Market Governance of the Emissions Trading Scheme: *Options and Analysis*

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Prepared for

Ministry for the Environment

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Executive Summary

Background and the Current Problem

This report explores options for market oversight of the emissions trading scheme (ETS). It addresses whether there is a need for regulation of the market in a similar way to regulation of financial markets, to address potential or actual problems which include the following issues.

Compared with an ideal market, there is some absence of **market transparency**, including:

- The way in which the Government releases information about policy changes which have market impacts, eg with information released on any one of six or more websites.[1] This has the potential to result in information asymmetry where some market participants know more than others.

- The absence of regulated exchanges for trading. These have requirements for transparency with respect to price and volume information. This would reduce market uncertainty and improve competition.

- Some evidence of poor advice, particularly for small (forestry) participants, eg with respect to whether post-89 forest land owners should join the ETS and sell units. Because they are a small component of the total market, it is unlikely to have had implications for overall market efficiency, but it can result in poor decisions with unfortunate outcomes for these participants.

There is less **market participation** than is ideal, including:

- The absence of a number of potential intermediaries in the market, ie those who buy and sell in the market and sit in between the suppliers to the market (eg the Government and forestry companies) and the demand customers (those with NZU surrender obligations). Increased participation of intermediaries would increase market liquidity, ie ensure that anyone who wanted to buy or sell could always find a counterparty to trade with. This absence partly reflects the current market and policy uncertainty.

- The potential for small players to access the market, including the limited opportunities for a number of firms which are given small allocations of units by the Government as compensation for cost increases. Because these parties are small in comparison to the total market, their lack of participation has equity more than efficiency effects.

[1] Climate change policy and other information is released on the websites of the Ministry for the Environment (MfE), Ministry of Primary Industry (MPI), Ministry of Business, Innovation and Employment (MBIE), the Environmental Protection Authority (EPA), plus Treasury (budget announcements), in addition to the separate registry website.

The potential exists for **market manipulation**, eg insider trading and market misconduct. This potential may have spill-over implications for market participation, and for international linking.

Possible Solutions

Potential solutions are identified and summarised in Table ES1.

Table ES1 Regulatory options

Option	Key points	Comments
1 Better information	No change to regulatory framework Non-regulatory tools enhanced: EPA monitoring resources increased. Participant information resources enhanced. Government resources co-ordinated / streamlined.	Assisting participants make better decisions through information and education.
2 Self-regulation	Central register of carbon advisers and intermediaries with an industry body (or Government). Advisers and intermediaries agree to terms and conditions (eg code of ethics / joining a dispute resolution scheme / being subject to a disciplinary tribunal).	Better decisions through better quality advice. Improved market governance.
3 Disclosure-based regime	Carbon advisers/brokers required to provide disclosure information (eg on capability, fees and conflicts). Offers of NZUs to be provided with standard form disclosures. Government warnings about firms to be wary of.	Better decisions through clear disclosures.
4 Standardised trading rules	Standardised trading rules and conduct standards apply to all intermediated transactions. Exchanges / platforms could be designated by Government.	Improving market transparency and governance
5 AML/CFT regulation	Entities advising on or trading carbon become AML/CFT reporting entities under AML/CFT Act. Only applies to trading/broking (if in the ordinary course of business), and, not advising (could be extended). Applies to wholesale only businesses. AML/CFT supervisor would be the FMA or DIA.	Improves NZ market reputation and increases potential for linking
6 NZU becomes Financial Advice Product (as defined in FMC Act, as revised)	FMC Act and FSPA (as revised) applies to carbon advisers (and intermediaries) with respect to advisory and broking services. Carbon advisers and intermediaries must register on the FSPR. All advisers are subject to a conduct obligation to put clients first, a code of conduct and disclosure obligations. FMA is active conduct regulator with strong enforcement powers, supported by Financial Advisers Disciplinary Tribunal. If advising retail investors,* advisors have to be licensed.	Focus on assisting participants make better decisions through better quality advice.
7 NZU becomes Financial Product (as defined in FMC Act)	As above plus: Offers of NZUs to retail investors* are subject to disclosure requirements. For example, a product disclosure statement is required. Exchange-based trading is regulated. Prescriptive trading rules apply and market operators must be licensed and subject to close FMA supervision.	Focus on increasing transparency, market integrity and supporting better-decision-making through better quality advice.

Notes: AML/CFT = anti-money laundering and countering the financing of terrorism; DIA = Department of Internal Affairs; FMA = Financial Markets Authority; FMC Act = Financial Markets Conduct Act 2013; FSPA = Financial Service Providers (Registration and Dispute Resolution) Act 2008; FSPR = Financial Service Providers Register

*A retail investor is anyone who is not a wholesale investor (see glossary). In practice, this usually means a person with less than $5m in assets or income pa (who is not otherwise subject to one of the exceptions).

Recommendations

Based on this analysis of problems and solution options, we suggest the following:

1. The EPA and MPI should continue to develop information packs or other information products for market participants and advisers.

2. The Government should release all market-relevant information, including policy developments, volume data and price projections, in a consistent way that is easily discoverable. Ideally this would be via a single website.

3. Further investigation could be undertaken to assess whether there is a problem with advice provided to less sophisticated ETS participants. We did not find any firm evidence of this as part of our research, although it is hard to find in the absence of a regulator or dispute resolution mechanisms. We suggest that the MfE or EPA consider surveying participants to uncover any concerns about quality of advice or market misconduct.

4. Engagement with the NZ Police Financial Intelligence Unit (FIU) (and AML/CFT supervisors) to consider whether the abuse of carbon credits has developed further as a money-laundering/terrorist financing (ML/TF) typology and risk-rate the NZ carbon trading market.

5. If options 6 or 7 are progressed, further engagement should be held with other types of advisers that provide advice on the ETS and NZU trading to assess reaction and estimate impact.

6. The EPA and MfE engage with financial markets regulators to gain their perspective on the regulatory options and the methods they could use to improve, for example, the monitoring of ETS participants and surveillance of the ETS data.

7. Conducting a thematic review of trading data to analyse potential for either ML/TF or market misconduct.

Further analysis of the potential for the ETS to be vulnerable to market misconduct should be conducted prior to the re-establishment of international linkages. We suggest that MfE should work closely with the EPA, the FMA and MBIE to conduct this research. Further, given the links to money laundering and terrorist financing risks, we recommend that the FIU, Ministry of Justice (MoJ) and AML/CFT regulators are also approached to participate to ensure a co-ordinated 'All of Government' approach.

1 Introduction

1.1 Background

This report explores options for market oversight of the emissions trading scheme (ETS). It addresses whether there is a need for regulation of the market in a similar way to regulation of financial markets, to address potential or actual problems which include poor investment advice, limited market entry and market abuse.

This report for the Ministry for the Environment (MfE) builds on a carbon market oversight project initiated by the Environmental Protection Authority (EPA) in 2015. That project started in response to concerns about the role played by market advisors, particularly during a period when there was a significant price gap between New Zealand Units (NZUs) and international units. The EPA commissioned a report from PWC which sets out how market oversight works in overseas ETSs, the purpose of effective market oversight regimes, and tools available to a regulator.[2] The EPA has subsequently developed three work-streams:

1. Improving investor education resources;
2. Enhancing operational policies / regulatory tools governing access to the ETS; and
3. Exploring high level options for oversight of the carbon market (eg using financial oversight mechanisms).

This project is addressing the third work-stream and focusing specifically on how a market oversight regime might:

- allow for broad participation;
- promote market liquidity;
- prevent abusive behaviour;
- prevent bad advice being provided; and
- prevent money laundering activity.

The approach taken to this work has included the following:

- A review of approaches taken in other countries and of commentaries in the literature;
- Conversations with market participants; and
- Our own analysis and considered views.

[2] PWC (2015) Carbon market oversight: international approaches. Environmental Protection Authority Research Report.

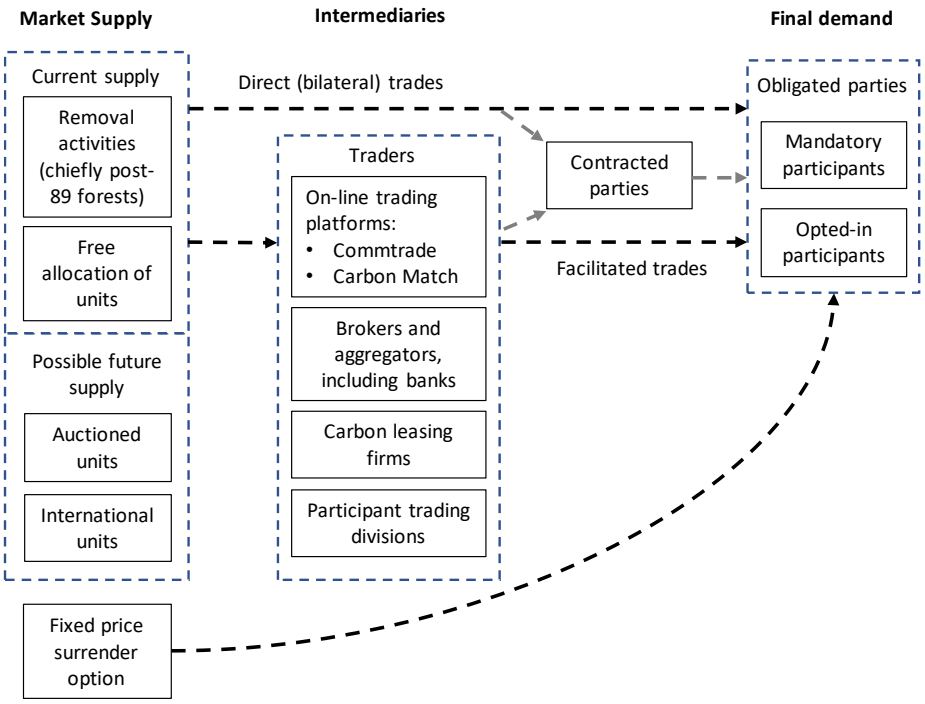
1.2 Market Context

To provide some context for the discussion, we first describe the current market, including the participants and the types of transaction.

1.2.1 Market Participants

The different market participants are shown in Figure 1. We refer to these categories in the discussion in the remainder of the report.

Figure 1 ETS Market Structure and Participation



Supply sources

The **primary market** is the initial set of supply sources providing emission units to the market. Currently this includes:

- the emission units which the Government starts with, reflecting the national target. These are placed on the market via **free allocation** of units to pre-1990 forest land owners with liabilities for deforestation, to emission-intensive, trade-exposed (EITE) entities and to the fishing industry and to the fishing sector; and

- emission units created through **removal activities**, which are chiefly from growth of post-1989 forests (there are also several other removal activities).[3]

Up to mid-2015, **international units** were a significant source of units to the New Zealand market. However, this supply source was stopped following New Zealand's decision not to take on commitments under phase 2 of the Kyoto Protocol, and as a

[3] As defined in the Climate Change (Other Removal Activities) Regulations 2009

response to the stockpiling of NZUs by market participants.[4] It is possible (or hoped) that international units will provide a source of supply to the market after 2020.

In the future it is expected that the Government will have additional units for distribution to the market, beyond those used for free allocation, eg using an **auction** mechanism.

The **fixed price option** allows obligated parties to pay $25/t rather than surrender units; it is effectively another source of supply.

Final demand

Final demand for units is made up of those with legal obligations to surrender emission units on the basis of their emissions. This includes **mandatory participants** and those which have **opted-in** to better manage their emission costs.

Intermediaries

Intermediaries are the firms which trade in the secondary market, linking buyers and sellers. They enter the market for a variety of reasons, including as businesses which charge on a transaction basis, and those which trade on their own account to profit from these trades, or (potentially) to hedge other risks.[5] In New Zealand these include:

- The **on-line platform** providers Commtrade and Carbon Match (a small number have also been sold on TradeMe);

- Banks and other firms providing **brokerage services** (intermediaries**)**. The banks and some other intermediaries take primary positions (ie they purchase units for later sale), including those which aggregate sales of small numbers of units, but other intermediaries just match buyers and sellers;

- **Carbon leasing firms** – 'carbon lease partnering' arrangements involve firms paying an annual amount to a forester for the rights to the NZUs generated from the growing forest. Carbon leasers take on the liability to repay the NZUs at the end of the lease term. They then on-sell the NZUs in bulk to ETS participants with surrender obligations. One bank we spoke to will provide loans to forest owners secured against these forward sale and purchase agreements (and supported with insurance and standard security arrangements over assets); and

- **Trading divisions of participants** – some large firms which are ETS participants with surrender obligations, are buying and selling in the market, rather than simply buying for compliance purposes.

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[4] NZUs were stockpiled because they had a greater value than international units. This was because international units had a limited lifespan (they could only be surrendered up to 2020) whereas NZUs had no time limit on use.

[5] Such as companies producing emission reducing technologies and facing financial exposure from carbon price changes: Interagency Working Group for the Study on Oversight of Carbon Markets (2011) Report on the Oversight of Existing and Prospective Carbon Markets. US Commodity Futures Trading Commission.

Contracted parties are included as a separate category. These are firms without surrender obligations but which are contracted by those with obligations. For example, a coal supplier may require a firm, under contract, to pay for coal supplies and to supply emission units as part of that transaction.

1.2.2 Types of Transaction

After the initial distribution of units by the Government, trading occurs in the secondary market. Purchases and sales of NZUs for immediate delivery ('spot' trades) are the most common transactions. However, because some market participants want to manage long-term liabilities, other types of transactions can develop; typically, these are forward agreements, eg via the Commtrade platform and the banks. These represent contracts to deliver a specified number of NZUs on a particular date in the future and are classified as derivatives, a class of FMC financial product under the Financial Markets Conduct Act 2013 (FMC Act). Certain banks, such as ANZ and Westpac, also provide other carbon derivative contracts, eg options, generally to wholesale customers only (see definitions in the Glossary on page 46).

Another instrument being developed and used in New Zealand is an offtake agreement. These involve forestry companies agreeing to deliver a specified number of units each year, for several years,[6] at an agreed price.

The primary uses of derivative contracts are for hedging (managing price risk) and speculation. For example, an emitter may be concerned about price rises, while a forester may be concerned about price falls. By agreeing to a contract based on future delivery at a specified price (or a price formula), both participants protect themselves against the effects of price changes. Derivatives markets help parties with price exposure to transfer their risk to other parties, who might be other hedgers or speculators.

Market participants could also seek to enter derivative contracts to actively gain exposure to price volatility and to (attempt to) profit from successful anticipation of price movements.[7]

1.2.3 Information Provision

Some information on market quantities is made available from Government sources. Price data are published voluntarily by Commtrade and Carbon Match. However, this is not always accompanied by trading volumes, such that the relevance of the price information might not be transparent.

Market Volumes

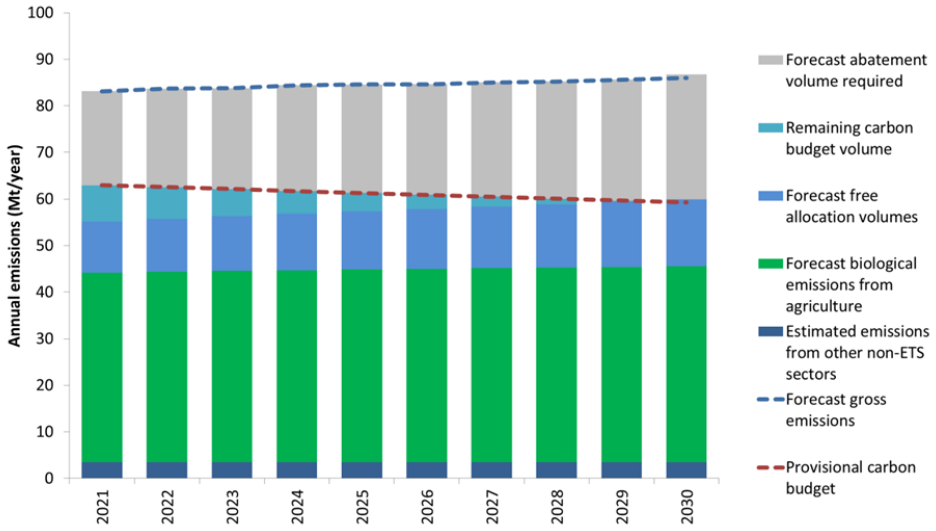
The supply of units includes stockpiles in holding accounts from a period (to mid-2015) in which there were significant imports of international units which were used for compliance purposes, while NZUs were largely retained for future use. In July 2015, approximately 140 million NZUs were held in private accounts, relative to a surrender

[6] Examples of agreements up to ten years are being pursued by current market participants.
[7] Interagency Working Group for the Study on Oversight of Carbon Markets (*op cit*)

obligation of under 30 million tonnes per annum and ongoing annual allocation of units to the market.[8] With the phasing out of the one-for-two obligation, and ban on use of most Kyoto units, the surplus in the ETS is estimated to fall to approximately 50 million tonnes by the end of 2020.[9] The New Zealand Government has an even larger surplus relative to its international target;[10] in May 2017 MfE estimated this surplus will be close to 90 million units in 2020.[11]

The quantities of emissions and the ETS context from 2021 is shown in Figure 2. In this period, it is possible there will be a large influx of international units, otherwise domestic emission reductions or absorptions will need to be very significant. It is also likely that emission units will be released to the market, eg via auction. This increases market liquidity and price discovery. Updated information of this nature is important for the market. It is also important that it is released in a coordinated way such that all market participants are informed at the same time. We discuss this issue in more detail below.

Figure 2 Volume projections (2021-2030)



Source: Ministry for the Environment (www.mfe.govt.nz/climate-change/nz-ets-and-nzs-carbon-budget-in-the-2020s)

1.2.4 Price Data

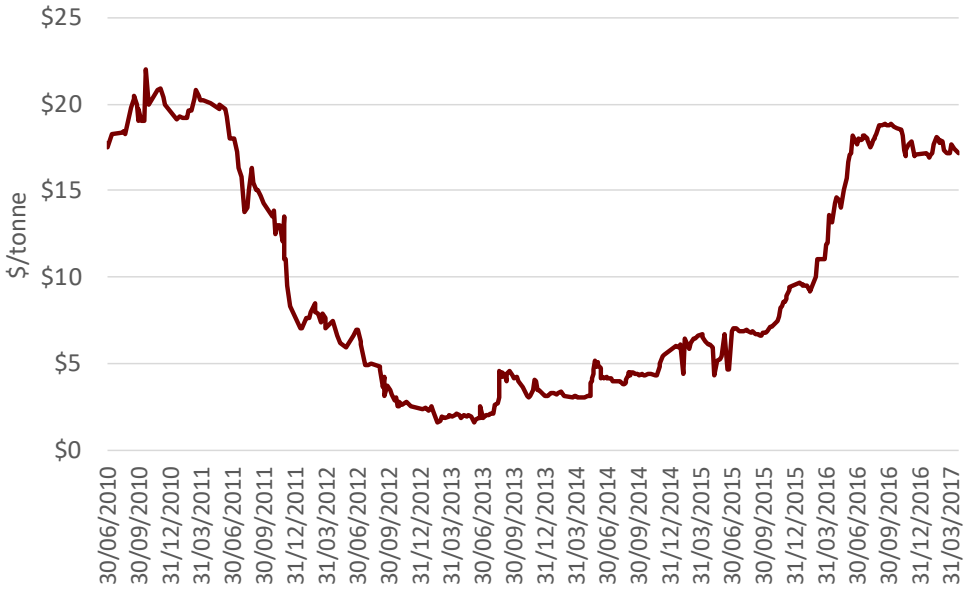
The main current sources of price data in the market are the on-line platforms, Commtrade and Carbon Match, although some other intermediaries provide bespoke pricing to clients. Volumes associated with these prices are not as transparent, although

[8] Ministry for the Environment (2016) Regulatory Impact Statement: Improving alignment of the New Zealand Emissions Trading Scheme with New Zealand's provisional 2030 emissions reduction target.
[9] Ministry for the Environment (2016) Regulatory Impact Statement: Improving alignment of the New Zealand Emissions Trading Scheme with New Zealand's provisional 2030 emissions reduction target.
[10] New Zealand has adopted an emissions reduction target under the United Nations Framework Convention on Climate Change (UNFCCC) to reduce net emissions by 5 per cent below 1990 GHG levels over 2013–20.
[11] http://www.mfe.govt.nz/climate-change/reporting-greenhouse-gas-emissions/latest-2020-net-position

large participants who scrape these sites for data or who make frequent visits to the websites, are able to obtain sufficient related volume data.

Figure 3 shows historical spot prices illustrating the data readily available. There is little price data available relating to future prices, apart from those based on the costs of carry (ie the opportunity cost of capital). Estimates of future prices based on market fundamentals which might be provided by market commentators, or a more active derivatives market, are largely absent in New Zealand. This reflects largely the significant policy uncertainty.

Figure 3 NZU Historical Spot Prices



Source: Commtrade/OMF data from GitHub

1.3 Structure of the Report

This report discusses the nature of the problem which might justify regulation (Section 2), reviews approaches used in other jurisdictions (section 3) and discusses regulatory options in Section 4.

2 The Intervention Rationale

2.1 The problem

Government regulation of any market should be justified on the basis that: (1) there is a real or potential market failure, and (2) that the benefits of regulation would exceed the costs.[12] In this section, we discuss the concept of market failure as it might apply to the ETS, and the problems which have been raised in discussion with government officials and market participants. These are:

- Market transparency issues, including information flow on prices, volumes and policy changes;
- The potentially poor quality of advice given to small participants;
- The potential for market manipulation;
- The potential for money laundering and terrorist financing;
- The potential confidence that regulation provides to market participants, thus encouraging additional market participation and increased liquidity; and
- The potential risk to international linking of not regulating the market.

2.2 Market Failure

The ETS is a market which was designed to ensure emission commitments in New Zealand are achieved most efficiently, including through interaction with international markets where possible. An efficient ETS market would ensure emission reductions and absorption was undertaken by all entities with costs (of these actions) which were no more than the price of units. It would also ensure prices reflected the marginal cost of abatement, or of NZ coming into compliance with its emission obligations, be that via domestic emission reductions or purchase of international units.

Market failures are said to arise when the market does not operate efficiently. To understand how and why markets 'fail', the starting place is the theoretical competitive market model from which actual markets might differ. The characteristics of the ideal market might include:

- **Complete markets**: a complete set of markets with well-defined property rights exists so buyers and sellers can exchange freely, eg markets exist for all types of units and their derivatives, which participants want in order to manage their risks.

- **Perfect competition**: there are numerous buyers and sellers behaving competitively and no barriers to entry. This ensures the market is liquid, so all participants wanting to buy or sell are able to do so, because there is always a counterparty available.

[12] English B and Hide R (2009) Government statement on regulation: better regulation, less regulation. Released on 17 August 2009. Wellington; NZ Treasury (2013) Regulatory system report 2013: guidance for departments.

- **Perfect information**: market prices (current and future) and product values (eg the extent to which all units are the same) are known and understood by all market participants. Also, the factors which determine price and volume in the market are known and understood, including Government announcements of policy change.

- **Zero transaction costs**: trading is simple and has no costs, so units will always transfer to those who value them most.

Market failures are the absence of these, eg incomplete markets, imperfect competition, imperfect information and/or non-zero transaction costs. The issues addressed in this report relate to a number of these market failures (Table 1), and we discuss them below.

Table 1 Identified potential market failures in the ETS

Market failure	Identified problems or potential problems
Incomplete markets	• The potential risk to international linking of not regulating the market • Absence of a significant derivatives market
Imperfect competition	• The potential for market manipulation and other anti-competitive behaviour to raise prices • The potential for lower participation and liquidity levels than would occur with greater market oversight • The potential for money laundering and terrorist financing – market participants not behaving competitively in the market
Imperfect information	• Potentially poor quality advice for small (forestry) participants • Lack of transparency in information flow, eg on policy changes with relevance to the market • Absence of complete price/volume information
Transaction costs	• Barriers to entry for small participants – relatively high costs of trades

2.3 Market Transparency

The widespread availability of price information, including current prices and information on the factors that determine future prices (including forward markets), improves market efficiency by ensuring participants make the best decisions about if, and when, to buy and sell. This has better final outcomes (units are owned by those who value them most) and ensures a smoother transition (lower volatility) to those final outcomes. Price discovery issues are discussed in greater detail in a separate consultancy report by Sapere. We simply note here that improved price transparency will improve market efficiency with potential spill-over benefits for market participation and liquidity.

In addition to price information, there are other aspects of market transparency which affect market efficiency. One issue which has been raised by many interviewees is the seemingly uncoordinated way in which Government policy announcements are made. Comparisons were made to the official cash rate (OCR) for which any changes are made to a pre-agreed schedule and for which announcements are made in a controlled way so that no market participant gains an advantage (information asymmetry). ETS participants interviewed have noted that climate policy decisions, with direct relevance to values of NZUs, are announced in many different ways and places, with market-

relevant information included on the websites (at various levels on those websites) of several Government Departments: MfE, Ministries of Primary Industry (MPI), and of Business, Innovation and Employment (MBIE), the EPA, plus Treasury (budget announcements), in addition to the separate registry website. People also noted that other market-relevant information had been made public through non-Government websites, eg Official Information Act (OIA) releases from websites of other organisations; an example was given of information on forestry allocation and surrenders published on the Motu website.

Releasing information in a way which ensures no companies or individuals are advantaged relative to others, can ensure a market is a fair and equal playing field for all participants.[13] This has implications for equity (some market participants may be able to profit relative to others) and efficiency (a market perceived as unfair may discourage entry).

Market transparency is also important from the regulator's perspective. Monast, for example, notes that regulators "*require sufficient information about the marketplace, including prices, volume, positions, and market trends, in order to prevent and punish market abuses. The more detailed information an oversight body receives, the better its capacity to detect trading irregularities and inconsistencies. With timely data, appropriate enforcement authority, and sufficient resources, regulators can quickly identify suspicious spikes in market price or trade volume.*"[14]

2.4 Trading Platform

Currently, there are no regulated exchanges for NZUs.[15] Carbon trades are effected 'over the counter' (OTC) either as bilateral contracts between two private parties (sometimes in standardised form, eg if buying or selling to a bank which has taken a principal position) or via the online platforms that currently operate.

The main bulk purchasers of NZUs are large companies:

- carbon emitters (such as electricity and oil gas companies and heavy industry); and
- a few financial institutions (principally Westpac and ANZ).

On the supply side, there is a large list of participants who have signed up to the ETS and are selling NZUs into the market, as discussed above.

The on-line platforms operate as quasi-exchanges but are unregulated. The lack of regulated exchange-based trading affects price transparency (and, potentially, liquidity) because of the absence of:

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[13] Kachi A and Frerk M (2013) ICAP Carbon Market Oversight Primer. International Carbon Action Partnership.

[14] Monast J (2010) Climate Change and Financial Markets: Regulating the Trade Side of Cap and Trade. Environmental Law Reporter, 40(1): 1051-1065

[15] As NZUs are not financial products, operators of exchanges and/or on-line platforms do not need to be licensed under the FMC Act and they are not regulated under the FMC Act.

- regulator-approved standard trading rules[16] and applicable conduct legislation;
- market oversight of trades and/or intermediaries;
- independent surveillance of trading data; and
- regulatory tools to enforce breaches of trading rules (or law).

It is unclear whether there is any appetite for a market operator[17]to set up a carbon exchange in NZ. It is also unclear whether enhanced market governance requirements would affect such a decision. Based on our research, it is likely that the primary driver of this decision would be potential trading volumes (and fees) rather than regulation.

However, we believe that the Government could work closely with such a market operator to encourage the design of an exchange that includes equivalent investor protections to those required of a financial product market regulated under the FMC Act.

2.5 Small investors

Issues relating to small investors include the ease of participation and the availability of good advice relevant to participation, eg on price trends and/or the benefits of participation.

2.5.1 Participation

Potential or actual small participants in the ETS include:

- Energy-intensive activities which receive small allocations of units, eg an allocation of five units for one tomato grower in 2015;[18]
- Small-scale post-1989 foresters[19] earning units for afforestation activities; and
- Small-scale investors or those wishing to offset emissions.

Currently there are few avenues for these participants to trade. The two on-line trading platforms (Commtrade and Carbon Match) restrict trades to several thousand units. Westpac formerly traded in small numbers of units, but is no longer doing so. Several companies provide aggregation services, including Carbon Forest Services Limited, Forest Management Limited and Woodnet 2005 Limited (as listed on the Carbon Match website), or carbon lease arrangements (eg NZ Carbon Farming). However, even these companies do not generally trade with very small market participants, ie those with fewer than a few hundred units, or will only do so at a price which makes such trades unattractive.

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[16] Although it is recognised that both Commtrade and Carbon Match have trading rules that participants have to accept.

[17] There are only three licensed market operators of financial product markets (regulated exchanges) in NZ: New Zealand Exchange Ltd (NZX), Australian Securities Exchange Ltd (ASX) and Intercontinental Exchange (ICE).

[18] http://www.epa.govt.nz/e-m-t/taking-part/Industrial-allocations/allocations-decisions/Pages/2015-final-allocation-decisions.aspx

[19] MPI advises that there are just over 2,000 registered post-1989 participants and that 67% of registered post-1989 forest owners have less than 50ha of forest registered in the ETS.

For those holding small numbers of units, participation currently has high transaction costs, either in fees (relative to the value of the units) or in finding a trading counterparty. A common response appears to be to wait and aggregate units over time. Small participants are a minor element of the total market, so their participation difficulties have little impact on the overall efficiency of the market. The participation difficulties may be regarded as unfair by these participants and suggests, for these participants, that allocation is having limited (compensation) benefit.

2.5.2 Investor Advice

Forestry owner participation in the ETS differs between pre-90 and post-89 forests. Over any five-year period, any deforestation of more than two hectares of pre-90 forest land, that has not been granted an exemption, is compulsorily included in the ETS and landowners are responsible for any emissions that occur because of the deforestation of their land. Post-89 forest owners can enter the scheme voluntarily; they receive emission units for increases in carbon stocks and must pay units for decreases.

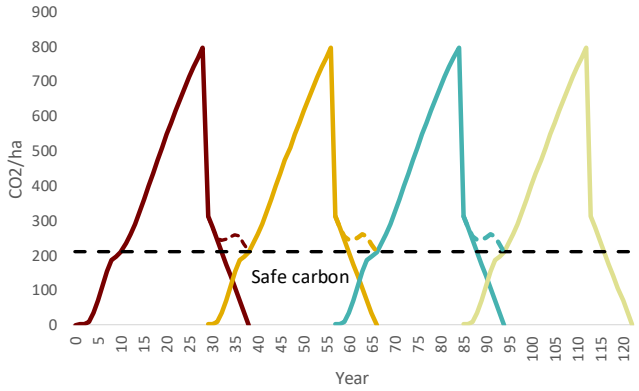
Anecdotal evidence suggests that some foresters, at least, are being provided with poor advice or are making decisions in the absence of advice. For example, some have been advised of the potential for earning and selling NZUs but not the liabilities associated with harvesting, or of the potential for prices to rise (or fall) significantly. The resulting poor decisions relate to:

- Price uncertainty and when to sell or purchase emission units – this applies to all foresters;
- Whether to enter the ETS voluntarily for post-89 forest owners;
- Submission of emissions returns when the forest owner no longer owns the forest;
- Incorrect reporting of deforestation, incorrect calculation of NZU entitlements and surrender obligations, especially with regard to harvesting and residual decay from first rotation forests;
- Failure to follow regulations associated with the Field Measurement Approach;
- How post-89 forests are registered in the ETS, eg assigning all forest stands to a single carbon accounting area versus multiple carbon accounting areas to maximise the value of the liability cap provisions; and
- The extent to which post-89 forest owners should sell the emission units earned rather than retaining them to cover future emissions at harvest, eg sales above a "safe carbon" level (see Box 1) or to ensure no reduction in land value because of liabilities for the future.

Box 1 The "Safe Carbon" concept

"Safe carbon" arises because, even under an assumption of instantaneous emissions at harvest, a percentage of total carbon in a forest is assumed to be retained in the harvest residue and to be released slowly over time (a constant rate over 10 years is assumed). If a forest is replanted at the time of harvest, and carbon begins to be absorbed again there is a quantity of units that never needs to be surrendered. Dependent on when a single aged stand joins, the safe level might be a small amount (or not exist if they joined with a carbon stock above the "safe carbon" amount), but the "safe carbon" may be significantly larger for a larger forest with many different age classes being harvested at different times. The safe level for a single stand with ongoing replanting is illustrated in Figure 4.

Figure 4 Safe carbon in a single stand



The solid lines represent the cumulative carbon (as CO_2) which is estimated (using look-up tables) to be in the tree biomass. To the left of the peak, it is the carbon sequestered during tree growth; to the right of the peak the drop-off represents the assumed release of CO_2 at harvest; some is released instantaneously and some is assumed to be retained in residues (stumps and branches) and to decay and release CO_2 over ten years. Subsequent solid lines show successive rotations, ie replanting at the time of harvest.

The (coloured) dashed lines are the sum of the quantity of carbon in the forest from the residues and from the growth of next rotation.

The horizontal dashed line is the estimated "safe carbon". It is the lowest level of carbon in the forest if this pattern of harvest and replanting is followed; in the figure, it is approximately 25% of the carbon in the forest at the time of harvest. A delay to replanting reduces this "safe" level.

The figure also shows that, at some time if there is no replanting, carbon levels fall to zero. The potential for this will remain as a liability on the land and would have an impact on land price.

Some of these incentives and the consequences of poor advice will change if there are changes to forestry accounting practices. Currently emissions are assumed to occur instantaneously at harvest for over 50% of the carbon in a forest, with a portion assumed to be emitted from decay of the residues over the 10 years following harvest. Options to this approach include:[20]

- **Averaging** – foresters would receive NZUs as their forest grows to the estimated long-term average carbon storage for that forest (taking account of future harvest and replanting cycles). Foresters would not have to surrender units at harvest, provided the land is not deforested.

[20] Ministry for the Environment (2016) New Zealand Emissions Trading Scheme Review 2015/16: Forestry Technical Note. Ministry for the Environment.

- **Harvested Wood Products (HWP)** accounting – emissions liabilities for harvested trees are deferred for the lifetime of the wood products which the timber is used for.

We have spoken to some forestry advisers who have suggested that there has been a problem of poor advice in the past. However, we have not undertaken a wide survey of small foresters or of forestry advisers as part of this study, so do not know how widespread is the incidence of poor advice. It is clear the sector has learnt lessons about the ETS over time, particularly when unit prices fell to very low levels (from around $20 per unit in June 2011 to $0.35 in February 2014).[21] The ETS is now regarded as riskier than it was previously and participants are being more risk averse with respect to future prices. However, this will not discourage sales of units to the extent that participants do not understand their future liabilities, or the potential impact on land value of opting in to the ETS and selling NZUs (as a post-89 forest).

Both EPA and MPI officials have noted that, in response to the perceived problem, they are developing information packs for those signing up to the registry. Usefully, it might also be targeted at forestry advisers, in addition to other professionals such as accountants, rural real estate agents and property lawyers. Increased and targeted information provision might go a long way to addressing this problem.

2.6 Market Manipulation, Insider Trading and Market Misconduct

2.6.1 Market Manipulation

Market manipulation might include behaviour which enables participants to influence price, or perceived price, in the market. An example of market manipulation (ramping) would be placing a series of small buy orders in quick succession, often just before the close of trading, to give the impression of higher trading activity and to raise the price artificially. A large sell order could then be placed to take advantage of the upwards price movement. Another example ('pump and dump') is sending out misleadingly positive information on a security, often to unsophisticated investors, to stimulate buying activity which allows the same trader (or an associate / client) to sell into that activity.

Currently the main sources of price in the market are the on-line platforms and it is here where market manipulation might occur. These platforms are the chief source of price information to the market (see Figure 3). However, they do not provide information to the market on all trades or all trading volumes. We understand that they have anti-avoidance rules to prevent market abuse occurring, but we have not looked at their effectiveness.

There have been some relatively significant shifts in prices over short periods of time, as seen in Figure 3, but market participants suggest there is no evidence of market manipulation. However, market participants have suggested it would be possible to manipulate the market and to make interventions (such as the examples above) which

[21] Ministry for the Environment (2016) Regulatory Impact Statement: Improving alignment of the New Zealand Emissions Trading Scheme with New Zealand's provisional 2030 emissions reduction target.

affect price. This is not currently prohibited in relation to NZUs, but would be if NZUs were a financial product and subject to the FMC Act.

Anti-competitive behaviour is regulated under the Commerce Act 1986 which prohibits anti-competitive agreements between businesses such as agreements to fix prices or to carve up markets. It also makes it illegal for companies to abuse any substantial market power. However, the market manipulation examples listed above would not be covered by the Commerce Act.

2.6.2 Information Asymmetry and Insider Trading

Information asymmetry involves some market participants having access to more market-relevant information than others. They might profit from this asymmetry by buying or selling units before others received information which resulted in a change in market price.

Several participants we spoke to mentioned that confusion and a lack of transparency around ETS policy announcements has led to information asymmetry, ie they had traded without knowing the latest policy changes, as discussed above (Section 2.3). Examples include information which is market-relevant being released to organisations or individuals in response to an Official Information Act (OIA) request.

Insider trading is a specific example of information asymmetry where the information is not publicly available, but some people gain access, eg because of personal contacts or through participation in policy development processes while also being a market participant.

It is likely that all market participants will eventually gain access to the new information and would be expected to act on it. The impacts are thus those of short-term profit gains for certain organisations, rather than long-term distortions to who owns units, who emits and/or who absorbs. The implications are more for perceptions of fairness and the overall reputation of the market. This can result in reduced participation and liquidity.

Better management of the release of market-relevant information by the Government would improve information symmetry and the integrity of the market.

The FMC Act prohibits insider trading on licensed financial product markets. It also prevents people who hold material information that has not been made generally available to the market (inside information) from disclosing that information or trading on it. According to the FMA, this prohibition is one of the key mechanisms for ensuring that markets remain fair and transparent. The insider trading prohibitions do not apply to NZUs or other commodities.

2.6.3 Potential for market misconduct and securities fraud

The potential in carbon markets for market manipulation and other types of securities fraud has been identified as a concern by Interpol. Its Guide to Carbon Trading Crime[22] gave international examples of emission trading schemes that have been the subject of criminal activity. Interpol suggests the intangible nature of carbon trading markets with large sums of money invested and a lack of oversight makes them particularly vulnerable to criminal activity such as securities fraud, insider trading, embezzlement and money laundering. It lists the following vulnerabilities:

- Manipulating measurements to fraudulently claim additional carbon credits;
- Sale of carbon credits that either do not exist or belong to someone else;
- False or misleading claims with respect to the environmental or financial benefits of carbon market investments;
- Exploitation of weak regulations to commit financial crimes, such as tax or securities fraud, transfer mispricing and money laundering; and
- Internet crimes and computer hacking to steal carbon credits, and phishing/theft of personal information or identity theft.

Whilst we did not find any suggestions of criminal activity of the types referred to above, one market commentator did highlight market misconduct as a potentially significant emerging risk. His view was that criminal activity and market misconduct issues are largely absent from the NZ ETS because of the strong 'reputational capital' between users in the NZ ETS, ie participants know each other and these close relationships reduce opportunism. Another inhibitor is the centralised nature of the Emissions Trading Register, with relatively strict registration requirements.

However, both of these risk controls would decrease in effectiveness (if not be eliminated altogether) if international linkages were re-established. The impact of international linkages is considered further in section 2.9.

The impact of an identified market misconduct issue such as market manipulation or insider trading could be significant, by damaging the carbon trading market's reputation and reducing confidence and, potentially, participation in the ETS. This damage could extend to NZ's international reputation too, reducing potential for international linkages.

2.6.4 FMA role in relation to capital market growth and integrity

One of the FMA's strategic priorities[23] is to facilitate capital market growth and support market integrity, with confident investors and participants. As market misconduct reduces market integrity and erodes confidence, it is highly focussed on this issue.

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[22] https://www.interpol.int/News-and-media/News/2013/PR090 and Interpol Environmental Crime Programme (2013) Interpol's Guide to Carbon Trading Crime. International Criminal Police Organisation.

[23] See Strategic Risk Outlook 2017 (https://fma.govt.nz/assets/Reports/170214-FMA-SRO.pdf) and Strategic Risk Outlook 2015.

The FMA has also stated that it has begun to look more at wholesale market activity (with respect to its impact on retail investors). In its Strategic Risk Outlook, the FMA also stated its focus on 'perimeter threats' (ie threats relating to unregulated activities) and confirmed that they will use their designation tool to 'call in' products if they see that those unregulated activities pose unacceptable risk to NZ markets or threaten the reputation of NZ's regulatory system.

Designating emissions units as a financial product is an option which may be attractive to the FMA, as addressing potential carbon market misconduct would seem to fit with its focus on market integrity (see section 4 for further discussion).

2.7 Money Laundering and Terrorist Financing

As mentioned above, Interpol has expressed concerns about the potential for carbon trading markets to be used to commit fraud, which is one of several predicate offences for the money laundering or terrorist financing offence under most anti-money laundering and countering the financing of terrorism ('AML/CFT') regimes.

Emission trading schemes have also been used for 'layering', a common money-laundering / terrorist-financing ('ML/TF') technique, given that carbon trading involves transfers of value, often using financial intermediaries, without any underlying goods having to be moved.[24] As other markets become better-regulated, it is possible this trend will increase.[25]

Further analysis of the NZ AML/CFT regime is set out in Section 4.8 below.

2.8 Market participation and liquidity

A liquid market is one in which buyers and sellers can always find a counterparty with which to trade. This is most likely when there are many participants, including intermediaries participating without compliance obligations. Market participation is encouraged when other conditions facilitating easy trading are in place also. This includes price transparency and low transaction costs.

There is currently limited price transparency and liquidity in relation to trading NZUs. This is a potential deterrent to participation by financial institutions and other trading participants. The on-line platforms will broker trades between participants but, they do not provide additional market liquidity through holding securities to trade themselves. Other participants, including some with significant surrender obligations, do trade actively on both sides of the market, ie buying and selling units in response to price movements. Such active traders increase liquidity although not necessarily price transparency as many trades are arranged without using intermediaries.

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[24]See Interpol's Guide to Carbon Trading Crime for further analysis (https://www.interpol.int/News-and-media/News/2013/PR090 (download from webpage). See also case 9 in AUSTRAC's Typologies and Case Studies Report 2011 (http://www.austrac.gov.au/sites/default/files/documents/typ_rpt11_full.pdf) and Belgian Financial Intelligence Processing Unit (undated) Fraud involving CO2 emission rights (www.ctif-cfi.be/website/index.php?option=com_content&view=article&id=23&Itemid=33&lang=en)

[25] http://www.activistpost.com/2010/07/carbon-trading-used-as-money-laundering.html

It is difficult to judge whether the absence of regulation affects market participation currently. On the one hand, improved market governance (particularly the creation of a regulated exchange) may attract more traders into the market through greater transparency. On the other hand, compliance risks and costs may deter intermediaries and potential liquidity providers.

Several participants interviewed said they would be less likely to participate if certain market governance rules were introduced. Key example identified are:

- offering NZUs for sale becomes a regulated offer under the FMC Act requiring a product disclosure statement and other enhanced disclosure requirements;
- AML/CFT compliance burden; and
- advice regulation, especially if carbon advisers had to become licensed.

Carbon advisers, aggregators and forestry consultants would face increased costs of participation if regulation of advisers were introduced; several indicated they would review their position if this were to happen.

Most participants that we interviewed referred to policy risk as a more important factor in the decision whether to participate in the market, ie the risk that the rules of the ETS will materially change in response to domestic or international factors (and its resulting impact on price stability).

Future international linking (or the future availability of international emission units), if it occurs, would be expected to boost liquidity significantly. Financial intermediaries we interviewed confirmed this, stating that their trading volumes dropped significantly after the linkages were broken in 2015.

2.9 International Linking

A question raised by officials is whether New Zealand not defining units as financial instruments would reduce the potential for international linking of the NZ ETS. Interviewees in New Zealand suggested this is unlikely to make a difference, especially in comparison with other factors which have prevented linking in the past, particularly:

- the inclusion of forestry; and
- the absence of quantity constraints on the use of international units.

For example, the EU has stated that the conditions for linking include:[26]

- system compatibility − the systems have the same basic environmental integrity, and a tonne of CO_2 in one system is a tonne in the other system;
- the mandatory nature of the system; and
- the existence of an absolute cap on emissions.

[26] https://ec.europa.eu/clima/policies/ets/markets_en

However, in preliminary work on the linking of EU and Australian schemes, one issue which was part of the considerations was the development of a comparable market oversight arrangement.[27] In Section 3.1 below we explore the oversight of the EU scheme and make some conclusions about the possible implications for linking with the NZ ETS with respect to the market oversight regime.

2.10 Summary of the Current Problem

A review of existing problems suggests that the following issues may be of concern.

- Market transparency, including:
  - the way in which the Government releases information about policy changes which have market impacts;
  - the absence of exchange-based trading which better enables price transparency; and
  - some evidence of poor advice, particularly for small (forestry) participants. Because they are a small component of the total market, it is unlikely to have had implications for overall market efficiency.

- Market participation, including:
  - the absence of a number of potential intermediaries in the market, with implications for market liquidity. This partly reflects the current market and policy uncertainty;
  - the potential for small players to access the market. This has equity more than efficiency effects.

- Market manipulation, insider trading and market misconduct – there is no real evidence of problems, but the potential for problems exist and this may have spill-over implications for market participation, including international linking.

[27] European Commission and Australian Minister for Climate Change and Energy Efficiency (2012) Australia and European Commission agree on pathway towards fully linking Emissions Trading systems. Joint Press Release Brussels, 28 August 2012. EC IP/12/916

3 International Experience

In this section, we review approaches to market oversight in other ETSs.

3.1 EU

To ensure sufficient liquidity, the EU ETS has encouraged non-compliance traders (entities participating voluntarily, eg traders, investors, individuals, financial intermediaries and so on), in addition to compliance buyers (those with obligations).[28] As a result there has been a significant development in derivatives markets, including futures and options. Trades in derivatives by non-compliance traders dominate the market,[29] although spot prices have a very significant impact on derivative prices.

The European Commission examined whether the allowance market is sufficiently protected from *insider dealing* and *market manipulation*,[30] and reported in December 2010.[31] Following a number of incidents of fraudulent activity, largely involving VAT[32] fraud and cyber-attacks,[33] changes were made to the security of the Registry and to the system of market regulation and oversight.[34] These changes coincided with revisions to the financial markets regulation framework, including the Markets in Financial Instruments Directive (MiFID) and the Market Abuse Directive (MAD). The Commission considered two options: (1) a tailor-made regime for the carbon market and (2) classifying emission allowances as financial instruments and including them in the MiFID/MAD framework (see Box 2).

Box 2 About the MiFID and MAD

The **Markets in Financial Instruments Directive (MiFID)** is a regulatory framework for investment services provided by EU banks and investment firms. Established in 2007, the MiFID's main objectives are to improve the competitiveness and transparency of EU financial markets by creating a single market for investment services, and strengthen the protection of investors in financial instruments. The **Markets Abuse Directive (MAD)**, another EU regulatory framework, complements the MiFID by helping prevent market manipulation and fraud. In 2016, the MAD was replaced by the **Markets Abuse Regulation (MAR)** which brought additional rules (such as those against *attempted* insider dealing) and requirements on firms operating in the EU financial markets. Together, the MiFID and MAR enhance and harmonise European financial markets.

Derivatives, which dominated the carbon market, were already classified as financial instruments. The Commission proposed the inclusion of secondary trading (ie trading

[28] European Court of Auditors (2015) Special Report: The integrity and implementation of the EU ETS. European Union.
[29] European Court of Auditors (op cit)
[30] Directive 2003/87/EC, as amended by Directive 2009/29/EC
[31] European Commission (2010) Towards an enhanced market oversight framework for the EU Emissions Trading Scheme Communication from the Commission to the European Parliament and the Council. COM(2010) 796 final
[32] Value added tax (equivalent to goods and services tax)
[33] European Commission (2010) Towards an enhanced market oversight framework for the EU Emissions Trading Scheme Communication from the Commission to the European Parliament and the Council. COM(2010) 796 final
[34] European Court of Auditors (op cit)

after issuance) of emission allowances in MiFID/MAD by classifying allowances as financial instruments. The proposal was adopted in 2014, with the rules applying from January 2017. The key implications for the EU carbon spot market include:

- compliance costs - all exchanges and intermediaries (eg advisors and brokers) require authorisation from the financial regulator;
- expansion of regulators capacity – eg greater budget and workforce to handle the extra workload;
- information transparency - participating entities need to disclose anything that might have a material impact on its market valuation; and
- position reporting for both traders and exchanges.

Other measures taken were:[35]

- enabling reverse charges (obligation to pay VAT on the buyer) to address the VAT fraud;
- additional security measures for the Registry to combat potential cyber-crimes and international credits recycling;
- integration of anti-money laundering provisions in the registry regulations, inspired by the anti-money laundering directive (2005/60/EC); and
- establishing conduct and participation rules for the primary market in the auctioning regulation.[36]

In addition to addressing the specific problems, the rules also "*aim to provide a safe and efficient trading environment to enhance confidence in the carbon market.*"[37] For example, the requirement of all carbon exchanges to be authorised and report positions aids price discovery and market transparency, while defining carbon allowances as financial instruments increases the market's resistance to fraud and abuse.

Despite the EU's progress in carbon market oversight, the European Court of Orders (ECO) believes that some regulatory gaps remain.[38] First, as compliance traders are exempt from MiFID authorisation, there is a risk to market integrity if such traders

[35] European Court of Auditors (op cit)
[36] Commission Regulation (EU)1031/2010 of 12 November 2010 on the timing, administration and other aspects of auctioning of greenhouse gas emission allowances pursuant to Directive 2003/87/EC of the European Parliament and of the Council establishing a scheme for greenhouse gas emission allowances trading within the Community.
[37] European Commission. Ensuring the integrity of the European carbon market FAQs: 2. 2. What is the expected benefit of applying financial markets rules to all segments of the carbon market? (https://ec.europa.eu/clima/policies/ets/oversight_en#tab-0-2)
[38] European Court of Orders (2015) The integrity and implementation of the EU ETS. Special report no. 6.

abuse this exemption. Furthermore, some parties may become participants in the primary market for the purpose of trading carbon without a MiFID license. Second, over-the-counter (OTC) trading (ie private trading of carbon allowances) is still not regulated. However, such transactions account for a very small portion (1%) of all carbon trades. Third, ECO believes that the carbon allowance classification needs to be more specific; defining allowances as financial instruments only clarifies how they should be treated under financial services legislation, but the rights of allowance holders are still unclear.

3.1.1 Implications for Linking

As noted above (Section 2.9), the EU has previously stated that the development of comparable market oversight arrangements was a relevant issue to the consideration of linking. From the review of issues which have resulted in the development of the current market oversight regime in the EU, issues of concern might include the following:

- Security measures to combat potential cyber-crimes to ensure that the units in the NZ Registry have integrity, ie that "a tonne is a tonne"; and

- Measures to address ML/TF concerns such that the EU ETS is not compromised by association.

We cannot be certain that these issues will not be a concern for linking, but agree with the views of NZ market participants that other issues currently comprise more significant barriers. It suggests that measures taken for other reasons, which reduce barriers to linking would be favoured, but it might not need to be pursued as an objective itself. A watching brief might be kept on developments in this space, eg whether market governance is a significant issue for any formal linkages which develop between other countries.

3.2 US

Currently, there are no federal regulations dealing specifically with the trading of emission allowances and it has been left to traders to determine the asset class of carbon units.[39] Emission allowances are treated as commodities, while derivatives are regulated as financial instruments.

The Commodity Futures Trading Commission (CFTC) has "exclusive jurisdiction" over commodity futures and options. Unless exempted, futures contracts and options must trade on a commodity exchange that has been designated as a contract market, but spot and forward transactions are not generally subject to CFTC jurisdiction.[40]

There are two mandatory emission allowance schemes for greenhouse gas emissions in the US:

[39] Button J (2008) Carbon: commodity or currency - the case for an international market based on the currency model.
[40] Kluchenek MF (2015) The Status of Environmental Commodities Under the Commodity Exchange Act. Harvard Business Law Review Online 39: 14-52

- The Regional Greenhouse Gas Initiative (RGGI) is an agreement among the governors of ten North-eastern and Mid-Atlantic States to cap and reduce the amount of carbon dioxide (CO_2) that certain power plants are allowed to emit.

- The California Cap-and-Trade Program is an ETS designed to help the state reduce its GHG emissions to 1990 levels by 2020. Even though it is not a financial regulator, the California Air Resources Board regulates the primary and secondary market. Its oversight is similar to that of the EU's MiFID, covering transaction reporting requirements, position limits, and authorisation to participate in the market.[41]

Other regional initiatives are in the development stages. California is one of seven Western states and four Canadian provinces participating in the Western Climate Initiative (WCI), a partnership formed in 2007 to develop and implement a joint strategy for reducing GHG emissions. Since the integration of California and Quebec schemes in 2014, the WCI recommended that allowances and offsets be legally defined as commodities.[42] Along with RGGI and WCI, the Midwestern Greenhouse Gas Reduction Accord is another regional collaborative effort of states working to identify and implement collaborative state-level strategies for reducing GHG emissions, which may involve the use of an emission allowance program.

There are also emissions allowance trading programmes for SO_2 and NOx. Emission allowances are defined as commodities and market participation is broad. The EPA is responsible for tracking the issuance and transfer of allowances, the number of allowances held by a person or company, and allowance deductions for compliance purposes. However, it does not collect any information about allowance prices or transaction terms. The scheme's success is often attributed to the clear and comprehensive legislation supporting the scheme, and data transparency both required of participants and provided by the EPA.[43]

3.3 China

China tested seven regional 'pilot' schemes from 2013 to 2016. Only carbon spot trading was allowed while carbon derivatives were banned. Thus, most pilot schemes did not allow financial speculators to participate in markets.[44] China's pilot schemes were characterised by limited liquidity. This was attributed to limited market participation, lack of data transparency and absence of financial products (such as derivatives) for risk management and/or speculative purposes (Huang, 2016).[45] To avoid the liquidity

[41] PWC (op cit)
[42] Western Carbon Initiative (2010) Status update on market oversight recommendations
[43] Napolitano S, Schreifels J, Stevens G, Witt M, LaCount M, Forte R & Smith K (2007) The US acid rain program: key insights from the design, operation, and assessment of a cap-and-trade program. The Electricity Journal, 20(7), 47-58.
[44] EY (2013) Understanding China's ETS and emissions reporting. Retrieved from www.ey.com
[45] Huang J (2016) Sink or swim – China needs to strengthen trading practices in its ETS. Retrieved from https://carbon-pulse.com/24056/

problems seen in the test schemes, China is currently developing financial products for their national ETS, which is set to be launched in 2017.[46]

3.4 South Korea

Market participation is restricted to compliance entities, with the exception of four banks.[47] Like China's test schemes, carbon derivatives and OTC transactions are not allowed.[48] These limitations reflect Korea's prioritisation of market stability over liquidity. Korea's preference for a basic market structure could also be explained by a more general lack of experience of risk management using derivatives.[49]

3.5 Summary

Trends can be seen in the regulatory approaches taken by international ETSs. They often define emission allowances so that regulatory responsibility is given to an agency that already oversees a commodity or financial instrument market. For example, in the US, the Commodity Futures Trading Commission (CFTC) was given regulatory oversight of the carbon derivatives market, and in the EU, the financial regulators already looked after the carbon derivatives market, so it was natural to extend their authority to spot markets.[50] Experience in China and South Korea, where market participation was relatively limited, supports theory that suggests this barrier to entry can significantly reduce liquidity and scheme efficiency.

[46] Thomson Reuters (2017) Carbon Market Monitor: A new hope dispelled: review of global markets in 2016. Retrieved from climateobserver.org
[47] Hyun J and Oh H (2017) Korea's Emission Trading System: An attempt of non-annex I party countries to reduce GHG emissions voluntarily
[48] PWC (2015) Carbon market oversight: international approaches. Environmental Protection Authority Research Report.
[49] Hyun & Oh (op cit)
[50] PWC (op cit)

4 Current Regulation and Regulatory Options

4.1 The Objectives of Market Regulation

Markets provide the means for buyers and sellers to interact and enable price discovery. Efficient markets ensure that trading results in the optimal allocation of goods and services. Where there are market failures which result in a less than efficient market, regulators generally focus on four objectives for improving market function:[51, 52]

1. To facilitate and protect price discovery in the carbon markets.
2. To ensure appropriate levels of carbon market transparency, including price and policy change.
3. To allow for appropriate, broad market participation.
4. To prevent manipulation, fraud and other market abuses.

This is consistent with the set of issues problems identified in Section 2 and summarised in Section 2.10. Consistent with the objectives noted above, a number of principles are suggested below (Table 2).

Table 2 Governance Principles

Objectives	Principles for Governance
To facilitate and protect price discovery in the carbon markets	1. ETS is fulfilling its purpose by providing efficient incentives for emission reduction, absorption and/or international trade
To ensure appropriate levels of carbon market transparency	2. Transparency and information symmetry 3. Market innovation, flexibility, market completeness and responsiveness
To allow for appropriate, broad market participation	4. Fairness, ethical conduct and market integrity 5. Efficiency, ease of transactions and low transaction costs
To prevent manipulation, fraud and other market abuses	6. Protecting NZ's reputation internationally (AML/CFT, market integrity)

Below we discuss the regulatory options to deal with the identified problems, and building on the governance principles.

4.2 Regulatory Options

The current system of financial regulation is summarised in the Annex. The identified regulatory options are listed in Table 3, including a brief description and some comments on the objectives or outcomes.

[51] Interagency Working Group for the Study on Oversight of Carbon Markets (2011) Report on the Oversight of Existing and Prospective Carbon Markets.
[52] Kachi A and Frerk M (2013) ICAP Carbon Market Oversight Primer. International Carbon Action Partnership.

Table 3 Regulatory options

Option	Key points	Comments
1 Better information	No change to regulatory framework Non-regulatory tools enhanced: EPA monitoring resources increased. Participant information resources enhanced. Government resources co-ordinated / streamlined.	Assisting participants make better decisions through information and education.
2 Self-regulation	Central register of carbon advisers and intermediaries with an industry body (or Government). Advisers and intermediaries agree to terms and conditions (eg code of ethics / joining a dispute resolution scheme / being subject to a disciplinary tribunal).	Better decisions through better quality advice. Improved market governance.
3 Disclosure-based regime	Carbon advisers/brokers required to provide disclosure information (eg on capability, fees and conflicts). Offers of NZUs to be provided with standard form disclosures. Government warnings about firms to be wary of.	Better decisions through clear disclosures.
4 Standardised trading rules	Standardised trading rules and conduct standards apply to all intermediated transactions. Exchanges / platforms could be designated by Government.	Improving market transparency and governance
5 AML/CFT regulation	Entities advising on or trading carbon become AML/CFT reporting entities under AML/CFT Act. Only applies to trading/broking (if in the ordinary course of business), and, not advising (could be extended). Applies to wholesale only businesses. AML/CFT supervisor would be the FMA or DIA.	Improves NZ market reputation and increases potential for linking
6 NZU becomes Financial Advice Product (as defined in FMC Act, as revised)	FMC Act and FSPA (as revised) applies to carbon advisers (and intermediaries) with respect to advisory and broking services. Carbon advisers and intermediaries must register on the FSPR. All advisers are subject to a conduct obligation to put clients first, a code of conduct and disclosure obligations. FMA is active conduct regulator with strong enforcement powers, supported by Financial Advisers Disciplinary Tribunal. If advising retail investors,* advisors have to be licensed.	Focus on assisting participants make better decisions through better quality advice.
7 NZU becomes Financial Product (as defined in FMC Act)	As above plus: Offers of NZUs to retail investors* are subject to disclosure requirements. For example, a product disclosure statement is required. Exchange-based trading is regulated. Prescriptive trading rules apply and market operators must be licensed and subject to close FMA supervision.	Focus on increasing transparency, market integrity and supporting better-decision-making through better quality advice.

Notes: AML/CFT = anti-money laundering and countering the financing of terrorism; DIA = Department of Internal Affairs; FMA = Financial Markets Authority; FMC Act = Financial Markets Conduct Act 2013; FSPA = Financial Service Providers (Registration and Dispute Resolution) Act 2008; FSPR = Financial Service Providers Register

*A retail investor is anyone who is not a wholesale investor (see glossary). In practice this usually means a person with less than $5m in assets or income pa (who is not otherwise subject to one of the exceptions).

4.3 Criteria for Analysis

The analysis of options uses criteria developed with reference to the problems identified and the objectives for intervention. The criteria used are as follows.

- **Costs** – the extent to which the regulatory changes would be expected to result in increased total costs, including those for the Government in developing or administering the regulations, or for market participants.

- **Improves transparency** – whether the intervention results in increased access to good information by market participants, including that relating to price (current and future), volumes (supply and demand) and policy changes.

- **Efficient participation by small firms** – whether the intervention is expected to improve entry and participation decisions by small firms, especially small forester decisions to sell NZUs.

- **Increased participation and liquidity** – if the regulation would encourage more participants, particularly amongst intermediaries, with a resulting improvement in market liquidity.

- **Reduced risk of market abuse** – if the intervention is expected to reduce risks of market manipulation or of money laundering.

- **Enhances international linking** – this addresses the issue of whether it would be likely to increase New Zealand's attractiveness to other ETSs and increase the likelihood of international linkages. As noted in Section 3.1.1, it is not clear that this is of high importance currently; achieving this objective is useful if it coincides with the achievement of other objectives.

Table 4 shows the results of the analysis of options against these criteria.

Table 4 Analysis of options

Option	Costs	Improves transparency	Small firm participation	Encourages participation	Reduces market abuse	Enhances international linking
1 Better information	L	✓	✓	×	✓	–
2 Self-regulation	L	x	–	×	×	×
3 Disclosure-based regime	M	✓	–	unsure	×	×
4 Standardised trading rules	M	✓	–	✓	✓	unsure
5 AML/CFT regulation	H	×	×	×	×	✓
6 NZU becomes Financial Advice Product	H	×		×	×	✓
7 NZU becomes Financial Product	H	✓		×	✓	✓

Costs are treated differently from the other criteria, because low (L) is better than high (H), whereas for the others, more (ticks) is better than less (crosses). The criteria are not mutually exclusive, eg increased costs may result in reduced participation, whereas improved transparency may increase participation. This means it is not appropriate to add the ticks across the columns.

We review the individual options in turn below. They are compared with the status quo in which no regulatory changes are made.

There are other non-regulatory options which are not considered. These include removing small supply-side participants from the ETS altogether, perhaps through having minimum thresholds for joining the ETS (and looking to other policy options to provide a carbon incentive), or requiring their NZUs to be dealt with by an aggregator or other entity acting as their nominee. In addition to small forestry participants, free allocation of very small numbers of units also appears to be highly ineffective in providing any form of compensation for small firms; the transaction costs are significantly high that selling these units is not viable for these small potential sellers.

However, removing small participants would be a significant change to the ETS and beyond the limited scope of this study. We do not consider this option further here.

4.4 Option 1: Better Information

4.4.1 Description

Better information would include two non-regulatory options:

1. The development and distribution of an information pack for new participants in the ETS, ie those joining the registry; and

2. Improvements to the Government's release of information, including market-relevant data and announcements of policy changes, which have implications for the market.

The information pack would be developed specifically to provide advice for small potential participants, ie those without the resources to devote to better understand the market and the implications of their decisions. It would provide sufficient information and in an understandable format such that a potential market participant would understand the implications of buying and selling NZUs.

A further element might be for new participants to do a simple test to check their understanding of the ETS and capability to trade.[53] This would be a step further than is justified at this stage and we have not analysed it as part of this option.

The improvements to the Government's release of information would include all releases which, if they were made available to one participant, would provide that

[53] This method is used by derivatives issuers to ensure product suitability for clients. See for example https://www.icmarkets.com/client-suitability-test/

participant with an advantage relative to others, particularly through their buying or selling units because of the implications of the information release for future price movements. This might include release of information on policy changes and the release of volume or other data.

Improvements in coordination might include:

- A clear statement and understanding of what is and is not market-relevant;
- A single website where all relevant information is released; and
- A pre-announced timetable or a fixed schedule for releases.

4.4.2 Analysis

Costs

The compliance costs for these enhancements to the status quo would be borne largely by the Government. The information packs would be expected to be relatively low cost to develop and distribute. The better coordination and release of information would require Departments to treat GHG emissions data and other ETS-related information differently from other data and policy issues. This may require additional education and the development of new systems and/or websites.

Market transparency

Both of these changes would improve market transparency.

- The information pack would reduce the potential for poor advice and poor decision making by small investors, which has the potential otherwise to result in forest owners joining the ETS, or selling units, when it is not in their best interests to do so.

- Policy coordination would increase information symmetry and reduced the opportunity for market participants to profit at others' expense. Because all market participants eventually obtain information (and thus, all other things equal, units will be purchased by those who value them most), the uncoordinated or inconsistent release of information does not have direct efficiency impacts, but it might have indirect effects. Specifically, asymmetric information reduces the (perceived) fairness of the market which can discourage entry (or continuation), with implications for long-term liquidity and efficiency.

These non-regulatory enhancements would appear to be sensible additions, regardless of any regulatory actions.

Small participants

Better information would be specifically targeted at improving that available to small participants, including targeted advice on whether or not to join the ETS and/or to sell NZUs.

Encouraging participation

Current problems with small participants appear to be more biased towards over- rather than under-participation. Better information for small participants may result in reduced total participation by this group.

Improving information releases by the Government would improve the overall integrity of the market with benefits for all potential participants. It would be expected to encourage entry because of the greater perceived fairness, including amongst intermediaries and liquidity providers.

Reduce market abuse

Better coordination of Government release of information reduces the scope for information asymmetry and insider trading.

Encourage international linking

These measures would both increase the overall integrity of the market with potential spill-over benefits for linking. However, this effect is unlikely to be significant.

4.4.3 Recommendations

These interventions appear to be relatively low cost and to have potentially significant benefits for small participants and overall market integrity. They could be introduced alone or alongside any other option considered here.

We recommend that that this option is implemented on a standalone basis, irrespective of the selection of other options.

4.5 Option 2: Self-Regulation

4.5.1 Description

Self-regulation is the first line of defence for any industry that seeks to set professional standards on a voluntary basis. Self-regulation would be aimed at both advisers who support participants with advice on the ETS and carbon trading and intermediaries who facilitate carbon trading.

In relation to advice, the New Zealand Institute of Forestry (NZIF) has been established as the industry body for forestry consultants. It encourages high professional standards for its registered members and requires them to adhere to its Rules and agree to its Code of Ethics.[54] Market feedback indicated that this body could be tasked with a stronger role in relation to advice on the ETS and carbon trading. However, not all carbon consultants are forestry consultants and not all forestry consultants have expertise to be carbon consultants.

If the NZIF could not be adapted to suit, a new industry body could be established to oversee individuals and firms that advise on or facilitate sales and purchases of NZUs

[54] https://www.nzif.org.nz/Category?Action=View&Category_id=390

and/or advise on the ETS generally. This could include intermediaries providing broking services (ie that facilitate, broker or aggregate NZU transactions without providing advice to participants).

An appropriate industry body could set up a governance framework (eg code of conduct or ethics, disputes resolution function, disciplinary tribunal), registration service for members and also provide an industry forum to connect with Government on policy and implementation issues. Its mandate could potentially be extended to include a market oversight function too, perhaps in conjunction with the EPA, to ensure that voluntary rules of trading conduct are adhered to.

4.5.2 Analysis

Costs

Compliance costs would be minimal, particularly if an existing industry body were selected. They would be higher if a new body was required.

Market transparency

The impact on market transparency would depend on the extent of the self-regulation framework implemented. Enhancements are unlikely to be significant without significant Government influence on the outcome.

Encouraging participation

Self-regulation may be sufficient to build greater trust and confidence where it is most needed, ie with smaller forestry participants. It is unlikely to affect decision-making by larger participants.

Reduce market abuse

We believe self-regulation would have minimal impact on market abuse issues. Self-regulation has often proved to be ineffective in relation to issues of misconduct and/or criminal behaviour. An example is of this is the UK self-regulation of the press under the Press Council and the conduct of the tabloid press, particularly *The Sun* and *News of the World* newspapers. A Code of Practice was eventually adopted, overseen by the Press Complaints Commission, but did not prove to be very effective in reducing misconduct.[55]

Encourage international linking

Given the lack of a formal regulatory framework, this option is unlikely to provide sufficient market governance of the NZ market from an international perspective.

4.5.3 Recommendations

We believe that this option would be low cost, both for Government and for industry. Based on our conversations with participants and advisers, we think it would be well-

[55] See article 'When does Press Regulation work? (http://law.unimelb.edu.au/__data/assets/pdf_file/0009/1587024/383FinkelsteinandTiffen2.pdf) and the findings of the Leveson Inquiry in 2011.

received by industry, although there is a question over whether there are sufficient potential members to support an industry body. We also think it would be beneficial for smaller forestry participants. Close government engagement may be required to ensure that a self-regulatory framework is adequate and as effective as possible.

We recommend that this option is explored further with industry.

4.6 Option 3: Disclosure-Based Regime

4.6.1 Description

Another option is to institute a disclosure-based regime. There are several different types of disclosure that could be introduced:

1) Risk statement: offerors (ie sellers and promoters) of NZUs could be required to include a mandatory risk statement on any offer of NZUs. An example of a risk statement is as follows:

   "*investing in [ ] carries significant risks and is not suitable for all investors. The value of your investment may go up or down. We recommend that you seek independent advice and ensure you fully understand the risks involved before investing*."

2) Adviser disclosure statements: advisers (and intermediaries) could be required to provide clients with a disclosure statement outlining their capability and qualifications, fees and conflicts. This is the current requirement under the Financial Advisers Act 2008 (FAA), although the disclosure requirements are currently being enhanced given previous issues with the format and content.

3) Compliance and enforcement information: a government agency, such as the EPA, could publish information on compliance concerns or enforcement actions or issue warnings. Examples of this include:

   a. incorrect advice or misleading information being provided to participants;
   b. issues with emissions returns incorrectly completed;
   c. penalties applied to participants;
   d. a list of firms that it has concerns about. Several regulators operate such a system, although they have to be managed carefully.[56]

4) Full product disclosure statement: a prescribed form of a product disclosure statement could be required to be provided to investors. This is the requirement under Part 3 of the FMC Act for retail offers.

[56] As an example, see FMA's webpage: https://fma.govt.nz/news/warnings-and-alerts/businesses-to-be-wary-of/.

4.6.2 Analysis

Costs

Compliance costs under 1-2 above would be low. They would be much higher for 3 and potentially prohibitive for 4.

Market transparency

The impact on market transparency would depend on the extent of the self-regulation framework implemented. Enhancements are unlikely to be significant without significant Government influence on the outcome.

Encouraging participation

Disclosure-based regimes can be appropriate for smaller or less complex markets, particularly where the majority of the participants are businesses with some level of sophistication (such as the ETS). As a result, we do not think enhanced disclosure rules will discourage participation. They may encourage participation from less sophisticated participants by increasing understanding and therefore improving confidence and decision-making.

Reduce market abuse

Financial markets have shown that disclosure-based regimes can be insufficient to protect investors from poor industry conduct. In addition, unless there is monitoring and enforcement of the disclosure rules they can provide little real protection to investors.

Encourage international linking

This option would assist international linking, particularly if robust offer disclosure rules were instituted. However, it is unlikely they would ever achieve mutual recognition status with other jurisdictions if they were outside the FMC Act regulatory framework.

4.6.3 Recommendations

As we have found very little evidence of poor industry conduct during our research, we believe that this option is worth considering as a short to medium-term solution. However, we would recommend that further evidence is sought in relation to industry conduct issues (though for example a participant survey).

4.7 Option 4: Standardised NZU trading rules

4.7.1 Description

Currently, there is a lack of consistency and standard documentation for the sale and purchase of NZUs. This option presents the case for providing a new, enhanced market governance regime for trading NZUs. See Option 7 for analysis of exchange-based trading under the FMC Act.

A single set of trading rules and conduct standards could be designed to apply when intermediaries facilitate the sale and purchase of NZUs on behalf of others in the

ordinary course of business. These rules could apply to on-line platforms or intermediaries broking transactions on an individual basis. They would not apply to bilateral arrangements or to principal trading by participants with compliance obligations (unless they transacted via an intermediary).

Requiring most or all transactions to occur in a consistent manner would improve price discovery, result in more liquidity and allow the Government to track trading activity on a small number of registered trading facilities that provide regular reports on market activity.[57]

There are options as to the extent of such market governance rules, ranging from self-regulation to a voluntary but centrally managed regime, a mandatory regime, through to full regulation as a licensed financial product market under the FMC Act (as considered under Option 7).

A single set of rules approved by Government could be made more attractive by offering a special designation to intermediaries that agree to comply with the official rules. This could provide comfort to participants and be an attractive marketing tool for intermediaries. One option would be to only offer this designation to intermediaries that provide enhanced trading transparency via an exchange or on-line platform.

A compromise might be to have different (but consistent standard) trading rules designed by each intermediary but approved by a Government agency such as the EPA.

4.7.2 Analysis

Compliance costs

This could incur reasonable-sized compliance costs for both Government and intermediaries, although these could be passed through to clients in higher transaction fees. Other participants would be impacted if this occurs.

Market transparency

This could be significant, particularly if the rules were designed to promote trading on exchange / on-line platforms.

Encouraging participation

This option should result in increased trust and confidence in the market plus greater price transparency. Both factors should encourage participation significantly.

Reduce market abuse

This option should significantly reduce the potential for market misconduct. To be most effective, monitoring of trading activity and enforcement of trading rules would have to be undertaken, either by the intermediary (with oversight by that Government agency) or directly by the Government agency.

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[57] Monast J (2010) Climate Change and Financial Markets: Regulating the Trade Side of Cap and Trade. Environmental Law Reporter, 40(1): 1051-1065

Encourage international linking
This option would assist international linking, particularly if robust trading rules were instituted. However, it's unlikely they would ever achieve mutual recognition status with other jurisdictions if they were outside the FMC Act regulatory framework.

4.7.3 Recommendations

This is our preferred option as it promotes the key principles that improved market governance seeks to achieve but avoids the high costs of compliance of options 5 - 7. We recommend that it should be explored further with industry to determine which version is most suitable for the market.

This option needs to be examined in the light of any recommendations on price discovery.

4.8 Option 5: AML/CFT Regulation

4.8.1 Description

New Zealand recently established an AML/CFT regime that largely follows the Recommendations of the Financial Action Task Force.[58] The core piece of legislation is the Anti-Money Laundering and Countering the Financing of Terrorism Act 2009. Significant investment has been made by the NZ Government to establish the regime, which has been operating for nearly 3 years.

The NZ Police Finance Intelligence Unit (FIU)'s National Risk Assessment[59] identified the abuse of carbon credits as a new ML/TF typology that may emerge. The NZ FIU has also identified capital markets as an area of higher ML/TF risk (whilst not specifically referencing carbon trading).[60] The AML/CFT regime does not currently apply to the carbon trading market. However, financial institutions that trade carbon derivatives, in the ordinary course of business, are subject to the AML/CFT Act because 'commodity futures trading' is captured by the AML/CFT regime.[61]

As part of the Phase 2 expansion of the AML/CFT regime,[62] which is due to be introduced in stages over 2018 and 2019, real estate agents, conveyancers, many lawyers, accountants, some additional gambling operators and some businesses that trade in high-value goods such as cars, boats, jewellery, bullion, art and antiquities, will become AML/CFT reporting entities subject to the Act. According to the FIU's National Risk Assessment, evidence shows these businesses are at high risk of being targeted by criminals to launder money.

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[58] http://www.fatf-gafi.org/publications/fatfrecommendations/?hf=10&b=0&s=desc(fatf_releasedate)
[59] NZ Police FIU National Risk Assessment on Anti-Money Laundering/Countering Financing of Terrorism. 2010.
[60] See NZ Police FIU Quarterly Typology Report Q1 2015/2016 (http://www.police.govt.nz/about-us/publication/fiu-assessments-reports)
[61] Refer to definition of financial institution in section 5 of the AML/CFT Act.
[62] See https://www.justice.govt.nz/assets/Documents/Publications/aml-phase-2-draft-information-paper.pdf for further details.

Including carbon trading as a financial activity under the AML/CFT Act would be consistent with the current expansionary nature of the NZ AML/CFT regime and international trends. For example,[63] in Australia, the AML/CFT legislation was amended in 2011 to specifically include traders and brokers of carbon credits to ensure they adopt anti-money laundering measures and report suspicious transactions. In addition, a European Union Directive requires AML/CFT compliance checks to be adopted by persons engaged in investment services, including dealing in financial instruments relating to climatic variables and emission allowances.

4.8.2 Analysis

It would be relatively straightforward to include carbon trading within the current regime,[64] although the advantages would have to be weighed against the disadvantages (Table 5).

Table 5 Advantages / disadvantages of AML/CFT regulation of carbon markets

Advantages	Rationale	Disadvantages	Rationale
Enhance international reputation of ETS and carbon trading market	Attract offshore financial institutions Increase liquidity	Increased compliance costs and bureaucracy	Decreases participation (especially advisers) inhibits business growth could unfairly impact small ETS participants
Increase regulatory touchpoints	Provides useful insight into participant conduct Useful in lightly-regulated markets	Fear of AML/CFT regulators & penalties	Regulatory risk may stifle innovation and decrease participation AML/CFT increasing conservatism of mainstream banks and financial institutions.
AML/CFT checks discourage financial crime and ML/TF	KYC/CDD increases knowledge of customers and their beneficial owners Transaction monitoring increases trading transparency. International trends suggest should be regulated for AML/CFT	Increased workload for AML/CFT regulators	AML/CFT regulators are already stretched due to commencement of Phase 2. Carbon trading may not be prioritised as a result.
Level playing field	Financial intermediaries seem to have adopted AML/CFT compliance voluntarily Their competitors would have to meet the same standard.	ETS registration requirements may be sufficient	Existing registry controls may be sufficient to deter and detect ML/TF (or could be enhanced further). Duplication of effort / government resources.

Costs

This option could result in high compliance costs for participants, advisers and intermediaries. In particular, it is likely to have a high impact on forestry consultants and other advisers that assist small forestry participants. These advisers are often very

[63] c/f Interpol's Guide to Carbon Trading Crime previously referenced.

[64] It would require a small change to the definition of financial institution in the AML/CFT Act, so that entities that trade NZUs or international emissions units on their own account or for the accounts of customers in the ordinary course of business are included in sub-category (a)(vii) of the definition.

small businesses or sole traders that cannot sustain the compliance burden. Given their importance to assisting forestry participants understand certain complexities of the ETS, this may be a significant disadvantage.

Some compliance costs can be mitigated through carve-outs from the existing AML/CFT regime. For example, with certain exceptions,[65] entities that are not financial institutions are not subject to the regime. Other entities that fall within the definition of financial institutions (eg they trade units on their own account but not on behalf of others), but should not be caught for other policy reasons, can be exempted.

Market transparency

AML/CFT reporting entities are required to conduct transaction monitoring and report suspicious transactions to the FIU. As a result, AML/CFT can enhance transparency, however it has little impact on price transparency.

Encouraging participation

Given the compliance burden, we think it will discourage participation by advisers and intermediaries. In addition, the more onerous client onboarding process may discourage participation too (although participants are already subject to due diligence as part of registering on the ETR).

Reduce market abuse

This option has the potential to reduce market misconduct, particularly fraud, due to the transaction monitoring obligations. Based on financial markets experience, it has limited impact on other types of abuse such as market misconduct and insider trading.

Encourage international linking

In our view, this option would assist with international linking. Many offshore jurisdictions make carbon trading subject to AML/CFT regulation to it will increase the likelihood of mutual recognition and other reciprocal arrangements.

4.8.3 Recommendations

We do not recommend that carbon trading be included in the AML/CFT regime currently as the disadvantages (primarily high compliance costs and onerous customer due diligence requirements acting as a barrier to participation) currently outweigh the advantages.

In addition, the inherent ML/TF risk of the activity may not be high enough to attract the interest of the AML/CFT regulators, due to the centralised registration of participants via the Emissions Trading Register. However, this should be reassessed prior to international linkages being formed as the ML/TF risk will increase at this point and the registry controls will be less effective as a prevention mechanism.

It would be useful to review trading data to analyse the potential for, or evidence of ML/TF or market misconduct. This might involve the analysis of trading data for:

[65] Certain financial advisers and other entities that are not financial institutions have been included in the AML/CFT regime by way of regulation.

- anomalous movements in volumes or prices just prior to a policy announcement, which would suggest insider trading; or

- unusual and sudden volume or price spikes (or falls), followed by significant trading volumes at those high/low prices, which would suggest market manipulation.

We recommend that the Ministry engages with the FIU to consider whether the abuse of carbon credits has developed further as a ML/TF typology and risk-rate the NZ carbon trading market.

We recommend that the Ministry engages further with the Ministry of Justice and AML/CFT supervisors to consider its appetite to expand the regime to include carbon trading in the future.

4.9 Option 6: Financial Advice Product

4.9.1 Description

Regulatory changes relating to financial advice

MBIE has recently published an exposure draft of the Financial Services Legislation Amendment Bill for public consultation. It repeals the FAA and introduces a comprehensive package of changes that will create a new regime for financial advice through amendments to the FMC Act and the Financial Service Providers (Registration and Dispute Resolution) Act 2008 (FSPA).

The proposed reforms are aimed at establishing a more level playing field of regulation for all financial advisers. The new regime should give retail investors better quality advice and make it more straightforward for financial advisers to comply. Key changes include the following.[66]

- Anyone providing financial advice will be required to put the interests of the client first and to only provide advice where competent to do so. All financial advice will also be subject to a Code of Conduct (still in development).

- Anyone (or any robo-advice platform)[67] providing financial advice will need to operate as a FMA licensed financial advice provider. To ensure this does not impose undue costs on industry or Government, licensing will be done at the firm level.

- The regime will be simplified, eg the definitions of class and personalised advice and different categories of products will be removed, creating a level playing

[66] See further information in MBIE's fact sheet: http://www.mbie.govt.nz/info-services/business/business-law/financial-advisers/review-of-financial-advisers-act-2008/consultation-on-exposure-draft-and-transitional-arrangements/factsheet-a-new-financial-advice-regime.pdf

[67] Online, automated advice

field for all types of advice.

- More meaningful disclosure requirements will be introduced to ensure consumers receive core information such as remuneration.

It should be noted that the legislative changes do not affect providers of broking services under the FAA. They are subject to an over-arching requirement to operate with care, diligence and skill and not mislead or deceive their clients. There are also more prescribed requirements about how they operate client money trust accounts. Note that firms that advise on or otherwise facilitate trades but do not handle client money or assets in connection with that trade are not regarded as brokers under the FAA. In effect, firms that facilitate trades of financial products without advice are largely unregulated.

Under the new legislation, FMA will have the power to call in products such as NZUs (and/or international emissions units) and designate them as a financial advice product under the FMC Act.

4.9.2 Analysis

Our view is that the over-arching requirements to put client interests first, and only provide advice if competent would be highly transferable (and beneficial) to the carbon advisory market. The requirement to join a dispute resolution scheme (for retail investors), disclosure requirements and FMA oversight should improve market governance too.

However, there are key aspects of the regime that are not so transferable, for example, the different professional qualifications for advisers, certain technical aspects of the Code of Conduct (eg requirement for independent research on investments) and the licensing requirements (if advising retail investors). Whilst the FMA has a wide ability to grant exemptions, it is unclear at this stage where it will apply this in relation to smaller financial advice providers.

Several forestry consultants indicated that they would be unlikely to transfer into a financial advice provider regime for these reasons and because of the relatively high costs of ongoing compliance. Alternatively, some advisers may opt to advise wholesale investors only, which would reduce access to advice for a lot of smaller ETS participations. MPI advises that there are currently a relatively small number of advisers, eg 22 representing 20 or more participants, 31 with 10 or more clients, and 47 with five or more clients. If this option (or options 5 or 7) is explored further, we recommend that there is further engagement with other types of advisers that provide advice on the ETS and NZU trading to assess their reaction and estimate impact.

There is a tension between regulating advice to improve quality and that regulation resulting in decreased access to advice. The financial advisory market has struggled with this since the FAA came into force, with adviser numbers dropping significantly (>10%) as a result and some providers moving from providing advice to 'information only' on financial products they sell. It is likely this would play out in the carbon advisory market also, at least at first. Given the small size of the carbon market, this

could have a significant impact, resulting in poorer access to advice for small participants.

Compliance costs

This could incur high compliance costs for participants and advisers, particularly given the licensing requirements and disclosure rules.

Market transparency

This will have little impact given the FAA regime has little impact on how transactions are brokered or disclosed, unless they are advised or client money or property is involved.

Encouraging participation

Given the compliance burden, we think it will discourage participation by advisers, particularly smaller advisers in the forestry sector. This may reduce access to advice which may in turn reduce trust and confidence in the market by smaller participants.

Reduce market abuse

The conduct rules will assist with reducing market abuse by advisers. However, given the limited impact of the proposed FAA regime on intermediaries (unless they handle client money or property) as opposed to advisers, this will have only a very limited impact.

Encourage international linking

In our view, this option would assist with international linking, although not to the same extent as options 5 or 7.

4.9.3 Recommendations

We do not recommend that this option is adopted given the costs of compliance and the issue of fit, ie focus of the FAA and FMC Act regimes on retail investors. However, many of the beneficial aspects of the financial advice regime (eg dispute resolution providers, disclosure obligations, the obligation to put clients first and operate with care, diligence and skill) could be replicated either on a voluntary basis by the carbon industry or separately mandated by the MfE or EPA.

In addition, the EPA, MfE and the MPI could voluntarily share information on poor advice and/or poor conduct with other regulators such as the FMA where it becomes aware of such issues. We understand that this may require amendment to the confidentiality provisions relating to the ETS to allow information-sharing with other regulators.[68]

[68] see s99 of the Climate Change Response Act 2002

4.10 Option 7: NZU Becomes Financial Product

4.10.1 Description

Similar to option 6, it would be possible for NZUs to be 'called in' and designated as a financial product under the FMC Act. This would afford a high level of protection to retail investors. It would put the NZU in the same classification as equity and debt securities, managed investment products and derivatives. It is a flexible regime which gives the FMA significant powers to call in products or exempt out products or providers from the requirements. It also gives the FMA a wide range of regulatory tools to monitor and enforce compliance.

FMA has recently shown an inclination to use its call-in powers, eg licensing of providers of short-term derivatives[69] and designating shares in investment companies as managed investment products.[70] This could suggest a trend towards widening its regulatory reach where it has concerns about potential harm to investors.

Our understanding is that the FMA has the power to designate NZUs as financial products as NZUs are, in principle, a form of security or investment product[71] rather than a commodity. It is likely that this would have to be supported by a valid reason to 'call it in' such as evidence of investor harm.

It is generally accepted that NZUs share characteristics with both financial products / financial instruments and commodities. International experience has shown that they can be classified as either. Table 6 below highlights some of the distinctions between emissions units and commodities.

Table 6 Emission Allowances and Commodities

	Characteristics	Supply	Disincentives to acquisition
(Standard) Commodities	Standardised, fungible, cost of which to be considered in production	Determined by factors of production	Generally physical mass, contracts which have a delivery time and place, storage and transportation costs
Emission Allowances	Standardised, fungible within jurisdiction, cost of which to be considered in production	Determined by policy decision	Intangible, no storage costs

Source: Adapted from Kachi A and Frerk M (2013) ICAP Carbon Market Oversight Primer. International Carbon Action Partnership.

[69] https://fma.govt.nz/news/media-releases/fma-confirms-short-term-derivatives-to-be-licensed/.
[70] http://stephenlayburn.co.nz/fma-designates-investment-company-shares-now-regulated-as-managed-investment-products.
[71] The Securities Commission had previously looked at whether carbon futures and carbon units were securities and subject to the Securities Act and the Securities Markets Act (SMA). The intent was to catch derivatives on carbon if traded so that the SMA applied and dealers would have to become Authorised Futures Dealers. We believe that their view was that the units did not fit well into the Securities Act definition of securities. They saw them as a 'right to emit carbon', ie a right to do an activity without penalty – not a right to participate in an asset. This issue is no longer relevant.

If the NZU became a financial product then it automatically becomes a financial advice product and trading NZUs becomes a regulated financial activity for the purposes of the AML/CFT Act. Carbon trading activity, where on exchange or OTC, would automatically be regulated.

The FMC Act contains provisions requiring financial market participants to comply with fair dealing provisions, offer disclosure requirements, governance requirements, market dealing requirements, licensing requirements and financial reporting requirements. However, many of the requirements only apply in respect of the offer of financial products to retail investors eg disclosure rules and licensing of advisory firms.

It should be noted that the majority of the participants in the ETS are likely to be classified as wholesale investors under the FMC Act so reclassifying may not provide the full extent of the protections available.

Regulation of advice

This is the same as for option 6.

Fair dealing provisions under the FMC Act

These largely reflect the protections set out in the Fair Trading Act 1986 (FTA) and prevent "*misleading or deceptive conduct, false or misleading representations, unsubstantiated representations and offers of financial products in the course of unsolicited meetings.*"

Given they mirror existing protections available at law to ETS participants, they are not considered further in this report however we note that there is a Memorandum of Understanding[72] in place between the FMA and the Commerce Commission. It sets out the framework of how the regulators will work together in areas of overlapping responsibilities. In particular, it sets out the processes and principles applying to the granting of consent to the Commerce Commission to exercise its jurisdiction under the FTA in relation to financial products and services.

Licensing

As discussed under option 6, all advisory firms advising retail investors would need to be licensed by the FMA and meet the minimum standards it sets.[73] It is also possible that offerors of NZUs could be licensed too, but this would have to be explored further directly with the FMA.

Licensing is a costly and intensive process, especially for small advisory firms and will create a significant barrier to entry for new firms seeking to enter the market.

[72] https://fma.govt.nz/assets/MOU/130331-memorandum-of-understanding-fma-and-commerce-commission.pdf

[73] These cover fit & proper, capability, operational infrastructure, financial resources and governance. See https://fma.govt.nz/assets/Licensing-guides/141101-derivatives-issuers-how-do-i-apply-for-a-licence-part-b5.pdf as an example.

Financial reporting obligations

Part 7 of the FMC Act creates significant financial reporting obligations for FMC reporting entities which includes most licensed entities (although it is unclear what requirements will apply to licensed advisory firms at this stage) and issuers of financial products.

These would have a significant cost impact on ETS participants that would be impacted, although it is likely that exemptions would be granted to smaller participants. For example, there are financial reporting exemptions in place for licensed providers of Discretionary Investment Management Services (DIMS) that have retail funds of under $250 million.[74]

Market oversight and impact on Market Misconduct

The market could continue to operate as an OTC market under the FMC Act. If it did, this substantially reduces the market oversight available under the FMC Act as Part 5 of the FMC Act 'dealing in financial products on markets' largely would not apply. The FMC Act requirements around advice and disclosure would still have an impact, but much less, particularly as they are primarily aimed at protecting retail investors.

However, If the NZU became a financial product, an operator of an NZU exchange would have to seek a licence from the FMA to operate a financial product market. Only three market operators have been granted licences to date. The operation of a financial product market is highly prescribed under the FMC Act and is closely supervised by the FMA so this would be a rigorous solution.

One option to reduce the regulatory impact is for the carbon trading market to be designated a 'prescribed wholesale market' under the FMC Act, and no retail investors would be permitted to trade in the market (at least directly). The wholesale market is much less regulated: the AML/CFT regime still applies and there are general obligations for providers of financial services to act with care, diligence and skill and not mislead or deceive their clients. Providers of financial products to wholesale investors only can also 'opt in' to the FMA's licensing regime.

However, from our conversations with participants and their advisers, we found little appetite for a purely wholesale market. Advisers and intermediaries recognised that their client classification systems would have to be enhanced to classify clients correctly and there would be a risk that some clients were treated as wholesale who were retail. Many of the smaller participants would be likely to fall into the retail category anyway.

Another option is to provide a partial exemption from the FMC Act provisions as has been done with markets such as Unlisted.[75]

[74] See http://www.legislation.govt.nz/regulation/public/2015/0142/latest/DLM6496601.html?src=qs
[75] See http://www.legislation.govt.nz/regulation/public/2015/0253/latest/whole.html.

4.10.2 Analysis

Compliance costs

It is likely that cost of compliance would be high under Option 7, particularly for those who trade principal positions, who would be likely to become issuers of NZUs (if they sell to retail investors). By making regulated offers, they would be required to issue a product disclosure statement and abide by the other offer disclosure rules in Part 3 of the FMC Act. One of the banks we spoke to did not regard this as an issue. Another said this would be likely to result in them leaving the market.

In most other conversations we had, where cost of compliance was mentioned, it was in connection with AML/CFT regulation and licensing of advisers rather than disclosure.

Costs of compliance associated with the disclosures rules or financial reporting obligations could also be mitigated through the use of limited exemptions, eg for certain classes of transactions or individual issuers and/or FMC reporting entities. There are a number of class exemptions (eg small offers exemption)[76] that exempt smaller participants from full compliance when the cost of compliance outweighs the benefits of regulation. FMA also has wide-ranging exemption powers under the FMC Act to make individual exemptions as well.

Market transparency

Rather than an active market governance regime increasing participation and liquidity, it might have the opposite effect, at least whilst the ETS remains a domestic market. The risk of reduced participation needs to be weighed against the potential benefit of stronger regulation, given the relatively small size of the carbon market currently.

Encouraging participation

This option has the potential to discourage participation due to the high compliance costs and regulatory risk for intermediaries, issuers and other active participants. However, it may encourage participation by other participants, both large and small, due to the trust and confidence engendered by a fully regulated market.

Reduce market abuse

This option would have the greatest impact on reducing market abuse, particularly if a financial product market(s) were created by a licensed operator.

Encourage international linking

Once international linkages are reinstated, there is the risk that large international institutions would not participate in a relatively unregulated market. In the case of financial institutions, without a Financial Action Task Force (FATF)-compliant[77] AML/CFT regime applying, they may not be able to under their own internal policies or procedures.

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[76] See https://fma.govt.nz/compliance/offer-information/offers-under-the-fmc-act/schedule-1-offers/

[77] FATF is an inter-governmental body which sets standards and promotes effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system.

4.10.3 Recommendations

We do not recommend that Option 7 is adopted whilst the ETS is a domestic market only, given the real risk of reduced participation. However, this should be reviewed if liquidity increases substantially and when international linkages are established.

We recommend that, if Options 6 or 7 were to be considered, MPI and EPA engage with the FMA to seek their opinion on the efficacy of these options to prevent the potential harms identified concerning poor advice and market transparency and integrity.

We have found no evidence of current issues requiring significant regulation. However, as previously noted, the ETS is potentially vulnerable to market misconduct and criminal activity, especially securities fraud and money laundering. This could be recognised as an emerging risk, which is likely to increase with international linking.

Further analysis of the potential for the ETS to be vulnerable to market misconduct should be conducted prior to the re-establishment of international linkages. We suggest that MfE should work closely with the EPA, the FMA and MBIE to conduct this research. Further, given the links to money laundering and terrorist financing risks, we recommend that the FIU, Ministry of Justice (MoJ) and AML/CFT regulators are also approached to participate to ensure a co-ordinated 'All of Government' approach.

Similarly, a thematic review of trading data could be conducted either via the ETR (although we note the lack of price data) or by requiring intermediaries and the on-line platforms to supply trade information for analysis.

Finally, the Ministry should consider whether the EPA should require participants to provide pricing data when registering NZU ownership changes. The EPA should also consider making such pricing data publicly available (on an anonymous basis) to increase price transparency.

4.11 Conclusions and Recommendations

Based on this analysis of problems and solution options, we suggest the following:

1. The EPA and MPI should continue to develop information packs or other information products for market participants and advisers.

2. The Government should release all market-relevant information, including policy developments, volume data and price projections, in a consistent way that is easily discoverable. Ideally this would be via a single website.

3. Further investigation could be undertaken to assess whether there is a problem with advice provided to less sophisticated ETS participants. We did not find any firm evidence of this as part of our research, although it is hard to find in the absence of a regulator or dispute resolution mechanisms. We suggest that the MfE or EPA consider surveying participants to uncover any concerns about quality of advice or market misconduct.

4. Engagement with the FIU (and AML/CFT supervisors) to consider whether the abuse of carbon credits has developed further as a ML/TF typology and risk-rate the NZ carbon trading market.

5. If options 6 or 7 are progressed, further engagement should be held with other types of advisers that provide advice on the ETS and NZU trading to assess reaction and estimate impact.

6. The EPA and MfE engage with financial markets regulators to gain their perspective on the regulatory options and the methods they could use to improve, for example, the monitoring of ETS participants and surveillance of the ETS data.

7. Conducting a thematic review of trading data to analyse potential for either ML/TF or market misconduct.

Further analysis of the potential for the ETS to be vulnerable to market misconduct should be conducted prior to the re-establishment of international linkages. We suggest that MfE should work closely with the EPA, the FMA and MBIE to conduct this research. Further, given the links to money laundering and terrorist financing risks, we recommend that the FIU, Ministry of Justice (MoJ) and AML/CFT regulators are also approached to participate to ensure a co-ordinated 'All of Government' approach.

Glossary of financial terms

Term	Definition
Bid	An offer made by an investor or trader to buy a financial instrument or commodity.
Call (option)	A call is an option which gives the owner the right, but not the obligation, to buy a specified amount of an asset at a specified price within a specified time.
Commodity	A good that has been grown or extracted from their natural state, and brought up to a minimum standard to be commercially traded. This lack of differentiation means that commodities are interchangeable with other commodities of the same type. Examples include gold, iron, oil and salt.
Derivatives	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.
Financial advice product	Financial advice product means (a) a financial product (as defined in section 7); or (b) a Discretionary Investment Management Services (DIMS) facility; or (c) a contract of insurance; or (d) a consumer credit contract; or (e) any other product declared by the regulations to be a financial advice product; or (f) a renewal or variation of the terms or conditions of an existing financial advice product (see Financial Services Legislation Amendment Bill)
Financial instrument	A contract that gives rise to both a financial asset to one entity and a financial liability to another. For example, financial instruments can be evidence of ownership in a business (stock) or entitlement to interest payments (bonds), or a contractual right to deliver or receive cash (derivative). Financial instruments enable an efficient transfer of capital between investors.
Financial Product	An equity security, debt security, managed investment product or derivative or any investment designated as a financial product (see Section 7 of the FMC Act)
Forwards	A private contract whereby a buyer/seller agree to purchase/sell an asset at a predetermined future date and price. The customised nature of forward contracts means they are not traded on a centralised exchange, and generally used to hedge against price volatility, eg in commodity and foreign exchange markets.
Futures	A type of forward that has been standardised so that it can be traded on a centralised exchange platform. Unlike forwards, futures are valued each day until the contract ends, and can be settled over a range of dates. The non-private, standardised nature of futures makes them particularly attractive to speculators.
Hedge	An investment that reduces one's risk to adverse price movements in an asset. It can be likened to paying for an insurance policy to avoid the costs price volatility. Purchasing a derivative (eg forward, future, option etc) and diversifying an investment portfolio to offset potential (undesirable) price movements are common forms of hedging.
Offer	The highest price a buyer will pay to purchase an asset, and the lowest that the seller will accept.
Option	A contract that offers buyers the right, but not the obligation, to buy (call) or sell (put) an asset at a predetermined price during a certain period of time or on a specific date.
Over-the-counter (OTC)	Transactions that are privately negotiated between two parties rather than through a market exchange. For example, one of the differences between a forward and a

	future is that the former is transacted OTC while the latter traded publicly via centralised exchange.
Security	Security means: (a) an arrangement or a facility that has, or is intended to have, the effect of a person making an investment or managing a financial risk; and (b) includes (i) a financial product; and (ii) any interest or right to participate in any capital, assets, earnings, royalties, or other property of any person; and (iii) any interest in, or right to be paid, money that is, or is to be, deposited with, lent to, or otherwise owing by, any person (whether or not the interest or right is secured by a charge over any property); and (iv) any renewal or variation of the terms or conditions of any existing security; but (c) does not include any interest or right that is declared by regulations not to be a security for the purposes of the FMC Act. (see section 6 of the FMC Act)
Put (option)	A put is an option giving the owner the right, but not the obligation, to sell a specified amount of an underlying security at a specified price within a specified time.
Retail investor	An investor not defined as a wholesale investor
Speculation	Financial transactions that expose investors to substantial risk in hope of potential monetary gain. Although it can be difficult to distinguish between speculation and investment, assets subject to speculation are often relatively higher in risk, shorter in term, and highly leveraged.
Swaps	A contract through which two parties exchange cash flows. Swaps typically require companies to exchange their fixed and variable interest rate obligations, ie an interest rate swap, to appeal to their different outlook or preferences on interest rates and/or cash flow requirements.
Wholesale investor	Defined in the FMC Act on the basis of activity (eg they are an investment business), the size of investments (over $750,000), their income and/or net assets (over $5 million) or if they are a government agency. (see section 6 of the FMC Act)

Annex: The NZ Financial Regulatory System

The regulation and supervision regime for the New Zealand financial system has been put in place to enhance its ability to absorb shocks and maintain financial stability.[78] The main players are shown in Figure 5 and their roles are explained in more detail in Table 7 and below.

Figure 5 Twin peaks financial regulation

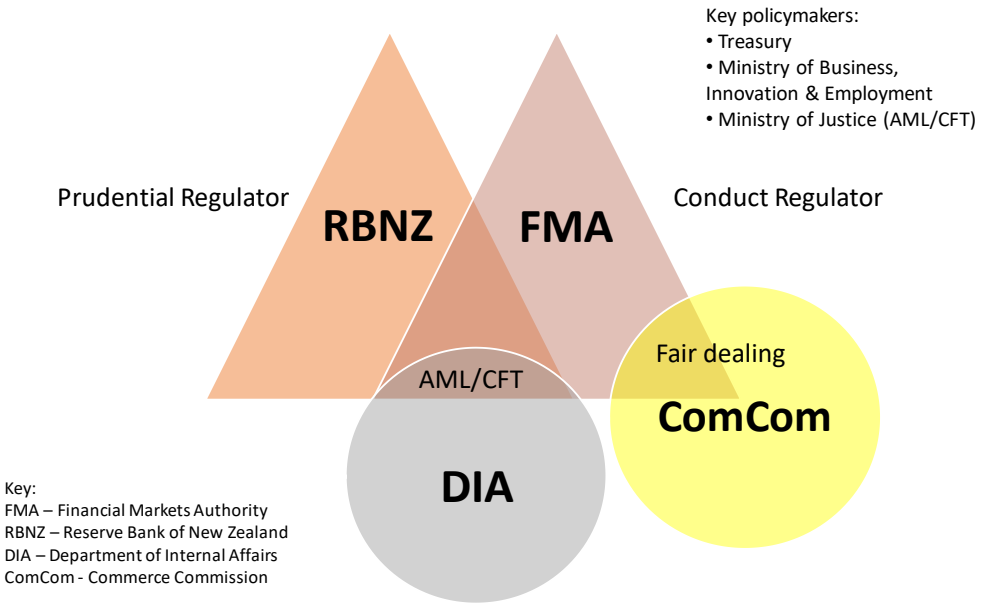

Table 7 Roles of the individual regulators

Regulator	Relevant responsibilities
RBNZ	• Licensing of banks, insurers and non-bank deposit takers. • Prudential supervision of licensees. • AML/CFT supervision of licensees.
FMA	• Licensing of the following financial service providers: Financial Product Market Operators, Equity Crowdfunders, P2P Lenders, MIS Managers, DIMS Providers, Supervisors, Financial Advice Providers* and Independent Trustees of Restricted Schemes. • Conduct supervision of licensees and other financial service providers, including fair dealing. • AML/CFT supervision of licensees and other financial service providers.
DIA	• AML/CFT supervision of AML/CFT reporting entities not otherwise supervised by RBNZ or FMA.
ComCom	• Competition • Consumer protection and fair trading, including fair dealing under the Fair Trading Act. In terms of the MoU, ComCom can enforce breaches with respect to financial products and services with FMA consent.

*under proposed reform of Financial Advisers Act

[78] Claus I, Jacobsen V and Jera B (2004) Financial systems and economic growth: An evaluation framework for policy. New Zealand Treasury Working Paper 04/17

Policy with respect to financial regulation is developed under advice from the Treasury and the Ministry of Business, Innovation and Employment (MBIE). The Ministry of Justice (MoJ) leads the development of NZ's anti-money laundering and countering the financing of terrorism (AML/CFT) frameworks. The Reserve Bank of New Zealand (RBNZ) and the Financial Markets Authority (FMA) are jointly responsible for the regulation of the financial system – the 'twin peaks' system of financial regulation.

RBNZ is NZ's prudential regulator, ie it requires banks and other key financial institutions to control risks and hold adequate capital to protect customers and maintain a sound and efficient financial system. It supervises banks, insurers and non-bank deposit takers, setting standards for those entities and requiring them to control risks and hold adequate capital as defined by capital requirements. It is also the AML/CFT supervisor (regulator) with respect to banks, insurers and non-bank deposit takers.

The **FMA** is NZ's financial markets conduct regulator. It regulates financial service providers, including financial advisers, fund managers, banks and insurers (in respect of areas not regulated by the RBNZ). As a conduct regulator, the FMA focuses on investor protection, market conduct rules and ethical codes of conduct for the individuals and entities it regulates. In particular, it is responsible for regulating financial advice, financial market integrity and fair dealing (prevention of misleading and deceptive conduct).

The FMA is also the AML/CFT supervisor with respect to the financial service providers that it licenses and supervises, with the exception of banks, insurers and non-bank deposit-takers.

The **Department of Internal Affairs (DIA)** has a limited role in relation to NZ's financial regulation system. It is the AML/CFT supervisor with respect to reporting entities which are not regulated by the RBNZ or the FMA, many of which are in the financial sector. These include casinos, non-deposit taking lenders, money changers, money remitters, payroll remitters, debt collectors, factors, financial lessors, safe deposit box vaults, non-bank credit card providers and stored value card providers.

The **Commerce Commission (ComCom)** is NZ's competition regulator. It enforces legislation that promotes competition in NZ markets and prohibits misleading and deceptive conduct by traders. It shares responsibility with the FMA for regulating fair dealing, ie the prevention of misleading and deceptive conduct by financial service providers.

Under a Memorandum of Understanding (MoU) between ComCom and FMA, FMA is the primary regulator of misleading and deceptive conduct in relation to financial products and services. These include products and services such as term deposits, shares, and derivatives. Responsibility for matters relating to consumer credit remains with ComCom. This includes financial products and services such as personal credit cards, loans, and mortgages.