

Regulatory Impact Statement

Assessment of alternative regulations under the Financial Markets Conduct Act to allow for NZX's proposed new market

Agency Disclosure Statement

1. This Regulatory Impact Statement (RIS) has been prepared by the Ministry of Business Innovation and Employment (MBIE).
2. It provides analysis of potential regulations under the Financial Markets Conduct Act (FMC Act) to allow NZX to operate an equity market with alternative ongoing disclosure obligation rather than full continuous disclosure of all material information required at present. The equity market is directed at small and medium sized enterprises (SMEs). This is intended to address, together with other design features of the market, the perceived barriers for SMEs listing on equity markets.
3. Analysis in this RIS is subject to a number of caveats relating to the evidence base:
 - There is quantifiable data available about firms' propensity to seek equity finance, whether finance was obtained, and the source of that finance. But there is little quantifiable data to assess whether or not SMEs face barriers when transitioning from private to public equity financing.
 - We have not been able to establish a strong causal connection between continuous disclosure and the low numbers of listings of SMEs.
 - We do not have any cost estimates relating to continuous disclosure or the cost of the proposed disclosure regime on NZX's new market. Our assumption is that more prescriptive, less ambiguous disclosure requirements will be less costly for SMEs and that this will reduce the perceived barriers to listing.
 - We have also not undertaken any systematic assessment or forecast the likely size and scope of any economic benefit that might be gained if the market was successful. It is hard to predict whether the market will be successful.
4. The analysis in this RIS has been informed by advice from the Financial Markets Authority (FMA), consultation undertaken by NZX and other data supplied by NZX of existing financial markets participants, our survey of existing literature and our own interviews with NZAX issuers and potential issuers on NZX's new market.

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INTRODUCTION

5. NZX is developing a market aimed at small and medium sized enterprises (SMEs). NZX submitted an application to MBIE and FMA on 1 April 2014 to apply for regulations to be made under the FMC Act that would allow the proposed market to operate with a more limited alternative ongoing disclosure regime rather than standard continuous disclosure. As will be discussed further in the problem definition, NZX has identified continuous disclosure as a potential barrier to SMEs listing and raising equity capital publicly.

STATUS QUO AND PROBLEM DEFINITION

Current framework for continuous disclosure

6. Continuous disclosure by issuers listed on NZX's markets has been in place, with statutory backing, since 2002. Under the continuous disclosure requirements firms must immediately notify the market of all events or matters that are material to share prices, as they arise. NZX has the primary role of monitoring compliance with the continuous disclosure obligations for its markets. FMA can enforce breaches under statute.
7. This is a "principles-based" continuous disclosure regime. It places the onus on the issuer to assess the materiality of information and release it immediately to the market, addressing timeliness of disclosure. It also minimises any discretion for the issuer to withhold information, reducing risks of selective disclosure.
8. If a market is fully informed in this way, there are key benefits:
 - The information in the market accurately reflects the value of the securities traded, assisting trading overall and positively impacting on efficiency and liquidity.
 - Investors are more informed and can make investment decisions based on accurate information.
 - A reduced risk of insider trading – continuous disclosure increases the amount of information available to the public, reducing the risk that individuals inside a firm could be trading on non-public information.
 - Firms can raise capital for an efficient price.
9. Studies¹ examining the level and quality of information on NZX since statutorily backed continuous disclosure was introduced have found that it has had a positive impact on the quality of information available to the market. Analysts' forecast accuracy (used as a proxy for investor beliefs) showed some improvement and the market anticipated earnings announcements more efficiently. The efficiency around earnings announcements is indicative of an improvement in the information environment on the market overall. New Zealand also rates well on internationally

¹Huang, M, Marsden, A and Poskitt, R, 'The impact of disclosure reform on the NZX's financial information environment', Working paper, University of Auckland [2006]; Dunstan, K, Gallery, G and Truong, TP, 'The impact of New Zealand's statutory-backed continuous disclosure regime on corporate disclosure behaviour', Working paper, Victoria University, September 2008.

accepted measures of private investor protections, one of which measures the disclosure of information to investors.²

10. NZX runs the only registered markets in New Zealand currently. Continuous disclosure applies to all of those markets. Continuous disclosure also applies to securities markets run in other developed economies. Its value is endorsed by the International Organization of Securities Commissions (IOSCO). IOSCO is an international body made up of international securities regulators and is recognised as the global standard-setter for the securities sector.
11. IOSCO recognises that full and fair disclosure to investors can be achieved via two methods:
 - A 'general obligation' approach. This approach is how New Zealand's current 'principles-based' continuous disclosure obligations would be described.
 - A 'prescription approach' about all "presumptively material" matters.³
12. There are however powers in the FMC Act that would allow for a market to operate with alternative disclosure rules. It is also a stated objective of Part 5 of the FMC Act to "encourage a diversity of financial product markets to take account of the differing needs and objectives of issuers and investors".

Problem - barriers for SMEs in listing on public markets

13. By undertaking research with company advisors, potential new market issuers, and other financial markets participants, NZX has identified that continuous disclosure is a barrier for SMEs to list and raise capital. This RIS considers options to address the problem continuous disclosure poses for SMEs seeking to list publicly.
14. In 2009 the Capital Market Development Taskforce (CMDT) recommended that exchanges could be developed with a lower regulatory burden than existing exchanges. CMDT noted that the listing fees, compliance costs and governance required to list on NZX's main board could be a hurdle for SMEs.
15. There is some evidence to suggest that continuous disclosure may pose a barrier to public listing for smaller companies. The barrier may be due to the following direct and indirect costs of the "principles-based" continuous disclosure regime:
 - The need for governance systems, and direct costs of obtaining external legal advice, to identify and determine what is "material information" that must be disclosed and when that information must be disclosed. There is guidance available about continuous disclosure obligations but judgement is still required when complying with the regime in practice.

² Cameron, L, 'Investor protection and the New Zealand Stock Market', New Zealand Treasury Policy Perspectives Paper 07/02, October 2007. Cameron uses a "set of widely-cited international comparisons". The comparisons used account for disclosure of information, approval of transactions, and access of minority investors redress in court.

³ International Organization of Securities Commissions (Statement by the Technical Committee), 'Principles of Ongoing Disclosure and Material Development Reporting by Listed Entities', October 2002.

- The reluctance of, particularly early stage companies, to release information that is commercially sensitive.

16. The evidence base on which to establish the extent of the problem continuous disclosure poses is limited and is mostly based on opinions expressed by issuers and their advisors. NZX undertook a survey of company advisors (investment bankers, accountants and lawyers) to assess the specific barriers SMEs face in listing. Continuous disclosure was identified as one of the barriers companies face, but it was not necessarily the most significant barrier. This finding has been reinforced by discussions MBIE has had with current NZAX issuers and prospective new market issuers.

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Small and medium firms' access to capital

18. There is a broader context in which the problem of continuous disclosure can be framed. This broader context positions NZX's proposal for a new market without continuous disclosure against the background of SMEs' access to capital more generally. This is also the context in which the CMDT taskforce recommendation was positioned. CMDT's recommendation to develop exchanges with a lower regulatory burden was intended to assist SME growth by creating an additional pathway between private and public equity funding, in essence to "pull firms through different stages of their growth".

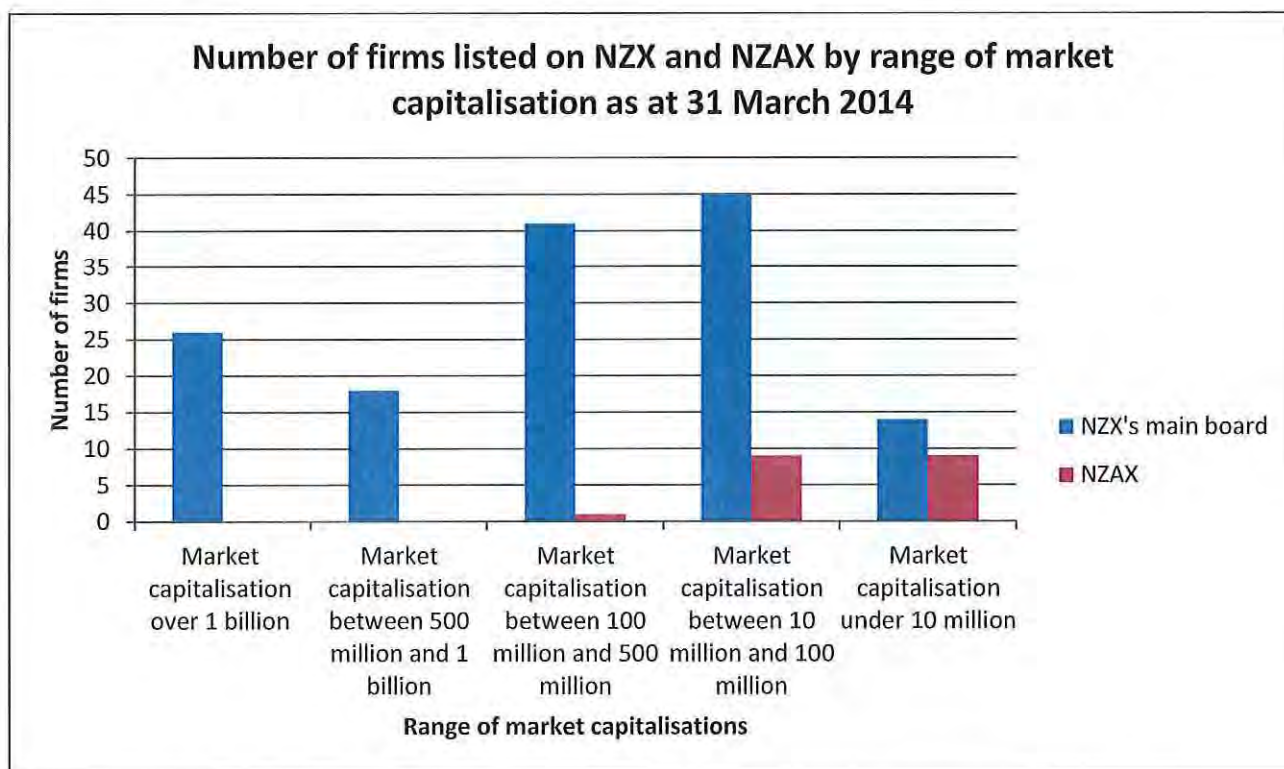
19. CMDT's recommendation aligns with a consistent theme that emerges within discussions about early stage capital markets in both the private and public sector. It is said that an equity capital raising gap exists around the \$2 million - \$10 million range within New Zealand's capital markets.
20. In addition, SMEs' ability to raise funds in New Zealand's capital markets will be impacted by the strength of capital markets activity overall. It is generally accepted, and often noted, that New Zealand's public capital markets function well, but are 'thin' as measured by market capitalisation, number of listed firms, and trading activity. CMDT noted that New Zealand has a low 'birth rate' of new companies on public markets and that this in itself may limit the ability of our capital markets to function effectively. CMDT outlined a 'virtuous circle' of listed markets activity, where new listings, liquidity, research and increased investment reinforce and impact on one another. Increased numbers of SMEs listing may inspire increased investment, which in turn promotes liquidity in the market.
21. The funding gap has been described as a lack of 'matching opportunities' rather than a lack of capital. There is, however, a mix of views about whether the funding gap is a lack of financial intermediaries with the skills, experience and reputation needed to attract capital and potential investors or whether companies themselves do not have the capability to make themselves 'investment ready'.
22. The perceived funding gap is positioned across the early expansion and expansion phases of business development, as outlined by the stylised stages of investment diagram below.

Investment stage	Type of investors active in this stage and indicative investment level	Funding gap
Pre-seed investment stage - firms are in the proof of concept stage.	Founders, friends and family - below \$100,000	Private and public sector views suggest a funding gap exists between \$2 million - \$10 million
Seed and start-up investment stage - where firms have a proven market concept, the firm is either pre-revenue or has some early revenue streams.	Angel investors - \$100,000 to \$2.5 million	
Early expansion and expansion phases - revenue streams are becoming steadier but the firm has either low or no earnings.	Venture capitalists - \$2.5 million to \$15 million	
Buy-out phase - the firm has matured both in revenue streams and earnings.	Initial public offering on NZX, NZAX, or Unlisted (a trading facility not subject to securities legislation) or investment by a private equity fund - greater than \$15 million	

27. New Zealand has well-developed seed and start-up funding markets, and recent changes made by the FMC Act should further support seed and start-up funding activity. There is, however, less evidence of available expansion capital, particularly within formal private equity markets. Although venture capital funds are active within this funding gap already (with existing government support provided by the New

Zealand Venture Investment Fund) the venture capital market was affected by the global financial crisis, with investment still relatively slow in 2011 and 2012, but rebounding in 2013.

28. More options for public listing at an earlier stage in a firm's growth cycle may assist in remedying the funding gap. It is unlikely that this funding gap will be directly filled by public listing, venture capitalists are still likely to be most active within the early expansion and expansion phase of funding. However, an attractive listing option could catalyse venture capitalists' activity by providing more certainty of a viable 'exit strategy' to their investment through an initial public offer.
29. However this is not to say that SMEs do not list currently. NZX's main board has a number of SMEs listed (for the purposes of this analysis, SMEs are defined by the type of firm NZX is targeting for its new market – specifically a firm with a market capitalisation of between \$10 million and \$100 million). Within NZX's listings (as at 31 March 2014) there were 45 SMEs. When combined with the number of SMEs listed on NZAX, of which 9 would be of an appropriate size for the new market, this takes the total to 54 SMEs currently listed out of a total of 163 listed companies on NZX's markets.



30. NZAX is NZX's current market targeted specifically at SMEs and NZX's new market is intended to replace NZAX. NZAX has not been successful in recent years. No new companies have undertaken an initial public offer on the market since 2007.
31. Given the number of SMEs currently listed on NZX's main board, the analysis in this RIS also needs to consider the effect NZX's new market might have on the main board and the integrity of New Zealand's financial markets more generally. In the future, some SMEs who might have listed on NZX's main board may list on the new market instead, and, if that new market is operating without continuous disclosure this might impact on perceptions of New Zealand's disclosure regime on listed markets, both within New Zealand and by international observers.

OBJECTIVES

32. Any regulations allowing for alternative disclosure arrangements on the proposed market would have a number of potential impacts on investors, issuers and financial markets more generally. When considering whether regulations should be made, the Minister of Commerce must have regard to specific aspects set out in the FMC Act.⁴

33. The key objectives, taken from the purpose of the relevant part of the FMC Act, are -

- to promote fair, orderly, and transparent financial product markets; and
- to encourage a diversity of financial product markets to take account of the differing needs and objectives of issuers and investors.

34. We have identified a number of policy objectives that reflect both these purposes and the broader objectives of sections 3 and 4 of the FMC Act:

Objective 1: The costs and difficulties of listing will be reduced for SMEs

Objective 2: Reduce the funding gap for SMEs and increasing the number and range of investment opportunities for retail investors

Objective 3: Information available on the market will allow efficient pricing of the securities traded, accurately reflecting the value of the securities

Objective 4: Maintaining low levels of market misconduct, and maintaining the integrity and reputation of securities markets as a whole.

35. If the policy objectives outlined above are met then NZX's proposed new market would provide a more effective, less costly and easier compliance method of raising equity capital for SMEs. We expect these objectives to be strongly linked to addressing the early expansion and expansion funding for SMEs. Investors would be informed of the type of investment available on the market and participate confidently when trading on the market. The market would operate with integrity and would not impact on the integrity of securities markets as a whole, particularly when compared to international markets.

OPTIONS ANALYSIS

36. This RIS considers the following two options:

- *Option one:* do not allow for alternative disclosure requirements (ie. status quo).
- *Option two:* make alternative regulations to allow for an alternative ongoing disclosure regime including periodic disclosures and a set list of immediate disclosure events, as put forward in NZX's application.

The options are outlined in more detail below along with their assessment against the policy objectives.

Additional elements of the market design that may impact on the policy objectives

⁴ The detailed requirements that must be considered by the Minister of Commerce are set out in Annex 1. For ease of understanding the policy objective that accounts for the particular aspects of the FMC Act that the Minister of Commerce must have regard to has been aligned to the statutory requirement in the Annex.

37. While the main problem that this RIS considers is the issue of continuous disclosure, there are other elements of NZX's market design that should inform the analysis of both options as they may influence the effectiveness of disclosure on the market and will impact the cost of listing on the market.
38. The design features of the new market are intended to address some of the additional problems and barriers (aside from continuous disclosure) that NZX identified as limiting SMEs' ability to list publicly. In particular, these features are intended to reduce the cost of producing prospective information in initial listing documents and may improve market liquidity. The additional features would increase ongoing listing costs, but, taken together they are intended to make the listing environment on the new market more attractive, potentially spurring more SMEs to list. The design features of the market are briefly described below:
- *Provision of research on companies listed on the market:* NZX is proposing to arrange research coverage for each firm listed on the new market.
 - *New Market Advisor:* Companies listed on the new market will be required to engage the services of a 'new market advisor' for three years after listing. New market advisors provide guidance and assistance through the initial public offer (IPO) process and after listing on matters such as compliance with listing rules.
 - *Market making:* NZX is proposing that market makers will operate on the new market in order to support liquidity and further encourage investment. Market makers support liquidity by ensuring that there is always an available buyer, should an investor wish to sell. Liquidity can be described as the degree to which a security can be bought or sold without affecting its price. A higher level of trading ensures a higher level of liquidity and market makers facilitate a higher volume of trading. Firms listed on the new market would pay a fee for market making services.
 - *Requirement for independent directors:* The new market will require a minimum of at least two independent directors or for one third of a listed SME's board to be independent. There is currently no requirement on NZAX for a certain number of independent directors, although of the 20 companies listed on NZAX, 14 have independent directors on their boards.
 - *Replacement of prospective financial information (PFI) with key operating milestones (KOMs):* NZX has identified that producing PFI accounts for a significant amount of a firm's initial listing costs. Rather than producing PFI as is currently required under standard continuous disclosure, the new market would require KOM as its primary mechanism for giving investors guidance as to a SMEs' future performance. KOMs are targets initially selected and disclosed by issuers at IPO and disclosed against in each periodic update to provide investors with guidance as to the SMEs performance in the previous quarter.
39. The KOMs would be set, reviewed and re-set according to the following process:
- the directors of the issuer would be satisfied that those metrics will result in understandable reporting for investors that cover the most significant factors by which the performance of the business should be assessed and monitored
 - the new market advisor would confirm to NZX that the metrics selected are suitable before the new market issuer lists (and the new market issuer would continue to consult the new market advisor on the selection of those metrics while the new market advisor is appointed)

- the new market issuer set and review at least annually, its metrics and targets for those metrics
- NZX would review and approve-
 - the metrics before approving the new market issuer for listing; and
 - any subsequent change to the metrics by the new market issuer.

Summary table of options analysis

Key

- ✓✓ Meets the policy objectives
- ✓ Partially meets the policy objectives
- ✗ Does not meet the policy objectives

Policy Objectives	Option one – do not allow for alternative disclosure requirements (ie. status quo)	Option two – allow for an alternative disclosure regime
The costs and difficulties of listing will be reduced for SMEs	<p>This option would increase the costs of listing as it would have the additional design features of the new market and the cost of continuous disclosure.</p> <p>This option may remove some of the costs and difficulties of listing for SMEs by the replacement of PFI with KOM, but it does not remove the difficulty of the perceived barrier or the costs of continuous disclosure for SMEs. ✗</p>	<p>It is presumed that unambiguous disclosure obligations will reduce the cost of disclosure obligations for SMEs. SMEs may also perceive the costs to be lower under this option, prompting them to consider listing more readily.</p> <p>However, there remains some uncertainty that savings could be made due to a lack of estimates about the savings that could be made in ongoing disclosure costs under this disclosure regime.</p> <p>The additional design features, such as research and market making services will add to the overall costs of ongoing listing and compliance with disclosure obligations on the market.</p> <p>Clear disclosure obligations may remove some of the difficulties SMEs face in listing.</p> <p>This option may meet the policy objectives but there is uncertainty about the actual benefits gained from this option. ✓</p>
Reduce the funding gap for SMEs and increase the number and range of investment opportunities for retail investors	<p>There would remain a funding gap between \$2-5 million, due to the fact that firms must be seeking an initial \$5 million capital raise at IPO.</p> <p>As outlined above this option may remove some of the costs and difficulties of listing for SMEs but it is more uncertain that the overall benefit gained would spur more SMEs to list or provide more investment options for retail investors when compared to option two. ✗</p>	<p>There would remain a funding gap between \$2-5 million due to the fact that firms must be seeking an initial \$5 million capital raise at IPO.</p> <p>If successful in spurring more SMEs to list, this option would improve retail investors' access to investment opportunities in SMEs. ✓</p>
Information available on the market will allow efficient pricing of the securities traded, accurately reflecting the	The option would be as effective as current continuous disclosure obligations. It would also have the additional benefit of research provision on listed SMEs and market making services.	SMEs would disclose information more regularly than under continuous disclosure obligations, due to the fact that the market rules would specify a quarterly update must be released to the market. SMEs would also have the benefit of research provision and market making services, both of which would contribute to efficient

value of the securities	<p>However, NZX has stated that under current continuous disclosure rules smaller firms provide fewer updates to the market. Less information available in the market about a firm may impact on the pricing of its securities.</p> <p>However, despite doubts about the <i>amount</i> of information currently in the market about SMEs, it still remains that continuous disclosure would result in more efficient pricing than when price sensitive information could potentially be excluded, as in option one. ✓✓</p>	<p>pricing within the market. The overall volume and regularity of information may be higher under this option.</p> <p>However, some price sensitive information would likely not be disclosed under this option. In particular, this would apply to situations where a SME has a material change in its performance but has not selected a KOM directly relating to that aspect of its business.</p> <p>This option partially meets the objectives as the amount of information released to the market by SMEs may improve under these disclosure obligations when compared to the status quo, but the risk of excluded information may detract from the overall benefit gained. ✓</p>
Maintaining low levels of market misconduct, and maintaining the integrity and reputation of securities markets as a whole	<p>Investors' confident participation in securities markets would be the same as the status quo of continuous disclosure.</p> <p>The potential for market misconduct is the same as would apply under the status quo.</p> <p>New Zealand's international reputation would be the same as under the status quo of continuous disclosure. ✓✓</p>	<p>There are greater opportunities for insider trading under this option as there may be more non-public information available to a greater number of people within SMEs due to the possibility of a flatter management structure within smaller firms. The new market proposes to have a more restrictive insider trading policy appropriate for SMEs' flatter management structure.</p> <p>There is also an increased risk that price sensitive information will not be disclosed under the disclosure regime. If investors feel they are not informed by the alternative disclosure requirements this has the potential to undermine the confident participation of investors in the market with implications for the integrity of New Zealand's securities markets.</p> <p>In addition, the disclosure regime on the market is a departure from internationally accepted norms of ongoing disclosure and has the potential to impact on international observers' opinions of New Zealand's disclosure obligations and financial markets more generally.</p> <p>This option has the potential to undermine the policy objectives but</p>

		there are mitigations within the market rules such as appropriate risk warnings and oversight by new market advisors, whose role is partly to assist and support SMEs to comply with securities law. ✓
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DESCRIPTION OF OPTION ONE: DO NOT ALLOW FOR ALTERNATIVE DISCLOSURE REQUIREMENTS (I.E. STATUS QUO)

40. For the purposes of this analysis we have assumed that if regulations are not made then NZX will launch the new market with continuous disclosure. The new market has additional features aimed at SMEs such as research and market making services. These features may make the market more attractive to SMEs, providing a more attractive option than the current listing environment and potentially alleviating the perceived funding gap for SMEs.

Analysis of option one against the policy objectives

Objective 1: The costs and difficulties of listing will be reduced for SMEs

41. We are assuming that the costs of complying with continuous disclosure obligations coupled with the costs of the additional design features of the new market would result in more expensive costs overall when compared to option two.
42. In addition, this option would also retain the perceived difficulties associated with continuous disclosure.

Objective 2: Reduce the funding gap for SMEs and increase the number and range of investment opportunities for retail investors

43. The additional design features of the market would be attractive to SMEs and there would be some savings made via the replacement of PFI with KOM. However because of the requirement to comply with continuous disclosure it is less certain that the overall benefit gained from this option would be attractive enough to encourage more SMEs to list.
44. Because this option is less likely to encourage SMEs to list in greater numbers it would not increase the number and range of investment opportunities available for retail investors.

Objective 3: Information available on the market will allow efficient pricing of the securities traded, accurately reflecting the value of the securities

45. NZX has asserted that under continuous disclosure smaller listed firms make fewer releases to the market than larger firms. NZX has also stated that smaller companies rarely give guidance about future business performance. A review of 19 of NZAX issuers found that in 2013, five NZAX issuers provided no general business updates over and above what was required by their financial reporting obligations and only two NZAX issuers provided investors with structured updates.
46. However, despite doubts about the *amount* of information currently in the market about SMEs, it still remains that continuous disclosure would result in more efficient pricing than when price sensitive information could potentially be excluded as in option two.

Objective 4: Maintaining low levels of market misconduct, and maintaining the integrity and reputation of securities markets as a whole

47. There would be no increased risk to investor confidence, insider trading and New Zealand's reputation internationally as continuous disclosure would apply to the new market under this option.

DESCRIPTION OF OPTION TWO: ALLOW FOR AN ALTERNATIVE ONGOING DISCLOSURE REGIME

48. Option two would disapply subpart 4 of Part 5 of the FMC Act and would introduce two new alternative disclosure obligations on new market issuers. These obligations include a quarterly periodic update disclosure and a set list of immediate disclosure matters and events. For further details about the particular conditions of the alternative disclosure regime see Annex 2.
49. This option would include a number of conditions and risk mitigations, including the requirement that before acquiring financial products on the new market investors must:
- be given an adequate risk warning regarding the nature of the new market, the fact that there are more limited rules for disclosure of price-sensitive information on this market than on the NZX Main Board and of the consequences this may have for investors; and
 - have confirmed that they understand the risk warning.

Quarterly periodic updates

50. The periodic disclosure would be released to the market within 20 working days after the end of each quarter. It would also include disclosures about changes and developments for the business of the new market issuer and of its performance against the targets for the metrics captured by the KOMs.
51. Between periodic disclosures, listed SMEs would be required to issue immediate disclosures to the market on a set list of matters and events. The set list of events would include significant matters and events that may affect the decisions of investors and the price of securities.
52. SMEs would also be required to correct false or misleading information generally available to the market that has been made available by the public issuer, or an associated person of the public issuer, or in circumstances that give the information substantial credibility.

Analysis of option two against the policy objectives

Objective 1: The costs and difficulties of listing will be reduced for SMEs

Cost of disclosure

53. This option may reduce the costs of the disclosure regime. Under current continuous disclosure obligations, if a matter arises that may be material a SME may seek legal advice irrespective of whether that information ultimately gets disclosed to the market. Therefore there are legal costs in *determining* the materiality of matters and events under continuous disclosure.

54. Whilst SMEs are expected to release a greater volume of information to the market under the alternative disclosure requirements, NZX is presuming that removing the ambiguity from the list of matters to be disclosed will reduce the cost of disclosure overall. It is presumed that clear disclosure obligations would allow SMEs to determine matters for disclosure internally without seeking legal advice, therefore reducing the ongoing costs of complying with their disclosure obligations.
55. However, NZX has not provided MBIE with an estimated reduction in legal costs for the new disclosure regime due to the difficulties in assessing legal costs across different issuers and their individual requirements.
56. In addition, it is unclear whether the overall costs of listing on this market will actually be reduced. The costs of the additional design features proposed for the new market, including requirements for independent directors and new market advisor services will impact on the ongoing costs of listing on the new market for SMEs.

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section 9(2)(b)

Difficulties of disclosure

57. The disclosure requirements in this option may reduce the perceived barrier, and therefore some of the difficulty for SMEs by making the obligations more defined and less overwhelming.
58. However there continues to be a risk that it is not whether or not continuous disclosure is the problem, but that listing requires disclosure to the public, with some SMEs reluctant to disclose commercially sensitive information to the public.
59. However, on the whole, we think an assumption can reasonably be made that the perceived barriers will be reduced under this option due to the more prescriptive requirements of the disclosure framework.

Objective 2: Reduce the funding gap for SMEs and increase the number and range of investment opportunities for retail investors

60. If successful, the new market could offer retail investors with the appropriate risk appetite a greater number of SMEs to invest in, providing more opportunities for appropriate 'investor matching'.
61. The market is aimed at firms with a potential market capitalisation of between \$10 million and \$100 million. Firms would need to be seeking a minimum initial capital raise of over \$5 million. Using the stylised investment stage, the following table provides an overview of the extent to which the market could remedy the funding gap identified in the problem definition, assisting firms to raise capital through public listing.

Investment stage	Type of investors active in this stage and indicative investment level	Funding gap	Capital raising on NZX's new market
<i>pre-seed investment stage</i>	Founders, friends and family - below \$100,000		Firms would need to undertake an initial capital raise of over \$5 million when doing their initial public offering on the new market.
<i>seed and start-up investment stage</i>	Angel investors - \$100,000 to \$2.5 million		
<i>early expansion and expansion phases</i>	Venture capitalists - \$2.5 and \$15 million	Private and public sector views suggest a funding gap exists between \$2 million - \$10 million	
<i>buy-out phase</i>	Initial public offering or private equity fund - greater than \$15 million		

62. The overview presented in the table above suggests that if the design of the market removes some of the difficulty firms face in listing it would somewhat assist SMEs in raising equity capital. However, it would not completely work towards remedying the 'funding gap' identified in the problem definition as firms seeking capital of between \$2 million - \$5 million would still be mainly relying on investment from venture capitalists.

Objective 3: Information available on the market will allow efficient pricing of the securities traded, accurately reflecting the value of the securities

63. The combined elements of the proposed alternative ongoing disclosure regime are intended to produce an environment where more regular and predictable disclosures are made to the market. This is likely to impact on:

- The timeliness of disclosure if information is only required to be disclosed in a quarterly report, rather than "immediately" as it arises, although some information will be disclosed immediately if it falls within the set list of matters and events requiring immediate disclosure to market.
- The quality of information disclosed. If some price sensitive information is not captured by the alternative disclosure obligations this reduces the quality of the information disclosed to the market.

Risk of inefficiency in the market between quarterly periodic updates

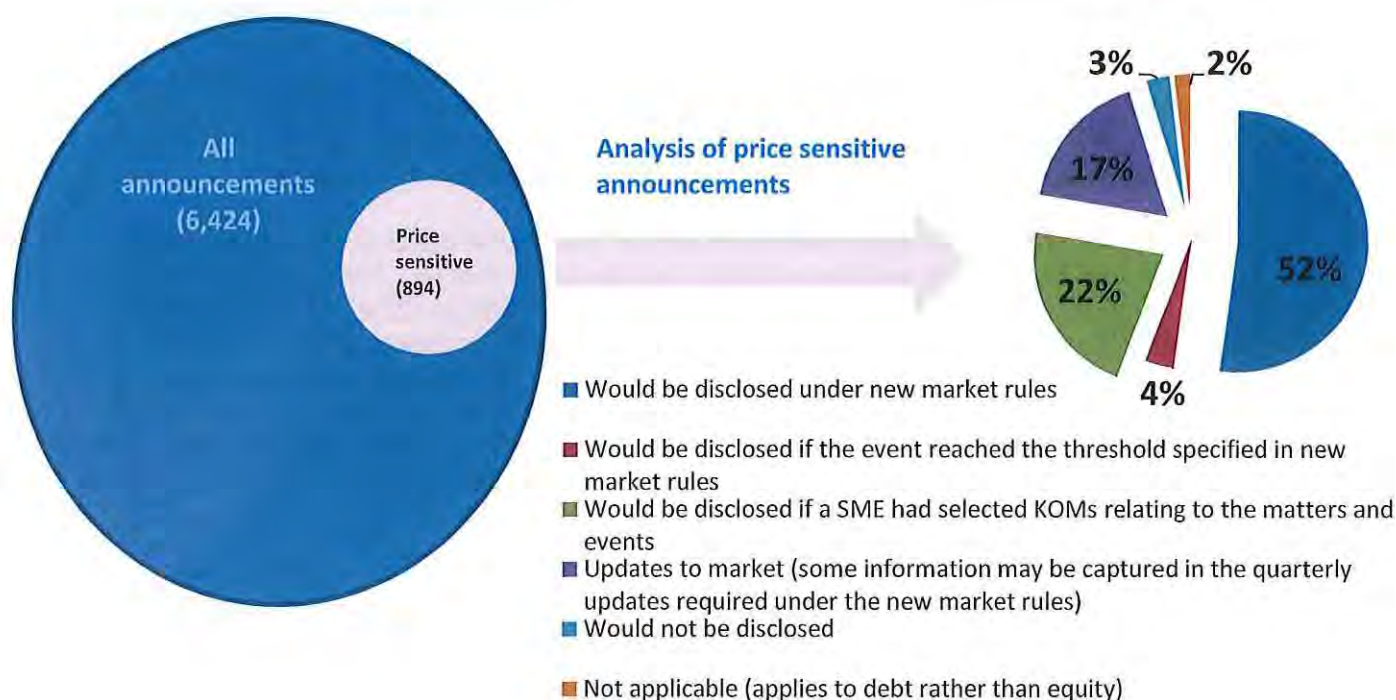
64. There is a risk that a reduction in the amount or timeliness of price sensitive information in the market could lead to inefficient pricing, impacting on the effectiveness of the market as a whole. This would happen when, due to a lack of information, investors become uncertain about the value of a security and become reluctant to trade due to their inability to assess the value of the security. Lack of trading leads to lack of liquidity and inefficiency in the market.

65. Disclosed information would be at its highest point at the time of the periodic update, potentially providing investors with their most complete picture of the value of their investment. The risk of inefficiency is greatest between quarterly updates as this is the time that investors are relying on firms' disclosure against the set list of items that would trigger immediate disclosure. If this list is deficient in events or matters accounting for price sensitive information there is a risk investors will not be informed between market updates, potentially impacting on efficiency in the market.
66. The risk is particularly acute during the 20 day 'window' at the end of a quarter before a firm has released its quarterly periodic update to the market. The risk is greatest at this time because it is the farthest point from the information released in the previous quarter's update. Investors would be relying on the immediate disclosure list to a greater extent during this time due to increasingly outdated information in the last quarterly periodic update. In addition, the longer it takes for a firm to publish the update for the latest quarter the more outdated it becomes. The time period allowed between the end of the quarter and publishing the update may be too long.

Examination of the risk of inefficiency

67. In order to understand the size and scope of the risk posed by NZX's set list of immediate disclosure events and matters, NZX provided MBIE with a comparative list and analysis of events that have resulted in 'price sensitive' announcements to NZX's main board between November 2013 and April 2014. The majority of price sensitive announcements would be covered under the new market's immediate disclosure rules. This analysis is illustrated in the diagram below.

NZX Main Board announcements between 1 November 2013 and 30 April 2014



68. However, as illustrated above there remains a risk that some price sensitive announcements would not be released to the market. This risk is particularly acute for earnings and profit guidance announcements. Under the proposed disclosure regime, if a SME has a material change in its performance but has not selected a KOM directly relating to that aspect of its business then the information would not be required to be released to the market.

69. There also remains a particular risk about the threshold that would trigger immediate disclosure against a KOM. In attempting to remove disclosure ambiguity around variances from KOMs, a 'brightline test' of a 10 per cent variance has been selected as the threshold that would trigger immediate disclosure to the market. When analysing this aspect of the alternative disclosure regime it has been difficult to determine whether this is an appropriate threshold. If the threshold is set too low it could potentially increase costs as listed SMEs would be making numerous updates to market. However, if it is set too high there is a risk that some price sensitive information may not be released. There is also a risk that this threshold will not be appropriate in all circumstances, and in fact the threshold should vary depending on the KOM chosen. MBIE has been unable to determine what an appropriate threshold might be from consultation with market participants and NZX has not provided any evidence supporting the selection of a particular threshold.

70. However, we accept that a definite threshold should be chosen in order to align with the overall intention of the alternative disclosure regime to create clear and unambiguous disclosure obligations for listed SMEs. FMA has stated that in most in public markets a movement of 5-10 per cent in any significant metric would be considered price sensitive. MBIE is relying on FMA's advice on this issue.

71. MBIE has also reviewed the list of immediate disclosure events and compared it to what is required in overseas alternative markets, such as, AIM (London), First North (Nordic Countries) and GEM (Hong Kong). It is difficult to make a direct comparison

to AIM and First North as both those markets require the immediate disclosure of price sensitive information, but a general comparison between the markets indicates that the majority of other significant events have been included in NZX's new market immediate disclosure list.

Potential mitigation of risk - overall level of information available in the market

72. Despite the potential for a lack of information in the market, under this option SMEs will actually be required to disclose information more regularly than is required under principles-based continuous disclosure. This approach may result in more context for understanding a company (and understanding price sensitive information when it is released), mitigating the risk of inefficient pricing, particularly in the period immediately following a quarterly disclosure.
73. There are other aspects of the new market design that may further mitigate the risk of inefficient pricing. Market makers will operate on the market and are required to buy and sell shares to stimulate trading and avoid an illiquid market. A market maker provides an assurance to investors that there is always an available buyer, should they wish to sell.
74. The provision of research has also been shown to improve liquidity. However, any research provided can only be based on information that is publicly available and is therefore based on information that may also be deficient in price sensitive information.

Objective 4: Maintaining low levels of market misconduct, thereby maintaining the integrity and reputation of securities markets as a whole

75. The new market could also increase the potential for insider trading as there would be a greater amount of information available to insiders that is not generally available to the market. Exacerbating the insider trading risk is the fact that SMEs may also have a flatter management structure increasing the number of insiders privy to non-public information. To mitigate this risk, the insider trading policy would be broader, including both directors and employees of a firm in order to counteract the flatter management structure of listed issuers.
76. Some price sensitive information may not be disclosed under the proposed regime. If investors feel they are not adequately informed by the disclosure on the market this may affect their confident participation in the market. Lack of investor confidence would impact on the integrity of the new market itself, with possible flow-on effects to financial markets as a whole.
77. There is also a risk that the departure from accepted norms of ongoing disclosure could impact on New Zealand's reputation internationally. Whilst IOSCO acknowledges that "full and fair" disclosure can be achieved via a prescriptive method (akin to NZX's alternative disclosure proposals) the risk of losing price sensitive information within the disclosure regime does not align with IOSCO's assertion that the "fundamental principle of full and fair disclosure is that the listed entity should provide all information that would be material to an investor's investment decision."
78. In addition, FMA has undertaken a review of 15 overseas alternative markets aimed at SMEs and has highlighted that all of those markets operate with some form of continuous disclosure, making NZX's alternative disclosure regime novel in its approach.

79. There is an additional risk that the new market may negatively impact on NZX's main board if the size of firm allowed to list on the market is set too high. This has the potential to reduce the number of future listings on the main board, potentially impacting on its successful operation. However, NZX already has a complete discretion to refuse firms seeking to list. To further mitigate the risk of any negative impact on NZX's main board, the exemption would require NZX, before approving applicants shifting from NZX's main board, to have regard to whether the applicant is an enterprise for which the market is designed. NZX intends to support this with guidance.
80. Additional mitigations in place to counteract some of the risks outlined above include that the new market will be differentiated from the main board through branding and a separate website. The definition and promotion of the market and the risk warnings available about the market would assist in ensuring investors trading on the market have the appropriate risk appetite. In addition, new market advisors would be giving guidance to SMEs listed on the market, providing initial and ongoing assistance to firms in complying with the disclosure rules on the new market and to ensure compliance with securities law more generally.

CONSULTATION

81. MBIE has undertaken informal consultation with FMA staff throughout the assessment of NZX's application and has received formal advice from FMA's Board on NZX's proposal for an alternative disclosure regime. FMA Board's advice on NZX's proposal has been incorporated into the analysis in this RIS. NZX has also been consulted about its application.
82. In order to formulate its proposals for a new market, NZX undertook its own consultation with existing market participants, including existing NZX and NZAX issuers and prospective new market issuers. Advisors to firms were also consulted. Consultation included a series of informal interviews, an online survey and a formal consultation on the proposed design of the market, including market rules, trading rules and disclosure requirements. MBIE has utilised NZX's consultation to inform the analysis presented in this RIS.
83. MBIE has also undertaken targeted consultation with two existing NZAX issuers and two potential new market issuers.

CONCLUSIONS

84. Following the options analysis presented above and the feedback gained from submissions, FMA advice and targeted consultation MBIE is recommending that regulations be made to provide for alternative ongoing disclosure obligations on NZX's new market.
85. There are some inherent risks within the design of the alternative disclosure regime, such as the risk that price sensitive information may not be released to the market under this model. This in turn may impact on investors' confident participation in the market, potentially leading to an illiquid and inefficient market. However, on balance, MBIE is of the view that the alternative ongoing disclosure regime proposed for NZX's new market may reduce the costs of disclosure by setting disclosure obligations that SMEs could largely manage internally, without reliance on external legal advice. In addition, MBIE believes that the alternative ongoing disclosure

obligations may also remove some of the perceived barrier SMEs face in listing, potentially encouraging more SMEs to list.

86. If the market is successful in attracting more SMEs to list, this could create a 'virtuous circle' on the market, where increased listings, increased investment, research and liquidity impact and reinforce one another, potentially counterbalancing some of the risk to market efficiency within the alternative disclosure regime. In addition, the requirement for SMEs to release a greater volume of information to market via the quarterly updates and the requirement for research provision and market makers should also counterbalance some of the risk to market efficiency.

87. However, due to the novelty of the alternative disclosure regime proposed, we cannot absolutely determine that the alternative disclosure regime will not introduce unacceptable risks into the market. Therefore our recommendations are also subject to a review of the new market within 24 months of its registration. NZX would be required to deliver a report to FMA and MBIE reviewing the extent to which the alternative disclosure regime achieves a fair, orderly and transparent market. Following receipt of the report, FMA and MBIE will conduct a formal review of the alternative disclosure regulations.

IMPLEMENTATION PLAN

88. If the proposed policy is approved by Cabinet then regulations would be made under the FMC Act to allow NZX to operate its new market with alternative ongoing disclosure obligations. These regulations would apply once new securities markets law comes into force under the FMC Act in December 2014.

MONITORING, EVALUATION AND REVIEW

89. MBIE's recommendation to make the regulations allowing for alternative ongoing disclosure obligations is subject to NZX undertaking a review within 24 months as outlined above.

ANNEX 1 – POLICY OBJECTIVES AS ALIGNED TO STATUTORY REQUIREMENTS

90. In making alternative regulations that would allow for alternative disclosure requirements, the Minister of Commerce must have regard to the following matters.

Relevant part of the FMC Act	Relevant policy objective
The purpose of Part 5 of the FMC Act.	
To promote fair, orderly, and transparent financial product markets	Information available on the market will allow efficient pricing of the securities traded, accurately reflecting the value of the securities
To encourage a diversity of financial product markets to take account of the differing needs and objectives of issuers and investors	<p>The costs and difficulties of listing will be reduced for SMEs</p> <p>Reduce the funding gap for SMEs and increase the number and range of investment opportunities for retail investors</p>
The Minister must also have regard to the main and additional purposes of the FMC Act set out in sections 3 and 4 of Part 1 of the Act.	
Promote the confident and informed participation of businesses, investors and consumers in the financial markets; and	<p>Maintaining low levels of market misconduct, and maintaining the integrity and reputation of securities markets as a whole</p> <p>Information available on the market will allow efficient pricing of the securities traded, accurately reflecting the value of the securities</p> <p>Reduce the funding gap for SMEs and increase the number and range of investment opportunities for retail investors</p>
Promote and facilitate the development of fair, efficient, and transparent financial markets	<p>Maintaining low levels of market misconduct, and maintaining the integrity and reputation of securities markets as a whole</p> <p>Information available on the market will allow efficient pricing of the securities traded, accurately reflecting the value of the securities</p>
To provide for timely, accurate, and understandable information to be provided to persons to assist those persons to make decisions relating to financial products or the provision of financial services	Maintaining low levels of market misconduct, and maintaining the integrity and reputation of securities markets as a whole

To ensure that appropriate governance arrangements apply to financial products and certain financial services that allow for effective monitoring and reduce governance risks	Maintaining low levels of market misconduct, thereby maintaining the integrity of securities markets as a whole
To avoid unnecessary compliance costs	Information available on the market will allow efficient pricing of the securities traded, accurately reflecting the value of the securities The costs and difficulties of listing will be reduced for SMEs
To promote innovation and flexibility in the financial markets	Information available on the market will allow efficient pricing of the securities traded, accurately reflecting the value of the securities Reduce the funding gap for SMEs and increasing the number and range of investment opportunities for retail investors

91. The Minister of Commerce must also have regard to the following matters (if relevant to the particular market) as set out in Part 5 section 308 (b) of the FMC Act:

- The nature of the activities conducted, or proposed to be conducted, on the market; and
- The size, or proposed size, of the market; and
- The nature of the financial products dealt with, or proposed to be dealt with, on the market; and
- The persons who participate in, or are likely to participate in, the market (either directly or by using the services of participants); and
- The technology used, or proposed to be used, in the operation of the market.

92. In addition, the regulation making power that would allow alternative regulations to be made for a licensed market is set out in the FMC Act in section 351. Section 351 (3)(b) establishes that in making any recommendation for alternative regulations the Minister of Commerce must consider the "extent to which the regulations disapply any enactment to a licensed market is not broader than is reasonably necessary to address the matters that gave rise to the regulations". In essence, the alternative regulations must not provide a broader solution than would otherwise be required to solve the identified problem.

ANNEX 2 –CONDITIONS OF THE ALTERNATIVE DISCLOSURE REGIME

The alternative disclosure regime must contain requirements for-

- (a) the setting and disclosure to the market by a new market issuer of metrics for measuring and reporting on the performance of its business and targets for those metrics:
- (b) ensuring that directors of the issuer are satisfied that those metrics will result in understandable reporting for investors that covers the most significant factors by which the performance of the business should be assessed and monitored:
- (c) the new market advisor to confirm to NZX that the metrics selected are suitable before the new market issuer lists [and for the new market issuer to continue to consult the new market advisor on the selection of those metrics while the new market advisor is appointed]:
- (d) the new market issuer to continue to set, and review at least annually, its metrics and targets for those metrics:
- (e) NZX to review and approve-
 - (i) the metrics before approving the new market issuer for listing; and
 - (ii) any subsequent change to the metrics by the new market issuer:
- (f) quarterly disclosures about changes and developments for the business of the new market issuer and of its performance against the targets for the metrics:
- (g) immediate disclosure of specified events relating to the following matters as they arise:
 - (i) a variance, or likely variance, of more than 10% from a target for a metric:
 - (ii) decisions affecting the number or terms of equity securities on issue
 - (iii) decisions on changing the constitution:
 - (iv) decisions on dividends and distributions:
 - (v) changes to directors, officers, or auditor of the new market issuer:
 - (vi) proposals to enter into (or change or complete) significant transactions (including an essential change to the nature of the business) and related party transactions:
 - (vii) changes to the new market issuer's name or share registry details:
 - (viii) communications to a class of investors and results of investor votes:
 - (ix) significant legal or disciplinary proceedings being brought by or against the new market issuer:
 - (x) events or matters that indicate a significant change in the creditworthiness of the new market issuer:
 - (xi) changes to the new market issuer's balance dates or other period for reporting:
 - (xii) material adjustments to the new market issuer's or its group's financial statements or a previous disclosure on those financial statements, or any qualification of an auditor's report or reference to a fundamental uncertainty
 - (xiii) proposals for takeover offers or changes in control.