

11 February 2016

*Many Investors, One Voice*

## **Submission from New Zealand Shareholders Association On the review of NZX Market participant Rules**

### **Introduction**

- The New Zealand Shareholders Association is the only nationwide organisation representing the “buy side” of the market.
- Our submission is written from the perspective of a retail or smaller investor. This view is important. Clear, transparent and effective rules governing the interaction between market participants and their (retail) clients has a direct effect on public perception of, and client confidence in the most public facing section of the capital markets.
- The over-arching thrust of our submission is that nothing should be done that reduces the protections available to retail investors. Where there are choices between differing rules or guidelines imposed by NZX or FMA , then we prefer to see the most investor friendly option imposed. An example of this is addressed in question 9.
- In our view, while we favour laws that are principles based, it is necessary for the NZX rules to be more prescriptive to ensure consistent application by participants. In some cases this may be achieved by guidelines which allow a degree of flexibility. However this must not allow dilution or watering down, and must be carefully considered to avoid creating loopholes or unintended consequences that may require later rectification.
- Where guidelines are utilised we believe a "comply or explain" process would be appropriate to encourage compliance.
- We accept that in some technical areas where we have limited knowledge and no expertise, it may be possible to streamline processes in a way that is more efficient for participants and no less effective in protecting investors.

### **Responses**

- With regard to the specific questions raised in the NZX discussion document dated 20 April 2015, our responses are as follows. For clarity we have followed the NZX numbering on the discussion document. **However we note that items 32 - 34 appear twice in the NZX numbering.** The subject headings should clarify our intent.

## **Financial advice**

1. As a general comment, NZSA is concerned that there are a number of areas where different groups seek to impose differing standards or requirements on both market participants and issuers. This has the potential to create unnecessary duplication, confusion and extra cost and has been widely recognised in initial submissions to the Financial Advisors Act (FAA) review. We consider that until the FAA review is finalised it will be prudent to retain the NZX rules, but these should be discontinued with legislation and FMA taking over except for NZX continuing to regulate the trading conduct as it applies to NZX. There remains a risk that if loopholes are discovered subsequent to completion of the FAA review coming into force that legislative solutions can take a long time to be imposed. We consider that NZX should retain a right to impose additional rules as a temporary measure in these circumstances in order to ensure the integrity of the market.

2a. We are unable to comment as we have no practical experience.

2b. In our view, retail investors would be guided by the FAA and FMA requirements for advisors and consider these to have precedence. Consequently we see no benefit or advantage in having a separate NZX designation.

3 / 4. See responses above.

## **Discretionary Accounts**

5 / 6a / 6b. No comment.

7. We see no direct role for NZX in regulating Discretionary management services (DIMS) providing that legislation is essentially similar. As for question 1 some ability to impose short term rules to address loopholes or unintended consequences that affect market integrity and confidence could be considered.

8. No comment required.

## **Custody**

9 / 10 / 11 /12. The main area of difference relates to minimum reporting cycles. (Legislation - 6 months. NZX - 3 months. We consider the shorter reporting requirement is more advantageous for retail clients as it gives them more frequent opportunities to review their holdings. we accept there may be a cost to some participants in meeting a 3 month cycle, but many already report monthly, so it is not an unreasonable burden. we believe legislation should be amended, but if not practical, NZX should retain this requirement.

## **Know Your Client**

13a. Current legislative rules require higher standards. Therefore, there is no justification for NZX to have its own requirements.

14. No. FAA requirements should be sufficient once the review is concluded.

## **Control of Broking Offices**

15. A broader range of individuals is acceptable. However, participant principals must still retain overall liability and responsibility to avoid any offsetting of duty of care.

16. Skill and expertise are essential requirements. In our view, non-broker managers may have better administrative and governance skills. Non-broker managers also potentially reduce any possibility of conflict of interest as they have no personal interest in transactions.

17. We see no need for a designated individual to be on site. Control can be maintained with modern communications supported by an appropriate governance and reporting structure as is common in many professions and businesses.

## **Contract Notes**

18. The default position for institutions should be "No contract notes". However, they should have an option to opt in if they wish to.

19. For retail, the default position should be that "Contract notes are always provided". In our view this is essential as many retail investors will not have any degree of sophistication in their record keeping and contract notes ensure at least a de minimis standard of documentation is available.

20. The retail default should be to receive contract notes only electronically. An opt in should be to receive them by post. Postal services are now so slow that with the shorter settlement being introduced, clients will not get postal contracts in time in most cases. However, not all retail investors use computers, so a physical process needs to be retained.

## **International Crossings**

21 / 22 / 23. Technical. No comment.

## **Authority to Act as Primary Participant**

24 / 25 / 26. Technical. No comment beyond observing that everyone acting as a primary market participant should be required to have the authority to do so.

## **Margin Cover**

27 / 28. Technical. The suggestions by NZX appear reasonable and logical.

## **Client and Principal Order Records**

29 / 30 / 31 / 32. Technical. No comment.

## **Disclosure of Interest**

33. NZSA supports disclosing any specific conflict of interest in all circumstances and supports the NZX view that generic statements may not be adequate.

34. Not applicable.

## Employee and Prescribed Person Rules

32 / 33 / 34 / 35 / 36 / 37. NZSA has insufficient knowledge of how the system currently functions to offer detailed views. However, in general we believe:

- that rules should be in place to prevent conflict of interest scenarios or other undesirable activity such as insider trading or market manipulation.
- At the same time, rules must be clear and enforceable which does not appear to be the case here.
- The logical solution appears to be to put the onus on the market participant firms to put in place processes that adequately control the actions of their employees and make failure to do so enforceable under the contractual terms of the relationship with NZX.
- NZX could provide a clear set of guidelines with participants being required to meet these, and if not, to explain why - and disclose this to their clients at every trade. We would expect that would encourage voluntary compliance.

## Capital Adequacy

38 -52. Technical and beyond our expertise. We expect any rule changes to be framed so that there is little or no risk to retail investors who do not generally have the skills, information or expertise to assess the financial strength of market participants. We think that some form of third party insurance or a fidelity fund should be in place to protect innocent parties.

## Surveillance requirements

53. Yes, underlying CSN's should be required to strengthen and speed up the surveillance process.

54. Yes. Employee trading is potentially higher risk. Investors are always concerned that employees may have some insider knowledge or the opportunity for market manipulation (real or perceived).

55. Yes. Lack of institutional identification is a significant weakness in the current surveillance regime, particularly in the timeliness and ease of investigation.

56. Yes if practical. Reasons as for (55) above.

57. Yes. NZX should be able to obtain access to this information to ensure the integrity of the market surveillance system is maintained. And it should be enforceable or it will be ineffective.

58. Yes. Otherwise it is an obvious loophole to avoid surveillance oversight.

59. Not applicable to NZSA. We expect push back from some quarters as more work may be required in a limited number of cases. However, this will be offset by far fewer enquiries being made overall. The key issue is the maintenance of market confidence and integrity which will not occur if systems to identify illegal trading are compromised.

## Summary

NZSA is in favour of simplification, removal of overlap between regulatory authorities and a reduction in compliance costs for market participants providing that there is no dilution of the current retail investor protections. We see a role for "comply or explain" guidelines as well as black letter legislation and rules. Where there are options that could be amalgamated into one, we consider the most "protective" choice should be made.

In our view, a number of proposals would be best delayed until the FAA review is completed.

We are concerned that retail investors continue to have access to hard copy documentation as not all are computer literate, but accept that electronic medium should be the default.

We advocate considerable change in the processes that will enable more accurate and faster market surveillance processes as this is an essential component in maintaining market integrity and confidence.

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NZSA Legal and Regulatory Committee

John Hawkins, Chairman

