

In Confidence

Office of the Minister for Climate Change

Chair, Cabinet Environment Energy and Climate Change Committee

Market governance for the New Zealand Emissions Trading Scheme: next steps

Proposal

1. This paper informs Cabinet how I plan to approach the next steps to address market governance risks relating to the NZ Emissions Trading Scheme (NZ ETS).
2. I propose to establish a separate market governance work programme to provide advice on a comprehensive package of options to ensure the full range of market governance issues are addressed. This will ensure that the proposals are fully developed and consulted on and the impacts on market participants are understood.
3. I propose to present a separate bill to amend the Climate Change Response Act 2002 (CCRA) and/or other Acts as necessary to be introduced to the House at a later date as it will not be possible to include these changes in the current bill.
4. In order to ensure that the proposals to address market governance risks are carefully considered in the context of this broader framework, I propose that tranche one decisions to explicitly prohibit insider trading and market manipulation and determine the appropriate regulator are now deferred and instead included in the scope of the market governance work programme.
5. I also propose to direct officials to progress any suitable non-regulatory options to address problems in the market in the short term.

Executive summary

6. The Government is reforming the NZ ETS to ensure the scheme is effective in assisting to meet emission reduction targets and in supporting the transition to a low-emissions and climate-resilient New Zealand. This requires amending the CCRA to provide:
 - certainty to the market of the long-term credibility and effectiveness of the NZ ETS by signalling the trajectory of our transition to a low-emissions economy
 - flexibility for the Government to manage the NZ ETS in changing circumstances.
7. I am in the process of bringing the tranche two amendments to Cabinet via a series of separate papers [CAB-19-MIN-0089 refers]. These amendments were anticipated to include further proposals to address market governance risks.
8. The current market governance framework of the NZ ETS is not fit for purpose as it does not adequately address risks around misconduct, market manipulation and lack of transparency. I propose to address this by establishing a work programme to provide advice on a broad and comprehensive market governance framework.

This will help ensure the integrity, efficiency and confidence in market trading in the NZ ETS and reduce the future risks of misconduct, which can distort the NZ ETS price and reduce the confidence in the scheme.

9. Due to their complexity, proposals for a broader, coherent market governance framework, as invited by Cabinet as part of the tranche one decisions [CAB-18-MIN-0606.01 refers], need to progress as part of this proposed market governance work programme. This will ensure that the proposals are fully developed and consulted on and the impacts on market participants are understood.
10. This proposed work programme will include implementing decisions already made during tranche one to prohibit insider trading and market manipulation and to determine the appropriate regulator. It will also address other risks to the market including:
 - the provision of inadequate, false or misleading advice to participants
 - transparency, monitoring and oversight of trades in the secondary market
 - money laundering/financing of terrorism in the NZ ETS
 - credit and counterparty risks
 - conflicts of interest.
11. I anticipate this work programme will result in the future introduction of a new amendment bill into the House.
12. A comprehensive and coherent approach to market governance in the NZ ETS is required in order for New Zealand to be viewed as a credible linking partner by established emissions trading schemes. This is necessary to retain the option of future access to high integrity international units. s 9(2)(j)

Background

What is market governance?

13. Good governance of the NZ ETS market is important because it can help to ensure the integrity, efficiency and confidence in market trading, and it can reduce the risks of misconduct, which can distort the NZ ETS price and reduce confidence in the NZ ETS.
14. Efficiency and market integrity are critical for price determination and transparency. In the NZ ETS, a more efficient market will ensure that the price of NZUs more accurately reflects the cost of carbon emissions, which in turn contributes to achieving New Zealand's emission reduction targets in the most cost-effective manner.
15. The risk of market misconduct is likely to increase in the future. This is due to the introduction of auctioning, the potential for higher NZU prices, and the possible inclusion of additional participants and the option for reopening of the NZ ETS to

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

Why do we need to put more attention on market governance?

16. The existing regulatory framework governing conduct in the NZ ETS is patchy and incomplete, creating risks to market function and trust.

17. The problems that officials have identified which require a broad, coherent framework to resolve include:

- market participants being provided with poor quality, false and/or inaccurate advice leading to a potentially inefficient and non-transparent secondary market.
- a lack of oversight leading to a potentially inefficient and non-transparent secondary market.

The NZ ETS currently has a patchy and incomplete market governance framework

18. The CCRA currently focuses on the establishment of the New Zealand Emissions Trading Scheme, rather than regulating the trading between participants.

19. While some types of misconduct fall under existing fraud¹, competition² and consumer laws³ and private contractual arrangements, there are substantial gaps in regulation.

20. Financial market regulations, such as those contained in the Financial Markets Conduct Act (FMCA), do not apply to the NZ ETS (with the exception of derivatives).

21. This patchwork of regulation means that there is no single regulator for the market. Instead, a number of regulators technically have roles in respect of the market. However the effectiveness of this arrangement appears to be low which is why improvements are needed.

22. The New Zealand situation differs from international emissions trading markets in that most international markets are much more strongly regulated. Several major international markets classify emissions units as financial products, meaning that they fall within the scope of financial market regulations.

Cabinet decided as part of tranche one to address key market governance risks

23. Cabinet decided in December 2018, as part of the tranche one improvements to the NZ ETS, to address priority governance issues considered to be a higher risk with the introduction of auctioning and to cover gaps in existing legislation.

24. Tranche one decisions included in principle agreement (subject to final decisions on the broader, coherent market governance framework) [CAB-18-MIN-0606.01 refers] to:

- prohibit insider trading and market manipulation in the NZ ETS market
- approach insider trading and market manipulation in the same manner as they are treated in the FMCA

¹ The Crimes Act 1961 which, among other things, prohibits various types of fraudulent conduct.

² The Commerce Act 1986, which, among other things, prohibits anti-competitive conduct.

³ The Fair Trading Act 1986, which, among other things, prohibits false and misleading conduct by those in trade.

- have penalties and offences for insider trading and market manipulation in the NZ ETS mirror the equivalent relevant penalties and offences in the FMCA.

25. Tranche one also:

- invited the Minister for Climate Change (and the Minister of Forestry as appropriate) to recommend final decisions on the broader, coherent market governance framework in the next tranche of NZ ETS decisions
- noted that Ministry for the Environment (MfE) officials would do further work determining the most appropriate regulator to enforce insider trading and market manipulation, including carefully considering which regulator would be most appropriate and ensuring that regulator is adequately resourced to deal with this conduct.

Analysis

Good market governance is complex and takes time to get right

26. It is challenging to balance over- and under-regulation for markets, particularly financial markets. Too little regulation may leave market participants exposed to high risks, but too much can stifle market participation and make it less efficient. For example, without good policy design, regulating advice provided to market participants with the intention of improving its quality could have the opposite effect, reducing the availability (and therefore quality) of advice altogether.

27. The NZ ETS market is also unique in that it includes a large number of effectively retail level participants, for example small forest owners. Most other emissions trading schemes have participants that can be categorised as wholesale. We need to recognise New Zealand's unique mix in the development of policy.

28. For these reasons, developing financial market regulations normally takes some years. For example, developing the new regime for financial advice took more than three years including multiple stages of consultation and an exposure draft of the legislation. This reflects the level of care and attention required to ensure regulations are robust and well-considered.

A separate market governance work programme is required to develop a broad, coherent framework

29. In light of this complexity, I propose to direct officials to initiate a separate market governance work programme to develop a broad, coherent market governance framework to address all governance risks within the NZ ETS.

30. Due to the importance of the market governance work, the complexity of the issues raised, and the potential impacts of the proposals on NZ ETS market participants and intermediaries, I consider that it is necessary to spend more time than originally allowed for in order to ensure that solutions are identified to address the full range of market governance issues.

31. The market governance work programme will consider proposals to appropriately address the following risks:

- the provision of inadequate, false or misleading advice to participants

- a potential lack of transparency, monitoring and oversight of trades in the secondary market leading to an inefficient market
- manipulation of the NZU price, including by spreading false market information, cornering or squeezing the market, or giving false impressions of market conditions
- insider trading, ie trading on the basis of material non-public information which, if it were made public, would likely have a significant effect on the price of NZUs
- money laundering/financing of terrorism in the NZ ETS
- credit and counterparty risks, where one party fails to deliver on their side of an agreement for NZUs. For example, a trade involving NZUs could take place whereby payment is made but the NZUs are not transferred because the selling party defaults
- conflicts of interest involving an NZ Emissions Trading Register (NZ ETR) account or a trade involving NZUs. For example, if advice were given about an NZU trade by a party that stood to benefit from that trade, there could be a real, or perceived, conflict of interest.

32. A longer time-frame would also allow us to consult with current market intermediaries (i.e. brokers, advisors, banks) and with a range of market participants, including NZ ETS participants and iwi/Māori. Consultation with all stakeholders is important to ensure we fully understand the impacts of our proposals, avoid unintended consequences and lower the risk of stifling market activity.

33. Addressing these issues will likely require development of a bespoke regime for the NZ ETS and a cross-agency work programme to ensure that agencies with the appropriate expertise in market regulation, such as the Ministry for Business, Innovation and Employment (MBIE), can support this work.

34. Under current emission projections it is unlikely that New Zealand will be able to meet its nationally determined contribution (NDC) for 2021 to 2030 under the Paris Agreement through domestic action alone. It is therefore likely that access to high integrity international units may be required to cost-effectively meet the NDC while also setting up New Zealand's long term transition. Cabinet has agreed to retain the option for future governments to use international carbon markets after 2020 under certain circumstances, noting that accessing international units is a last resort rather than a first choice [CAB-18-MIN-0248].

35. s 9(2)(i)

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Determining and appointing a market regulator needs to be part of the market governance work programme

37. A key aspect of any market governance regime is the selection of a market regulator and determining their role and functions. Most market regulators are Crown entities tasked with providing oversight of the operation of their target market.
38. The functions of the market regulator may include overseeing and licensing market operators (including existing secondary market operators) or market intermediaries, regulating the provision of advice, investigating breaches of rules regarding misconduct and creating and stewarding rules for market operation.
39. Proposals to define the roles and functions of the market regulator will have a significant impact on existing market operators and market participants. Therefore it is important to ensure that there is time to consult with all stakeholders before decisions are taken.

Insider trading and market manipulation to be included in the market governance work programme

40. Decisions taken during tranche one of the NZ ETS improvement to prohibit insider trading and market manipulation require a market regulator in order to be enforced. I am now proposing that the determination and appointment of a market regulator occur later as part of the separate market governance work programme.
41. Prohibiting insider trading and market manipulation requires the appointment of an interim regulator, however there is a risk that taking early decisions on an interim market regulator would be inconsistent with the later development of the broader market governance framework.
42. In order for insider trading prohibitions to work effectively a disclosure regime may also be required. The introduction of such a regime may create a range of issues for participants that require time to work through.
43. Therefore, in order to ensure that these tranche one decisions on insider trading and market manipulation are addressed within the context of the wider market governance framework, I propose that implementation of these decisions is included in the market governance work programme.
44. Including the implementation of these decisions in the market governance work programme will mean that these behaviours are not prohibited within the NZ ETS when auctioning begins during 2020. I am presenting a related Cabinet paper today to enable an 'auction monitor' to be established to mitigate auction integrity risks and provide independent oversight of the auctions.

Anti-money laundering

45. Currently transactions occurring in the NZ ETS market are not covered by the Anti-Money Laundering and Countering Financing of Terrorism Act 2009.
46. The Ministry of Justice strongly recommend keeping all anti-money laundering legislation in one place. Therefore considering how the NZ ETS market may fit within this existing legislative framework should form part of the new market governance work programme.

Consideration of non-regulatory options, particularly provision of advice

47. The quality of advice provided to market participants is a concern that may require addressing during 2019. Issues have been identified regarding the quality of advice provision in the NZ ETS for small landowners, including iwi/Māori.
48. In the long-term the risks presented by this problem may be reduced by legislative reform, but even immediate legislative reform would not reduce this risk during 2019.
49. I therefore propose to recommend to officials to consider non-regulatory options to progress this work during 2019 and to consider a range of options that may include:
- discussing with industry the possibility of establishing a voluntary code of conduct
 - Government publication of additional guidelines for advice provision
 - targeted engagement/consultation with potentially affected stakeholders.
50. I further propose that officials consider progressing any non-regulatory options that may be identified to address other key risks within the scope of the market governance work programme during 2019.
51. While non-regulatory options may address some concerns, the risks identified in relation to the current market governance framework will continue and may increase with the introduction of auctioning, or dependent on decisions related to agriculture.

Consultation

52. Consultation in August and September 2018 sought submitter views on the extent to which seven misconduct risks may exist in the NZ ETS market and/or may become more prevalent in future. The risks consulted on include:
- false or misleading advice provided to participants
 - a potential lack of transparency, monitoring and oversight of trades in the secondary market
 - manipulation of the NZU price (referred to as market manipulation)
 - insider trading
 - money laundering/financing of terrorism
 - credit and counterparty risks
 - conflicts of interest.
53. The majority of submitters who replied acknowledged that the risks outlined in the consultation document are things that should be addressed by the Government, and agreed that these risks are likely to increase in the future. In particular submissions received on this question from businesses/industry groups, the electricity sector, non-government organisations and individuals were more likely to identify the risks above as future risks rather than current.
54. However, there was a consistent message from submitters that any design changes should be carefully considered and well signalled, as they are likely to be

disruptive to market intermediaries. Further consultation will be necessary on any proposed approach to ensure that changes take stakeholder views into account and are proportionate.

Agency Consultation

55. The following agencies were consulted on this paper: the Ministry of Business, Innovation and Employment, the Ministry for Primary Industries, Treasury, the Ministry for Foreign Affairs and Trade, the Environmental Protection Authority, the Department of Conservation, Te Puni Kōkiri, the Ministry of Transport and the the Ministry of Justice. The Department of the Prime Minister and Cabinet was informed.

Financial implications

56. There are no financial implications for the Government resulting from this Cabinet paper. The financial implications of the market governance work programme will be outlined when further proposals are brought back to Cabinet.

Legislative implications

57. Policy decisions resulting from the market governance work programme are likely to require legislative amendment to the CCRA and/or other relevant legislation.

58. Subject to the usual process for agreeing the next Legislation Programme, the market governance work programme will result in an amendment bill to be introduced at a later date.

Regulatory impact analysis

59. A regulatory impact assessment is not required for this Cabinet paper as it does not contain regulatory proposals.

Human rights

60. The proposals in this paper are consistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Crown-Māori Partnership

61. Māori have a significant stake in climate change action, and a significant interest in the NZ ETS. Māori have a large economy and asset base sitting largely in the primary industries, as well as Treaty-based rights and interests in natural resource use and management. It will be critical when implementing the proposals to continue to adhere to Treaty of Waitangi principles as provided by section 3A of the CCRA.

62. A Māori Leaders' Forum was held in Wellington on 17 September 2018 as part of consultation on improvements to the NZ ETS. The Ministry for the Environment plans to further engage with iwi/Māori on a range of environmental issues through a series of hui in May. This will include discussions on the NZ ETS and seek views on how we can best support iwi/Māori ahead of consultation on regulations

anticipated for the second half of this year and further consultation for the market governance work programme.

Gender implications

63. There are no gender implications arising from this paper.

Disability perspective

64. There are no disability implications arising from this paper.

Publicity

65. Announcements about the NZ ETS need to be managed carefully to avoid any inconsistencies and market risks, including sudden NZU price rises in the NZ ETS. In addition, information should not be disseminated in a way that advantages some markets participants over others and compromises NZ ETS investments.

66. I intend to make public announcements on the proposed amendments to the CCRA and the Climate Change Response Amendment Bill as part of a wider climate change communications plan, in consultation with other Ministers.


Proactive Release

67. Once public announcements have been made, I propose to proactively release this paper on MfE's website in whole, subject to redactions as appropriate and equivalent to those under the Official Information Act 1982.

Recommendations

The Minister for Climate Change recommends that the Committee:

1. **note** that the current market governance framework of the NZ ETS is not fit for purpose, as it neither ensures the integrity, efficiency and confidence in market trading in the NZ ETS nor addresses the risks of misconduct which could distort the NZ ETS price and reduce the confidence in the NZ ETS.
2. **note** as part of the tranche one amendments to the Climate Change Response Act 2002 (CCRA), Cabinet agreed in-principle (subject to final decisions on the broader, coherent market governance framework) to:
 - prohibit insider trading and market manipulation in the NZ Emissions Trading Scheme (NZ ETS) market
 - approach insider trading and market manipulation in the same manner as they are treated in the Financial Markets Conduct Act (FMCA)
 - have penalties and offences for insider trading and market manipulation in the NZ ETS mirror the equivalent relevant penalties and offences in the FMCA.
3. **note** that a separate market governance work programme is required due to the importance of the market governance work, the complexity of the issues raised, the new issues that have emerged since tranche one and the potential impact of any proposals on NZ ETS stakeholders.

4. **note** that a comprehensive and coherent approach to market governance in the NZ ETS is required in order for New Zealand to be viewed as a credible linking partner by established emissions trading schemes with high integrity international units, ^{s 9(2)(j)}

5. **agree** that the Ministry for the Environment (MfE) will work with the Ministries for Primary Industries and Business, Innovation and Employment to prepare a broad, coherent market governance package to address all identified market governance risks including:
 - false or misleading advice provided to participants
 - a potential lack of transparency, monitoring and oversight of trades in the secondary market
 - manipulation of the NZU price (referred to as market manipulation)
 - insider trading
 - money laundering/financing of terrorism
 - credit and counterparty risks
 - conflicts of interest.
6. **invite** the Minister for Climate Change to report back to Cabinet by the end of November on a plan to progress the market governance work programme.
7. **direct** officials to, in the short-term, prioritise any non-regulatory options to address any of the problems identified as part of the market governance work programme, with a particular focus on advice provision.

Authorised for lodgement.

Hon James Shaw

Minister for Climate Change