including issuers, market participants and investors. It must ensure participants meet the conventions and standards of behaviour that are expected on a registered exchange, including operating within the bounds of legislation and the market rules. It must ensure those rules remain appropriate and relevant and are kept up to date with, for example, a changing market environment or changes to legislation.

### Agreed action from 2013

- NZX would amend its guidance note on the process for amending NZX conduct rules, as it did not reflect its practice. We encouraged NZX to consider whether other guidance notes also required updating.

### Conclusion

We are satisfied this agreed action has been met and that NZX complied with this obligation during 2014. We are satisfied it had adequate arrangements for monitoring the conduct of exchange participants

on, or in relation to, the markets. A new case management system allows better co-ordination of activities and reporting across different teams with monitoring responsibilities, as well as oversight from management. NZX has continued to develop its internal processes, and is addressing errors from manual processes, to ensure quality and consistency in its monitoring activities. A dedicated policy team should enable it to ensure the market rules are kept up to date with market developments and requirements.

NZX has rules for different types of participants and markets. It also has business processes and system-driven rules for access to, and the use of, its trading system.

The conduct of exchange participants is monitored by its regulation, surveillance, and client and market services (CMS) teams. NZX's technology function also plays a role in ensuring the appropriate use of its technology.

### NZX functions relevant to the obligation

The regulation team monitors the conduct of exchange participants through many of its normal activities and investigates potential breaches of the market rules, taking enforcement action when necessary. The issuer regulation team is mainly responsible for monitoring and promoting compliance with the listing rules. Normal activities include reviewing offer documents and new listing applications, considering waivers and rulings, approving notices of meetings, monitoring issuers' compliance with continuous disclosure

requirements, and considering applications for trading halts.

The participant compliance team is responsible for supervising compliance with the participant rules and derivatives market rules. Normal activities include considering applications for accreditation, waivers and rulings; monitoring client funds and capital adequacy reporting; and onsite and desk-based inspections. It also does regulatory oversight services for NZCDC.

The surveillance team is focused almost entirely on monitoring conduct. It monitors trading for potential breaches of the market rules, or secondary markets legislation such as insider trading and market manipulation. It monitors the activities of investors, brokers, issuers and anyone placing orders in the registered markets through brokers. Where potential misconduct is identified, it is referred to the regulation team or another relevant party such as the FMA.

The CMS team monitors and releases market announcements from companies through the market

announcements platform (MAP), and reviews periodic disclosures, such as preliminary announcements and annual reports, for compliance with the listing rules. CMS also regularly contacts issuers to help with compliance, such as reminding them when their financial reporting is due. When any potential breaches are identified, they are referred to the regulation team, and both teams maintain an 'issuer risk list' to identify companies with a history of non-compliance.

NZX has security and access procedures that ensure only appropriately authorised users can access its technology, and systems that can detect any attempts at unauthorised access.

Special division is an independent division of the tribunal, established under the tribunal rules. It has the same powers and functions as the regulation team, but only for NZX as a listed issuer and its related entities. Its aim is to foster market confidence that the market rules are applied to NZX and related entities in an impartial and independent way. NZX's related entities are currently the 10 funds managed by Smartshares. This list is to be reviewed annually by special division together with the conflicts committee.

The market services and regulation teams follow documented policies and procedures for completing tasks and recording information. NZX uses monitoring information for trend analysis, and to help identify when action may need to be taken such as market guidance, issuer education, rule changes, or changes to its monitoring.

The RGC manages the board's governance responsibilities for NZX's monitoring function. The prime focus of the RGC is monitoring the quality of regulatory decision-making, which includes assessing whether appropriate referrals from market services' monitoring activities are being made to the regulation team.

### **Agreed action – guidance note updates and withdrawals**

During 2014, NZX continued an in-depth review of the guidance notes on continuous disclosure, and on trading halts and suspension, which began in 2013. It also reviewed all other guidance notes applying to the listing rules. This review led to proposed changes to some guidance notes, such as its guidance on waivers and rulings, and on spread requirements. It also proposed withdrawing some guidance notes, such as those on hybrid securities and share purchase plans. It suggested these be withdrawn either because they no longer reflected market practice, or they were no longer relevant. The guidance note on the process for amending rules was one of those withdrawn.

Following public consultation, the guidance notes were withdrawn in December 2014. The consultation document is available on the NZX website at [www.nzx.com/regulation/rules-consultation-archive](http://www.nzx.com/regulation/rules-consultation-archive). The withdrawn guidance notes are also available, at [www.nzx.com/regulation/listing-rule-guidance](http://www.nzx.com/regulation/listing-rule-guidance).

We are satisfied this withdrawal was appropriate. The guidance note was prescriptive on the frequency of rules reviews. We believe it is more apt that NZX reviews its rules in response to requirements such as market developments and trends, or legislative change. NZX uses trend analysis of regulatory information, such as breaches and waiver applications, to help identify areas of the market rules that may require review or additional guidance.

In the absence of specific guidance on when NZX will undertake rules reviews, we believe it would be useful for NZX to keep the market informed of its policy developments and priorities.

## Other activities during 2014

### Case management system implementation

NZX has continued to develop its internal processes in the regulation and market services teams, to enhance its regulatory activities. A key project during 2014 was the introduction of a case management system for record-keeping and information-sharing. The new system has been used across the CMS, surveillance and regulation teams for several months.

NZX says the new system has enabled better sharing of relevant information between teams, document control, and the ability to search the system for precedents or relevant background to help reach decisions. It also helps collate operational performance data and metrics for reporting purposes.

All activities undertaken by the surveillance and regulation teams are recorded in the case management system, while CMS uses it primarily for managing periodic reporting. Referrals and escalations can be made within the system, and alerts can be used to inform the relevant staff member that a matter requires their attention. The system allows the head of market supervision to oversee all regulatory activities underway, including those being undertaken by market services. The head of market supervision carries out regular reviews of certain decisions made within the CMS and surveillance teams, particularly decisions not to refer a matter to the regulation team or to the FMA. Reporting to the RGC, and review by the RGC, has also been expanded to include such decisions.

We believe the case management system is a significant addition to NZX's arrangements for monitoring market conduct, as well as for enforcing compliance. It also addresses matters we have previously raised about the need for the head of market supervision to oversee decisions made within the market services team that potentially have a regulatory impact, such as price enquiries issued by the surveillance team. It is also a useful tool for NZX to monitor the consistency and quality of its own regulatory decisions.

### Identification of price-sensitive announcements

In August 2014, a substantial security holder (SSH) disclosure containing material information about a takeover was released to the market. It is unusual for an SSH notice to contain this type of information and the announcement was released without a price-sensitive designation. An administrative trading halt is normally applied to price-sensitive announcements, to give the market an opportunity to absorb the information and factor it into the price. In this case, there was no administrative trading halt. NZX and the FMA received several complaints and made public statements about the incident.

SSH disclosures are generally received by email, not directly into MAP, and the process for their release is therefore manual. Following this event NZX reviewed the circumstances and processes involved, identified where improvements could have been made, and made changes to the process that reduce the risk of a repeat error recurring. NZX also gave staff more guidance on how to identify the price-sensitivity of announcements.

In response to our suggestion in the *2013 General Obligations Review*, NZX used issuer updates published during 2014 to encourage issuers to indicate their view of an announcement's price-sensitivity when submitting announcements to MAP. NZX says the number of issuers identifying the price sensitivity of their announcements has increased, and it will continue to focus on this.

We note that NZX carried out training for the CMS team on identifying price-sensitive announcements during 2013 and 2014. The team also has monthly announcement reviews, monitoring for general accuracy, and tries to identify price sensitivity indicators not recognised in announcements. These findings are incorporated into market services processes.

NZX does not guarantee that a price-sensitive announcement will be identified before release to the market, and we acknowledge that market reaction to an announcement is sometimes unpredictable.

However, announcements that either issuers or NZX believe are price-sensitive are labelled as such, to help the market recognise them. NZX has previously reported to us that market feedback on this labelling is generally positive. However, it can result in the market placing less emphasis on announcements that are not labelled. The accurate identification of price-sensitive announcements should therefore continue to be a priority for NZX.

The event concerning the SSH disclosure led to NZX reviewing whether and how administrative trading halts should be placed on price-sensitive announcements. NZX has collaborated with the New Zealand Shareholders' Association to conduct a survey of its members' preferences, and it intends to seek wider market feedback on this subject during 2015.

### **Market participant inspection programme**

During 2014, the participant compliance team refined the risk profile and rating process for market participants. Information from market participants, the surveillance team and New Zealand Clearing Limited was included in the risk assessments. Quantitative information was analysed using risk assessment and management methodologies, and overlaid with a qualitative assessment based on the participant compliance team's knowledge of the market participants. Several factors are assessed as part of a market participant's risk profiling, including financial performance and liquid capital, complexity of business activities and operations, clearing and settlement risk, waivers requested and granted, and compliance history. This new risk-profiling process has improved NZX's risk-based approach to preparing its schedule of onsite and desk-based inspections, ensuring greater focus on market participants with higher-assessed risk profiles.

A comprehensive review of the inspection programme was also carried out. Detailed information was obtained from market participants before inspections, enabling NZX to target both specific and general areas of interest. New areas of interest for NZX were included

in the overall inspection programme as they arose, helping to keep the programme current and relevant.

NZX introduced detailed questionnaires for compliance managers and managing principals as part of its pre-inspection information-gathering. It has found this has also been helpful for market participants, as it has required managers to focus their attention on their internal compliance programmes. New templates were designed and used for inspections, and these were continually adapted during 2014. The participant compliance team has also improved its inspections of the capital adequacy rules, such as reviewing the calculation methods used for capital monitoring and creating a new template for capital adequacy reporting.

NZX says this has resulted in a more focused inspection programme and a better allocation of resources. The increased range and depth of inspections has also helped identify more potential rule breaches. NZX covered a broad range of issues in greater depth in its inspections during 2014, which will allow it to sharpen the focus of its inspections in 2015. With the addition of new equity derivatives products on the derivatives market, the market participant team is including conduct in these products in its annual inspection processes. Market manipulation and direct market access (DMA) trading issues will also be incorporated in 2015's inspection programme.

### **Rules reviews and policy development**

In 2013, NZX created a policy team within its regulation team, demonstrating the board's desire to be active in policy development and rules reviews. In August 2014, the former head of regulation was appointed in a new role as head of policy and legal, separating the policy function from regulation. A new head of market supervision was appointed with sole responsibility for NZX's regulatory function, reporting directly to the board.

Work carried out by the policy and legal team during 2014 included developing the market framework for the NXT market, such as the NXT market rules and procedures and accompanying guidance notes; the listing rules guidance note updates and consultation process; and reviewing all rules to identify changes required to align with the FMC Act. The tribunal rules were also amended for changes to the structure of the appeal panel of the tribunal.

Ongoing work includes consultation on a proposal to move to a shortened trading settlement cycle, and a review of the corporate governance provisions of the listing rules, begun in 2013. A working group of industry representatives has been involved in the review of the corporate governance provisions, and public consultation is planned for 2015. A review of the participant rules and NZX's guidance note on market manipulation is discussed below in the 'market quality project' section.

Since the end of 2014, NZX has announced further structural changes, resulting in a policy team that will focus purely on policy and rules development initiatives, separate to regulation and with no ancillary responsibilities for other NZX commercial or legal matters.

### **Market quality project**

NZX has had a market quality monitoring project underway since late 2012, focused primarily on changes in algorithmic and off-market trading in NZX's markets. It is examining the potential effects these behaviours have on market quality, including liquidity and price discovery; determining whether they are becoming more prevalent on the registered markets; and whether changes are needed to regulation of the registered markets. During 2014, research into these matters led to a new focus on DMA trading.

NZX has reported that continued research into trends and developments in the level of off-market trading will form part of additional work being carried out with the Securities Industry Association during 2015 into trading practices and industry economics.

Information gathered by NZX from market participants and through its own surveillance indicated that the level of algorithmic, or 'algorithmic-like', trading as a percentage of all trading in the registered markets remains low. However, it has continued to increase and is therefore being monitored. During 2014, NZX focused on considering whether the participant rules relating to this type of trading needed to be changed. Research included how this trading was regulated in other countries, particularly the UK and Australia.

It concluded that the current rules, along with NZX's monitoring activities, provide adequate controls for the current levels of algorithmic trading and therefore did not need immediate change. However, it identified certain rules that may need to be amended in anticipation of growth in this area. Issues noted included the identification of end clients and market participants' controls in providing DMA to clients.

DMA enables the submission of orders directly into NZX's trading system through an account with a market participant, usually without the intervention of a dealer. The rules require market participants with DMA clients to put controls in place, to ensure market integrity. These include the authorisation of people who may place orders via DMA, and the setting of appropriate filters, screens and security measures on the market participant's order entry system to prevent detrimental orders from being placed.

Increasingly, institutional investors in New Zealand and overseas are trading on the registered markets through DMA accounts, for quick, direct order placement. During 2013, NZX determined that the size and structure of the New Zealand market meant an increase in the level of algorithmic trading would



help to improve liquidity in the registered markets. As algorithmic trading is typically carried out via DMA, NZX introduced a programme reducing the costs for registered DMA traders, and saw an increase in DMA trading as a result.<sup>5</sup> Online trading platforms aimed at retail investors are also DMA systems.

In August 2014, we successfully brought civil proceedings against an individual for market manipulation, and in January 2015 we issued a private warning to another individual for suspected market manipulation, including transactions resulting in no change in beneficial ownership. In each of these cases, the trading was through DMA online trading platforms. We enquired into four other cases of possible market manipulation during 2014, all of which involved DMA trading. In one case, the orders originated overseas and two international regulators were required to get the details of the underlying client, as the transactions were made through wholesale intermediaries.

This highlights the potential regulatory issues with DMA trading, and the importance of ensuring the rules remain appropriate for the nature and volume of trading through DMA, as well as the importance of ensuring compliance with the rules. Given the relative growth in DMA trading, NZX will review this area in the 2015 market participant inspection programme.

An in-depth review of NZX's guidance note on market manipulation was begun in 2013, and work on this project continued during 2014. Due to reprioritisation of policy work, it wasn't finished and NZX now intends to combine the review with broader policy work on market quality and trading behaviour. NZX has indicated this policy work is targeted for 2015.

Given that initiatives from the market quality project have contributed to increased levels of DMA trading, and the market manipulation and DMA trading issues during 2014, we are pleased to see NZX focusing on these areas. We believe it should make the update of the market manipulation guidance note a priority and aim for its completion by the end of 2015. The FMA and NZX will collaborate on this project as necessary.

NZX intends to undertake a staged and targeted review of the participant rules, beginning in 2015, which will include changes required under the FMC Act, and an assessment of the rules on capital requirements and DMA trading. Information obtained through 2015's inspection programme will help this review.

NZX is finalising an application for membership of the Intermarket Surveillance Group (ISG), an association of international securities exchanges and regulators that perform frontline market surveillance in their respective jurisdictions. A key purpose of the ISG is information-sharing between members, and members must have the authority to obtain and share information about market transactions, including those making them. Membership of the ISG should therefore help NZX monitor trading that originates from overseas, including DMA trading, which might otherwise be anonymous.

### Changes to processes

NZX made other changes to its processes during 2014:

- There was a notable increase in new listings from 10 in 2013, to 16 in 2014. The issuer regulation team reviewed several processes for new listings, such as reducing specific focus on legislative requirements not in NZX's immediate jurisdiction. We have been working closely with the issuer regulation team on new offers, particularly as issuers transition from the Securities Act disclosure requirements to the new offers regime of the FMC Act. NZX also revised the listing sub-committee handbook to reflect recent trends for new offers and refine the scope of the committee's review.
- In the surveillance team, process improvements included new databases to help detect and analyse potential market misconduct. The surveillance team also began documenting the formal processes for interaction and referrals between itself and the regulation team. We note that we recommended documentation of these processes in the *2012 General Obligations Review*, and we are therefore pleased this is underway.

<sup>5</sup> From NZX's market assessment report for the period 1 January – 31 December 2013

- The CMS team reviewed and changed internal procedures for establishing new issuers, products and corporate actions within NZX's systems, as well as documenting the processes that apply. New checklists have also been introduced.
- CMS recorded 14 errors in 2014 compared with six the previous year. Some of the errors occurred outside market trading hours. Examples of errors during market trading hours included trading halts remaining in place for longer than required, and trading halts being placed on incorrect stocks. In each instance, the error was discovered and rectified quickly. NZX monitors errors closely and took appropriate remedial action after each event to reduce the likelihood of errors recurring. Examples include staff training, changes to processes, and an adjustment in the trading system. Towards the end of 2014, CMS began a review of data-entry processes, focusing on reducing manual entry and duplication, and therefore errors. NZX provides the market services error log to the FMA quarterly. We will review errors in 2015 and will address any ongoing issues with NZX if required.

### Issues affecting dual-listed issuers

Having observed a continuing trend of issuers seeking dual listings on both NZX and ASX markets, the regulation team engaged with counterparts at ASX and met with dual-listed issuers to discuss operational and regulatory issues. NZX hopes to continue to engage with ASX on relevant matters such as rule reviews, market announcements and trading halts. NZX noted the most recent guidance from ASX when reviewing its guidance note on continuous disclosure, and the proposal to shorten the settlement cycle is also partly aimed at ensuring consistency with ASX.

### Liaison with the FMA

Communication between NZX's operational functions and the FMA was further enhanced during 2014. The regulation team regularly engages with us on live market matters, particularly in the area of continuous disclosure where both parties have regulatory responsibilities. We meet regularly with the issuer regulation team about new listings, offer documents and related matters, and continue to work closely with the surveillance team on market misconduct matters, both before and after any formal referrals from NZX.

We also work closely with the participant compliance team on inspections of market participants, to help reduce the compliance burden where there is crossover between the requirements of the participant rules and relevant financial markets legislation. Co-ordinated inspections of NZX market participants are now undertaken.

We are also working collaboratively with NZX on wider market training and education initiatives.



## ARRANGEMENTS FOR ENFORCING COMPLIANCE

This obligation requires NZX to have systems, processes and people in place to determine whether breaches of the market rules have occurred, and take appropriate action when breaches are identified. Effective enforcement supports the operation of fair, orderly and transparent markets by contributing to improved compliance. Visibility of enforcement is important to give the markets confidence in the effectiveness of the regulator, and that the markets are operating in a fair, orderly and transparent manner.

### Agreed actions from 2013

Efficient, visible enforcement of the market rules is an important factor in deterring non-compliance and increasing market confidence in NZX's regulatory function. In the *2013 General Obligations Review*, we reported on improvements in NZX's enforcement function, including better processes and increased efficiency. However, NZX agreed that further enhancements could help demonstrate the effectiveness of NZX's arrangements in this area. NZX therefore agreed to the following actions in respect of enforcement:

- to enhance visibility of regulatory matters and enforcement activities
- to amend internal service levels to better reflect the nature and complexity of different types of investigation and the variety of possible outcomes

- to improve communication with complainants
- to review the penalty structure for minor and unambiguous breaches of its rules.

### Conclusion

NZX complied with this obligation in 2014. The agreed actions from 2013 were either met, or underway to be completed in 2015, helping to increase visibility of NZX's regulatory decisions and enforcement activities. We hope this will increase market confidence in NZX's regulatory role. NZX worked to complete legacy enforcement cases and improve efficiency further, particularly regarding more complex cases, and an increased number of potential breaches were referred to the tribunal, including cases regarding market participants. The operation of the RGC was embedded and the regulation team finds the additional oversight beneficial.

### Relevant NZX functions

NZX's enforcement function is responsible for considering potential breaches of the market rules and taking appropriate enforcement action when required. Sources of initial information include NZX's monitoring activities, public complaints and self-reporting by issuers and market participants. NZX has an enforcement policy (publicly available on [www.nzx.com/regulation/ensuring-quality](http://www.nzx.com/regulation/ensuring-quality)) and enforcement procedures that guide this work. The function is managed by a dedicated team, comprising a team leader and solicitor who co-ordinate investigations and enforcement actions.

Support is provided by other solicitors in regulation as required, and the function is overseen by the head of market supervision. The enforcement team also takes responsibility for developing and updating enforcement procedures.

The participant compliance team handles complaints and carries out initial investigations into potential breaches of the rules. The enforcement solicitor is consulted from the beginning of an investigation and prepares the statement of case if a referral is to be made to the tribunal.

When the surveillance or CMS teams are concerned with issuer or market participant behaviour, an initial investigation is conducted. If a potential breach of the market rules is identified, the matter is referred to the regulation team. The surveillance team is responsible for real-time supervision of all trading activity. To enforce compliance, it is responsible for administering price enquiries to issuers when significant changes in trading activity occur that cannot be explained by information in the market. These price enquiries are published under the issuers' codes on MAP and NZX's website. The surveillance team is also responsible for referring matters to the FMA when possible insider trading or market manipulation is detected.

The tribunal is an independent body set up to determine whether there has been a breach of the market rules in matters referred to it by NZX and, if a breach is determined, to assess the appropriate penalty. The RGC carries out the board's governance responsibilities for NZX's enforcement function.

### **Agreed action – enhance visibility of enforcement**

In many cases of non-compliance with the market rules, NZX takes an enforcement action that is not visible externally, but has been effective in changing the behaviour of an issuer or market participant and has therefore had a positive outcome for the market. NZX also carries out investigations where initial facts appear to show a breach, but an investigation of all the facts finds that no breach has occurred. This agreed action was intended to improve the market's awareness and understanding of this type of 'invisible' enforcement activity, to help increase market confidence in how NZX carries out its regulatory role.

In further efforts to improve visibility of the enforcement function, during 2014 NZX designed and launched a new 'regulation' page on its website, [www.nzx.com](http://www.nzx.com), setting out significantly more information than was previously available about its regulatory model and approach, including the arrangements for oversight of the quality of regulatory

decision-making. The additional information helps provide context for the enforcement policy, which sets out the regulation team's goals, priorities and approach to enforcement action. It also shows how NZX's overall regulatory framework is structured to ensure that regulatory decisions and enforcement outcomes are appropriate.

The updated website has a dedicated page for tribunal decisions, making this information easier to find and therefore more accessible. NZX has included summaries of tribunal determinations in its issuer updates, published on MAP and distributed to NZX listed issuers, ensuring that issuers are made aware of NZX's enforcement activities and expectations. The tribunal also provided guidance to issuers on the application and interpretation of the continuous disclosure provisions of the listing rules in certain determinations published during 2014. Information on enforcement activity, including summaries of breaches found and enforcement actions taken, has been published in the tribunal's annual report in the past two years. NZX also provides quarterly statistics to the market on regulatory activities, which contains information on the number and type of activities undertaken.

During 2014, NZX issued media releases following certain tribunal determinations where it considered this was useful, both as a message to the market and for educational purposes. Examples include a matter concerning Marsden Maritime Holdings and voting rights, and a matter concerning BLIS Technologies and continuous disclosure.

In August 2014, five weeks after listing, Gentrack Group released a downgrade of forecast financial results, and subsequently discussed the contents of the announcement in private with certain shareholders. This prompted complaints to the FMA and NZX, as well as significant media commentary, questioning whether Gentrack had complied with all its disclosure obligations, both at the time of listing and subsequently. In line with its amended policy on providing public comment, NZX confirmed the

matter was being investigated. When it finished its investigation, it made a short public statement on its findings.

We are satisfied that increased information and communication from NZX during 2014 generally met the purpose of the agreed action and demonstrated NZX's willingness to be open and transparent with the market. We believe NZX can continue to develop its communication with the market and investors on matters of public interest. When NZX comments publicly on a matter that has been concluded, we would support the statement providing sufficient information to clarify the facts of the matter and the rationale for NZX's conclusions.

In the Gentrack example, the investigation resulted in no enforcement action because it was found that no breach had occurred. It was helpful for the market to hear from NZX on the outcome, as this precluded the market believing that a breach had occurred but that NZX had failed to take appropriate action. However, the statement gave no information on the scope of the investigation, particulars of the facts of the case, or why the circumstances did not constitute a breach of the listing rules. A more detailed statement would have had greater value in demonstrating the effective performance of NZX's regulatory function. It would also have provided an opportunity to inform the market about areas of focus for NZX in the particular circumstances.

This has been discussed with NZX during the end-of-year review process and we are satisfied that NZX is giving due consideration to how it can continue to develop this type of market communication.

#### **Agreed action – amend internal service levels**

This was intended to establish reasonable timeframes for each stage of an inquiry or investigation, ensuring the efficient conclusion of all types of enforcement matters, including more complex investigations and referrals to the tribunal.

NZX has revised its internal service levels for enforcement matters. Continuous disclosure inquiries have been differentiated from other inquiries regarding issuers, allowing more time for completion, as NZX considers they are generally more complex. NZX has also differentiated between issuer inquiries and market participant inquiries, and has developed service levels specifically for completing inquiries regarding potential breaches of the participant rules. Although the participant compliance team leads such inquiries, the enforcement team is involved from early on, if required. For matters that are to be referred to the tribunal, NZX has added new service levels to prepare the statement of case and completion of the referral. The tribunal rules contain prescribed timeframes for it to conclude its determinations.

NZX's enforcement procedures have been changed for the revised service levels. Specific procedures have been added for when certain information is omitted from an issuer's annual report, such as gender statistics, as this type of breach is often minor and can be quickly rectified. Normal enforcement procedures must be followed if the review of an annual report reveals a more serious breach of the listing rules, such as failure to provide notification of a director's resignation. Monitoring activities carried out by the CMS team help the prompt identification of these breaches.

Improvements are visible in the number of investigations completed, the number of referrals to the tribunal, and increased efficiency in referring breaches to the tribunal. The chair of the tribunal has commented on this in the tribunal's annual report for 2014, available at [www.nzx.com/NZMDT/annual-reports](http://www.nzx.com/NZMDT/annual-reports).

#### **Agreed action – improve communication with complainants**

This was intended to assure NZX complainants that their complaints are being addressed, and to inform them of NZX's conclusions. For investors to have confidence in NZX's regulation function, complaints

must be investigated promptly. Providing information to complainants helps make the process transparent, as well as helping investors understand the market rules and their application. Revisions to NZX's enforcement procedures during 2014 have therefore included improved communication with complainants at different stages of an inquiry.

### **Agreed action – review penalties for clear breaches**

NZX agreed to review the penalty structure for minor and unambiguous breaches of its rules to be able to take disciplinary action quickly and easily for clear breaches. NZX began this project during 2014, in consultation with the tribunal. A discussion document was released on 20 April 2015 seeking public comment on several considerations, and NZX intends to consult on proposed amendments to the tribunal rules later this year, with changes to come into effect by the end of 2015.

### **Other activities during 2014**

#### **Embedding the regulatory governance committee (RGC)**

This committee was established in the second half of 2013 and its operation was embedded during 2014. Its primary role is to monitor the quality of regulatory decision-making for logic and appropriateness, consistency with the market rules and any policy or guidance issued by NZX, and compliance with NZX processes. It has no delegation to make regulatory decisions, nor any authority to reverse or alter any decision.

The committee is provided with a summary schedule of all regulatory decisions made for a specified period. During 2014, the regulation team adapted its reporting to the committee, partly at the request of the committee. It provided much more detailed written information and commentary on the decisions selected for review, based on questions from the committee. This comprehensive set of information is provided ahead of the committee's quarterly meetings, at which

the particular decisions are discussed further with the head of market supervision. Having more information in advance of its meetings has enabled the committee to review and discuss more decisions.

Decisions reviewed during 2014 included waiver applications, continuous disclosure investigations, and complaints that resulted in no enforcement action, concerning both issuers and market participants. In the *2013 General Obligations Review*, we commented that the committee should ensure its reviews include a selection of material about regulatory activities being carried out by the market services team, and particularly matters that do not result in referrals to the regulation team. These have been included for review since the last quarter of 2014 and we understand the committee has focused on these decisions at the most recent meetings to better understand what influences these decisions.

The minutes from the committee's meetings demonstrate a thorough review of the cases selected and good oversight of the overall regulatory function. Detailed discussions are held with the head of market supervision at the meetings, and the committee requests follow-up action by the regulation team when required. Matters raised by the committee have included trends in breaches, trends in waiver applications, and the rationale for non-referrals by the surveillance team to the regulation team. The committee also reviews performance against the regulation team's service levels, and has questioned the time taken on investigations when applicable.

During 2014, the committee also discussed tribunal matters, such as the review of penalties and the re-appointment of members, and oversaw the implementation of agreed actions from the *2013 General Obligations Review* that required board approval.

The regulation team has found it useful to compile the information requested by the committee, as it obliges it to re-examine its own decisions and rationales. The head of market supervision gives relevant feedback from committee meetings to the regulation team.

We note the committee has a governance role and its procedures and interaction with the regulation team may change according to requirements. Changes to the composition and terms of reference of the committee are discussed in 'Arrangements for handling conflicts'.

### **Referrals to the tribunal**

During 2014, NZX referred 18 matters to the tribunal for determination, compared with nine in 2013. Six of these were for breaches of the participant rules, compared with one market participant matter in 2013. This increased use of the tribunal to make determinations on potential breaches of the market rules demonstrates the increased effectiveness of NZX's enforcement processes, particularly in participant compliance. It also signals to the market NZX's position on non-compliance, and its willingness to take appropriate enforcement action.

Notably, three determinations by the tribunal during 2014 concerned breaches of continuous disclosure obligations, by Rakon, Fonterra Co-operative Group and BLIS Technologies. The tribunal has provided the market with guidance in its published determinations from these cases on the meaning and interpretation of the relevant rules, helping issuers to better understand their obligations and how the rules will be applied in particular circumstances, such as when a material contract is entered into.



## A SUFFICIENTLY INDEPENDENT ADJUDICATIVE BODY

Under the SMA, this obligation required that an independent adjudicative body be in place. Having adequate arrangements to ensure the body was available when required included having rules and procedures in place relating to the composition, the operation, the scope of responsibility, and the powers of the body; applying sufficient financial resources to fund the operation of the body; and providing adequate information to the body to enable efficient and effective adjudication on matters referred to it.

Using the independent adjudicative body effectively is implicit in the obligation to have adequate arrangements for enforcing compliance with the relevant market rules, and under the FMC Act the concept of an independent adjudicative body is contained in the obligation to have arrangements for enforcing compliance, rather than as a standalone obligation.

### There were no agreed actions from 2013.

#### Conclusion

NZX was compliant with this obligation during 2014. We are satisfied that, during 2014, NZX had adequate arrangements to ensure the tribunal was a sufficiently independent body to adjudicate on any contraventions of NZX's rules that were referred

to it. NZX updated the tribunal rules to maintain the continued effectiveness of the tribunal and the appeal panel, and a review of further changes to the tribunal rules, and particularly penalties, is underway. Through ongoing engagement and consultation, NZX is making effective use of the tribunal as a resource that can enhance NZX's enforcement function.

### NZ markets disciplinary tribunal

The tribunal is an independent adjudicative body, established under the tribunal rules, which considers disciplinary matters referred to it by NZX in respect of the markets.

The tribunal's principal role is to determine whether referrals made to it by NZX or NZCDC demonstrate breaches of the market rules or the clearing and settlement rules; and to impose penalties for any breaches. The tribunal's jurisdiction does not extend to reviewing decisions made by NZX about approvals of listings, designations of market participants, changes to the market rules, published policy decisions, trading halts, or pricing schedules. In certain circumstances, the tribunal can review decisions on waivers and rulings of the market rules.

The tribunal must be composed of various categories of members, 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 with particular expertise.

The tribunal rules require NZX to provide a report to the tribunal for each calendar year, with information regarding breaches identified, complaints received, and the use of the disciplinary fund during that year. The report from NZX is included in the tribunal's annual report to the public. The tribunal's annual report for 2014 is available at [www.nzx.com/NZMDT/annual-reports](http://www.nzx.com/NZMDT/annual-reports).

The full powers and responsibilities of the tribunal are set out in the tribunal rules. The tribunal rules are supplemented by the tribunal procedures and tribunal user guide.



## Independence

The operation of the tribunal, for cases referred by the regulation team, is independent of NZX. The tribunal ordinarily acts by division, with divisions comprising three or five non-conflicted members who are selected by the tribunal chair, under the tribunal rules and subject to relevant experience.

Monetary penalties imposed by the tribunal go into a discipline fund. This fund may be used to meet the tribunal's costs and for other purposes specified in the tribunal rules. NZX must fund any costs of the tribunal not met by the discipline fund.

Members of the tribunal are appointed by NZX, but must be confirmed by the FMA. Consultation between NZX and the tribunal is required for certain matters, such as proposing amendments to the tribunal rules or appointing new members.

We believe the tribunal is sufficiently independent to adjudicate on contraventions of the market rules.

## Activities during 2014

### Changes to the structure of the appeal panel

The appeal panel of the tribunal is established under the tribunal rules. If a party wishes to appeal a determination made by the tribunal at a full hearing procedure, they apply to the appeal panel.

During 2013, the rules sub-committee of the tribunal considered whether the structure of the appeal panel should be changed, as it had only been used once, and all of the panel's members were due to retire. The rules sub-committee and NZX agreed on proposed changes and these were done through amendments to the rules, approved by the FMA in June 2014.

Under the amended rules, should an appeal panel be required, members will be drawn from current tribunal members who are free of conflicts in the matter under consideration, with an ability to co-opt additional members if required.

## Engagement between the regulation team and the tribunal

A good working relationship between NZX and the tribunal is necessary to ensure the tribunal is used effectively, and its rules and procedures remain current. The head of market supervision meets the chair and executive counsel of the tribunal quarterly to discuss developing regulatory trends and matters relating to the discharge of NZX's enforcement function, as well as matters specific to the tribunal. During 2014, these discussions included tribunal membership and resourcing, online information about the tribunal, case trends, and policy. NZX is also working with the tribunal over the review of penalties under the rules, discussed in the section 'Arrangements for enforcing compliance'.

A new process means the head of market supervision must consult with the tribunal's chair before granting rulings or waivers, or making enforcement decisions, which in their view could have a significant market impact, or present a specific conflict for NZX. This has been discussed in the section 'Arrangements for handling conflicts'.



## SUFFICIENT RESOURCES TO OPERATE THE MARKETS

### There were no agreed actions from 2013.

#### Conclusion

NZX was compliant with this obligation during 2014. We are satisfied that, during 2014, NZX had sufficient financial, technological, and human resources to operate the markets properly. NZX took action to

address the technological incidents that occurred as quickly as possible and has implemented permanent solutions for the issues found. The board continued to monitor human resources and NZX employed additional resources as necessary to maintain productivity in the regulation team during times of increased workload.

#### Financial resources

This obligation requires NZX to make sufficient financial resources available to ensure the adequacy of all other resources required to operate its markets in a fair, orderly and transparent manner. This includes both annual expenditure on operation of the markets, and having sufficient capital resources in the balance sheet.

NZX does not allocate capital to lines of business, except those operated as separate subsidiaries. NZX states that this reflects that the capital requirements and financial variability of the non-markets businesses will ultimately affect the markets businesses. NZX does not therefore account separately for the operation of the markets, and does not forecast separately for the regulatory and non-regulatory aspects of the business. However, the individual business functions prepare annual budgets and the head of market supervision prepares a budget independently of the CEO for expenditure in the regulation team.

The board reviews and approves the annual budgets, then receives monthly reporting tracking performance against budget and prior year results. Management provides the board with detailed papers when significant changes to planned expenditure are proposed.

#### Debt

At the end of 2014, NZX had no term debt and a strong cash balance. NZX believes this provides it with 'substantial ability to absorb financial shocks or

a sustained downturn in financial performance or cashflows without adverse impact on the operation of the Markets<sup>6</sup>. Operations are primarily funded from internally generated cashflows. NZX also maintains a large overdraft facility to help manage its working capital needs. At the end of 2014, NZX had not drawn on this facility.

After the end of 2014, NZX took on term debt of \$10 million to finance the purchase of SuperLife. However, NZX's cash position means that it continues to have no net debt, and we are satisfied that NZX has the ability to service this term debt.

#### Expenditure

A key component of NZX's capital expenditure is technology. During 2014, this investment was focused on physical infrastructure rather than software, and expenditure was therefore not specific to the operation of its markets, other than the implementation of the case management system.

Expenditure on human resources is an important part of NZX's operational expenditure and we are satisfied that it allocated financial resources for this as necessary. This is discussed later in the section 'Human resources'.

We are satisfied NZX's current financial position will enable it to continue to operate the markets in a fair, orderly and transparent manner.

<sup>6</sup> From the market assessment report.

### Technological resources

This obligation requires NZX to have technological systems in place on which to run the markets, and to support the operation of the markets, to ensure they operate in a fair, orderly and transparent manner. Technology is central to the operation of NZX's markets. All market transactions are electronic, from placing client orders through to settling trades. Material information is provided to NZX electronically and distributed via the NZX data feed to the NZX website and data vendors, at which point it is deemed to be generally available to the public. NZX communicates with market participants via the trading system, and with issuers via MAP. Stable, secure, accessible, and up-to-date technology is therefore essential to the operation of fair, orderly and transparent markets, as the failure of any element could lead to a lack of fairness, orderliness or transparency.

### NZX functions relevant to the obligation

The technology function of NZX has responsibility for the performance of NZX's technological systems across its regulated and unregulated activities. This area's core function is to ensure the availability, security, capacity and maintenance of NZX's trading platforms and settlement systems, internal monitoring systems, and general systems. These systems must operate as intended and be accessible to all users when required. The key systems for operating the markets include:

- X-stream (the trading system)
- TCS BaNCs (the clearing system)
- MAP (for the disclosure of market announcements and corporate actions)
- SMARTS (the core market surveillance system).

NZX uses other technology such as its websites, a market data feed of live announcements and prices, and general systems, including server facilities and communications. It has a primary production site and a secondary disaster recovery site, with real-time data synchronisation between them.

NZX continuously monitors its systems to ensure that any network, software or hardware problems are detected as quickly as possible. Team members receive alerts when exceptions occur, on a 24-hour basis. The trading system allows NZX to monitor client connectivity and market states, and this data is recorded. The systems are checked daily, weekly and monthly for capacity and performance. Network usage is also monitored to ensure there is sufficient bandwidth allocated for the trading and clearing network.

When problems occur, the priority for the technology team is to get the affected service running properly as quickly as possible, with minimal disruption to business operations and the markets. A full analysis of the root cause occurs after the service capabilities have been returned. For issues affecting the trading system, support is available from NASDAQ, the licensor of the X-stream trading platform, both at the time of an event and to help with analysis after the event.

The head of technology, head of operations and head of market supervision are immediately notified of any technological issues. If the problem affects the market, the market is notified via the CMS team.

## Disruptions to the trading system

There were five incidents during 2014 that resulted in disruptions to the trading system.

### 28 April 2014 (incident #1)

Prior to the market opening, NZX was alerted that the trading system had shut down. A cause was identified and action taken to resolve the issue. Trading on the debt market and derivatives market were affected, and opening of the main board and alternative market were delayed by 15 minutes.

### 30 May 2014 (incident #2)

At 2.46am NZX was alerted that the trading system had shut down. On-call support restored the system by 4.50am. This incident affected trading on the derivatives market, but all other markets were closed. Following this incident, extra system monitoring was introduced.

### 9 June 2014 (incident #3)

At 4.51pm NZX was alerted that the trading system was down. Initial investigation determined that the cause appeared similar to incident #1. The system was restored by 5.20pm and the closing market auction took place at 5.45pm, 45 minutes later than normal. Following this incident, NZX found the issue was linked to an earlier upgrade and fixed it. There have not been any related trading system issues since then.

### 10 June 2014 (incident #4)

Shortly after the market opening, some people had problems viewing orders submitted to market. All trading system components were checked and were found to be operating normally, and market trading information was visible on X-stream trader workstations. Investigation by NZX identified the issue and the market was halted while it was fixed. Trading resumed at 11.25am, after a halt of approximately half-an-hour.

### 27 June 2014 (incident #5)

Shortly after the market opening, NZX received a system notification regarding the market data feed, and initial checks found an issue similar to incident #4. The same solution was applied, but didn't resolve the issue. It decided to move to disaster recovery arrangements. Market participants were advised and the changeover was successful. Trading resumed on all markets at 1.30pm following a halt of approximately three hours.

The orderliness of the markets can be affected by technology failures. It is therefore imperative that NZX has robust arrangements for managing and resolving issues when they arise.

We are satisfied NZX's systems and processes enable it to respond efficiently and appropriately to problems with technology, to ensure minimum disruption to the markets, and to mitigate the possibility of recurrence. NZX has 24-hour IT monitoring and support. When an incident occurs, services are restored as quickly as possible and full analysis is carried out after the event to identify its cause and whether a permanent solution

is required. NZX has a strong support agreement in place with NASDAQ regarding X-Stream, ensuring that specialised help is available when an adverse event affects the trading system.

After each of the incidents described, NZX extensively analysed the issue, together with NASDAQ when necessary. The causes were identified and NZX is confident the fixes are permanent. We note that an issue occurred with the trading system on 23 February 2015, but this issue was unrelated to the earlier incidents.

We are also satisfied that NZX communicated effectively with affected parties in each case. Market participants, data vendors, and other key stakeholders were kept informed of relevant matters. Market announcements were released on MAP when trading in the market was affected. On 27 June, when the trading halt was prolonged, NZX released market updates at regular intervals. The board was kept informed of the issues at all times and oversaw progress on analysis of the causes and the solutions.

Although full testing had been carried out for the upgrade linked to incidents #1, #2 and #3, the issue identified led NZX to review its change control process. It has introduced extra controls to further safeguard against issues arising after changes are made to its systems.

## Activities during 2014

### IT changes

NZX improved its technology infrastructure during 2014, including infrastructure and network upgrades. It also introduced a new monitoring tool that enables analysis of data across all systems logs simultaneously when an adverse event occurs, enhancing its system diagnostic and troubleshooting capabilities. A number of patches were successfully released for various systems.

### Systems security

NZX continually reviews its security arrangements. During 2014, it engaged a third party to test its network security and it is making recommended improvements. It has scheduled a rolling programme of security testing.

### Business continuity planning

Business continuity planning and disaster recovery are essential to the orderliness of NZX's markets, and NZX has been updating and co-ordinating business continuity planning across the entire group since 2013. The technology function has responsibility for this project and for ongoing business continuity planning and disaster recovery. Existing business continuity planning arrangements include remote access to systems and back-up office space in the Wellington region.

During 2014, NZX undertook an organisation-wide review of business continuity planning with help from specialist third party, which included completing business impact analysis studies for each business unit and drafting revised business continuity plans for some areas. Work on plans for other areas will be continued in 2015. One area's business continuity plan was fully tested in December 2014 and this experience will be applied to plans for the market operations teams.

Failover and disaster recovery testing is conducted annually on the trading and clearing systems, to check that the markets can be operated through either the primary or secondary site. Testing involves 'failing over' the system from the primary site to the secondary site. The market is operated from the secondary site for one week then switched back. The trading system failover and disaster recovery testing for 2014 was carried out without incident in February 2014. On 27 June, when incident #5 was experienced, disaster recovery processes for the trading system were implemented. A switch to the secondary site was successful and trading continued on the secondary site for the remainder of that day.

### Human resources

This obligation requires NZX to employ enough people across the organisation to carry out all of the tasks required to operate the markets in a fair, orderly and transparent manner. It also implies that those people should have the appropriate skills to carry out those tasks, and that there should be substitute resources available to ensure consistent standards of service at all times.

NZX has identified the following drivers of human resource requirements for the operation of the markets:

- **the volume and nature of the work.** For example, the number and complexity of waiver applications, or volumes and types of trading
- **the scalability of the function.** For example, technology resources are largely scalable (within a range), whereas regulation resource requirements vary with the volume of work
- **the number, skill and experience of staff operating the function.** This affects the capacity of business functions to manage increases in volume effectively without proportionate increases in the number of staff. As experience grows, capacity increases.

The adequacy of human resources is measured within operational teams by the ability to meet internal service levels. The board monitors the adequacy of resourcing through monthly reporting and metrics from the business units regarding resourcing levels and allocation of shared resources, as well as compliance with service levels. Resourcing in the regulation team is also monitored through the RGC's oversight and regular interaction between the head of market supervision and the chair of the board.

### Resourcing during 2014

While levels of business-as-usual activity in the regulation team were similar to the previous year, the

level of IPO activity and the development of the NXT market meant an increased workload for the regulation and the policy and legal<sup>7</sup> teams during 2014. The regulation team was also focused on completing legacy enforcement cases.

The overall level of human resources in the regulation team increased during 2014. Recruitment included the head of market supervision, a second team leader in issuer regulation, and the permanent appointment of a contractor as the participant compliance team leader. NZX also filled vacancies from resignations, and employed additional permanent solicitors, as well as seconding two external solicitors to supplement permanent resources when needed.

Although the average tenure of staff in the regulation team decreased during 2014, regulation maintained service levels and the quality of decision-making, as well as completing several enforcement cases. We consider using seconded solicitors was a pragmatic approach to resourcing a temporary increase in workload. NZX also implemented career progression opportunities in the regulation team during 2014 to help staff retention.

The surveillance team gained one member during the review period, while the CMS team had a vacancy at the end of the year which has since been filled. The technology team grew from 24 to 28 staff during 2014, reflecting the significance of technology to NZX's businesses.

The CMS team experienced staff turnover during 2014, including the team leader moving to another role at NZX. The manual and process-driven nature of much of the work carried out by CMS means that it is difficult to eliminate human error entirely, and we have noted an increased number of errors by CMS. It is therefore important that NZX maintains a focus on training and streamlining processes in this area. We acknowledge NZX is working to reduce manual processes where possible.

We are satisfied NZX took appropriate action during 2014 to ensure that resources were increased as necessary to manage increased activity levels.

<sup>7</sup> The policy and legal team was created in August 2014. The policy team was previously included in the regulation function.



## FAIR, ORDERLY AND TRANSPARENT MARKETS

In this section, we describe activities and functions within NZX that may not correspond directly to any of the more defined obligations, but are relevant to the overarching obligation to ensure that the markets operate in a fair, orderly and transparent manner. As noted earlier in this review, this obligation underlies all of the other obligations, and therefore the activities and functions previously discussed all contribute to compliance with this obligation.

### **There were no agreed actions from 2013.**

#### **Conclusion**

NZX complied with this obligation during 2014.

We are satisfied that, during 2014, to the extent that

it was reasonably practicable, NZX did all things necessary to ensure that each of its markets was fair, orderly and transparent.

### **NZX activities and functions relevant to the obligation**

#### **Information**

The timely, accurate, and non-discretionary dissemination of market information is a cornerstone of fair, orderly and transparent markets. Investors need access to material information about listed companies to assess the value of securities and make informed investment decisions. Information about market bids and offers must be available, to give investors a view of the supply of and demand for a security, and at what prices. Post-trade information must also be published to reflect the market prices of securities and the level of trading activity.

NZX provides the market with relevant, timely information in a number of ways:

- It provides market participants and market information system providers, such as Iress and Bloomberg, with real-time trading information from its trading system. Investors gain access to this information through broker relationships
- MAP allows issuers to release information to the market, particularly material information that requires immediate disclosure under the listing rules
- [www.nzx.com](http://www.nzx.com), NZX's markets website, gives real-time access to announcements from MAP and also provides information on trading activity and the prices of securities, on a delayed basis.

Information about the operation and regulation of the registered markets is also of relevance and interest to the market, and NZX provides a range of information on its markets website. Examples of the operational information available are trading statistics for individual securities and the overall market, and index compositions and performance. Examples of regulatory information include the market rules, tribunal determinations, and information about NZX's regulatory arrangements and policies. Quarterly regulation metrics are released on MAP under NZX's stock code. NZX also uses its markets website to provide information that may be of use to investors, such as links to business news headlines.

#### **Client and market services**

As noted in the section 'Arrangements for monitoring conduct', the CMS team plays a role in NZX's monitoring activities, and refers matters to the regulation team as required. CMS carries out a number of other activities that contribute to the operation of fair, orderly and transparent markets, such as:

- releasing market announcements under the correct headings and with the correct issuer authority
- identifying and flagging price-sensitive announcements
- processing corporate actions
- updating the trading status of securities in the trading system (eg, ex-dividend)

- administering trading halts and suspensions
- helping issuers to understand and meet continuous disclosure requirements and deadlines
- notifying issuers and market participants of market events
- helping issuer education by publishing issuer updates together with the regulation team.

Matters relating to CMS have been discussed in the section 'Arrangements for monitoring conduct'.

### Processes and procedures

Effective processes and procedures which are documented and easily accessible to staff across the organisation, help ensure consistency and accuracy in carrying out tasks, and reduce errors. They also help the induction of new employees, and cross-training for covering periods of holiday and sick leave. NZX has documented procedures in place for most of its normal functions in the regulation, market services and technology teams. As noted earlier, the documentation of procedures for referrals from the surveillance team to the regulation team is underway.

### Activities during 2014

#### Issuer relationship manager

During 2014, an issuer relationship manager role was created in the market services team as a dedicated point of contact for issuers. This role is responsible for effective communication between NZX and issuers, as well as developing and managing initiatives to help issuers understand and comply with their obligations.

The issuer relationship manager oversees communication between NZX and issuers through the issuer update, published quarterly on MAP, as well as direct engagement with individual issuers through site visits. Other functions of the role include helping new issuers preparing to list, and helping issuers with operational and regulatory issues. This person also helps with any support or liaison required between an issuer and the regulation team or CMS.

An issuer 'best practice' programme is being developed, aimed at improving issuers' understanding of the listing rules requirements, particularly continuous disclosure obligations. It is also intended to provide issuers with access to the information and other resources they need to achieve and maintain a high standard of compliance. The issuer relationship manager will also co-ordinate forums and workshops on issuer-specific topics, helping to raise issuers' awareness and knowledge of key market and operational issues.





# APPENDICES

**BUY**



## APPENDIX 1 – HOW WE CONDUCTED THIS REVIEW

Our oversight of NZX is undertaken throughout a review period, with any matters identified by the FMA during the period as relevant to NZX's compliance with its obligations being discussed and dealt with as they occur. Our engagement with NZX continued to increase during 2014, and in January 2015 the two parties entered into a memorandum of understanding (MOU) which sets out a formal framework for engagement and co-operation between the parties. The MOU includes provision for regular operational meetings and reporting by NZX to the FMA, as well as protocols for interaction between us, particularly in areas of joint regulation such as market misconduct and continuous disclosure.

The *General Obligations Review* provides the FMA with the opportunity to formally report on the adequacy of the arrangements NZX had in place during a particular review period to comply with its obligations, and to identify any changes or enhancements that we believe might help NZX to ensure it continues to operate its markets in a fair, orderly and transparent manner.

### Methodology

The FMA's oversight of NZX during 2014 included the following:

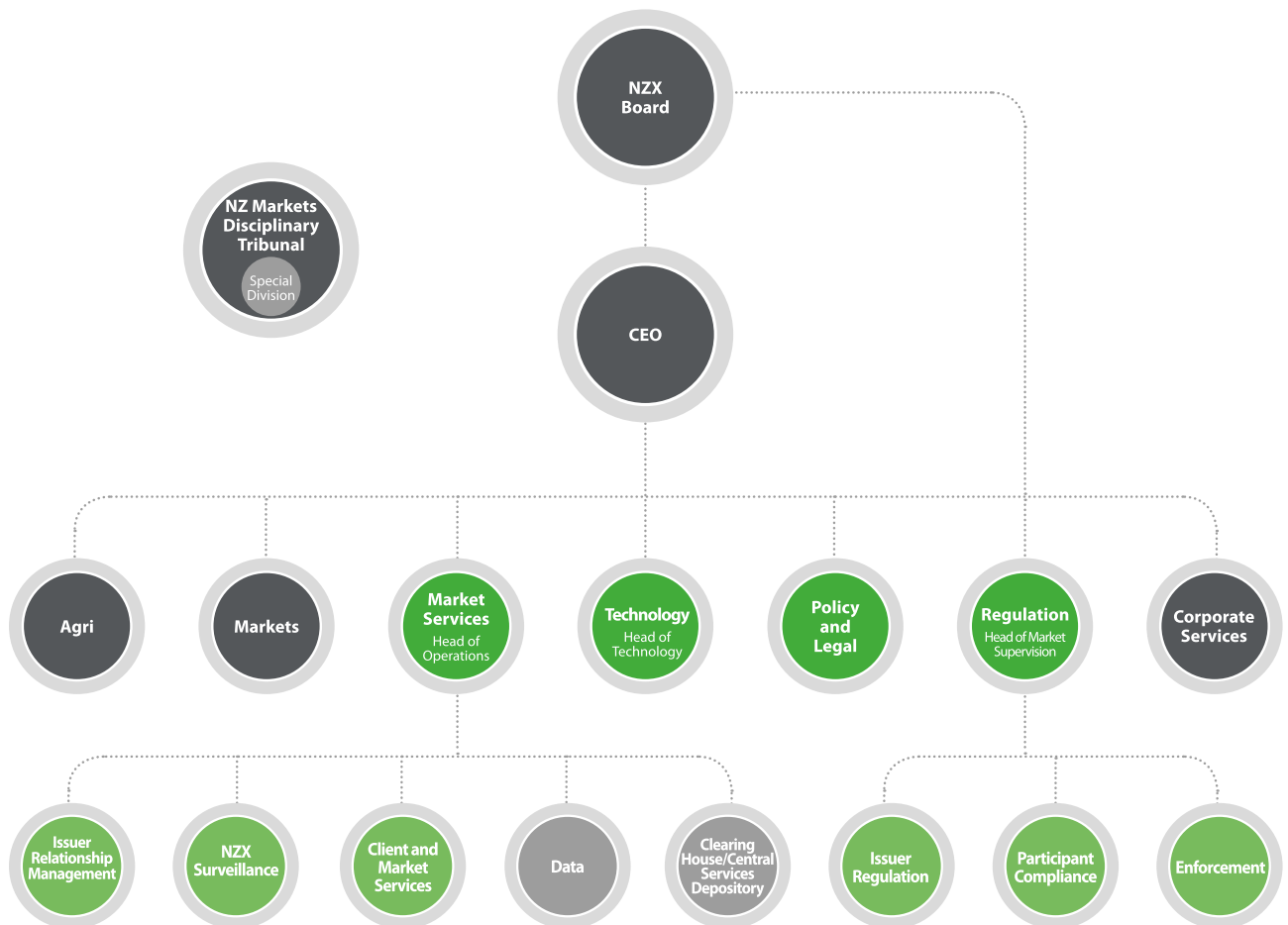
- periodic operational meetings
- discussions about specific matters arising, as required
- assessment of how NZX addressed the agreed actions from the *General Obligations Review* for 2013, published on 30 June 2014
- ongoing review of continuous disclosure practices of issuers
- feedback on referrals made to the FMA by NZX under the SMA/FMC Act
- consultation on NZX policies and guidance notes, where appropriate.

This work contributed to our assessment of whether NZX met its statutory obligations during 2014. We also reviewed the following:

- NZX's market assessment report and supporting information
- quarterly documentation provided by NZX relating to the operation of its markets, including internal reporting to the board and relevant board papers and minutes
- relevant NZX procedures and policies.

## APPENDIX 2 – ABOUT NZX

### NZX organisational chart (as at December 2014)



NZX is a markets, information and infrastructure company that operates securities, derivatives and wholesale energy markets in New Zealand. It builds and maintains the infrastructure on which these markets operate, and produces a range of information and data products.

Its role includes:

- providing the technology and business processes required to operate its markets, and ensuring connectivity to, and the availability of, those systems
- supplying accurate and timely data feeds and other data products, to enable exchange participants to trade on an informed basis
- calculating and supplying index information
- setting rules for the markets
- governing the admission and market conduct of market participants and issuers of equity and debt securities
- monitoring the market for transactions that potentially breach the market rules or legislation investigating potential breaches of the market rules and taking appropriate enforcement action when breaches are determined.

Within NZX's organisational structure, the functional areas of regulation, market services, policy and legal (since August 2014), and technology contribute to the operation of its markets. An independent adjudicative body, the NZ markets disciplinary tribunal, acts alongside the regulation team to enforce compliance with the market rules. Special division is an independent division of the tribunal that acts as the regulator of NZX and related entities as listed issuers, in the same way that the regulation team acts as the regulator of other listed issuers. These functions have been part of this review.

The NZX board has ultimate responsibility for ensuring NZX complies with the statutory obligations, and for discharging NZX's regulatory function. The board delegates all decisions about regulatory matters solely to the head of market supervision<sup>1</sup>, with authorisation to sub-delegate authorities to employees in the regulation function. Although the head of market supervision sits on NZX's executive team, the role reports directly to the board about regulatory matters. The CEO has delegation of approvals of new listings and certain products, but otherwise has no authority for regulatory decision-making.

### **NZX's market assessment report**

The FMC Act requires NZX to produce a report for each financial year, assessing its own performance against its statutory obligations. NZX provided its market assessment report on 26 February 2014.

NZX's assessment was that its activities during 2014 had met the required standard for it to comply with the statutory obligations. It concluded that it had done everything necessary to ensure that its markets were fair, orderly and transparent, to a reasonably practicable extent.

The market assessment report noted actions taken by NZX during 2014 that contributed to compliance with the statutory obligations, including:

- establishing a conflicts committee of the board
- introducing a case management system for use across its regulation and market services functions
- refining the enforcement procedures and service levels
- enhancing the procedures for the regulation and client and market services (CMS) teams
- improving communication with the market.

It also noted a number of initiatives for NZX in 2015. These included:

- continuing work on market rules and guidance note reviews
- assessing opportunities for greater co-ordination with ASX on matters affecting dual-listed issuers
- reviewing manual data entry processes
- reviewing alerts in the SMARTS surveillance system
- testing of revised business continuity plans.

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<sup>1</sup> In August 2014, responsibility for policy was shifted from the regulation team to a new policy and legal team. The previous head of regulation role was changed to head of market supervision, and given sole responsibility for the regulatory function.

## GLOSSARY

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

ASX	Australian Securities Exchange Limited
BaNCs	The core clearing and settlement system operated by NZX
board	NZX board
CEO	chief executive officer
clearing and settlement rules	NZX rules governing clearing and settlement with New Zealand Clearing Limited
CMS	client and market services business team
derivatives market	New Zealand Derivatives Market authorised under the Authorised Futures Exchange (NZX Limited) Notice 2012
derivatives market conditions	Conditions contained in clause 7(1) of the Authorised Futures Exchange (NZX Limited) Notice 2012
derivatives market rules	NZX rules governing the derivatives market
DMA trading	Direct market access trading using electronic access facilities that give investors wanting to trade in financial instruments a way to interact with the order book of an exchange
FMA	Financial Markets Authority
FMC Act	Financial Markets Conduct Act 2013
Fonterra	Fonterra Co-operative Group Limited
Futures Exchange Notice	Authorised Futures Exchange (NZX Limited) Notice 2012
general obligations	General obligations of registered markets set out in section 36Y of the Securities Markets Act 1988 or general obligations of licensed financial product market operators set out in section 314 of the Financial Markets Conduct Act 2013
General Obligations Review	A review carried out by FMA pursuant to section 36YB of the Securities Markets Act 1988 or section 338 of the Financial Markets Conduct Act 2013
IOSCO	International Organisation of Securities Commissions
IPO	Initial public offering where shares in a company are sold to institutional investors and the public on a securities exchange for the first time.
issuer or listed issuer	Any company that is or has been listed on any of NZX's markets
IT	information technology
listing rules	NZX rules governing the NZX main board, debt market and alternative markets.
MAP	The markets announcements platform, which is an electronic platform used by NZX to publish market announcements
market assessment report	Report produced by NZX under section 337 of the Financial Markets Conduct Act 2013
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 Fonterra shareholders market rules
market services	The market services division of NZX comprising the surveillance, client and market services, derivatives operations, clearing, indices and data teams
NASDAQ	The NASDAQ OMX Group, which supplies the X-stream trading system
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
New Zealand Clearing Limited	The company that operates clearing and risk management services for NZX's markets
NZX	NZX Limited
participant rules	NZX rules governing market participants
registered exchange	A person that holds a market registration under section 36F of the Securities Markets Act 1988
registered markets	Registered markets of NZX as defined under the Securities Markets Act 1988, comprising the main board, debt market, alternative market, Fonterra shareholders' market and NXT market
regulation	The regulatory function of NZX, led by the head of market supervision and comprising three functional areas – issuer regulation, participant compliance, and enforcement
related entity	Any participant in an NZX market, or person who applies to NZX to become a participant, that has a connection or relationship with NZX such that 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 beginning on 1 January 2014 and ending 31 December 2014
RGC	The regulatory governance committee of the NZX board
special division	A division of the tribunal responsible for administering and enforcing the market rules in relation to NZX's own listing and related entities
SMA	Securities Market Act 1988
SSH	A substantial security holder, defined in the Securities Market Act 1988 as a person holding a relevant interest of 5% or more or a class of listed voting securities
statutory obligations	The general obligations and the derivatives market conditions
tribunal	New Zealand markets disciplinary tribunal
tribunal rules	The rules governing the operation of the New Zealand markets disciplinary tribunal
X-stream	The NASDAQ OMX X-stream trading system