Regulatory Impact Statement

Securities Law Review: Additional Policy Decisions and Costings

Agency Disclosure Statement

This regulatory impact statement (RIS) has been prepared by the Ministry of Economic Development.

This RIS relates to February 2011 RIS and Cabinet paper that proposed a comprehensive reform of New Zealand's securities law.

This RIS addresses three issues:

- Regulation of securities and derivatives exchanges
- Penalties for breaches of securities legislation, and
- Costings for a number of proposed licensing regimes.

These are the key areas where further decisions are needed to complete the design of the overall securities regime.

A full status quo, problem definition, objectives and set of options are provided for the regulation of securities and derivatives exchanges. However, the liability regime was largely agreed by Cabinet in February and the options considered are therefore confined to further design of the penalties. Similarly various licensing agreements were agreed in principle in February, subject to providing costings.

As with the previous RIS, this RIS is based largely on impacts identified in submissions received in response to the securities law review discussion document (released June 2010), and information received from subsequent targeted consultation with stakeholders. Submissions seldom included quantitative estimates of costs and benefits, and data are not collected on regulatory costs. The proposals in respect of exchanges largely implement recommendations made by the Capital Market Development Taskforce in its 2009 report.

Some of the policy options are considered to have consequences that the Government has stated will require a particularly strong case before regulation is considered. In particular some of the options considered in relation to the regulation of securities and derivatives exchanges would require a wider range of exchange operators to seek authorisation or exemption. This would impose additional costs on those businesses and affect market competition. Important objectives of the options considered are (a) encouraging the development of markets with compliance costs for operators, issuers and participants proportionate to the firms involved and the size of the market, and (b) providing a greater degree of competitive neutrality between different market operators operating equivalent markets.

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INTRODUCTION

This RIS relates to February 2011 RIS and Cabinet paper that proposed a comprehensive reform of New Zealand's securities law.

This RIS addresses three issues:

- Regulation of securities and derivatives exchanges
- Penalties for breaches of securities legislation, and
- Costings for a number of proposed licensing regimes.

These are the key areas where further decisions are needed to complete the design of the overall securities regime.

Part 1: Regulation of securities and derivatives exchanges

STATUS QUO AND PROBLEM DEFINITION

The Securities Markets Act (SMA) currently regulates "registered exchanges" (operators) who operate "registered markets" in securities. An operator becomes a registered exchange by applying to the FMA for registration and submitting the rules of its markets for approval. Once the market rules are approved, registration follows automatically. NZX is currently the only registered exchange, and operates several registered markets.

Under the SMA registered markets must have FMA approval of their rules and rule changes. The issuers listed on them are subject to continuous disclosure rules, which require them to inform the market of all matters that are material to the price of their securities. Insider trading and market manipulation are prohibited, and directors, company officers and substantial securities holders must disclose their holdings and trades.

Once registered, operators are subject to regular (at least annual) oversight reviews by the FMA. The FMA assesses how well the operator is meeting its obligations, such as running fair, orderly and transparent markets and enforcing its rules.
The SMA also regulates derivatives markets. There are two different legislative ways that a derivatives market can be registered. NZX and ASX both operate "authorised futures exchanges". Since 2009 an additional option has been created for those operating registered exchanges to also operate "registered futures markets". This registration process is the same as that for securities, but can only apply to those with existing registered markets in securities.

Unregistered market operators such as Unlisted (operated by Efficient Market Services Limited) and ShareMart (operated by Computershare Investor Services Limited) also allow issuers to list their shares and allow participation by members of the public. However, their markets, issuers and participants are not subject to the SMA provisions that apply to registered markets. There are still some restrictions on these markets and their issuers under other pieces of legislation and the common law. For example, the Fair Trading Act covers misleading and deceptive conduct and there are some more limited insider trading provisions in the Companies Act and Securities Act.

Market operators are generally not required to register, but an unregistered operator cannot call itself a “stock exchange” or “securities exchange”, or imply that it is regulated. The Minister of Commerce is also able to require an operator and its markets to be registered if not being registered is likely to be detrimental to the integrity and effectiveness of securities markets in New Zealand, or the confidence of investors in securities markets in New Zealand.

Most of the problems with the status quo that we identify below arise from the context in which the SMA and its amendments were developed. The registration procedure for securities exchanges was intended to allow the demutualisation of NZX in 2002 and many of the provisions of the SMA were designed with the regulation of NZX’s main market and its participants in mind. This means that the SMA does not provide a regulatory framework to suit the full range of desirable securities and derivatives markets, or potential new entrants.

The registration process does not align well with the formal oversight role of the FMA and the new obligations of registered exchanges under the amended SMA. An operator must be registered automatically if the rules of its proposed markets are approved. There is no testing of the character of the individuals managing the exchange (i.e. "fit and proper" standards) or the capability of the exchange to operate its market and meet its obligations. Without such testing, an exchange could be registered but then fail its first oversight review, or fail to operate its markets properly with consequent adverse effects for market participants and investors.

Derivatives markets have an up-front registration test (under the “authorised futures exchange” procedure), but the legislation does not specify what matters have to be considered in making the registration decision, nor does it specify the operator’s ongoing obligations. Stakeholders have reported dissatisfaction with the registration terms and conditions and supervision applied to derivatives exchanges over time.

The threshold for when a market operator and its markets are required to be registered is unclear and ineffective, and creates risks to the integrity and confidence in New Zealand’s financial markets. It is not clear that the public has particular expectations of a business calling itself a “securities exchange” or “stock exchange” that do not apply to businesses using other terms such as “securities market”, “stock market”, “share market” “share trading facility”, or “securities trading facility”.

Should trading on an unregistered market cause harm to investors (e.g. through undisclosed insider trading or deliberate market manipulation), it may be some time before the harmful activities occurring on it were discovered by regulators – and the damage may have already been incurred. Unregulated markets have been vehicles for widespread fraud in other countries, such as the United States.

The Minister of Commerce can require a market operator to register. However, there is a high threshold before this power can be used and the criteria for its exercise are unclear. It would be difficult to use this power pre-emptively.

The current regulatory system also discourages the development of "stepping stone" markets. These are markets that are not completely unregulated, but which also do not impose the same high level of regulation as the main board of NZX. The provisions of the SMA that currently apply to the main board of NZX and public issuers listed on it, including continuous disclosure, are costly and therefore often preclude smaller businesses from accessing capital to develop and grow their business. Some markets aim to facilitate share trading among insiders in private and closely held companies. If the standard insider trading prohibition were applied to those markets it would be difficult or impossible for insiders to make use of them. Regulatory inflexibility is likely to have contributed to the lack of development of these markets.

The Capital Market Development Taskforce recommended a more flexible regulatory system that would allow the development of markets that had less stringent disclosure and governance requirements. While there is now greater ability for the Minister of Commerce to give partial exemptions from the SMA, stakeholders have indicated that an exemption regime does not provide the regulatory certainty required to undertake the development of new markets. Legislation could better accommodate alternative rules, including for disclosure and insider trading.

OBJECTIVES

As with the overall reform of securities law, the objective is to facilitate capital market activity to encourage capital raising by businesses and better investment opportunities for investors. For this to occur, regulation needs to allow the development of markets that both investors and issuers are willing to engage in. The following are intermediate objectives:

- Improve the coherency and clarity of the regulatory regime;
- Provide competitive neutrality between different market operators operating equivalent markets;
- Support the development of "stepping stone" markets with compliance costs for operators, issuers and participants proportionate to the characteristics of the firms involved and the size of the market; and
- Transparent market rules and effective enforcement, that help investors to understand the risks of investing in less regulated markets, and give them a degree of assurance that they can rely on rules being enforced.

REGULATORY IMPACT ANALYSIS

Three sets of options are considered to address these problems:

- Changes to the process for registering securities and derivatives markets, for example by requiring an up-front assessment of an operator's ability to meet its regulatory obligations before registering it;
- Changes to the criteria for when a market has to be registered and the substantive regulatory obligations applying to registered markets and their operators; and
- If the preferred options for the above are implemented, transitional provisions for existing registered and unregistered markets.

The most important trade-off arises in relation to the criteria for when a market has to be registered and the substantive regulatory obligations applying to registered markets and their operators. Allowing markets to operate with fewer regulatory requirements than on NZX's main board has benefits for the market operators and the issuers listed on them, with the greatest potential gains accruing to small and growing businesses seeking equity capital. However, these markets do pose risks to investor confidence in New Zealand's financial markets and of investor confusion and harm.

Therefore we recommend a regulatory regime that balances these objectives by registering all financial markets (apart from those explicitly exempted) and allowing some registered markets to operate with less onerous rules that are agreed with the FMA or set out in regulations.

The following sections set out the options and their costs, benefits and risks in more detail. A summary table is provided on page 8.

Changes to the process for registering securities and derivatives markets

As noted in the status quo section, securities markets have their rules approved and are then automatically registered. Derivatives markets may go through the same process as securities markets (but only if the operator has an existing registered securities market) or registered separately as an "authorised futures exchange". The registration process for "authorised futures exchange" includes up-front testing by the FMA, and the FMA can also require the market operator to comply with conditions.

We have considered two options, both of which we recommend, for changing these mechanisms.

The first option is to adopt a single system of registering the operators of financial markets (both securities and derivatives markets). Under this option, an operator would be registered to operate particular securities or derivatives markets, which would be specified in its registration. The separate systems for registering derivatives markets would be removed. This option would simplify the regime and improve clarity.

A further option is to require an up-front assessment of an operator's ability to meet its regulatory obligations before registering it, and to allow terms and conditions to be imposed or registration to be removed. There would be an application procedure, including submitting market rules for approval. The registration obligations would be similar to the current ongoing obligations of market operators. Conditions on the registration could be imposed, for example specifying the kinds of financial products that may be traded on the market.

The second option would further improve the coherency of the regime by resolving the misalignment (discussed in "status quo and problem definition") between the registration procedure and the oversight role of the FMA. The ability to set and varying terms and conditions of registration and the ability to remove registration power may impose additional costs on securities market operators in the form of further regulatory requirements and restrictions on their activities. It may also have additional, minor benefits for investors compared to the status quo, for example conditions could be used to apply additional disclosure requirements on some registered markets. However, the FMA and the Minister of Commerce currently have extensive powers that could – in the worst case – impose significant costs on a registered operator, disrupt its operations and make it unviable. The addition of registration terms and conditions may therefore provide an alternative supervisory tool that is more efficient in some circumstances.

The securities law review discussion document asked submitters about whether any changes should be made to the process for registering exchanges. Submitters did not comment on this specific matter. Subsequent feedback from market operators and brokers indicated they were comfortable with the second option, on the basis that it was logical to require operators to pass an up-front test before being authorised rather than subjecting them to the review after being authorised.

Changes to the criteria for when a market has to be registered and the substantive regulatory obligations applying to registered markets and their operators

Regardless of which registration process is adopted, two separate questions arise: Which markets must be registered? And what substantive regulatory obligations will apply to registered markets?

Although these are two distinct issues, the costs and benefits of adopting a particular threshold for registration are highly dependent on the substantive regulatory obligations that will apply to registered markets. To avoid a complex matrix of costs and benefits, the following four representative options have been selected, ordered from the most flexible and liberal to the most restrictive:

- Option 1: Make securities and derivatives market regulation opt-in, with customised regimes for issuer disclosure, issuer governance, participant disclosure, market manipulation and insider trading;

- Option 2: Make minor changes to the requirements to become registered and allow low regulation markets to adopt customised rules;

- Option 3: Require all markets to be registered or exempted, and allow low regulation markets to adopt customised rules (the preferred option); and

- Option 4: Require all markets to adopt continuous disclosure and a prohibition on insider trading.

Option 1 is to make registration “opt-in”, with the legislation also allowing the creation of customised rules for each registered market.

No operator would be compelled to seek registration, but some would likely choose to do so in order to obtain stronger legal backing for their rules (e.g. civil and criminal penalties for rule breaches) and credible enforcement mechanisms (e.g. the FMA enforcing some rules). This is the way that designated settlement systems are regulated by Part 5C of the Reserve Bank of New Zealand Act 1989. It is also effectively the way that Reserve Bank Act regulates banks, since an organisation must only register as a bank if it uses “bank” (or its derivatives) in its name or title. (Although prudential regulation has recently been extended to non-bank deposit-takers such as finance companies.)

Legislation would provide for markets to adopt their own rules covering matters such as for issuer disclosure, issuer governance, participant disclosure, market manipulation and insider trading. These would be backed by regulations recommended by the Minister after consultation with the FMA. The regulations would define the role of the FMA in enforcement, and breach by an issuer, broker or investor could attract civil or criminal liability within some constraints (e.g. on the size of fines or pecuniary penalties).

Option 2 would maintain the status quo in respect of who is required to become registered, with modifications to improve clarity. Unregistered markets would not generally be required to become registered, but they could not be misrepresented as regulated, and the Minister of Commerce would have a reserve power to compel them to become registered under some circumstances. The criteria for use of this reserve power would be redrafted to be clearer than under the current SMA. For example, it might include specific reference to incidence of actual harm to retail investors from the operation of the market, its size and significance to New Zealand’s financial markets, and whether it fails to present its regulatory status clearly to investors.

Legislation would provide for the standard continuous disclosure and insider trading regimes, as at present. However, markets could adopt alternative rules for ongoing disclosure, insider trading and other matters, in a similar manner to Option 1.

Option 3 (the preferred option) would be to require all markets within some broad definition of “financial market” to be registered – with the possibility for exemptions. This will require a definition of “financial market” in legislation that includes significant securities and derivatives markets, but excludes those who simply facilitate private share transactions on an ad hoc basis.

Legislation would provide for the standard continuous disclosure and insider trading regimes with the ability to introduce alternative rules for disclosure, insider trading and other matters, via regulation or through agreement with the FMA.

Exemptions from registration would be permitted where FMA oversight would be excessively onerous, and the risks to investor confidence posed by the markets are low. These exemptions would be subject to conditions that would help to ensure that the market continued to be operated in a low-risk manner, for example limits on the way that the market is represented to investors.

Option 4 would, like Option 3, require all markets within some broad definition of “financial market” to be registered or exempted. However, all registered markets would be required to adopt the current, standard continuous disclosure and insider trading regimes.

All these options would improve the clarity and coherency of the regulatory regime and competitive neutrality to greater or lesser extent, as well as competitive neutrality.

The first three options would each provide a more flexible system of regulation than under the status quo. For example, tailored disclosure and insider trading rules could be developed for stepping stone exchanges. However, with more flexibility comes the risk of investor confusion. Investors would be faced with multiple tiers of markets and each would provide different rule sets and levels of protection. In some cases these could be operated by the same company. These risks could be mitigated if registration conditions placed restrictions on the branding and promotion of low regulation and alternative markets, so that they were clearly distinguished from fully regulated markets. Many other countries have secondary exchanges that are operated by the same businesses as primary exchanges. For example, the London Stock Exchange operates the Alternative Investment Market, and NADSAQ OMX operates a secondary market called OMX First North. Within these secondary markets there are sometimes “premium” markets which impose more onerous regulation on issuers than the secondary markets but less regulation than on the primary exchange. An example of this latter type of market is NASDAQ OMX’s First North Premier.

There are other important trade-offs. The more flexible options would be more likely to encourage the entry of new operators and financial markets, and a greater diversity of financial markets. They would therefore tend to promote the establishment of stepping stone markets than the more restrictive options. However, they also come with greater risks that markets in New Zealand are established without transparent market rules and effective enforcement, and greater risks of investor harm.

Transitional provisions for existing registered and unregistered market

Introducing a new system of exchange regulation creates costs, uncertainty and risk for the operators of existing registered and unregistered markets. Registered markets and authorised futures exchanges would potentially be required to re-apply for registration. Operators of existing unregistered markets may be concerned that they or their market participants will subject to new and disproportionate regulatory obligations that will prevent them from operating. So far no registered market has been granted exemptions under the SMA, and the FMA is a new and independent regulator that has not had time to develop an approach to low-regulation financial markets.

One option to address this issue is for the new securities bill to give initial registration and exemptions to the operators of existing registered and unregistered markets. Finalising these before the new securities law comes into force would reduce the uncertainty – and hence risks – that regulatory changes might otherwise pose for current operators.

However, it would result in a less coherent regulatory system, since existing markets would not have gone through the same process as new markets. Additionally if criteria are applied differently before legislation is enacted compared to afterwards, existing operators may have competitive advantages over new entrants or visa versa.

Summary of options, costs, benefits and risks

The following table outlines our assessment of how each of the options impacts on the objectives. Our assessments are largely qualitative, based on the information provided by submitters throughout the consultation process and our own research. The analysis is constrained in that very few submitters provided detailed information about quantifiable costs in relation to each of the issues.

We have described the impacts on the objectives as being either positive (benefit) or negative and the scale of the impact as small, moderate or high.

Option	Impact on objective: Improve the coherency and clarity of the regulatory regime	Impact on objective: Provide competitive neutrality between different market operators	Impact on objective: Support the development of “stepping stone” markets	Impact on objective: Trans-parent market rules and effective enforce-ment	Preferred option Y/N	Comments and risks
Registration mechanism						
Adopt a single registration system for both securities and derivatives markets, and remove the separate category of “authorised futures exchanges.	Small benefit	-	-	Small benefit	Y	Would simplify the regime and improve consistency
Require operators to pass registration criteria before becoming registered, and allow the FMA to impose terms and conditions on registration.	High benefit	-	Small negative	Small benefit	Y	Would improve the clarity and consistency of the regime, but other impacts would be minor, as registered exchanges are already subject to ongoing oversight by the FMA.
Changes to the criteria for when a market has to be registered and changes to the substantive regulatory obligations applying to registered markets and their operators						
Option 1: Make securities and derivatives market regulation opt-in and allow low regulation markets to adopt customised rules for continuous disclosure, insider trading, etc	Moderate benefit	High benefit	High benefit	High negative	N	Would free exchanges to develop their own rules and enforcement mechanisms, but also comes with risks that rogue market operators and traders harm investor confidence.
Option 2: Make minor changes to clarify the requirements to become registered and allow low regulation markets to adopt customised rules.	Small benefit	-	High benefit	Moderate negative	N	This would be a clearer and more flexible version of the status quo. However, registration would still be opt-in to some extent.
Option 3: Require all markets to be registered or exempted, and allow low regulation markets to adopt customised rules.	Moderate benefit	Moderate benefit	Moderate benefit	Small negative	Y	Requiring registration creates a barrier to entry at the lower end, but this is a lower risk option as all exchanges must be registered or explicitly exempted.
Option 4: Require all markets to adopt continuous disclosure and a prohibition on insider trading.	High benefit	High benefit	High negative	Moderate benefit	N	This option would probably close down the current unregistered exchanges and would prevent the development of “stepping stone” exchanges.
If the preferred options are accepted, transitional provisions for existing exchanges						
Introduce initial registrations and exemptions for existing registered and unregistered markets.	Small negative	Small negative	Moderate benefit	-	Y	Would reduce the risks that regulatory changes might otherwise pose for current operators. However, it would result in a less coherent regulatory system, and there are risks that existing operators have competitive advantages over new entrants or visa versa.

CONSULTATION

Many of the current ideas and policies on the regulation of exchanges have developed from the work and recommendations of the Capital Market Development Taskforce. The Taskforce saw an important challenge for New Zealand as attracting more risk capital and capability to help businesses, particularly small and medium enterprises, to grow. It envisaged unregistered or partly exempt markets operating with rules that sat between current unregistered exchanges like Unlisted and fully regulated markets like NZX's main board. These listing venues would keep compliance costs for listed issusers relatively low, while providing investors with greater rights and assurances than on existing unregistered exchanges or private share transfers. They would help to attract capital and capability to growing companies and prepare them for a listing on a fully regulated market.

The Taskforce's December 2009 report recommended that unregistered exchanges be allowed to remain unregistered, and there should be more willingness to allow "exempt" exchanges that are registered but exempt from some of the requirements of the SMA. The Taskforce noted that it needed to be clear to investors what laws and rules the issuers on these exchanges were subject to. The Taskforce also recommended that unregistered and exempt exchanges be allowed to develop their own listing rules and that registered exchanges be allowed to own and operate unregistered and exempt markets.

Following the Taskforce report, the Review of Securities Law discussion paper of June 2010 sought views from submitters about whether any changes were required to the provisions of the SMA that govern the registration and regulation of exchanges. This was followed by targeted consultation with operators of registered and unregistered exchanges (NZX, Unlisted and Computershare), brokers, and the New Zealand Shareholders Association.

The discussion document asked whether the current mechanisms for registering, requiring the registration of, and exempting securities markets were working, and how they could be improved. Six submissions (Unlisted, VINZ, Securities Industry Association, Grant Thornton, Blue Sky Meats, and Armillary Private Capital) appeared to support unregistered exchanges being allowed to remain unregistered. Three submissions (BNZ, the New Zealand Shareholders Association and NZX) appeared to favour all exchanges being registered. NZX's submission commented that "NZX considers that more work needs to be done to ensure that there is proper regulation of entities that are offering into New Zealand, and are, in substance, and regardless of the precise form of the operation, operating a securities' market."

Unlisted has subsequently indicated that operating as a registered exchange would be feasible if the process for obtaining registration is low cost, regulation applying to Unlisted and its issuers is sufficiently flexible (particularly in regard to disclosure and insider trading), and the FMA could not easily impose a higher regulatory burden subsequent to registration. Unlisted is of the view that the FMA is likely to be risk averse, with incentives that bias it towards imposing higher levels of regulation on registered exchanges than is desirable for market development.

The discussion document also asked about the pros and cons of allowing partial and full exemptions for registered exchanges (apart from the main board of the NZX) from the SMA.

Four submissions (Unlisted, William Foster, VINZ and Armillary Private Capital) argued that allowing NZX to operate an unregistered exchange would confuse investors. Two of these submitters (William Foster and Armillary Private Capital) also stated that it would allow anti-competitive cross-subsidisation.

Four submitters (Simpson Grierson, Grant Thornton, ISI and AMP) considered that all issusers listed on markets operated by registered exchanges should be subject to continuous disclosure.

Five submitters (Blue Kiwi Group, Bell Gully, NZX, INFINZ, Fonterra and the New Zealand Shareholders Association) supported partial exemptions for registered exchanges in appropriate circumstances. Submitters commented that:

- It would create a level of liquidity to small issuers which could be used as a first step to national markets;
- Some market depth could be gained by creating different tiers of markets; and
- There should be clear disclosure of the difference between registered exchanges that operate on the basis of partial exemptions and other registered exchanges.

The New Zealand Shareholders Association submission supported the possibility of second-tier exchanges, but considered that exemptions should not be given lightly (especially from continuous disclosure and insider trading requirements) and others should be able to make submissions on applications. They suggested that issuers above a certain size be required to list on a fully regulated market.

Part 2: Liability

STATUS QUO AND PROBLEM DEFINITION

The February Cabinet paper and regulatory impact statement set out and analysed issues with the current liability regime for contravening securities law. In summary, the present liability regime lacks coherence and contains confusing overlaps between different instances of liability. It is unclear how the different instances of liability interact to promote the objectives of the regime.

The February Regulatory Impact Statement noted that the effectiveness of securities law depends not only on the regulatory requirements imposed on issuers and others involved in financial products, but also on how those requirements are enforced by the FMA. In this context, the range of remedies available is a crucial part of the regime.

Cabinet agreed to simplify and rationalise this regime to meet the objectives of deterring non-compliance and encouraging voluntary compliance with securities law, providing remedies for those harmed by undesirable conduct, and punishing contraventions of the law. In order to achieve this, Cabinet agreed to a framework that would contain a combination of minor regulatory offences, pecuniary penalties, and serious criminal offences. Cabinet directed the Minister of Commerce to report back on the detail of this regime by the end of May 2011.

OBJECTIVES

The key objective of the liability regime is to encourage compliance with the law, as noted above. It is also important that the remedies or punishments in liability regime be proportionate to the wrongdoing in question, and that the costs of enforcement be kept low where possible.

REGULATORY IMPACT ANALYSIS

Penalty categorisation

We have assessed all current instances of liability in the Securities Act and Securities Markets Act, and where they will be retained, have categorised them into three main categories of liability event. We have also placed proposed offences within these categories. This will result in improved coherence of offence levels for different types of liability events, ensuring that the consequences of offending are proportionate to the seriousness of the contravention.

The three main categories of liability event: regulatory offences, civil pecuniary penalties, and serious criminal offences. We describe these categories in the table below.

Proposed category	Type of contravention	Comment
Regulatory offence	Contraventions with basic 'compliance' obligations that would not have serious consequences, e.g. failure by an issuer to maintain a register of securities.	Strict liability offences. Would be used for behaviour that results in simple clear-cut contraventions of the law. The FMA would have the ability to issue an infringement notice in respect of these offences. Penalty level would be a minor fine.
Pecuniary penalty	Civil liability for more serious contraventions, e.g. insider trading.	Civil liability for behaviour that is not sufficiently egregious to warrant the use of serious criminal offences. This category will be important for deterrence and will also provide a mechanism for harmed investors to seek compensation. Penalty will be a considerable fine.
Serious criminal offence	Egregious contraventions of securities law, e.g. knowing or reckless misstatements in a product disclosure statement.	Criminal responsibility for egregious contraventions of securities law. The behaviour must be reckless or intentional. Conviction will result in the potential for a significant term of imprisonment, creating a strong deterrent effect and effective punishment.

Infringement notices

We are proposing that the FMA will have the power to issue infringement notices in respect of the first category of offences. This would mean that the FMA would be able to issue a notice in respect of the contravention instead of the status quo of having to pursue the matter in a criminal court proceeding. The person receiving the notice would have the right to challenge the notice in court. We summarise the differences between the status quo and the proposed regime in the table below.

	Incentive to comply with law	Cost of enforcement	Proportionality to seriousness of contravention	Comments
Status quo: criminal enforcement through court proceedings	Low	High	Low	Unlikely to be enforced due to relatively high costs of court proceedings in relation to seriousness of contravention. Criminal conviction can be disproportionate to seriousness of contravention. Enforcement places burden on court system. Overall low deterrence value.
Proposal: Infringement notices	Medium	Low	High	Simple and cost-effective enforcement mechanism. Reduces costs for justice system. A fine that is proportionate to the seriousness of the contravention can be issued. FMA may still bring criminal proceedings for serious contraventions.

CONSULTATION

The proposals in respect of the liability regime were consulted on through the Review of Securities Law Discussion Document released in June 2010. The views of submitters were taken into account in the creation of the liability framework that Cabinet approved in the February Cabinet paper and in the design of the details described in this document. We have also consulted the Crown Law Office, Ministry of Justice, Treasury and Financial Markets Authority in relation to policy proposals concerning liability issues.

Part 3: Costings of licensing regimes

Cabinet has agreed in principle to the following licensing regimes, subject to costings:

- Derivatives dealers;
- Regulated intermediaries;
- Fund managers; and
- Trustees of workplace savings schemes.

All of the licensing regimes will involve fees, set by regulation (following consultation with stakeholders). The fees will not change the FMA's baseline appropriation (as agreed by Cabinet, CBC Min (11) 4/3, CAB Min (11) 10/1 refer). The FMA will absorb the cost of implementing the regime within its baseline and the fees charged will therefore offset the levy that it is proposed to charge financial market participants.

Fund managers

The licensing regime proposed for fund managers is a fit-and-proper person regime which looks at the character and experience of senior staff. It is expected that this regime will involve a similar test to that applied by the Reserve Bank for directors of banks.

Peer-to-peer lenders

Peer-to-peer lenders are effectively precluded from operating in New Zealand given the regulatory regime. Licensing is intended to introduce a regulatory regime proportionate to the risks that they pose. The licensing criteria will look at the character and background of the key individuals involved, and also a limited assessment of organisational processes.

Derivatives dealers

The FMA currently licenses futures and options dealers – these will be known as derivatives dealers in the new regime. The licensing criteria will look at the character and background of the key individuals involved, and also a limited assessment of organisational processes.

Trustees of workplace superannuation schemes

Cabinet agreed in principle to a requirement that workplace superannuation schemes (which do not have external supervisors) should be required to have at least one trustee licensed by the FMA who can demonstrate a degree of skill and experience.

The estimated costs of each licensing regime are:

	Average cost per organisation	Total annual cost for licensing the industry
Fund managers	$7,750 per organisation per five years	$108,500
Regulated intermediaries	$10,000 per organisation per five years	$4,000
Derivatives dealers	$10,000 per organisation per 5 years	$100,000
Trustees of workplace savings schemes	$1,550 per workplace scheme per five years	$31,000

These costings have been developed in consultation with the Financial Markets Authority. They are based upon estimates of how long it will take to assess applicants for the various kinds of licence and estimated hourly charging rates which include staff time and overheads. The costings take account of Treasury *Guidelines for Setting Charges in the Public Sector*.

CONCLUSIONS AND RECOMMENDATIONS

On the basis of our assessment of the overall benefits, costs, and risks of each option for the regulation of securities and derivatives exchanges, we recommend:

- There should be a single system of licensing the operators of financial markets (both securities and derivatives markets) by the FMA;
- All markets should be licensed or exempted, with low regulation markets allowed to adopt alternative rules, including alternative disclosure and insider trading regimes. Exemptions should be granted where FMA oversight would be excessively onerous, and the risks to investor confidence are low. These exemptions should be subject to appropriate conditions to ensure that the exempt market continues to be operated in a low-risk manner; and
- The new securities bill should provide initial licenses and exemptions for existing registered and unregistered markets.

We recommend the above categorisation of penalties, and the use of infringement notices for regulatory offences. This will implement Cabinet's previous decisions in regard to the liability regime, and will result in improved and cost-effective enforcement of lower-level contraventions.

We recommend implementing the licensing regimes that were previously agreed in principle.

IMPLEMENTATION

The implementation process is the same as for the previous set of Cabinet decisions. In summary, new securities legislation implementing the policy proposals discussed in this RIS is likely to be introduced into Parliament towards the end of 2011. This legislation will repeal the Securities Act 1978 and Securities Markets Act 1988 and re-enact them as a single Act containing the proposals discussed in this RIS and in the previous Cabinet paper and RIS. This legislation is likely to be enacted in 2012.

18 months after enactment operators of financial markets will need to be licensed or exempted and will need to comply with the new oversight arrangements.

MONITORING, EVALUATION AND REVIEW

Monitoring, evaluation and review will be conducted in accordance with the plan in the previous RIS. MED will undertake a review of the effectiveness of the new legislation within five years of its enactment. MED will use information that will be gathered by the FMA as part of its market surveillance function, the information in the FMA's annual reports and the post-implementation review of the FMA to inform this review.

The effectiveness of the exchanges regime will be assessed against the objectives outlined earlier in the RIS (e.g. improving the coherency and clarity of the regime, providing competitive neutrality between exchange operators, and ensuring transparent market rules and effective enforcement). The assessment will be informed by the FMA's annual oversight reports on registered exchanges, and by observing the extent to which "stepping stone" exchanges are able to operate and develop within the regime. To the extent that information is available, particular attention will be paid to the amount of capital raised by firms listed on stepping stone exchanges and any issues that arise for investors (including confusion).

The effectiveness of the liability and enforcement regime will be largely informed by the FMA's annual reports which will provide both detailed and high level measures regarding enforcement and deterrence of breaches of securities law.