

The Chair
CABINET

**SETTLEMENT SYSTEMS, FUTURES, AND EMISSIONS UNITS BILL: APPROVAL
FOR INTRODUCTION AND PARALLEL POLICY PROCESS**

PROPOSAL

- 1 This paper seeks Cabinet's approval to introduce the Settlement Systems, Futures, and Emissions Units Bill (the Bill) to Parliament. This paper also seeks the Committee's agreement to consult on a New Zealand approach to clearing and settlement while the Bill progresses through the Parliamentary process.

EXECUTIVE SUMMARY

- 2 At the end of 2007, Cabinet invited the Minister of Commerce to issue drafting instructions to the Parliamentary Counsel Office to give effect to Cabinet decisions in relation to clearing and settlement systems, securities and futures exchanges, and various other technical amendments relating to emissions units (CBC Min (07) 22/11 and CAB Min (07) 44/4B).
- 3 Following initial engagement with NZX in 2007, the government undertook targeted consultation with a wider group of stakeholders. A discussion document was released for public consultation in February 2008, in conjunction with an exposure draft Emissions Units, Settlement Systems, and Futures Bill.
- 4 The Settlement Systems, Futures, and Emissions Units Bill is intended to signal that trades in securities and other products can be cleared and settled through systems that meet the expectations of international and domestic participants. The Bill provides settlement systems operating in New Zealand with the option of applying for designation and being regulated to relevant international standards. In return, a designated settlement system receives additional legal protections to support the integrity of the system in the case of a participant's insolvency or default.
- 5 The Settlement Systems, Futures, and Emissions Units Bill also reduces compliance costs by amending the Securities Markets Act to align the regulation of exchanges seeking to operate in both the securities and futures markets, and by enacting that a person approved by the operator of an authorised futures exchange is an authorised futures dealer. NZX is expected to benefit from these amendments through a reduction in compliance costs.

- 6 The Settlement Systems, Futures, and Emissions Units Bill clarifies the regulatory treatment of emissions units to support the development of the market for emissions units. The Bill gives effect to this policy through a number of technical amendments to existing legislation. There is nothing in the Bill that is necessary for the operation of the New Zealand Emissions Trading Scheme.
- 7 Settlement systems contribute to a well functioning capital market, capital market development, and world class infrastructure objectives. Consultation on an exposure draft of the Emissions Units, Settlement Systems, and Futures Bill revealed significant concerns about the provision of settlement services and how these systems are expected to develop in future. These concerns warrant further analysis of our settlement services in terms of competition, structure, ownership, and governance of our settlement services.
- 8 I therefore announced that I intend to undertake further consultation on wider questions concerning New Zealand's settlement system infrastructure, while the Settlement Systems, Futures, and Emissions Units Bill is progressed through Parliament. This paper outlines some of the questions that I intend to consider in the course of that review, as part of a New Zealand approach to clearing and settlement.

BACKGROUND

- 9 The New Zealand Exchange Limited (NZX) is seeking to upgrade its existing clearing and settlement system and expand its exchange traded products to include futures and emissions units (through its subsidiary TZ1). NZX asserts that it requires several amendments to existing financial market legislation to support these services. In 2007, NZX requested that the government provide legislation relating to designated settlement systems, registered securities and authorised futures exchanges, and the legal treatment of emissions units.

POLICY

- 10 At the end of 2007, Cabinet invited the Minister of Commerce to issue drafting instructions to the Parliamentary Counsel Office, to give effect to Cabinet decisions in relation to clearing and settlement systems, securities and futures exchanges, and various other technical amendments relating to emissions units (CBC Min (07) 22/11 and CAB Min (07) 44/4B).

Settlement Systems

- 11 Settlement systems are used to give effect to transactions in our financial markets. Once the parties to a transaction have agreed to buy or sell an asset, a settlement system can be used to effect and complete the transfer of ownership of that asset. The asset could be a financial instrument (e.g. securities), but there are also systems that settle commodity products (e.g. oil). A payment system (such as a system for settling foreign currency) settles transfers of funds between parties, and can stand alone or form part of a settlement system.

- 12 Designation of a settlement system gives statutory backing to the system's rules, to support finality of settlement and the effectiveness of netting arrangements, by providing that certain aspects of the operating rules of a designated settlement system are valid and enforceable despite any law or agreement to the contrary. That in turn gives a designated settlement system protection against claims that might otherwise be made by the liquidator of a failed participant.
- 13 The design of some systems relies on participants to supply collateral to back their obligations. In this case, in the event of a default, a designated settlement system will receive primacy of interest (or "super-priority") in collateral posted as margin by the participant, through an amendment to the Personal Property Securities Act.
- 14 Designation confers certain benefits, therefore to become designated and maintain that status, the operating rules of a settlement system are required to meet certain standards. To receive designation under the Settlement Systems, Futures, and Emissions Units Bill, a settlement system must have its rules approved by the joint-regulators (the Reserve Bank of New Zealand and the Securities Commission) according to criteria that can include relevant international standards. If the designated settlement system subsequently seeks to amend its operating rules, the joint-regulators have the power to disallow the rule change e.g. where the rule would no longer have met the designation criteria.
- 15 The designated settlement system is subject to the ongoing oversight of the joint-regulators. The joint regulators also have the power to recommend that the conditions of a designation be varied, including by adding a condition requiring a change to the rules of the settlement system. Such a variation is made by the Governor-General, by Order in Council, on the advice of Ministers given in accordance with a joint recommendation by the joint regulators. The legislation sets out the purposes for which such powers must be exercised and the matters that may be taken into account by the joint regulators in making such a recommendation. These purposes and the matters that may be taken into account set out the detail of what constitutes the public interest in this context, noting that the Cabinet decision limited the joint-regulators' ability to require rule changes to situations where a change was "in the public interest" (CAB Min (07) 44/4b).
- 16 At present, New Zealand's legislation provides for the designation of payment systems under part 5C of the Reserve Bank of New Zealand Act 1989. Settlement systems could also be designated under this provision, but designation may only provide the protection of irrevocability to the payment component of the transaction, and not to settlement of the property component of the transaction i.e. if the payment was made in consideration for a transfer of title to property, the transfer of title may not be protected under existing legislation. Under the Settlement Systems, Futures, and Emissions Units Bill, the designation regime in part 5C will be extended to systems that clear and settle products as well as payments.

- 17 Although NZX currently operates a settlement system without designation, NZX asserts that the upgraded settlement system they are developing needs to be designated in order to meet the expectations of international and domestic participants when NZX extends its exchange to emissions units and futures products. NZX also advises that they will not be able to operate a central counterparty without designation, because they will have difficulty accessing the necessary synthetic capital required to support this model of settlement.
- 18 International standards can be met without designation. Designation merely provides an official stamp of approval for a settlement system. There are no obvious international concerns about the overall payment and settlement system in New Zealand, primarily because our central bank operates the core infrastructure and the dominant settlement system. This is evidenced by the International Monetary Fund's positive financial sector assessment of New Zealand and by the very high level of penetration of New Zealand's debt and equity markets by overseas investors compared to most other countries. However, NZX's settlement system is not operated by New Zealand's central bank. Without an explicit regulator of settlement systems in New Zealand, it could be difficult for a private operator to convince participants that a settlement system meets international standards.

Futures Exchanges

- 19 The Australian Securities Exchange (ASX) is the current market operator of futures and options trading and clearing services for the New Zealand market. These products are currently traded through the Sydney Futures Exchange and centrally cleared through SFE Clearing Corporation Pty Ltd. NZX currently has an agreement with ASX regarding derivative products on NZX traded securities. NZX has recently announced its intention to enter the futures market independently.
- 20 Registered securities exchanges and authorised futures exchanges are regulated slightly differently from each other under existing legislation. NZX currently operates a registered securities exchange and is seeking to develop its business by using its exchange to trade futures products. NZX has asked for the regulation of futures and securities exchanges to be aligned in the situation where an exchange is seeking to perform both functions, in order to reduce their compliance costs.
- 21 The Settlement Systems, Futures, and Emissions Units Bill aligns the regulatory environment for exchanges seeking to operate in both securities and futures markets by amending the Securities Markets Act 1988 so that an exchange registered under Part 2B of the Securities Markets Act may be registered either with respect to securities markets only or with respect to both securities markets and futures markets. This amendment does not affect the ability of an exchange to be authorised for futures trading only under Part III of the Securities Markets Act.
- 22 Part 2B of the Securities Markets Act provides a more prescriptive regulatory approval process than Part III and is therefore the most appropriate to apply to

exchanges seeking to perform functions in both the securities and futures markets. An exchange registered for operating securities markets and futures markets under Part 2B, and whose conduct rules for futures markets have effect under Part 2B, will be deemed to be an authorised futures exchange under Part III of the Securities Markets Act. The Settlement Systems, Futures, and Emissions Units Bill also extends the exemption power in s36E of the Securities Markets Act to include futures markets under Part 2B.

- 23 New Zealand legislation currently only provides for the Securities Commission to authorise futures dealers, although there are class authorisations for the Sydney Futures Exchange under the Authorised Futures Dealers Notice (No 2) 2004 and for the NZX under the Authorised Futures Dealers Notice (No 3) 2004. The effect of these class authorisations is that person's approved by the Sydney Futures Exchange or NZX are authorised futures dealers. NZX is seeking to provide futures products on its exchange and has requested that the existing class authorisations be given the authority of legislation.
- 24 The Settlement Systems, Futures, and Emissions Units Bill provides that market participants who have been approved by an authorised futures exchange under its operating rules shall be deemed to be authorised to deal in futures contracts under section 38 of the Securities Markets Act. This does not affect the ability of the Securities Commission to authorise futures dealers independently, but codifies the existing class authorisation granted by the Securities Commission for the Sydney Futures Exchange under the Authorised Futures Dealers Notice (No. 2) 2004 and for the NZX under the Authorised Futures Dealers Notice (No. 3) 2004. Giving effect to these class authorisations in legislation makes it clear that there is consistent regulatory environment for any authorised futures exchange in this regard.

Technical Amendments

- 25 Emissions units are a relatively new product in our markets. NZX asserts that in order to trade emissions units and emissions units futures products on an exchange, and to clear and settle those transactions adequately, the treatment of emissions units under our securities legislation needs to be clarified. However, the Australian Securities Exchange submitted that there is nothing within the existing regulatory framework to prohibit or restrict firms in New Zealand or elsewhere from providing over the counter and exchange infrastructure to support the New Zealand Emissions Trading Scheme.
- 26 The New Zealand government is committed to taking action on climate change. This commitment goes further than the Kyoto Protocol and the New Zealand Emissions Trading Scheme in that the government regards the voluntary carbon market as complementary to the regulated market, useful for meeting consumer demand for action on climate change, and a valuable testing ground for new emissions reduction measures.
- 27 The Settlement Systems, Futures, and Emissions Units Bill therefore goes beyond what is simply necessary for the trading of emission units under the New Zealand Emissions Trading Scheme. The policy objective is to clarify the regulatory treatment of emissions units to support the development of the

market for emissions units. This applies to both units issued under binding regulations, such as the New Zealand Emissions Trading Scheme, and units issued in the voluntary market.

28 Cabinet has agreed to technical amendments to clarify the regulatory treatment of emissions units (CBC Min (07) 22/11). It is important to note that none of these technical amendments are necessary for the operation of the New Zealand Emissions Trading Scheme. On 15 October 2007, Cabinet agreed:

- 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 (CBC Min (07) 22/11). As such, Cabinet's decisions should apply equally to emissions units issued under a binding emissions trading scheme, such as the Kyoto Protocol or the proposed New Zealand Emissions Trading Scheme, or by voluntary emissions units providers;
- to provide that an emissions unit is not a security (CBC Min (07) 22/11). This is given effect by amending the Securities Act 1978 to ensure that the issuance of emissions units will not need to meet the requirements of the regulatory regime for offers of securities, or the relevant provisions of the Securities Markets Act unless they are part of an investment scheme;
- to extend the priority provided by section 97 of the Personal Property Securities Act in respect of shares and other securities to emissions units (CBC Min (07) 22/11). Under the Personal Property Securities Act, emissions units will be defined as investment securities. Without this amendment, the benefits of anonymous exchange trading would be lost since a purchaser would need to check the Personal Property Securities Register to ascertain whether anyone else had a registered security interest over the specific emissions units they were seeking to purchase. NZX maintains that it is not possible to trade emissions units on an exchange without this amendment;
- to make clear that "futures contract" extends to a futures contract for emissions units (CBC Min (07) 22/11). This decision is given effect by amending the Securities Markets Act 1988 to include emissions units in the definition of commodity, providing certainty that futures contracts in emissions units are regulated by the Securities Markets Act.
- to provide that registration of an emissions unit on a register is prima facie evidence of title (CBC Min (07) 22/11) i.e. registration is evidence of title to an emissions unit unless evidence is produced to the contrary. During consultation, submitters criticised this technical amendment. Submitters suggested that the government should either regulate the quality of voluntary emissions unit registers, which are recognised by this provision, or that it should restrict the technical amendments to units issued by the government on its emissions unit register.

The legislation that establishes the government register for emissions units already provides that entry on the government register is prima facie evidence of title. Unfortunately, it is not currently possible to provide an acceptable definition for 'register of emissions units' in the voluntary carbon market because the market is still developing and consistent standards and practices have not yet evolved. NZX considered that they would be able to operate without this technical amendment. I therefore recommend that this technical amendment should not be given effect through the Settlement Systems, Futures, and Emissions Units Bill, and that the Cabinet decision should be rescinded.

- to confirm the ability to register an electronic transfer of securities and emissions units traded through a registered clearing and settlement system. (CBC Min (07) 22/11). When finalising this technical amendments for introduction, it became apparent that this provision was applied too narrowly to securities and emissions units, since designation is equally available to any settlement system for any products. Rather than limit the amendments to those products that NZX is seeking to clear and settle, I recommend that this provision be extended to cover any product transferred through a designated settlement system.

New Zealand's Approach to Clearing and Settlement

- 29 Settlement systems contribute to a well functioning capital market, capital market development, and world class infrastructure objectives. The inter-agency Financial Markets Saving and Investment work programme has also identified efficient clearing and settlement infrastructure as a necessary element for a well performing financial system in the medium to long term. To date there has not been a coordinated review of the settlement system infrastructure that underpins New Zealand's financial system.
- 30 Consultation on an exposure draft Emissions Units, Settlement Systems, and Futures Bill revealed significant concerns about the provision of settlement services and how these systems are expected to develop in future. These concerns warrant further analysis of our settlement services in terms of competition, structure, ownership, and governance of our settlement services. It is important to consider the perspectives of all stakeholders, both onshore and offshore, and their expectations of further government consultation on these issues.
- 31 There are currently two domestic providers of securities settlement services in New Zealand and one designated payment system. The Reserve Bank's "Austraclear" settlement system processes an average total value of daily transactions of NZ\$6 billion compared to NZX's "Faster" settlement system which processes approximately NZ\$115 million. The New Zealand Central Securities Depository, which is part of Austraclear, holds about NZ\$92.5 billion of securities. CLS Bank International, based in New York, is a designated payment system and settles foreign exchange transactions including New Zealand dollars at a gross daily average of NZ\$67 billion. The diagram in the **appendix** shows the current configuration of systems and where they fit within New Zealand's financial market infrastructure.

- 32 The Reserve Bank of New Zealand became the default provider of security settlement services in a New Zealand market that could not reach consensus on a service owned and operated by participants. To date, the dominance of Austraclear in the market has not been a concern because it is government owned and operated. Government ownership has also inspired confidence in the stability and financial backing of the system. The downside of government ownership is that Austraclear might not provide the competitive pressures on other service providers that a privately owned system might.
- 33 Each securities settlement system primarily services a particular market segment or product, although there is overlap between them. The Austraclear system primarily services the over the counter market and is also the conduit for a significant proportion of trades originating from NZX. NZX primarily services users of its exchange. Each system requires reinvestment from time to time, a decision made by the system provider, typically based on user and technological resiliency requirements. Austraclear's development is informed by its industry users' group and Austraclear's services were upgraded in the last few years. NZX has also recently decided to upgrade its services. It is expected that both the Reserve Bank of New Zealand and NZX will seek designation for their systems following the passage of the Settlement Systems, Futures, and Emissions Units Bill.
- 34 Consultation with the finance sector on legislation to provide for the designation of settlement systems revealed concerns about the implications of NZX's upgraded services for the rest of the market, given the perceived potential for NZX to attain a more dominant position in the provision of clearing and settlement services through aggressive expansion of its services and direct competition with existing service providers. Some members of the financial sector have expressed dissatisfaction with NZX's consultation over the upgrade in its settlement services and the costs involved for them in complying with this upgrade. Others have said that the model of settlement and clearing proposed by NZX is not well suited to certain exchange participants. In addition, one submitter expressed concern about NZX's vertically integrated position as provider of trading, clearing, settlement and some registry services and encouraged the government to examine the costs and benefits of NZX's decision to move away from real time gross settlement of transactions.
- 35 NZX is developing a clearing and settlement system with a central counterparty. This model of clearing and settlement is well suited to managing the risks of a party to a transaction defaulting on their obligations in a futures market or on an exchange where the parties to a transaction are anonymous. The default risk is managed in over the counter transactions because the contracting parties are known to each other and any risk can be priced into the transaction. Officials understand that some participants in the exchange perceive settlement risk for New Zealand exchange transactions can currently be effectively managed without a central counterparty due to the limited number of exchange participants. Based on the limited information available, it appears that potential clearing participants in NZX's upgraded clearing and settlement system expect to spend approximately \$0.5-\$1 million to upgrade their interface with NZX. In addition, these parties will need to provide capital

backing for their participation with NZX's central counterparty. A rough estimate of the capital required is in the range of \$1-\$5 million.

- 36 Competition authorities in other jurisdictions have been concerned by a potential or actual concentration of market power in the provision of settlement services. There are a number of possible market configurations; including a regulated vertical monopoly provider of financial services, competing and complementary settlement systems, or the separation of settlement and trading system providers. There are advantages and disadvantages to each approach. In New Zealand's case, there may be benefit in sourcing settlement services offshore. From a policy point of view, the key element is whether participants have reasonable access to services, not necessarily who provides them.
- 37 I therefore announced my intention to undertake consultation on New Zealand's approach to clearing and settlement, following introduction of the Settlement Systems, Futures, and Emissions Units Bill and in parallel to the passage of the Bill through Parliament. This approach requires substantive analysis of New Zealand's financial infrastructure needs and consultation with market participants.
- 38 The objective of the review will be to undertake analysis and consultation to inform recommendations for New Zealand's clearing and settlement infrastructure with regard to the following criteria: at a minimum, New Zealand's clearing and settlement system infrastructure should deliver reliable clearing and settlement services to the financial sector at a reasonable cost; New Zealand's infrastructure should be responsive to the demands of users of clearing and settlement services and, as appropriate, the structure should address any public interest concerns; and finally, New Zealand's clearing and settlement infrastructure should support innovation of products and services in the financial sector.
- 39 Examples of the types of questions that the review of settlement and clearing services should consider include:

Scope

- a. Which systems and which transactions are within the scope of the review e.g. over the counter transaction derivatives settlement systems?
- b. How do clearing and settlement systems fit within New Zealand's financial system e.g. which transactions and products require clearing and settlement services?

Background

- c. To what degree does our existing settlement systems infrastructure meet our policy objectives and relevant international standards?
- d. What are the characteristics of the existing market e.g. to what extent are there economies of scale/scope or network effects and are there any barriers to entry?

Competition

- e. Are there potential barriers to competition - for example, does the settlement system infrastructure in New Zealand exhibit the characteristics of a network?
- f. What are the merits of a monopoly structure to exploit any economies of scale and scope within the system and to ensure efficient service delivery?
- g. To what degree can competition be provided by offshore service providers and what is the ability of offshore providers to meet demand for services in New Zealand

Ownership

- h. What is the nature of ownership and governance that will ensure that users needs are considered and that the system is stable (reliable)?
- i. Does New Zealand ownership of clearing and settlement matter in terms of financial system development?

Innovation

- j. Are there any barriers to innovation in the provision of clearing and settlement systems?
- k. What clearing and settlement structure will support innovation in other parts of the financial system?

Policy responses

- l. What are other countries' approaches to the provision of clearing and settlement services and to what extent are these applicable to New Zealand?
 - m. Is regulation needed to ensure that any public interest concerns are addressed, including whether there should be some sort of regulatory oversight of pricing and other significant decision making by settlement systems?
- 40 Members of the financial sector have already exhibited a great deal of enthusiasm to become involved as a result of my announcement that the government would undertake further consultation on the structure of clearing and settlement in New Zealand. It is therefore recommended that the scope and content of the review should be signalled early to financial sector participants by releasing this Cabinet paper and a press statement announcing Cabinet's agreement to this approach.
- 41 However, it should be noted that in the past, members of New Zealand's financial sector have found it difficult to agree upon an industry-led approach to clearing and settlement (for example, the industry initiated review in 2004). While there are some historical tensions in this area, we should seek to draw on the goodwill of those industry organisations who have already expressed an interest in contributing to this process.
- 42 The Ministry of Economic Development is already working closely with Treasury, the Reserve Bank of New Zealand, and the Securities Commission. Officials also expect to consult with international experts and officials from

other jurisdictions. For example, officials have already spoken with a representative of the Reserve Bank of Australia, on secondment from the Bank of England, to discuss their recent “Review of Settlement Practices for Australian Equities”.

- 43 The programme of work on New Zealand’s clearing and settlement infrastructure is scheduled to take place following the introduction of the Settlement Systems, Futures, and Emissions Units Bill into Parliament; to be completed while the Bill progresses through Parliamentary processes and before the amendments pass into statute. It is estimated that this process will take up to nine months from introduction, taking into account the 2008 general election and full select committee process for the Settlement Systems, Futures, and Emissions Units Bill itself. It is therefore recommended that I report back to Cabinet in March 2009 with recommendations arising from a policy review of New Zealand’s approach to clearing and settlement. It is not yet clear whether this process will result in any recommendations for the Settlement Systems Bill.
- 44 The timetable for the parallel policy process poses no risks for New Zealand’s financial system. However, NZX might be concerned because they have spent \$5-\$7million¹ on the new system they are developing before the government had considered the policy proposals and give final approvals for changes to the regulatory environment for settlement systems.
- 45 At the end of 2007 Cabinet directed 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 (POL (07) 382). This review is no longer relevant in the context of a broader policy review of New Zealand’s approach to clearing and settlement.

CONSULTATION

- 46 The Ministry of Economic Development consulted closely with the Securities Commission, the Reserve Bank of New Zealand, and the Treasury in the preparation of the Settlement Systems, Futures, and Emissions Units Bill as part of an inter-agency working group. The Department of the Prime Minister and Cabinet, the Ministry of Agriculture and Forestry, the Ministry for the Environment, and the Emissions Trading Group have also been consulted.
- 47 Following initial engagement with NZX in 2007, the government undertook targeted consultation with a wider group of stakeholders in the preparation of a discussion document which was released in February 2008, with an exposure draft of the proposed legislative amendments. The Ministry of Economic Development received 19 submissions on the exposure draft Emissions Units, Settlement Systems, and Futures Bill. The most significant submissions are summarised below with the government’s responses.

¹ “NZX to milk futures” The Dominion Post, 11 June 2008

- i Submitters were generally critical of the consultation and policy development process, requesting more time to make comments, wider consultation, workshops and additional consultation documents. A significant proportion of submitters expressed concern that legislation was drafted solely to further NZX's commercial interests. The government has since individually met with a number of submitters to hear their concerns and will conduct further consultation as part of a New Zealand approach to clearing and settlement.
- ii Several submitters were concerned that the implications for New Zealand's financial market infrastructure should be further examined given the public utility nature of clearing and settlement systems. These implications will be examined in parallel to the passage of the legislation as part of a New Zealand approach to clearing and settlement.
- iii At least one submitter suggested that the proposed joint-regulator model would be difficult to make operational, suggesting that a single or primary regulator is more suitable. Officials are confident that the joint-regulator model is the best model for recognising both the Reserve Bank of New Zealand and the Securities Commission's interests in the regulation of settlement systems and the joint-regulators are preparing a memorandum of understanding to govern their roles. Cabinet agreed to the preparation of a memorandum of understanding (CAB Min (07) 44/4b) and this is currently under development, although it is not an explicit requirement in the Settlement Systems, Futures, and Emissions Units Bill and Cabinet does not have authority to direct independent agencies.
- iv At least one submitter requested a process for managing potential conflicts of interest within the Reserve Bank of New Zealand, given its roles as industry regulator and operator of Austraclear. Institutional arrangements are in place to ensure a high degree of independence between the Reserve Bank's operations and policy functions. The joint regulator model also addresses potential conflict of interest relating to the Reserve Bank being the operator of Austraclear NZ.
- v A couple of submitters were critical of the requirement to seek the regulator's approval for every "critical rule" change that is material to the designation order. This process has been amended to assume that any rule change is valid unless challenged and disallowed by the regulators within a specified period before the rule comes into effect.
- vi One submitter requested that the regulation of designated payment systems be delineated from designated settlement systems. The proposed legislation has been amended to reflect that the Securities Commission has a limited interest in systems that solely settle payments, in recognition of the status quo for payment systems under part 5C of the Reserve Bank Act.
- vii Several submitters suggested that the approval criteria for a designated settlement system should explicitly include adequacy of financial resources and adequacy of the system's arrangements in the event of a default by

the central clearing party. These criteria are implicit in the more general criteria outlined in the Settlement legislation.

- viii A couple of submitters suggested that improvements could be made to provisions on collateral, priority, and the Personal Property Securities Act. Where possible, these provisions have been refined, but general submissions on the Personal Property Securities Act are outside the scope of this policy process.
- ix Several submitters were concerned that the proposed amendment relating to the authorisation of futures dealers removed the ability of the Securities Commission to authorise futures dealers independently. This is not the case; the proposed amendments simply codify the status quo in legislation.
- x Many submitters were confused by the bundling of emissions trading issues with generic financial market reform, and felt this was a barrier to understanding the legislative amendments. Officials have therefore been careful to delineate the discrete policy issues for emissions units and settlement systems in their advice. Officials also see merit in separating the technical amendments relating to emissions units into a standalone bill, although not at the expense of the increased administration required to introduce and process two separate bills.
- xi Several submitters suggested that government should either regulate the quality of voluntary emissions unit registers, which are recognised by the Settlement Systems, Futures, and Emissions Units Bill, or that it should restrict the Bill to the compliance market. The government has taken the view that voluntary carbon markets are complementary to regulated markets. As such, the technical amendments have not been restricted to the compliance market. However, the technical amendment providing that entry on an emissions unit register is prima facie evidence to title has been removed, removing the need to define which registers (and which voluntary emissions units) are recognised by the Settlement Systems, Futures, and Emissions Units Bill.
- xii At least one submitter was concerned that the government was willing to clarify how the futures regime applies to emissions units but not other products; and others submitted that the proposed changes failed to distinguish between futures and physical forward contracts. Officials are satisfied that the technical amendments do not confuse futures and physical forward contracts. The futures regime for other products falls outside the scope of the policy objective for these technical amendments.
- xiii One submitter requested that the definition of emissions units be extended to include other environmental products such as wetlands credits. This issue is expected to be raised at select committee. The Ministry of Agriculture and Forestry also asked whether there was potential to address other forms of environmental offsets. For example, in Lake Taupo there is a proposal for trading in nitrogen offsets. This falls outside the scope of the current policy objective.

LEGISLATIVE IMPLICATIONS

- 48 Cabinet's 2007 policy decisions (CBC Min (07) 22/11 and CAB Min (07) 44/4b) were initially developed into the consultation draft Emissions Units, Settlement Systems, and Futures Bill, which was prioritised as category two in the legislative programme i.e. must be passed in 2008 (CAB Min (08) 6/3A).
- 49 Consultation on a draft Emissions Units, Settlement Systems, and Futures Bill revealed that the majority of stakeholders were critical of the consultation and policy development process, requesting more time to make comments, wider consultation, workshops and additional consultation documents. A significant proportion of submitters expressed concern that legislation was drafted solely to further NZX's commercial interests.
- 50 It is not realistic to enact the Settlement Systems, Futures, and Emissions Units Bill in 2008 without compromising the select committee process, the quality of resulting legislation, and the opportunity for input from affected industry participants. This paper therefore seeks agreement to prioritise the Settlement Systems, Futures, and Emissions Units Bill as category four in the legislative programme: to proceed to a select committee in 2008.
- 51 NZX's upgraded settlement system is still under development. In a recent meeting with Ministers NZX's CEO said that the new system may not be operational until April 2009. Once the Settlement Systems, Futures, and Emissions Units Bill is enacted, NZX will still need to undergo a designation application and approval process with the joint-regulators, although NZX intends to submit some of the necessary application documentation in advance. While NZX currently operates a settlement system without designation, NZX advises that they will not be able to operate a central counter party without designation because they will have difficulty accessing the necessary synthetic capital required to support this model of settlement.
- 52 The Settlement Systems, Futures, and Emissions Units Bill provides a number of technical amendments to existing legislation. There is nothing in the Bill that is necessary for the operation of the New Zealand Emissions Trading Scheme. However, in Part I of the Settlement Systems, Futures, and Emissions Units Bill, some of the proposed amendments to the Personal Property Securities Act 1999 are already contained in similar, but not identical, form in clause 65 of the Climate Change (Emissions Trading and Renewable Preference) Bill (as reported back to the House by the Finance and Expenditure Committee in June 2008). This part may therefore require amendment in the future in order to reflect the ultimate wording of the related clauses of the Climate Change (Emissions Trading and Renewable Preference) Bill.

FISCAL IMPLICATIONS

- 53 The Settlement Systems, Futures, and Emissions Units Bill creates additional functions for the Reserve Bank of New Zealand and the Securities Commission with respect to designated settlement systems. These functions

complement existing functions and should largely be absorbed within the agencies' existing baselines (noting also that the Bill provides for the Reserve Bank and the Securities Commission to charge fees for applications and variations under Part 5C of the Reserve Bank Act). The Settlement Systems, Futures, and Emissions Units Bill also expressly allows each joint regulator to have regard to work produced by the other to ensure that cross-agency synergies can be effectively captured.

REGULATORY IMPACT ANALYSIS

54 The Ministry of Economic Development has complied with the Code of Good Regulatory Practice and the Regulatory Impact Analysis requirements, including the consultation requirements. The Ministry of Economic Development considers the Regulatory Impact Statement and the Regulatory Impact Analysis undertaken to be adequate. The Ministry of Economic Development prepared a Regulatory Impact Statement and circulated a draft for departmental consultation.

PRINCIPLES OF THE TREATY OF WAITANGI

55 The Settlement Systems, Futures, and Emissions Units Bill is not inconsistent with the principles of the Treaty of Waitangi.

THE PRIVACY ACT 1993

56 The Settlement Systems, Futures, and Emissions Units Bill is not inconsistent with the principles and guidelines set out in the Privacy Act 1993.

RELEVANT INTERNATIONAL STANDARDS AND OBLIGATIONS

57 Under the Settlement Systems, Futures, and Emissions Units Bill the joint-regulators may have regard to relevant international standards when considering an application for designation. The Bill is not inconsistent with relevant international standards and obligations such as the Kyoto Protocol.

LAC GUIDELINES

58 The Settlement Systems, Futures, and Emissions Units Bill is not inconsistent with the Legislation Advisory Committees Guidelines on Process and Content of Legislation.

HUMAN RIGHTS

59 The Ministry of Justice has identified that the Settlement Systems, Futures, and Emissions Units Bill raises potential issues under sections 21 and 25(c) of the Bill of Rights Act 1990, but that those issues may be justified and the Bill is not inconsistent with the Bill of Rights Act 1993.

PUBLICITY

60 It is recommended that this Cabinet paper be released on the Ministry of Economic Development's website. It is also recommended that the Minister of

Commerce make a press statement when the Settlement Systems, Futures, and Emissions Units Bill is introduced to Parliament and a press statement to announce the process of engagement with stakeholders in determining a New Zealand approach to clearing and settlement.

DEEMED REGULATIONS

- 61 The Settlement Systems, Futures, and Emissions Units Bill does not contain any provisions empowering the making of deemed regulations.

DEFINITION OF MINISTER

- 62 The Settlement Systems, Futures, and Emissions Units Bill contains a generic definition of Minister of Commerce: "**Minister** means the Minister of the Crown who, under the authority of any warrant or with the authority of the Prime Minister, is for the time being responsible for the administration of the Securities Act 1978". The Cabinet Office was consulted on this definition.

COMMENCEMENT OF LEGISLATION

- 63 The Settlement Systems, Futures, and Emissions Units Bill will come into force on the day after the date of assent.

PARLIAMENTARY STAGES

- 64 The Settlement Systems, Futures, and Emissions Units Bill should be introduced to Parliament once the government has confirmed support for its introduction and should be referred to the Finance and Expenditure Select Committee.

RECOMMENDATIONS

- 65 The Minister of Commerce recommends that Cabinet:

Policy

- 1 **Note** that the prior Cabinet decision confirming the ability to register the electronic transfer of securities and emissions units traded through a registered clearing and settlement system (CBC Min (07) 22/11) applies too narrowly to the products NZX is expected to settlement through their upgraded system.
- 2 **Agree** to extend the prior Cabinet decision confirming the ability to register the electronic transfer of securities and emissions units traded through a registered clearing and settlement system (CBC Min (07) 22/11) to any product cleared and settled through a designated system.
- 3 **Note** that Cabinet's prior decision to clarify definitions to make clear that an emissions unit is not a security (CBC Min (07) 22/11) has been given effect through amendments to both the Securities Act and the Securities

Markets Act to ensure that trades in emissions units will not be inappropriately fettered by those two Acts.

- 4 **Note** that it is not currently possible to define which voluntary emissions unit registers meet standards acceptable to the New Zealand government but that Cabinet previously decided 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 (CBC Min (07) 22/11).
- 5 **Agree** to rescind Cabinet's prior decision to make a technical amendment providing that entry on an emissions unit register is prima facie evidence to title (CBC Min (07) 22/11) in order to avoid either regulating emissions units registers in the voluntary carbon market or restricting legislation to emissions units recognised by the New Zealand Emissions Trading Scheme.

Settlement Systems, Futures, and Emissions Units Bill

- 6 **Note** that Cabinet's prior decisions on settlement systems, futures exchanges, and technical amendments for emissions units (CBC Min (07) 22/11 and CAB Min (07) 44/4b) were initially developed into the consultation draft Emissions Units, Settlement Systems, and Futures Bill, which was prioritised as category two in the legislative programme i.e. must be passed in 2008 (CAB Min (08) 6/3A).
- 7 **Agree** to give the Settlement Systems, Futures, and Emissions Units Bill category four priority in the legislative programme: to proceed to a select committee in 2008, since it is no longer possible to pass the Bill in 2008 without compromising the select committee process.
- 8 **Note** that the Settlement Systems, Futures, and Emissions Units Bill: signals that trades in securities and other products can be cleared and settled in New Zealand through systems that meet the expectations of international and domestic participants; reduces compliance costs by aligning the regulation of exchanges seeking to operate in both the securities and futures markets; and enacts that participants approved by the operator of an authorised futures exchange are authorised futures dealers.
- 9 **Note** that the Settlement Systems, Futures, and Emissions Units Bill makes technical amendments that clarify the regulatory treatment of emissions units to support the trading of emissions units and the development of the market for emissions units.
- 10 **Approve** the introduction of the Settlement Systems, Futures, and Emissions Units Bill to Parliament.
- 11 **Agree** to introduce the Settlement Systems, Futures, and Emissions Units Bill to Parliament following confirmation that there is sufficient support for introduction at caucus.

- 12 **Agree** that to propose that the Settlement Systems, Futures, and Emissions Units Bill be referred to the Finance and Expenditure Select Committee for consideration.

New Zealand's approach to clearing and settlement

- 13 **Direct** the Minister of Commerce to report back to Cabinet in March 2009 on recommendations arising from a policy review of New Zealand's approach to clearing and settlement.
- 14 **Note** that it is unlikely that the policy review of New Zealand's approach to clearing and settlement will result in any recommendations for the Settlement Systems, Futures, and Emissions Units Bill itself.
- 15 **Note** that Cabinet previously directed 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 (POL (07) 382)
- 16 **Agree** that the report back in recommendation eleven is no longer relevant in the context of a broader policy review of New Zealand's approach to clearing and settlement.

Publicity

- 17 **Agree** to release this Cabinet paper on the Ministry of Economic Development's website.
- 18 **Note** that the Minister of Commerce will issue press statement(s) when the Settlement Systems, Futures, and Emissions Units Bill is introduced to Parliament and to announce the process of engagement with stakeholders in determining a New Zealand approach to clearing and settlement.

Hon Lianne Dalziel
Minister of Commerce

Date signed: _____

REGULATORY IMPACT STATEMENT: SETTLEMENT SYSTEMS, FUTURES, AND EMISSIONS UNITS BILL

EXECUTIVE SUMMARY

To provide a signal that trades in securities and other products can be cleared and settled in New Zealand through systems that meet the expectations of international and domestic participants, the preferred option is to extend the current payments system designation regime under Part 5C of the Reserve Bank of New Zealand Act 1989 to settlement systems, make the Securities Commission a joint regulator with the Reserve Bank of New Zealand (the **Reserve Bank**), and make explicit reference to relevant international standards as a matter that the joint regulators may have regard to when designating systems.

The preferred option for futures exchanges is to reduce administration and compliance costs by amending the Securities Markets Act 1988 to align the regulation of exchanges seeking to operate in both the securities and futures markets and codifying that participants approved by the operator of an authorised futures exchange are authorised futures dealers. New Zealand Exchange Limited (**NZX**) expects to benefit from these amendments through a reduction in costs.

Emissions units are a relatively new product in New Zealand's markets NZX asserts that in order to trade emissions units and emissions units futures products on an exchange, and to clear and settle those transactions adequately, the treatment of emissions units under New Zealand legislation needs to be clarified. The objective of the Emissions Units Bill is to clarify the regulatory treatment of emissions units to support the development of the market for emissions units, which is given effect through technical amendments to New Zealand's personal property securities, securities, and securities markets legislation. None of these technical amendments are necessary for the operation of the New Zealand Emissions Trading Scheme.

ADEQUACY STATEMENT

The Ministry of Economic Development considers the regulatory impact statement and the regulatory impact analysis undertaken to be adequate.

STATUS QUO AND PROBLEM

Settlement systems

Part 5C of the Reserve Bank of New Zealand Act 1989 currently provides for the Reserve Bank to designate a settlement system that settles payments. It is also currently possible to designate a settlement system that settles products, but the designation may only provide protection of irrevocability to the settlement of the payment component of a transaction and not to the settlement of the property component of the transaction. Therefore, if the payment was made in consideration for a transfer of title to property such as securities, the transfer of title may not be protected.

Designation lends statutory backing to the settlement of transactions. Designation is approved if the system meets certain criteria and subjects itself to ongoing regulatory oversight. NZX asserts that the upgraded settlement system they are developing needs to be designated in order to meet the expectations of international and domestic participants when NZX extends their exchange to emissions units and futures products.

International standards can be met without designation. However, without an explicit regulator of settlement systems in New Zealand it can be difficult to convince participants that a settlement system meets international standards. Designation provides an official stamp of approval for a settlement system. There are no obvious international concerns about the overall payment and settlement system in New Zealand primarily because our central bank operates the core infrastructure and the dominant settlement system. This is evidenced by the International Monetary Fund's positive financial sector assessment of New Zealand and in the very high level of penetration of New Zealand's debt and equity markets by overseas investors compared to most other countries.

Futures

The Australian Securities Exchange (**ASX**) is the current market operator of futures and options trading and clearing services for the New Zealand market. These products are currently traded through the Sydney Futures Exchange and centrally cleared through SFE Clearing Corporation Pty Ltd. NZX currently has an agreement with ASX regarding derivative products on NZX traded securities. NZX has recently announced its intention to enter the futures market independently.

Registered securities exchanges and authorised futures exchanges are regulated slightly differently from each other under existing New Zealand legislation. NZX has asked for the regulation of futures and securities exchanges to be aligned in the situation where an exchange is seeking to perform both functions, in order to reduce their compliance costs and the Securities Commission's administrative costs.

In addition, New Zealand legislation currently only provides for the Securities Commission to authorise futures dealers, although there are class authorisations under the Authorised Futures Dealers Notice (No 2) 2004 and the Authorised Futures Dealers Notice (No 3) 2004. The effect of these class authorisations is that the Sydney Futures Exchange and the NZX can authorise exchange participants as futures dealers. NZX is seeking to provide futures products on its exchange and has requested that the existing exemption be given the authority of legislation.

Emissions Units

Emissions units fall into two broad categories: units issued under binding regulations such as the New Zealand Emissions Trading Scheme; and units issued in the voluntary market. The Government regards the voluntary carbon market as complementary to the regulated market, useful for meeting consumer demand for action on climate change, and a valuable testing ground for new emissions reduction measures.

Emissions units are a relatively new product in New Zealand's markets. In some instances, it is unclear how emissions units will be treated when traded within New Zealand's existing regulatory environment. NZX has established TZ1, which is developing an exchange platform for trading emissions units. NZX asserts that in order to trade emissions units and emissions units futures products on an exchange, and to clear and settle those transactions adequately, the treatment of emissions units under New Zealand's personal property securities, securities, and securities markets legislation needs to be clarified. However, the Australian Securities Exchange submitted that there is nothing within the existing regulatory framework to prohibit or restrict firms in New Zealand or elsewhere from providing over the counter and exchange infrastructure to support the New Zealand Emissions Trading Scheme.

OBJECTIVES

The policy objective for settlement systems is to signal that trades in securities and other products in New Zealand can be cleared and settled through systems that meet the expectations of international and domestic participants.

The policy objective for futures exchanges is to reduce compliance costs by aligning the regulation of exchanges seeking to operate in both the securities and futures markets and codifying that participants approved by the operator of an authorised futures exchange are authorised futures dealers.

The policy objective for emissions units is to clarify the regulatory treatment of emissions units (for market operators and market participants) to support the trading of emissions units and the development of the market for emissions units.

ALTERNATIVE OPTIONS

For the policy on settlement systems, the alternative options available are to—

- maintain the status quo; or
- require all settlement systems in New Zealand to be designated; or
- undertake a general review of clearing and settlement law in New Zealand.

For the policy on futures exchanges, the alternative options available are to—

- maintain the status quo; or
- undertake a general review of the regulation of registered securities exchanges and authorised futures exchanges.

For the policy on emissions units, the alternative options available are to –

- maintain the status quo; or
- to restrict the technical amendments to emissions units traded in regulated emissions trading schemes.

Maintaining the status quo

Maintaining the status quo for settlement systems does not meet the policy objective of signalling that trades in securities and other products in New Zealand can be cleared and settled through systems that meet the expectations of international and domestic participants.

Maintaining the status quo for authorised futures exchanges does not meet the policy objective of reducing compliance costs by aligning the regulation of exchanges seeking to operate in both the securities and futures markets and codifying that participants approved by the operator of an authorised futures exchange are authorised futures dealers.

NZX maintains that technical amendments are required to New Zealand's legislation in order to trade emissions units and emissions units futures products on an exchange in New Zealand, and to clear and settle those transactions adequately. Exchange trading is a useful step in the development of any new market. Maintaining the status quo for emissions units is therefore not sufficient to meet the policy objective to support the development of the market for emissions units.

Requiring all settlement systems in New Zealand to be designated

The characteristics of different settlement systems vary to service the needs of a particular market segment or product. Mandatory designation could reduce the options available to consumers of settlement services while potentially increasing the cost of those services. The policy objective for settlement systems does not require that all trades be cleared and settled through a designated system.

General review of clearing and settlement law

Undertaking a general review of clearing and settlement law in New Zealand before introducing the requested legislative amendments is not preferred. The stated policy objective is much narrower than the scope of a general review of clearing and settlement law in New Zealand. A general review, including analysis and engagement with stakeholders, would take some time.

NZX would prefer the requested legislative amendments to be in force before their settlement system becomes operational, or alternatively at least have the necessary legislative amendments progressing through parliament. NZX's upgraded settlement system is still under development. In a recent meeting with Ministers, NZX's CEO said that the new system may not be operational until April 2009. However, NZX has indicated publicly that it will be ready in October 2008.

Although NZX currently operates a settlement system without designation, NZX advises that they will not be able to operate a central counter party without designation because they will have difficulty accessing the necessary synthetic capital required to support this model of settlement. Any delay will cost NZX lost revenue from their expanded services and upgraded services.

General review of the regulation of securities and futures exchanges

A general review of Parts 2B and 3 of the Securities Markets Act 1988 is not preferred to meet the policy objective. A general review of those parts of the Securities Markets Act 1988 would be broader than the amendments required to give effect to the stated policy objective for futures and securities exchanges. NZX would incur costs under both regimes until such time as a general review was complete.

Restricting technical amendments to regulated emissions units

Restricting the technical amendments to emissions units traded in regulated emissions trading schemes would simplify the amendments since regulated emissions units are well defined in existing legislation. There are many challenges inherent in any attempt to adequately define voluntary emissions units because the market is still developing and consistent standards and practices have not yet evolved. However, excluding voluntary emissions units from the technical amendments would be inconsistent with the policy objective and the Government's regard for the voluntary carbon market.

PREFERRED OPTION

To provide a signal that trades in securities and other products can be cleared and settled in New Zealand through systems that meet the expectations of international and domestic participants, the preferred option is to extend the current payments system designation regime under Part 5C of the Reserve Bank of New Zealand Act 1989 to settlement systems, make the Securities Commission a joint regulator with the Reserve Bank, and make explicit reference to relevant international standards as a matter that the joint regulators may have regard to when designating systems.

NZX and the Reserve Bank are both expected to seek designation for their settlement systems under the new law. The cost of complying with the new regulatory regime is optional for settlement system operators. Although NZX has been the catalyst for these amendments to Part 5C of the Reserve Bank of New Zealand Act 1989, the preferred option is to design an opt-in designation regime for settlement systems that is available to any provider of settlement services in New Zealand who applies for designation and meets the relevant criteria, and is thus of general benefit to the development of the New Zealand financial market.

In parallel, the Government will undertake a general review of New Zealand's settlement and clearing infrastructure in response to concerns raised during consultation.

The preferred option for futures exchanges is to reduce compliance costs by amending the Securities Markets Act 1988 to align the regulation of exchanges wanting to operate in both futures and securities markets and codifying that participants approved by the operator of an authorised futures exchange are authorised futures dealers. The NZX expects to benefit from these amendments through a reduction in costs.

The preferred option is to give effect to the policy objective for both voluntary and regulatory emissions units through technical amendments to New Zealand's personal property securities, securities, and securities markets legislation. While it is already possible to trade emissions units through over the counter transactions and other means, registered exchange trading of emissions units and emissions units futures products would provide an additional trading option for those in the market. Exchange trading generally supports liquidity, aids price discovery, and can reduce transaction

costs, while the availability of futures products can assist businesses to manage their emissions reduction liabilities.

The proposed amendments should not impose any costs on the market, but rather should improve certainty for those trading in emissions units and related products and make it possible to provide an additional trading mechanism for emissions units.

IMPLEMENTATION AND REVIEW

The Settlement Systems, Futures, and Emissions Units Bill gives effect to the policy objective for settlement systems through an extension of the existing regime for the regulation of designated payment systems in New Zealand under Part 5C of the Reserve Bank of New Zealand Act 1989. The Bill provides settlement systems operating in New Zealand with the option of applying for designation and being regulated to relevant international standards by the Reserve Bank and the Securities Commission. In return, a designated settlement system receives additional legal protections to support the integrity of the system in the case of a participant's default, including through an amendment to the Personal Property Securities Act 1999. Once the amendments take effect, the operators of any settlement systems seeking designation will still need to apply for approval from the joint regulators.

The Settlement Systems, Futures, and Emissions Units Bill gives effect to the stated policy objective for futures exchanges by amending the Securities Markets Act 1988 so that an exchange registered under Part 2B of that Act may be registered either with respect to securities markets only or with respect to both securities markets and futures markets. The Settlement Systems and Futures Bill also provides that market participants who have been approved by an authorised futures exchange under its operating rules shall be deemed to be authorised to deal in futures contracts under section 38 of the Securities Markets Act 1988.

The Settlement Systems, Futures, and Emissions Units Bill gives effect to the preferred option through technical amendments to the—

- Personal Property Securities Act 1999 to give more certainty as to the effect of that Act in relation to emissions units, which will include emissions units in the property category of investment securities, and facilitate the trading of emissions units on an exchange:
- Securities Act 1978 to ensure that the issue of emissions units will not need to meet the requirements of the regulatory regime for offers of securities or the relevant provisions of the Securities Markets Act 1988 unless they are part of an investment scheme:
- Securities Markets Act 1988 to include emissions units in the definition of commodity, providing certainty that futures contracts in emissions units are regulated by the Securities Markets Act 1988.

None of these technical amendments are necessary for the operation of the New Zealand Emissions Trading Scheme.

CONSULTATION

The Securities Commission, the Reserve Bank of New Zealand, and the Treasury, have been closely consulted in the preparation of the Settlement Systems, Futures,

and Emissions Units Bill as part of an inter-agency working group. The Department of the Prime Minister and Cabinet, the Ministry of Agriculture and Forestry, the Ministry for the Environment, and the Emissions Trading Group have also been consulted.

Following initial policy engagement with NZX in 2007, the Government undertook targeted consultation with a wider group of stakeholders in the preparation of a discussion document, which was released in February 2008 with an exposure draft of Emissions Units, Settlement Systems, and Futures Bill. The Ministry of Economic Development received 19 submissions on the draft Emissions Units, Settlement Systems, and Futures Bill (the draft Bill). Significant submissions on the draft Bill are summarised as follows:

- submitters were critical of the consultation and policy development process, requesting more time to make comments, wider consultation, workshops, and additional consultation documents. A significant proportion of submitters expressed concern that legislation had been drafted solely to further NZX's commercial interests. The Government has since individually met with a number of submitters to hear their concerns and will conduct further consultation as part of a New Zealand approach to clearing and settlement:
- submitters were concerned that the implications for New Zealand's financial market infrastructure should be further examined given the public utility nature of clearing and settlement systems, and the network effects that could result from a private, vertically integrated monopoly provider. These implications will be examined as part of a New Zealand approach to clearing and settlement:
- submitters suggested that the Government should amend the proposed joint regulator model, and provide a process for managing potential conflicts of interest within the Reserve Bank. Officials are confident that the joint regulator model is the best model for recognising both the Reserve Bank's and the Securities Commission's interests in the regulation of settlement systems. The joint regulators are preparing a memorandum of understanding to govern their roles. Institutional arrangements are in place to ensure a high degree of independence between the Reserve Bank's operations and policy functions. The joint regulator model also addresses potential conflicts of interest relating to the Reserve Bank being the operator of Austraclear NZ:
- submitters were critical of the requirement to seek the regulators' approval for every critical rule change that is material to the designation order. This process has been amended to assume that any rule change is valid unless challenged and disallowed by the regulators:
- one submitter requested that the regulation of designated payment systems be delineated from designated settlement systems. The proposed legislation has been amended to reflect that the Securities Commission has a limited interest in systems that solely settle payments, in recognition of the status quo for payment systems under Part 5C of the Reserve Bank of New Zealand Act 1989:
- submitters suggested that the approval criteria for a designated settlement system should explicitly include adequacy of financial resources and adequacy of the

system's arrangements in a default by the central clearing party. These criteria are implicit in the more general criteria outlined in the Bill:

- submitters suggested that improvements could be made to provisions on collateral, priority, and the Personal Property Securities Act 1999. Where possible, these provisions have been refined, but general submissions on the Personal Property Securities Act 1999 are outside the scope of this policy process and cannot be addressed in the Bill.
- submitters were concerned that the proposed amendment relating to the authorisation of futures dealers removed the ability of the Securities Commission to authorise futures dealers independently. This is not the case; the Bill simply codifies the status quo in legislation.
- submitters were confused by the bundling of emissions trading issues with generic financial market reform and felt this was a barrier to understanding the legislative amendments. Officials have therefore been careful to delineate the discrete policy issues for emissions units and settlement systems in their advice. Officials also see merit in separating the technical amendments relating to emissions units into a standalone bill, although not at the expense of the increased administration required to introduce and process two separate bills.
- submitters suggested that the Government should either regulate the quality of voluntary emissions units registers, which were recognised by the draft Bill, or that it should restrict the draft Bill to the compliance market. Excluding voluntary emissions units from the technical amendments would be inconsistent with the policy objective and the Government's regard for the voluntary carbon market. As such, the technical amendments have not been restricted to the compliance market. However, the technical amendment providing that entry on an emissions units register is prima facie evidence to title has been removed, removing the need to define which registers (and which voluntary emissions units) are regulated by the Settlement Systems, Futures, and Emissions Units Bill:
- submitters were critical of the fact that the Government is willing to clarify how futures regulations apply to emissions units, but not other products, and submitted that the technical amendments failed to adequately clarify the difference between futures and physical forward contracts. Officials are satisfied that the technical amendments do not confuse futures and physical forward contracts. The futures regime for other products falls outside the scope of the policy objective for these technical amendments:
- one submitter requested that the definition of emissions units be extended to include other environmental products such as wetlands credits. This issue is expected to be raised at Select Committee. The Ministry of Agriculture and Forestry also asked whether there was potential to address other forms of environmental offsets. For example, in Lake Taupo there is a proposal for trading in nitrogen offsets. This falls outside the scope of the current policy objective.

APPENDIX: Existing clearing and settlement services and their role in New Zealand’s financial markets

Bargain Layer

