

The Chair
CABINET POLICY COMMITTEE

REFORM OF THE LAW RELATING TO FUTURES EXCHANGES AND CLEARING AND SETTLEMENT SYSTEMS

PROPOSAL

- 1 I seek the agreement of this committee to the reform of the regulatory environment relating to futures exchanges and clearing and settlement systems so as to facilitate the establishment of a robust and efficient emissions trading platform in New Zealand.

EXECUTIVE SUMMARY

- 2 The proposals in this paper reform the law regulating futures exchanges and clearing and settlement systems so as to facilitate a more robust legislative framework that meets the expectations of potential international participants.
- 3 NZX has indicated that it wishes to establish an emissions trading platform (called 'TZ1'). They have identified a first mover advantage that would be available to any person in the region who can establish an efficient and robust emissions trading platform. NZX plan to launch their emissions trading platform in mid 2008 (expected May 2008) and would prefer to have the necessary legislative amendments in place by then (or alternatively at least progressing through Parliament so that it can be passed before the end of the current parliamentary term), in order to provide their platform with the international credibility that comes with the regulation of trading functions. Officials expect legislation to be drafted by the end of 2007 for introduction to Parliament in February 2008.
- 4 The proposed reforms involve:
 - a rationalising the regulatory framework for securities and futures exchanges – these are desirable from a policy perspective to provide for simpler administration of the regime, but are not legally necessary to allow establishment of a futures exchange or clearing and settlement system;
 - b amendments so that the New Zealand regime for clearing and settlement systems better conforms with IOSCO recommendations – these are considered commercially necessary to give the platform international credibility and thus make it more attractive to potential international participants; and
 - c technical amendments in response to the emergence of emissions units in New Zealand (both NZ ETS units and non-NZ ETS units), and the way they fit into New Zealand's current regulatory environment.

BACKGROUND

- 5 Emissions trading is developing as one of the primary means of combating human induced climate change around the world.

- 6 NZX argue that provision of a trading platform has the potential to benefit not only its operator but also the government and New Zealand as a whole, by furthering the government's sustainability and economic transformation agenda. For example, it could:
- demonstrate international leadership in sustainability;
 - provide protection and enhancement of New Zealand's green brand, including brand leverage for participating New Zealand companies; and
 - increase liquidity in the New Zealand emissions market through international trade.
- 7 Officials therefore consider it important to consider the regulatory environment to ensure that there are no legal or commercial impediments to prevent a person from attempting to establish a platform in New Zealand.
- 8 Officials have been mindful in analysing the regulatory framework in this area of the undesirability of legislating for one type of trading platform or for one type of market participant only. On this basis, the proposals in this paper are not NZX specific, but would apply to any participant who sought to provide such a platform in New Zealand.

Emissions trading

- 9 There are two types of markets for the trading of emissions units internationally:
- a Mandatory schemes: Markets that arise from a government requirement to participate in an emissions trading scheme such as the scheme proposed in New Zealand, or currently in the European Union; or
 - b Voluntary schemes: Markets that arise as participants voluntarily create an emissions trading scheme to satisfy an environmental requirement or to meet consumer preference or wider sustainability preferences. For example, the Landcare Carbon Zero scheme.

Types of units

- 10 Government has decided in-principle to introduce an economy wide, internationally linked emissions trading scheme (NZ ETS) and is currently engaging with stakeholders over the detail of the proposed scheme [CBC Min (07) 19/2 refers].
- 11 For the purposes of this paper, it is important to distinguish between:
- a Emissions units that are registered on the NZ ETS register that is currently being developed ("NZ ETS units");
 - b Emissions units that are not registered on the NZ ETS register ("non-NZ ETS units") and therefore operate in voluntary or "grey" markets;
 - c Both NZ ETS units and non-NZ ETS units ("emissions units").
- 12 NZ ETS units include Kyoto protocol units, NZUs and in the future may, by a linking mechanism, include units from overseas emissions trading schemes.

- 13 Non-NZ ETS units are comprised of both units that do not derive from any government regulated ETS (“voluntary market units”) and units that form part of an overseas emissions trading scheme but that have not yet been linked to the NZ ETS. Once units from an overseas emissions trading scheme is accepted for linking with the NZ ETS, it will be able to be registered on the NZ ETS register and will then become a “NZ ETS unit”).
- 14 Only NZ ETS units may be used under the NZ ETS in satisfaction of a participant’s obligation (imposed by the NZ ETS legislation) to surrender units to the Crown on emitting greenhouse gases. No other units are valid for surrender. Nevertheless, voluntary market units are currently being traded by persons who, for example, want to claim “carbon neutrality”. Although these units are not valid to off-set a government-imposed liability, the market still sees them as valuable commodities. It is not clear at this stage, how the voluntary market will respond to the introduction of the formal NZ ETS.

Types of trading

- 15 The trade of emissions units can occur through a variety of methods, such as through bilateral contracts, brokers, or an emissions trading platform.
- 16 Some private sector entities have indicated plans to explore the establishment of emissions registers and/or trading platforms, including NZX, M-Co and Trade-me for the trade of both NZUs and voluntary emissions units. It is important to consider the nature of the market (ie the product being bought and sold) separately from the potential market platform through which trades occur. With respect to the NZETS, Ministers have already agreed that participants should be able to weigh the transaction costs associated with a particular method of trading against their desire to manage risks, and therefore the government has chosen not to prescribe the means by which the market trades emissions units. Over time, it is expected that trade will gravitate toward the market that has the greatest liquidity.
- 17 Overseas experience has shown that a large proportion of emissions trading has occurred in the form of futures contracts. Therefore, it is important to ensure that New Zealand’s regulatory environment for futures exchanges allows for emissions trading.

Suitability of current law to emissions trading

- 18 There are currently no legal impediments to trade in emissions units or to establishment of a trading platform for emissions units. That is, the commercial opportunities for New Zealand firms to engage in emissions trading will arise regardless of any further law reform.
- 19 There are, however, legal impediments in relation to the conducting of a market or exchange for trading in futures contracts in emissions units. These are discussed below.
- 20 There are also certain practical or commercial problems in relation to attracting international and other participants to participate in a regional emissions trading platform, especially in relation to futures contracts. Many of these relate to the fact that New Zealand law relating to clearing and settlement systems and futures exchanges does not currently meet the standards set by the Bank for International Settlements and International Organisation of Securities Commissions (BIS-IOSCO).

- 21 The regulatory framework governing trade of emissions units on a registered exchange under New Zealand's securities law is conceptually no different to the approach taken for the trade of any other "commodity". It is important to note that many of the proposals in this paper do not relate solely to emissions trading, but rather reform the law relating to clearing and settlement systems and futures exchanges more generally. These reforms will help facilitate efficient trading of emissions units, but, apart from providing that emissions units are "commodities" in respect of which futures may be traded, are not essential to permit trading in emissions units or the establishment of an emissions trading platform.

NZX TZ1 Proposal

- 22 NZX has requested legislative amendments that would make it feasible for them to establish a futures trading platform and settlement and clearing functions. The legislative amendments sought would also enable other participants to provide these functions should they see commercial opportunity. NZX is requesting these amendments in order to facilitate a commercial imperative of establishing a regional emissions trading platform 'TZ1'. Their central argument is that the trading of units through a regulated futures exchange and clearing house that meets the expectations of international participants will bring a degree of rigour and confidence to a domestic emissions trading scheme, and represent a significant business opportunity for positioning New Zealand as a regional emissions trading hub.
- 23 NZX currently has an online register system 'FASTER' Fully Automated Screen Trading and Electronic Registration which provides clearing and settlement functions. This system was originally built in 1988 based on the international best practice standards of the time. Although the system has been subject to ongoing development it is no longer able to meet current international best practice standards.
- 24 The FASTER system has a high level of built in dependency risk and the market is fully dependent on third parties to facilitate and provide some of the conditions which allow trading and settlement to occur. The third parties act as counterparties in the market and record a risk equal to their daily deposit into FASTER.
- 25 Currently settlement transactions may be unwound in the event of insolvency should a participant fail and notification not be made to NZX such that the participant continues to trade after it is insolvent. Also as each existing counterparty represents a point of risk it is apparent that there exists multiple points of risk (the more points of risk that exist the greater the possibility of that point of risk failing). These points of risk are out of the control of the exchange which in turn cannot give the highest assurance that the market will stay open in the event of a point of risk failure. There also exists a greater physical risk in the current system compared to NZX's proposed model such as outages, telecommunications failures and other failures can occur at each point of risk.
- 26 This level of risk is seen as a structural flaw as it creates many points of susceptibility than exist in the self contained central counter party (CCP) proposal. Current IOSCO standards recommend reducing points of risk and failure in national markets and making them as secure as possible.
- 27 The NZX TZ1 proposal eliminates the markets vulnerability as identified above by establishing a CCP and improves the markets integrity and enhances New Zealand's reputation for international investment.

- 28 In order to make it commercially viable to implement the CCP infrastructure adequate capital backing is required in the form of cash and synthetic capital (used to manage participants risk positions). The supply of synthetic capital is dependent on NZX receiving a satisfactory rating from an international capital market risk rating agency. The rating agency will judge the proposed system on the robustness of the clearing house and the regulatory environment in which it operates.
- 29 Officials believe that legislative changes as outlined in this paper are necessary to reform New Zealand's regulation of clearing and settlement systems. The proposed legislative amendments would enable NZX (or any other entity) to have a facility of international standing that is more likely to attract international participation than a system based on current legislation.

Proposed timing

- 30 NZX believe the proposed amendments are necessary to ensure the proposed futures trading platform meets international best practice as recommended by the Bank of International Settlements (BIS) and the International Organisation of Securities Commissions (IOSCO) and thus gains international credibility. Further they believe this credibility will make the platform attractive to potential investors.
- 31 NZX plan to launch their emissions trading platform in mid 2008 (expected May 2008) and would prefer to have the necessary legislative amendments in place by then (or alternatively at least progressing through parliament so that it can be passed before the end of the current parliamentary term), in order to provide their platform with the international credibility that comes with the regulation of trading functions. Officials expect legislation to be drafted by the end of 2007 for introduction to Parliament in February 2008.
- 32 The proposed amendments would apply generically to any exchange seeking to operate authorised futures trading or entity seeking to operate a regulated clearing and settlement system. The amendments would therefore not give NZX a legislated monopoly over emissions trading, futures trading or clearing and settlement functions.

CURRENT LAW REGULATING FUTURES EXCHANGES AND CLEARING AND SETTLEMENT SYSTEMS

- 33 There are some practical difficulties which arise out of the current law regulating futures exchanges and clearing and settlement systems which mean that it is difficult for a person to establish an efficient and robust trading platform for futures contracts for any commodity (including emissions units). These problems include:
- A perception that the New Zealand regulatory environment does not conform with international best practice, as reflected in the recommendations of IOSCO. This has an impact on the ability to attract domestic and international participants to New Zealand markets.
 - Different regulatory treatment of securities exchanges and futures exchanges, and the compliance costs associated with needing to seek regulatory approval twice.

- Current regulation of clearing and settlement systems was developed with a different focus (ie focused on the payments system rather than the underlying securities/commodities market), before the IOSCO recommendations were made and includes no formal monitoring and enforcement role for the securities market regulator.
- 34 Current legislation regarding clearing and settlement systems focuses on the integrity of the payment system, rather than managing the risk of non-delivery of the commodity or security being traded. This means that current New Zealand law does not provide sufficient certainty for participants regarding finality of a futures contract cleared and settled through the existing regulatory framework.
- 35 While it is possible under current New Zealand law to establish a clearing and settlement system associated with a securities or futures exchange, at a practical level the current law does not sufficiently promote confidence for potential customers regarding the regulatory environment. Therefore, in order to encourage the creation of a futures exchange capable of trading emissions units, it is necessary to reform New Zealand legislation.
- 36 The proposed amendments in this paper have been identified by officials to fall into three categories these are:
- a rationalising the regulatory framework for securities and futures exchanges – these are desirable from a policy perspective to provide for simpler administration of the regime, but are not legally necessary to allow establishment of a futures exchange or clearing and settlement system;
 - b amendments so that the New Zealand regime for clearing and settlement systems better conforms with IOSCO recommendations – these are considered commercially necessary to give the platform international credibility and thus make it more attractive to potential international participants; and
 - c technical amendments in response to the emergence of emissions units in New Zealand (both NZ ETS units and non-NZ ETS units), and the way they fit into New Zealand’s current regulatory environment.

CLEARING AND SETTLEMENT SYSTEMS

- 37 Clearing and settlement systems manage the risk of non-delivery of the commodity or security traded once the market has determined the price of the thing being traded. Clearing and settlement systems are an integral component of a safe, sound and efficient market.

Current status and issues in New Zealand

- 38 The New Zealand regulatory framework for the purposes of securities and futures clearing and settlement systems does not currently conform to the BIS-IOSCO recommendations. Legislation on securities transfer, enforceability of netting arrangements in winding up, bankruptcy and statutory management and clearing houses does currently exist and is robust for the purposes of government, semi-government and private sector debt and equity securities, however this legislation is neither comprehensive nor organised in a coherent manner for the purposes of a securities and futures clearing system.

- 39 The relevant provisions address payments systems rather than securities settlement systems. The subject of clearing houses appears in the Companies Act with Section 310K empowering the Reserve Bank to declare any person as a 'recognised clearing house' for the purposes of the provisions of the Companies Act that ensure the enforceability of multilateral netting arrangements. The Reserve Bank is also empowered under Reserve Bank Act to recommend that a payment system be declared a 'designated payment system'.
- 40 There are currently two designated payments systems in New Zealand: the Reserve Bank's Austraclear, a real time settlement system (used for debt and equity securities) and ESAS an Exchange Settlement Account System providing settlement accounts for the settlement of all real time payments. Austraclear and ESAS are designated payment systems under Part 5C of the Reserve Bank Act.
- 41 Notably New Zealand's legislation does not adequately address clearing and settlement for securities markets when measured against the BIS-IOSCO recommendations. Specifically the Companies Act and the Reserve Bank Act provisions were designed in a different context and before the BIS-IOSCO recommendations for central counterparties were finalised in March 2004. For example, there is no formal monitoring and enforcement role for the securities market regulator (the Securities Commission) in relation to clearing and settlement systems. Rather the Reserve Bank has some regulatory responsibility but its focus in the existing legislation is directed to the financial system of New Zealand as a whole, rather than the specifics of the securities and futures markets.
- 42 The Companies Act focuses on the event of company liquidation and the transactional aspect of clearing and settlement rather than the underlying financial system. It applies to settlement of payment obligations and does not apply to underlying commodity and security delivery obligations. This leaves uncertainty as to enforcement of transactions in, and delivery of, the underlying product.

Approval and monitoring of a clearing and settlement system

- 43 I propose to create a new "opt-in" regime for clearing and settlement systems. Note that, following the establishment of the new regime, Ministry of Economic Development officials will undertake scoping and report back to me on further work required in the 2008/9 year in relation to whether the new regime should remain opt-in or become mandatory for trading in emissions units and whether the new regime should be opened to clearing and settlement in relation to products other than securities and emissions units.
- 44 It is proposed to insert new provisions in the Securities Markets Act which will allow the regulation of clearing and settlement in a similar manner to provisions relating to registration of securities exchanges (including in relation to application procedures, assessment criteria and rule approval). The new regime will run on an "opt-in" basis in parallel to the existing Companies Act regime for clearing and settlement systems. This will ensure that existing clearing houses which operate in relation to payment systems can continue to operate in accordance with the Companies Act under the supervision of the Reserve Bank.

- 45 The Securities Markets Act provides for registration of securities exchanges and the regulation of conduct rules that relate to trading on securities exchanges. Clearing and settlement, while not limited to securities, is nonetheless an integral process that occurs post-trading of the securities on the exchange. For these reasons there are several advantages in including provisions relating to regulation of clearing and settlement of securities and futures contracts in the same legislative context as provisions dealing with the trading of securities and the exchanges on which they are traded. Use of similar application procedures and rule approval criteria will contribute to efficient application processes, both for simplification of legislation and for persons most likely to “opt-in”. While NZX is the only exchange that has indicated it wishes to operate a clearing and settlement system, other clearing and settlement systems owned independently from the NZX may also opt-in to avail themselves of this enhanced official recognition. The regulatory framework and regulator’s powers already in the Securities Markets Act are necessary to meet monitoring, inspection, etc requirements of the IOSCO principles.
- 46 Locating rules on clearing houses associated with exchanges in the same piece of legislation as the requirements for exchanges is adopted in many overseas jurisdictions and is familiar to international market participants. Transparency and accessibility are enhanced.
- 47 This maintains the use of the existing procedures, which apply to a registered exchange and which are equally appropriate for clearing and settlement system, and it will also allow for ease of administration and oversight by regulators where a registered exchange, such as NZX, will also operate a registered clearing and settlement system.
- 48 Note that the proposal will mean that there are parallel regimes under the Securities Markets Act and the Reserve Bank Act for approving and regulating clearing and settlement systems. However, this will allow potential operators of a clearing and settlement system to opt-in to the most appropriate regime. The Securities Commission and the Reserve Bank would each have responsibility for monitoring and enforcing the activities of the clearing and settlement system which are relevant to each agency’s area of responsibility.
- 49 Ministry of Economic Development officials, in conjunction with the Reserve Bank and Securities Commission will undertake a review of the regime once it is operating in relation to systemic stability implications and the interface between the clearing and settlement system and the payments system and I will report back if further changes are necessary.

Clearing house rules and approval criteria

- 50 An approved clearing and settlement system will be required to meet the relevant IOSCO recommendations on securities settlement systems and central counterparties. This will include developing rules governing:
- a criteria for membership;
 - b the conduct of clearing and settlement activities within the clearing and settlement system, including collateral and clearing fund requirements;
 - c the basis upon which delivery and payment instructions are given;

- d the basis on which delivery and payment obligations are calculated and effect (either on a gross basis or using netting); and
 - e default procedures, including any action to be taken if a participant in the system is unable, or likely to become unable, to meet the participant's obligations to any or all of the following:
 - i the operator of the system;
 - ii another participant in the system;
 - iii any other party to the operating rules.
- 51 The rules of the clearing and settlement system would have effect despite any other law to the contrary. These requirements are consistent with the IOSCO Recommendations for clearing and settlement systems.
- 52 In considering an application for designation by a clearing and settlement system, the Minister must have regard to:
- a The purpose and scope of the clearing and settlement system, including the importance of the clearing and settlement system to the integrity and effectiveness of the markets for which it clears and settles trades;
 - b The financial resources of the clearing and settlement system and its proposed governance arrangements;
 - c The proposed operating rules of the clearing and settlement system, and whether they are adequate for the purpose and scope of the clearing and settlement system, including their ability to manage risks that the clearing and settlement system is exposed to (including risks in linkages with other clearing and settlement systems);
 - d Any laws or regulatory requirements relating to the operation of the clearing and settlement system and the extent to which the system complies (or would comply) with those laws or regulatory requirements; and
 - e Whether it is in the public interest to approve the application.
- 53 The proposed new regime enables the Minister of Commerce to assess the appropriateness of the operating rules in light of the purpose and scope of the particular system. The proposed assessment criteria are partly derived from the Securities Markets Act and the Reserve Bank of New Zealand Act and allow the Minister to utilise the existing processes and expertise of the Securities Commission and the Reserve Bank in assessing an application.

Primacy of the interests of the clearing and settlement system

- 54 In addition to changes in relation to the establishment of a clearing and settlement system, it is also proposed to make changes to facilitate the operation of the clearing and settlement system which will provide greater certainty to market participants that multilateral netting arrangements are enforceable, trades cleared through a clearing and settlement system are final, and insolvency rules applying to the transaction are appropriate.

Validation of operating rules

- 55 It is proposed that certain aspects of the operating rules of the system be valid and enforceable despite any law or agreement to the contrary. This is equivalent to what section 156O(1) of the RBNZ Act provides in relation to designated payment systems.
- 56 Note that this is not a blanket validation of the operating rules in their entirety. Rather (as with designated payment systems), the validation will only cover certain aspects of the rules that deal with matters specifically addressed in the IOSCO Recommendations (for example, netting, defaulting participants, and the finality of settlements).

Netting

- 57 Netting is a fundamental feature of a clearing and settlement system and is specifically addressed in the IOSCO Recommendations. It is proposed that any netting under the rules of a clearing and settlement system will be valid and enforceable despite any law to the contrary. The equivalent designated payment system rule is contained in section 156R of the RBNZ Act.

Default of participants and finality of settlements

- 58 Without further protection, a clearing house is exposed to risk that, if a market participant becomes insolvent, the liquidator may be able to wind back a transaction which has been conducted on the exchange. This could have a flow-on effect on other transactions and threaten the stability of the clearing and settlement system and the market.
- 59 It is proposed to give primacy to the interests of the clearing and settlement system in the event of insolvency of a market participant. It should be noted that NZX's proposal stated that it would be desirable for there to be a blanket priority for all aspects of a transaction involving a clearing house. However, this could raise the potential for "gaming", ie two parties using a clearing house in a non-arms length transaction to avoid a liquidator. This situation is unlikely to arise where the transaction occurs on a market such as NZX, however the reforms in this paper are more generic and would not prevent a clearing house taking transactions other than those on the market, such as over the counter transaction.
- 60 In order to address this, I propose that the primacy apply only in so far as it is necessary to protect the integrity of the clearing system (i.e., the ability of the clearing house to finalise and settle the transaction). While this primacy will give the clearing house protection against clawback of the transaction by a liquidator of a market participant, it will not affect the liquidator's right to pursue the original parties to the underlying transaction. The underlying trades themselves do not threaten the integrity of the clearing system and should continue to be vulnerable to challenge by a liquidator of a clearing participant.
- 61 It is also proposed to give priority to the clearing house in relation to any collateral posted by a clearing participant, in so far as necessary to settle any transaction relating to that participant. This ensures that any transactions conducted through the clearing and settlement system can be completed providing certainty for other participants. To get this priority, the clearing house will need to have operating rules that contain mechanisms by which the interests of existing security holders in the collateral are taken into account before collateral is lodged in the system. The intention is to balance the interests of the clearing house against the interests of existing security holders as fairly as possible.

Priority under the Personal Property Securities Act in relation to the underlying transaction

- 62 It is also proposed to extend the priority provided by section 97 of the Personal Property Securities Act (“PPSA”) in respect of shares and other securities to emissions units. This will have the effect that a purchaser who gave value for an emissions unit, acquired it without notice of a security interest, and takes possession (by recording their interest in the register of emissions units), will have priority over the holder of a security interest in the emissions unit.
- 63 Note that commodities other than securities and emissions units will not be able to take advantage of this special priority rule under the PPSA.
- 64 NZX’s original proposal was put forward before the finalisation of the ETS, and therefore NZX envisaged that a regulated clearing house would be responsible for running a private register of emissions units, rather than there being a government register. A private register could have a wider range of types of emissions units, including voluntary units.
- 65 Following establishment of the ETS, it could be appropriate to limit the protections available through clearing and settlement to NZ ETS units only. However, such limitation could have the practical effect of making a clearing house commercially unviable. Officials believe therefore that it is not appropriate to limit the scope of emissions units that may be cleared and settled through a regulated clearing and settlement system.

RATIONALISING REGULATION OF SECURITIES AND FUTURES EXCHANGES

Current situation in New Zealand

- 66 Currently a person who describes themselves as a “stock exchange” or “securities exchange”, or who wishes to hold themselves out as a regulated securities market, must apply to the Minister of Commerce to be a registered exchange under Part 2B of the Securities Markets Act. If the same exchange wishes to hold itself out as a regulated exchange for trading in futures contracts in New Zealand, the exchange must apply separately to the Securities Commission for authorisation under Part III of the Securities Markets Act.
- 67 It is proposed to amend the Securities Markets Act so that a registered securities exchange under Part 2B of the Securities Markets Act may be registered either for securities only or for securities and futures trading. An exchange registered for operating securities markets will be deemed to be an authorised futures exchange under Part III of the Securities Markets Act, subject to the Minister being satisfied on the advice of the Securities Commission that the operating rules and infrastructure of the exchange are satisfactory for conducting a market in futures trading.
- 68 Subsequent changes to the existing (or introduction of new) operating rules of an authorised futures exchange proposed to be made on the basis of provisions similar to the current disallowance and approval provisions for the conduct rules of registered exchanges under the Securities Market Act.

Futures Dealers

- 69 Currently futures dealers are required to make an application to the Securities Commission to obtain authorisation to deal in futures contracts. It is proposed to codify the existing class exemption for NZX participants who are futures dealers under the Authorised Futures Dealers Notice (No 3) 2004 into the legislation so that all dealers in futures contracts who have been approved by a registered exchange to deal in the futures contracts shall be deemed to be authorised to carry on the business of dealing in futures contracts for the purposes of Part III of the Securities Markets Act 1988.
- 70 This removes the need for futures dealers, who have already been subjected by the registered exchange to a substantially similar application process for admission as a participant in its futures market, from the need to separately seek authorisation from the Securities Commission.

Clarification of the general powers and functions of the Securities Commission

- 71 It is proposed to make a minor amendment to clarify that the Securities Commission has the power to review and comment on the law relating to, and activities on, futures markets and registered clearing and settlement systems, including advising the Minister in relation to conduct rules.
- 72 This will give clear guidance to the market and potential participants as to the Commission's statutory functions and powers as regulator.

TECHNICAL AMENDMENTS

- 73 It is also proposed to make certain technical amendments which will provide greater certainty. These amendments are legally necessary to enable the proposal to proceed.

Legal effect of registration

- 74 Under current law relating to title to securities or shares in a company, entry onto a register is prima facie evidence of title. This provides certainty for persons transacting on the basis of ownership of the securities or shares that the person registered as the holder of the securities or shares has legal title.
- 75 It is necessary to extend the provisions relating to registration of securities to emissions units. This will further support certainty and integrity of the system. Note that owners of ETS units will receive certainty of title through the legislation establishing the ETS.

Registrability of electronic transfers

- 76 It is proposed to confirm the registrability of electronic transfer of securities and emissions units traded through a registered clearing and settlement system (similar to a FASTER Order under the Securities Transfer Act).
- 77 The current provisions under the Securities Transfer Act are limited to securities (and do not currently apply to emissions units).

- 78 In addition to providing certainty as to the legal effect of entry onto a register of emissions units, it is necessary to provide comfort to persons acquiring securities or emissions units cleared and settled through a registered clearing and settlement system that they will be registered as the holder of the product. This is currently provided for in respect of securities under the Securities Transfer Act that are transferred in accordance with prescribed procedures (including in respect of securities transferred electronically through the FASTER system).

Clarification of the definition of a futures contract

- 79 It is proposed to clarify the definition of futures contract so that it extends to a futures contract for emissions units. It is unlikely that the current definition in the Securities Markets Act is broad enough to include an emissions unit. Clarifying this provides certainty as to the application of the futures contract regime in the Securities Markets Act to futures contracts for emissions units. Officials consider it desirable to extend the definition to both NZ ETS units and non-NZ ETS units. This will enable authorised futures exchanges to trade in voluntary market units as well as NZ ETS units.

Clarification that an emissions unit is not a security

- 80 It is proposed to expressly exclude an emissions unit from the definition of “security”. This will provide certainty as to the legal treatment of an emissions unit, in particular, that it is not a security and therefore trading in emissions units will not attract the provisions of the Securities Act and Securities Markets Act applicable to a security (eg prospectus, insider trading, etc). Again, officials consider it desirable to make this change in respect of both NZ ETS units and non-NZ ETS units, as the applicability of the Securities regime does not “fit” well with emissions units.

CONSULTATION

- 81 The following agencies have been consulted and agree with the recommendations in this paper: Securities Commission, Reserve Bank, Treasury (Emissions Trading Group).
- 82 NZX has also been consulted during the preparation of this paper.

FISCAL IMPLICATIONS

- 83 The Securities Commission already conducts monitoring of securities exchanges, and has an existing regulatory role in relation to futures exchanges and futures dealers. Given this, the additional costs to the Securities Commission of performing its statutory functions as regulator under the proposals outlined in this paper are expected to be minimal and can be met from the Securities Commission’s existing funding.
- 84 Similarly, as the Reserve Bank has an existing oversight role in relation to New Zealand’s financial system under the Reserve Bank of New Zealand Act 1989, the additional costs to the Reserve Bank under the proposals outlined in this paper are also expected to be minimal.

HUMAN RIGHTS

- 85 The proposals in this paper are not inconsistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

LEGISLATIVE IMPLICATIONS

- 86 The proposals require amendments to be made to the Securities Markets Act 1988, the Personal Properties Securities Act 1999, the Securities Act 1978 and the Securities Transfer Act 1991 (along with other minor consequential amendments). Officials consider legislation can be drafted by the end of 2007 for introduction to parliament in February 2008.
- 87 NZX submit that the proposed amendments are necessary to ensure the proposed futures trading platform meets international best practice. NZX plan to launch their emissions trading platform in mid 2008 (expected May 2008) and would prefer to have the necessary legislative amendments in place by then. I propose, therefore, that the recommendations in this paper be the subject of a standalone Bill separate from the anticipated Bill on a New Zealand Emissions Trading Scheme and that the standalone Bill be added to the 2007 legislative programme with a category 5 priority (instructions to the Parliamentary Counsel Office to be provided in the year).

REGULATORY IMPACT ANALYSIS

- 88 The Ministry of Economic Development (MED) confirms that the Code of Good Regulatory Practice and the regulatory impact analysis requirements, including the consultation RIA requirements, have been complied with. A RIS was prepared and MED considers the RIS and the RIA analysis undertaken to be adequate. A draft RIS was circulated with the Cabinet paper for departmental consultation purposes.

PUBLICITY

- 89 It is important to ensure that there is a clear conceptual separation between the Emissions Trading Scheme (which provides a register of ownership of interests in emissions units) and the proposals in this paper (which relate to improvements to the regulatory environment for futures exchanges and clearing and settlement systems more generally).
- 90 Therefore, I do not intend to issue a general media release, however I will communicate Cabinet's decisions to NZX in order to provide them with the assurance they require to continue development of the TZ1 emissions trading platform.

RECOMMENDATIONS

- 91 It is recommended that the Committee

Background

- 1 **Note** that the government has decided in-principle to introduce an economy wide, internationally linked emissions trading scheme (NZ ETS) and is currently engaging with stakeholders over the detail of the proposed scheme [CBC Min (07) 19/2 refers].
- 2 **Note** that the proposed New Zealand Emissions Trading Scheme does not require the trading of emissions units to occur through a registered exchange or on a particular platform.
- 3 **Note** that the trading of emissions units (including those arising from regulated/mandatory or voluntary markets) is expected to grow as the international actions to combat climate change increase.

- 4 **Note** that NZX has identified that there is a commercial opportunity for a New Zealand private-sector enterprise to benefit from a first mover advantage to establish a regional emissions trading platform ahead of its competitors overseas.
 - 4.1 **Note** that NZX plan to launch their emissions trading platform in mid 2008 (expected May 2008) and would prefer to have the necessary legislative amendments in place by then in order to provide their platform with the international credibility that comes with the international credibility that comes with the regulation of trading functions. Officials expect legislation to be drafted by the end of 2007 for introduction into parliament by February 2008.
- 5 **Note** that overseas experience has shown that a large proportion of emissions trading has occurred in the form of futures contracts. Therefore, it is important to ensure that New Zealand's regulatory environment for futures exchanges allows for emissions trading.
- 6 **Note** that, following establishment of the ETS, it could be appropriate to limit the protections available through clearing and settlement to NZ ETS units only. However, such limitation could have the practical effect of making a clearing house commercially unviable.
 - 6.1 **Agree** that it is not appropriate to limit the scope of emissions units that may be cleared and settled through a regulated clearing and settlement system.

Clearing and settlement systems

- 7 **Note** that there are some practical difficulties which arise out of the current law regulating futures exchanges and clearing and settlement systems which mean that it is difficult for a person to establish an efficient and robust trading platform for futures contracts. These problems include:
 - 7.1 Lack of conformity with international best practice, as reflected in the recommendations of the International Organisation of Securities Commissions (IOSCO). This has an impact on the ability to attract domestic and international participants to New Zealand markets.
 - 7.2 Different regulatory treatment of securities exchanges and futures exchanges, and the compliance costs associated with needing to seek regulatory approval twice.
 - 7.3 Current regulation of clearing and settlement systems was developed with a different focus (ie focused on the payments system rather than the underlying securities/commodities market), before the IOSCO recommendations were made and includes no formal monitoring and enforcement role for the securities market regulator.
- 8 **Agree** to amendments so that the New Zealand regime for clearing and settlement systems better conforms with IOSCO recommendations. These are considered commercially necessary to give a trading platform international credibility and thus make it more attractive to potential international participants.

- 9 **Agree** to establishment of an “opt-in” regulatory regime under the Securities Markets Act 1988 which will allow the regulation of clearing and settlement in a similar manner to provisions relating to registration of securities exchanges (including in relation to application procedures, assessment criteria and approval of operating rules by the Securities Commission).
- 9.1 **Note** that there will be parallel regimes under the Securities Markets Act and the Reserve Bank Act for approving and regulating clearing and settlement systems. The Securities Commission and the Reserve Bank will each have responsibility for monitoring and enforcing the activities of the clearing house which are relevant to each agency’s area of responsibility.
- 10 **Direct** Ministry of Economic development officials to undertake scoping and report back to the Minister of Commerce on further work required in the 2008/9 year in relation to whether the new regime should remain opt-in or become mandatory for trading in emissions units and whether the regime should be opened to clearing and settlement in relation to products other than securities and emissions units.
- 11 **Agree** that the certain aspects of the operating rules of the clearing and settlement system be valid and enforceable despite any law or agreement to the contrary. Note that this is not a blanket validation of the operating rules in their entirety. Rather (as currently the case with designated payment systems), the validation will only cover certain aspects of the rules that deal with matters specifically addressed in the IOSCO Recommendations (for example, netting, defaulting participants, and the finality of settlements).
- 12 **Agree** for a clearing house to have protection against a liquidator of a participant from clawback of a transaction which has been settled through the clearing house in so far as it is necessary to protect the integrity of the clearing system. Note that while this primacy will give the clearing house protection against clawback of the transaction by a liquidator of a market participant, it will not affect the liquidator’s right to pursue the original parties to the underlying transaction.
- 13 **Agree** to give priority to the clearing house in relation to any collateral posted by a clearing participant (in so far as necessary to settle any transaction relating to that participant) subject to the interests of existing security holders being taken into account before the collateral is lodged in the system.
- 14 **Agree** to extend the priority provided by section 97 of the Personal Property Securities Act (“PPSA”) in respect of shares and other securities to emissions units.

Rationalising regulation of securities and futures exchanges

- 15 **Note** that officials see the benefit in rationalising the current law for authorisation of securities and futures exchanges to simplify administration of the law and reduce compliance costs. These amendments are desirable from a policy perspective to provide for simpler administration of the regime, but are not legally necessary to allow establishment of a futures exchange or clearing and settlement system.

- 16 **Agree** that a registered securities exchange under Part 2B of the Securities Markets Act may be registered either for securities only or for securities and futures trading. An exchange registered for operating securities markets will be deemed to be an authorised futures exchange under Part III of the Securities Markets Act, subject to the Minister being satisfied on the advice of the Securities Commission that the operating rules and infrastructure of the exchange are satisfactory for conducting a market in futures trading.
- 17 **Agree** that market participants who have been approved by an authorised futures exchange under its operating rules shall be deemed to be authorised to carry on the business of dealing in futures contracts under section 38 of the Securities Markets Act (in effect codifying in law the existing exemption granted by the Securities Commission under the Authorised Futures Dealers Notice (No 3) 2004).

Technical amendments

- 18 **Note** that technical amendments are required in response to the emergence of emissions units in New Zealand (both NZ ETS units and non-NZ ETS units), and the way they fit into New Zealand's current regulatory environment.
- 19 **Agree** to clarify provisions relating to title and registration of emissions units to:
- 19.1 provide that registration of an emissions unit on a register is prima facie evidence of title .
- 19.2 confirm the registrability of electronic transfer of securities and emissions units traded through a registered clearing and settlement system.
- 20 **Agree** to clarify definitions to make clear that:
- 20.1 a "futures contract" extends to a futures contract for emissions units.
- 20.2 an emissions unit is not a security.

Legislative implications

- 21 **Note** that the proposals in this paper will be the subject of a standalone Bill separate from the anticipated Bill on a New Zealand Emissions Trading Scheme.
- 22 **Agree** that a standalone Bill be added to the 2007 legislative programme with a category 5 priority (instructions to the Parliamentary Counsel Office to be provided in the year).
- 23 **Invite** the Minister of Commerce to issue drafting instructions to Parliamentary Counsel Office to give effect to the above proposals.
- 24 **Agree** to delegate to the Minister of Commerce the power to make decisions on minor issues that arise during the drafting process.

Publicity

- 25 **Note** that it is important to ensure there is a clear conceptual separation between the proposed New Zealand Emissions Trading Scheme (which requires participants to obtain and surrender certain emissions units) and the proposals in this paper (which relate to improvements to the regulatory environment for futures exchanges and clearing and settlement systems more generally).
- 26 **Agree** for the Minister of Commerce to communicate Cabinet's support of the proposals in this paper to NZX.

Hon Lianne Dalziel
Minister of Commerce

Date signed: _____

Regulatory Impact Statement

EXECUTIVE SUMMARY

The proposals in this paper reform the law regulating futures exchanges and clearing and settlement systems so as to facilitate a more robust legislative framework that meets the expectations of potential international participants.

The proposed reforms involve:

- rationalising the regulatory framework for securities and futures exchanges – these are desirable from a policy perspective to provide for simpler administration of the regime, but are not legally necessary to allow establishment of a futures exchange or clearing and settlement system;
- amendments so that the New Zealand regime for clearing and settlement systems better conforms with IOSCO recommendations – these are considered commercially necessary to give the platform international credibility and thus make it more attractive to potential international participants; and
- technical amendments in response to the emergence of emissions units in New Zealand (both NZ ETS units and non-NZ ETS units), and the way they fit into New Zealand's current regulatory environment.

ADEQUACY STATEMENT

The Ministry of Economic Development considers that the RIS is adequate according to the adequacy criteria.

STATUS QUO AND PROBLEM

There are some practical difficulties which arise out of the current law regulating futures exchanges and clearing and settlement systems which mean that it is difficult for a person to establish an efficient and robust trading platform for futures contracts for any commodity (including emissions units). These problems include:

- A perception that the New Zealand regulatory environment does not conform with international best practice, as reflected in the recommendations of IOSCO. This has an impact on the ability to attract domestic and international participants to New Zealand markets;
- Different regulatory treatment of securities exchanges and futures exchanges, and the compliance costs associated with needing to seek regulatory approval twice; and
- Current regulation of clearing and settlement systems was developed with a different focus (ie focused on the payments system rather than the underlying securities/commodities market), before the IOSCO recommendations were made and includes no formal monitoring and enforcement role for the securities market regulator.

Current legislation regarding clearing and settlement systems focuses on the integrity of the payment system, rather than managing the risk of non-delivery of the commodity or security being traded. This means that current New Zealand law does not provide sufficient certainty for participants regarding finality of a futures contract cleared and settled through the existing regulatory framework.

While it is possible under current New Zealand law to establish a clearing and settlement system associated with a securities or futures exchange, at a practical level the current law does not sufficiently promote confidence for potential customers regarding the regulatory environment.

An opportunity has been identified to establish in New Zealand a regional market for emissions unit products. To capture this opportunity, it is important that the legal and regulatory framework in which emissions unit markets in New Zealand operate provides for clear regulatory treatment of emissions units, and more generally that regulatory settings for market infrastructure in New Zealand is appropriate to attract domestic and international participants to New Zealand markets.

OBJECTIVES

Overall – to capture the opportunity to establish a regional emissions unit market in New Zealand and will contribute to New Zealand’s international reputation on climate change issues, as well as create a platform for growth of emissions trading in New Zealand.

Clearing and settlement systems – to ensure that trades in securities and other products on a multilateral trading platform can be cleared and settled through a clearing and settlement system that has the confidence of international and domestic participants.

Rationalising the regulatory framework for securities and futures exchanges – to streamline the application procedures for approval as a registered exchange for securities and an authorised futures exchange.

Technical amendments – to provide certainty for market operators and market participants as to the regulatory treatment of emissions units, and thereby reduce transaction costs arising out of the current uncertainty.

ALTERNATIVE OPTIONS

The alternative options available are:

- maintain the status quo; and
- undertake a general review of clearing and settlement law in New Zealand.

Maintaining the status quo

This option would involve no changes to New Zealand’s legislation governing futures exchanges and clearing and settlement systems.

On the basis of market research and discussion with potential traders conducted by NZX, it is believed that without an international benchmark approach to regulation of clearing and settlement systems, the chances of the emergence of a substantial regional emissions unit market based in New Zealand are remote. Futures traders in particular face substantial default risks due to the long term nature of their exposure under futures contracts. Successful futures markets throughout the world depend on appropriate legal and regulatory infrastructure to manage default risks (most commonly though a regulated “central counterparty” clearing and settlement system).

Under the status quo, NZX (or any other entity) could apply to the Securities Commission for authorisation of its proposed emissions futures market as an “authorised futures exchange” under section 37(8) of the Securities Markets Act. Preliminary discussion between NZX and the Securities Commission on this option included proposing as a condition of authorisation that NZX adopt conduct rules and market infrastructure for the futures markets that meet international standards as reflected in the IOSCO recommendations.

However this option does not achieve the objective of enacting a legal and regulatory framework that would allow for the establishment of a clearing and settlement system that meets international standards. A Securities Commission authorisation does not have the power to address the problems in current New Zealand law that give rise to issues when measured against the IOSCO recommendations, namely:

- insolvency risks, and the inadequacies of the New Zealand law approach to insolvency risk in multilateral trading regimes;
- the effect of, and impact on, prior security interests and other third party interests in securities or commodities traded through, or collateral or margin posed with, the clearing and settlement system; and
- evidence of title to the securities or commodities, in particular issues relating to the effect of registration of securities and any tradable commodities that can be registered.

These problems can only be addressed through legislation.

Also, without the technical amendments to the definitions of securities and futures contracts to clarify the legal treatment of emissions units, there is a risk of confusion as to how emissions unit products fit within New Zealand’s capital market’s regulatory framework. This confusion may result in inefficient transaction costs for potential participants in emissions unit trading activities, and a reluctance by overseas participants to trade on the New Zealand markets.

In light of the above, we do not think that maintaining the status quo is a satisfactory option.

General review

A general review of clearing and settlement law in New Zealand would potentially affect a number of sectors and stakeholders in the New Zealand economy (for example, the Reserve Bank and other banking sector participants, the electricity sector and other securities markets operators). Given the breadth and complexity of the subject matter of a general review, it is likely that a general review, including preparation and consultation with stakeholders on a policy discussion document and proposing and advancing legislation, would take some time.

NZX plan to launch their emissions trading platform in mid 2008 (expected May 2008) and would prefer to have the necessary legislative amendments in place by then (or alternatively at least progressing through parliament so that it can be passed before the end of the current parliamentary term), in order to provide their platform with the international credibility that comes with the regulation of trading functions. Officials expect legislation to be drafted by the end of 2007 for introduction to Parliament in February 2008.

A general review of the law would result in the loss of the opportunity to establish in New Zealand a regional emissions unit market as other likely alternative jurisdictions in the region already have legal and regulatory infrastructure for clearing and settlement systems that meet international best practice standards. Accordingly, undertaking a general review is not a preferred option within the timeframe identified for establishing a emissions unit market.

PREFERRED OPTION

The preferred option is legislative amendments that:

- rationalise the regulatory framework for securities and futures exchanges to provide for simpler administration of the regime.
- Establishes an opt-in regime under the Securities Markets Act for clearing and settlement systems which will better conform with IOSCO recommendations, to give the platform international credibility and thus make it more attractive to potential international participants.
- Make technical amendments in response to the emergence of emissions units in New Zealand (both NZ ETS units and non-NZ ETS units), and the way they fit into New Zealand's current regulatory environment.

The advantages of an opt-in approach is that it would:

- Only apply to those clearing and settlement systems that apply for regulation under the new legislation, and accordingly would not apply to clearing and settlement systems regulated under existing legislation (such as the Reserve Bank's "ESAS" system for settlement of financial payments, which is regulated under Part 5C of the Reserve Bank of New Zealand Act);
- Be consistent with current New Zealand law on clearing and settlement, being the opt-in mechanisms under the Companies Act and Reserve Bank of New Zealand Act (except that the proposed pilot scheme would enable a clearing and settlement system to be established in New Zealand that meets international standards as set by IOSCO);
- Facilitate the establishment of a regional emissions unit market in New Zealand that meets international best practice in relation to the clearing and settlement systems through which the market operates, providing one of the key infrastructural requirements necessary to enable the establishment of a regional emissions unit market;
- Avoid the risks of any unintended consequences on other stakeholders in the securities and financial sector, until such time as the impact of more general law reform is fully assessed through a consultation process with stakeholders; and
- Assist in identifying issues for subsequent consideration in a general review of clearing settlement law in New Zealand.

It is also proposed that the application procedures for a registered exchange and an authorised futures exchange be rationalised. This would have the following benefits:

- The powers of the regulator to approve and monitor both securities markets and futures markets would be brought together under one part of the Securities Markets Act;
- It is easier to explain the structure of the market operator regulatory regime to prospective overseas participants in the markets, particularly the futures markets, as NZX seeks to launch a regional emissions market for both spot and futures trading of emissions; and

- Rationalisation brings administrative simplicity for market operators and market participants, and the regulator, in a framework that provides a more principled structure for regulation and better reflects overseas practice.

As the proposed regulatory regime for clearing and settlement is an “opt-in” form of regulation, only those clearing and settlement systems that apply and are registered under the new regime would directly incur the costs of compliance with the new regulatory regime.

NZX, who has indicated that they would “opt-in” to the proposed regulatory regime for clearing and settlement and apply for registration as a registered clearing and settlement system, estimate the cost to NZX of complying with the new regulatory regime would be marginal. While NZX will incur costs in terms of new IT and other systems (including preparation and approval of operating rules) for the new clearing and settlement system, such costs periodically arise for securities markets as systems are updated or adapted as part of normal business procedures. Investment decisions by NZX in IT and other systems will however need to reflect the legal and regulatory regime in which the proposed new system will operate.

It is anticipated that there will also be short term compliance costs incurred by clearing participants who directly interface with the clearing and settlement system, in the form of learning costs of adapting to the new clearing and settlement infrastructure and operating rules. Again, these are costs that market participants will incur in any event whenever conduct rules are amended from time to time or market infrastructure evolves.

NZX has stated that, in the medium to long-term, an international best practice clearing and settlement system will likely result in overall relative cost benefits for participants due to:

- lower “use of money” costs that would otherwise be incurred by clearing participants due to the capital adequacy requirements of current NZX rules, but which will not arise due to the operation of “central counterparty” clearing house that will itself manage (and more efficiently manage) the financial risk of default; and
- increased revenue from increased trading activity.

Additionally, rationalising the existing duplicative application procedures (and associated costs) for securities exchanges under Part 2B of the Securities Markets Act Parts 2B and for futures exchanges and dealers under Part III of the Securities Markets Act will lead to lower compliance costs for both exchanges and market participants.

The Securities Commission already conducts monitoring of securities exchanges, and has an existing regulatory role in relation to futures exchanges and futures dealers. Given this, the additional costs to the Securities Commission of performing its statutory functions as regulator under the proposals outlined in this paper are expected to be minimal and can be met from the Securities Commission’s existing funding.

Similarly, as the Reserve Bank has an existing oversight role in relation to New Zealand’s financial system under the Reserve Bank of New Zealand Act 1989, the additional costs to the Reserve Bank under the proposals outlined in this paper are also expected to be minimal.

The preferred option will achieve a timely legislative response to the current opportunities New Zealand has to establish a regional emissions unit market, without impacting on other stakeholders in the New Zealand economy, as well as operate as a pilot to a subsequent general law review. Any costs outlined above also need to be balanced against the potential cost to New Zealand if the opportunity to establish a regional emissions unit market in New Zealand is lost. These costs are difficult to assess.

IMPLEMENTATION AND REVIEW

The proposal is for appropriate amendments to be made to the Securities Markets Act 1988, the Personal Properties Securities Act 1999, the Securities Act 1978 and the Securities Transfer Act 1991 (along with other minor consequential amendments).

The proposal will come into effect shortly after passage of the necessary legislation. As the proposal is an opt-in regime, no transition period is necessary, although there will be a lead in time for development of operating rules, approval processes, etc before a regulated clearing and settlement system can become operational.

CONSULTATION

The following agencies have been consulted and agree with the recommendations in this paper: Securities Commission, Reserve Bank, Treasury (Emissions Trading Group).

NZX has also been consulted during the preparation of this paper.