

Report to

**Efficient Market Services Ltd (trading as Unlisted)**

**Economic Appraisal of Minister of Commerce's  
Arguments for Making a Declaration regarding Unlisted  
under Section 36D of the Securities Markets Act 1988**

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<b>Contents</b>	<b>Page</b>
<b>Executive Summary</b>	<b>1</b>
<b>1. Overview</b>	<b>6</b>
<b>2. Background and Interpretation</b>	<b>7</b>
2.1 Unlisted and Other New Zealand Securities Markets	7
2.1.1 Unlisted	7
2.1.2 New Zealand Exchange (NZX)	9
2.1.3 Other Security Trading Mechanisms	9
2.2 Sections 36A to 36E of Securities Markets Act 1988	10
2.3 Officials' Draft Guidelines on Exercise of Minister's Power	11
2.4 Interpretation	12
2.4.1 Section 36D Likely Detriments Test	12
2.4.2 Officials' Draft Guidelines	13
2.4.3 Counterfactual	16
<b>3. Regulation and the Potential for Cross-Market Disturbances</b>	<b>18</b>
3.1 Introduction	18
3.2 Extent to which Unlisted is "Unregulated"	18
3.3 Evidence on Cross-Market Disturbances	21
3.3.1 International	21
3.3.2 New Zealand	23
3.4 Mechanisms underlying Cross-Market Disturbances	27
<b>4. Response to the Minister's Arguments</b>	<b>31</b>
4.1 Introduction	31
4.2 Summary of Minister's Letter	31
4.3 Size and Nature of Unlisted	32
4.3.1 Significance of Unlisted's Presence	32
4.3.2 Extent of Shareholder Exposure to Adverse Events	33
4.4 Comparative International Regulation	34
4.5 Regulatory Differences and Arbitrage	35
4.6 Potential for Confusion	36
<b>5. Implications of Unlisted becoming a Registered Exchange</b>	<b>38</b>
<b>6. Conclusions</b>	<b>40</b>

<b>Appendices</b>	<b>Page</b>
<b>Appendix 1 – Sections 36A to 36E, Securities Markets Act 1988</b>	<b>42</b>
<b>Appendix 2 – Officials’ Draft Guidelines on Exercise of Minister’s Power</b>	<b>44</b>
<b>Appendix 3 – Letter from the Minister of Commerce</b>	<b>46</b>

## **Important Notice**

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## **Executive Summary**

### **Unlisted**

Unlisted is an internet-based security trading and information dissemination platform, enabling subscribing companies to post company announcements over a centralised website (as opposed to company websites, or via other media, if at all) for free access by all, and to facilitate trading in those companies' various types of security (e.g. shares, convertible notes). It was established in December 2003 to provide a "cost-efficient, easy way for small to medium sized companies to trade their shares and to keep their shareholders informed."

Unlisted has been trading since February 2004, and currently has 21 subscribed companies, with a combined market capitalisation at the beginning of February 2005 exceeding \$880 million. These companies have a median number of shareholders of around 530, a median ownership stake of around 75% for the largest 20 shareholders, and a median foreign ownership stake of less than 1.5% (compared with almost 50% for firms having shares listed with New Zealand Exchange Limited, NZX). Institutional ownership of Unlisted issuers – whether by local or overseas institutions – is negligible. By providing a centralised platform for bilateral, or over-the-counter (OTC) trading, Unlisted reduces trading (including search) costs, and generally contributes to the price discovery process, creating price transparency and liquidity for companies that would otherwise trade via decentralised OTC.

### **Other New Zealand Securities Markets**

NZX is New Zealand's only registered stock exchange. Its markets comprise the main share board (NZSX), a debt market (NZDX), and a growth-oriented board for small to medium-sized businesses (NZAX).

Shares can also be traded through unregistered Sharemart NZ Limited, and debt-type instruments can be traded via Debex, The New Zealand Debentures Exchange. Other than through these organised trading platforms, trading occurs via decentralised, OTC markets, none of which is subject to the Securities Market Act.

### **Registered Exchanges under Securities Markets Act 1988**

Only exchanges registered under the Securities Markets Act may hold themselves out as a "stock exchange" or "securities exchange", which are terms defined in the act and which denote coverage by that Act's insider trading prohibitions, and continuous disclosure and other requirements (Appendix 1 reproduces the relevant sections of the Act). The Minister of Commerce may require a trading services provider to become a registered exchange under Section 36B of the Act if and only if the following Section 36D test is satisfied:

*36D Criteria and process for applying restriction on operating securities markets—*

- (1) The Minister may declare that section 36B applies to a person only if he or she is satisfied that the result of that section not applying to the person is likely to be detrimental to—
  - (a) the integrity or effectiveness of securities markets in New Zealand; or
  - (b) the confidence of investors in securities markets in New Zealand.

The structure of the Securities Markets Act, decisions of Cabinet, and acknowledgement of officials, point to acceptance that not all exchanges must be registered in New Zealand. Instead, it is anticipated that issuers and investors will choose among registered exchanges and unregistered securities trading facilities based on their risk appetites, preferred regulatory coverage, and other relevant factors. This presumes that both groups are able to competently make such a choice, just as the Act elsewhere presumes that investors are competent to assimilate and understand information made available to them where its continuous disclosure obligations apply. The approach in the Act deliberately differs to that taken in other jurisdictions, so as to not hamper the development of smaller and/or more innovative markets in New Zealand.

### **Application of Section 36D Test**

Officials have issued non-binding draft guidelines to assist in determining when the Section 36D test applies (reproduced in Appendix 2). These relate to parties' perceptions regarding a trading operator's activities and the extent to which they may give rise to confusion regarding their regulatory status, regulation of comparable operators overseas, the size of an operator's activities, and perceived or actual discriminatory or unfair treatment of market participants. They are relevant only to the extent they have a bearing on the Section 36D test.

Furthermore, in applying the Section 36D test the Minister must show that there are real, direct, measurable and material detriments of the required sort likely to arise if a securities trading facility is not required to become a registered exchange. This would need the required detriments to be demonstrated on robust theoretical grounds, backed up by empirical and/or experimental evidence. In particular, it would be necessary for the Minister to show that there is a channel by which the required detriments would be likely to arise. The Minister's determination would also need to weigh any status quo detriments of the required sort with those arising should a securities trading facility be required to become a registered exchange under the Act.

### **Minister's Arguments for Unlisted to become a Registered Exchange**

The Minister of Commerce has written to M-co, advising her intent to require Unlisted to become a registered exchange under the Securities Markets Act (letter attached as Appendix 3). In support of her position the Minister argues that Unlisted is now of a size that there are sufficient investors at risk of adverse events of the type regulated by the Act that the Section 36D test is satisfied. This conclusion is also based on

her belief that Unlisted would face such regulation if it operated in comparable jurisdictions overseas. It is further based on her concern that Unlisted is engaging in regulatory arbitrage, undercutting registered exchanges on regulatory coverage, and that Unlisted's activities are in some respects sufficiently similar to those of registered exchanges as to give rise to investor confusion.

The Minister's arguments, and officials' draft guidelines:

- 1) Overstate the extent to which Unlisted is "unregulated". Unlisted and its issuers operate within an overall legal environment that international research demonstrates is among the most protective of investors in the world. Moreover, marginal regulatory measures, such as those now contained in the Securities Markets Act, are of themselves not determinative of the level of investor protection, and research indicates that for developed markets such as New Zealand's they have no or only little incremental protective effect. Focusing only on explicit regulation ignores the numerous other formal and informal means by which issuers and securities trading facilities compete to ensure investors are offered their required level of protection, including investor self-selection of trading venues and issuers with which they are most familiar and comfortable. Focusing on comparable regulation of like operators overseas overlooks the fact that in respect of bank sector regulation – where systemic risks are higher than for securities markets – the Reserve Bank of New Zealand has chosen to diverge from approaches commonly adopted elsewhere. It also overlooks the fact that NZX itself recognises that NZSX and NZAX warrant differing levels of conformity with international governance norms.
- 2) Contradict the presumption underlying the Act that registered exchanges and unregistered securities trading facilities can properly coexist, with investors choosing their preferred level of regulatory coverage, seeming instead to suggest that unregistered securities trading facilities are inherently likely to satisfy the Section 36D test.
- 3) Contradict the presumption that investors are sufficiently sophisticated to understand information made available to them by continuous disclosures required of issuers subject to the Act, in that they suppose investors are not sufficiently sophisticated to distinguish Unlisted's regulatory status from that of registered exchanges, despite clear and unequivocal disclaimers on the subject posted on Unlisted's website
- 4) Draw a very long bow to connect the issues identified with Unlisted and the required Section 36D detriments, offering little by way of causal nexus, making no reference to theory or empirical evidence, and ignoring key features of Unlisted that mean it lacks the channels or substance required to transmit adverse events to other New Zealand securities markets.
- 5) Assume a faulty counterfactual, in that the effect of requiring Unlisted to become a registered exchange is unlikely to extend the coverage of the Securities Markets Act, instead driving existing transparent trading on Unlisted back to predominantly OTC trading, or trading on other unregistered venues (such as Sharemart) and thereby reducing its reach.

- 6) Mistakenly view Unlisted's rapid growth as a threat to, rather than a signal of, New Zealand's securities markets' integrity and effectiveness, and investor confidence therein. .

## Theory and Evidence on Cross-Market Disturbances

International evidence suggests that the risk of a major collapse of share prices on Unlisted is extremely low – in the order of once every 40 years. The chance of such a collapse, should it occur, transferring to NZSX or NZAX (or Sharemart, for that matter) is a fifth of that extremely low probability – i.e. once every 200 years. Furthermore, the risk of a collapse on Unlisted transferring to New Zealand's debt markets (e.g. NZDX, or Debex) is the lowest of all such cross-market disturbances, being much less common than once every 200 years. In any event there is just as much chance of debt markets gaining from a flight to quality in the highly unlikely event that Unlisted experience a widespread collapse. Indeed, NZX might be expected to gain from a collapse on Unlisted – as unlikely as such a collapse is – through a flight to liquidity.

International evidence on major cross-market disturbances identifies three key elements distinguishing cases where cross-market disturbances occur from those where they do not:

- 1) a prior surge in inflows of international capital;
- 2) unanticipated precipitating negative macroeconomic announcements; and
- 3) the presence of a leveraged common creditor(i.e. commercial banks, hedge funds or bondholders) who helped to propagate the disturbance across borders.

Since Unlisted issuers tend to be closely held and locally owned, without significant ownership by highly leveraged and diversified international or local investors, Unlisted lacks a critical mechanism for transmitting adverse shocks from it to other markets. Given its inconsequential size relative to New Zealand's main securities markets – representing a mere 1.2% of total securities market capitalisation and less than 0.1% of daily trading volume and value (averaging a mere five trades per day on average) – it is hard to see how even a major adverse event on Unlisted could have any measurable effect on New Zealand's other securities markets. To the contrary, theory predicts that adverse events – to the extent they are significant enough to be transmitted within let alone across a New Zealand market – are unlikely in any event to result in adverse consequences for New Zealand's main and most developed markets, NZX.

Recent New Zealand corporate history – the crises experienced by Air New Zealand, Tower and Tranz Rail, and the collapse of Access Brokerage – show that even major corporate crises have little discernable impact (if any) on even their own trading venues, let alone other New Zealand securities markets. It therefore seems unlikely that any adverse event on Unlisted would have discernable effects in other New Zealand markets. This view is reinforced by the fact that multiple recent Credit Union failures in New Zealand had no discernable impact on bank depositor confidence, which would arguably be more sensitive to systemic contagion than securities markets.

## **Implications of Unlisted becoming a Registered Exchange**

Requiring Unlisted to comply with the Securities Markets Act is unlikely to measurably improve New Zealand's overall securities markets arrangements. It is likely to result in Unlisted's current activity migrating to less transparent venues beyond the reach of the Act. This would adversely affect the development of venture capitalism in New Zealand, as well as limit the capital raising options for New Zealand's smaller issuers. It is also likely to spawn its own form of investor confusion, namely the moral hazard risk associated with investor misperceptions regarding regulatory and government guarantees. Such misperceptions are fuelled by NZX's voluntary underwriting of losses suffered by Access Brokerage customers, and government rescue packages for failing "strategic" companies such as Air New Zealand and Tranz Rail.

Unlisted's forced registration would also therefore detrimentally affect the competitive makeup of New Zealand's securities markets. The development of "third" and "fourth" markets is a worldwide phenomenon facilitated by advances in communications technology. Theory and practice shows that these markets, while often remaining on the fringe of mainstream exchange trading, impose important disciplines on exchanges that have typically enjoyed market dominance for decades. These disciplines have resulted in improved service levels and reduced trading costs. By stifling Unlisted, and signalling to would-be like providers that they face a similar fate should they be too successful, this important embryonic competition would be lost.

## **Conclusion**

Unlisted's rapid growth – which complements rather than substitutes for that of NZAX – should be taken as a sign of issuer and investor confidence in the integrity and effectiveness of Unlisted as well as New Zealand's other securities markets. Mature markets can withstand diversity. The fact that an unregulated venue has enjoyed rapidly growing patronage is a clear sign of revealed investor preference, and hence investor confidence in Unlisted's integrity and effectiveness. This suggests the Section 36D test is in this case not relevant, let alone satisfied.

## **1. Overview**

Our analysis of the proposal to require Unlisted to become a registered exchange under Section 36D of the Securities Markets Act proceeds in four steps.

First, in the next section, we provide some background information on New Zealand market trading facilities – including Unlisted – and explore the relevant sections of the Act.

The remaining sections focus on the economics of requiring Unlisted to become a registered exchange. In Section 3, we examine two issues:

- 1) the extent to which Unlisted trading activity is truly unregulated; and
- 2) the potential for adverse events in one market to have a negative effect on other markets, these being prerequisites for the view that not requiring Unlisted to become a registered exchange can potentially impair the effectiveness and integrity of New Zealand securities markets.

Of course, even if such impairment can occur, it need not follow that the conditions for doing so are met in Unlisted's case. Section 4 therefore considers, one by one, the arguments raised by the minister supporting her intention to declare Unlisted subject to the Act.

Finally, we also examine the wider picture. Even if Unlisted's current mode of operation does have the potential to hurt New Zealand securities markets, it need not follow that it should be required to become a registered exchange. In Section 5, we outline some additional factors that should also be taken into consideration.

## **2. Background and Interpretation**

### **2.1 Unlisted and Other New Zealand Securities Markets**

#### **2.1.1 Unlisted**

Unlisted is owned and operated by Efficient Market Services Ltd, a joint venture involving The Marketplace Company (M-co) and individuals involved in the New Zealand finance sector. According to Unlisted's website ([www.unlisted.co.nz](http://www.unlisted.co.nz)), it was established to provide a "cost-efficient, easy way for small to medium sized companies to trade their shares and to keep their shareholders informed." It is an internet-based security trading and information dissemination platform, enabling subscribing companies to post company announcements over a centralised website (as opposed to company websites, or via other media, if at all) for free access by all, and to facilitate trading in those companies' various types of security (e.g. shares, convertible notes). Some of its subscribing companies had been listed on the unlisted securities market discontinued by New Zealand Exchange Limited (NZX) in 2004, and migrated to Unlisted subsequently. Others joined Unlisted after having their shares traded in the bilateral or "over-the-counter" (OTC) market, which is the norm for most small companies to medium-sized companies in New Zealand.

Unlisted was established in December 2003, has been trading since February 2004, and currently has 21 subscribed companies with a combined market capitalisation at the beginning of February 2005 of at least \$883 million (based on 21 of its 25 traded securities for which there were trades on the measurement date). Based on responses from Unlisted's issuers to a survey conducted in February 2005, each company has a median number of shareholders of around 530, a median ownership stake of around 75% for the largest 20 shareholders, and a median foreign ownership stake of less than 1.5% (compared with almost 50% for NZX, PricewaterhouseCoopers 2002). Institutional ownership of Unlisted issuers – whether by local or overseas institutions – is negligible.

All trading on Unlisted occurs through approved stockbrokers, who are able to enter or remove bids and offers at any time and trading occurs from 9am to 5pm, Monday to Friday. Brokers set their own fees to clients for trades in Unlisted stocks, but to date pay Unlisted no fees per trade. Trades are settled by brokers using their standard agreements with clients and other brokers. Orders are generally matched in standard price then time priority.

By providing a centralised platform for OTC trading, Unlisted reduces trading (including search) costs, and generally contributes to the price discovery process, creating price transparency and liquidity for companies that would otherwise trade via decentralised OTC (see Madhavan's 2000 survey of market microstructure for a discussion of these market metrics). It also increases its subscribing companies' "bankability", in that their market values are more easily ascertained than when valuation appraisals must be obtained, and also their attractiveness to venture capitalists, by providing them with a market-based entry/exit option. Unlisted is therefore intended to appeal to:

- 1) small to medium-sized businesses for which main stock exchange listing is uneconomic (e.g. due to trading infrequency or level of listing costs);
- 2) companies with small shareholder bases, or shareholding restrictions or other non-standard governance arrangements (which can preclude listing on registered exchanges);
- 3) high-growth/high-risk and less mature companies; and
- 4) companies seeking an intermediary step before listing on a registered exchange.

It has no on-platform capital raising capacity, contributing indirectly to capital raising for its subscribing companies through improved price formation, price transparency and trading liquidity, and through enhanced issuer profile with investors.

Unlisted's business model is more subscription-based than transaction-based, since its companies' securities trade infrequently. Unlike exchanges, it provides no settlement or clearing facilities. These features are reflected in its choice of an internet-based technology platform, which does not facilitate real-time, exchange-type trading, but instead offers a low-cost means of widely distributing information while being refreshed sufficiently often to support its level of trading activity. Unlisted states that it would need to make a substantial investment in information technology, and would experience an associated increase in cost structure, if it was to match the level of service provided by exchange-type operators such as NZX.

Unlisted is not a registered exchange under the Securities Markets Act 1988 (discussed further in Section 2.2), and hence is not subject to the regulatory requirements under that Act. Its website contains a prominent disclaimer reading:

“Unlisted is a trading facility that is not a registered stock exchange under the Securities Markets Act. Investors in companies quoted on Unlisted are not protected by the Securities Market Act's protections relating to insider trading, continuous disclosure, Directors' and officers' relevant interest disclosure or Substantial security holder disclosure. The Takeovers Code does not apply unless the company has 50 or more shareholders and \$20 million or more of assets, and the usual regulatory assurances associated with a registered exchange and Securities Commission enforcement of them are not available.”

In recognition of the unregistered nature of the Unlisted trading platform and the participating issuers, anyone trading shares in Unlisted issuers is required by their broker to sign an investor information statement confirming that the purchaser recognises that Unlisted is an unregistered facility, and that the obligations for issuers on Unlisted are not as high as for issuers whose shares are traded on a registered exchange. Unlisted sets terms and conditions for both issuers and brokers which they must accept before they can use its services. Unlisted can “delist” its participants for detected instances of market abuse or fraud, but does not actively monitor or seek out such instances (i.e. it has only minimal self-regulation).

### **2.1.2 New Zealand Exchange (NZX)**

New Zealand Exchange Limited (NZX) is New Zealand’s only registered stock exchange. Its markets comprise:

- 1) the main share board, “New Zealand Stock Market” (NZSX, 222 listed securities);
- 2) the “New Zealand Debt Market” (NZDX, 85 listed securities), including corporate and government bonds and other fixed interest securities; and
- 3) a growth-oriented board for small to medium-sized businesses, the “New Zealand Alternative Market” (NZAX, 23 listed securities), also targeting companies with non-traditional structures (such as co-operatives and mutual societies), having a “more flexible” regulatory regime than the main board.

NZX operates real-time information technology to facilitate fully electronic securities exchange, incorporating trading, and settlement, as well as other information and support services.

Unlike Unlisted, NZAX provides on-platform capital raising as well as real-time exchange services. It is subject to the regulatory requirements of the Securities Markets Act 1988. NZX claims that NZAX is cost efficient for firms wishing to raise \$10 million or more, but that other capital sources (such as venture capital) are more cost-efficient for smaller amounts. It is targeted at companies with annual turnover of \$5 to 50 million, with the only minimum criterion being that the company has at least 50 shareholders. Unlike NZSX, which is moving towards globally aligned corporate governance standards, NZAX allows for governance arrangements more suited to New Zealand’s environment and the types of companies for which an NZSX listing is infeasible, uneconomic or simply not preferred.

### **2.1.3 Other Security Trading Mechanisms**

In addition to Unlisted and NZX, shares can be traded through a screen-based, electronic trading system, Sharemart NZ Limited ([www.sharemart.co.nz](http://www.sharemart.co.nz)). Sharemart currently trades around 40 companies, mostly unlisted property companies. Debt-type instruments can be traded via Debex, The New Zealand Debentures Exchange ([www.debentures.co.nz](http://www.debentures.co.nz)). Other than through these organised trading platforms, decentralised OTC securities trading occurs through company secretaries (sometimes involving company websites), rural accounting firms (e.g. forestry partnership interests) and the like, none of which openly post prices and other relevant information, and hence facilitate price discovery, transparency or liquidity in the way that Unlisted does. Also, none of these alternative platforms is subject to the Securities Market Act, and because of their

lack of transparency it is not possible to accurately quantify the extent of their trading (or gauge the extent of any trading anomalies).

## 2.2 Sections 36A to 36E of Securities Markets Act 1988

These sections are reproduced in Appendix 1. According to New Zealand government officials:<sup>1</sup>

“The Securities Markets Amendment Act 2002, which was implemented on 1 December 2002, inserted registration provisions for securities exchanges into the Securities Markets Act 1988. Section 36A of the Act prohibits any person from carrying on business in New Zealand using the title or style “stock exchange” or “securities exchange” unless they apply to become a registered exchange and follow the requirements specified in the Act. This prohibition also applies if they hold themselves out, or imply that they are, authorised or regulated as a securities exchange. Any entity whose shares are traded on a registered exchange’s market must enter into a listing agreement and are thereby subject to the listing rules and securities laws.

“This regime was intended to give investors clarity about which entities that provide trading facilities for securities are regulated by New Zealand law, so that they can then make an informed decision about whether they want to trade through an entity that offers statutory protections or not. It also gives entities seeking to have their securities traded the choice to opt in or opt out of being regulated by New Zealand law.

“The regime was developed so as not to discourage the development of smaller, more innovative markets, potentially affecting the ability for small or start-up businesses (whose shares are often traded on less formal systems) to raise capital, and to encourage competition in relation to securities trading facilities. A regime that regulated all securities trading facilities and then exempted smaller markets would incur compliance costs for persons setting up these facilities and may discourage such facilities from developing.”

Similarly, officials state:<sup>2</sup>

“In making policy decisions in this area, Cabinet agreed that not all markets need to be regulated. Specifically, Cabinet agreed not to adopt the Australian approach in this area – to regulate all markets, subject to exceptions. . . . It was intended that companies should have the ability to decide whether to be part of a registered market and take advantage of the reputational advantages this provides, or use other facilities without these advantages.

“The Securities Markets Act regime then provides a certain amount of flexibility for securities trading in an unregulated space.”

Section 36B prohibits a person to whom that section applies from operating a securities market in New Zealand unless they are a registered exchange or a subsidiary of a registered exchange, and sets out penalties for contraventions of this requirement.

Under Sections 36C and 36D of the Securities Markets Act 1988 the Minister of Commerce can declare that Section 36B applies to a person, and hence that that person may not operate a securities market in New

<sup>1</sup> *The Marketplace Company's Unlisted Securities Facility*, dated 26 September 2003, released under the Official Information Act.

<sup>2</sup> *The Unlisted Securities Trading Platform*, 28 July 2004, RCP 04/237, released under the Official Information Act.

Zealand unless they become a registered exchange and fulfil the regulatory requirements imposed under that Act. Specifically, those statutory requirements relate to continuous disclosure obligations, insider trading restrictions, disclosure requirements where company directors and officers have “relevant interests” in traded securities, substantial security holder disclosure, and exchange rule approval and regulatory oversight.

However, the Minister can only make such a declaration if that person’s operations, if not required to comply with these statutory requirements, is likely to be detrimental to the integrity and effectiveness of securities markets in New Zealand, or to the confidence of investors in securities markets in New Zealand. The precise statutory test the Minister must satisfy in order to make this declaration is set out in Section 36D:

*36D Criteria and process for applying restriction on operating securities markets—*

- (1) The Minister may declare that section 36B applies to a person only if he or she is satisfied that the result of that section not applying to the person is likely to be detrimental to—
  - (a) the integrity or effectiveness of securities markets in New Zealand; or
  - (b) the confidence of investors in securities markets in New Zealand.

Section 36E enables the Minister of Commerce to exempt a securities market from any of these provisions, on terms or conditions that the Minister thinks fit, with advice from the Securities Commission.

## **2.3 Officials’ Draft Guidelines on Exercise of Minister’s Power**

Appendix 2 contains draft guidelines, dated 20 November 2003, prepared by officials to give market participants further guidance as to the matters the Minister might consider when assessing whether there is a need to exercise the powers contained in Sections 36B to 36D. Officials emphasise that none of the draft guidelines are determinative or derogate from the requirements of the Securities Markets Act 1988.

The draft guidelines comprise the following factors:

1. How investors, potential investors, participants of the market, other participants in securities markets generally, and other interest groups' perceive the market, including whether the market is sufficiently similar to a registered exchange to cause confusion in investors' minds;
2. Whether the operator seeks to regulate (or is perceived to regulate), in a manner analogous to general securities regulation or any registered exchange, the conduct of activities occurring on its market, or the behaviour of its participants, or the public perception of the market or its participants, through the use of Rules, Codes of Conduct, Guidelines or other means, beyond those controls that are necessary for the operation of the system;
3. The proportion (or perceived proportion) of the total New Zealand market activity, including size, number, volume, type or importance of: companies listed, executed trades, and overall market percentages;

4. Comparative international regulation of securities markets/facilities, including the types of market that attract regulatory requirements or exemptions from regulatory requirements; and
5. The operation of the market and its treatment of participants, and whether the operation of the facility causes (or is perceived to cause) unfair or discriminatory treatment of market participants.

Additionally, while not linked to the Section 36D criteria, nor the guidelines themselves, officials suggest that the underlying policy rationale of the Act may be helpful when considering the exercise of the Minister's declaratory power. In particular, reference is made to the desire to facilitate the development of smaller and/or more innovative markets in New Zealand bearing in mind (among other factors) the costs of registration.

## **2.4 Interpretation**

### **2.4.1 Section 36D Likely Detriments Test**

The clear point at issue is whether or not the Minister has shown, by the reasons set out in her letter of 15 December 2004 (attached as Appendix 3), whether a failure to require Unlisted to become a registered exchange, and hence that its trading activities and the companies that use its services become subject to the requirements regarding continuous disclosure (etc) under the Securities Markets Act 1988, is likely to be detrimental to the integrity or effectiveness of, or investor confidence in, New Zealand's securities markets ("the required detriments"). There are no other grounds under the Act on which the Minister may force such registration.

We presume that the required detriments must be not only likely, which implies the possibility of a real, direct and measurable effect, but also material in scale. It would seem unlikely, for example, that the Act intends Unlisted to be required to become a registered exchange simply because a single investor failed to understand its regulatory status and felt disadvantaged as a consequence. It would similarly appear unreasonable to force registration simply because the continuing existence of Unlisted outside of the Act might be argued to lead to some vague, immeasurable or inconsequential adverse effect for either Unlisted or one or more other of New Zealand's securities markets.

Indeed, it would appear reasonable to suggest that the required detriments test would not be satisfied unless it could be demonstrated, based on robust theoretical principles backed up by empirical and/or experimental evidence, that Unlisted's continued operations outside of the Securities Markets Act is likely to directly lead to significant security price declines, materially reduced market participation, reduced trading activity, increased trading costs, reduced market efficiency or some other such actual detriment, on one or more of New Zealand's securities markets. It would need to be shown that there is some mechanism or channel by which a causal connection could be made between these. Moreover, this determination should weigh such status quo detriments against any like detriments arising if Unlisted is required to register. This would take

into account what changes may occur in Unlisted's and its participant companies' and other market participants' activities upon registration (i.e. allowing for "unforeseen consequences," or the likely "counterfactual" – more below).

It should be noted that even if the Minister is able to show that the required detriments are likely to arise if Unlisted is not required to become a registered exchange, this does not oblige the Minister to impose that requirement. Section 36D(1) makes it clear that the Minister "may" make the relevant declaration, not that he or she must do so upon satisfaction of the test. The Act is silent on the matters the Minister must or may wish to consider in exercising this residual discretion, but on its face the section anticipates that the Minister may change his or her view regarding the likelihood or extent of the required detriments, and/or that counter-veiling considerations may be taken into account. Such other factors would presumably include matters other than those affecting the integrity or effectiveness of, or investor confidence in, New Zealand's securities markets, such as regulatory compliance costs, or the impact of regulation on market development, market coverage and competition in security trading services. They would also appear to be contemplated by officials in the light of the policy objectives summarised above, and referred to in the draft guidelines.

#### **2.4.2 Officials' Draft Guidelines**

As to the status of the officials' draft guidelines, while the legal rules of statutory interpretation may require consideration of Parliament's intentions when the Securities Markets Amendment Act was enacted, where the criteria set out in Section 36D are clear, those guidelines are pertinent only to the extent they are consistent with those criteria. Hence the guidelines, if they are to have any force, must relate to the question of whether or not allowing Unlisted to continue operating outside of the Securities Markets Act 1988 requirements is likely to be detrimental to the integrity or effectiveness of, or investor confidence in, New Zealand's securities markets. Each is interpreted below.

##### *First Officials' Draft guideline*

The first draft guideline, relating to various parties' perceptions regarding Unlisted, or regarding any similarities it shares with registered exchanges (or any confusion possibly arising therefrom), has two limbs: (1) parties' perceptions of the trading activity; and (2) the narrower issuer of whether the activity is sufficiently similar to a registered exchange so as to confuse investors. The first limb seems to suggest that if investors think it is an exchange, then it ought to be a registered exchange. That of course is at direct odds with the structure and intent of the Securities Market Act 1988, as discussed earlier. Section 36 of the Act contemplates unregistered securities trading facilities operating alongside registered exchanges, and companies and investors competently discerning and opting for their preferred level of regulatory coverage. Thus the mere existence of unregistered securities trading facilities cannot itself be likely to cause the detriments required to be shown before registration can be forced.

The second limb of the first draft guideline presumably distinguishes the case of where an unregistered securities trading facilities mimics all the features of a registered exchange – including any statutory investor protections – by means other than regulation, since in this case investors would not be confused in thinking the unregistered securities trading facilities is similar to a registered exchange. Instead it must relate to the case where an unregistered securities trading facilities is sufficiently similar to a registered exchange, but for the Securities Markets Act’s regulatory provisions, that investors might mistakenly believe it complies with the Act’s requirements. This of course is at odds with the statutory presumption noted above, that investors are competent to discern and opt for the level of regulatory coverage they desire. However, setting that to one side, for this second limb to have content it must be shown that such investor confusion leads to a direct, material and measurable effect on security prices, market participation, trading activity or the like, on one or more of New Zealand’s security markets, for the Section 36D test to be satisfied.

#### *Second Officials’ Draft guideline*

The second draft guideline suggests that attempts (whether actual or perceived) by Unlisted to self-regulate, “beyond those controls that are necessary for the operation of the system,” and in a way which may or may not be analogous to the manner in which registered exchanges are regulated, is likely to cause the relevant detriments. This cannot reasonably be an argument that statutory regulation should apply if a trading platform adopts substantive self-regulation, since where self-regulation effectively replicates statutory regulation the required detriments test would clearly not be relevant. Instead it must be an argument that there is some level of self-regulation at which investors do not receive the level of protection afforded by the Securities Markets Act, but beyond which they may mistakenly believe they do, and that beyond this level the required detriments are likely to be caused. More plainly, it includes the case where actual or perceived self-regulation is used to dupe investors into using securities markets under the false belief that they enjoy different types of regulation to those actually in place. Clearly fraudulent misrepresentations should be proscribed, as they are for Unlisted like any other New Zealand company, under the Fair Trading Act. Once again, however, the presumption appears to be at odds with investors’ and companies’ otherwise presumed competence to discern and opt for their preferred level of regulatory coverage. Either they are or they are not, but clearly they cannot be both. Even allowing for specific cases where unsophisticated investors are at risk of making a genuine mistake, for the detriments test to be satisfied under this draft guideline it would be necessary to show that this risk gives rise to a direct, material and measurable effect on investment flows, trading activity, security valuations or the like, on one or more of New Zealand’s security markets.

#### *Third Officials’ Draft guideline*

The third draft guideline, relating to actual or perceived scale of securities market activity, suggests that simply having a sizeable (however measured) security market that is not subject to the Securities Markets

Act, is inherently likely to cause the required detriments. The presumption appears to be that securities markets not subject to the Securities Markets Act requirements, irrespective of other laws and regulations with which they must comply, and irrespective of whether or not they impose self-regulation, are inherently likely to cause the required detriments. This follows because mere market scale is not inherently detrimental to market integrity or effectiveness, or investor confidence – if it were, then no market would prosper unless and until it was subject to the Securities Market Act. The mere existence of a sizeable stock exchange in New Zealand prior to the Securities Markets Act is sufficient to show that markets can enjoy integrity and efficiency, and investor confidence, without Securities Markets Act protections. Thus, this draft guideline also conflicts with the Act’s intent that registered exchanges and unregistered securities trading facilities coexist, and presumption that companies and investors are competent to discern and opt for their preferred level of regulatory coverage. However, setting that to one side, the argument appears to be that once a security market reaches a certain scale, this presumed inferiority of markets not subject to the Act becomes material or otherwise reaches a level likely to satisfy the required detriments test.

#### *Fourth Officials’ Draft guideline*

The fourth draft guideline, relating to comparative international regulation, suggests that differences in regulatory treatment of like securities markets, whether within or across national markets, are likely to cause the required detriments. This hints at regulatory variation being inherently undesirable: that in effect, intra- and inter-national regulatory conformity is necessary for overall market integrity and effectiveness, and to ensure investor confidence. It is perhaps suggested with a mind to investors familiar and comfortable with overseas regulatory regimes, and is consistent with the stance taken by NZX that governance for NZSX issuers should move towards greater conformity with international norms. Noting that the Securities Markets Act deliberately differs from the Australian approach, this draft guideline presumably allows for the possible desirability of regulatory variation – that some investors, domestic or foreign, might prefer certain regulatory environments over others, and that different investors may be better suited to certain markets and regulatory arrangements than others (which perhaps explains why NZAX issuers, unlike NZSX issuers, are not to be required by NZX to move towards international governance norms). It also presumably allows for regulatory variations being necessary or desirable for different kinds of market activity, security types, or issuers (which to some extent officials’ appear to acknowledge in the materials quoted earlier). The question is begged, however, as to the precise point at which local regulatory variations become likely to be detrimental to market integrity or effectiveness, or investor confidence, considering also the scope for non-regulatory mechanisms to provide investors with their preferred regulatory coverage.

#### *Fifth Officials’ Draft guideline*

The fifth and final draft guideline relates to actual or perceived discriminatory or unfair treatment of market participants arising on a securities market not subject to the Securities Market Act. The presumption appears

to be that such actual or perceived discriminatory or unfair treatment of market participants would be less likely to arise on a securities market subject to the Act, even allowing for non-regulatory mechanisms that attenuate any adverse effects of such treatment, or indeed, supervisory or enforcement failures where discriminatory or unfair treatment is prohibited. Not least among these non-regulatory mechanisms is the natural self-selection by which investors incline towards trading venues with which they are familiar and most comfortable. It is instructive to note that Officials have stated: “We are not aware of any suggestion of unfair treatment to participants on Unlisted.”<sup>3</sup>

#### **2.4.3 Counterfactual**

There appears to be a presumption underlying both the Securities Markets Act and officials’ draft guidelines that trading activity conducted on an unregistered facility such as Unlisted will remain on that (or a similar) platform when registration occurs. This is a critical assumption, as unregulated trading activity commonly occurs outside of organised securities markets or exchanges, and does so outside of the requirements of the Act. Indeed, the bulk of trading activity now conducted on Unlisted was previously conducted through less transparent, decentralised OTC arrangements. If Unlisted is required to become a registered exchange, companies that currently use the facility may simply return to OTC trading. In Section 5, we present some evidence suggesting that this is indeed the most likely outcome.

If Unlisted’s current trading activity migrates to a registered Unlisted or other registered exchanges, this might have entirely different implications for the integrity and effectiveness of, and investor confidence in, New Zealand’s securities markets, than if it returns instead to decentralised, OTC trading. Indeed, if Unlisted’s trading activity should return to OTC trading, which is not subject to the Securities Market Act, the requirement that Unlisted comply with that Act would then be self-defeating, as the detriments presumed to arise with trading outside of the Act’s requirements would then be predicted (under the Act’s logic) to be exacerbated, not lessened. Moreover, it must be asked whether the trading activity currently taking place on Unlisted might simply migrate to some other platform facilitated by electronic communications advances (e.g. Sharemart, or Trademe).

The essential point is that the Securities Market Act applies, if at all, to operators of registered exchanges, not to exchange itself. Trading activity (i.e. exchange) will continue to occur through whichever available venue best meets the needs of those undertaking that trading activity, irrespective of whether or not Unlisted or any other party is required to comply with the Securities Market Act. That is, unless all possible other such parties are also required to comply with the Act, in which case it would effectively be exchange itself that is regulated.

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<sup>3</sup>

*The Unlisted Securities Trading Platform*, 28 July 2004, RCP 04/237, released under the Official Information Act.

### **3. Regulation and the Potential for Cross-Market Disturbances**

#### **3.1 Introduction**

In this section, we focus on two issues. First, we critically examine the view that Unlisted trading is inherently unregulated, or at least insufficiently regulated. If sufficient protections already exist for the types of investor who participate in Unlisted companies, then it is difficult to see how Unlisted trading is any more likely to undermine New Zealand securities markets than is trading on other platforms, including those operated by NZX. Second, we investigate the potential for adverse events to migrate across markets. A collapse by a company trading on Unlisted, even if attributable to a lack of regulation, has no implications for the effectiveness and integrity of New Zealand securities markets if its effects remain in-house.

#### **3.2 Extent to which Unlisted is “Unregulated”**

In the Minister’s letter and official documents there is frequent reference to Unlisted’s “unregulated” status. This overstates the case: Unlisted is subject to a different level of regulation to that of registered exchanges, but this does not mean it is not subject to a host of other laws governing its conduct, not to mention any self-governance provisions it has in place, or fundamental economic disciplines on the nature and quality of its services.

It is important to emphasise that Unlisted is a company, and its issuers are companies, subject to New Zealand’s Companies Act, with its numerous fundamental shareholder protections, augmented by the protections of the Crimes Act and Serious Fraud Office Act. All of these companies are subject to the Fair Trading Act, which prohibits misleading conduct in trade. Unlisted’s companies must comply with the Takeovers Act and the Takeovers Code to the same extent that Code Companies must where traded on any other trading facility. Financial information disclosures are regulated under the Financial Reporting Act. And all these companies are subject to the common law, which provides protections to owners in addition to statutory protections, and the jurisdiction of a legal system that is commonly classified among the most efficient in the world. Unlisted and its issuers are clearly regulated – the only questions remaining are to what extent, and are any differences material?

A large body of empirical evidence based on global data has grown over the past decade establishing a clear association – but not causal relationship – between legal protections for investors and the strength of capital markets measured as stock market capitalisation as a percentage of GNP. Recent examples include Johnson 2000 and La Porta et al. 2000. One of the clearest findings of this literature is that investor protection and legal enforcement are significantly better in common law countries, which include New Zealand, than in civil law countries. While strong market regulation is found to be an effective substitute for weak law enforcement in countries with weak legal systems and poor investor protection. New Zealand does not fall into this category, instead ranking among those countries with the highest levels of investor protection

according to the criteria used by La Porta et al. (which, it should be noted, do not include continuous disclosure requirements or insider trading prohibitions, and predated New Zealand's Securities Markets Amendment Act).

Even if this were not the case, authors such as Rajan and Zingales 2003 and Berglof and von Thadden 1999 caution against drawing the naïve policy implication from La Porta et al.'s evidence that countries should automatically aim to strengthen legal protections for minority shareholders. Berglof and von Thadden instead suggest that improvements in investor protection require the overhaul of entire legal systems, which in New Zealand's case would appear more than unwarranted. They even warn that protecting smaller investors may also attract international portfolio investors, a highly volatile source of funds (a point returned to in Section 3.4). La Porta et al. themselves state (La Porta et al. 1999, p. 15): "the most developed financial markets are the ones in which investors are best protected from expropriation by insiders. [But the research] does not tell us what the best form of such protection is, which may well include self-regulation and judicially enforced laws, as well as government regulation."

Moreover, international evidence on the impact of insider trading laws and their enforcement shows that while such laws can be beneficial for emerging and transition economies, they show no or only negligible benefit for developed economies such as New Zealand (Bushman et al. 2005). Such evidence is consistent with the weight of evidence that insider trading is not necessarily any more detrimental than insider trading prohibitions, given mechanisms investors can use to reduce any informational disadvantages they have relative to insiders, and because of the fundamental role insider trading can play in disseminating price-sensitive information (e.g. Chiang and Venkatesh 1988, Holden and Subrahmanyam 1992, Bainbridge 2000, Bhattacharya and Nicodano 2001; but see also O'Hara 2003). It is also consistent with evidence that insider trading is less of an issue for smaller, closely-held firms, such as those on Unlisted (Hauser et al. 2003), and predictions that market makers face incentives to detect and discourage any harmful insider trading even absent statutory insider trading prohibitions (Chowdhry and Nanda 1991). The conclusion for New Zealand would appear to be that its legal system is fundamentally protective of investor rights, and hence that marginal changes to those rights – such as those introduced by the Securities Markets Amendment Act – may have little or no incremental value.

Furthermore, this literature also emphasises that mechanisms other than laws and regulations can compensate for any inadequacies in investor protections. Ownership concentration (where few owners own most of companies, such as family-controlled companies) is one such compensation found to be protective where laws or enforcement are weak. So too are high gearing levels (i.e. ratio of debt to total funding) and dividend payout rates (i.e. dividends as a proportion of profits), both of which force firms to disgorge free cash flows. And firms are able to satisfy investors' desired level of investor protection by issuing securities in those investors' preferred regulatory jurisdictions (e.g. Johnson 2000, Siegel 2005), or by cross-listing in multiple countries' exchanges. For example, developing market issuers can use American Depository Receipts, or ADRs, allowing access to US capital markets without requiring full listing. Moreover, dynamic considerations mean that issuers wishing to raise share capital or maintain equity levels to enhance their

borrowing capacity have strong incentives to ensure minority investors are not harmed by majority investors (Gomes 2000).

For example, companies can voluntarily adopt information disclosure policies that reduce their cost of capital, with large firms benefiting most from increased disclosure (Diamond and Verrecchia 1991, Easley and O'Hara 2004), meaning firms themselves bear a cost if they do not cater to their investors' disclosure preferences. In New Zealand's case, of course, investors ultimately have a choice between different levels of regulatory coverage by trading OTC, on platforms such as Unlisted or Sharemart which are not subject to the Securities Markets Act, or on registered exchanges such as NZSX or NZAX. Conversely, evidence from the US following the imposition of uniform information disclosure rules in 2000 (Regulation FD) shows that small firms on average were found to have lost analyst following, and to have experienced higher forecast errors and volatility at earnings announcements, and higher costs of capital (Gomes et al. 2004). Thus there are possibly strong economic grounds for Unlisted's companies to opt for disclosure levels other than the continuous disclosure required for registered exchanges. Firms can even have private incentives to disclose more information than is socially optimal (Fishman and Hagerty 1989). As Kim 1993 states (p. 747): "In general there is no optimal disclosure policy that is best for all shareholders." It should therefore be expected that different firms will optimally choose to disclose different levels of information, firms which fail to meet their investors' preferences will suffer, and that even without strict regulation investor preferences are likely to be catered to.

Thus it is unfair to suggest that Unlisted is "unregulated". By international standards it is subject to laws and a legal system shown to be among the world's best in terms of investor protections – and this before passage of the Securities Markets Amendment Act. Noting the marginal benefit (if any) of incremental protections such as insider trading laws, where Unlisted is relatively unregulated the import of this difference would appear insignificant. Moreover, should it not be insignificant, the ownership and capital structures of Unlisted's issuers, and their dividend and disclosure policies – not to mention any self-governance provisions adopted by Unlisted – can provide investors with compensating protections should they need or desire them. In the final analysis, investors can arbitrage regulatory differences across New Zealand's existing securities markets in either direction.

Indeed, if Unlisted is not providing its investors with their requisite level of protection, its very advent now provides them with a more effective way to reduce their Unlisted issuer holdings and migrate to regulated venues such as NZX, should they consider those venues to offer a more desirable regulatory coverage. To the extent such a process occurs, this would force Unlisted's issuers, and Unlisted itself, to move their investor protections closer to those offered by Unlisted's alternatives. To date this migration has not occurred, suggesting Unlisted's investors are content with their level of regulatory protection. The very fact that 21 issuers have opted to trade on Unlisted's platform since the company's establishment in December 2003, and that its trading levels have been growing, suggest that Unlisted enjoys investor confidence, and has added to the integrity and effectiveness of New Zealand's securities markets.

### **3.3 Evidence on Cross-Market Disturbances**

#### **3.3.1 International**

##### *Likelihood of Intra- and Cross-Market Disturbances*

How likely is it that a collapse by one of Unlisted's companies would undermine confidence in NZ capital markets generally? One way to address this question is to consider the international evidence on financial market contagion, the extent to which shocks in one market carry over into other markets, within and across countries and security types.

The worst-case scenario, and certainly the one where contagion is most likely to occur, is when an entire market receives a major shock. Significant securities market disturbances, like major earthquakes, are notable, but are also extremely rare. Cross-market disturbances, where adverse events on one market spill over to other markets, are even rarer still, and indeed, adverse events on one market often lead to gains on other markets (for reasons such as the so-called flight to quality). Direct empirical evidence on these likelihoods for developed economies, in this case the G-5 (France, Germany, Japan, United Kingdom and United States), is provided by Hartmann et al. 2001. In summary, they find:

- 1) Stock market crashes in the order of 20% weekly loss and bond market crashes in the order of 8% weekly loss happen about once or twice per human lifetime respectively (e.g. for the US a stock market crash happens about once every 40 years);
- 2) G-5 stock markets experience a co-crash in about one of five crashes (i.e. once every 200 years);
- 3) Bond markets experience co-crashes even less regularly (around half as frequently as stock market co-crashes), and co-crashes between stock and bond markets are least commonly experienced (i.e. widespread securities market meltdowns in the main industrialised countries happen much less than once every 200 years); and
- 4) The flight to quality phenomenon is about as common as the co-crash of a stock and bond market (i.e. both are very rare, but bond markets are positively affected as often as they are negatively effected by stock crashes) – “highlighting some limits to the (‘systemic’) propagation of financial market crises within and between G-5 countries.” (p. 6)

In short, the risk of even a major collapse of share prices on Unlisted transferring to NZSX or NZAX (or Sharemart, for that matter), assuming the relevant transmission mechanisms are as great as those among G-5 countries (and this is questioned in Section 3.3), is a fifth of the low probability of such a collapse occurring in the first place. The risk of a collapse on Unlisted transferring to New Zealand's debt markets (e.g. NZDX,

or Debex) is even lower. Indeed, there is just as much chance of debt markets gaining from a flight to quality in the highly unlikely event that Unlisted experiences any collapse.

### *Flight to Quality and Flight to Liquidity*

There is growing evidence that the flight to quality phenomenon is augmented by an associated flight to liquidity phenomenon. Vayanos 2004 and Longstaff 2001 discuss and provide evidence in support of the latter, in which investors can suddenly exhibit a preference for holding liquid assets, especially during highly volatile periods. Thus disturbances on Unlisted could be predicted to spur a flight to more liquid markets, including NZX, in addition to the usual flight to higher “quality” bond markets. In this case there is a further positive case for disturbances on Unlisted leading to gains on New Zealand debt markets, but now a case for NZX, with its higher liquidity, to also gain from such a disturbance. Both the flight to quality and flight to liquidity phenomena, which are theoretically and empirically supported, suggest that a disturbance on Unlisted may actually benefit New Zealand’s securities markets (depending on the relative size of losses on Unlisted and gains elsewhere).

### *Factors in, and Non-Contributors to, Cross-Market Disturbances*

Where major cross-market disturbances have arisen, it is critical to note that in no instances were these precipitated by a single company’s failure, or due to an unexplained loss of investor confidence absent some other major precipitating event (even the infamous collapse of Long Term Capital Management in 1998 was a result of a Russian government debt default rather than the cause of the ensuing international financial disturbance). Certainly mere regulatory differences between markets have not spawned losses in investor confidence. Kaminsky et al. 2003, analysing financial crises over 1980-2000, show that where such crises occur, it is usually due to government or regulator actions, such as country or government debt defaults, exchange rate depreciations, or currency floatations. Moreover, they show that there are three key elements – their “unholy trinity” – distinguishing cases where cross-market disturbances occur from those where they do not:

- 1) a prior surge in inflows of international capital;
- 2) unanticipated precipitating negative macroeconomic announcements; and
- 3) the presence of a leveraged common creditor(i.e. commercial banks, hedge funds or bondholders) who helped to propagate the disturbance across borders (see also Dornbusch et al. 2000).

Significantly, the presence or absence of investor protection regulations such as those contained in the Act do not seem to be important in determining the likelihood of cross-market contagion.

Finally, while there is some evidence that poor investor protections can exacerbate the extent of declines in response to adverse events, this does not show that the lack of such protections affects the likelihood of, or vulnerability to, adverse events. Johnson et al. 2000 find evidence from the 1997-1998 Asian financial crisis suggesting that corporate governance variables, and the protection of basic minority shareholder rights in particular, are at least as important as macroeconomic factors in explaining the extent of stock market and currency declines. However, these factors do not indicate which countries are vulnerable to a loss of confidence. Also, given the significant differences between investor protections offered in New Zealand and those in the Asian countries covered by this research, they are unlikely to offer much guidance on the likely extent of declines in response to adverse market events in New Zealand.

Thus, to the extent that issuers trading on Unlisted do not have structural or other features compensating for the fact that they are not covered by Securities Markets Act protections – and to the extent that their investors seek those protections and are therefore unsatisfied – not only does this predict a migration of capital from Unlisted to NZX, but on this evidence also that the extent of an adverse event on Unlisted should be worse for Unlisted's issuers than if it were regulated under the Securities Markets Act. It says nothing, however, about the impact of such an event on NZX issuers, or about whether Unlisted is more or less vulnerable to a loss of confidence. It therefore says nothing about whether or not Unlisted's unregistered status poses a greater or lesser risk of a loss of investor confidence in other New Zealand securities markets.

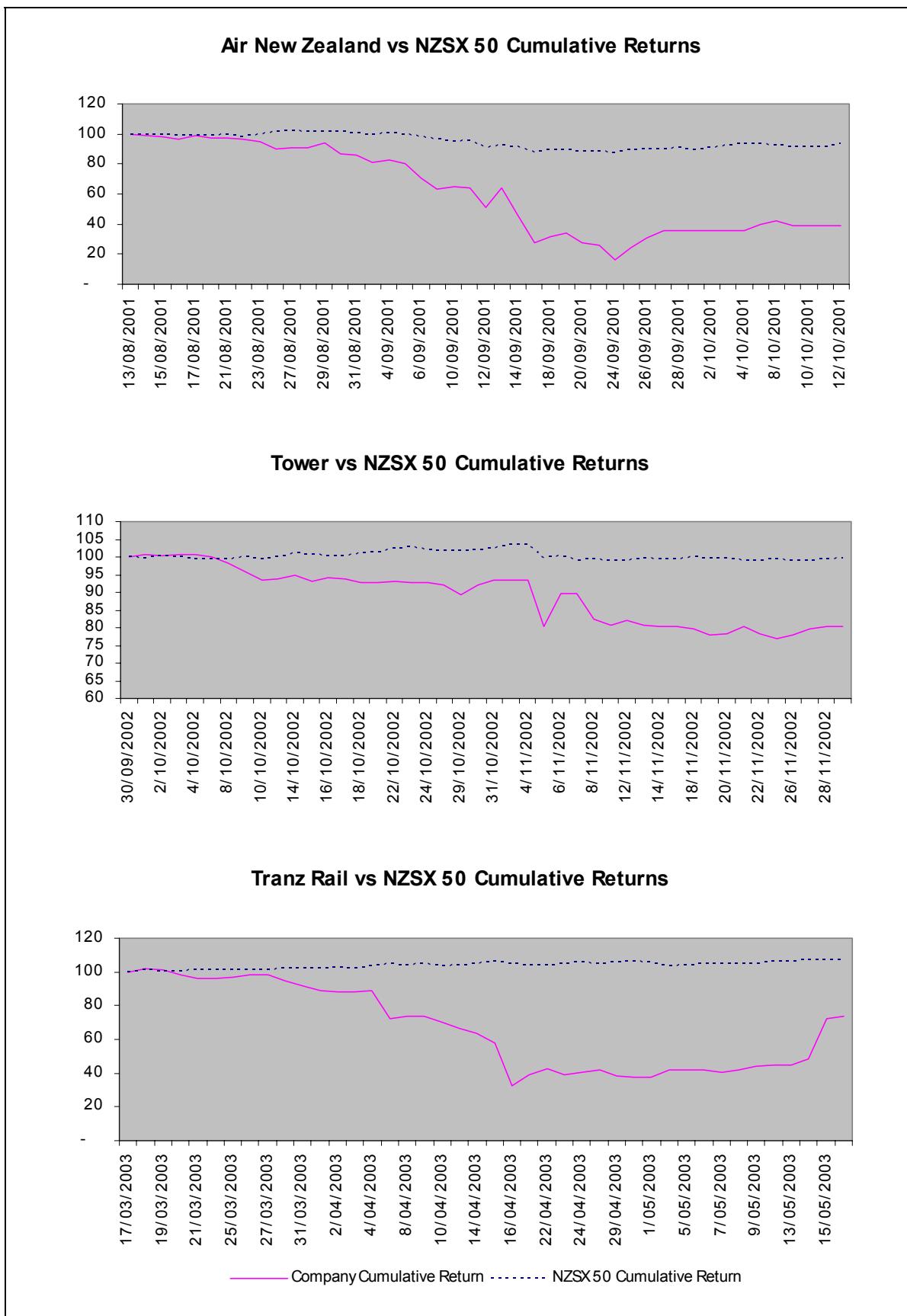
### **3.3.2 New Zealand**

#### *Air New Zealand, Tower and Tranz Rail*

The previous sub-section considered the evidence for the proposition that systemic problems in one market transfer to others, both within and across countries and market types, and found it lacking. To focus on the narrower issue of intra-country cross-market disturbances, we examine some recent crises that have occurred in major NZX companies. As we show below, these have had little or no impact on investor confidence in New Zealand capital markets, so it seems unlikely that the relatively insignificant event of an Unlisted company collapse or similar adverse event could do so.

Figure 1 plots cumulative gross returns for Air New Zealand, Tower and Tranz Rail (now Toll NZ) over a period consisting of a month either side of their recent crises, and compares these with concurrent movements in the NZSX 50. In each case, the crises involved significant own-price declines, but barely caused a ripple in the NZSX 50. They barely moved their own markets, so it seems reasonable to surmise that they made even less of a dent on New Zealand's other security markets (and if they did, possibly positively).

**Figure 1. Impact on NZSX of Recent NZX Corporate Crises**

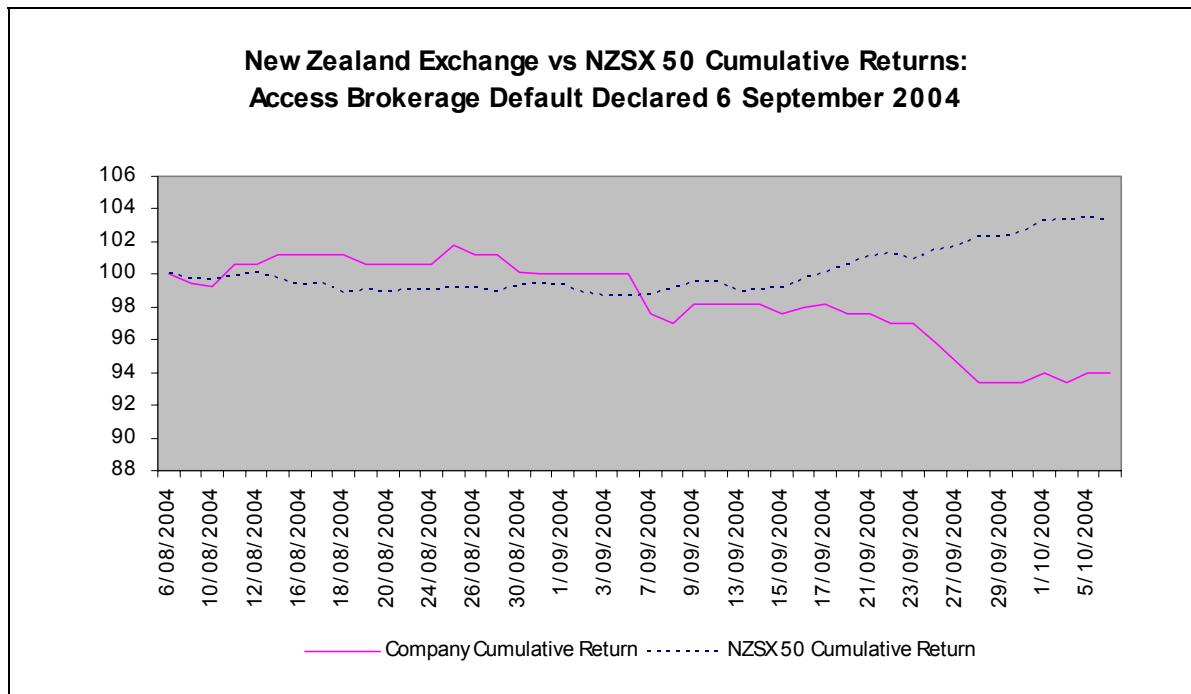


The greater market reaction in the case of Tower, despite it being half the relative size of Air New Zealand, is explicable in terms of its own shareholdings in NZSX. When Tower's problems became clear, it faced increased liquidity needs to meet investor withdrawals and margin calls on its borrowing facilities, requiring it to sell-down some of its own significant holdings in New Zealand securities, thereby providing a channel for market-wide impacts from its own crisis. It might also reflect the number of Tower shareholders – 116,000 – which is very high for a New Zealand company. But even in Tower's case the impact was small and short-lived. It is therefore no surprise that the Air New Zealand and Tranz Rail crises, in which neither company held significant stakes in other New Zealand shares, and both of which had substantially fewer shareholders than Tower, should have caused no measurable decline in the NZSX 50.

#### *Access Brokerage*

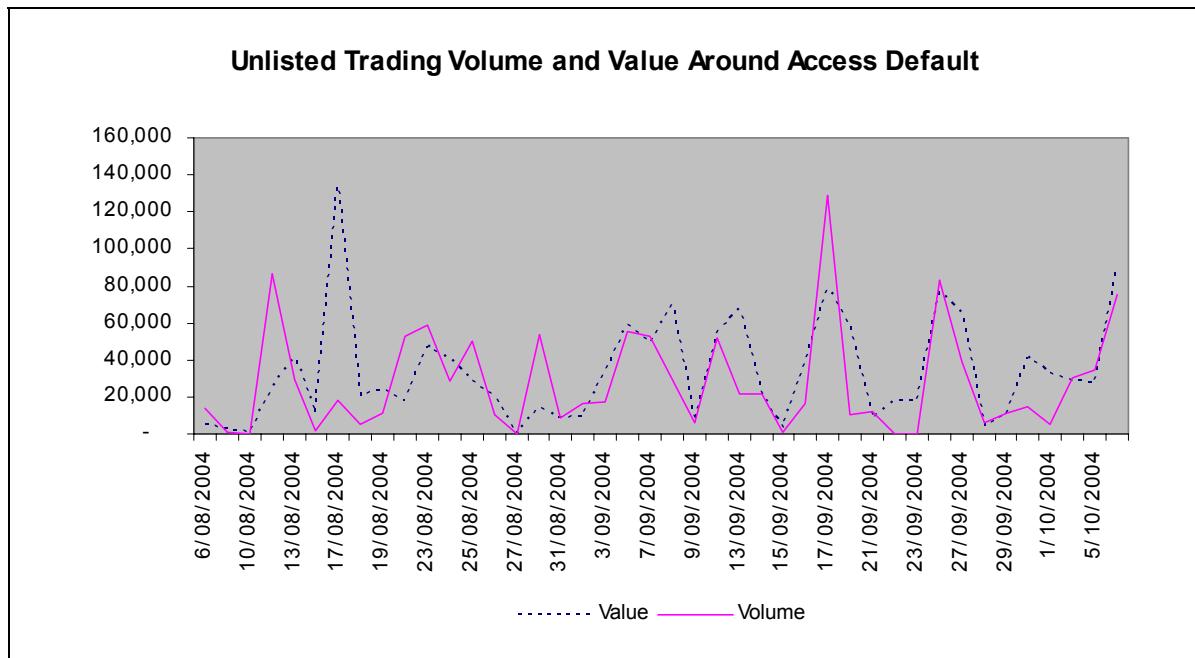
The 2004 failure of Access Brokerage is interesting for additional reasons. For starters, it is not a failure of an NZSX issuer as such, instead being a brokerage that was monitored by NZX as part of its duties as securities market co-regulator. It is therefore not surprising that NZX's own share price suffered a significant decline when Access' default was announced, as illustrated below. What is more significant is that the NZSX 50 index moved positively around the time of the announcement, suggesting that the market's confidence in NZX supervision was not rocked by this clear failure to detect irregularities in Access' practices.

**Figure 2. Impact on NZSX and NZX of Access Brokerage Failure**



The Access Brokerage failure is also interesting because it occurred after Unlisted had commenced trading. Figure 3, overleaf, shows that the announcement of Access' default on 6 September 2004 had no discernable effect on Unlisted's trading. If the argument is that unregistered securities trading facilities like Unlisted are somehow more risky, or vulnerable to market disturbance, than registered exchanges such as NZSX, then it might be predicted that Unlisted would react more strongly than even NZX to this event, given its bearing on market confidence and supposing such confidence impacts on all of New Zealand's securities markets. In this case no such reaction is evident, providing evidence against the contention that New Zealand's securities markets are so linked, and investor confidence so fragile, that isolated failures can lead to cross-market disturbances. For reasons discussed in Section 3.4, this should come as no surprise, as Unlisted lacks certain critical linkages to NZX or other securities markets (local or offshore) that international evidence shows are necessary for spreading cross-market disturbances.

**Figure 3. Impact on Unlisted of Access Brokerage Failure**



#### *Credit Union Collapses*

The risk of bank sector contagion, or "systemic" bank risk, is arguably materially greater than the risk of securities markets contagion. Credit Unions bear much the same relationship to banks as Unlisted companies do to NZSX companies, and might therefore be argued to pose contagion risks to other banks in the same way that company or market collapses might be argued to pose contagion risks to other companies or markets. Yet despite the liquidations of Credit Union Northwide (1995), Canterbury Port and Province Union (1998) and Credit Union Wairarapa (1998), and the current receivership of Far North Credit Union, the wider New Zealand banking sector has not experienced a ripple in depositor confidence as a consequence. As with the above major corporate crises, none of these is large enough to transmit

disturbances elsewhere, and the necessary mechanisms are not in place for those disturbances to be transmitted in the first place.

### **3.4 Mechanisms underlying Cross-Market Disturbances**

It is extremely reassuring that New Zealand's securities markets did not collapse along with others caught up in the Asian financial crisis of 1997-1998, the Russian default and resulting international financial crisis of 1998, or other headline episodes of international financial contagion. New Zealand weathered these storms, as did the world's other developed securities markets, relatively unscathed. And it did so at a time when international institutions held around 30%, and international corporations around 20%, of the then New Zealand Stock Exchange (PricewaterhouseCoopers 2002), and prior to the introduction of continuous disclosure requirements. To provide some added insight into the evidence-based results discussed above, we set out some of the economic theory as to the mechanisms by which cross-market disturbances do, or do not, arise.

If New Zealand weathered these major storms, then it is no surprise that it weathered the various domestic company crises discussed in Section 3.3. It would clearly take something more than a crisis or scandal relating to an Unlisted issuer – given all of Unlisted's issuers account for less of New Zealand's total securities market capitalisation than does Tower – for that to lead to measurable impacts on New Zealand's securities markets. That being the case, Unlisted's registration status appears to be a non-issue for regulators concerned with the integrity and effectiveness of, and investor confidence in, New Zealand's securities markets. The following discussion shows that this is explicable in terms of the key mechanisms required to cause cross-market disturbances being absent in the case of Unlisted.

In general, the robustness of New Zealand's securities markets is explicable in terms of:

- 1) the fundamental soundness of its protections for investors overall, aside from the details of its specific statutory regulations (e.g. insider trading prohibitions); and
- 2) the relative lack of information asymmetry between company insider and investors compared to jurisdictions that have been vulnerable to contagious financial crises (regardless of any continuous disclosure requirements)

It is because of these that New Zealand's securities markets have been insulated from major financial crises despite sharing features with affected countries that have been found to be central to the spread of financial contagion. The main such feature, noted earlier, is the presence of large, leveraged international investors who hold internationally diversified investment portfolios. When major events precipitate market declines in some jurisdictions, such investors provide a critical channel by which those declines are transmitted to other markets. Dornbusch et al. 2000, for example, paint a contagion scenario along the following lines: when

foreign investors withdraw deposits and loans (e.g. due to some adverse shock), asset prices decline and markets become illiquid, banks and other financial institutions then risk failure because they cannot readily liquidate their assets, which may cause a run on these intermediaries, provoking a banking or confidence crisis and speculative attack on the country's currency. These crises spread to other countries when international investors are forced to sell off their positions in other national markets to make up for the liquidity shortage caused by the crisis in one country.

Kaminsky et al. 2003 provide similar explanations: leveraged funds may sell down across multiple markets following losses in one, in anticipation of future fund withdrawals/redemptions and a consequent need for liquidity. Alternatively, leveraged investors facing margin calls from lenders due to asset price collapses may need to sell asset holdings, but since they receive only fire-sale prices on the collapsed assets they instead must sell others, spreading the downward pressure on prices. Commercial banks can propagate contagion by calling in loans across markets when some go bad in others. Such predictions are consistent with those of Yuan 2005.

Aside from these liquidity-based arguments, informational asymmetries are identified as a mechanism also playing a role in financial contagion. Kaminsky et al. 2003 survey, *inter alia*, herding theories based on mass investor behaviour. These include informational cascades, in which investors disregard their private information when they see other investors acting in certain ways (e.g. bailing out of particular markets). Such herding is likely to increase as investment options and the range of investors widens, and creates positive feedback, since it induces even more to do likewise. It can arise in the presence of global diversification where there are fixed costs of gathering and processing country-specific information, since it can then be rational for investors to infer information from the conduct of others, particularly informed investors (Calvo 1999). Calvo and Mendoza 2000 argue that globalisation worsens the phenomenon, by weakening incentives for gathering costly information and by strengthening incentives for imitating arbitrary market portfolios. Along with Kodres and Pritsker 2002, they predict that countries with more internationally traded assets and more liquid markets should be more vulnerable to cross-market disturbances (Kaminsky et al. 2003). That international market linkages can have an important effect on local security prices is commonly appreciated. A recent commentary by Terry Hall in the *Dominion Post*, referring to the experience of Fisher & Paykel Appliances and The Warehouse, noted that: "Overseas funds can spark huge and unjustified price falls and continuing volatility".<sup>4</sup>

Thus, to the extent that a given market lacks common shareholders with other markets, especially leveraged, internationally diversified shareholders, these arguments suggest they should be less exposed to the transmission of cross-market collapses, and less likely themselves to be involved in transmitting disturbances, whether emanating within or from elsewhere, to other markets. More specifically, since Unlisted's issuers lack shareholders of this type, and are instead predominantly owned by non-institutional and/or financially unleveraged, local investors, they are unlikely themselves to suffer from shocks emanating

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<sup>4</sup> "Overseas Funds can Rock our Market", 7 February 2005.

from other markets, and to the extent any shocks occur among Unlisted issuers, those shocks are unlikely to be transmitted to other New Zealand securities markets.

An alternative explanation for the effects of informational asymmetries on the transmission of shocks across markets is provided by Kodres and Pritsker 2002. According to their analysis:

- 1) when there is more information asymmetry in less-developed markets than in developed markets (e.g. because public information about asset values is less available in less-developed markets), large price shocks can be transmitted from one less-developed market to another *via developed markets without significantly affecting the developed market's prices*;
- 2) conversely, *more* information asymmetry in developed markets *reduces* contagion among less-developed markets, suggesting that reduced information asymmetries in developed markets (e.g. continuous disclosure rules) may in fact enhance the role of developed markets as a conduit for contagion among less-developed markets;
- 3) more information asymmetry in a less-developed market increases its own vulnerability to contagion, as this increases the likelihood that shocks transmitted to that market from abroad will be mistakenly viewed as an information shock within that market, magnifying price changes; and
- 4) while contagion across markets requires that their asset values be linked through shared exposures to macroeconomic fundamentals, the actual level of macroeconomic exposure in any one market can either increase or decrease its vulnerability to shocks from abroad.

These predictions are consistent with evidence cited by Kodres and Pritsker showing that contagion could have spread from Mexico through New York to Asia following the Mexican peso devaluation in 1994, and Calvo 1999's analysis of the role New York may have played in spreading the 1998 Russian default to Asia.

In other words, a startling prediction of this analysis is that to the extent that there is greater information asymmetry in Unlisted than in NZX, as might be argued but which is not a given in the absence of continuous disclosure requirements for Unlisted's issuers, this does not pose a risk of cross-market disturbance to NZX. If it poses a risk at all, it is to any other securities markets in New Zealand that share such greater information asymmetry (e.g. Sharemart, perhaps). Rather, this analysis predicts that NZX, to the extent it has lower relative information asymmetry than other New Zealand securities markets, acts as a conduit for transmitting disturbances from one asymmetric market to another (for argument's sake, from Unlisted to Sharemart), while itself remaining relatively unscathed.

There is further support for the suggestion that securities markets with less informational asymmetry play a role in financial contagion. Stiglitz and Bhattacharya 1999 argue that not only are disclosure requirements unnecessary, since markets can and do provide optimal incentives for disclosure, but that under certain

circumstances they can exacerbate fluctuations in financial markets and precipitate a financial crisis. Bushee and Noe 1999, for example, examining US equity market data, found that improved disclosure by firms increased the volatility of their stock price, as it attracted more transient institutional investors (characterised by short-term focus and aggressive trading) due to the seemingly reduced information asymmetry and increased liquidity of the market. Such predictions are similar to those of Berglof and von Thadden 1999, discussed above, who warn that protecting smaller investors may attract international portfolio investors, a highly volatile source of funds.

Thus consistent with the liquidity- and herding-based explanations for financial contagion discussed above, and international evidence on market disturbance likelihoods and pathways, this analysis suggests that so long as Unlisted issuers are not held in significant proportions by leveraged, diversified investors (such as local or foreign financial institutions), collapses on Unlisted are exceedingly unlikely to have flow-on effects for New Zealand's other securities markets. Indeed, to the extent that NZX is less information asymmetric than other New Zealand securities markets, and has significant holdings by leveraged domestic and international diversified institutional investors, disturbances on NZX pose the greater threat to New Zealand's other securities markets. In any event, the risk in either direction must be regarded as inconsequential, as Unlisted lacks the fundamental linkages with other New Zealand and international securities markets predicted by theory and shown by international evidence to be necessary for the transmission of disturbances across markets.

## 4. Response to the Minister's Arguments

### 4.1 Introduction

In the previous section, we examined the evidence on financial market contagion and found little support for the view that unregulated trading on Unlisted posed a threat to the overall health of NZ capital markets. We now assess the arguments made by the Minister supporting that view.

### 4.2 Summary of Minister's Letter

The Minister of Commerce's letter, advising Unlisted of her intention to make a declaration pursuant to the process set out in Section 36D of the Securities Markets Act 1988, is attached as Appendix 3.

In brief, the Minister's arguments in support of Unlisted's continued operation outside of the Act being likely to be detrimental to the integrity or effectiveness of, or investor confidence in, New Zealand's securities markets, may be summarised as follows:

- 1) **Size and nature** – Unlisted now has a significant presence in New Zealand's securities markets, with a market capitalisation greater than that of NZAX, and with some of Unlisted's issuers with sizeable market capitalisations by New Zealand standards, and large shareholdings. *A risk is therefore perceived due to the number of shareholders exposed if something should go wrong of a kind that being a registered exchange would address* (e.g. insider trading, or a company failure in the absence of continuous disclosures). It is suggested that the reporting of such an event, and the lack of shareholder recourse, is likely to be detrimental to the integrity and effectiveness of, and the confidence of investors in, New Zealand's securities markets.
- 2) **Comparative international regulation** – *Unlisted would be subject to some form of regulation in like overseas jurisdictions.* Leaving Unlisted outside of the Act is likely to have a detrimental effect on international perceptions of New Zealand's markets, and hence on those markets' integrity and investors' confidence in them. The country's ability to attract international investment is an important measure of its markets' integrity.
- 3) **Regulatory difference and arbitrage** – Despite Unlisted claiming that it is not in direct competition with NZAX, some of its issuers are large enough to be potential candidates for listing on NZAX, or even NZSX. A key difference between Unlisted and a registered exchange is that it does not need to comply with or be subject to statutory provisions for continuous disclosure obligations, the insider trading regime, director's and officer's relevant interest disclosure, substantial security holder disclosure, rule approval or regulatory oversight. *While Unlisted's fees are comparable to those of a registered exchange, its cost structure [presumably*

*meaning the lower overall compliance costs to issuers] is such as to create a potential disincentive for issuers to participate in regulated markets* (where issuers face higher compliance costs). To the extent this disincentive is so created, it is likely to be detrimental to the integrity and effectiveness of securities markets in New Zealand and the confidence of investors in those markets.

- 4) **Potential for confusion** – *There are aspects of Unlisted’s operations that are sufficiently similar to those of registered exchanges that some investors might think Unlisted is a registered exchange (or incompletely understand the implications of its status)* despite its disclaimers regarding its regulatory status and other features of its services that differ from those offered by such exchanges. This possible confusion is exacerbated by Unlisted’s self-governance measures (e.g. listing agreements with issuers allowing for public censure, broker agreements requiring compliance with specified standards), which are at odds with its disclaimers. It is detrimental to the integrity and effectiveness of, and the confidence of investors in, New Zealand’s securities markets.

Each argument is responded to below, in the light of the preceding analysis and discussion.

## 4.3 Size and Nature of Unlisted

### 4.3.1 Significance of Unlisted’s Presence

The Minister’s letter suggests Unlisted now has a significant presence in New Zealand’s securities markets. The following tables, using January 2005 data, place this in context:

**Table 1. Size of Unlisted Relative to Other New Zealand Securities Markets**

Market	Securities Traded	Market Capitalisation (\$m)	Relative Market Capitalisation	Avg. Mkt. Cap. Per Security (\$m)*
NZSX	222	68,720	<89.9%	310
NZDX	85	6,358	<8.3%	75
Sharemart	40	n.a.	n.a.	n.a.
<b>Unlisted</b>	<b>25</b>	<b>883+</b>	<b>c1.2%</b>	<b>c42 (c28)</b>
NZAX	23	490	<0.6%	21 (16)
Debex	n.a.	n.a.	n.a.	n.a.
OTC markets	n.a.	n.a.	n.a.	n.a.
Total	395+	\$76,449m+		

\* Medians shown in parentheses.

In other words, Unlisted has a total market capitalisation of around 1.2% of that of New Zealand's major securities markets. This compares with the market capitalisations of Air New Zealand, Tower and Toll, as a percentage of NZSX market capitalisation, of 2.3%, 1.1% and 0.8% respectively. As discussed earlier, major crises for each of these companies barely caused a ripple within the market on which they are traded (i.e. NZSX). In the light of the statistical rarity of cross-market disturbances, and lack of leveraged common shareholdings between Unlisted and NZX, there is even less reason to believe that a failure of one or more Unlisted issuers would have any effect at all on NZX. Indeed, to the extent it did, there are grounds to believe it may even have a positive effect, if not on NZSX/NZAX (flight to liquidity), then on NZDX (flight to liquidity and flight to quality).

**Table 2. Unlisted Daily Trading Activity Relative to Other New Zealand Markets**

Market	Average Trades	Share of Trading Volume	Share of Trading Value	Volume per Trade	Value per Trade (\$)
NZX	2,135	<87.5%	<95.9%	13,584	45,892
NZDX	58	<12.1%	<4.0%	68,722	69,876
NZAX	18	<0.3%	<0.1%	6,212	4,653
<b>Unlisted</b>	<b>5</b>	<b>&lt;0.1%</b>	<b>&lt;0.1%</b>	<b>8,941</b>	<b>13,938</b>
Sharemart	n.a.	n.a.	n.a.	n.a.	n.a.
Debex	n.a.	n.a.	n.a.	n.a.	n.a.
OTC markets	n.a.	n.a.	n.a.	n.a.	n.a.
Total	2,216+				

As to Unlisted's share of total New Zealand trading activity, it barely registers, with a mere five trades per day on average. This emphasises that adverse trading events on Unlisted would be extremely limited – indeed, inconsequential – in scale, adding further weight to the argument that they would have little if any impact on New Zealand's other security markets.

#### 4.3.2 Extent of Shareholder Exposure to Adverse Events

The Minister notes that New Zealand Rural Property Trust has 3,100 unit-holders. Indeed, King Country Energy has over 9,000 shareholders. But many unlisted issuers have well less than 1,000 security-holders, with at least two having less than 300 – as reported earlier, a median figure of 530 shareholders was obtained from a survey of Unlisted's issuers in February 2005. These figures compare with Telecom, for example, with more than 50,000 shareholders, or Carter Holt Harvey with almost 37,000 shareholders. It should be noted that many other large and very high profile unlisted New Zealand companies have a comparable or even far greater number of owners than Unlisted's largest issuers, yet are not argued to be required to be subject to the same level of disclosure and other requirements as Unlisted. Zespri is a very obvious example,

with over 2,500 owner-producers and more than 6% of the company’s shares traded, OTC, in the year to March 2004.<sup>5</sup> The absolute number of shareholders in any one Unlisted issuer, therefore, would appear so small as to not satisfy the materiality threshold that should apply in any application of the Securities Markets Act’s Section 36D test.

It is instructive to compare Unlisted issuer shareholder numbers with those of Air New Zealand, Tower and Tranz Rail (now Toll), given each of these companies have recently suffered financial crises. Latest annual reports for each put their shareholder numbers at around 35,000, 116,000 and 2,000 respectively. Even with 116,000 shareholders Tower’s recent financial crisis was unable to move NZSX to any significant extent, and with 35,000 shareholders Air New Zealand’s crisis did not move the NZSX at all. It is hard to see, therefore, how a failure on Unlisted of even its most widely-held issuers could be expected to have effects beyond that issuer, let alone across New Zealand’s other securities markets.

The media exposure recently given to allegations of insider trading in Tranz Rail are also pertinent in this regard. If insider trading can allegedly occur on a registered exchange in which such trading is prohibited by law, and for a company with thousands of shareholders (at the time Tranz Rail had closer to 4,000 shareholders) – and this has not measurably undermined investor confidence in NZX – how could a much smaller episode occurring on Unlisted, in which such laws are not applicable, lead to a greater loss in investor confidence? The evidence would suggest that the likely detriment to New Zealand’s securities markets from an adverse event on Unlisted would be inconsequential, if anything.

#### **4.4 Comparative International Regulation**

As outlined in Section 3.2, New Zealand’s overall regulatory environment is comparable to that of other common law countries worldwide, ranking in the top tier of legal systems in terms of investor protection. It enjoys such a favourable ranking on measures that have been found to be associated with capital market development, but which do not include continuous disclosure requirements or insider trading prohibitions, and which predate the Securities Markets Amendment Act. Indeed, the incremental benefits of such refinements appear negligible for countries such as New Zealand whose overall regulatory environment is protective of investor rights, and hence must be carefully weighed against the costs of imposing them on operators like Unlisted.

Thus, whether or not Unlisted is comparably regulated to like operators in other legal jurisdictions is largely irrelevant for the integrity or effectiveness of, or investor confidence in, New Zealand’s securities markets. On the contrary, the fact that Unlisted has enjoyed such rapid growth in its first year of operation indicates that companies and traders have confidence in its integrity and effectiveness, notwithstanding differences in its regulatory treatment relative to overseas jurisdictions. Indeed, the same could be said of NZAX’s rapid

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<sup>5</sup> ZESPRI Group Limited Annual Report 2003-04, and [www.zespri.com](http://www.zespri.com).

growth over the past year, not least because it too is subject to regulatory provisions which themselves are not identical to overseas models (as acknowledged in NZX's website comparison of NZSX and NZAX).

In any case, as pointed out by Berglof and von Thadden 1999, the overall environment is more determinative of a country's investor protections than are specific regulations. That environment includes a range of features, not confined to explicit regulation, that shape those protections. Moreover, where investor protections in any one country are inadequate for the liking of overseas investors, this creates inherent and natural pressures for issuers to adopt regulatory arrangements that better suit the needs of their target investors, irrespective of explicit regulation. Accordingly, while the identification of regulatory differences between the treatment of Unlisted and like operators in other jurisdictions might be revealing if Unlisted was operating in a country with weak overall investor protections, the international evidence indicates that this is not so because of the simple fact that Unlisted operates in New Zealand, with the strong overall investor protections this entails.

It should also be noted that New Zealand has been content to differ from international norms in a more critical area of financial sector regulation, namely bank sector regulation, where the systemic risks of individual company failure are arguably markedly greater than those in securities markets. Despite the fact that banks play an unusually predominant role in New Zealand's financial system relative to many other jurisdictions, New Zealand has deliberately diverged from international central banking practice of heavy regulation and inspection in favour of light-handed regulation and information disclosure (Reserve Bank of New Zealand 2004). Thus the mere fact of regulatory differences relative to like activities in overseas jurisdictions is clearly not an inherent argument for convergence. It is perfectly reasonable for New Zealand to adopt its own regulatory arrangements where they better suit local conditions.

Even if there were sound reasons for following international practice in this regard, it would clearly come at a cost. First, competition among trading providers would be stifled, thereby hurting both issuers and investors. Second, one of the policy aims underlying the Act's deliberate deviation from international practice – not requiring automatic registration of all securities trading facilities to avoid hampering the development of small and/or more innovative markets in New Zealand – would be frustrated.

## **4.5 Regulatory Differences and Arbitrage**

The Minister's argument appears to be at odds with the presumption underlying the Securities Markets Act – that investors and companies should be able to opt for their preferred level of regulatory coverage. She suggests that Unlisted can effectively undercut registered exchanges such as NZAX and NZSX, if not directly in terms of listing fees (which are in fact comparable to those of NZAX), but indirectly in terms of its issuers enjoying lower compliance costs than issuers on registered exchanges (particularly in respect of continuous disclosure). Her concern is that this may – not that it actually does – create a disincentive for

issuers to opt for Unlisted instead of registered exchanges, and that this disincentive is inherently likely to cause the required detriments.

It should be noted that both Unlisted and NZAX have enjoyed growing patronage despite any such potential disincentive. Indeed, if the incentive were that severe, it must be asked why NZAX issuers have not abandoned NZAX in favour of Unlisted? That they have not suggests that this incentive, if it exists, is not especially strong. The simultaneous growth of patronage in both NZAX and Unlisted indicates that individual issuers have their own preferred level of regulatory coverage, and ability to bear the costs of making that choice (net the avoided economic costs of failing to provide their shareholders and target investors with their preferred regulatory coverage). In other words, Unlisted, NZAX, NZSX and New Zealand's OTC markets – not to mention overseas securities trading facilities – influence and constrain each other in terms of service provided, regulatory coverage, compliance costs, and listing costs. These pressures can arise in either direction, with whichever party not meeting its investors' needs facing inherent market disciplines to better conform with arrangements that do meet those needs.

Since not all investors have identical regulatory preferences, it is therefore no surprise that Unlisted, NZSX, NZSX, Sharemart, OTC trading and overseas trading systems can durably coexist. If Unlisted is forced to become a registered exchange, given that there are clearly issuers and traders who do and will continue to legitimately operate outside of the Securities Markets Act, a certain amount of trading activity would naturally migrate to Sharemart, Trademe, OTC or other trading venues that are not subject to the Act.

Since the Securities Markets Act does not require the automatic registration of securities trading facilities, there is nothing improper in Unlisted offering a different regulatory coverage to other markets. And since both Unlisted and NZAX (and NZSX) have enjoyed concurrent patronage growth, there appears little evidence for the Minister's contention that Unlisted's regulatory differences relative to other trading providers have given rise to any detriment to the integrity or effectiveness of, of investor confidence in, New Zealand's securities markets. The very opposite would appear evident.

#### **4.6 Potential for Confusion**

The main difficulty with this argument is that it simultaneously presumes investors are, and are not, competent, let alone the fact that it conflicts with the presumption underlying the Securities Markets Act that companies and investors are competent to both discern and opt for their preferred regulatory coverage. On the one hand it is contended that despite clear disclaimers on Unlisted's website regarding its regulatory status, investors may be confused on this point by virtue of the fact that Unlisted engages in a limited measure of self-regulation. Yet if Unlisted were to be forced to become a registered exchange, with one of the main suggested benefits being that investors would enjoy continuous information disclosures, these investors are then presumed to be competent to assimilate and understand that greater and typically more complicated information.

One of the objections to enforced disclosure is that it precludes companies from channelling disclosures to parties such as investment analysts who provide less informed investors, or those lacking the resources to make such analyses, with guidance on the import of those disclosures. Evidence offered by Gomes et al. 2004 cited earlier indicates that enforced disclosure in fact reduces analyst coverage and otherwise adversely affects smaller firms, such as those traded on Unlisted. Thus, to the extent there are investors genuinely so unsophisticated that they are unable to understand both Unlisted's regulatory status and the import of disclosures by its issuers, forcing Unlisted's registration risks solving the former at the expense of the latter.

In any event, there is no recorded evidence of investor confusion being a cause of poor capital market growth, or adverse intra- or cross-market disturbances. Since even large company collapses and crises are incapable of causing such things, this is little surprise. Given New Zealand's securities markets have been so robust as to have weathered major international financial crises, it would require a great leap to think that the mere confusion in the minds of a limited number of investors as to Unlisted's regulatory status could change this. Given further that there is a large degree of self-selection in investors' choice of trading venues (e.g. the well-documented home-market bias indicates investors incline towards environments which they understand and with which they are familiar), it should be expected that most traders on Unlisted are perfectly aware of and indeed comfortable with the regulatory differences between it and other trading venues. If investors were in fact confused, they enjoy the reassurance of having NZX as an alternative trading venue, where their confusion is presumably less. Given that there are likely to be few, if any, Unlisted traders – bearing in mind it facilitates very infrequent trades – who might be confused as to its regulatory status, this would hardly make the case for risks to New Zealand's other, significantly greater securities markets.

## **5. Implications of Unlisted becoming a Registered Exchange**

Unsurprisingly, forcing Unlisted to become a registered exchange is likely to have unintended, but foreseeable, consequences. These need to be carefully considered before committing to what is largely an irreversible decision.

First since registration would require Unlisted to offer products and services more alike those of other venues, this would result in a net loss of choices available to traders. Given the relative paucity of trading volumes, registration may in fact prove unviable for Unlisted, meaning that all its trading activity will have to migrate to other venues – whether to OTC markets, registered exchanges like NZAX and NZSX, or other unregistered trading platforms like Sharemart. Not all of Unlisted’s current issuers are capable of migrating to NZAX or NZSX, and even if they were it cannot be assumed that they would automatically do so should Unlisted cease trading. Indeed, responses (11) to our survey of Unlisted companies reveal that any migration uptake is likely to be low: six indicated they would not, four were unsure, and only one indicated it would migrate. Thus, a significant number of Unlisted’s current issuers are likely to return to OTC trading if Unlisted is required to become a registered exchange. Moreover, a return to OTC trading is also more likely than migration to other or new unregistered securities trading facilities, since the forced registration of Unlisted would act as a warning to would-be like service providers that they risk the same fate if they prove too successful.

A return to OTC trading would not be a desired consequence of registration. Rather than expanding the coverage of the Securities Markets Act regulations, it would result in much of Unlisted’s current trading activity moving further beyond the Act’s reach. Indeed, there is a sound argument that the ongoing threat of forced registration acts as a discipline on Unlisted and its issuers to ensure they remain “whiter than white”, whereas the carrying out of that threat instead forces trading activity to venues not even subject to that threat (i.e. own-company OTC trading). A return to OTC trading would simultaneously degrade the price discovery process, reduce the liquidity and transparency of prices currently formed on Unlisted, and diminish the information disclosures Unlisted facilitates. Such backward steps would hinder venture capital development and reduce other capital raising options for smaller New Zealand issuers. All of these seem at odds with the Section 36D test’s objective of preserving the integrity and effectiveness of, and investor confidence in, New Zealand’s securities markets, and with the policy aim of encouraging the development of smaller and/or more innovative markets.

Second, forced registration might give rise to its own source of investor confusion and the moral hazard risks associated with perceived statutory guarantees. As Oesterle 2000 puts it for the US system (p. 4), “the illusion that the SEC is guaranteeing the integrity of exchanges removes the incentive for the exchanges themselves to exercise diligence, lest they lose their customers. And customers are lulled into a false sense of security, believing that the SEC is closely policing the day-to-day activities of the exchanges.” To the extent investor confusion arises, it can and will arise irrespective of any differences between Unlisted’s regulatory arrangements and those elsewhere. The possibility of confusion as to Unlisted’s regulatory status

is not inherently detrimental to the integrity or effectiveness of, or investor confidence in, New Zealand's securities markets. Forcing it to become a registered exchange may in fact spawn greater investor confusion and risks to market integrity.

Third, forcing Unlisted to become registered may lead to unsophisticated investors holding riskier portfolios. By forcing a minimum level of regulatory oversight on all securities, investors with a high tolerance for unregulated offerings may quit some of their NZ holdings in order to free up funds to invest in such opportunities elsewhere. But the securities they sell must then be held by other investors, who thus end up with portfolios that are riskier than the ones they would otherwise have held. Moreover, they will only do so if offered sufficient inducement in the form of a higher risk premium, so the firms' cost of capital rises. Danielsson and Zigrand 2001 develop a model in which exactly these perverse effects occur.

Finally, the forced registration of Unlisted would have important implications for the mutual pressures and disciplines imposed on each other by New Zealand's various securities markets, and hence for the quality and quantity of trading services offered to traders, trading innovations, and the costs of trading. Rust and Hall 2001 show that distinctive trading systems segment the trading market, catering to distinct clienteles, and even where a centralised exchange has a near monopoly on trading services, a fringe operator is important in forcing down trading costs and improving price discovery. This view is echoed by Pirrong 2001, who argues that inter-market disciplines improve market liquidity otherwise restricted by exchanges with market power.

Thus the advent of Unlisted and other trading operators such as Sharemart and Debex represents an important innovation in the structure of New Zealand's trading services. Consistent with the international trends towards so-called "third" and "fourth" markets, often involving electronic communications networks (ECNs) facilitated by improvements in communications technologies, NZX now faces pressures that formerly it did not. If Unlisted is forced to become a registered exchange, with the result that it is no longer viable given the size of the New Zealand market, this would discourage the emergence of like operators capable of constraining NZX at the margin and strengthen NZX's ability to influence regulatory and market arrangements in its favour, and reduce its incentive to meet the service level requirements of its investors (subject, though, to corresponding pressures from overseas securities trading facilities). In the light of the likely return of Unlisted issuers to OTC trading should it be registered, with the unintended consequences of reduced Securities Markets Act reach and reduced transparency and liquidity of trading in Unlisted's current issuers' securities, such a reduction in market disciplines on NZX should be regarded as likely to be detrimental to the integrity or effectiveness of New Zealand's securities markets.

## **6. Conclusions**

The advent of Unlisted represents a major development in New Zealand’s securities markets, in line with trends overseas. Major exchanges, having enjoyed market dominance for decades, now face beneficial disciplines affecting the quality and price of their products and services, albeit often at the margin, from innovators exploiting advances in communications technology. New Zealand’s Securities Markets Act has paved the way for such innovation by allowing for the coexistence of trading facilities differentiated not only in terms of price, but also quality – including choice of regulatory coverage. As such, it presumes that issuers and investors are inherently competent to discern and opt for their preferred level of regulatory coverage. Indeed, it presumes they are similarly competent to take make sense of the extra information the Act’s continuous disclosure requirements are intended to induce.

Yet, at their heart, the arguments contained in the Minister of Commerce’s letter advising her intention to require Unlisted’s registration under the Securities Markets Act, and officials’ draft guidelines which underlie the Minister’s letter, contain two key contradictions. The first is that differences between the regulatory treatment of Unlisted and other New Zealand trading platforms are inherently likely to cause the detriments that Section 36D of the Act is intended to prevent. The Act anticipates such regulatory differences – it is a separate question as to whether the required detriments are likely to arise if Unlisted does not become a registered exchange. The second contradiction is that investors are apparently so unsophisticated as to not be able to discern and comprehend these regulatory differences, despite unequivocal warnings on Unlisted’s website on the subject, yet they are presumed sophisticated enough to make sense of continuous information disclosures.

Setting these contradictions to one side, another feature of the Minister’s arguments and officials’ draft guidelines is that they draw a very long bow to make the required connections between the issues they argue relate to Unlisted, and the detriments required to be likely under Section 36D if Unlisted is not required to register. Indeed, they offer extremely little by way of causal nexus between the issues raised and the detriments required. They certainly make no reference to evidence from recent corporate crises in New Zealand regarding the nature and extent of the detriments they gave rise to, or indeed failed to give rise to. And there is no hint in the arguments and guidelines of any reference to the abundant international literature on the conditions required for financial market contagion. There is also little acknowledgement that there are particular features of Unlisted – including the absence of critical market linkages, and its relatively insignificant scale – that make it unlikely that adverse events on that platform will be transmitted to other New Zealand securities markets. As such, it is hard to see how the Section 36D test can be said to apply, let alone be satisfied.

Furthermore, underlying the Minister’s arguments and officials’ draft guidelines is a faulty counterfactual. If Unlisted is forced to register under the Securities Markets Act, this does not mean that its current issuers and Unlisted’s current trading activity will automatically become subject to the Act’s requirements. The Act regulates exchanges, not exchange, and for various reasons it should be predicted that much of Unlisted’s

current business will either migrate back to OTC trading – which is beyond the Act’s reach – or to other trading venues such as Sharemart which are also not registered exchanges, if Unlisted is required to register. Such other trading venues would also take note of Unlisted’s experience before they enhanced the transparency of their own operations, for fear of suffering Unlisted’s fate. Not only would the principal aim of Section 36D – the extension of the Securities Markets Act’s reach – be defeated, but one of the policy rationales underlying the Act’s divergence from Australia’s regulatory approach would be frustrated. Other small and/or more innovative trading platforms would be discouraged, with resulting adverse implications for the development of venture capitalism in New Zealand, and capital raising for small New Zealand issuers. It would also likely result in decreased mutual disciplines amongst New Zealand trading service providers, with resulting declines in service level and quality, and increases in trading costs.

Finally, the Minister’s arguments and officials’ draft guidelines potentially misinterpret a key first phenomenon, Unlisted’s rapid growth. That growth, which clearly complements rather than substitutes for that of NZAX, should be taken as a sign of issuer and investor confidence in the integrity and effectiveness of Unlisted as well as New Zealand’s other securities markets. Mature markets can withstand diversity. The fact that an unregulated venue has enjoyed rapidly growing patronage is a clear sign of revealed investor preference.

\* \* \*

## **Appendix 1 – Sections 36A to 36E, Securities Markets Act 1988**

*Source: http://www.legislation.govt.nz/browse\_vw.asp?content-set=pal\_statutes*

### **PART 2B - SECURITIES EXCHANGES**

#### **SUBPART 1—REGISTRATION, CONDUCT, AND CONTROL OF EXCHANGES**

##### **Restrictions on activities relating to securities exchanges unless registered under this subpart**

*36A No holding out as securities exchange unless registered under this subpart—*

- (1) No person may, in connection with carrying on business in New Zealand,—
  - (a) use a style or title including the words ``stock exchange'' or ``securities exchange''; or
  - (b) state or imply, or permit a statement or implication, that—
    - (i) the person is a registered securities exchange or authorised securities exchange; or
    - (ii) a securities market that the person operates is regulated under New Zealand law.
- (2) Subsection (1) does not apply to—
  - (a) a registered exchange; or
  - (b) a subsidiary of a registered exchange.
- (3) Every person who acts in contravention of subsection (1) commits an offence and is liable on summary conviction to a fine not exceeding \$10,000 for every day or part of a day during which the contravention occurs.

*36B No operation of securities markets unless registered under this subpart (if restriction applies)—*

- (1) No person to whom this section applies may operate a securities market in New Zealand unless that person is—
  - (a) a registered exchange; or
  - (b) a subsidiary of a registered exchange.
- (2) Every person who acts in contravention of subsection (1) commits an offence and is liable on summary conviction to a fine not exceeding \$10,000 for every day or part of a day during which the contravention occurs.

*36C Power to apply and remove restriction on operating securities markets—*

- (1) The Minister may, by notice in the Gazette,—
  - (a) declare, in accordance with section 36D, that section 36B applies to a person;
  - (b) declare that section 36B ceases to apply to a person.
- (2) The notice may include any exemption granted under section 36E.

*36D Criteria and process for applying restriction on operating securities markets—*

- (1) The Minister may declare that section 36B applies to a person only if he or she is satisfied that the result of that section not applying to the person is likely to be detrimental to—
  - (a) the integrity or effectiveness of securities markets in New Zealand; or
  - (b) the confidence of investors in securities markets in New Zealand.
- (2) The Minister must, before making the declaration,—
  - (a) give at least 2 months' written notice of the proposed declaration, and of the Minister's reasons for his or her opinion under subsection (1), to—
    - (i) the person to whom it is proposed to apply section 36B; and
    - (ii) the Commission; and
    - (iii) any other persons that the Minister thinks are representative of the interests of persons likely to be substantially affected by the proposed declaration; and
  - (b) have regard to any submissions made by those persons within the notice period given; and
  - (c) before making the declaration, give at least 14 days' written notice to the persons referred to in paragraph (a), and in the Gazette, of his or her intention to do so and of the reasons for his or her opinion under subsection (1).
- (3) A failure to comply with subsection (2) does not invalidate any notice published under section 36C.

*36E Power to exempt securities markets from this Part—*

- (1) The Minister may, by notice in the Gazette, exempt a securities market, or class of securities markets, from any provision or provisions of this Part.
- (2) The exemption may be on any terms or conditions that the Minister thinks fit.
- (3) The exemption has effect according to its tenor.
- (4) In determining whether or not to grant an exemption, the Minister must seek the advice of the Commission.
- (5) The Minister may vary an exemption in the same way as the exemption may be granted under this section.
- (6) The Minister may, by notice in the Gazette, revoke an exemption granted under this section.

## **Appendix 2 – Officials’ Draft Guidelines on Exercise of Minister’s Power**

*Source: [http://www.med.govt.nz/buslt/bus\\_pol/bus\\_law/financial-markets/guidelines/](http://www.med.govt.nz/buslt/bus_pol/bus_law/financial-markets/guidelines/)*

The Securities Markets Amendment Act 2002, which was implemented on 1 December 2002, inserted registration provisions for securities exchanges into the Securities Markets Act 1988. Under sections 36B to 36D of the Act the Minister of Commerce can declare that a person must not operate a securities market in New Zealand unless they became a registered exchange and fulfil the New Zealand regulatory requirements that imposes. The Minister can only restrict a market from operating, without registration, if it is considered that its operation is likely to be detrimental to the integrity and effectiveness of securities markets in New Zealand or confidence of investors in securities markets in New Zealand (section 36D). Submissions from market participants must be accepted and considered, and consultation with the Securities Commission must be undertaken.

Other than the fact the Minister must be satisfied that either the operation of a facility is likely to be detrimental to the integrity and effectiveness of, or the confidence of investors in, securities markets in New Zealand, the Act does not provide a specific list of matters that must be considered in determining whether to use the declaration power. The main reason for this is the desirability of retaining sufficient flexibility to make sound decisions on a case by case basis, that focus on the overall merits of the individual situation, rather than a number of criteria that might or might not have been met. The risk of having more specific rules is that they may undermine the purpose of the regime and lead to arbitrary and indiscriminate outcomes.

Although it is essential to retain this flexibility, it is also useful to give market participants some further guidance regarding the matters the Minister might consider when assessing whether there is a need to exercise the powers contained in sections 36B to 36D. The Minister of Commerce, Hon Lianne Dalziel, therefore released the following draft guidelines that have been developed by the Ministry of Economic Development, in consultation with the Securities Commission and interested market participants, to assist in determining the circumstances under which she might exercise her powers to make a declaration in accordance with the integrity, effectiveness or confidence tests set out in section 36D of the Act:

1. How investors, potential investors, participants of the market, other participants in securities markets generally, and other interest groups' perceive the market, including whether the market is sufficiently similar to a registered exchange to cause confusion in investors' minds;
2. Whether the operator seeks to regulate (or is perceived to regulate), in a manner analogous to general securities regulation or any registered exchange, the conduct of activities occurring on its market, or the behaviour of its participants, or the public perception of the market or its participants, through the use of Rules, Codes of Conduct, Guidelines or other means, beyond those controls that are necessary for the operation of the system;

3. The proportion (or perceived proportion) of the total New Zealand market activity, including size, number, volume, type or importance of: companies listed, executed trades, and overall market percentages;
4. Comparative international regulation of securities markets/facilities, including the types of market that attract regulatory requirements or exemptions from regulatory requirements; and
5. The operation of the market and its treatment of participants, and whether the operation of the facility causes (or is perceived to cause) unfair or discriminatory treatment of market participants.

It must be emphasised that none of these guidelines are determinative. Further, they do not derogate from the requirement of the Act to consider the overall circumstances applying to a specific trading facility. Finally, although they seem appropriate at the current time, they are draft only and may be subject to change as situations develop.

In addition, officials consider the underlying policy rationale of the Act is the desire to facilitate the development of smaller and/or more innovative markets in New Zealand bearing in mind (among other factors) the costs of registration. Although this does not directly relate to the section 36D criteria, nor the guidelines that may be of assistance in determining whether those criteria are met, it may be another factor that could be helpful when considering any possible exercise of the declaration power.

### **Appendix 3 – Letter from the Minister of Commerce**

[CLEAN COPY TO BE PHYSICALLY INSERTED]

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