

Impact Summary: Prohibiting insider trading and market manipulation in the New Zealand Emissions Trading Scheme

Section 1: General information

| Purpose |
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| The Ministry for the Environment (MfE) is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final decisions to proceed with a policy change to be taken by or on behalf of Cabinet. |

| Key Limitations or Constraints on Analysis |
|--|
| <ul style="list-style-type: none">• Describe any limitations or constraints — both those listed below and any others you have identified:• Scoping of the problem• Evidence of the problem• Range of options considered• Criteria used to assess options• Assumptions underpinning impact analysis• Quality of data used for impact analysis• Consultation and testing |
| <p>We have identified seven risks to market function that potentially impact upon the effectiveness of the New Zealand Emissions Trading Scheme (NZ ETS).</p> <p>Two of these risks – insider trading and market manipulation – should be addressed now. This is because we have identified them as being of higher magnitude than the remaining five risks, and because measures to address these risks support other improvements currently being undertaken to the NZ ETS. We have completed the necessary policy analysis and consider the Climate Change Response Act 2002 (CCRA) to be the appropriate vehicle to govern insider trading and market manipulation conduct within the NZ ETS.</p> <p>The remaining five risks are not included in this Regulatory Impact Assessment, as further policy development work is required. These five risks are:</p> <ul style="list-style-type: none">• false or misleading advice provided to participants• a potential lack of transparency, monitoring and over-sight of trades in the secondary market• money laundering/financing of terrorism |

- credit and counterparty risks
- conflicts of interest.

Constraints on the analysis of the problem

The key limitation on deciding how best to govern these risks is the lack of empirical evidence to indicate that insider trading or market manipulation are occurring now, or have occurred in the past. This is primarily because the conduct itself is inherently difficult to detect, as it takes place between individuals within firms engaging in conduct that is very similar to sound and acceptable trading behaviour. The second reason that there is little to no evidence of this conduct having occurred in the past is partly due to the regulatory gap that exists, which means that there is no regulator that is looking out for evidence of this conduct.

Constraints on options

We have considered a range of options to deal with this problem. The key constraint is timeliness: amending the primary legislation for the NZ ETS, the CCRA, is the most viable way to create adequate prohibitions and/or other forms of deterrence for this conduct in time for the anticipated 2020 commencement date for Government auctioning of NZUs in a manner that also applies to trading between market participants in the secondary market.

The option of making these changes through the Financial Markets Conduct Act 2013 (FMCA) is problematic as NZUs do not fit within any of the existing product categories outlined in the Act, including financial products. This leaves the option of using the CCRA to prohibit these two forms of conduct as most desirable and practical for the current time, while continuing to rely on the competition law provisions for risks of anti-competitive conduct.

Responsible Manager (signature and date):



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Climate Change Directorate

Ministry for the Environment

Date:

22/11/18.

A Quality Assurance Panel with representatives from the Ministry for the Environment and the Treasury Regulatory Quality Team has reviewed the Regulatory Impact Assessment (RIA) "Impact Summary: Prohibiting insider trading and market manipulation in the New

Zealand Emissions Trading Scheme” produced by the Ministry for the Environment and dated November 2018. The panel considers that it meets the Quality Assurance criteria.

More detail on the assessment of this and the other RIAs can be found at: [link to be added].

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

- Describe the current situation and how it is expected to develop if no action is taken, over and above what is already intended. This is the “counterfactual” against which other options should be assessed, and your preferred option described, in section 4.
- Why does the current situation constitute “a problem”, or why is it expected to do so if it continues?
- What is the underlying cause of the problem? Why does government need to act – why can’t individuals or firms be expected to sort it out themselves, under existing arrangements?
- Why does it need to be addressed now?
- How much confidence is there in the evidence and assumptions for the problem definition?

The problem

We need an effective New Zealand Emissions Trading Scheme (NZ ETS) to help meet our domestic and international emissions reduction targets under the Paris Agreement and the proposed Zero Emissions Bill. Market governance is an integral part of good market function and therefore the effectiveness of the NZ ETS as a policy instrument.

Market governance relates to the processes, policies and rules applied to manage risks of misconduct in the NZ ETS primary, secondary or derivatives market. Ensuring market participants are adequately informed and protected against misconduct assists in building a robust, efficient, credible emissions trading scheme.

The Climate Change Response Act 2002 (CCRA) is the primary legislation that establishes the NZ ETS and provides the legal framework for its implementation, operation and administration. The CCRA currently does not have any market governance provisions. Some types of misconduct already fall under existing competition and consumer laws. However, financial market regulations, such as those contained in the Financial Markets Conduct Act (FMCA), do not apply to the NZ ETS (with the exception of derivatives) as NZUs are classified as commodities as not as financial products. In addition, the NZ ETS itself does not regulate some forms of misconduct which are regulated in emissions trading schemes in other jurisdictions. Therefore there are currently no provisions to govern some forms of market misconduct in the NZ ETS.

The NZ ETS currently has a secondary (spot trading) market for NZUs, and the Government intends to introduce a primary market for auctioning NZUs through a new auctioning mechanism expected to commence in 2020. Proposed market governance provisions should apply equally to the two markets.

There are also increasing drivers building the case for why we need to ensure that the market governance regime is robust, including:

- likelihood of a higher NZU price in future;
- introduction of auctioning;
- potential for linking with other international markets; and
- potential addition of new participants to the NZ ETS.

These drivers increase both the incentives for misconduct and the range of actors who may benefit from any misconduct.

In relation to one of the key drivers outlined above (the introduction of auctioning), the risks for market manipulation and (to a lesser extent) insider trading will substantially increase, once auctioning has been introduced. These two risks sit alongside risks of anti-competitive conduct (particularly collusion and abuse of market power) as the three key risks that the Government needs to guard against at auction. Anti-competitive conduct is already captured by the existing competition law provisions found in the Commerce Act 1986, so the same type of regulatory gap does not exist in relation to those forms of conduct.

Insider trading includes individuals trading on the basis of material non-public information which, if it were made public, would likely have a significant effect on the price of NZUs. For example, this could occur if a participant had information that a large emitter planned to shut down their entire operation, or substantively reduce their emissions, and then used that non-public information to trade NZUs in order to make a profit. This can distort the market price and reduce the overall efficiency and effectiveness of the NZ ETS.

Market manipulation (i.e. manipulation of the NZU price) includes spreading false market information, cornering or squeezing the market, or giving false impressions of market conditions, typically with the aim to influence the market price and profit from that conduct. Again, this conduct can distort the market price and reduce the overall efficiency and effectiveness of the NZ ETS.

At present, the regulatory framework underpinning the NZ ETS secondary market does not outline clearly what types of conduct are unacceptable (in relation to general conduct in the marketplace and trading behaviour, rather than behaviour strictly tied to complying with the obligations of the NZ ETS itself which we are not covering here).¹ In order for markets to function effectively and efficiently they need to operate within robust frameworks that clearly outline the types of conduct that are unacceptable. We are looking to remedy this by plugging two key regulatory gaps in the law in relation to insider trading and market manipulation.

Confidence in the problem

There is a lack of clear evidence that either of these forms of conduct have occurred in the past. This is primarily due to the nature of the conduct itself, which is inherently difficult to detect as it takes place by individuals within firms engaging in conduct that is very close to sound trading behaviour. The second reason that there is little to no evidence of this conduct having occurred in the past is the regulatory gap that exists, which means that no regulator is looking out for evidence of this conduct. However, this conduct is prohibited in other

¹ Note that the framework relating to auctioning is currently being developed as auctioning has not yet been introduced.

financial markets in New Zealand (through the FMCA) and other emissions trading schemes internationally also have prohibitions in relation to these two forms of conduct.

If no action is taken, a regulatory gap will persist in regard to these two forms of conduct. This will lead to a less than desirable regulatory framework being in place when auctioning is implemented, potentially reducing confidence in the integrity of this new aspect of the NZ ETS and therefore the effectiveness of the NZ ETS more broadly.

2.2 Who is affected and how?

- *Whose behaviour do we seek to change, how is it to change and to what purpose?*
- *Who wants this to happen? Who does not?*

We are seeking to reduce risks of misconduct taking place in the future. This will, in turn, create a trading market with integrity and trust, and ensure that market participants and other intermediaries that operate in the NZ ETS are adequately protected, including during auctions once the auctioning mechanism is implemented. The behaviour that the Government is seeking to deter or prevent is likely to be conduct contemplated or engaged in only by a small number of people.

The Government wants to reduce the risks of misconduct in order to ensure that all parties trade in a fair and transparent manner, creating a level playing field for all traders in the market. This is also in the interests of New Zealanders more broadly who have an interest in the NZ ETS being effective, efficient and not creating the conditions whereby some individuals are able to use the NZ ETS to their undue advantage.

Those who unduly seek gains through insider trading or market manipulation without real risk of detection and enforcement action may not want these forms of behaviour to be prohibited. On the other hand, they should also have an incentive for this behaviour to be prohibited if they are interested in the NZ ETS market being effective, efficient and robust.

2.3 Are there any constraints on the scope for decision making?

- *What constraints are there on the scope, or what is out of scope? For example, ministers may already have ruled out certain approaches.*
- *What interdependencies or connections are there to other existing issues or ongoing work?*

The scope of these decisions are narrow. Ideally the treatment of these two forms of conduct would be dealt with as part of a broader package of reforms to the market governance of the NZ ETS. However, due to timing constraints this is not practicable. No options have been ruled out at present, and there are partial options that remain achievable at a later date, particularly through the development of auctioning regulations. The decisions being taken now do not inhibit, preclude or constrain further development of the broader governance framework for the NZ ETS.

There is a key interdependency between this work and the auctioning project. There are also key links into the treatment of the other five of seven identified risks to market function.

For example, the Government may make decisions regarding the appointment of the auctioneer and the auctioning monitor is (if any monitor is appointed), and it would be preferable to take these risks into account as part of the appointment decisions. For timing reasons it is not possible to delay decisions now in order to take this approach.

Section 3: Options identification

3.1 What options have been considered?

- *List the options and the criteria you used to assess them. Briefly describe their pros and cons.*

The options considered to better govern the risks of insider trading and market manipulation in the NZ ETS market, and their associated pros and cons, are as follows:

1. **Status quo.** Under this option there are two clear legislative gaps, meaning there are no rules prohibiting this conduct, no relevant offences, penalties or a regulator who is monitoring and able to enforce any instances of this conduct having taken place. The pros of this option are that it provides the most certainty to participants, which was a key piece of feedback received during a 2015 review of the NZ ETS. The cons of this option are that the risks of these two forms of conduct occurring in the future are expected to increase, meaning that this option will likely lead to a position where misconduct is potentially not able to be adequately dealt with, reducing confidence in the NZ ETS market and leaving the Government in a position where it has to make rushed and unsignalled changes to the market. This was also a key criticism from stakeholders that we received during the review, and something that should be avoided where possible.
2. **Prohibit these forms of conduct through the CCRA.** The pros of this option are that it is the simplest way to prohibit these forms of conduct in the short term, avoiding the unintended consequences that come with the FMCA option (see next option below). This will send a strong deterrent signal to the market and apply also to the secondary market. The cons of this option are that the decisions are needed now in advance of decisions on the broader market governance framework, due to timing considerations. It is also not proposed that decisions will be taken now regarding and which party has responsibility for monitoring the market and what regulator² has responsibility for bringing enforcement action. This could be problematic if additional barriers to all potential regulators are surfaced after further work. The prohibitions

² We have identified three potential regulators who are obvious options for enforcing these two new prohibitions. They include the Environmental Protection Authority (EPA), the Commerce Commission and the Financial Markets Authority (FMA). The EPA has existing knowledge of the NZ ETS, potentially has better access to trading data and therefore the ability to monitor and detect this conduct occurring, and the benefit of pre-existing data protection and other confidentiality protocols that another regulator may not have. However, the EPA does not currently deal with what are substantively conduct concerns in a financial (or quasi-financial) market context. The FMA on the other hand is the only regulator in New Zealand with experience enforcing these two forms of conduct (albeit in the context of other financial markets in New Zealand), so is likely to have the best skill set to play this role in the NZ ETS market. The Commerce Commission is the regulator tasked with enforcing breaches of anti-competitive conduct as so may play an increased role in relation to the NZ ETS in the future once auctioning begins (and therefore when risks of anti-competitive conduct increase). However, the Commerce Commission does not typically deal with financial or quasi-financial markets, as laid out in a Memorandum of Understanding with the FMA. These pro's and con's all require further testing.

may have little practical effect if no regulator can be designated in this way, as it is unlikely that the regulator will be able to pursue breaches before the date on which the prohibitions come into force. The penalties adopted under this option will mirror those currently found in the FMCA in relation to these two types of conduct, and are explained further below. This is primarily for reasons of consistency.

3. **Prohibit these forms of conduct through the FMCA.** This option places the NZ ETS alongside the regulation of other financial markets in New Zealand, helping to ensure consistency of treatment of this type of conduct. The FMA would also likely be the default regulator given its existing roles in respect of the FMCA. The pro of this option is that it is likely to add to the above perception of a strong governance regime for these two issues. The con of this option is that this would require making NZUs financial products or otherwise drafting a completely new regime within the FMCA relating to NZUs.
 - a. The first sub-option for how this could be done is to attempt to make NZUs financial products. This also comes with a wide range of unintended consequences, impacting on the ability of existing market intermediaries to remain in the NZ ETS market. For example, if NZUs were financial products, providers of advice in relation to NZUs may be required to be licensed. This, in turn, may come with too many compliance costs for advisors and force them to exit the market, potentially reducing the overall quality of advice to participants. It also remains uncertain whether this first sub-option would be achievable without a significant number of other changes to the FMCA and working with other government agencies, with consequent risks to the desired implementation timing.
 - b. In relation to the second sub-option, with respect to timing, we are not in a position to begin drafting an entirely separate regime within the FMCA relating to NZUs, for the purposes of being able to then deal with these two risks.
4. **Prohibit these forms of conduct through auctioning regulations.** The pros of this option are that it will be simpler to implement, and is already planned to take place over the next ~six months, regardless of this work. The con is that it is unclear that it will have a sufficient deterrent effect as it will not be a criminal prohibition, it will mean this conduct is not dealt with in the same way that the FMCA does (i.e. there is no ability to have imprisonment as a penalty and the fines are also likely to be much lower), and questions remain regarding the enforcement options available and it will not be able to cover the secondary market, leaving a regulatory gap with no clear way to resolve it.
5. **Prohibit these forms of conduct through market intermediaries.** The pro of this option is that it could form part of a wider set of rules and regulations laid out clearly by one intermediary. This may be easiest for participants to understand. The con of this option are the same as for the option above. However, in addition to this con, this option is also likely to require legislative change it also risks not meeting the timing objectives due to the ability of the Parliamentary Counsel Office (PCO) to draft any such changes in advance of auctioning. This option will also only apply to auctions (assuming an intermediary plays a role in respect of auctioning) and will leave a gap in the secondary market. The only way to avoid this and also cover the secondary market would be if a market intermediary played an active role in respect of both auctioning (likely by becoming the auctioneer) and the secondary market (likely by becoming a market exchange). As no decisions have yet been made about

either role, it remains too uncertain to know whether an intermediary could adequately deter these two forms of conduct in both the auctioning and secondary markets.

The criteria used to assess these options are the operational criteria used for the broader NZ ETS improvements package. These criteria include:

- **Integrity** – ensuring that the NZ ETS market operates with integrity at all times and through all trading markets (primary auctioning market, secondary trading market and the derivatives market³).
- **Minimal complexity and administrative cost** – wherever possible, the costs of participating in the market are minimised for participants and traders. All rules, regulations and legislation are as simple and understandable as possible. In particular, how the NZ ETS market is governed has clear regard for the impacts on market participation of key intermediaries, traders and other parties.
- **Consistency and proportionality** – wherever possible, the same solutions are used to apply to the primary auctioning market, secondary trading market and the derivatives market. In addition, the solutions are consistent with similar solutions used in other similar contexts and they are proportional to the risk at issue.
- **Clarity and transparency** – ensuring that all market relevant information is clearly presented, at the right time and in a clear format. The risk of collusion due to too much transparency is also considered. All rules, regulations and legislation are clearly explained so that market participants, traders and other intermediaries understand their obligations and what type of conduct is expected of them.
- **Market efficiency** – an ETS market is efficient when it achieves allocative efficiency and delivers efficient price discovery. Allocative efficiency is the market's capacity to channel resources, in this case, NZUs – to their highest value uses. That is, emissions are reduced by those best placed to abate, at the best time. Efficient price discovery means, for NZUs to flow to their highest value uses, the carbon price needs to reflect all available information. Provision of relevant market information and predictable policy will help participants and others to identify and understand the overall supply and demand conditions for permits, facilitating efficient price discovery. This will produce a reliable price signal that informs investment decisions, while minimising the cost impact of the carbon price. In order to ensure this price is maintained, there need to be adequate rules and oversight in place to guard against the risks of manipulation of the price, insider trading and anti-competitive conduct.

For a summary of the options analysis, please see Appendix 1.

3.2 Which of these options is the proposed approach?

- *Which is the best option? Why is it the best option?*
- *How will the proposed approach address the problem or opportunity identified?*

³ A derivative is a contract between two or more parties with a value determined by fluctuations in an underlying asset. Common underlying assets include stocks, bonds, commodities, currencies, and interest rates. Different contractual terms have made way for different types of derivatives such as forwards, futures, options, and swaps. Derivatives are often used to insure against (hedging) or betting on (speculation) future asset price movements.

- *Identify and explain any areas of incompatibility with the Government's 'Expectations for the design of regulatory systems'.*
See <http://www.treasury.govt.nz/regulation/expectations>

The preferred option is to:

Option 2: Prohibit these forms of conduct through the CCRA.

This option will address the problem by filling the legislative gap that currently exists in respect of these two forms of conduct. The key reason that this option is preferred is because it is able to improve integrity and efficiency across both auctioning and the secondary market in a way that is proportionate to the risks and consistent with how the conduct is treated in other financial markets in New Zealand. Because this option involves criminalising this conduct it is able to improve integrity strongly. We also see it as consistent with how the conduct is viewed by other emissions trading schemes internationally, such as the EU ETS. It is able to achieve this with little administrative cost to participants while avoiding the complex requirements being applied through the FMCA. Note however there will be costs for the Government in enforcement. Compared to the option of using auctioning regulations or market intermediaries, this option allows the clearest message to come from the Government regarding its expectations in relation to these two forms of conduct and how/why they are prohibited (in other words, they apply at all times and the potential consequence is a regulator will detect and enforce this conduct).

The approach taken in the FMCA with regards to offences and penalties⁴ is emulated here, and the provisions themselves in the FMCA relating to insider trading and market manipulation will also be emulated,⁵ at least as a starting point. No decision is being taken now with regard to the relevant regulator.

By way of example, the penalties for insider trading found in section 244 of the FMCA are, in the case of an individual, imprisonment for a term not exceeding 5 years and/or a fine not exceeding \$500,000. In any other case, the maximum penalty for insider trading is a fine not exceeding \$2.5 million.

The only aspect of this option that may not sit well with the Government's 'Expectations for the design of regulatory systems' is the inability to consider the broader changes to the market governance regime that may be desirable in future, pending further analysis of the remaining five risks that have been identified. However, on the other hand these expectations are being followed to the extent that this option will involve largely emulating the approach taken in the FMCA to these two forms of conduct. So it is emulating a well-functioning and well-considered regulatory system. As highlighted above, as the policy analysis has not yet been completed in relation to the remaining five risks, it is not yet clear whether it is desirable to include a range of other issues into an overarching governance regime. Following that, it is not clear whether the CCRA is an appropriate home for such an overarching regime or if the FMCA may become more appropriate once the wider scope of issues is included.

⁴ As a starting point we are emulating sections 244, 257-261, 264, 268, 269, 512 and 533-542.

⁵ As a starting point we are emulating sections 240-243 regarding insider trading, 262 and 265 regarding market manipulation and the exceptions as outlined in sections 266, 267 and 245-256.

For a summary of the options analysis, please see Appendix 1.

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Summarise the expected costs and the benefits in the form below. Add more rows if necessary.

Give monetised values where possible. Note that only the **marginal** costs and benefits of the option should be counted, ie costs or benefits additional to what would happen if no actions were taken. Note that “wider government” may include local government as well as other agencies and non-departmental Crown entities.

See <http://www.treasury.govt.nz/publications/guidance/planning/costbenefitanalysis/x/x-guide-oct15.pdf> and <http://www.treasury.govt.nz/publications/guidance/planning/costbenefitanalysis> for further guidance

| Affected parties (identify) | Comment: nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks | Impact \$m present value, for monetised impacts; high, medium or low for non-monetised impacts |
|--------------------------------|--|---|
|--------------------------------|--|---|

Additional costs of proposed approach, compared to taking no action

| | | |
|-------------------|--|--------|
| Regulated parties | Regulated parties will not see any obvious or short-term cost impact, however there may be some cost incurred in fully understanding these two prohibitions and building in processes that ensure their conduct is in line with them. | Low |
| Regulators | There will be a cost incurred by the relevant regulator in the form of monitoring and enforcing this conduct (and potentially understanding the NZ ETS and relevant market more generally). There is a related funding question regarding the relevant regulator, to ensure they are adequately resourced to enforce these prohibitions. These are two issues that do not form part of this paper now as they are decisions being sought later. However they can be expected to be relatively significant. | Medium |
| Wider government | There may be more work required by the Ministry of Business, Innovation and | Low |

| | | |
|-----------------------------|---|------------|
| | Employment (MBIE) regarding the role of the FMA or Commerce Commission in respect of this market. In addition, this could lead to ongoing analysis required any time a relevant part of the regime is changed. | |
| Other parties | The auctioneer and auctioning monitor are two parties who are expected to come into existence before these new arrangements come into effect. Those two parties will need to consider how these prohibitions apply to them and build in appropriate processes to reflect them. They may also be expected to play a monitoring/detection role, for example analysing trading patterns. They may also be expected to play an educational role in respect of these two prohibitions. | Low |
| Total Monetised Cost | | Medium |
| Non-monetised costs | | <i>Nil</i> |

| Expected benefits of proposed approach, compared to taking no action | | |
|--|--|--------|
| Regulated parties | Market participants and other market players will be more confident in the good functioning of the market and will also be protected against situations whereby some are able to use the NZ ETS to profit (for example sophisticated players with access to material non-public information able to trade and make a profit on the basis of that information). The benefits to market participants and other market players will be unclear, but real. | High |
| Regulators | There are no clear benefits for the regulators. By having this conduct more proactively monitored and enforced this may have other flow-on benefits such as the development of a better understanding of the state of the market, behaviour at auction or other issues with trading that participants face. | Nil |
| Wider government | The benefits for the wider Government are that they can be more confident that it is not exposing itself to new, undue risks through the auctioning platform. This could help prevent the Government needing to intervene in the future. | Medium |

| | | |
|--------------------------------|--|------|
| Other parties | <p>Potential international linking partners - Addressing the risks identified will provide potential international linking partners with more confidence in the NZ ETS, improving the potential for New Zealand to access international emission units in the future, thereby reducing the economic cost of meeting our international emissions commitments and helping to ensure New Zealand is able to meet its ambitious climate change targets.</p> <p>New Zealanders - by having robust rules in place the NZ ETS will be able to more effectively and efficiently achieve its policy goals of helping New Zealand to reduce emissions and avoid creating the conditions whereby some parties can create windfall gains for themselves.</p> | Low |
| Total Monetised Benefit | | Nil |
| Non-monetised benefits | | High |

4.2 What other impacts is this approach likely to have?

- *Other likely impacts which cannot be included in the table above, eg because they cannot readily be assigned to a specific stakeholder group, or they cannot clearly be described as costs or benefits, eg equity impacts*
- *Potential risks and uncertainties*

Other key remaining uncertainties are: who is the appropriate regulator to enforce measures preventing this conduct, and what is the role of any related parties (such as an auctioning monitor) who would be responsible for reporting instances of prohibited conduct to the regulator. Decisions on both the regulator and auction monitor are expected to be made in 2019.

There is also some risk that market participants do not fully understand these two prohibitions. This is because rules governing conduct in the NZ ETS marketplace have not yet been clearly communicated to participants. Adding two new prohibitions in the CCRA rather than other existing legislation will require clear communication. We will mitigate this by exploring options to more clearly communicate existing legislative rules governing conduct in the Fair Trading Act 1986 and the Commerce Act 1986.

Secondly, there is also a risk that participants may confuse how the prohibitions relate to the responsibilities of the FMCA. We will mitigate this by clearly explaining the new prohibitions at the appropriate time.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?

- *Who has been, or will be, consulted, and at what stage(s)? Has consultation with iwi/hapū occurred, or should it?*
- *What is the nature of their interest?*
- *Do they agree with your analysis of the problem and its causes?*
- *Do they agree with your proposed approach?*
- *Has your proposed approach been modified as a result of stakeholder feedback?*

In July 2018, Cabinet approved public consultation on proposals for improving the NZ ETS [CAB-18-MIN-0374], which included proposals for market governance. From 13 August to 21 September 2018, officials from the MfE, the Ministry for Primary Industries (MPI) and Te Uru Rākau conducted a joint public consultation on the implementation of the four in-principle decisions and other proposed improvements to the NZ ETS.

Public consultation was performed on this issue and several others over August and September 2018. Feedback was sought on the extent to which seven misconduct risks may either exist at the moment in the NZ ETS market and/or may become more prevalent in future. No formal, specific proposal to prohibit these forms of conduct were outlined in the discussion document. However the possibility of prohibiting insider trading or market manipulation was used as an illustrative example in the document (on page 50).

Seeking feedback in this way was intended to inform further work to improve the way that these risks are governed in the NZ ETS. Good governance of the NZ ETS is important because misconduct could distort the NZ ETS price and/or reduce the confidence in the NZ ETS.

Stakeholder views were relatively consistent. A significant number of submitters acknowledged that the risks outlined in the consultation document are things that should be addressed by the Government, and noted that these risks are likely to increase in the future. However there was a strong indication that any design changes should be carefully considered and well signalled, as they are likely to be disruptive to market intermediaries in particular.

Submitters assessed that the risks of market manipulation will be particularly important moving forward, particularly at auction, but noted that these risks are generally not problematic in the current market environment. Very few submitters provided evidence of any of the seven risks having materialised to date. This can be read as a positive signal of good market behaviour, although it should be noted that these risks are very difficult to detect and do not lend themselves to self-reporting.

Section 6: Implementation and operation

| 6.1 How will the new arrangements be given effect? |
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| <ul style="list-style-type: none">• <i>How is the proposed approach to be given effect? Eg,</i><ul style="list-style-type: none">○ <i>legislative vehicle</i>○ <i>communications</i>○ <i>transitional arrangements</i>• <i>Once implemented, who will be responsible for ongoing operation and enforcement of the new arrangements? Have they expressed any concern about their ability to do so?</i>• <i>When will the new arrangements come into effect? Does this allow sufficient preparation time for regulated parties?</i>• <i>How will implementation risks be managed or mitigated?</i> |
| <p>The preferred approach is to be given effect through legislative amendment to the CCRA in 2019.</p> <p>A regulator will be made responsible for ongoing enforcement (and potentially surveillance/monitoring). Work on these issues is progressing.</p> <p>The other key work stream that is relevant is auctioning. Prohibitions should be in effect before auctioning starts. This will allow more time for the regulator and participants to become familiar with the obligations in advance of them also needing to prepare with how auctioning itself works.</p> |

Section 7: Monitoring, evaluation and review

| 7.1 How will the impact of the new arrangements be monitored? |
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| <ul style="list-style-type: none">• <i>How will you know whether the impacts anticipated actually materialise?</i>• <i>System-level monitoring and evaluation</i><ul style="list-style-type: none">○ <i>Are there already monitoring and evaluation provisions in place for the system as a whole (ie, the broader legislation within which this arrangement sits)? If so, what are they?</i>○ <i>Are data on system-level impacts already being collected?</i>○ <i>Are data on implementation and operational issues, including enforcement, already being collected?</i>• <i>New data collection</i><ul style="list-style-type: none">○ <i>Will you need to collect extra data that is not already being collected? Please specify.</i> |

It will be difficult to know whether the new arrangements are successful. This is because, firstly it is not yet certain what type of monitoring of auctions will be in place and this will be the easiest way to try to monitor the success of the new arrangements.

Secondly, these two forms of conduct are inherently difficult to detect as they take place by individuals within firms engaging in conduct that is very close to sound trading behaviour. They also do not lend themselves to self-reporting or other forms of detection.

There is little to no data relating to these two issues already being collected, which is part of the reason why the level of risk and extent of the problem are currently unclear.

As part of our further work on deciding who the relevant regulator will be, and also our future work on developing the auctioning regulations and defining roles such as an auctioning monitor, we will include the monitoring of these two new arrangements.

7.2 When and how will the new arrangements be reviewed?

- *How will the arrangements be reviewed? How often will this happen and by whom will it be done? If there are no plans for review, state so and explain why.*
- *What sort of results (that may become apparent from the monitoring or feedback) might prompt an earlier review of this legislation?*
- *What opportunities will stakeholders have to raise concerns?*

Further policy work is expected in relation to the remaining five risks highlighted above. This provides an opportunity to review the appropriateness of using the CCRA as the means by which to deal with insider trading and market manipulation.

Given the nature of these two forms of conduct, it will be very difficult to closely review the results of these changes in the form of evidence (or the absence of evidence) of this conduct taking place.

Appendix 1: Summary of options analysis for better governing insider trading and market manipulation risks in the NZ ETS

| Criteria | Option 1 – Status quo | Option 2 - Prohibit conduct through the CCRA | Option 3 - Prohibit conduct through the FMCA | Option 4 - Prohibit conduct through auctioning regulations | Option 5 - Prohibit conduct through market intermediaries |
|--|---|---|---|---|---|
| Integrity | o Clear legislative gaps and risks which are increasingly in magnitude given plans to auction and possibility of linking, among others | ✓✓ Strong improvement to the integrity of the market | ✓✓✓ Strong improvement to the integrity of the market through clear deterrent signal and improved perception of alignment with other financial markets | ✓ Partial improvement to the integrity of the auctioning market as secondary market not captured and no ability to give criminal penalties | ✓✓ Partial improvement to the integrity of the market as secondary market not captured unless new roles are created in secondary market (but is possible). No ability to give criminal penalties |
| Minimal complexity and cost | o Status quo will become more complex if gaps remain when auctioning begins and rules are required to deal with these risks. Also lowest cost option | ✓ Primary legislation provides clear expectations regarding permissible market conduct | x Unintended consequences apply if NZUs become financial products | x Lack of clarity regarding the ability of a regulator to enforce breaches of this conduct and give sufficient penalties | o To use market intermediaries would come with cost for the Government, and potentially also traders pending contractual arrangements |
| Consistency and proportionality | o Inconsistent treatment with other financial markets in NZ (that are covered by the FMCA) and other international ETS'. Risks being unmanaged | ✓✓ Consistent treatment with other financial markets in NZ (that are covered by the FMCA) and other international ETS'. Proportional response to the risks | ✓ Most consistent as same treatment achieved across all financial markets in NZ (that are covered by FMCA) and other NZ ETS'. However not a proportional response to risks | o Inconsistent treatment of this conduct between the auctioning market and the secondary market within the NZ ETS, which could create distortions and overall be insufficient to guard against risks | o Inconsistent treatment of conduct between the auctioning and the secondary market within the NZ ETS unless new roles are created. Unlikely to be proportional response to risks given low expected deterrence and lack of criminal sanctions |

| Criteria | Option 1 – Status quo | Option 2 - Prohibit conduct through the CCRA | Option 3 - Prohibit conduct through the FMCA | Option 4 - Prohibit conduct through auctioning regulations | Option 5 - Prohibit conduct through market intermediaries |
|---------------------------------|---|--|---|---|--|
| Clarity and transparency | 0 Currently little clarity or transparency on how market misconduct is dealt with and what is expected | ✓✓ Clear deterrent message sent regarding the conduct expected of traders | ✓ FMCA requirements may be unclear unless there is extensive training / information provided | ✓ One clear place for all auctioning rules (i.e. in the auctioning regulations, with the exception of competition law requirements in the Commerce Act 1986) | ✓ Likely that the intermediaries could be required to clearly communicate the rules relating to this conduct, but subject to contractual arrangements |
| Market efficiency | 0 Low integrity creates low market efficiency (if market misconduct is taking place) | ✓✓✓ High integrity supports high market efficiency | ✓✓✓ High integrity supports high market efficiency | ✓ Partial improvement to integrity creates partial improvement to efficiency | ✓✓ Partial improvement to integrity creates partial improvement to efficiency |

Key:

- ✓✓✓ Strongly meets criteria
- ✓✓ Clearly meets criteria
- ✓ Meets criteria
- X Does not meet criteria
- 0 Neutral