OVERSIGHT REVIEW OF NZX

2008

SECURITIES COMMISSION
NEW ZEALAND

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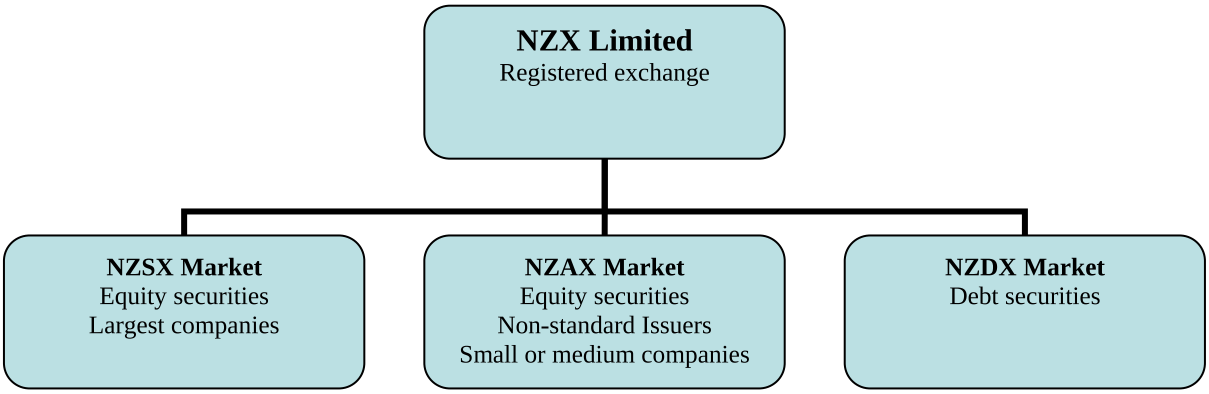
TABLE OF CONTENTS

STRUCTURE OF NZX AND ITS MARKETS



A. ABOUT THIS REVIEW

1. The Securities Commission, pursuant to the Securities Act 1978, undertakes an annual oversight review of NZX's supervision of its markets. This is the fourth annual review completed. It covers the period from 1 January until 31 December 2008.

2. The review covers NZX's performance of its regulatory functions as a registered exchange under the Securities Markets Act 1988. NZX has regulatory obligations under section 36G of the Securities Markets Act 1988 to ensure compliance with its Listing and Participant Rules, and to perform any obligations that lie on NZX under those rules.

3. The review examines NZX's regulatory performance in the following areas:

   - Matters arising from the review of the 2007 year
   - NZX's frontline regulation
   - Relationship of NZX's expanding commercial activities to its regulatory function
   - New Zealand Markets Disciplinary Tribunal
   - Special Division of the New Zealand Markets Disciplinary Tribunal
   - NZX's risk-based approach to supervision
   - Responsibility for the supervisory function

4. Whilst the review covers mainly calendar year 2008, during the course of the review a number of matters came to the attention of the Commission, and the Commission believed it appropriate to discuss some of these matters in this report as they include some important improvements and developments in the performance of NZX's supervision of its markets.

B. EXECUTIVE SUMMARY

5. The Commission's overall conclusion is that NZX is satisfying its obligation to operate its markets in accordance with its Conduct Rules. NZX's performance as a registered exchange according to the requirements of the Securities Markets Act 1988 is good.

6. The Commission has made findings which are summarised below.

Matters arising from the review of the 2007 year

7. The Commission is satisfied that the matters arising from the review of the 2007 year have been resolved appropriately.

NZX's frontline regulation

8. The Commission is satisfied with the processes which NZX uses in considering admission or approval of listed issuers and market participants to its markets. The Commission is satisfied that NZX is taking appropriate action to minimise the risk of non-compliance by listed issuers and market participants in relation to their obligations under the Listing Rules and Participant Rules.

9. NZX informs the Commission that NZX has improved and refined its frontline regulation processes.

10. During the review period, NZX increased the disclosure requirements relating to back-door and reverse listings, which is likely to have positive outcomes for investors.

Relationship of NZX's expanding commercial activities to its regulatory function

11. The Commission is concerned with the risk of potential conflicts that might arise between its regulatory and commercial functions as NZX expands its commercial activities. While we are not aware of any such conflicts at this time, we will continue to review this issue in our future oversight review of NZX.

New Zealand Markets Disciplinary Tribunal

12. The New Zealand Markets Disciplinary Tribunal (NZMDT) is an independent disciplinary body that deals with market conduct issues referred by the NZX. The Commission is satisfied with the New Zealand Markets Disciplinary Tribunal's execution of its function.

13. The review encountered correspondence between the NZMDT and NZX in regard to referrals from NZX to the NZMDT.

14. The NZMDT believes that the number of referrals from NZX to the NZMDT is an issue for the Commission to review in regard to the performance of NZX and its regulatory function and its oversight of the markets, rather than an issue for the NZMDT. The Commission agrees.

15. The Commission supports the implementation of meetings every four months between the CEO of NZX and the NZMDT Chairman to improve communication in this important regulatory relationship.

16. The Commission further recommends that NZX and the NZMDT establish a protocol for referrals from NZX to NZMDT to improve the transparency of their relationship.

17. The Commission notes that the NZMDT believes that NZX has liberally resourced the NZMDT.

The Special Division of the New Zealand Markets Disciplinary Tribunal

18. The Special Division of the New Zealand Markets Disciplinary Tribunal is an independent body that regulates NZX as a listed issuer, in the same way that NZX regulates other listed issuers. The Commission is satisfied with the Special Division's execution of its function.

NZX's risk-based approach to supervision

19. NZX supervises market participants based on their potential risk of non-compliance with the Participant Rules. Under this regime, inspections of high-risk participants are scheduled more than once a year, and low risk participants less than once a year.

20. The Commission finds that NZX's risk-based supervision programme has an appropriate process for assessing market participants' risk of non-compliance with the Participant Rules and a thorough on-site inspection process.

21. In 2008, NZX issued most of its draft inspection reports to market participants outside the time period outlined in NZX's reporting schedule. The Commission accepts NZX's position that such timing was caused by NZX's necessary and appropriate reallocation of its regulatory personnel to manage market risk under the severe market conditions created by the global financial crisis. The Commission also recognises that during this period of extraordinarily difficult market conditions there was no collapse of any NZX market participant.

22. While the Commission understands NZX's position, the Commission considers that market participants should be able to expect timely reports. NZX should resource its supervisory function appropriately so that feedback can be provided to market participants in a timely way.

Responsibility for the supervisory function

23. NZX continues to manage appropriately the conflicts of interest between its commercial and regulatory functions.

24. The NZX Board formally adopted a conflicts management policy in January 2008. This policy includes a delegation of responsibility for the supervisory function to both the CEO and the Head of Supervision. Under Board direction, the CEO may solely exercise the supervisory function by taking on the role of Head of Supervision.

25. However, the Commission considers the dual delegation of the responsibility for the supervisory function inadvisable. The Commission accepts that NZX has a different view. The Commission is concerned that the dual delegation imbeds an inevitable ongoing source of conflicts of interest between the NZX's two roles. The Commission notes that international best practice is for the commercial and regulatory functions of demutualised exchanges such as NZX to be formally separated to remove the potential for supervisory functions being deprioritised for commercial reasons.

26. This issue of dual delegation of responsibility for the supervisory function may be a matter that the Government may wish to consider in the review of the regulatory landscape under the Securities Act review later this year.

C. INTRODUCTION

27. This is the fourth oversight review of NZX's performance of its regulatory functions as a registered exchange under the Securities Markets Act 1988. The review covers the 2008 calendar year and developments up until the date of this report. The extension of the review period into 2009 has been encouraged by NZX as it views developments during the period as of public interest.

28. This review placed particular emphasis on the effectiveness of NZX's risk-based approach to supervision of market participants. The Commission considered in-depth review and analysis of this specific area would be valuable.

29. The Terms of Reference for the Commission's review, the scope of and the background to the review and the process that we followed, are set out in the Appendix to this report.

30. The findings of the review are outlined in seven sections:

- Matters arising from the review of the 2007 year
- NZX's frontline regulation
- Relationship of NZX's expanding commercial activities to its regulatory function
- New Zealand Markets Disciplinary Tribunal
- The Special Division of the New Zealand Markets Disciplinary Tribunal
- NZX's risk-based approach to supervision
- Responsibility for the supervisory function

D. MATTERS ARISING FROM THE REVIEW OF THE 2007 YEAR

31. In its last oversight review report, the Commission required responses on two matters. NZX has addressed these matters as follows:

- NZX makes available on its website attachments to company announcements without the need to make a request; and

- the revised New Zealand Markets Disciplinary Tribunal Rules came into effect in January 2009.

32. The Commission also acknowledges that NZX has recently abolished the 20 minute waiting period before general release of the details of company announcements, a matter which the Commission had commented on in previous reports.

33. The Commission is satisfied that the matters arising from the review of the 2007 year have been resolved appropriately.

E. NZX'S FRONTLINE REGULATION

34. Although NZX does not undertake active supervision of the Listing Rules in the ordinary course, NZX endeavours to minimize the risk of non-compliance by issuers. NZX grants waivers and makes rulings which minimize the risk of non-compliance with the Listing Rules. Waivers and rulings recognize that the Listing Rules cannot contemplate every commercial arrangement.

35. NZX seeks to minimize non-compliance with the Participant Rules through providing guidance notes, compliance briefings, compliance manager forums and on-site inspection reports. NZX also communicates regulatory guidance through the Securities Industry Association and the Listed Companies Association.

36. In April 2009, NZX's amendments to the Listing Rules for NZSX, NZDX and NZAX became effective. These amendments seek to make it easier for listed companies to raise capital.

37. NZX has adopted and implemented a policy on back-door and reverse listings which sought to improve the processes by requiring: (i) the production of a profile for the post-transaction entity, (ii) director certifications in respect of the information in the profile and to certify that all material information has been disclosed and (iii) a change in fees to align them with those payable in respect of a conventional listing. A back-door listing involves a listed company with little or no active business, a trading shell, which acquires an unlisted company which is seeking to become listed. A reverse listing involves a shell company that lists on the market with the aim of identifying a business to acquire.

38. Subsequent to implementing its policy on back door and reverse listings, NZX issued a revised guidance note to ensure that sufficient information was provided to the market about the entities to be listed. In regard to backdoor and reverse listings on NZAX during the review period, NZX required several issuers to provide the required increased disclosure and certification. We anticipate that these new requirements will continue to have positive outcomes for investors.

39. NZX is developing a new system for trade clearing and settlement.

40. NZX informs the Commission that NZX has improved and refined its frontline regulation processes.

F. RELATIONSHIP OF NZX'S EXPANDING COMMERCIAL ACTIVITIES TO ITS REGULATORY FUNCTION

41. The Commission notes that NZX has expanded its commercial activities to include various information and data services.

42. In 2008-2009 NZX acquired the following businesses:

- Dairy Week Limited, a news service on the New Zealand and Australia dairy industries;
- A 22% shareholding in Bond Exchange of South Africa (BESA);
- NZX ProFarmer Australia Pty Limited, an agricultural news service;
- Country-Wide Publications Limited, an agricultural publishing service; and
- M-Co, operator of New Zealand's electricity and gas markets.

43. In 2008, total NZX Markets operating revenue grew to $29.8 million, a 4% increase over 2007, with $12.3 million generated from the NZX Information business, a 17% increase over 2007.

44. The Commission is concerned with the risk of potential conflicts that might arise between NZX's regulatory and commercial functions as NZX expands its commercial activities. While the Commission is not aware of any such conflicts at this time, we will continue to review this issue in our future oversight review of NZX.

45. NZX has since sold its shareholding in BESA.

G. NEW ZEALAND MARKETS DISCIPLINARY TRIBUNAL

46. The NZMDT, formerly known as NZX Discipline, is an independent body charged with hearing and determining matters referred to it by NZX in regard to the conduct of market participants under the Conduct Rules.

47. In 2008, NZMDT appointed a new chairman and also established a new role of executive counsel to NZMDT. The responsibility of this new role includes the management of disciplinary matters, drafting of decisions and the provision of legal advice to NZMDT.

48. NZMDT appointed six additional members in 2008, raised member fees and improved administrative procedures in regard to documenting the process for disciplinary proceedings, providing formal records of its determinations and selecting division members.

49. The Commission is satisfied that the NZMDT has applied appropriately its policy guideline in regard to publishing the names of market participants in disciplinary actions.

50. The review encountered correspondence between the NZMDT and NZX in regard to referrals from NZX to the NZMDT.

51. The NZMDT believes that the number of referrals from NZX to the NZMDT is an issue for the Commission to review in regard to the performance of NZX and its regulatory function and its oversight of the markets, rather than an issue for the NZMDT. The Commission agrees.

52. The Commission supports the implementation of meetings every four months between the CEO of NZX and the NZMDT Chairman to improve communication in this important regulatory relationship.

53. The Commission further recommends that NZX and the NZMDT establish a protocol for referrals from NZX to NZMDT to improve the transparency of their relationship.

54. The Commission notes that the NZMDT believes that NZX has liberally resourced the NZMDT.

H. THE SPECIAL DIVISION OF THE NZMDT

55. The Special Division of the NZMDT (Special Division) is an independent body established under the New Zealand Markets Disciplinary Tribunal Rules which regulates NZX as a listed issuer in the same way that NZX regulates other listed issuers. In 2008, one new member was appointed to the Special Division.

56. No significant matters arose concerning the Special Division during this oversight review.

I. NZX'S RISK-BASED APPROACH TO SUPERVISION

57. This review paid particular attention to NZX's risk-based approach to supervision of market participants. The risk-based approach is central to NZX's regulatory methodology and as such, the practical execution of the approach requires thorough examination.

58. Under NZX's risk-based regime, NZX assesses a participant's risk of non-compliance with the Participant Rules, and would schedule inspections of high risk participants more than once a year and low risk participants less than once a year.

Risk assessment processes

59. NZX uses three processes by which to supervise participants. First, NZX reviews the mandated daily, weekly and annual filings by participants with NZX, which include daily liquid capital returns. Second, NZX conducts on-site inspections of participants. Third, NZX uses participant questionnaires to make specific requests of participants for data and information.

60. NZX's process for assessing compliance risk involves assessing an individual participant's compliance risk on both a global and an individual level.

61. To ensure that supervision is focused on risks affecting the market environment generally, NZX assesses global risks. Global risks are relevant to all participants and include the following: operational processes and procedures; key person risk (the continuity of a participant's senior management and managing principals);

custody rules and process; new rules; trading (desk-based supervision with review of trading records for market manipulation); and margin lending.

62. The framework within which each participant is assessed includes a review of organisational structure, compliance, business areas, business risks, recent compliance activity, and financial processes and procedures.

63. NZX staff develops a risk matrix for each participant against specific risk factors by: identifying broad areas of risk; assessing the magnitude of risk for each area; and determining for each area whether the supervision should be desk-based or conducted during an on-site inspection. The risk matrix is an assessment of the total impact plus the probability of a participant's non-compliance with the Participant Rules. NZX will also ask a participant to provide its own risk assessment against which NZX will compare its risk matrix.

64. To maintain its knowledge of an individual participant's business, NZX requires participants to complete periodic self-assessment questionnaires. NZX uses the questionnaire responses to define the scope of its on-site supervision of an individual participant and to provide guidance and feedback on generic risk issues.

65. The on-site inspection focuses in-depth on specific risk areas rather than covering all areas.

66. NZX also conducts desk-based supervision in which NZX reviews a participant's daily, weekly and monthly reporting of its capital positions to NZX. Participants report to NZX via an on-line system which automatically generates exception based reports. These reports show the percentage of actual liquid capital to prescribed liquid capital and compares client assets to client obligations. These participant filings and exception reports are reviewed by designated NZX compliance staff with experience in accounting.

67. Also, NZX compliance staff has contact with a participant's key personnel which inform NZX staff of compliance issues.

68. Participant trading on NZX markets is monitored by NZX market surveillance staff.

69. Based upon the risk assessment, NZX places market participants into risk categories for supervision purposes. NZX's procedures require that the risk ratings of market participants are conducted annually and monitored throughout the year to ensure that changes to participant risk categories are made appropriately and in a timely manner. Based upon the risk categories, NZX's procedures require NZX to schedule inspections for the calendar year, with some participants having inspections more than once per year and others having inspections less than once per year, but no less frequently than once every two years.

70. The NZX Board has delegated responsibility for the supervisory function to both the CEO and the Head of Market Supervision. The Head of Market Supervision reports to both the CEO and the NZX Board. NZX compliance team business

leaders report to the Head of Market Supervision, and the compliance team members report to the business leaders. The business leaders decide when compliance issues should be escalated to the Head of Market Supervision. The compliance staff regularly provides written reports highlighting key supervisory issues to the Head of Supervision, who also regularly provides written reports to the CEO and the Board.

71. A participant may apply to NZX for a waiver from compliance with participant rules. In deciding whether or not to grant a waiver, NZX will consider the underlying purpose of the rule and whether or not the underlying purpose is served if a rule is waived.

72. NZX has delegated the power to declare a participant a defaulter under the participant rules to the Head of Market Supervision, or a compliance team business leader if the Head of Market Supervision is unavailable. NZX did not exercise that power in 2008.

73. NZX personnel and resources are assigned to supervisory tasks in accordance with the risk-based assessment of participants.

74. NZX has its own business continuity plan to ensure its continued operations if there is a systems failure or major event.

75. NZX also has contingency plans in the event of market or participant failure which include ensuring the safety of client assets and limiting the market impact caused by trade settlement failures.

76. The Commission finds that NZX's risk-based supervision programme has an appropriate process for assessing market participants' risk of non-compliance with the Participant Rules.

On-site inspection

77. NZX staff develops an inspection process overview for each on-site inspection which gives guidance to participants regarding the on-site inspection process and attendant timeframes. The NZX on-site inspection team develop and use planning memoranda which outline the specific risk areas in each participant's business and the work to be completed in the course of the inspection. NZX staff also use a detailed manual for the on-site inspection which explains the objectives and tests to be used for specific risk areas.

78. Using the risk matrix and planning memoranda developed for each participant, NZX prepares a table showing the areas for on-site inspections, areas for desk-based supervision, and number of inspection days anticipated for each inspection. Also, a visit planning memorandum is prepared which includes the participant's background and the risk areas to be inspected. This planning memorandum forms the basis of a checklist of work to be completed during the on-site inspection.

79. Within the NZX compliance team, a specific person is assigned as the client relationship manager for each participant. This person would be involved with the

onsite inspection, analyse responses to periodic questionnaires and update the risk matrix for the assigned participant.

80. The compliance team prepares for the on-site inspections by: reviewing the participant's files which include correspondence, applications for waivers and rulings, and data submissions; discussing the inspection with the participant's client relationship manager; reviewing the responses to periodic questionnaires; reviewing the inspection file from the previous year; reviewing issues from the NZX supervisory internal control checklists; and obtaining a list of the participant's advisors, dealers and settlement officers.

81. In preparing for the on-site inspection, NZX staff will review a participant's compliance with the Participant Rules involving annual reporting returns, complaints, trading, market making, client assets and capital adequacy.

82. NZX staff will contact the participant between two weeks and one month before the proposed inspection date to confirm the proposed date (there will be shorter notice for branch office inspections). NZX will then send a request for information to the participant reflecting the areas to be inspected on-site. Approximately one week before the inspection date, NZX will email the participant outlining the data and the personnel which the participant should make available to the NZX inspection team during the on-site inspection.

83. NZX will also conduct unscheduled inspections of participants if there is a breach or suspected breach of participant rules, such as actual liquid capital less than prescribed liquid capital, client obligations in excess of client assets or self-reported fraud. NZX would conduct these unscheduled visits in order to determine whether client assets are protected and whether there is market risk from the participant's continued operations.

84. The actual on-site inspection begins with a meeting between NZX staff and the participant's staff at which NZX staff explain the format of the inspection. NZX staff and the participant's staff will also meet at the conclusion of the inspection, at which NZX staff will discuss issues identified during the inspection and may include issues identified during NZX's desk-based and questionnaire reviews.

85. Although there is a meeting between NZX and participant staff at the completion of an on-site inspection, it is not until a draft report is issued and a participant responds to that draft report that remedial action is agreed to formally.

86. During the on-site inspection NZX staff will review participant staff lists, organisational charts, job descriptions, training records, new employee induction materials, professional staff licenses, and registers of dealers and shareholder schedules to ensure that all staff are accounted for, licensed and accredited.

87. Also, NZX staff will review the management structure chart, reporting lines, business continuity and contingency planning, and lists of advisors and clients to determine whether a principal broking office is under direct control of a managing principal. The staff will also assess the firm governance, compliance infrastructure and segregation between roles and duties.

88. To assess a participant's compliance infrastructure, NZX staff will review audits of internal processes, system access records, compliance manuals, employee security portfolio records, customer reporting and conflict management policies to ensure that there is independence of the compliance manager from operations.

89. NZX staff will test the reliability of a participant's reported financials by reconciling back office systems data to underlying ledger trial balances and daily/monthly returns and performing calculations to ensure accuracy. The staff also reviews the participant's bank statements and reconciliations to ensure that client funds have been appropriately attributed to client ledger accounts.

90. According to its supervision plan, NZX is to issue a draft inspection report within 20 business days of the on-site inspection outlining issues and actions the participant must take and a timeframe for completion of action items. If NZX is not likely to keep to this timeframe, NZX's policy requires it to communicate this to the market participant in advance of the deadline. The inspection report will contain a section on "Best Practice Recommendations" which raises awareness and understanding of industry developments and standards. The participant is required to respond within 15 business days of receipt of the draft report to its handling of any breaches, action items and required timeframes outlined in the draft report. NZX is to review the participant's response and issue the final inspection report within 10 business days of receipt of the participant's response. Also, participants are required to advise NZX of the implementation of each recommendation by or before the due date for completion of the implementation.

91. NZX's response to compliance failures includes entry into the breaches log or into an inspection report. The NZX staff member initially handling the matter will bring it to the attention of one of the NZX compliance team business leaders who will then discuss it with the other compliance team business leader and the Head of Market Supervision in making the decision as to whether or not to refer the breach to the NZMDT.

92. NZX informs the Commission that NZX's CEO in his capacity as dual delegated Head of Market Supervision from the NZX Board is generally informed of the referral decisions, but does not generally participate in the decisions.

93. The Commission finds that NZX's risk-based supervision programme has a thorough on-site inspection process.

NZX's supervision of market participants

94. NZX's procedures call for NZX to use its risk-based assessment of market participants to allocate resources for heightened supervision to areas in which there is the greatest risk of non-compliance with NZX rules. NZX inspects high risk firms more frequently than other firms.

Implementation of the on-site inspection programme

95. For 85% of the inspections conducted during 2008, NZX issued the draft inspection reports to participants beyond the period of 20 business days or four

weeks after the completion of the on-site inspection, which is the time period articulated in NZX's supervisory procedures.

96. The on-site inspections, as part of risk-based supervision, may reveal conduct which is in breach of the Participant Rules. NZX's notifying participants of these inspection results and requiring remedial actions assist in ensuring that participants remain in compliance with the Participant Rules.

97. The Commission finds that NZX's risk-based supervision programme has an appropriate process for assessing market participants' risk of non-compliance with the Participant Rules and a thorough on-site inspection process.

98. In 2008, NZX issued most of its draft inspection reports to market participants beyond the time period outlined in NZX's reporting schedule. The Commission accepts NZX's position that such timing was caused by NZX's necessary and appropriate reallocation of its regulatory personnel to manage market risk, under the severe market conditions created by the global financial crisis. The Commission also recognizes that during this period of extraordinarily difficult market conditions, there was no collapse of any NZX market participant.

99. While the Commission understands NZX's position, the Commission considers that market participants should be able to expect timely reports. NZX should resource its supervisory function appropriately so that feedback can be provided to market participants in a timely way.

100. As market conditions improve, the Commission anticipates that NZX will ensure timely delivery of its draft inspection reports to market participants.

J. RESPONSIBILITY FOR THE SUPERVISORY FUNCTION

101. The NZX Conflicts Management Policy approved in January 2008 contemplates that the dual role of market operator and supervisor may lead to a conflict or perception of a conflict between regulatory and commercial function, because commercial interests have the objective to maximize value for shareholders and the obligation as a market operator is to utilise resources to supervise its market.

102. Accordingly, the policy requires that commercial interests should not be allowed to influence supervisory decision making; that supervisory activity and information is to be quarantined from commercial activity, and that supervisory activity and decision making must be consistent and transparent.

103. The NZX Board has responsibility for both the commercial and regulatory sides of NZX's business.

104. The Board operates subject to a regulatory charter which outlines that the Board and CEO have a dual accountability for commercial and supervisory operations.

105. Pursuant to this charter, the Board must ensure that strategy of the business will not diminish the high integrity reputation of the capital markets; that no

commercial interests will be permitted to unduly influence supervisory strategy or decision-making; that supervisory activity will be performed in a consistent and transparent manner; and that supervisory activity will be resourced to an appropriate level.

106. The Board has made a joint delegation in respect of regulatory activity to the CEO and the Head of Supervision. The Head of Supervision undertakes the day-to-day management of the supervisory function and the CEO must retain accountability for the supervisory function.

107. To ensure that the Board is properly informed of supervisory activity and that no undue influence may be brought to bear upon the supervisory activity undertaken by the Head of Supervision and her team, the Head of Supervision presents a regulatory paper to the Board at each of its regular meetings. The report addresses key supervisory activity, inappropriate behaviour of any commercial staff seeking to influence supervisory decision making or strategy, any breach of conflict management protocols, and, until November 2008, adequacy of resourcing.

108. The Head of Supervision may and does report to the Board without the presence of the CEO. The Head of Supervision also may escalate a supervisory or potential conflict issue to the Board where a difference has arisen and cannot be resolved between the Head of Supervision and the CEO.

109. Supervisory decision making and information is quarantined from the commercial side and all core supervisory functions are undertaken by a separate regulatory division.

110. Specifically, the CEO is bound by a regulatory code of conduct in that the CEO may not inappropriately use his power to influence or direct the outcome of a supervisory matter for reasons that are not relevant to the supervisory issue.

111. The International Organization of Securities Commissions (IOSCO), Objectives and Principles of Securities Regulation (February 2008) outline principles relating to a regulator which include that "[t]he regulator should be operationally independent and accountable in the exercise of its functions and powers" and that "[t]he regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers." These IOSCO Principles specifically recommend that "[t]he regulator should be operationally independent from external political or commercial interference in the exercise of its functions and powers and accountable in the use of its powers and resources."

112. The assessment methodology for the IOSCO Principles notes that while all exchanges should have procedures in place to address conflicts of interest, there may be more concern for conflicts of interest, or the appropriate use of self-regulatory resources, in the case of for-profit, demutualised markets. One concern is that such an exchange would seek to cut its regulatory activities or standards in order to boost returns for its shareholders.

113. While NZX continues to manage appropriately the conflicts of interest between its commercial and regulatory functions, this dual delegation remains of concern to

the Commission. While this delegation is in place, there remains a potential for conflict to exist.

114. Demutalised exchanges around the world have taken different approaches to ensure separation of regulatory and commercial functions. While models differ, a consistent standard is that the head of regulation is completely autonomous from any other executive function. The NZX has proffered the view that the dual delegation has worked in practise and no commercial concerns have affected the regulatory exercise of the delegation.

115. During the period under review the CEO, under the direction of a committee of the NZX Board, exercised fully on occasion the delegation as Head of Supervision. The Commission considers that the function was competently discharged, and no conflict was evident in the discharge of that function.

116. However the Commission considers that the dual delegation is inadvisable. In the Commission's view the issue which required the exercise of the delegation could have been resolved by the retaining of external counsel or an expert, who could have independently reported to the Board, thereby retaining the separation of the commercial and regulatory functions. The NZX disagrees with this perspective but does agree that the process of obtaining a regulatory outcome is important as well as the outcome itself.

117. The current legislation makes no provision for resolution of these differing perspectives between NZX and the Commission. This may be a matter that the Government may wish to consider in the review of the regulatory landscape under the Securities Act review later this year.

K. CONCLUSION

118. The Commission's overall conclusion from this review is that NZX is satisfying its obligation to operate its markets in accordance with its Conduct Rules and the requirements of the Securities Markets Act 1988. Specifically, the Commission has found as follows:

Matters arising from the review of the 2007 year

119. The Commission is satisfied that NZX has resolved all issues that arose from the 2007 review.

NZX's frontline regulation

120. The Commission is satisfied with NZX's frontline regulation processes.

121. NZX informs the Commission that NZX has improved and refined its frontline regulation processes.

Relationship of NZX's expanding commercial activities to its regulatory function

122. As the NZX expands its commercial activities, the Commission has concerns that there is a risk of potential conflicts arising between NZX's commercial and regulatory functions.

New Zealand Markets Disciplinary Tribunal (NZMDT)

123. The Commission is satisfied with the NZMDT's execution of its function as an independent disciplinary body dealing with matters referred by NZX.

124. The review encountered correspondence between the NZMDT and NZX in regard to referrals from NZX to the NZMDT.

125. The NZMDT believes that the number of referrals from NZX to the NZMDT is an issue for the Commission to review in regard to the performance of NZX and its regulatory function and its oversight of the markets, rather than an issue for the NZMDT. The Commission agrees.

126. The Commission supports the implementation of meetings every four months between the CEO of NZX and the NZMDT Chairman to improve communication in this important regulatory relationship.

127. The Commission further recommends that NZX and the NZMDT establish a protocol for referrals from NZX to NZMDT to improve the transparency of their relationship.

128. The Commission notes that the NZMDT believes that NZX has liberally resourced the NZMDT.

The Special Division of the New Zealand Markets Disciplinary Tribunal

129. The Commission is satisfied with the NZMDT's execution of its function as an independent regulator of NZX as a listed issuer.

NZX's risk-based approach to supervision

130. In this review, the Commission placed particular emphasise on NZX's risk-based supervision approach. The Commission finds that this approach provides an appropriate process for assessing market participants' risk of non-compliance with the Participant Rules and a thorough on-site inspection process.

131. NZX issued most of its draft inspection reports to market participants beyond the time period outlined in its 2008 reporting schedule. While the Commission accepts NZX's position that these delays were caused by NZX's necessary and appropriate reallocation of its regulatory personnel to manage extraordinary market risk during the period, the Commission considers that market participants should be able to expect timely reports.

132. The Commission recommends that NZX should resource its supervisory function appropriately so that feedback can be provided to market participants in a timely way.

133. The Commission also recognizes that during this period of extraordinarily difficult market conditions there was no collapse of any NZX market participant. This is a positive endorsement of NZX's performance as a supervisor of market participants.

Responsibility for the supervisory function

134. The Commission has concerns relating to the dual delegation of responsibility for the supervisory function at NZX and the risk that this will create conflicts of interest that have the potential to compromise regulatory effectiveness.

135. While there is no evidence that any conflict has caused regulatory activity to be compromised by commercial pressures during the period covered by this review, the Commission considers any structure that imbeds ongoing potential for conflict of interest as inadvisable.

APPENDIX

Glossary of key terms and abbreviations

Conduct Rules	The Participant Rules and Listing Rules of NZX.
Issuer	Any entity which is or has been listed on the NZSX, NZAX or the NZDX.
Listing Rules	Rules made by NZX that govern the conduct of Issuers listed on NZX's markets, approved as Listing Rules under the Securities Markets Act 1988.
Market Participant	An organisation accredited by NZX to participate in the markets that NZX operates.
Market Supervision Group	A group within NZX led by the Head of Market Supervision comprising two teams – Issuer and Participant Compliance.
NZAX	New Zealand Alternative Stock Market.
NZSX	New Zealand Stock Market.
New Zealand Markets Disciplinary Tribunal	A disciplinary body constituted by NZX under the NZX Discipline Rules (formerly called NZX Discipline).
New Zealand Markets Disciplinary Tribunal Rules	The New Zealand Markets Disciplinary Tribunal Rules as made by NZX.
NZX	NZX Limited.
Participant Rules	Rules made by NZX that govern the conduct of business on securities markets operated by NZX and persons authorised to undertake trading activities on those markets, approved as Business Rules under the Securities Markets Act 1988.
Special Division	The division of the New Zealand Markets Disciplinary Tribunal that exercises the powers and functions of NZX in relation to NZX or a related entity as a Listed Issuer.

Scope of review

1. Section 36G of the Securities Markets Act 1988 says that NZX must operate each of its securities markets in accordance with approved rules for that market. The Conduct Rules include Listing Rules, and Business Rules that govern the conduct of persons authorised to undertake trading activities on the market.

2. NZX's obligations under section 36G are to secure compliance with its Listing and Business Rules, and to perform any obligations that lie on NZX under those rules. To do this, NZX has established a Market Supervision Group with responsibilities for discharging NZX's regulatory function. The New Zealand Markets Disciplinary Tribunal Rules establish a dedicated body, the New Zealand Markets Disciplinary Tribunal, to determine questions of non-compliance with the Listing or Business Rules. Decisions can be appealed to the Appeal Panel. An independent body, the Special Division of the New Zealand Markets Disciplinary Tribunal, exercises the powers and functions of NZX in relation to NZX as a Listed Issuer and its related entities.

3. The Commission has statutory functions to review practices relating to securities and activities on securities markets, and to comment on these. In relation to NZX, performance of these functions requires the Commission to keep under review and comment on NZX's obligations as a registered exchange. The oversight review was conducted under sections 10(b), 10(c) and 10(caa) of the Securities Act 1978.

4. The Commission's Terms of Reference for the review were:

   The Securities Commission ("the Commission") is conducting an oversight review of NZX Limited ("NZX") under sections 10(b), 10(c) and 10(caa) of the Securities Act 1978. The purpose is to review NZX's performance of its co-regulatory function, in particular its obligations under section 36G of the Securities Markets Act 1988 and, in respect of futures and options dealers, NZX's regulation of dealers under its Futures and Options Participant Rules.

   In particular, the Commission will review the following aspect of NZX's activities:

   (a) the effectiveness of NZX's risk-based approach to supervision of market participants by ensuring that:

      (i) NZX has adequate processes and procedures in place to appropriately make an assessment of a market participant's risk of non-compliance with NZX rules;

      (ii) NZX is making appropriate risk-based assessments of NZX market participants;

      (iii) NZX is applying its risk-based assessments by properly allocating its resources to provide heightened supervision to areas in which there is the greatest risk of non-compliance with NZX rules; and

(iv) NZX is appropriately supervising market participants.

The review may also consider any issues arising in the course of the review in respect of the following areas:

(a) supervision of market participants and enforcement of the Participant Rules;

(b) supervision of listed issuers and enforcement of the Listing Rules;

(c) allocation of human, technological and financial resources as it affects performance of the regulatory functions of NZX;

(d) internal practices and procedures associated with investigations, price enquiries, complaints-handling and referrals;

(e) discipline practices, procedures and resources;

(f) arrangements for market infrastructure development and maintenance;

(g) Special Division practices, procedures and resources;

(h) corporate governance arrangements, including board composition, policy setting, crisis response and oversight of executive management, with reference to regulatory standards relating to governance of demutualised exchanges under IOSCO and other international principles; and

(i) the impact, if any, of NZX's expanding commercial activities on its regulatory function.

The Commission's review will consider the progress made by NZX (up to the date of the Commission's report on this oversight review) in addressing matters arising as set out in its report dated 20 June 2008.

AND accordingly, will obtain, consider and utilise information for the purposes of any recommendation, report or comment the Commission may decide to make under sections 10(b), 10(c) or 10(caa) of the Securities Act 1978 in relation to the above matters.

SUBJECT to the Commission's discretion to amend these Terms of Reference as it may consider fit.

December 2008

Background to review

5. In 2002 the *Securities Markets and Institutions Bill* created a co-regulatory regime for registered exchanges. NZX is the only registered exchange in New Zealand. Under the co-regulatory regime it is intended that the Commission monitors the performance of NZX's statutory responsibilities.

6. In 2003 the International Monetary Fund conducted a Financial Sector Assessment Programme (FSAP) review of New Zealand. The FSAP measured New Zealand's framework of securities regulation and its operation against the Objectives and Principles of Securities Regulation (October 2003) published by IOSCO. The IOSCO principles include principles for self-regulatory organizations and are accepted as the international standards for securities regulation by the International Monetary Fund and the World Bank.

7. One of the recommendations in the FSAP report was that the Commission develop a formalised oversight plan for regulated exchanges, providing for risk assessment criteria and periodic inspections that take into account best practices for self-regulatory organisations and exchanges. It recommended that there should be public disclosure summarising the objectives of the oversight plan and of the key findings of such reviews. The Government response noted that the Commission had decided to develop a formal oversight plan for regulated exchanges and had informed NZX.

8. Demutualisation and listing of stock exchanges has been an emerging phenomenon overseas in the past decade. In all cases we have seen, regulatory structures have been put in place accompanying such moves, reflecting the core importance of stock exchanges to countries' capital markets and broader economies. In New Zealand these regulatory structures include an ownership cap, regulatory review of exchange rules, and oversight by the Commission. Different approaches have been taken in various jurisdictions overseas. The approach taken in New Zealand was settled after consideration of international models existing at the time, and the particular circumstances of the New Zealand markets. It has not been a part of this review to reconsider these arrangements.

9. However, as encouraged by the FSAP review, we have looked to the emerging high-level standards in overseas jurisdictions to gain an insight into best practices for exchanges. We have taken into account the report of the FSAP inspectors, the IOSCO Objectives and Principles of Securities Regulation (October 2003), and the methodology used for assessing compliance with these standards, in particular the principles applying to self-regulatory organisations.

10. The Commission has also looked to the legal obligations of exchanges in similar jurisdictions to gain an understanding of the expectations that overseas investors in particular are likely to have for the conduct of a registered exchange. While there are differences in the approaches taken by each jurisdiction, there are a number of standards that can be taken from an overall assessment of the IOSCO Principles and overseas law and practice. These suggest that a stock exchange should:

(a) meet and maintain adequate standards of integrity and fitness to operate a market;
(b) develop rules for the conduct of listed issuers and market participants;
(c) develop and operate fair procedures for the enforcement of its rules;
(d) conduct a fair, orderly, informed, and efficient market;
(e) maintain effective trading, clearing, and settlement systems;
(f) have adequate capacity to carry out its regulatory functions and enforce its rules; and
(g) have procedures in place to manage conflicts of interest.

11. Development of rules is addressed in New Zealand under the statutory approval and disallowance process for conduct rules. The IOSCO Principles also address competition issues, which are outside the remit of the Securities Commission. The remaining matters have been addressed in this review.

12. The oversight review conducted this year is the fourth oversight review of NZX conducted by the Commission. The review focussed on the 2008 calendar year.

Process

13. The Commission requested information from NZX under section 36ZK of the Securities Markets Act. Section 36ZK says that a registered exchange must give the Commission (or any person authorised by the Commission) information, assistance, and access to the exchange’s facilities if the Commission reasonably requests it to carry out its functions.

14. The Commission sent questionnaires to NZX, the New Zealand Markets Disciplinary Tribunal and the Special Division seeking information the Commission considered necessary to effectively evaluate NZX’s performance of its regulatory functions. The questionnaires covered the areas identified in the Terms of Reference.

15. The Commission requested copies of any procedures manuals and process documents that evidenced NZX’s policies and procedures for each of the areas covered by the questionnaires. Where written procedures and policies were not available, we requested written explanations and information from NZX in response to each specific information request.

16. NZX provided information in response to the questionnaires, including procedures manuals and process documents where relevant. Questions relating to the New Zealand Markets Disciplinary Tribunal and the Special Division were answered by the Chairs of those bodies.

17. Commission staff selected and reviewed a sample of NZX’s files across a range of regulatory activities.

18. Commission staff conducted interviews with NZX personnel and Board members and market participants. Commission staff also interviewed the Chairman of the New Zealand Markets Disciplinary Tribunal and the Chairman of the Special

Division. Thirteen interviews were conducted and the interviews were recorded. Affected parties made submissions and appeared before the Commission.

19. Confidentiality and privacy orders were in place throughout the review.