



FINANCIAL MARKETS AUTHORITY

TE MANA TATAI HOKOHOKO - NEW ZEALAND



# MARKET OPERATOR OBLIGATIONS REVIEW - NZX


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June 2020

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# Executive summary

## Purpose of this report

We are required by law to report on how well NZX is meeting its licensed market operator obligations<sup>1</sup>. These obligations generally relate to areas of NZX's operations that are regulatory in nature but also cover the operational performance of certain key functions related to the operation of the markets. This report provides transparency into our review of NZX for the period from 1 January to 31 December 2019 ("the review period").

## Scope of review

This year's review of NZX's compliance with its market operator obligations was completed within the constraints of COVID-19.

Shortly after we began our formal review process, concerns around COVID-19 heightened and the New Zealand Government implemented nationwide "Alert Level 4" protocols.

Heightened concerns around COVID-19 resulted in the NZX experiencing record trading activity, significant market volatility, increases in demand for capital, and a need to consider appropriate regulatory relief.

In light of the burden that this increased activity placed on NZX, the FMA considered it was most appropriate for NZX to prioritise its resources by responding to these issues.

The impact of the Level 4 lockdown meant the FMA was unable to conduct face-to-face meetings, on-site visits or testing of NZX Surveillance's handling of automated surveillance alerts. Testing of selected processes

and controls was also unable to occur.

However, the FMA considers its engagement with, and monitoring of, NZX throughout the review period, as well as its engagements with market participants, was sufficient to provide meaningful comment on NZX's compliance with its obligations for the review period. Appendix 1 sets out in more detail how this year's review was conducted.

## Key findings

Overall, NZX has demonstrated its compliance with its market operator obligations during the review period by:

- ensuring, wherever reasonably practical, that its licensed markets operated in a fair, orderly and transparent way
- having adequate arrangements to notify disclosures made to it from participants in its markets and continuing to make these disclosures available
- having adequate arrangements for handling conflicts between its commercial interests and the need to ensure its markets are fair, orderly and transparent
- having adequate arrangements to enforce compliance with market rules
- having sufficient resources (including financial, technological and human resources) to properly operate its licensed markets.

There has been an improvement in the quality of NZX Surveillance's investigative processes and its analysis of possible market misconduct.

<sup>1</sup>: The market operator obligations are set out in Appendix 1.

We reviewed NZX's preparedness for market developments such as an escalation of automated trading strategies on its markets and the resulting complexities this could pose for market surveillance. During the review period, NZX increased its focus on algorithmic trading and conducted a targeted review of its impact. This review found no systematic algorithmic misbehaviour in the market during the review period.

NZX responded appropriately in carrying out root cause analysis and implementing long-term solutions for technology issues experienced during the review period (the year to 31 December 2019). Subsequent to our review, the NZX experienced technology disruptions during the COVID-19 alert period. As part of our ongoing monitoring, we have recently commenced a review of these technology problems to examine the cause and overall appropriateness of NZX's response. These matters will also be the subject of comment in our next obligations review for the period ending 31 December 2020, including a review of NZX's strategic management of technology and the quality of its response to these incidents.

Despite measures to improve the quality of continuous disclosure by market participants through engagement and guidance, we consider NZX Regulation's approach to investigations could be improved in some instances.

We will continue to monitor these specific focus areas identified during our review:

- management of conflicts, particularly as relates to policy decision-making
- management of surveillance alerts
- investigations into possible continuous disclosure breaches
- management of market technology issues, including those that have arisen in the current period.

We expect our ongoing monitoring to demonstrate that NZX has delivered improvements in the areas identified above. Identification of any repeated or systemic issues in these areas may put NZX's future compliance with its obligations at risk.

# Findings

While we reviewed NZX's compliance with all of its licensed market operator obligations during the review period, this report only highlights our main findings.

To determine our areas of focus for the review, we considered the following:

- the content of prior years' reports;
- our engagements with NZX and the market; and
- developments and issues that arose during the review period.

## Focus area: Market surveillance

The NZX Surveillance team sits within NZX Regulation, reporting to the Head of Market Supervision<sup>2</sup>.

This function plays a critical role in ensuring market integrity. It must have adequate arrangements for monitoring the conduct of participants in NZX's markets. It must also have sufficient resources and appropriately skilled people to ensure that market surveillance is being conducted effectively.

### Activities during the period

For the review period, we observed that:

- NZX Surveillance handled a significantly increased number of surveillance system alerts
- NZX Surveillance had a good level of engagement with the broader NZX Regulation team
- enhancements were made to the surveillance framework, including a review of some key

procedures, surveillance system parameters and alerts:

- surveillance activities were supported by technical training for surveillance staff
- there was an overall increase in referrals of potential misconduct to the special division and FMA.

Given that automated trading is becoming more prevalent on NZX's markets, particularly with an increase in the use of this technology by Direct Market Access (DMA) clients of Participants, NZX Regulation included algorithmic trading in its focus areas during the review period. It also completed a targeted review into the participation of algorithms in the NZX auction sessions. While NZX Surveillance identified instances where trading executed by algorithms was deemed not to be operating as optimally as they could, it did not identify systematic misuse of algorithms in the market.

### Our assessment and next steps

We consider that the steps taken by NZX during 2018 to enhance the capability of its surveillance function continue to have a positive impact on the effectiveness of the NZX Surveillance team. We noted continued improvements in its investigative processes and in the scope and quality of analysis completed in the matters referred to the FMA. The number of surveillance system alerts generated during the review period is a concern. For the reasons stated at the beginning of this report, we were unable to test how effectively they were managed during the review period. Decision-making

<sup>2</sup>: See Appendix 2 for the operational structure of NZX and NZX Regulation.

around recalibration of surveillance alerts, the appropriateness and effectiveness of alert management, and overall performance of the function will remain a key area of focus.

## Focus area: Continuous disclosure

Continuous disclosure is a key mechanism for facilitating the confident and informed participation in financial markets. NZX's framework for continuous disclosure, including system functionality, monitoring and enforcement, is therefore an area of high interest.

### Continuous disclosure framework initiatives

During the review period, NZX implemented amendments to its Listing Rules, and Issuers had from 1 January 2019 to 30 June 2019 to transition to the revised rules. NZX published a Guidance Note for Continuous Disclosure on 1 January 2019, and completed a Thematic Review of issuer practices for identifying and flagging Material Information with a view to improving market practice in relation to continuous disclosure.

NZX Issuer Compliance also provided training for Issuers and their advisers on release of the updated Listing Rules. These training sessions included a range of topics focussing on key changes under the amended Listing Rules, and in particular, the introduction of a constructive knowledge test overlay to Issuers' continuous disclosure obligations.

### Monitoring and enforcement of continuous disclosure

During the year, there was an overall increase in investigations into Issuers. Many of these related to administrative issues. NZX conducted 34 continuous disclosure investigations, one of which was found to be a breach. No referrals were made to the NZ Markets Disciplinary Tribunal (NZMDT) for breaches of continuous disclosure obligations.

We tested the NZX's handling of potential continuous disclosure breaches as part of our quarterly file reviews. We do acknowledge there is often a high degree of judgment involved in the assessment of continuous disclosure matters. In each instance, we considered that NZX Regulation's decision was supported by a record of engagement with Issuers, and assessed with a documented rationale for the outcome.

While acknowledging that the level of inquiry will vary on a case-by-case basis, we consider that there is scope for NZX to increase the depth of its inquiries and promote a more robust process. This can be done by requiring Issuers to provide broader contemporaneous support for their responses in the more complex or high impact cases.

### Our assessment and next steps

NZX undertook a number of initiatives focused on enhancing the continuous disclosure regime, and we have not identified any material or systemic issues in this area, noting our comments above about the level of evidence required. Given the importance of a well-

informed market and the recent Listing Rule changes, we will continue to test the quality of continuous disclosure breach assessments in our next review.

## Focus area: Technology and systems

NZX must have sufficient technological resources to operate its markets effectively, which includes ensuring the availability, security, capacity and maintenance of NZX's trading platforms, settlement systems, internal market monitoring systems and other systems<sup>3</sup>. Infrastructure failure can have a significant impact on market integrity and confidence, even when the overall number of incidents is low.

As in previous years, we considered how NZX dealt with systems issues, resourcing and infrastructure work undertaken.

### System availability, initiatives and resourcing

During the review period, systems generally operated above SLA-level measurements with system availability over 99%. NZX also implemented a number of IT projects and enhancements, including the delivery of enhanced testing and oversight in support of its cybersecurity framework for critical infrastructure. Human resources allocated to technology remained stable and continued to represent the highest number of staff within the teams responsible for regulated markets and infrastructure.

### System disruptions during the review period

On 6 November 2019, NZX experienced a major Trading System incident, which resulted in a total market impact and delayed opening of the debt and equities markets until 12:45pm. In this instance, the trading engine failed, terminating connectivity to the Trading System due to a code defect in the Trading System. The failure was corrected intra-day with NZX implementing a temporary solution. A permanent solution was obtained from Nasdaq on 22 November 2019. After successful testing, NZX released the solution to production on 7 December 2019.

There were also three network issues during the review period, two in late November and one in early December 2019. The network connectivity issues related to activity by NZX's external network provider, and each was rectified the same day. NZX has changed procedures with its provider to ensure that the likelihood of similar disruptions recurring is minimised.

We noted the following:

- a. In each case, NZX took prompt action to implement recovery solutions that addressed the interruption and enabled trading and connectivity to resume the same day;
- b. NZX was able to implement permanent solutions to the issues within reasonable timeframes, minimising further risks to market participants; and
- c. The 2019 issues were different in nature from the major disruption that occurred in August 2018.

<sup>3</sup>: See Appendix 2 for the operational structure of NZX and NZX Regulation.

## Our assessment

We are concerned with the duration of the major Trading System incident, and the impact it may have had on market participant confidence, but consider that the NZX took prompt steps to remedy the issue and that it was not systemic in nature.

## Incidents occurring after the review period and next steps

We are aware of recent, repeated instances of technology disruptions, particularly in April 2020, following record levels of trading activity. As a result, NZX announced an external review of the issues and proposed remediation actions, establishment of an internal Board Technology Committee, work with the clearing system vendors to split certain functionality into different processing streams to improve throughput, and other steps to reduce system stress.

This will be a significant area of focus for our next review. As part of our ongoing monitoring, we have recently commenced a review to understand the cause of these technology disruptions, and consider the overall appropriateness of NZX's response.

This process will include consideration of how NZX strategically manages its technology. Our expectations are that, apart from a robust review of incidents, appropriate consideration is given to the broader picture in terms of optimising, future proofing, and assessing potential risks to its technology infrastructure.

## Focus area: Conflicts management

NZX is required to have adequate arrangements in place to manage any actual or perceived conflicts of interest between its regulatory responsibilities and its commercial interests.

This is an area of continued focus given that appropriate conflicts management arrangements are important for maintaining market confidence in NZX as a self-regulating organisation.

### Conflicts management initiatives

In this review period, NZX:

- made further refinements to its Conflicts of Interest Management Policy and Conflict Committee Charter;
- obtained an external review of the adequacy of its arrangements for dealing with potential or actual conflicts; and
- completed a review of its regulatory operating and governance model.

We note that the external review by EY found no material concerns or significant control weaknesses and made minor suggestions for continuous improvement around training protocols. In some cases, implementation is ongoing during 2020.

Following a review of its regulatory model and subsequent to the review period, on 31 March 2020 NZX announced a proposal to structurally separate its commercial and regulatory roles through creation of a wholly-owned operating



subsidiary to perform all frontline regulatory functions ("the new regulatory model").

### **Our assessment and next steps**

We acknowledge that the policy function can sit within the commercial function where there are formalised conflicts management and escalation procedures. We have previously discussed with NZX the potential conflicts that may arise where policy decision-making sits within, and is driven by, its commercial function. We want to ensure that the regulatory impacts of policy decisions are given sufficient consideration. Over the coming year, we will seek to understand how regulatory considerations are evaluated as part of the NZX's policy decision-making. The implementation of the new regulatory model of itself does not address this conflict and policy decision-making is an area of continued interest to us.

We are satisfied that NZX meets its obligations to have adequate arrangements in place to manage conflicts. We also note that it is actively pursuing improvements to its conflicts management approach.

### **Other areas:**

#### **Key person risk**

In our 2018 review we had some concerns that staff turnover within NZX Regulation could contribute to increased key person risk. While we are satisfied that there is sufficient resourcing within NZX for the effective regulation of

its licensed markets, its dependency on certain staff members is an area of risk. NZX is currently considering initiatives to mitigate this risk. For example, NZX has commenced a project to assess establishment of a dedicated third party provider panel, which would give NZX Regulation access to external expertise in support of regulatory activity. Those arrangements would include litigation and audit/valuation support. In addition, NZX has advised this would mean enhanced real time and strategic support will be available to the exchange's regulatory function on implementation of the new regulatory model.

#### **Enforcement**

NZX Regulation continues to use a wide range of its enforcement tools. There has been an overall increase in the number of investigations and referrals to the NZMDT.

#### **Market Engagement**

The promotion of an open and constructive dialogue with market participants is important to complement NZX's interactions at a regulatory and enforcement level. During the review period, we noted an increase in the frequency of direct engagement with market participants by the various arms of NZX.

# Appendix 1: Our review

## Our role

We are an Independent Crown Entity and one of two main regulators of New Zealand's financial markets. Our purpose is to promote and facilitate the development of fair, efficient and transparent financial markets.

Under the Financial Markets Conduct Act 2013 (FMC Act), we are required to review, at least annually, how well a licensed market operator is meeting its obligations. We are also required to publish a written report.

## Market operator obligations

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

- the general obligations in respect of licensed markets (section 314):
  - to ensure, to the extent that is reasonably practicable, that each of its licensed markets is a fair, orderly and transparent market
  - to have adequate arrangements for notifying disclosures made to it from participants in its markets, and for continuing to make those disclosures available
  - to have adequate arrangements for handling conflicts between its commercial interests and the need to ensure its markets operate in a fair, orderly and transparent manner
  - to have adequate arrangements for monitoring the conduct of participants in its markets
  - to have adequate arrangements for enforcing compliance with market rules
  - to have sufficient resources (including financial, technological and human resources) to operate its licensed markets properly

- an obligation to respond to a request from the FMA to make changes to market rules (section 333)
- an obligation to give the FMA an annual self-assessment of compliance with its obligations (section 337)
- an obligation to act on the directions of the FMA or the Minister, if the operator is found to be failing to meet any of its obligations (sections 340 to 342)
- any obligation imposed as a condition of a market operator's licence.

## NZX

NZX is licensed to operate the following markets in New Zealand:

- NZX Main Board
- NZX Debt Market
- Fonterra Shareholders' Market
- NZX Derivatives Market

As part of recent market structure changes, the NXT and NZAX markets were closed to create a single equity board, the Main Board. NXT and NZAX Issuers were able to apply to migrate to the Main Board. The NXT and NZAX markets and the rules governing those markets ceased to exist from 1 July 2019.

Details of NZX's licences are on [our website](#).

## Our oversight of NZX

The Memorandum of Understanding between the FMA and NZX, signed in January 2015, sets out the principles for our engagement and co-operation, and provides for our regular operational meetings. This means NZX kept us up to date about its key

initiatives and developments throughout the review period. We also have an agreed set of protocols for communications when we deal with normal business activities concerning both of us.

Our ongoing oversight of NZX in 2019 included:

- quarterly operational meetings
- quarterly review of NZX documentation under the Memorandum of Understanding
- discussions about market matters arising as required
- consulting on NZX policies and proposed rule changes where appropriate
- liaising on market misconduct matters
- feedback on NZX referrals to the FMA under the FMC Act.

We based our assessment of NZX's compliance with its market operator obligations during the review period on the following material and information:

- Review of the Market Assessment Report provided by NZX on 31 March 2020 as self-assessment of its compliance with its market operator obligations.
- Quarterly review of NZX Regulation case files (selected from logs provided by NZX Regulation). We provided specific and thematic feedback arising from the quarterly reviews to NZX Regulation throughout the review period.
- Review of NZX's "Oversight and Engagement Report" for the review period, published by NZX Regulation on 28 February 2020. This report provides insights into the work carried out by NZX Regulation to ensure integrity of its markets. The report provides detailed information on the investigation and enforcement activities undertaken during the

review period, including complaints received by NZX Regulation;

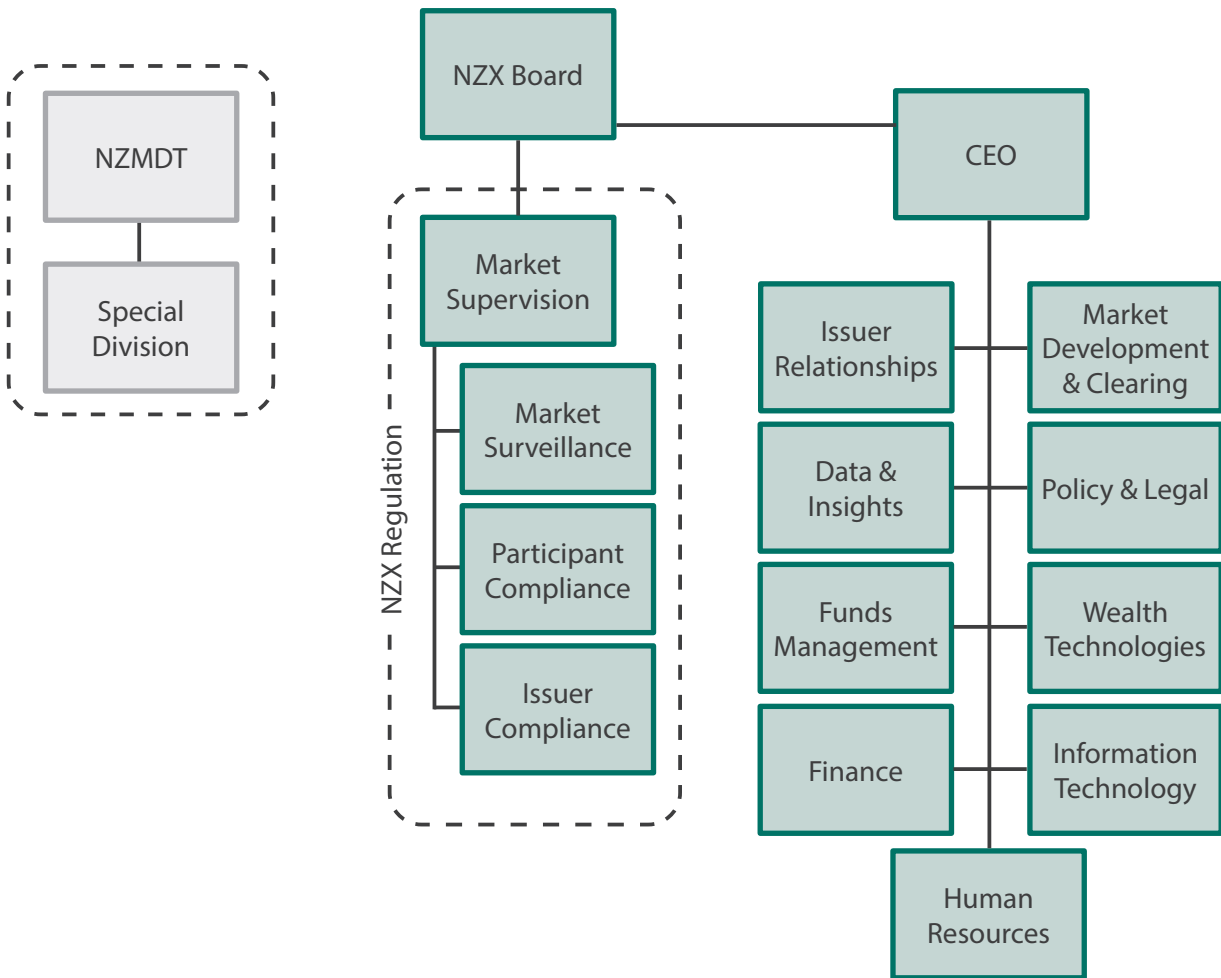
- Review of the 2019 NZX Regulation Thematic Review that focuses on Listed Issuer practices for identifying and flagging market announcements containing Material Information, and NZX's Guidance Note on Continuous Disclosure.
- Review of New Zealand Markets Disciplinary Tribunal Annual Report 2019.
- Ongoing engagement with NZX, including quarterly meetings and other "issues driven" and ad hoc interactions.

The areas of our scheduled Obligations Review excluded from the planned scope for this year's Obligations Review include the following:

- On-site visits at NZX, in both its Wellington and Auckland locations, to conduct interviews with key NZX staff, the Chair of the New Zealand Markets Disciplinary Tribunal (NZMDT), the Chair of the Special Division, and the Head of the Regulatory Governance Committee;
- On-site testing of NZX Surveillance's handling of SMARTS automated surveillance alerts; and
- Testing of selected processes and controls (including around policy determinations);
- Offering Trading Participant firms and Listed Issuers the opportunity to provide any further feedback and insights by way of targeted meetings.

Despite the reduced scope of this year's Obligations Review, we were still able to evaluate NZX's performance effectively over the review period. We note that during the review period, as in previous years, we have maintained frequent contact with NZX at various levels and on a wide range of operational and regulatory topics.

# Appendix 2: NZX Structure Chart





# Glossary

Term	Explanation
<b>DMA</b>	Direct Market Access, a trading arrangement that allows clients of Participant firms to enter orders directly into NZX's trading system, unless the firm's system controls do not allow the order
<b>EY</b>	Ernst & Young, referring to the global organisation, and may refer to one or more of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity
<b>FMC Act</b>	Financial Markets Conduct Act 2013
<b>Head of Market Supervision or HOMS</b>	The NZX Board delegates all decision-making responsibility for regulatory matters solely to the Head of Market Supervision
<b>IPO</b>	Initial public offering, which is the process of offering shares in a private company to the public for the first time
<b>Issuer or Listed Issuer</b>	Any company that is or has been listed on any of NZX's markets
<b>Licensed markets or NZX's markets</b>	The financial product markets NZX is licensed to operate under the FMC Act
<b>Listing Rules</b>	NZX rules governing Issuers on NZX's licensed markets
<b>Market supervision</b>	The regulatory function of NZX, led by the HOMS. It has three functional areas – issuer compliance, participant compliance, and market surveillance
<b>Market operator obligations</b>	Obligations imposed on a licensed market operator as a condition of its licence or under sections 314, 333, 337, 340, 341 and 342 of the FMC Act
<b>Market rules</b>	All of the rules governing NZX's licensed markets, including Listing Rules, participant rules and NZMDT rules
<b>Nasdaq</b>	National Association of Securities Dealers Automated Quotations System
<b>NZ Markets Disciplinary Tribunal or NZMDT</b>	An independent regulatory body that determines potential breaches of NZX's market rules
<b>NZDX</b>	NZX Debt Market

<b>Term</b>	<b>Explanation</b>
<b>NZX Regulation</b>	The regulatory function of NZX, led by the HOMS. It has three functional areas – Issuer Compliance, Participant Compliance, and NZX Surveillance
<b>Participant</b>	A participant in the licensed markets who has been accredited and approved by NZX under the participant rules
<b>Participant rules</b>	NZX rules governing participant firms
<b>Review period</b>	The 2019 calendar year
<b>Regulatory Governance Committee or RGC</b>	A sub-committee of the NZX Board whose role is to facilitate the board’s monitoring of NZX’s regulatory function
<b>Special Division</b>	A division of NZMDT responsible for administering and enforcing the Market rules for NZX’s own listing and its related parties, including the Smartshares funds
<b>Trading System</b>	Nasdaq X-stream platform through which orders may be entered in relation to markets



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