



COVERSHEET

Minister	Hon Dr David Clark	Portfolio	Commerce and Consumer Affairs
Title of Cabinet paper	Regulations to facilitate the operation of a 'stepping-stone' financial product market	Date to be published	By 29 June 2021

List of documents that have been proactively released		
Date	Title	Author
November 2020	Agreement to regulations for a 'stepping-stone' financial product market	Office of the Minister of Commerce and Consumer Affairs
20 November 2020	Proposed Regulations for a 'stepping-stone' Financial Product Market DEV-19-MIN-0313	Cabinet Office
May 2021	Regulations to facilitate the operation of a 'stepping-stone' financial product market	Office of the Minister of Commerce and Consumer Affairs
13 May 2021	Regulations to facilitate the operation of a 'stepping-stone' financial product market LEG-21-MIN-0059	Cabinet Office
May 2020	Impact Summary: Assessment of regulations under the Financial Markets Conduct Act 2013 for 'MyCap Markets'	MBIE

Information redacted

NO

Any information redacted in this document is redacted in accordance with MBIE's policy on Proactive Release and is labelled with the reason for redaction. This may include information that would be redacted if this information was requested under Official Information Act 1982. Where this is the case, the reasons for withholding information are listed below. Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

In Confidence

Office of the Minister of Commerce and Consumer Affairs

Chair, Cabinet Economic Development Committee

AGREEMENT TO REGULATIONS FOR A 'STEPPING-STONE' FINANCIAL PRODUCT MARKET

Proposal

1. This paper advises Cabinet of my intention to issue a licence for a 'stepping-stone' financial product market, targeted at early stage growth companies, under the Financial Markets Conduct Act 2013. It also seeks policy decisions from Cabinet to change some of the regulatory settings that will apply to this market to better reflect its 'stepping-stone' nature.

Executive Summary

2. I intend to issue a licence to operate a financial product market to MyCap Markets Ltd under the Financial Markets Conduct Act 2013. The proposed market is intended to operate as a 'stepping-stone' market targeted primarily at early stage growth companies. It is intended to be a low cost market, offering periodic trading by way of an online auction platform.
3. I am also proposing that changes be made to how certain regulatory requirements apply to issuers listed on this market. These changes will provide for:
 - 3.1. alternative disclosure requirements allowing for periodic disclosure (to align with periodic trading) rather than continuous disclosure; and
 - 3.2. reduced financial reporting requirements for firms that are subject to a higher standard of financial reporting and auditing only because they are listed on this licensed market.
4. These changes are required to reflect the periodic trading model of the proposed market. They are also important to ensure that the costs are appropriate for, and do not act as a barrier to, small growth firms listing on public markets.
5. This market, with the proposed regulatory changes to allow it to operate, will have clear differences to existing market arrangements. However, I believe these differences are justified.
6. The development of a 'stepping-stone' market is in line with one of the stated purposes of the Act, which is to encourage a diversity of financial product markets to take account of the differing needs and objectives of issuers and investors. By making it easier for small firms to raise capital, the market may address an

understood shortage of capital available to small, growth oriented companies in New Zealand.

Background

7. The Financial Markets Conduct Act 2013 (the Act) governs how financial products are created, promoted and sold, and the ongoing responsibilities of those who offer, deal and trade them. It aims to promote confident and informed participation in financial markets, and promote and facilitate the development of fair, efficient and transparent markets.

Licensed Financial Product Markets

8. One of the specific purposes of the Act is to promote fair, orderly and transparent financial product markets. Financial product markets are facilities to allow for the trade of financial products (such as debt or equity shares in a company).
9. The Act requires that financial product markets are licensed, and it also sets out the general obligations and requirements for those who operate financial product markets, those who issue on them, and those who trade over them.
10. Currently, the only licensed financial product market based in New Zealand is the New Zealand Exchange (the NZX). As New Zealand's main exchange, which trades on a continuous basis, all of the general obligations contained in the Act for licensed market operators apply to it. These relevantly include requirements for issuers on that market to notify the market of all events or matters that are material to the prices of quoted financial products as they arise (known as "continuous disclosure").

Encouraging a diversity of markets

11. The Act has also been designed to encourage a diversity of markets to take account of the differing needs and objectives of issuers and investors. To allow for diversity of markets, the Act provides flexibility to change the general obligations that apply for particular types of markets.
12. The Act's stated objective of encouraging a "diversity" of financial product markets (with the related flexibility provided in the Act to achieve this) was included in response to a recommendation made by the Capital Markets Development Taskforce (the Taskforce).
13. The Taskforce, which was established just after the Global Financial Crisis with the purpose of developing a blueprint for New Zealand's capital markets, recommended that exchanges could be developed with a lower regulatory burden than existing exchanges. It noted that the listing fees, compliance costs and governance required to list on NZX's main board could be a barrier to public listing for small and medium enterprises. The Taskforce thought that a market with a lower regulatory burden might support the growth of firms by creating an additional pathway between private and public equity funding.

I am able to issue a licence under the Act

14. Under the Act, I am able to issue a licence to operate a financial product market, after receiving advice from Financial Markets Authority (the FMA), the regulator in this area, if I am satisfied that:
 - 14.1. the applicant is capable of operating a financial product market in accordance with general obligations specified in the Act;
 - 14.2. there is no reason to believe the applicant will not comply with applicable market operatory obligations; and
 - 14.3. the applicant is a body corporate and is (or will be) registered under the Financial Service Providers (Registration and Dispute) Resolution Act 2008 on and from commencing to operate the market.

I have received an application for a licence to operate a 'stepping-stone' market

15. I have received an application from MyCap Markets Ltd for a licence to operate a financial product market targeted primarily at small growth companies. These are companies who would benefit from raising capital (of around \$2 million to \$20 million), but cannot easily afford initial and ongoing compliance costs of listing on the NZX. These are companies who might choose to seek money privately instead of listing. This market could operate as a stepping-stone to listing on the NZX for smaller growth companies.
16. While the market is targeted primarily to companies seeking equity or debt finance, it will also be open to small managed investment schemes.
17. The distinctive characteristic of the proposed market is that products on it will only trade during periodic auctions, which is in contrast to the NZX and most international markets which trade continuously. The auction frequency will be set by each issuer and could take place monthly, quarterly, or yearly. Sellers and buyers will bid the price which they would sell or buy that product for and the final price will be that which allows the most trades to take place.
18. The auction format is designed to concentrate demand and supply to increase liquidity for less traded financial products. It is also intended to reduce the costs for issuers because trading will only be available during limited windows.

Regulatory changes are necessary for the 'stepping-stone' market to operate

19. Changes to how the general obligations in the Act apply to the proposed market are required to reflect the periodic trading model of it. They are also important to ensure that the costs are appropriate for, and do not act as a barrier to, small growth firms listing on public markets.
20. Broadly, changes are required to provide for:
 - 20.1. alternative disclosure requirements allowing for periodic disclosure (to align with the periodic auctions) rather than continuous disclosure; and

- 20.2. reduced financial reporting requirements for firms that are subject to a higher standard of financial reporting and auditing only because they are listed on this licensed market.

I intend to issue a licence for the ‘stepping-stone’ market

21. The FMA has provided me with information and advice on this application. Based on that advice, and having regard to the requirements in the Act, I intend to issue a licence to the applicant, MyCap Markets, to operate the proposed ‘stepping-stone’ market.
22. I am satisfied that the applicant for the licence is capable of operating a financial product market in accordance with the general obligations set out in the Act. I have no reason to believe that the applicant will not comply with the market operator obligations that will apply under section 314 of the Act. As is also required by the Act, the applicant is a body corporate, and will register under the Financial Service Providers (Registration and Dispute Resolution) Act 2008 on and from commencing to operate a financial product market.

Assessment of resources and capabilities

23. I am satisfied that, if the licence is issued, the applicant will (to the extent reasonably practicable) do all things necessary to ensure that the market is a fair, orderly and transparent one.
24. Based on the information I have received about the market, how it will be run, and the rules that will apply to it, I am also satisfied that:
- 24.1. there will be sufficient resources to operate the market properly; and
- 24.2. adequate arrangements on the market will be in place for:
- notifying required disclosures of information from issuers;
 - handling conflicts of interest;
 - monitoring conduct on the market; and
 - enforcing compliance with relevant rules.
25. In making this assessment, I have had regard to the scale and design of the market and some of the issues that this raises, for example:
- 25.1. limited resourcing while the market is small;
- 25.2. the related impact this has on the independence of decision-making and the ability to monitor the market; and
- 25.3. sufficient technical resources.
26. However, I am satisfied that these issues can be addressed by imposing conditions on the licence. These conditions will include, but are not limited to, requiring:

- 26.1. that an experienced independent director be appointed prior to the market commencing any licensed activity;
 - 26.2. the appointment of additional regulatory staff to strengthen conflicts management when the market exceeds a certain size;
 - 26.3. specified activity levels are not exceeded until further staff are appointed; and
 - 26.4. an appropriate technology solution be subject to the FMA's approval before launch.
27. I am aware that the periodic trading model of MyCap Markets, in tandem with the supporting regulatory changes to allow the market to operate, would be a departure from existing market arrangements. Issuing a market operator licence may therefore pose some risks in terms of the perception of the required regulatory standards for financial product market operators, and of consistency of approach to licensing.
28. However, an objective of the Act is to encourage a diversity of financial product markets to take account of the differing needs and objectives of issuers and investors. A periodically traded auction platform, as a low cost and simplified early-stage financial product market, should promote growth, participation, innovation and flexibility in financial markets.
29. I understand that there is a shortage of capital available to small, growth oriented companies in New Zealand, particularly where angel and venture funding is a poor fit. Making it easier for small firms to raise capital will help address this. This will also increase the number of opportunities available in New Zealand for investment. I consider the benefits such a market may provide in addressing this shortage of capital outweigh the potential risks associated with departing from the regulatory standards that apply to other licensed markets.

I intend to impose conditions on the licence relating to the size of issuers

30. Given the departure from existing market arrangements, however, I intend to impose conditions on the licence relating to the size of issuers which will provide:
- 30.1. only issuers with an initial market capitalisation of \$60 million or less are eligible to list on the market; and
 - 30.2. issuers whose market capitalisation subsequently exceeds \$100 million have a two year period to transition off the market.
31. These conditions will be reviewed by the FMA within 24 months to assess their on-going appropriateness and impact.
32. These conditions will ensure that the market targets small companies as it is intended to, and that those companies will have a transition plan when they get to a certain size. That is the basis on which I am comfortable licensing it, and also why I believe that the departures from standard regulatory settings set out below are justified.

33. My decision to issue the licence, with a number of relevant conditions, is supported by the advice I received from the FMA. At Annex One, I have set out all of the conditions that I intend to impose when issuing the licence.

The FMA considers some exemptions are appropriate

34. The FMA also intends to use its powers under the Act to issue exemptions from certain regulatory requirements based on the stepping-stone nature of this market. These exemptions will exempt issuers on the market from “regulated offer” requirements¹, including issuing a “Product Disclosure Statement” (which provides investors with key information), when:
- 34.1. raising \$2 million or less capital in any 12 month period; and
 - 34.2. issuing financial products of the ‘same class’ as those which have already been issued, provided that the financial product has been trading for at least three months and during at least three auctions. This is limited to \$20 million or less in any 12 month period.
35. The FMA has a power under the Act to issue exemptions which are necessary or desirable to promote one or more of the purposes of the Act. It considers that these exemptions will help facilitate the development of an innovative growth market which has the potential to offer small growth companies more funding options at an earlier stage in their growth cycle, helping to address a funding gap within New Zealand’s capital markets.

Regulations are necessary for the market to operate as intended

36. I am proposing to change some of the obligations and requirements that apply to issuers on the proposed market, specifically disclosure and financial reporting and auditing requirements.
37. I believe that these changes are justified based on one of the purposes of the Act, which is to encourage a diversity of markets, as well as wider policy objectives. Drawing from both, my objectives are to:
- 37.1. maintain the integrity and reputation of our capital markets, and investor confidence, including by ensuring low levels of market misconduct;
 - 37.2. ensure information available on the market will allow efficient pricing of financial products traded, accurately reflecting value;
 - 37.3. reduce the costs and difficulties of listing for small growth companies; and
 - 37.4. reduce the funding gap for small growth companies, and increase the number and range of investment opportunities for retail investors.

¹ If an offer is a “regulated offer” it will be subject to a number of obligations. The offeror will need to provide any retail investors with a product disclosure statement. Other obligations such as governance and financial reporting will also apply.

I am seeking agreement for alternative disclosure requirements to apply

38. The default position under the Act for ongoing disclosure of information by issuers offering financial products is that information about all events or matters that are material to the price of quoted financial products (“material information”) be disclosed continuously. Continuous disclosure is intended to reduce information asymmetries and ensure investors are informed, so that the market is fair, efficient and transparent. It allows for accurate price discovery and improves market liquidity.
39. Continuous disclosure has clear benefits, but it also imposes costs and legal risks on issuers. For large companies this is justified and appropriate, as the costs are proportionally smaller, and the impact on market integrity of fair, efficient and transparent trading is greater. Further, while it makes sense in the context of a continuously traded market, this is less so for a market trading periodically.
40. I am proposing that an alternative disclosure regime be created allowing for periodic disclosure to fit with the proposed periodic trading nature of the market. Under this, “material information” would need to be disclosed, but only prior to, and during, each trading auction. The alternative disclosure provisions would be Part 5 market provisions under the Act. This means a breach of these provisions may give rise to civil liability under the Act, providing the FMA with an equivalent range of enforcement options for breaches of alternative disclosure requirements as they have for continuous disclosure requirements.
41. There would also be some other minor provisions to ensure that this alternative disclosure regime fits within the parameters of the Act:
 - 41.1. provisions directed at ensuring that a breach of the alternative disclosure obligations will be treated in the same way as if it were a breach of the continuous disclosure provisions in the Act; and
 - 41.2. the test for when the FMA can approve a rule change relating to disclosure (replacing a test in the Act which refers to continuous disclosure).
42. While periodic disclosure could potentially reduce the amount of information available to the market (for instance, where there is material information between auctions, but this is no longer material immediately preceding the auction), I believe this is a low risk.
43. I consider that a periodic disclosure regime appropriately reflects the periodic nature of trading on the market. I also think that it is justified for small growth companies that are otherwise unlikely to list. If this market, with this form of disclosure, did not go ahead, the likely alternative for a number of these companies would be to continue to seek money privately, which may not require any disclosure.
44. Importantly, the broader requirements and protections for licensed markets in the Act will apply here. They relevantly include the provisions relating to insider trading, market manipulation, substantial product holder disclosure and relevant interest disclosure.

I am seeking to reduce financial reporting requirements for certain issuers

45. Under the Act, certain entities are designated as 'FMC reporting entities' and subject to a higher standard of financial reporting and auditing. This is generally where there is a higher degree of public interest, and more rigorous and definite reporting standards are appropriate. The FMC reporting entity requirements include requiring financial statements to be audited by a FMC licensed auditor. There are only a small number of FMC licensed auditors, which may increase the cost of the audit.
46. The Act allows for regulations to be made to provide that issuers are not 'FMC reporting entities' if the only reason for this is that they are listed on a specified financial product market. I am proposing to exempt those issuers on this market who are caught on this basis. Issuers would still be considered 'FMC reporting entities' if they meet any of the other classifications – for example, if they issue a regulated product (unless they have fewer than 50 shareholders).
47. Issuers will only be exempt from being 'FMC reporting entities' under the proposed regulations if they comply with the relevant market rules, which are approved by the FMA. I understand the market rules will require that issuers do the following (without an ability to opt-out of these requirements):
 - 47.1. meet general reporting obligations for large companies under the Companies Act 1993;
 - 47.2. file their financial statements with the Companies Office within five months;
 - 47.3. have their financial statements audited by a qualified auditor (but not by FMC licensed auditors).
48. I think this appropriately balances the cost imposed on smaller issuers as against the acceptable degree of financial reporting and auditing that is required. It would reduce, to some degree, one barrier to small firms seeking public capital.

Approval for an electronic transfer system

49. For the market to operate efficiently, it is necessary that share ownership can be transferred electronically. Share ownership of a listed financial product can only be transferred electronically via an approved electronic transfer system. Electronic transfer systems must be approved, by Order in Council, under the Act.
50. MyCap Markets has sought approval for its proposed electronic transfer system, and the FMA has recommended that it be approved. Its recommendation takes into account the design of the market, MyCap Markets' projections for the market, and its assessment of the checks and balances that will be incorporated into the proposed system. It considers the electronic transfer system represents a sufficiently robust mechanism to justify its use in preference to a paper-based system (which is more likely to exhibit slower processing, higher likelihood of errors, complexity, and unnecessarily higher costs).
51. Based on that recommendation, I consider that the applicant's proposed electronic transfer system should be approved under section 376 of the Act. I consider that

approval should be based on certain terms, including that the system is subject to independent testing in line with timeframes specified in conditions imposed on the licence.

Consultation

52. The Treasury, the Department of the Prime Minister and Cabinet (Policy Advisory Group), and the FMA have been consulted on this paper.
53. Together with the FMA, the Ministry of Business, Innovation and Employment (MBIE) also carried out a process of targeted consultation and engaged with existing market operators, advisors, and investors on the proposed regulatory changes. The response to the development of a 'stepping-stone' market was generally positive.
54. There was a concern, however, that this market would benefit from regulatory concessions which would not be available to other markets. This may raise questions of fairness and competition, particularly given the regulations I am proposing will be specific to this market rather than institution-agnostic.
55. While I understand these concerns, the regulatory changes that I consider appropriate here are specific to the 'stepping-stone' nature and design of this particular market, and are not necessarily appropriate for other financial product markets. I will consider future markets which may apply for licences, including any regulatory concessions sought, on their merits.

Financial Implications

56. There are no direct financial implications to the Crown arising from this market. However, the FMA's funding and levies are currently being considered in a broader review. The levies that the market operator and issuers on the market will pay will be established as part of that. The review will ensure that the levies do not act as a barrier to entry, and properly reflect the benefit to the market and issuers from operating in a licensed regime.

Legislative Implications

57. The proposals in this paper will require the making of regulations under sections 351 and 376 of the Financial Markets Conduct Act 2013.

Impact Analysis

58. MBIE's Regulatory Impact Analysis Review Panel has reviewed the attached Regulatory Impact Summary prepared by MBIE. The Panel consider that the information and analysis summarised in the Regulatory Impact Summary meets the criteria necessary for Ministers to make informed decisions on the proposals in this paper.

Human Rights

59. There are no human rights implications arising from the proposals in this paper.

Gender Implications

60. There are no gender implications arising from the proposals in this paper.

Disability Perspective

61. There is no relevant disability perspective arising from the proposals in this paper.

Publicity

62. Subject to Cabinet's agreement to the recommendations relating to regulatory changes, and after I have issued a licence to MyCap Markets Ltd, I intend to issue a press release announcing the new market and Cabinet's decisions in relation to it.

Proactive Release

63. I intend to delay the release of this paper until after I have issued the licence to MyCap Markets to operate the licence. The paper will be released subject to any redactions as appropriate under the Official Information Act 1982.

Recommendations

The Minister of Commerce and Consumer Affairs recommends that the Committee:

1. **note** that one of the purposes of the Financial Markets Conduct Act 2013 (the Act) is to encourage a diversity of markets to take account of the differing needs and objectives of issuers and investors;
2. **note** that I am able to issue a licence under the Act to operate a financial product market, and that I intend to issue a licence to MyCap Markets Ltd to operate a financial product market, subject to certain conditions;
3. **note** that certain regulations are necessary for the market to operate as a low cost market, with a periodic trading model;
4. **agree** that regulations be made providing for an alternative disclosure regime. This regime would:
 - 4.1. require that material information (as defined in the Act) be disclosed prior to, and during, each trading window (an auction);
 - 4.2. provide that the alternative disclosure provisions are Part 5 provisions under the Act;
 - 4.3. make minor modifications to ensure that the alternative disclosure regime fits within the parameters of Part 5 of the Act, including;
 - 4.3.1. provisions directed at ensuring that a breach of the alternative disclosure obligations will be treated in the same way as if it were a breach of the continuous disclosure provisions in the Act;

- 4.3.2. the test for when the FMA can approve a rule change relating to disclosure (replacing a test in the Act which refers to continuous disclosure);
5. **agree** that regulations be made stating that:
 - 5.1. issuers on this market are not automatically 'FMC reporting entities', if the only reason for that is because they are listed on MyCap Markets' licensed market; and
 - 5.2. those issuers must comply with the financial reporting and auditing requirements set out in the market rules of the licensed market.
6. **agree** that regulations be made approving the electronic transfer system proposed by MyCap Markets under section 376 of the Act subject to certain terms;
7. **authorise** the Minister of Commerce and Consumer Affairs to issue drafting instructions to the Parliamentary Counsel Office to give effect to the above recommendations; and
8. **authorise** the Minister of Commerce and Consumer Affairs to make minor and technical changes consistent with the policy decisions in this paper.

Authorised for lodgement

Hon Kris Faafoi

Minister of Commerce and Consumer Affairs