

# Designing a governance framework for the New Zealand Emissions Trading Scheme

Consultation document



Ministry for the  
**Environment**  
Manatū Mō Te Taiao

New Zealand Government

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# Message from the Minister

Over the past four years, New Zealand has made progress towards the institutional and governance framework we need to reduce greenhouse gas emissions and adapt to the impacts of climate change.

The New Zealand Emissions Trading Scheme (referred to as the NZ ETS, the ETS, or the scheme) is an important part of this framework. The recent legislative reforms will support reductions in emissions and the transition to a low-emissions economy. The next step in these reforms is to improve how we govern the ETS market.



Good governance will help ensure the integrity and efficiency of the scheme, promote confidence in market trading, and reduce the risk of misconduct distorting the price of New Zealand Units. Creating a solid framework to govern the market will strengthen the scheme, in line with international best practice.

This consultation is an opportunity for the Government, industry and the public to consider how best to address risks to the ETS market. The Government has previously identified these risks during the reform process.

The scheme has worked successfully for the past 10 years, with little evidence of these risks in practice. However, now is the time to put the right framework in place, so the scheme stays robust and effective well into the future.

The Government has a range of regulatory and non-regulatory tools, and the final framework is likely to be a combination of the options presented here. We need a balance, so that we regulate the market efficiently and appropriately, to address the level of risk. A key factor will be to appoint a market regulator with a clearly defined role.

Your feedback on the options in this document will shape the legislative changes for a better framework for market governance in the NZ ETS.

A handwritten signature in black ink that reads "James Shaw". The signature is fluid and cursive, with a large loop at the end of the last name.

Hon James Shaw  
Minister of Climate Change

# About this consultation document

## We are seeking your feedback on options to improve governance of the New Zealand Emissions Trading Scheme

The Government is considering changes to the market governance framework for the New Zealand Emissions Trading Scheme (referred to as the NZ ETS, the ETS, or the scheme). Your feedback is a key part of improving the framework. We are keen to hear your views on how these options may affect you and the market.

### What this document covers

- **Section 1:** Background information on the ETS as a tool to respond to climate change, and an overview of trading in the scheme.
- **Section 2:** An overview of governance in the ETS, the problem definition, and how international schemes address governance risks.
- **Section 3:** Governance of advice – risks and options. Risks include poor advice and conflicts of interest when advising.
- **Section 4:** Governance of trading – risks and options. Risks include poor market transparency, oversight and monitoring trades; credit and counter-party risks.
- **Section 5:** Governance of market conduct – risks and options. Risks include price manipulation, insider trading, money laundering, and financing terrorism.
- **Section 6:** Options to appoint a market regulator to oversee the NZ ETS.
- **Section 7:** An analysis of how well each option addresses the seven market governance risks, and meets our five operating criteria.
- **Section 8:** Possible governance scenarios, if one or more of the options are progressed.
- **Section 9:** Consultation process: how to have your say.
- **Section 10:** The full list of questions in this document.
- **Appendices:** Case studies; detailed analyses of risk coverage, impact and governance scenarios.

### Next steps

This consultation will run from **Thursday 8 July 2021** until **Friday 17 September 2021**. To find out how to participate and make a submission, see [section 9](#).

We will include your feedback in a summary of submissions that will be published in late 2021. The results from this consultation, alongside further policy analysis, will inform advice to Ministers on designing a governance framework for the ETS.

## More information

- Visit the website at <https://consult.environment.govt.nz/climate/designing-a-governance-framework-for-the-nz-ets>
- Contact the ETS team: [etsconsultation@mfe.govt.nz](mailto:etsconsultation@mfe.govt.nz)
- Attend one of the online events and hui. Details will be added to website linked above.

# Glossary

Term	Meaning
Climate Change Response Act 2002 (CCRA)	This Act puts in place a legal framework for New Zealand to meet its international obligations under the UN Framework Convention on Climate Change, the Kyoto Protocol, and the Paris Agreement.
Derivative	A type of contract that derives its value from the performance of underlying assets.
Insider trading	The practice of buying or selling financial products while in possession of material information that is not generally available to the market; passing on and sharing material information that is not generally available to the market.
Market governance	The processes, policies and rules for managing risks of misconduct in the NZ ETS and protecting users from financial harm.
Market manipulation	Includes spreading false market information; cornering or squeezing the market; giving false impressions of market conditions – typically with the aim of influencing the market price for profit.
Nationally determined contribution (NDC)	NDCs represent efforts by each country to reduce national emissions and adapt to the impacts of climate change, as part of their obligations under the Paris Agreement.
New Zealand Emissions Trading Register (the Register, NZ ETR)	New Zealand’s national registry for emission units, including those owned by the Crown. Anyone wanting to own or trade NZUs in New Zealand must have an account in the Register.
New Zealand Emissions Trading Scheme (NZ ETS)	A market-based approach to reducing emissions of greenhouse gases. The NZ ETS puts a price on emissions, charging certain sectors of the economy for the greenhouse gases they emit.
New Zealand Units (NZUs)	One ‘emissions unit’ is equal to one tonne of carbon dioxide equivalent. NZUs can be traded among people and businesses participating in the NZ ETS.
NZ ETS participant	A registered person or entity that carries out an activity listed in the CCRA.
NZ ETS user	Any registered person or entity in the NZ ETS.
NZU adviser	A person or entity that gives financial advice or guidance on NZUs in their ordinary course of business.
NZU trader	A registered person or entity that buys and sells NZUs in the NZ ETS.
Over the counter (OTC)	Direct, bilateral trades between two NZ ETS users, without supervision or using an exchange.
Paris Agreement	The Paris Agreement is a legally binding international treaty on climate change, to which New Zealand is a party. It came into force on 4 November 2016. Its goal is to limit global warming to well below 2, preferably to 1.5 degrees Celsius, compared to pre-industrial levels.
Primary market	Includes the distribution of NZUs from the Government to NZ ETS users, through auctions and industrial allocation.
Secondary market	The market in which previously issued NZUs are bought and sold.
Western Climate Initiative (WCI)	An initiative of US states and Canadian provinces to jointly develop climate change policies.

# Executive summary

This Government is committed to cutting New Zealand's emissions and responding to climate change, by moving to a low-emissions, climate-resilient economy in a manner that is fair for all New Zealanders.

The NZ ETS is an important tool in this shift, alongside other policies, to help us meet our domestic and international climate change targets. The proposals here aim to improve the governance framework for the scheme, so it effectively supports the transition.

## New Zealand lacks a robust ETS governance framework

We need to improve the current framework for the ETS. It is patchy and there is no regulator overseeing the market.

Setting up a comprehensive framework and appointing a regulator is important for:

- the integrity and efficiency of the scheme
- promoting confidence in market trading
- reducing risks of misconduct that distorts the price of New Zealand units (NZUs).

A sound framework will also keep the market working as intended, and put in place enough rules and regulations to protect NZ ETS users.

## Key risks and themes

### Risks

The Government has identified seven risks for market governance, set out in [table 2](#).

### Themes

We have combined the seven risks into three themes for discussion:

1. **Governance of advice** addresses:
  - poor, false or misleading advice
  - conflicts of interest when trading NZUs.

These can lead to financial harm for NZ ETS users who trade based on poor advice, lowering confidence in the NZ ETS.

2. **Governance of trading** addresses:
  - poor transparency of market information
  - counter-party risk when trading.

These lead to inefficient price discovery in the NZ ETS and present undue risks to trading NZUs.

3. **Governance of market** conduct addresses:
- insider trading
  - manipulation of the NZU price
  - money laundering / financing of terrorism in the ETS.
- Market misconduct reduces confidence and integrity of the ETS.

## Your views

We are interested in your input on two issues:

1. The Government is consulting on a range of **low-regulatory and regulatory options** (Table 1). These are not mutually exclusive and include a range of scenarios. We are seeking feedback on the impact of these options.
2. Setting rules and regulations for conduct in the ETS market also requires the Government to consider who oversees and enforces those rules and regulations. We are seeking feedback on **the role and functions of a market regulator**. Proposals to define these may have a significant impact on existing market operators and participants.

## Market governance options

Table 1: Market governance options

Governance of advice
<ul style="list-style-type: none"> <li>• <b>Education campaign and information pack.</b> Develop an education campaign and information pack to improve knowledge and understanding of the ETS. For foresters and landowners there will be a section on forestry.</li> <li>• <b>Sector guidelines for NZU advisers.</b> Set guidelines to benchmark the expected level of service from advisers, and to promote quality advice.</li> <li>• <b>Code of conduct, licensing and registration of advisers.</b> Introduce a package for mandatory licensing, public registration and code of conduct, to raise the standards of advice, and better protect users.</li> </ul>
Governance of trading
<ul style="list-style-type: none"> <li>• <b>Voluntary reporting of trades.</b> Introduce a mechanism for users to voluntarily report market transactions, for greater post-trade transparency. A regulator would monitor market developments and investigate suspected market abuse.</li> <li>• <b>Participant position reporting.</b> Require users to disclose the number of NZUs they are holding or borrowing. This increases transparency of the distribution of market power, counter-party risk, and market conditions.</li> <li>• <b>Exchange-based trading.</b> A regulated and licensed exchange, requiring users to register and meet conduct obligations. This would increase oversight of trades, reduce counter-party risk, and help detect market misconduct.</li> </ul>
Governance of market conduct
<ul style="list-style-type: none"> <li>• <b>Position and purchase limits.</b> Position limits restrict the number of NZUs a user can hold at any one time, limiting their ability to exercise market power. Purchase limits restrict the maximum number of NZUs a user can buy at primary NZU auctions. Typically, ETS participants with surrender obligations can buy more units than speculative traders.</li> </ul>

- **Price reporting.** Require all NZU trades to disclose prices to the regulator, to increase transparency and protect against fraudulent activity and price manipulation.
- **Full transaction detail reporting.** Require full transaction disclosure and reporting to the regulator. This would increase transparency, and protect against fraudulent activity, price manipulation, money laundering and financing of terrorism.

### Appointing a regulator

- **Self-regulating body.** Set up a voluntary framework led by a self-regulating body to oversee market governance.
- **Advisory regulator.** Establish an advisory regulator to give independent advice to the Government, without investigative or enforcement powers.
- **Market monitoring regulator.** Establish a market monitoring regulator with investigatory powers to collect information from users and monitor compliance with existing Acts and regulations. The regulator would not have enforcement powers and would report its findings to the Government.
- **Market compliance regulator.** Establish a market compliance regulator with investigatory powers to collect information from users, monitor compliance with existing Acts and regulations, and enforce compliance.
- **Market design regulator.** Establish a market design regulator with the power to design and administer an industry participation code that defines the obligations of industry participants. The regulator could also amend and update the code to ensure the framework stays fit for purpose.

# Section 1: Context

## NZ ETS: a key tool for addressing climate change

The Government is committed to cutting New Zealand's emissions and responding to climate change by transitioning to a low-emissions, climate-resilient economy in a manner that is fair for all New Zealanders.

The ETS, alongside other climate change policies, is an important tool in this transition

### How the scheme works

The Climate Change Response Act 2002 (CCRA) established the NZ ETS in 2008 as an important tool for meeting our international and domestic emissions targets. The ETS puts a price on greenhouse gas emissions by requiring people and businesses covered by the scheme to purchase and surrender units to the Government for their emissions.

### Why change the ETS governance framework?

A review of the ETS in 2015/16 found that the framework is incomplete and could be improved. The proposals set out here aim to improve the framework so it effectively supports the transition.

### Options to address market governance risks

Market governance refers to the rules and oversight of different types of conduct in the ETS market (including the primary, secondary and derivatives markets). The Ministry for the Environment,<sup>1</sup> Climate Change Commission,<sup>2</sup> Productivity Commission<sup>3</sup> and the Government's response<sup>4</sup> note that there are risks in the scheme due to a lack of governance.

A comprehensive framework facilitates a well-functioning market and protects the integrity of the scheme. At present, there is no complete framework, but some misconduct could be covered under existing legislation.

A robust framework could also facilitate links with international emissions trading schemes. Improving the NZ ETS can help New Zealand reach its international and domestic emissions targets, and make a just and inclusive transition to a low-emission economy.

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<sup>1</sup> Ministry for the Environment. 2018. *Improvements to the New Zealand Emissions Trading Scheme*.

<sup>2</sup> Climate Change Commission. 2021. *2021 Draft advice for consultation*.

<sup>3</sup> Productivity Commission. 2018. *Low-emissions economy*.

<sup>4</sup> Ministry for the Environment. 2019. *Transitioning to a low-emissions future – the Government response to the Productivity Commission's Low Emissions Economy report*.

## Your views

We invite feedback from NZ ETS users on the issues set out in this document:

- the seven potential market risks in the scheme (table 2).
- regulatory and non-regulatory options to address these risks (table 1 and sections 3–5)
- options for appointing a market regulator to oversee the NZ ETS (section 6).

The options are not mutually exclusive and could be applied in various combinations.

## Overview of trading in the NZ ETS

### A trading market for NZUs

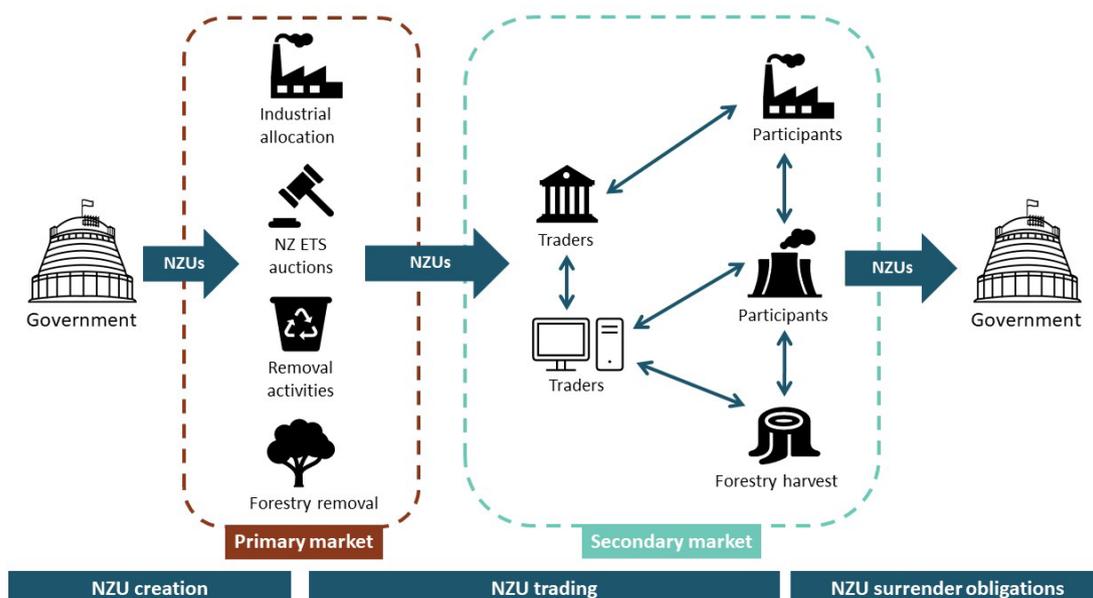
The ETS helps reduce emissions by:

- requiring people and businesses to measure and report on their greenhouse gas emissions
- requiring people and businesses to surrender one ‘emissions unit’ (known as an NZU) to the Government for each tonne of CO<sub>2</sub> equivalent emitted
- limiting the number of NZUs available to emitters (ie, supplied into the scheme).

NZUs can be traded among people and businesses participating in the scheme (figure 1). The price of NZUs reflects supply and demand in the scheme.

The Government sets the number of units supplied into the scheme. This number reduces over time, limiting the total amount that people and businesses can emit, in line with New Zealand’s targets.

Figure 1: The primary and secondary markets in the ETS



## NZUs are created in the primary market

In the NZ ETS, the primary market includes the supply of NZUs from the Government to users in the scheme. The Government does this in various ways:

- **Industrial allocations.** The Government allocates NZUs to industries that are emissions-intensive and trade-exposed (EITE)<sup>5</sup> to prevent emissions leakage.
- **Auctioning.** The Government auctions NZUs directly into the market. The volume of units auctioned is capped annually to align with emissions targets.
- **Removal activities.** The Government may reward some participants for activities that reduce global warming gases in the atmosphere.
- **Forestry.** Forestry is a type of removal because forests sequester (capture) carbon. Foresters in the scheme receive NZUs from the Government for this.

## NZUs are traded in the secondary market

The secondary market is the platform where previously issued NZUs are bought and sold. It includes users from various sectors that trade NZUs in several different ways. NZUs can be traded through direct bilateral agreements with other users directly, through a broker or through a trading platform.

The Government is not responsible for trades on the secondary market, and secondary market trading platforms are run independently.

Trading on the secondary market can only occur between users with accounts in the New Zealand Emissions Trading Register (the Register), operated by the Environmental Protection Authority. The Register records the total volume of units exchanged between users.

## NZ ETS users

There are many different types of people and businesses in the ETS. Anyone that buys or sells NZUs is required to have an account in the NZ ETR. There are 8343 account holders, which we collectively refer to here as 'NZ ETS users', or 'users'.

Examples of these users include:

- **NZ ETS participant** – A registered person or entity that carries out an activity listed in the CCRA. They report on emissions (or on carbon captured). They may need to surrender units to cover their emissions, or they may receive an entitlement of units for carbon capture. There are 2470 participants registered in the NZ ETR, of which 2204 are forestry participants and 266 are non-forestry.
- **NZU trader** – A registered person or entity that buys and sells NZUs in the scheme. A trader may buy units for themselves, another person or an institution. Traders tend to hold NZUs to capitalise on price trends.

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<sup>5</sup> Industrial allocation assists EITE industries with their surrender obligations, to avoid emissions leakage. Leakage can occur when industries relocate to a country with less regulation on greenhouse gas emissions, resulting in an increase in global emissions.

- Those undertaking **forestry removal**<sup>6</sup> (foresters) – A person who owns or has a registered lease or right (relating to carbon) over post-1989 forest land, and is the participant for that land. Foresters are participants whose actions can result in both unit entitlements and surrender obligations. These can arise several years (or decades) after the action, and may be uncertain as it depends on the performance of biological systems. Foresters will require specific consideration due to these, and other factors.
- **NZU adviser** (not currently defined in legislation) – A person or entity that gives NZU financial advice services or guidance in their ordinary course of business. Services may include:
  - NZU financial advice
  - investment planning relating to NZUs
  - discretionary investment management of NZUs, including buying and selling on behalf of a client, or managing some or all of a client’s NZUs.

To clarify these terms:

- An adviser gives technical and financial advice on NZUs. This applies to those whose business is to advise on technical forestry regarding plant species, type of forests and logging,<sup>7</sup> but who may also advise on carbon value, options and obligations in the ETS.
- A person or entity may be covered by multiple definitions, depending on their activities. For example, a forester who generates units, buys and sells units for profit, and then has surrender obligations at harvest, would be covered by three definitions: forestry removal, trader, and participant, respectively.

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<sup>6</sup> There are ‘other removal activities’ in the ETS that permanently or temporarily embed a substance in a product, store CO<sub>2</sub> after capture, or export or destroy hydrofluorocarbons or perfluorocarbons.

<sup>7</sup> Which may be addressed under the forestry advisers provisions of the Forests (Regulation of Log Traders and Forestry Advisers) Amendment Act 2020.

# Section 2: Market governance framework

## Objective

Market governance relates to the processes, policies and rules for:

- managing risks of misconduct in the NZ ETS
- protecting users from financial harm.

The Government's objective is to create a sound framework, so that:

- the ETS market functions well and continues to be an effective tool to respond to climate change
- there are enough rules and regulations to protect users.

## Defining the problem

The ETS is maturing, and the risk of misconduct is likely to increase due to rising NZU prices, NZU auctioning, the possible inclusion of additional users, and potentially reopening the scheme to international units.

These factors could increase the incentives for misconduct, and the range of actors who might be able to benefit from this.

## No unified framework or regulator

Currently, there is no integrated legislative framework for market governance in the NZ ETS, creating risks to market function, integrity and confidence.

The Climate Change Response Act (CCRA) is the primary legislation that established the ETS and the legal framework for its implementation, operation and administration. The CCRA does not have any market governance provisions for the scheme.

Many different legislations and regulatory systems cover a small aspect of ETS market governance, but none provide full coverage of the risks. Examples of legislation include:

- **Financial Markets Conduct Act 2013** – Generally regulates listed market derivatives. Prohibitions only cover quoted derivatives, and currently no NZU derivatives are listed on a licensed market.
- **Anti-Money Laundering and Countering Financing of Terrorism Act 2009** – Generally prohibits various types of fraudulent conduct.
- **Forests (Regulation of Log Traders and Forestry Advisers) Amendment Act 2020** – Establishes a registration system for log traders and forestry advisers.
- **Fair Trading Act 1986** – Generally prohibits false and misleading conduct by those in trade.
- **Commerce Act 1986** – Generally prohibits anti-competitive conduct.
- **Climate Change (Auctions, Limits, and Price Controls for Units) Regulations 2020** – Provides some regulation for primary markets, for example auctioning regulations.

This patchwork of regulation means there is no single regulation or regulator for the NZ ETS to:

- oversee the quality of advice for users
- increase transparency of market trading information
- monitor misconduct.

As a result, some forms of misconduct, which are regulated in New Zealand's financial markets and in international ETSs, are not regulated in the NZ ETS.

## Seven market risks

In 2018, the Government consulted on improving the NZ ETS<sup>8</sup> and identified seven risks for market governance. We have combined these into three risk themes (table 2).

**Table 2: Market governance risks and themes**

THEME	RISK
<b>Theme A</b> Governance of advice	<b>Risk 1:</b> Inadequate, false or misleading advice to NZ ETS users
	<b>Risk 2:</b> Conflicts of interest involving the New Zealand Emissions Trading Register
<b>Theme B</b> Governance of trading	<b>Risk 3:</b> Potential lack of transparency, oversight and monitoring of trades in the secondary market
	<b>Risk 4:</b> Credit and counter-party risks
<b>Theme C</b> Governance of market conduct	<b>Risk 5:</b> Insider trading and information asymmetry
	<b>Risk 6:</b> Manipulation of NZU prices
	<b>Risk 7:</b> Money laundering and financing of terrorism

These risks are complex and intertwined. To address them together requires a more comprehensive governance framework.

At present, there is limited evidence of some of these risks becoming a reality, because there is no regulator overseeing all aspects of the ETS. By their nature, many of these forms of misconduct are designed to remain undetected. However, we have seen some of this behaviour in international ETSs ([appendix A](#)).

## Market regulator

The Government is also considering appointing a market regulator to oversee the operation of the NZ ETS and its users. A key aspect of the discussion is determining the appropriate type of regulator, and setting out their role and functions.

## Your views

The Government is seeking feedback on:

- the extent to which these risks have materialised
- options to address these risks
- appointing a regulator to oversee the market.

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<sup>8</sup> Ministry for the Environment. 2018. *Improvements to the New Zealand Emissions Trading Scheme*.

## How international ETSs address governance risks

Many of these risks have materialised in international ETSs, and as a result, most schemes are more strongly regulated than the NZ ETS. This section outlines some of the similarities and differences of the more prominent international ETSs (table 3).

**Table 3: Examples of international emissions trading schemes**

Name	Country/region	Notes
European Union Emissions Trading System (EU ETS)	European Union	This multinational scheme was established in 2005 and operates in 31 countries: all 28 EU Member States and Iceland, Liechtenstein and Norway. It is the EU's central policy instrument to meet their cap set in the Kyoto Protocol, and is the largest ETS in the world.
California and Québec cap-and-trade systems	North America	Québec links its scheme with California through the Western Climate Initiative (WCI). Both systems are cap-and-trade ETSs.
South Korea national emissions trading scheme (K-ETS)	South Korea	South Korea's scheme is part of its efforts to reduce greenhouse gas emissions.

### EU Emissions Trading System

To foster confidence and maintain a safe and efficient trading environment, EU allowances (EUA) are regulated as financial instruments. They are subject to the Directive on Markets in Financial Instruments and Market Abuse Regulation.

Stringent standards apply to all market participants. Businesses are subject to strict insider information rules, to prevent unfair advantages in the market. Volume and price trading information is reported regularly for market transparency. Anti-money laundering safeguards are in place across all segments of the market. The EU ETS is governed by the European Securities Markets Authority (ESMA).

### California and Québec cap-and-trade systems

California and Québec have set up separate ETSs that are linked under the Western Climate Initiative (WCI).

The WCI has an auction and reserve system that allows qualified bidders to participate in auctions. After the auction, the platform generates reports and informs participants about the results, creating transparency of trades in the primary market.

An independent regulator – The California Air Resources Board (CARB) – oversees the market. CARB reviews and evaluates trades at auctions and monitors secondary and derivative markets to identify any inappropriate activity. It also requires participants to obtain authorisation to participate in the market, imposes transaction reporting requirements and sets position limits.

### South Korean ETS

Trading in the South Korean ETS is solely through the Korean Exchange (KRX). The Government applies market stabilisation measures and restrictions on market participation if required.

## Comparing the NZ ETS with international schemes

International ETSs use a range of approaches and tools to regulate and monitor their schemes. This can provide important lessons for market governance in the NZ ETS.

Many ETSs include emissions allowances as a financial instrument under their own definitions, and therefore they are regulated as a financial product. California and Québec take a different approach and regulate emissions allowances as commodities.

The main tools for market oversight are transaction monitoring, position monitoring, position limits and participation restrictions. Table 4 compares the international and New Zealand approaches.

**Table 4: Comparison of international and New Zealand market oversight**

	EU	California and Québec	South Korea	New Zealand
Primary and secondary markets	Financial instrument	Commodity	Financial instrument	Commodity
Derivative markets	Financial instrument	Financial instrument	Not allowed	Financial instrument
Transaction monitoring	✓	✓	✓	X
Position reporting	✓	✓	?	X
Position limits	X	✓	?	X
Participation restrictions	✓	✓	No commercial traders	X

## Section 3: Governance of advice

This theme addresses two risks, set out below.

### Risk 1: Inadequate, false or misleading advice to users

Inadequate, false or misleading advice includes:

- poor advice to a user on meeting their obligations (technical ETS advice)
- poor advice to a user on trading in the NZ ETS market (NZU financial advice).

The Government has received complaints from users<sup>9</sup> about poor advice. Examples include:

- **Advice that does not reflect forestry accounting and liabilities:**
  - NZ ETS foresters being advised to sell the units they will need to surrender when they harvest the forest. The result is either buying units later at a higher price or not harvesting. Financial implications could be significant.
  - Land buyers being unaware they are buying NZ ETS registered land with reporting, compliance and NZU surrender obligations with financial implications.
- **Forward sale contracts:** A forest owner, on the advice of a consultant, entered into a multi-year contract to sell NZUs for a fixed price that did not accurately take into account forward-looking NZU price modelling.
- **Fewer units earned than participants were advised they would receive:** Based on a forestry consultant's inaccurate modelling of land eligibility.

The risk of poor advice will grow as more foresters enter the scheme, and as the management of entitlements and obligations change over time. As with financial markets, the likelihood of receiving and acting on poor advice is higher for smaller landowners, including iwi/Māori. Some Māori land, under Te Ture Whenua Māori Act 1993, represents small areas with complex management. For these groups, the financial impacts may be complex.

### Risk 2: Conflicts of interest

A conflict of interest can arise when an NZU adviser has several interests, financial or otherwise, and serving one could involve working against another. Examples include advisers:

- putting their own interests ahead of their clients'
- not disclosing emission units holdings
- receiving undisclosed commissions for referrals.

Users may be unaware of an adviser's conflicts of interest. A perceived conflict can be as harmful as a real conflict in terms of consumer confidence.

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<sup>9</sup> To maintain confidentiality, participants and advice providers cannot be named.

## Options

### A1. Maintain the status quo

Under this option, there are no checks to ensure advisers are experienced. There is poor transparency and no minimum assurance standards.

#### Benefits

- No additional administrative cost to the Government, users or advisers.

#### Disadvantages

- Small landowners, including iwi and Māori, and new entrants to the scheme are at a disadvantage when it comes to understanding, entering and negotiating NZU trades for fulfilling emissions obligations.
- Smaller users may continue to face financial loss because of poor advice.

### A2. Consumer education campaign and information pack

This option affects participants, NZU traders, and foresters seeking NZU advice.

Users need to know where to seek professional advice, the state of the NZ ETS market, the trading options available, and redress if they receive poor advice.

The Government could consider a cross-agency education campaign and information, addressing issues such as legal requirements and financial knowledge specific to the NZ ETS.

The information pack could also guide users on choosing an adviser, by listing questions about advisers' experience and qualifications, how they are paid, and the costs and liabilities of joining the scheme.

#### Benefits

- Helps users make better choices about engaging with the NZ ETS.
- Helps users understand whether they have received poor advice.
- Enhances transparency and clarity in the ETS.
- A low-cost option for users and advisers. The Government will bear the cost to design and implement, but it will likely be low.

#### Disadvantages

- Does not entirely address the risk of poor advice. Users are still at risk of financial loss.
- Does not prevent an adviser giving misleading or poor advice.

### A3. Sector guidelines for NZU advisers

This option affects NZU advisers.

The Government could consider introducing guidelines to benchmark the expected level of service from advisers. These could be developed by industry, by the Government, or by both in consultation.

The guidelines could be voluntary – advisers would be recommended to use them when on the NZ ETS or trading NZUs. Or the Government could strengthen the guidelines by putting them into legislation.

### Benefits

- Clearly sets out the expectation for advisers and their level of service.
- Relatively low-cost option for users. The cost would likely be borne by the body that develops the guidelines: either industry, the Government or both.

### Disadvantages

- Does not enforce the expected service levels or regulate advisers, allowing poor advice to persist.
- Does not necessarily inform users on their rights, if they receive bad advice.

### Examples of industry guidelines and toolkits

Guidelines are a common feature of complex or large sectors. Examples of public guidelines include:

- **Financial Markets Authority** – *Guidance library*.
- **WorkSafe** – *Industry guidance for working with hazardous substances* and *Working safely with hazardous substances*.
- **New Zealand Construction Industry Council** – *Design guidelines*.

## A4. Code of conduct, licensing and registration of NZU advisers

This option affects advisers directly. It would also require the Government to appoint a regulator to enforce and monitor compliance.

This option would amend primary legislation to introduce:

- a code of conduct that sets expectations for advisers
- compulsory licensing to provide the regulated services on a commercial basis
- compulsory registration of advisers on a public, searchable registry.

The purpose of registering and licensing advisers would be to:

- raise the professional standards of advice on the ETS
- address concerns that there are no industry safeguards on the quality of advice for users
- increase confidence in the ETS.

### Code of conduct – setting the standards

A code could set out the standards of professional conduct expected of advisers. Advisers would be obliged to always comply with the code when giving advice.

The content of the code could be based on principles, describing the values and behaviour an adviser is expected to uphold. Given the similarities between the financial and carbon markets, some of the principles could be similar to those in the *Code of Professional Conduct for Financial Advice Services*.

Introducing the code would serve several purposes:

- inform users what they can expect from an adviser
- set a benchmark for advisers' conduct and behaviour
- set the standards of competency and ethical conduct for advisers.

### Registration and licensing of NZU advisers

Advisers would be required to hold a licence to be eligible to give advice on a commercial basis. They could be required to undergo a comprehensive competency, capability and integrity background check, including a police or financial check, to ensure they are suitable candidates. This check should not be any more burdensome than those for financial advisers.

There could be ongoing requirements to ensure the adviser remains suitably qualified and credible. Examples include ongoing conduct and care obligations, joining an approved dispute resolution scheme, and disclosing the types of advice they gave during the year.

A licensed adviser could be required to enrol on a public register, so users could quickly find and engage them. An appointed regulator could be responsible for maintaining a public register of current licence holders.

Legislation would need to establish or appoint a regulator with registration and licensing powers. The regulator would oversee registration and licensing, including the assessment of applications, auditing, compliance and promotion of the system.

Any proposal to implement licensing and registration of advisers must work alongside the regulation of forestry adviser services under the Forests Act (1949). We will be considering this alignment as we develop the policy options.

### Benefits

- Clear rules and criteria that set out what is high-quality NZU advice.
- Compliance with the code would be monitored and enforced, discouraging misleading and poor advice.

### Disadvantages

- May be too restrictive for small or new advisers.
- Will likely require a regulator with compliance functions and powers. The cost of setting up a regulator to enforce the code will fall on the Government. Establishing and maintaining the code will be relatively expensive.

### Examples from other sectors

A code, registration and licensing system has parallels with other advisory industries, such as real estate, finance and advisers on forestry supply chain.

#### *Codes of conduct exist for other services*

Several New Zealand agencies and authorities use a code, registration and licensing system:

- **Financial Markets Authority** – *Code of Professional Conduct for Financial Advice Services*.
- **Real Estate Authority** – *Code of Conduct*.

- **Immigration Advisers Authority** – *Code of Conduct*.
- **Nursing Council of New Zealand** – *Tikanga Whanonga Code of Conduct*.

### *Public registers for professional services*

Public registers are commonplace for some services in New Zealand.

- **The Companies Office** maintains a [register of financial service providers](#).
- **The Real Estate Authority** maintains a [public register of all licensed real estate agents, salespeople, branch managers and companies](#).
- **The Immigration Advisers Authority** maintains a [register of all licensed immigration advisers and their business contact details](#).
- **The Nursing Council of New Zealand** maintains a [public register for any registered nurse who holds a current annual practising certificate](#).

## Consultation questions

### **Poor and conflicted advice**

1. As an NZ ETS user, have you received poor, misleading or inaccurate advice on NZU prices or ETS trading? If so, how did this affect you, and what was the financial impact?
2. As an NZ ETS user, have you received advice with financial implications from an NZU adviser with a real, or perceived, conflict of interest? If so, how did this affect you, and what was the financial impact?

### **Education campaign and information pack**

3. To what extent would an education campaign and information pack improve decision-making for users?
4. What information could help users and traders make informed decisions about engaging with the NZ ETS or selecting an adviser?

### **Guidelines for NZU advisers**

5. To what extent would voluntary guidelines for advisers improve the quality of their advice?
6. What should be included in the guidelines to improve the quality of advice?

### **Code of conduct, registration and licensing**

7. To what extent would a code of conduct, registration and licensing framework for advisers improve the quality of their advice?
8. What content would you expect in a code of conduct for advisers?
9. Which licensing requirements and standards would you expect for an adviser?

### **Other options**

10. What other changes, if any, could improve the quality of advice in the NZ ETS?

## Section 4: Governance of trading

This theme addresses two risks, set out below.

### Risk 3: Lack of transparency, oversight and monitoring of trades in the secondary market

Increasing transparency in these areas has three benefits:

1. **Allows for price discovery.** Transparent trading sends more efficient price signals, which help users decide whether it is worth reducing emissions on their own or buying NZUs to cover obligations.
2. **Creates a fair and equal playing field.** Equal access to information creates a level playing field for all users. This includes market information, such as trading price and volume, and information about future policy changes.
3. **Helps identify manipulation and fraud.** Monitoring trades allows a regulator to identify any wrongdoing, misconduct or anti-competitive behaviour. It also keeps the NZ ETS market performing as intended, and users' behaviour in line with the rules.

### Risk 4: Credit and counter-party risk

Credit and counter-party risk is the possibility that one of the parties to an NZU trade defaults on their contractual obligations. Examples of this include:

- one user defaults on payments for their NZU as part of a trade
- payment is made but the NZUs are not transferred, as the selling party defaults.

Trades that cannot be settled affect the compliance and financial position of users. If the receiving user does not have units to surrender by the due date, because of a trade failing to settle, they would face the penalty under section 134 of the Climate Change Response Act 2002 – three times the price of NZUs multiplied by the number of outstanding units, as well as fulfilling their surrender obligation.

## Options

### B1. Maintain the status quo

Most NZU trades today are over the counter (OTC), involving a direct trading relationship between a buyer and seller. Some traders act as dealers by forming trading networks and relationships. OTC trades occur without government supervision or using an exchange. There is no transaction or price reporting for OTC trades, but NZU holdings are maintained in the Register.

OTC trading has the following challenges:

- **Poor transparency.** Because it involves bilateral trades, only the NZU buyer and seller know the final trade price and trading details, which limits price discovery in the scheme.

- **OTC trades can be illiquid.**<sup>10</sup> Traders can exit the market at any time, limiting the ability of other traders to buy or sell NZUs.
- **Greater credit and counter-party risk.** The bespoke nature of OTC trades means one of the parties may default on the trade. Neither party will have knowledge of the other's financial position or ability to cover the NZU obligations.
- **It does not create a level playing field.** In OTC trading, the user may not be getting a fair market price for the NZUs they are buying or selling. With little visibility of other trades, there is no way to compare the details of the transaction.

### Benefits

- Avoids extra administrative cost to the Government or users.

### Disadvantages

- Trading information that would support efficient price discovery for all users remains hidden.
- Users will continue to be exposed to credit and counter-party risk, which can lead to financial loss for the receiving user if the trades are not fulfilled.

## B2. Voluntary transaction reporting

This option will affect NZU traders and NZ ETS participants.

The Government could consider a voluntary transaction reporting framework. Users could choose to voluntarily report transactions to a regulator, either on a regular basis or after each trade.

Transaction reporting is designed to increase post-trade transparency in financial markets by allowing a regulator to view all historical transactions data. This is a common feature for markets, such as on the [National Association of Securities Dealers Automated Quotations \(NASDAQ\)](#). It is not common practice in other international ETSs.

Transaction reporting has two functions, allowing a regulator to:

- use historical transaction data to determine whether there is evidence of market abuse, and the enforcement or remedies needed
- monitor developments in the market that could affect price stability.

Transaction reporting can be achieved by:

- Users submitting a transaction report file directly to the regulator. Larger investment firms or NZU traders may already have post-trade processing systems for reporting. This option replicates obligations in other commodity and financial markets and avoids disrupting their processes.
- Indirect reporting via a third party. Transaction information can be automatically recorded and submitted to the regulator by the third party or platform on behalf of traders.

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<sup>10</sup> In a liquid market, assets can generally be bought and sold quickly. In an illiquid market, the seller may need to wait longer than necessary for a buyer or may need to discount the asset so that it sells quickly.

## Benefits

- Requires low cost and effort from users.
- Provides some historical trade data and insight into market developments in the ETS.

## Disadvantages

- Records of trading data are likely to be infrequent and incomplete.
- Self-reported data is not verified.
- Unlikely to collect historical trading data from users who engage in misconduct.

### **B3. NZU trader position reporting**

This option affects NZU traders and ETS participants.

This option requires all users to disclose the total number of NZUs they hold (called long positions) or borrow (called short positions).<sup>11</sup>

Position reporting provides information about trading activity and market sentiment. These are signals to regulators and other ETS users about market developments and price discovery.

Position reporting can help:

- users to better understand counter-party risk
- regulators to better understand the distribution of market power
- the public to better understand market developments.

For maximum transparency, the position reporting obligation could apply to any person or business that holds or trades NZUs, whether or not they have compliance obligations.

Similar to option B2 (voluntary transaction reporting), position reporting can be:

- direct, by submitting a report to the relevant regulator, or
- indirect, via a third party. For example, a regulated exchange can submit a summary of positions to a regulator.

## Benefits

- More transparency and insight into market conditions and trading conduct.

## Disadvantages

- Self-reported data is not verified.
- Reporting increases administrative burden.

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<sup>11</sup> Short selling is selling a NZU that is not currently owned by the seller, but the seller is obliged to deliver at some point in the future. For example, the seller has borrowed the NZU from another trader, and promises to repay that NZU in the future. The seller hopes market prices decline over time, allowing the seller to buy an NZU from the market at a cheaper price than when they borrowed.

## Examples of ETSs with position reporting

The EU ETS requires commodity derivative exchanges to report on aggregate position by trader type on a weekly basis. Reporting improves financial stability, market transparency, and strengthens investor protection.

### **B4. Requiring exchange-based trading**

This option affects all users and requires oversight by a regulator.

Under this option, most or all NZU trades would have to take place on one or more regulated exchanges.

In exchange-based trading, all buy and sell orders are automatically matched and executed to ensure fair trading across all users. Exchanges enable trading at scale, because each trader has access to a much wider pool of counter-parties to trade with.

All traders must be registered on the exchange. This may include traders posting collateral or bonds to cover potential losses. Requiring collateral can act as a barrier to trading, but gives some protection against credit and counter-party risk.

Generally, exchanges provide more information to the public and regulators through aggregate data reporting, such as live price and volume data. These statistics support price discovery and market efficiency for all traders.

#### **Benefits**

- Reporting on buy and sell orders improves price discovery and market efficiency.
- Exchanges are generally liquid. The pool of buyers and sellers is larger because traders meet in a centralised location to transact.
- A common set of rules ensures users are:
  - treated equally when buying or selling
  - able to buy or sell at a fair market price.
- Exchange rules, collateral and margins help reduce credit and counter-party risk.

#### **Disadvantages**

- Users must register with an exchange and may incur set up costs.
- Users may be required to pay trading fees to participate.
- Requiring collateral to trade may discourage some small users.
- Could be costly for the Government to start up and maintain.

The Government could leverage existing commodity platforms or markets for NZUs. To ensure they align with the Government's objectives, these platforms could operate under licence and oversight by a regulator. This option would be similar to the market operator licensing framework set up under the Financial Markets Conduct Act 2013 for the financial securities market.

## Consultation questions

### Transparency of trades

11. To what extent would more visibility on the price or volume of other NZU trades improve transparency in the NZ ETS, and better inform your decisions about buying and selling?
12. What other types of information would make trades more transparent?

### Credit and counter-party risks

13. To what extent has credit and counter-party risk affected your ability to buy or sell NZUs? What was the financial impact on you?

### Voluntary transaction reporting

14. As a NZ ETS user, what impact would voluntary transaction reporting have on your business or trading activity?
15. As a NZ ETS user, what impact would position reporting have on your business or trading activity?
16. As a NZ ETS user, what impact would exchange-based trading have on your business or trading activity?

### Other options

17. What other options could increase transparency of trades, or reduce market risks associated with trading NZUs?

## Section 5: Governance of market conduct

This theme addresses four risks, set out below.

### Risk 5: Insider trading and information asymmetry

Insider trading refers to:

- buying or selling NZUs while in possession of material information that is not generally available to the market
- passing on and sharing material information that is not generally available to the market.

In these situations, information is 'material' if a reasonable person would expect the information to influence the price of NZU if it were generally available.

Insider trading could occur if, for example, an NZ ETS user had confidential information that a large emitter planned to shut down, or substantively reduced their emissions, and then used that information to trade NZUs to make a profit following its release.

### Risk 6: Manipulation of NZU prices

Market manipulation includes spreading false market information or giving false impressions of market supply or demand for NZUs, typically with the aim of influencing the market price for profit.

Manipulation in the **primary market** (ie, government-run auctions) could include collusion among bidders or bidding with knowledge of the confidential reserve price.

Manipulation in the **secondary market** could include trading with the primary purpose of setting or maintaining the price of NZUs on a secondary trading platform.

The main consequence of market manipulation is distortion of the market price. This could cause financial loss to other users and undermine the NZ ETS's effectiveness in reducing emissions.

### Risk 7: Money laundering and financing of terrorism

Money laundering involves transferring illegitimate money into the legitimate economy through a market such as the NZ ETS. This is achieved by distancing criminal proceeds from their source until the funds are no longer traceable and appear to be legitimate.

Financing of terrorism involves moving money from the legitimate economy to be used for criminal acts.

There are similar methods and channels for each.

## Options

In 2019, the Government identified insider trading and market manipulation as risks to address in the ETS.<sup>12</sup> Given the seriousness of these risks of misconduct, the Government believes only regulatory options should be considered – bringing the NZ ETS in line with how these risks are traded in financial markets and international ETSs.

### C1. Maintaining the status quo

The Government would not make any changes to monitor or prohibit market misconduct, nor introduce offences, penalties, or a regulator to monitor and enforce these rules.

Given the Government has already identified insider trading and market manipulation as risks that should be addressed, the status quo is unlikely to continue.

#### Benefits

- No additional administrative cost for the Government or users.

#### Disadvantages

- Users will continue to be exposed to the risk of financial loss.
- Greater risk of these two forms of conduct in the future.
- Less confidence in the NZ ETS market as a consequence of inaction.

### C2. Position and purchase limits

This option affects NZU traders, NZ ETS participants and foresters. It would also require a regulator to enforce position and purchase limits.

Position limits prevent any one user or group from acquiring such a large share of NZUs that they could exercise unfair market power.

Purchase limits act in a similar way, but restrict the maximum number of units any user can buy when they are initially auctioned.

#### Benefits

- Prevents unfair dominance of the market by a few users.
- Reduces the risk of money laundering and financing of terrorism.
- Gives small users a fairer chance to compete in the market.
- Adds to transparency of the NZ ETS.
- Relatively low cost to implement.

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<sup>12</sup> *Impact Summary: Prohibiting insider trading and market manipulation in the New Zealand Emissions Trading Scheme.*

### Disadvantages

- Does not prevent insider trading.
- Reduces the opportunity for market misconduct but does not eliminate the risk.
- Unduly strict position limits might affect participants' ability to comply with obligations.

## C3. Price reporting

This option affects all users.

Price reporting involves including an additional field in the Register to allow a user to disclose the price of NZUs traded.

### Benefits

- Low cost and effort to users, as they already report volume in the Register.
- Gives a regulator some transparency into market conditions.

### Disadvantages

- Difficult to verify because reporting is based on the negotiated value of NZUs, which may be unrelated to the current market price. For example, a forester may sell a forest block and include the NZUs for 'free', reporting them at zero price.
- Does not support price discovery or efficient markets because the transaction data is only visible to the NZU buyer, seller and the regulator.

Overall, self-reporting is unlikely to be effective at addressing concerns about misconduct and does little to increase price discovery.

## C4. Full transaction detail reporting

This option would replicate many prescribed transaction reporting obligations in Part 1 of the [Anti-Money Laundering and Countering Financing of Terrorism \(Prescribed Transactions Reporting\) Regulations 2016](#).

Users could be required to record and provide a comprehensive list of transaction details to the regulator.

Mandatory full transaction reporting attempts to address the limitation of voluntary self-reporting. It requires all users to report all transaction details, including whether the NZU was part of a larger transaction – for example, a land purchase.

This option could be complemented with a disclosure framework that requires a person or business to disclose any new information that might have a material impact on NZU market prices. For example, a decision to decommission a coal-power electricity plant, or reduce its utilisation rate, might reduce demand for NZUs and therefore their market price.

### Benefits

- Requires all users to report all transaction details, including price.
- A regulator is able to detect fraudulent activity or price manipulation.
- Price and volume details improve price discovery for users.

## Disadvantages

Apart from selection bias, this option has all the disadvantages of [option C3 \(price reporting\)](#).

Further disadvantages include:

- the obligation applies equally to all users, so the cost and effort may be disproportionate for small foresters and traders, reducing participation in the scheme
- given limited ability to verify this data, spurious data will damage the transparency of the scheme, undermining price discovery.

This option would likely only apply under OTC arrangements. The same transaction details can be reported using exchange-based trading.

## Examples of ETSs with transaction reporting

- To improve transparency for OTC trades in the EU ETS, the European Commission requires regulated firms to submit a detailed report on trades of financial instruments, including carbon market derivatives.
- The WCI requires transaction reporting, reducing the risk of market misconduct. Trades clearing on a central registry require buyer and seller authentication, protecting market participants from theft and market manipulation. The ownership of the unit over time can also be tracked, reducing the risk of money laundering.

## Consultation questions

### Insider trading, price manipulation and money laundering

18. To what extent would position and purchase limits protect all users against price manipulation, money laundering, and financing of terrorism?

### Full transaction reporting

19. As a NZ ETS user, what impact would full transaction reporting have on your business or trading activity?
20. What information should be disclosed as part of full transaction reporting?

### Other options

21. What other options could reduce the risk of insider trading, price manipulation, money laundering, or financing of terrorism?

## Section 6: Appointing a regulator

The Government is seeking feedback on options for regulatory oversight of the NZ ETS. A key aspect of any market governance framework is selecting a market regulator and determining their role and functions. Defining these will have a significant impact on existing market operators and ETS users.

The Government could consider:

- appointing an existing public or private agency to provide oversight, or
- establishing a new agency.

To avoid conflating new ETS responsibilities with existing functions, we are considering options in the absence of any existing agency's current responsibilities. This approach allows fair comparison of public, private and new regulator options, without preferring one option because it is already established.

The regulatory arrangements would be reviewed as part of wider reviews of the ETS, and depending on the type of regulator appointed, they may be monitored by the Ministry for the Environment or another department as appropriate.

### Options

#### D1. Maintain the status quo

This option assumes the Government will not establish a new regulator, nor assign functions or responsibilities to an existing regulator or agency. As outlined in [section 2](#), the regulatory framework governing conduct in the ETS has gaps and is incomplete.

Although it can be assumed most users are law-abiding, the financial harm from poor advice and misconduct makes it unlikely that this option will be pursued.

#### D2. Appoint a self-regulating industry body

This is the option with the lowest regulatory burden.

#### Structure

Industry self-regulation involves one or a group of members of an industry agreeing to assume the responsibility of overseeing their sector.

The governing body could be wholly responsible for overseeing the sector, or they could work with government entities in a co-regulatory capacity.

For members governed by the body, membership is often voluntary but could also be required by legislation.

## Functions

The body may develop a voluntary standard of practice and monitoring. It may use enforcement, compliance or disciplinary measures for non-complying entities.

Industry self-regulation is flexible and can involve a myriad of tools to maintain standards. Table 5 sets out examples in the NZU adviser industry.

**Table 5: Examples of self-regulation tools for NZU advisers (adapted from Business NZ (2006))**

Self-regulatory tools	Description	Impact
<b>Aspirational code</b>	Industry outlines a voluntary code of practice	Intended to raise awareness or promote industry reputation
<b>Accreditation/quality assurance scheme</b>	A voluntary scheme where an industry body accredits participants to advertise that they are members of it, or have complied with certain standards	An industry association has considerable reputation, and accreditation is an advantage for members
<b>Model contracts</b>	Offer industry and consumers more balanced contractual terms and conditions	Help establish more balanced terms and conditions that protect consumers and service providers
<b>Dispute resolution</b>	Establishes an external dispute resolution service for consumers	Independent and binding dispute resolution or mediation by an ombudsman
<b>Standards</b>	Sets the minimum performance requirements for NZU advisers	Voluntary, but could have legal force through incorporation in legislation
<b>Legal codes/co-regulation</b>	Codes with some legislative backing; often developed by industry and enforced by the Government	Can be mandated, but often left to industry to develop detailed rules

## Advantages

- Advisers are motivated to maintain reputation by improving the quality of their advice.
- Advisers generally have the best institutional knowledge to regulate themselves.
- Self-regulation is generally a lower cost for the Government and will fall on the industry, which will be motivated to keep costs down.
- We expect advisers would prefer self-regulation, due to flexibility and more choice of how they are regulated.

## Disadvantages

- Has an inherent conflict of interest by asking a participant-funded body to govern themselves.
- Advisers who give poor advice are likely to withdraw from any voluntary frameworks. Therefore, the option fails to protect consumers from exposure to misleading, poor or false advice.
- Lacks any oversight or powers to investigate ETS risks associated with transparency, credit and counter-party risk, price manipulation, insider trading, money laundering, or financing of terrorism.
- With no information-collecting or investigatory powers it cannot address NZU trading risks.
- The nature of misconduct means the perpetrators seeks to hide their behaviour from both an oversight body and other NZU traders. With lack of enforcement, risks to misconduct cannot be addressed.

### D3. Appoint an advisory regulator

To distinguish this role, we refer to it as ‘advisory regulator’.

#### Structure

The advisory regulator would have a clear role to give independent, expert advice to the Government on the ETS.

This option may involve either granting additional oversight to an existing agency, or establishing a new agency.

#### Functions and powers

The purpose of the independent advisory regulator would be to improve the scheme’s long-term performance by:

- advising on quality of advice given to NZU traders
- advising the Government on the current state of the ETS and any emerging issues from industry
- giving the Government independent advice on a long-term strategy
- producing independent reports on the ETS, industry performance and emerging issues.

The advisory regulator will provide:

- **Strategic insight** – providing strategic insight into the ETS, and reporting on market developments.
- **Information and knowledge** – proactively informing both the Government and industry about the functioning of the ETS.
- **Central coordinator** – serving as a conduit for consumers, industry and the Government.

#### Benefits

- **Sets expectations.** Establishing an independent regulator signals the Government’s expectations of regulated entities.
- **Unbiased advice.** Financial independence from industry guards the regulator from inappropriate influences from industry and any conflicting interests.
- **Independence from the Government.** The public and industry will have confidence that the sector governance is impartial and objective, increasing trust in the market.
- **Specialist advice to the Government.** The advisory regulator as an independent specialist can objectively advise on particular ‘stress points’ in the ETS, which the Government can then act on.

#### Disadvantages

- **Lack of compliance and enforcement.** The inability to act on their advice means that users are not fully protected from risks.
- **Lack of data collection powers.** The regulator may have limited powers to collect information or investigate, and therefore would be restricted to mainly public information.

## D4. Appoint a market monitoring regulator

The Government could consider appointing or establishing a regulator that has information collection powers and an investigatory role. For this option, we will refer to the agency as a 'market monitor'.

### Structure

The market monitor would build on the advisory regulator role (D3), providing independent, expert and evidence-based advice to the Government on the operation of the ETS.

A market monitor will have information collection powers that:

- expose misconduct, such as insider trading or price manipulation
- provide data to help the Government make evidence-based decisions.

### Functions

Market monitoring typically covers two functions:

- market surveillance, which includes identifying any misconduct
- market performance, which includes examining and reporting on the efficient functioning of the market.

At a high level, the market monitor would require additional monitoring and investigation powers. To enact these, primary legislation would need to be amended to:

- require participants to provide information, such as papers, recording or documentation to the regulator
- allow the regulator to take statements from officers or employees of the regulated entities
- require participants to provide reasonable and necessary assistance so that the regulator can carry out its functions.

The market monitor would use the information-collection powers to benchmark surveillance and performance against NZ ETS statutory objectives, set in primary legislation.

In terms of surveillance, the presence of a market monitor is crucial to ensuring the market functions as intended.

The market monitor could also collect, aggregate and publish information on market performance.

### Benefits

- **Monitoring and oversight.** The market monitor has powers to collect data and oversee trades in the ETS market.
- **Evidence.** Access to data enables analysis and evidence of any misconduct.
- **Initiate policy reviews.** Evidence can lead to investigation by policy teams, and a review of the ETS market policy.

## Disadvantages

- **Lack of investigative powers.** Although a market monitor has access or powers to collect market data, it could not further investigate suspicious activity.
- **Slow process to improve market.** This regulator could inform the policy agency of misconduct, but this would be ineffective against bad behaviour in the short term.
- **Lack of enforcement.** A lack of a clear and efficient penalty for misconduct may not deter bad behaviour.

## D5. Appoint a market compliance regulator

The Government could consider appointing or establishing a regulator which has information collection powers, an investigatory role and additional powers of enforcement and compliance. The role would include supervising behaviour in the ETS.

### Structure

This role would build on that of the market monitor (D4), giving independent, expert and well-informed advice to the Government on the operation of the scheme.

A market compliance regulator also plays a key role in evidence-based decision-making on ETS governance. Their information collection powers help to:

- expose misconduct, such as insider trading or price manipulation
- establish objective facts to help the Government make evidence-based decisions
- ensure compliance with the market rules set in primary legislation or regulations by:
  - monitoring the behaviour of regulated entities
  - investigating and enforcing compliance.

### Functions

The market compliance regulator would require all the powers and functions of the market monitor, but with an enforcement and compliance role. Primary legislation would need to be amended so that the regulator could request:

- written statements on whether an entity has complied with the legislation or regulation
- enough information to determine whether they have complied with legislation or breached it.

This regulator could also have the power to require a regulated entity to pay a penalty to the Crown or fine for breach of legislation or regulation. Legislation would clearly define the method and maximum penalties.

### Benefits

- **Enforcement powers.** In addition to the benefits of a market monitoring regulator (D4), a compliance regulator has the authority to issue penalties for misconduct in the market. This could be an effective deterrent.

## Disadvantages

- **Lack of powers to set market rules.** A compliance regulator cannot update market rules if they are no longer fit for purpose, and must rely on the policy department to review policy.
- **High costs.** Depending on the complexity of the regulator's functions, this option could be expensive to implement.

## D6. Appoint a market design regulator

The Government could appoint a market design regulator with powers to create or amend (or recommend that the Minister create or amend) market rules, regulations or other secondary legislation.

Of the options here, this regulator would have the most influence on the ETS.

## Structure

As well as performing the same role as the compliance regulator (D5), this regulator could design policy, and consult and make market rules independent of other departments or ministries.

Whereas the other proposed regulators only give expert advice to others, a market design regulator can also act on its own advice.

## Functions

A market design regulator would have:

- investigatory powers to collect information from industry participants
- power to monitor compliance with existing acts and regulations
- power to enforce compliance
- delegated authority to administer market design regulation.

## Benefits

- **Efficiency.** Can act on their findings about issues in the market.
- **Specialised expertise.** Would develop a high level of expertise.

## Disadvantages

- **Perception of excessive regulation.** The perception of increasing and burdensome regulation may be daunting for affected parties and discourage participation in the market.
- **Greater regulatory power and lack of accountability.** Affected parties may be concerned about instability if a regulator has powers to amend market rules, even if this is enacted in consultation with industry.
- **High costs.** Would likely impose high administrative costs or effort on affected parties. This option could also be expensive to implement.

## Estimated cost of appointing a regulator

The cost of establishing a regulator depends on whether the magnitude of the market governance risks require a new regulator or can be addressed by extending the functioning of an existing regulator.

We expect the median operating cost of a new regulator will align with the cost of existing government agencies. A survey of 2020 annual reports for 20 agencies<sup>13</sup> indicates the median operating cost is about \$6.5 million per annum, but ranged from \$1.4 million to \$122.8 million per annum. The actual cost of an NZ ETS regulator will depend on the magnitude of governance risks, the number of parties they regulate, and the type of regulator required.

The cost of establishing an NZ ETS regulator can be significantly reduced by extending the functions and role of an existing regulator. Expanding the role of an existing regulator might require a new personnel to monitor the NZ ETS, but we expect the costs to be between \$1 million to \$5 million.

The costs of establishing a new regulator and any new regulations could be recovered or partially recovered from market participants, through licensing and registration fees or other cost recovery mechanisms. Further consultation on any cost-recovery mechanisms would be undertaken in due course.

## Estimated timeframes for each option

Implementation of each regulatory option requires the establishment of a regulator in the first instance. Setting up a regulator whether self-regulating body, advisory regulator, market monitoring regulator, market compliance regulator or market design regulator could take around 12 months. Implementing each further option will require additional time after the appropriate regulator is set up.

**Table 6: Estimated time to implement options after a regulator is set up**

Option	Time to implement after regulator is set up
<b>Governance of advice options</b>	
Education campaign and information pack*	6 months
Sector guidelines for NZU advisers*	12 months depending on detail and who is responsible for these
Code of conduct, licensing, and registration of NZU advisers	18 months depending on detail required, licencing etc.
<b>Governance of trading options</b>	
Voluntary reporting of trades	6 months
Participant position reporting	6 months
Exchange-based trading	18 months to set up the platform
<b>Governance of market conduct options</b>	
Position and purchase limits	6 months
Price reporting	6 months
Full transaction detail reporting	6 months

\* Non-regulatory option that does not require regulator set up

<sup>13</sup> The sample included Crown agencies, independent Crown entities and autonomous Crown entities.

## Announcing ETS policy

The Government wants all users to have fair access to information about potential or actual changes to policy that may affect NZU prices.

## Material information

During the ETS reform process, the Ministry for the Environment implemented procedures to manage the announcement of material information on key policy decisions on the ETS.

We consider information to be 'material' if a reasonable person would expect it to have a significant effect on the price of NZUs if it were publicly available. For example, changes to New Zealand's domestic emissions budgets, or how many NZUs will be sold at auction.

## Announcement process

The process includes a pre-announcement and then an announcement:

- A pre-announcement is a statement made one or two days early. It states when an announcement is due, and that officials will not be answering questions until that time. In some cases, information may be released without a pre-announcement.
- Announcements are:
  - made outside ETS market trading hours
  - on the date and as close to the announcement time as practicable
  - disclosed to the market on a public website
  - followed by emails to all ETS account holders and stakeholders.

There is currently no requirement for the Government to follow such processes, but as the lead policy agency for the ETS, the Ministry for the Environment, considers this good practice.

## Consultation questions

### Appointing a regulator

22. To what extent would appointing a regulator improve trust, efficiency and confidence in the ETS?
23. What functions and powers would a regulator require to improve trust, efficiency and confidence in the ETS?

### Material information

24. Do you agree with the definition of 'material information' as it relates to NZUs?
25. Do you agree that the Government should be required to disclose 'material information' about NZUs to the market in a way that encourages equal access to information?

### Other options

26. What other types of regulator could the Government consider appointing?

# Section 7: Analysis of options

This section has two parts:

1. a **risk coverage analysis**: considers how well each option in sections 3 to 6 addresses the market governance risks
2. an **impact analysis**: considers each option in sections 3 to 6 against five criteria.

## Analysis of risk coverage

The following paragraphs provide a qualitative risk coverage analysis of how each option addresses each of the seven market governance risks.

For accessibility, the risk coverage analysis is grouped into the governance themes:

- Governance of advice options
- Governance of trading options
- Governance of market conduct options
- Appointing a regulator.

## Governance risks

The initial analysis considers each options' ability to adequately deal with the governance theme's main risks described in [table 2](#).

## Approach to assessing risk coverage

Table 7 shows the operational criteria used for assessing options for NZ ETS governance risk coverage.

**Table 7: Notation for risk coverage assessment**

Notation	Description	Notation	Description
✓✓✓	Strongly addresses risk	O	Neutral
✓✓	Addresses risk	X	Does not addresses risk
✓	Partially addresses risk		

This approach is intended to enable stakeholders to comment on our understanding of the market governance risk, our assessment options in terms of risk coverage, and provide further information we should consider as part of the risk coverage analysis. This feedback is a very important source of information that will help the Government understand the impacts of each option.

## Results

For a detailed analysis, see [appendix B](#).

We found that:

- the options requiring regulation have the best risk coverage
- some options bring co-benefits, addressing other risks across the governance themes.

## **Status quo**

The status quo options (A1, B1, C1 and D1) do not adequately address any of the market governance risks. For this reason, these are unlikely to be progressed as viable options.

Set out below, the analysis looks at:

- the governance of advice, trading and market conduct
- appointing a regulator.

## **Governance of advice**

Best risk coverage – Option A4: Code of conduct, licensing and registration of NZU.

We expect Option A4:

- will perform strongly against poor advice and conflicts of interest risks, by regulating the minimum standards of advice and expectations of an NZU adviser
- could bring co-benefits, by:
  - requiring advisers to check for money laundering and funding of terrorism, and to report suspicious activities to a regulator
  - informing users, especially smaller ones who are likely to use advisers, about credit and counter-party risks of trading NZUs.

## **Governance of trading**

Best risk coverage – Option B4: Requiring exchange-based trading.

We expect option B4 will:

- give the best protection against credit and counter-party risk, by requiring users to maintain an acceptable credit rating, secure a guarantor or post collateral to trade NZUs via an exchange. This protects all users against risky trades
- offer the greatest market transparency and improve a regulator's ability to monitor trades through regular reporting.

Exchange-based trading can also reduce the risk of misconduct. Greater transparency and reporting allow a regulator to monitor trades and detect unusual activity that could indicate price manipulation, insider trading, and money laundering or financing of terrorism.

## **Governance of market conduct**

No options thoroughly address market conduct risks.

Some risk coverage:

- Option C3: Price reporting
- Option C4: Full transaction detail reporting.

C3 and C4 require self-reporting to a regulator, which would require an extra validation step. This approach is likely to be onerous for users.

## Appointing a regulator

Best risk coverage – Option D6: Market design regulator.

Good risk coverage – Option D5: Market compliance regulator – can enforce existing rules in legislation.

## Impact analysis

The following paragraphs provide a qualitative impact analysis of how each option performs against the five NZ ETS criteria.

### Operational criteria

A set of operational criteria are used to assess the options in this document (see table 8). These criteria were drawn from the 2015–16 review of the NZ ETS. These criteria have underpinned the policy decisions made throughout the NZ ETS reform. We have decided to continue using these criteria because the establishment of a market governance framework is a key part of the NZ ETS reform and is being designed with the same objectives in mind.

Table 9 shows the operational criteria used for assessing options to improve market governance in the NZ ETS.

### Approach to assessing options

The impact analysis provides our judgment to what extent we think each option meets the NZ ETS assessment criteria. Table 8 shows the notation used in the impact assessment.

**Table 8: Notation for impact assessment**

Notation	Description	Notation	Description
✓✓✓	Strongly meets criteria	O	Not applicable
✓✓	Meets criteria	✗	Does not meet criteria
✓	Partially meets criteria		

Similar to the risk analysis, this approach is intended to enable stakeholders to comment on our understanding of the market governance risk, our assessment of options, and provide further information we should consider as part of the analysis. This feedback is a very important source of evidence that helps the Government to strengthen proposals and understand their impacts.

**Table 9: Option selection criteria**

Operational criterion	Description
<p><b>Integrity</b></p>	<p>Integrity means ensuring that the NZ ETS market operates with integrity at all times and through all trading markets (primary auctioning market, secondary trading market, and the derivatives market).</p> <p>Integrity also means being consistent with the overall NZ ETS objectives of helping New Zealand meet emissions reduction targets and reduce net emissions below business-as-usual levels.</p> <p>In practical terms, this means preserving the environmental integrity of the NZ ETS, as well as encouraging compliance and enabling enforcement of the scheme’s rules. It also includes minimising opportunities for collusion or market manipulation, and avoiding perverse incentives or unintended consequences</p>
<p><b>Minimal complexity and administrative cost</b></p>	<p>This relates to ensuring implementation is as straightforward as possible, so administration and transaction costs for both participants and the Government are manageable.</p> <p>Wherever possible, the costs of participating in the market are minimised for participants and traders. All rules, regulations and legislation are as simple and understandable as possible. In particular, how the NZ ETS market is governed has clear regard for the impacts on market participation of key intermediaries, traders, and other parties.</p> <p>There may be trade-offs between costs for the Government and simplicity for participants, and in these cases a balance should be struck to minimise the overall administrative burden.</p>
<p><b>Consistency and proportionality</b></p>	<p>Implementation should treat participants consistently and similarly, to avoid advantaging some participants over others.</p> <p>Wherever possible, the same solutions are used to apply to the primary auctioning market, secondary trading market and the derivatives market. In addition, the solutions are consistent with similar solutions used in other similar contexts and they are proportional to the risk at issue.</p> <p>Proportionality means interventions, for example, compliance actions, are appropriately scaled to address the problem or achieve the outcome sought.</p>
<p><b>Clarity and transparency</b></p>	<p>Policies and operational processes should be understandable and unambiguous. Transparency also includes ensuring that appropriate market information is made publicly available in a timely manner (this may need to be balanced with confidentiality where required and for managing integrity risks). The risk of collusion due to too much transparency is also considered.</p> <p>All rules, regulations and legislation are clearly explained so that market participants, traders and other intermediaries understand their obligations and what type of conduct is expected of them.</p>
<p><b>Market efficiency</b></p>	<p>An ETS market is efficient when it achieves allocative efficiency and delivers efficient price discovery.</p> <ul style="list-style-type: none"> <li>• Allocative efficiency is the market’s capacity to channel resources, in this case, NZUs – to their highest value uses. That is, emissions are reduced by those best placed to abate, at the best time.</li> <li>• Efficient price discovery means, for NZUs to flow to their highest value uses, the carbon price needs to reflect all available information. Provision of relevant market information and predictable policy will help participants and others to identify and understand the overall supply and demand conditions for permits, facilitating efficient price discovery. This will produce a reliable price signal that informs investment decisions, while minimising the cost impact of the carbon price.</li> </ul>

Operational criterion	Description
	To ensure market efficiency, there need to be adequate rules and oversight in place to guard against the risks of manipulation of the price, insider trading and anti-competitive conduct.

## Results

For a detailed analysis, see [appendix C](#).

We found that a combination of non-regulatory and regulatory options might fit together to form an effective market governance framework.

### Status quo

The status quo options (A1, B1, C1 and D1) do not adequately meet our criteria. Although keeping the status quo appears to be the least expensive option, it fails on all the other criteria – integrity, consistency and proportionality, clarity and transparency, and market efficiency.

### Governance of advice

The most viable options are:

- A3: Sector guidelines for NZU advisers.
- A2: Education campaign and information pack.

A3 scored better on integrity, and consistency and proportionality. It can be combined with co-regulation to make the sector guidelines enforceable, significantly increasing the integrity score.

### Governance of trading

Best option: B4: Requiring exchange-based trading.

This meets or strongly meets all criteria, offering the most integrity, transparency and market efficiency. The trade-off is that setting up and maintaining an exchange would be a significant cost to the licensed operators. There would also be set-up and trading costs for users.

Although B2 and B3 meet and partially meet criteria, a lack of independent data validation means lower integrity of reported data and market efficiency.

### Governance of market conduct

Best option – C2: Position and purchase limits. This scored well overall and met all criteria, including a relatively low implementation cost to the Government and traders.

### Appointing a regulator

To set up and enforce each option, we need to appoint a regulator with the regulatory function to govern the market.

Best balance – D5: Market compliance regulator. This offers the best balance across the criteria. A compliance function is critical to implement and enforce rules for the market. The trade-off for better regulatory function is the set-up cost to the Government.

## Impacts on Māori and Te Tiriti o Waitangi implications

Iwi and Māori have significant stake in climate policy as climate change threatens the loss of culturally significant land, taonga species, and resources affecting mātauranga and tikanga Māori.

There is a strong Tiriti and Māori interest in NZ ETS. This is driven by a commitment in te ao Māori to reduce emissions and address climate change, and the potential impacts of emissions pricing on Māori involvement in forestry and agriculture – particularly as these sectors dominate Māori economic development and employment.

The market governance proposals in this document will affect iwi and Māori differently, depending on the specific option proposed and what role iwi and Māori have engaging with the NZ ETS. For example, Māori landowners seeking investment in forestry may experience financial benefit from the proposals aimed to improve the quality of financial and technical NZ ETS advice. An additional consequence may be that greater regulation of NZ ETS advice providers results in a higher cost for engaging an NZU advisor. However, higher quality advice will reduce the likelihood of the NZ ETS user experiencing financial harm when compared to the status quo, which currently disproportionately impacts smaller landowners, including iwi and Māori.

The proposal to introduce exchange-based trading could have similarly complex impacts on iwi and Māori. For example, exchange-based trading would reduce the risk of financial harm from price manipulation, insider trading, and credit and counter party risk. However, the cost of using the exchange may disproportionately impact smaller NZ ETS users including iwi and Māori who can currently trade bilaterally with minimal administrative cost.

The proposals in this document are high-level policy options that the Government is seeking feedback on. To inform further policy analysis, the Government wants to hear from iwi and Māori about their particular interests and how these proposals could impact them. The details for targeted engagement with iwi and Māori will be provided at <https://consult.environment.govt.nz/climate/designing-a-governance-framework-for-the-nz-ets>. Information shared through targeted engagement and submissions from iwi and Māori will be used by the Ministry to undertake a full Te Tiriti o Waitangi analysis.

## Consultation questions

### Risk coverage analysis

27. Do you agree with the Government's approach to assessing risk coverage analysis? If not, please provide your assessment of the risks.

### Impact analysis

28. Do you agree with the Government's approach to assessing impact analysis? If not, please provide your assessment of the impact.

### Other options

29. What other factors, if any, should the Government consider in its decision-making?
30. What impacts do you see these proposals having on iwi or Māori in particular?

## Section 8: Scenarios for ETS market governance

This section sets out three scenarios, made up of different combinations of the options set out above. They are: a low regulatory scenario, a balanced scenario, and a risk-mitigation scenario. These are not proposals. They help visualise how options would work together in practice.

### Low regulatory scenario

This scenario presents a combination of options for a low regulatory market governance framework.

Although it has low administrative cost, it is less comprehensive, and poorly addresses the seven market governance risks (table 2). For this reason, the Government is unlikely to consider progressing this scenario.

This scenario uses the following combination of options:

- A2: Education campaign and information pack
- A3: Sector guidelines for NZU advisers
- B2: Voluntary reporting of trades
- C3: Price reporting
- D3: Appointing an advisory regulator.

### Applying the low-regulatory scenario

#### Governance of advice: Education campaign and information pack, and sector guidelines for advisers

This scenario could reduce risk of poor advice, and NZU advisers having a conflict of interest. However, it would not entirely address the issue.

Raised awareness about conflicts of interest, and informative guidelines for advisers may improve the quality of advice and could help participants do their due diligence. However, a lack of regulation of advisers or their advice means there would be no enforceable repercussions for failure to meet the guidelines. This may mean there is not a strong enough deterrent for negative behaviour.

#### Governance of trades: Voluntary reporting of trades

This would allow users to voluntarily report any details of the trade, including type of funds, reporting entity and customer details, price and volume. This would give users some post-trade transparency. However, it is unlikely any users who engage in price manipulation, insider trading, money laundering, or financing of terrorism would voluntarily report details of their trades. Reporting bias could lead to an inaccurate representation of trades in the market, undermining true transparency.

## Governance of market conduct: Price reporting

Price reporting could be made mandatory by adding a field to the Register (NZ ETR), without requiring regulatory change. With this, and the existing information the Register receives about trade volume, a regulator could receive transparent trade information at low administrative cost. However, detecting and discouraging market manipulation and insider trading would require a regulator with a monitoring and compliance role.

## Appointing a regulator: Advisory regulator

An advisory regulator could set voluntary industry standards for quality advice and trading conduct. However, this role would lack the monitoring and enforcement powers to adequately reduce bad behaviour. Because of the regulator's limited oversight and inability to act, users would not be properly protected from the risks. Therefore, this measure does not meet the objectives.

## Consultation questions

### The low-regulatory scenario

31. To what extent would the low-regulatory scenario address the market governance risks?
32. What other non-regulatory options could be considered in this scenario?

## The balanced scenario

This scenario balances risk mitigation, cost and proportionality of response.

It includes the following combination of options:

- A3: Guidelines for advisers (and co-regulation)
- B4: Requiring exchange-based trading
- C2: Position and purchase limits
- D6: Appointing a market compliance regulator.

## Applying the balanced scenario

### Governance of advice – Sector guidelines and information packs

Industry or the Government would draw up sector guidelines for advisers to follow. With the option of co-regulation, a compliance regulator could impose penalties if the guidelines are not adequately followed. This would have a low cost to participants and advisers, and would deal with negative behaviour through penalties.

Guidelines for both advisers and co-regulation is an optimal combination for governance of advice. The guidelines would outline expectations for advisers, setting the standard for good advice in the market. This would bring transparency and clarity on rules to the market, with minimal cost to participants. Costs to produce the guidelines would be met by the Government or industry. Supported by a regulator, this measure effectively deals with all criteria at minimal cost to participants and retains integrity for the ETS.

## Governance of trades – Requiring exchange-based trading

An exchange-based system would allow a centralised regulated trading platform to detect misconduct and report on trades. This would create transparency and reduce credit and counter-party risk to traders. Also, access to the underlying transaction data enables analysis of misconduct and money laundering in the secondary market. An exchange-based system removes any need for additional reporting by participants, reducing their processes and financial burden.

The public visibility of trades on a central exchange leads to effective price discovery. Although exchange-based trading scores well on all criteria, and is a low-cost option to participants, the cost of set-up and maintenance could be high for licensed market operators and the Government.

## Governance of conduct – Position and purchase limits (optional)

Position and purchase limits for participants are a common feature to prevent market power. Limits reduce the risk of laundering large sums of money through the market, large-scale manipulation and insider trading. The risk drops significantly when there is a cap on potential financial harm.

Limits would be set in the register and would have no cost to participants. As the limits will be public information, this increases transparency and ease of monitoring. Introducing position limits may have a downside for large-scale participants. However, to deal with that, a range of limits can be applied, based on compliance obligations.

## Appointing a regulator – Market compliance regulator

A market compliance regulator would have access to market data, supplied by the exchange-traded platforms, and could develop deeper insights into how the secondary market works. This regulator could identify and issue penalties for misconduct, effectively discouraging bad behaviour.

The regulator would ensure a high level of integrity in the market, at a low cost to participants but with substantial cost and complexity for the Government. Having a compliance monitor is proportional to the perceived risk in the market and is consistent with other ETS markets internationally.

The set-up cost is balanced by gains in integrity and good governance. This would help us meet our objective of being viewed as a credible ETS on the international stage.

## Consultation questions

### The balanced scenario

33. To what extent would the balanced scenario address the market governance risks?
34. What other options could be considered in this scenario?

## The risk mitigation scenario

This scenario prioritises risk mitigation, which means that some of the options have a high complexity and administrative cost, or do not meet the consistency and proportionality criteria. The Government believes it does not yet have enough evidence to progress with this option, but that does not preclude considering it if more evidence of the risks comes to light.

This scenario includes the following combination of options:

- A4: Code of conduct, licensing and registration of NZU advisers
- B4: Requiring exchange-based trading
- C2: Position and purchase limits
- D6: Appointing a market design regulator.

### Applying the risk mitigation scenario

#### Governance of advice – Code of conduct, licensing and registration of NZU advisers

This option comprehensively addresses the advice risks. A code of conduct provides high integrity, transparency and clarity, and improves market efficiency. It sets out a detailed set of rules to govern the market, removing ambiguity and reducing bad advice. A code can be heavily regulated and enforced by an appropriate regulator. A market design regulator can enforce the code and update it to make it more effective.

The drawbacks are that this measure, with a market design regulator, would be relatively costly, either to users or to the Government. It could be complex and may not be proportional to the risk.

#### Governance of advice – Requiring exchange-based trading

Requiring exchange-based trading removes the need for potentially onerous reporting, while addressing many of the risks. Because all trades take place through an exchange, position and purchase limits are easy to set, protecting against market manipulation. For analysis, see [appendix D](#).

#### Governance of conduct – Position and purchase limits (optional)

For analysis, see [appendix D](#).

#### Appointing a regulator – Market design regulator

In combination with the other options in this scenario, a market design regulator could mitigate every risk. This regulator has all the functions of a monitoring and compliance regulator to collect data, analyse, investigate and issue penalties for non-compliance. It also has the authority to redesign secondary legislation in its jurisdiction, to ensure the ETS is properly governed. If existing legislation is not useful it can be updated, without going through a policy agency.

Implementing this scenario (or something similar) would depend on whether the governance risks are big enough to justify the cost and complexity.

## Consultation questions

### **The risk mitigation scenario**

35. To what extent would the risk mitigation scenario address the market governance risks?
36. What other options could be considered under this scenario?
37. What other combination of options or scenarios could address the market governance risks?

# Section 9: Consultation process

## How to make a submission

The Government welcomes your feedback on this consultation document. The questions posed throughout this document are summarised in section 10. They are a guide only and all comments are welcome. You do not have to answer all the questions.

To ensure your point of view is clearly understood, you should explain your rationale and provide supporting evidence where appropriate.

## Timeframes

This consultation starts on 8 July 2021 and ends on 17 September 2021.

When the consultation has ended, we will develop final policy advice that considers these submissions.

## How to provide feedback

There are two ways you can make a submission:

1. via Citizen Space, our consultation hub, available at <https://consult.environment.govt.nz>
2. write your own submission.

If you want to provide your own written submission you can provide this as an uploaded file in Citizen Space.

We request that you don't email or post submissions as this makes analysis more difficult. However, if you need to please send written submissions to NZ ETS team, Ministry for the Environment, PO Box 10362, Wellington 6143 and include:

- the title of the consultation: Designing a governance framework for the New Zealand Emissions Trading Scheme
- your name or organisation name
- postal address
- telephone number
- email address.
- If you are emailing your submission, send it to [etsconsultation@mfe.govt.nz](mailto:etsconsultation@mfe.govt.nz) as a:
- PDF
- Microsoft Word document.

**Submissions close at 5 pm on 17 September 2021.**

## More information

Please direct any queries to:

Email: [etsconsultation@mfe.govt.nz](mailto:etsconsultation@mfe.govt.nz)

Postal: Designing a governance framework for the New Zealand Emissions Trading Scheme, Ministry for the Environment, PO Box 10362, Wellington 6143

## Publishing and releasing submissions

All or part of any written submission (including names of submitters), may be published on the Ministry for the Environment's website, [environment.govt.nz](http://environment.govt.nz). Unless you clearly specify otherwise in your submission, the Ministry will consider that you have consented to website posting of both your submission and your name.

Contents of submissions may be released to the public under the Official Information Act 1982 following requests to the Ministry for the Environment (including via email). Please advise if you have any objection to the release of any information contained in a submission and, in particular, which part(s) you consider should be withheld, together with the reason(s) for withholding the information. We will take into account all such objections when responding to requests for copies of, and information on, submissions to this document under the Official Information Act.

The Privacy Act 2020 applies certain principles about the collection, use and disclosure of information about individuals by various agencies, including the Ministry for the Environment. It governs access by individuals to information about themselves held by agencies. Any personal information you supply to the Ministry in the course of making a submission will be used by the Ministry only in relation to the matters covered by this document. Please clearly indicate in your submission if you do not wish your name to be included in any summary of submissions that the Ministry may publish.

# Section 10: Consultation questions

## Poor and conflicted advice

1. As a NZ ETS user, have you received poor, misleading or inaccurate advice on NZU prices or trading? If so, how did this affect you, and what was the financial impact?
2. As a NZSuser, have you received advice with financial implications from an NZU adviser with a real, or perceived, conflict of interest? If so, how did this affect you, and what was the financial impact?

## Education campaign and information pack

3. To what extent would an education campaign and information pack improve decision-making for users?
4. What information could help users and traders make informed decisions about engaging with the NZ ETS or selecting an NZU adviser?

## Voluntary guidelines for NZU advisers

5. To what extent would voluntary guidelines for advisers improve their quality of advice?
6. What should be included in the guidelines to improve the quality of advice?

## Code of conduct, registration and licencing

7. To what extent would a code of conduct, registration and licensing framework for advisers improve the quality of their advice?
8. What content would you expect in a code of conduct for advisers?
9. Which licensing requirements and standards would you expect of an adviser?

## Other options

10. What other changes, if any, could improve the quality of advice in the NZ ETS?

## Transparency of trades

11. To what extent would more visibility on the price or volume of other NZU trades improve transparency in the NZ ETS, and better inform your decisions about buying and selling?
12. What other types of information would make trades more transparent?

## Credit and counter-party risks

13. To what extent has credit and counter-party risk affected your ability to buy or sell NZUs? What was the financial impact on you?

## Voluntary transaction reporting

14. As a NZ ETS user, what impact would voluntary transaction reporting have on your business or trading activity?
15. As a NZ ETS user, what impact would position reporting have on your business or trading activity?
16. As a NZ ETS user, what impact would introducing exchange-based trading have on your business or trading activity?

### **Other options**

17. What other options could increase transparency of trades, or reduce market risks associated with trading NZUs?

### **Insider trading, price manipulation and money laundering**

18. To what extent would position and purchase limits protect all users against price manipulation, money laundering, and financing of terrorism?

### **Full transaction reporting**

19. As a NZ ETS user, what impact would full transaction reporting have on your business or trading activity?
20. What information should be disclosed as part of full transaction reporting?

### **Other options**

21. What other options could reduce the risk of insider trading, price manipulation, money laundering, and financing of terrorism?

### **Appointing a regulator**

22. To what extent would appointing a regulator improve trust, efficiency and confidence in the ETS?
23. What functions and powers would a regulator require to improve trust, efficiency and confidence in the ETS?

### **Material information**

24. Do you agree with the definition of 'material information' as it relates to NZUs?
25. Do you agree that the Government should be required to disclose 'material information' about NZUs to the market in a way that encourages equal access to information?

### **Other options**

26. What other types of regulator could the Government consider appointing?

### **Risk coverage analysis**

27. Do you agree with the Government's approach to assessing risk coverage analysis? If not, please provide your assessment of the risks.

### **Impact analysis**

28. Do you agree with the Government's approach to assessing impact analysis? If not, please provide your assessment of the impact.

### **Other options**

29. What, other factors, if any, should the Government consider in its decision-making?
30. What impact do you see these proposals having on iwi or Māori in particular?

### **The low-regulatory scenario**

31. To what extent would the low-regulatory scenario address the market governance risks?
32. What other non-regulatory options could be considered in this scenario?

**The balanced scenario**

33. To what extent would the balanced scenario address the market governance risks?
34. What other options could be considered in this scenario?

**The risk mitigation scenario**

35. To what extent would the risk mitigation scenario address the market governance risks?
36. What other options could be considered in this scenario?
37. What other combination of options or scenarios could address the market governance risks?

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# Appendix A: Case studies

## CASE STUDY – COUNTER-PARTY RISK

### Failure to deliver carbon credits

Three Australians were found guilty of a carbon credit tax scam over 2009-12. They lured customers into buying carbon offsets that were never delivered.

A solicitor, financial planner, and accountant were fined a total of AU\$9.4 million for convincing clients to buy carbon offsets from projects reducing deforestation in south-east Asia, against promises of tax deductions. In reality there were no offset associated tax deductions, and the buyers received no offsets. In several cases, buyers were later required to pay the additional and unexpected tax that they thought, based on advice, they were not required to pay, and lost the whole value of their investment.

The three based their tax-avoidance scheme on the then-government's Carbon Pollution Reduction Scheme (CPRS), initiated by former prime minister Kevin Rudd. The CPRS offered tax deductions to emitters covered by the programme. The scammers convinced their victims that they would receive similar deductions, which they were not actually eligible for.

This case covers misleading advice, credit and counter-party risks, and potentially misconduct in the market.

Source: Carbon pulse. 2021. *Three Australians fined millions for carbon credit tax scam.*

## CASE STUDY – MISLEADING ADVICE TO INVESTORS

### Carbon credit investor fraud scheme

In April 2021, directors of World Wide Carbon from Georgia, USA, were sentenced for orchestrating a carbon credit scandal, defrauding individuals of more than US\$1 million. Along with conspirators, they misled seven investors about the company's use of funds, marketed return on the investment, and risks relating to those investments. Their fraud included:

- **Misleading use of investor funds.** Telling a victim that investor funds would be channelled into a portfolio of carbon credits "developed, established, and validated by WWC", registered with California regulator Air Resource Board (CARB), and held in the entity's carbon market account.
- **False claim of generating carbon credits.** World Wide Carbon did not actually generate these credits. A previous version of the company's now-defunct website showcased three Saskatchewan-based forestry offset projects that did not appear to exist.
- **False information about emission abatement.** The company's website said its offset projects generated 30 million tonnes of greenhouse gas emission reductions annually, at a market value of more than \$530 million. This would have placed the company among the largest carbon credit developers in the world, according to Carbon Pulse calculations.
- **False information about credit verification.** They stated that the credits were also verified by an independent entity and the CARB, before undergoing another verification by insurance firm Lloyds of London. This does not actually audit carbon offset projects.
- **False information about return on investment.** They claimed that the carbon offsets would be sold at the next quarterly auction of the Western Climate Initiative (WCI) trading scheme, and receive a 5 per cent return on the investment.

## CASE STUDY – MISLEADING ADVICE TO INVESTORS

They were given a three-year prison sentence, five years' probation, and one-year home confinement. They were jointly and severally liable for paying \$1.64 million in restitution from their fraud scheme.

Source: Carbon Pulse. 2021. *Two US men sentenced in carbon credit investor fraud scheme.*

## CASE STUDY – MARKET MANIPULATION

### Market manipulation in New Zealand

The first case of manipulation in the New Zealand financial market was filed in 2015. The allegations against the individual included that they:

- placed small trades directly on the market in one direction, followed by large off-market trades in the opposite direction
- manipulated the closing price
- used their trading orders to move the price, rather than for a genuine commercial purpose.

Under the Financial Markets Conduct Act 2013, the Financial Markets Authority (FMA) must prove:

- the individual traded in a certain way
- that their trading was likely to have the effect of creating a false or misleading appearance about the extent, or demand for, trading in those securities
- that they knew or ought reasonably to have known, their trading was likely to have that effect.

The High Court found that, in two of the 10 claims made by the FMA, the individual had manipulated the market. They mainly traded with two brokers. They had a pattern of on- and off-market buying of shares that would inflate the price, to allow them to sell at a higher value. The court found they had engaged in conduct which had, or was likely to have had, the effect of creating a false or misleading appearance, relating to the extent of active trading in the relevant securities or the supply of, demand for, price for trading in, or value of those securities.

Reference: First case on Market Manipulation decided in New Zealand.

## Case study – Fraud in emission trading schemes

### VAT fraud in the EU ETS

Since its inception in 2005, the EU ETS has grown rapidly, and is now the largest carbon market in the world. As the market has increased in complexity, so has the need for governance and oversight.

### Value added tax (VAT) fraud

An article in the EUobserver reported that:

“A carousel fraud involving the trade of emission credits in 2008 and 2009 amounted to a loss of €5 billion for national tax revenues.

A front company in one EU country would sell the carbon credits to a company in another, but without transferring VAT tax. The credits would then be traded and sold for a price that included VAT – but did not hand over that VAT to the relevant tax authority.”

### The fix

Following the fraud scheme, the EU adopted a directive which gave member states the possibility to implement a VAT reverse charge mechanism. This puts the obligation to pay VAT on the person to whom credits are transferred.

### Emission allowances are financial products

In the early years of the EU ETS, fraudsters and hackers tried to gain illegal profits from the European carbon market. This led to several preventive measures in the field of VAT and the Union registry. In addition, since January 2018 the classification of emission allowances as financial instruments has allowed regulation financial products, and made the EU ETS a robustly regulated, safe and efficient trading environment. Legislation for carbon allowances includes the Directive on Markets in Financial Instruments (MiFID2), Regulation on Market in Financial Instruments (MiFIR), and Market Abuse Regulation (MAR).

References: EU carbon credit system still ‘at risk of VAT fraud’

Ensuring the integrity of the European carbon market

# Appendix B: Risk coverage analysis

**Table 10: Governance of advice: Risk coverage analysis**

	A1: Status quo	A2: Education campaign and information pack	A3: Sector guidelines for NZU advising	A4: Code of conduct, licensing and registration of NZU advisers
<b>Poor advice</b>	O Advisers can continue to give poor advice to participants	✓ Quality of advice may improve if advisers read the information pack	✓ Quality of advice may improve if advisers read the information pack	✓✓✓ Advisers must comply with a code of conduct rules, including penalties for non-compliance.
<b>Conflict of interest</b>	O Advisers can continue to provide advice when conflicted	✓ Helps participants do due diligence on conflicts of interest	✓ Helps advisers identify when they are conflicted and how to manage conflicts	✓✓ Advisers found to be acting when conflicted could have their licence suspended or revoked
<b>Transparency, monitoring and oversight of trades</b>	O Not applicable	O Not applicable	O Not applicable	O Not applicable
<b>Credit and counter-party risk</b>	O Not applicable	✓ Could help participants do due diligence when entering trades	O Not applicable	✓ Advisers could be required to inform participants about credit and counter-party risks
<b>Price manipulation</b>	O Not applicable	O Not applicable	O Not applicable	O Not applicable
<b>Insider trading</b>	O Not applicable	O Not applicable	O Not applicable	O Not applicable
<b>Money laundering and financing of terrorism</b>	O Not applicable	O Not applicable	✓ Could help advisers identify and report suspicious activities such as money laundering or financing of terrorism	✓✓✓ Advisers could be required to do Anti Money Laundering or Counter Financing of Terrorism checks and report suspicious activity to a regulator

- ✓✓✓ Strongly addresses risk
- ✓✓ Addresses risk
- ✓ Partially addresses risk
- O Neutral

**Table 11: Governance of trading: Risk coverage analysis**

Risk	B1: Status quo	B2 Voluntary reporting of trades	B3: Participant position reporting	B4: Requiring exchange-based trading
<b>Poor advice</b>	O Not applicable	O Not applicable	O Not applicable	✓ Exchanges could be required to ensure independent participants are informed of the risks of trading
<b>Conflict of interest</b>	O Not applicable	O Not applicable	O Not applicable	O Not applicable
<b>Transparency, monitoring and oversight of trades</b>	O No transparency over trades	✓ Some transparency for reporting participants	x Participants must report on NZU holdings which can be monitored by a regulator, but does not require any price information	✓✓✓ Exchanges must report on trades, which can be monitored by a regulator
<b>Credit and counter-party risk</b>	O Not applicable	O Not applicable	✓ Provides some information on participants' ability to fulfil trades	✓✓ Collateral can be required to engage in exchange-based trading
<b>Price manipulation</b>	O Not applicable	x Parties that engage in price manipulation are unlikely to report	O Not applicable	✓✓✓ Helps a regulator monitor and detect unusual trades that could indicate price manipulation
<b>Insider trading</b>	O Not applicable	x Parties that engage in insider trading are unlikely to report	✓ Provides some information on holdings and transaction dates	✓✓✓ Helps a regulator monitor and detect unusual trades that could indicate insider trading
<b>Money laundering and financing of terrorism</b>	O Not applicable	x Parties that engage in money laundering or financing of terrorism are unlikely to report	✓ Provides some information on holdings and holdings values	✓✓✓ Helps a regulator monitor and detect unusual trades that could indicate money laundering or financing of terrorism

- ✓✓✓ Strongly addresses risk
- ✓✓ Addresses risk
- ✓ Partially addresses risk
- x Does not address risk
- O Neutral

**Table 12: Governance of trading: Risk coverage analysis**

Risk	C1: Status quo	C2: Position and purchase limits	C3: Price reporting	C4: Full transaction detail reporting
<b>Poor advice</b>	O Not applicable	O Not applicable	O Not applicable	O Not applicable
<b>Conflict of interest</b>	O Not applicable	O Not applicable	O Not applicable	O Not applicable
<b>Transparency, monitoring and oversight of trades</b>	O No transparency over trades	✓ Some monitoring and oversight of position	✓✓ Reporting transaction price increases price transparency and can be monitored by a regulator	✓✓ Participants must report on all details of a transaction; increases transparency and can be monitored by a regulator
<b>Credit and counterparty risk</b>	O Not applicable	O Not applicable	O Not applicable	✓ Provides some information on participants' ability to fulfil trades
<b>Price manipulation</b>	O Not applicable	✓✓ Prevents parties gaining undesirable power in the market	✓✓ Helps a regulator monitor and detect unusual trades that could indicate price manipulation	✓✓ Helps a regulator monitor and detect unusual trades that could indicate price manipulation
<b>Insider trading</b>	O Not applicable	O Not applicable	✓✓ Helps a regulator monitor and detect unusual trades that could indicate insider trading	✓✓ Helps a regulator monitor and detect unusual trades that could indicate insider trading
<b>Money laundering and financing of terrorism</b>	O Not applicable	O Not applicable	✓✓ Helps a regulator monitor and detect unusual trades that could indicate money laundering or financing of terrorism	✓✓ Helps a regulator monitor and detect unusual trades that could indicate money laundering or financing of terrorism

- ✓✓ Addresses risk
- ✓ Partially addresses risk
- O Neutral

**Table 13: Appointing a regulator: Risk coverage analysis**

Risk	D1: Status quo	D2: Self-regulating body	D3: Advisory regulator	D4: Market monitoring regulator	D5: Market compliance regulator	D6: Market design regulator
<b>Poor advice</b>	O No regulator	✓ Sets voluntary industry standard for quality of advice	✓ Advises on industry standards for quality of advice, hears complaints, and advises central government	✓ Could monitor reports on complaints, and advise central government	✓✓ Could require reporting, and enforce compliance with primary legislation	✓✓✓ Could require reporting, enforce compliance, and amend adviser requirements
<b>Conflict of interest</b>	O No regulator	✓ Could recommend against trading when conflicted	✓ Could advise on conflicts of interest, hear voluntary complaints, and advise central government	✓ Could monitor participants report on complaints, and advise central government	✓✓ Could require reporting, and enforce compliance with primary legislation	✓✓✓ Could require reporting, enforce compliance, and amend adviser requirements
<b>Transparency, monitoring and oversight of trades</b>	O No regulator	x No oversight of transactions	x No oversight of transactions	✓ Could monitor transactions and advise central government	✓✓ Could monitor transactions and enforce compliance with primary legislation	✓✓✓ Could monitor trades, enforce compliance and amend trading rules
<b>Credit and counter-party risk</b>	O No regulator	x No oversight of credit or counter-party risk	x No oversight of credit or counter-party risk	✓ Could monitor participants' accounts for credit and counter-party risks, and advise central government	✓✓ Could monitor participants' accounts for credit and counter-party risks, and restrict risky trades and trading of offenders	✓✓✓ Could monitor participants' holdings, restrict risky trades, restrict trading of offenders, and amend collateral requirements
<b>Price manipulation</b>	O No regulator	x No oversight of price manipulation	x No oversight of price manipulation	✓ Could monitor trades and identify potential price manipulation, and advise central government	✓✓ Could monitor trades for potential price manipulation, enforce compliance with primary legislation, and restrict trading of offenders	✓✓✓ Could monitor participants' trades for price manipulation, restrict risky trades or traders, address undesirable trading situations, and amend trading rules

Risk	D1: Status quo	D2: Self-regulating body	D3: Advisory regulator	D4: Market monitoring regulator	D5: Market compliance regulator	D6: Market design regulator
<b>Insider trading</b>	O No regulator	x No oversight of insider trading	x No oversight of insider trading	✓ Could monitor trades and accounts, identify potential insider trading, and advise central government	✓✓ Could monitor trades and accounts, enforce compliance with primary legislation, and restrict trading of offenders	✓✓✓ Monitors participants' accounts and trades for insider trading, restricts risky trades or traders, addresses undesirable trading situations, and amends trading rules
<b>Money laundering and financing of terrorism</b>	O No regulator	x No oversight of money laundering or price manipulation	x No oversight of money laundering or price manipulation	✓ Could monitor trades and accounts to identify potential money laundering, and advise central government	✓✓ Monitors trades for money laundering or financing of terrorism activity, enforces compliance with primary legislation, and restricts trading for offenders	✓✓✓ Monitors trades for money laundering and financing of terrorism, restricts or remedies undesirable trading situations, and amends trading rules

- ✓✓✓ Strongly addresses risk
- ✓✓ Addresses risk
- ✓ Partially addresses risk
- x Does not address risk
- O Neutral

# Appendix C: Impact analysis

**Table 14: Governance of advice: Impact analysis**

Criterion	A1: Status quo	A2: Education campaign and information pack	A3: Voluntary sector guidelines for NZU advisers	A4: Code of conduct, licensing and registration of NZU advisers
<b>Integrity</b>	x There is anecdotal evidence that traders are receiving poor advice	✓ Does not stop bad advice, but helps traders do due diligence	✓✓ Sets the expected standard of advice	✓✓✓ Sets the standards of good advice, and there is a penalty for falling below these
<b>Minimal complexity and administrative cost</b>	✓ Least administrative cost, but the ETS is complex to understand for small traders	✓✓✓ Minimises complexity for traders, with no administrative cost for participants and traders	✓✓✓ Minimises complexity for advisers, with no administrative cost for participants and traders	x The highest administrative cost for participants
<b>Consistency and proportionality</b>	x Does not address the risks, and small traders are disproportionately exposed to poor advice	✓ Education campaigns are common practice, but may not be proportional given the risk of harm to traders	✓✓ Guidelines are common practice in service-based industries and a proportional response to the evolving market	x May be too onerous for advisers, given the current evidence of the poor advice risk
<b>Clarity and transparency</b>	x The information traders need exists, but is not all in one place	✓✓✓ An information pack can give traders useful information, in one place	✓✓✓ Guidelines set a public standard of what to expect of an adviser	✓✓ Provides the most standardised rules, but these are not always clearly understood by traders or the public
<b>Market efficiency</b>	x	✓ Education campaigns support efficient price discovery by helping traders better understand the ETS	✓ Guidelines encourage advisers to give better advice on price discovery	✓✓ Improves the quality of advice, and therefore price discovery, through a regulated regime

- ✓✓✓ Strongly meets criteria
- ✓✓ Meets criteria
- ✓ Partially meets criteria
- x Does not meet criteria
- O Not applicable

**Table 15: Governance of trading: Impact analysis**

Criterion	B1: Status quo	B2 Voluntary reporting of trades	B3: Participant position reporting	B4: Requiring exchange-based trading
<b>Integrity</b>	x Lack of transparency means market integrity cannot be observed	✓ Helps with understanding emission reductions, but does not address market integrity	✓✓ Helps traders and the regulator better understand market sentiment and traders' NZU holdings and behaviour	✓✓✓ A regulated platform can detect misconduct and report on trades
<b>Minimal complexity and administrative cost</b>	✓ Least administrative cost and complexity for sophisticated traders	✓ Applied on a voluntary basis, but may be complex for some traders	✓ Low complexity and administrative cost; can be automated	✓✓ Some risk protection for small traders
<b>Consistency and proportionality</b>	x Most markets have some form of trading oversight	✓ Transaction reporting occurs in other markets, but may not be enough to detect misconduct	✓ Position reporting can occur in other markets	✓✓ Exchange-based trading is common practice in financial markets and helps expose any misconduct through trade reporting
<b>Clarity and transparency</b>	x Over the counter trades provide little transparency	✓ Gives some insight into trades, but is unlikely to detect misconduct	✓✓ Provides the regulator with more transparency of trades	✓✓✓ Exchanges can produce reports and charts that improve transparency for the public
<b>Market efficiency</b>	x Over the counter trades do not help with price discovery because the information is private	x No verification of trade information, which is important for detecting misconduct	x Does not help with price discovery, because the information is accessed by only the regulator	✓✓✓ Public price and volume trading offers the best price discovery

✓✓✓	Strongly meets criteria
✓✓	Meets criteria
✓	Partially meets criteria
x	Does not meet criteria

**Table 16: Governance of market conduct: Impact analysis**

	C1: Status quo	C2: Position and purchase limits	C3: Price reporting	C4: Full transaction detail reporting
<b>Integrity</b>	x No oversight to prevent misconduct	✓✓ Limits are common features to prevent market power	x Self-reporting is unlikely to deter traders who are intentionally engaging in misconduct	x Self-reporting is unlikely to deter traders who are intentionally engaging in misconduct
<b>Minimal complexity and administrative cost</b>	✓✓ Low cost to operate, but does not consider complexity and cost for small participants	✓✓ Limits can be set via the NZ ETR	✓✓ Easy to implement because this option involves adding a 'price' field to an existing NZ ETR report	x Requires reporting on several fields and is likely to be too burdensome for traders
<b>Consistency and proportionality</b>	x Most international ETSs and markets have some form of governance and oversight	✓✓ Limits are common features in financial markets	x Does not address the risks of misconduct, money laundering or financing of terrorism because the prices are not validated	x Not proportional given the level of risk of misconduct and likely to be too burdensome for traders
<b>Clarity and transparency</b>	x Complex to understand and not transparent	✓✓✓ Limits are a simple mechanism to understand, the limits are public, and it is easy to monitor limits	✓ Clear to understand but the information is not validated and not shared publicly	✓ Clear to understand but the information is not validated and not shared publicly
<b>Market efficiency</b>	x Poor price discovery with over the counter trades	✓✓ Fairer NZU by limiting a trader's ability to manipulate prices and corner the market	x This information is in the registry and not public, so does not aid with price discovery	x This information is in the registry and not public, so does not aid with price discovery

✓✓✓	Strongly meets criteria
✓✓	Meets criteria
✓	Partially meets criteria
x	Does not meet criteria

**Table 17: Appointing a regulator: Impact analysis**

Criterion	D1: Status quo	D2: Self-regulating body	D3: Advisory regulator	D4: Market monitoring regulator	D5: Market compliance regulator	D6: Market design regulator
<b>Integrity</b>	x Low integrity because there is no oversight of the market	✓ A good industry body can set industry expectations	✓ Independent from the industry and can advise the Government on improvements to the ETS	✓✓ Has access to market information and can develop a deeper insight into market governance issues	✓✓✓ Can issue penalties for poor conduct	✓✓✓ Can issue penalties and amend the market rules to prevent further misconduct
<b>Minimal complexity and administrative cost</b>	x Not having any governance makes the NZ ETS difficult to understand and navigate	✓ Potentially low administrative cost for industry	✓ Some administrative cost to the Government, but with limited data collection powers	✓✓ Some administrative cost to the Government	✓ More functions to administer, therefore higher cost and complexity	x The most expensive and complex options to administer
<b>Consistency and proportionality</b>	x Markets and international ETSs ordinarily have some form of governance	x Not proportional to the potential risk of misconduct and final harm	✓ The independent nature of an advisory regulator supports effective governance	✓✓ Monitoring and reporting powers provide better detection and insight into misconduct	✓✓✓ The ability to enforce compliance effective for good governance	✓ The ability to amend market rules may not be proportional at this stage
<b>Clarity and transparency</b>	x OTC trades provide no transparency of conduct	x Provides little additional insight into market behaviour and misconduct	✓ An independent regulator ensures misconduct is reported where discovered. However, limited transparency due to lack of information collecting powers	✓✓ Monitoring and reporting powers provides better detection and insight into misconduct	✓✓✓ Enforcement and penalties send a public signal to industry of acceptable behaviour	✓✓✓ Market rules are clear and transparent, and amended in consultation with industry
<b>Market efficiency</b>	x OTC trades provide no information useful for price discovery	x No obligation to report or provide any information useful for price discovery	x Some limited reporting helps with price discovery	✓✓✓ Access to market information and public reporting aids price discovery	✓✓✓ Access to market information and public reporting aids price discovery	✓✓✓ Access to market information and public reporting aids price discovery

- ✓✓✓ Strongly meets criteria
- ✓✓ Meets criteria
- ✓ Partially meets criteria
- x Does not meet criteria

# Appendix D: Analysis of scenarios

These tables set out the assessment of the three scenarios that combine different options – see [section 8](#).

## Non-regulatory scenario

**Table 18: Risk coverage analysis of non-regulatory scenario**

Risk	A2: Education campaign and information pack	A3: Voluntary sector guidelines for NZU advisers	B2 Voluntary reporting of trades	C3: Price reporting	D3: Advisory regulator
<b>Poor advice</b>	✓ Quality of NZU adviser advice may improve if they engage with the information pack	✓ Quality of adviser advice may improve if they engage with the guidelines and information	○ Not applicable	○ Not applicable	✓ Could set industry standard for quality advice, applied on a voluntary basis
<b>Conflict of interest</b>	✓ Helps participants do their due diligence regarding conflicts of interests	✓ Guidelines may improve adviser’s awareness of when they have a conflict of interest	○ Not applicable	○ Not applicable	✓ Could recommended against trading when conflicted, applied on a voluntary basis
<b>Transparency, monitoring and oversight of trades</b>	○ Not applicable	○ Not applicable	✓ Provides some transparency of trade for reporting participants	✓✓ Reporting transaction price increases transparency for a regulator	x No oversight of transactions
<b>Credit and counter-party risk</b>	✓ Could help participants do due diligence when entering trades	○ Not applicable	○ Not applicable	○ Not applicable	x No oversight of credit or counter-party risk
<b>Price manipulation</b>	○ Not applicable	○ Not applicable	x Parties that engage in price manipulation are unlikely to report	✓✓ Helps a regulator monitor and detect unusual trades that could indicate price manipulation	x No oversight of price manipulation
<b>Insider trading</b>	○ Not applicable	○ Not applicable	x Parties that engage in insider trading are unlikely to report	✓✓ Helps a regulator monitor and detect unusual trades that could indicate insider trading	x No oversight of insider trading

Risk	A2: Education campaign and information pack	A3: Voluntary sector guidelines for NZU advisers	B2 Voluntary reporting of trades	C3: Price reporting	D3: Advisory regulator
<b>Money laundering and financing of terrorism</b>	O Not applicable	✓ Guidelines could raise advisers' awareness of money laundering or financing of terrorism, and prompt reporting of suspicious activities	x Parties that engage in money laundering or financing of terrorism are unlikely to report	✓✓ Helps a regulator monitor and detect unusual trades that could indicate money laundering or financing of terrorism	x No oversight of money laundering or price manipulation

- ✓✓✓ Strongly addresses risk
- ✓✓ Addresses risk
- ✓ Partially addresses risk
- x Does not address risk
- O Not applicable

**Table 19: Impact analysis of non-regulatory scenario**

Criterion	A2: Education campaign and Information pack	A3: Voluntary sector guidelines for NZU advisers	B2 Voluntary reporting of trades	C3: Price reporting	D3: Advisory regulator
<b>Integrity</b>	✓ Does not stop the provision of bad advice, but helps traders perform due diligence	✓✓ Sets the standard of good conduct	✓ Helps with understanding emission reductions, but does not address market integrity	x Self-reporting is unlikely to deter traders who are engaging in misconduct	✓ They are independent from the industry and can advise the Government on improvements to the ETS
<b>Minimal complexity and administrative cost</b>	✓✓✓ Minimises complexity for traders, with no administrative cost for participants and traders	✓✓✓ Minimises complexity for advisers, with no administrative cost for participants and traders	✓ Applied on a voluntary basis, but may be complex for some traders	✓✓ Easy to implement because this option involves adding a 'price' field to an existing NZ ETR report	✓ Some administrative cost to the Government, but with limited data collection powers
<b>Consistency and proportionality</b>	✓ Education campaigns are common practice, but may not be proportional given the risk of harm to traders	✓✓ Guidelines are common practice in service-based industries and a proportional response to the ETS's evolving market	✓ Transaction reporting occurs in other markets, but may not be a proportional response to detect misconduct	x Does not address the risks of misconduct, money laundering or financing of terrorism because the prices are not validated	✓ The independent nature of an advisory regulator supports effective governance
<b>Clarity and transparency</b>	✓✓✓ An information pack can present all the information traders need in one place	✓✓✓ Guidelines set a public standard of what to expect of an adviser	✓ Provides some insight into trades, but is unlikely to detect misconduct	✓ Clear to understand but the information is not validated and not shared publicly	✓ Limited transparency given lack of information collecting powers, but an independent regulator ensures misconduct is reported where discovered
<b>Market efficiency</b>	✓ Education campaigns support efficient price discovery by helping traders better understand the ETS	✓ Guidelines encourage advisers to give better advice to traders on price discovery	x No verification of trade information, which is important for detecting misconduct	x This information is in the registry and not public, so does not aid price discovery	x Some limited reporting helps with price discovery

✓✓✓	Strongly meets criteria
✓✓	Meets criteria
✓	Partially meets criteria
x	Does not meet criteria

## Balanced scenario

Table 20: Risk coverage analysis of balanced scenario

Risk	A3: Voluntary sector guidelines for NZU advisers + co-regulation	B4: Requiring exchange-based trading	C2: Position and purchase limits	D5: Market compliance regulator
<b>Poor advice</b>	✓✓ Improved quality of advice with the information pack + regulated by regulator	✓ Exchanges could be required to ensure independent participants are informed of the risks of trading	○ Not applicable	✓✓ Could require reporting and enforce compliance with primary legislation
<b>Conflict of interest</b>	✓ Advisers can be regulated by compliance regulator when conflict exists	○ Not applicable	○ Not applicable	✓✓ Could require reporting, and enforce compliance with primary legislation
<b>Transparency, monitoring and oversight of trades</b>	○ Not applicable	✓✓✓ Exchanges must report on trades, which can be monitored by a regulator	✓ Provides some monitoring and oversight of position	✓✓ Could monitor transactions and enforce compliance with primary legislation
<b>Credit and counter-party risk</b>	○ Not applicable	✓✓ Collateral can be required to engage in exchange-based trading	○ Not applicable	✓✓ Could monitor participants' accounts for credit and counter-party risks, and restrict trading of offenders
<b>Price manipulation</b>	○ Not applicable	✓✓✓ Helps a regulator monitor and detect unusual trades that could indicate price manipulation	✓✓ Prevents parties gaining undesirable power in the market	✓✓ Could monitor trades for potential price manipulation, enforce compliance with primary legislation, and restrict trading of offenders
<b>Insider trading</b>	○ Not applicable	✓✓✓ Helps a regulator monitor and detect unusual trading activity	○ Not applicable	✓✓ Could monitor trades and accounts, enforce compliance with primary legislation, and restrict trading of offenders
<b>Money laundering and financing of terrorism</b>	✓ Could help advisers identify money laundering or financing of terrorism, and voluntarily report suspicious activities	✓✓✓ Helps a regulator monitor and detect unusual trades that could indicate money laundering or financing of terrorism	✓✓ Limits scale at which money can be laundered in the market	✓✓ Could monitor trades for potential money laundering or financing of terrorism, enforce compliance and restrict trading of offenders

- ✓✓✓ Strongly addresses risk
- ✓✓ Addresses risk
- ✓ Partially addresses risk
- Not applicable

**Table 21: Impact analysis of balanced scenario**

Criterion	A3: Voluntary sector guidelines for NZU advisers + co-regulation	B4: Requiring exchange-based trading	C2: Position and purchase limits	D5: Market compliance regulator
<b>Integrity</b>	✓✓ Sets the standard of good conduct and a compliance regulator can issue penalties	✓✓✓ A regulated platform can detect market misconduct and report on trades	✓✓ Position and purchase limits are common features to prevent market power	✓✓✓ Issuing penalties ensures integrity
<b>Minimal complexity and administrative cost</b>	✓✓✓ Minimises complexity for advisers, with no administrative cost for participants and traders	✓✓ Some risk protection for small traders	✓✓ Setting limits via the NZ ETR results in no additional cost to participants	✓ Cost to the Government to set up a market compliance regulator
<b>Consistency and proportionality</b>	✓✓ Guidelines are common practice in service-based industries and a proportional response to the NZ ETS's evolving market	✓✓ Exchange-based trading is common practice in financial markets and helps expose any misconduct through trade reporting	✓✓ Position and purchase limits are common features in financial markets to limit the developing risk of misconduct	✓✓✓ Consistent with international ETSs and for good governance
<b>Clarity and transparency</b>	✓✓✓ Guidelines set a public standard of what should to expect of an adviser	✓✓✓ Exchanges can produce reports and charts which improve transparency for the public	✓✓✓ Limits are a simple mechanism to understand, the limits are public, and it is easy to monitor limits	✓✓✓ Enforcement and penalties send a public signal to industry of acceptable behaviour
<b>Market efficiency</b>	✓ Guidelines encourage advisers to give better advice to traders on price discovery	✓✓✓ Public price and volume trading provides the best price discovery	✓✓ Fairer NZU by limiting a trader's ability to manipulate prices and corner the market	✓✓✓ Access to market information and public reporting aid with price discovery

- ✓✓✓ Strongly meets criteria
- ✓✓ Meets criteria
- ✓ Partially meets criteria

## Risk mitigation scenario

Table 22: Risk coverage analysis of risk mitigation scenario

Risk	A4: Code of conduct, licensing and registration of NZU advisers	B4: Requiring exchange-based trading	C2: Position and purchase limits	D6: Market design regulator
Poor advice	✓✓✓ Advisers must comply with a detailed code of conduct, including penalties for non-compliance	✓ Exchanges could be required to ensure independent participants are informed of the risks of trading	○ Not applicable	✓✓✓ Could require reporting, enforce compliance and amend adviser requirements
Conflict of interest	✓✓ Advisers found to be acting when conflicted could have their licence suspended or revoked if detected	○ Not applicable	○ Not applicable	✓✓✓ Could require reporting, enforce compliance and amend adviser requirements
Transparency, monitoring and oversight of trades	○ Not applicable	✓✓✓ Exchanges must report on trades, which can be monitored by a regulator	✓ Provides some monitoring and oversight of position	✓✓✓ Could monitor trades, enforce compliance and amend trading rules
Credit and counter-party risk	✓ Advisers could be required to inform participants about credit and counter-party risks	✓✓ Collateral can be required to engage in exchange-based trading	○ Not applicable	✓✓✓ Could monitor participants' accounts for credit and counter-party risk, restrict risky trades, restrict trading of offenders, and amend collateral requirements
Price manipulation	○ Not applicable	✓✓✓ Helps a regulator monitor and detect unusual trades that could indicate price manipulation	✓✓ Prevents parties gaining undesirable power in the market	✓✓✓ Could monitor participants' trades for price manipulation, restrict risky trades or traders, address undesirable trading situations, and amend trading rules
Insider trading	○ Not applicable	✓✓✓ Helps a regulator monitor and detect unusual trades that could indicate insider trading	○ Not applicable	✓✓✓ Could monitor participants' accounts and trades for insider trading, restrict risky trades or traders, address undesirable trading situations, and amend trading rules
Money laundering and financing of terrorism	✓✓✓ Advisers could be required to undertake AML or CFT checks and report suspicious activity to a regulator	✓✓✓ Helps a regulator monitor and detect unusual trades that could indicate money laundering or financing of terrorism	○ Not applicable	✓✓✓ Could monitor participants' accounts and trades for money laundering or financing of terrorism, restrict risky trades or traders, address undesirable trading situations, and amend trading rules

- ✓✓✓ Strongly meets criteria
- ✓✓ Meets criteria
- ✓ Partially meets criteria
- Not applicable
- ✗ Does not meet criteria

**Table 23: Impact analysis of risk mitigation scenario**

Criterion	A4: Code of conduct, licensing and registration of NZU advisers	B4: Requiring exchange-based trading	C2: Position and purchase limits	D6: Market design regulator
<b>Integrity</b>	✓✓✓ Sets the standards of good conduct, and there is a penalty for falling below these standards	✓✓✓ A regulated platform can detect market misconduct and report on trades	✓✓ Position and purchase limits are common features to prevent market power	✓✓✓ Can issue penalties and amend the market rules to prevent further misconduct
<b>Minimal complexity and administrative cost</b>	x The highest administrative cost for participants	✓✓ Some risk protection for small traders	✓✓ Setting limits can be achieved via the NZ ETR and is an additional administrative cost for participants	x The most expensive and complex options to administer
<b>Consistency and proportionality</b>	x May be too onerous for advisers given the current evidence of the poor advice risk	✓✓ Exchange-based trading is common practice in financial markets and helps expose any misconduct through trade reporting	✓✓ Position and purchase limits are common features in financial markets	✓ The ability to amend market rules may not be proportional at this stage
<b>Clarity and transparency</b>	✓✓ This option provides the most standardised rules, but they are not always clearly understood by traders or the public	✓✓✓ Exchanges can produce reports and charts which improve transparency for the public	✓✓✓ Limits are a simple mechanism to understand, the limits are public, and it is easy to monitor limits	✓✓✓ Market rules are clear and transparent, and amended in consultation with industry
<b>Market efficiency</b>	✓✓ This option improves the quality of advice, and therefore price discovery, through a regulated framework	✓✓✓ Public price and volume trading provides the best price discovery	✓✓ Fairer NZU by limiting a trader's ability to manipulate prices and corner the market	✓✓✓ Access to market information and public reporting aid price discovery

- ✓✓✓ Strongly meets criteria
- ✓✓ Meets criteria
- ✓ Partially meets criteria
- x Does not meet criteria