



## PROACTIVE RELEASE COVERSHEET

|                               |                                                        |                             |                |
|-------------------------------|--------------------------------------------------------|-----------------------------|----------------|
| <b>Minister</b>               | Hon James Shaw                                         | <b>Portfolio</b>            | Climate Change |
| <b>Title of Cabinet paper</b> | New Zealand Emissions Trading Scheme market governance | <b>Date to be published</b> | 22 August 2023 |

### List of documents that have been proactively released

| <b>Date</b>  | <b>Title</b>                                                                                | <b>Author</b>                |
|--------------|---------------------------------------------------------------------------------------------|------------------------------|
| 28 June 2023 | Cabinet paper: New Zealand Emissions Trading Scheme market governance                       | Ministry for the Environment |
| 28 June 2023 | DEV-23-MIN-0135 - New Zealand Emissions Trading Scheme Market Governance Minute of Decision | Ministry for the Environment |

### Information redacted **YES**

Any information redacted in this document is redacted in accordance with the Ministry for the Environment's policy on proactive release and is labelled with the reason for redaction. This may include information that would be redacted if this information was requested under Official Information Act 1982. Where this is the case, the reasons for withholding information are listed below. Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

### Summary of reasons for redaction

E.g. Some information has been withheld for the reasons of commercial information, confidential information entrusted to Government, confidential advice to Government and legal professional privilege.

## **Policy and Privacy**

## **In-Confidence**

## **Office of the Minister of Climate Change**

## **DEV - Cabinet Economic Development Committee**

# **New Zealand Emissions Trading Scheme market governance**

## **Proposal**

- 1 I seek Cabinet approval to progress a staged approach to the market governance framework for the New Zealand Emissions Trading Scheme (NZ ETS).
- 2 The proposals in this paper seek to establish oversight from the Financial Markets Authority (FMA) through 'Fair Dealing' provisions, to respond to risks relating to advice, trading and misconduct in the marketplace for New Zealand Units (NZUs), referred to as the NZU market.<sup>1</sup>
- 3 I intend to return to Cabinet in June 2024 alongside the Minister of Commerce and Consumer Affairs for other decisions to progress a comprehensive regulatory framework.
- 4 I also seek Cabinet approval to progress the procurement process with a report back proposing detail for centralised clearing and settlement systems (clearing system) and optional to use exchange (exchange), alongside an education campaign, to inform NZ ETS users on the reforms.
- 5 I will report back to Cabinet in March 2024 alongside the Minister of Commerce and Consumer Affairs on the outcomes of the RFP.

## **Relation to Government priorities**

- 6 The Government declared a climate emergency on 2 December 2020, with the Cabinet Business Committee agreeing that climate change “demands a sufficiently ambitious, urgent, and coordinated response across government to meet the scale and complexity of the challenge” [CBC-20-MIN-0097 refers].
- 7 In 2021, the Climate Change Commission (Commission) recommended the Government commit to “establishing an effective market governance regime for the NZ ETS as soon as possible to mitigate risks to market function”. In


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<sup>1</sup>

Note, the NZ ETS and NZU market are interconnected parts of New Zealand's greenhouse gas emissions strategy. The NZ ETS is the government's cap-and-trade scheme for limiting emissions, while the NZU market serves as the marketplace for trading NZUs among NZ ETS participants and NZU market users.

2021, Cabinet noted that improved market governance would help ensure the integrity and efficiency of the NZ ETS and that a market governance work programme consider all risks in the NZU market [ENV-21-MIN-0037].

## Executive summary

- 8 The NZ ETS is a key tool for the government's emission reduction efforts and a vital component of New Zealand's climate change response. The NZ ETS is expected to make a significant contribution to meeting our domestic emissions targets under the Emissions Reduction Plan, and international climate change targets. The integrity of the scheme is critical for New Zealand's climate change response.
- 9 Currently, there is no integrated comprehensive governance framework for the trading of NZUs in the NZU market. This lack of market governance contributes to a perceived lack of integrity and confidence in the NZU market by market users. It also negatively affects the functioning and efficiency of the market.
- 10 I note that in 2022, Cabinet agreed in principle, subject to further analysis and funding on the comprehensive package to progress an education campaign, a clearing system, and exchange [CAB-22-MIN-0344 refers]. I therefore propose that Ministry for the Environment (MfE) work with agencies to establish the education campaign that would serve as a foundational, preliminary component to aid knowledge of the NZU market. Such a campaign would assist the transition into a more robust market governance landscape.
- 11 Furthermore, to increase transparency and oversight in the NZU market, I propose that officials begin a Request for Proposal (RFP) process, with a report back, to procure a clearing system and exchange. s 9(2)(f)(iv)  
  
However, this will be subject to a report back to Cabinet by March 2024 alongside the Minister of Commerce and Consumer Affairs, on the outcomes of the RFP process.
- 12 I also propose that the Climate Change Response Act 2002 (CCRA) and other relevant legislation be amended to improve the Environmental Protection Authority's (EPA) ability to collect, store, publish and share information that would improve transparency, monitoring and oversight of NZU trades. Improving access to market-wide post-trade information is useful for transparency, monitoring, and oversight of the NZU market as it provides more visibility into transactions, prices, volumes, and market user activity.
- 13 I also propose to increase regulatory oversight of the NZU market, by making NZUs financial products for the purpose of the 'fair dealing' provisions of Part 2 of the Financial Markets Conduct Act 2013 (FMC Act). The fair dealing proposal prohibits conduct that is misleading or deceptive, and the making of false or misleading representations, and the making of unsubstantiated

representations. This would allow the FMA to use its extensive regulatory toolkit in response to misconduct relating to NZUs.

- 14 I propose that a regulation-making power is also added to the FMC Act to enable emissions units to be called into regulation under Part 2 of the FMC Act. Legislative changes would also be needed to enable FMA, MfE, Ministry for Primary Industries (MPI), Ministry of Business, Innovation and Employment (MBIE), and the EPA to share and receive information to give effect to their regulatory responsibilities.
- 15 While I consider the fair dealing provisions to be the appropriate regulatory response for now, further regulation may be warranted as the NZU market develops. I therefore propose that I report back to Cabinet alongside the Minister of Commerce and Consumer Affairs by June 2024. This report back would include final decisions to progress comprehensive regulatory solutions.

## **Background**

- 16 The CCRA is the primary legislation that establishes the NZ ETS and provides the legal framework for its implementation, operation, and administration. However, the CCRA currently does not have provisions regulating market risks and misconduct relating to the trading of NZUs.
- 17 There are multiple Acts and regulatory systems that cover some aspects of the NZU market, but none provide comprehensive coverage. Additionally, there is no single regulator responsible for market oversight.
- 18 This lack of governance of the market can have negative consequences. It may hinder our ability to meet domestic and international emissions targets, and undermine the robustness and international reputation of the NZ ETS which is crucial for New Zealand's climate change response.

## *Review of New Zealand Emissions Trading Scheme*

- 19 In 2014, the government received complaints relating to poor advice provided to forestry participants in the NZ ETS. These included situations where forestry participants received bad advice on their forestry obligations, entering in financial contracts, and NZU advice on the returns of their investments. This risk of poor advice has been partially addressed by the introduction of registration for forestry advisers under the Forests Act 1949.<sup>2</sup> People providing forestry adviser services, including on the application of the NZ ETS to forestry activities, must register and comply with regulatory standards, including with a code of ethics.
- 20 In 2015, a review of the NZ ETS found that the scheme could be improved. Particularly, the market governance framework is not fit for purpose and does not ensure integrity, efficiency, and confidence, nor address potential misconduct in the market.

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<sup>2</sup> The Forests (Regulation of Log Traders and Forestry Advisers) Amendment Act 2020 amended the Forests Act 1949 to introduce registration from 6 August 2022.

*Concern regarding seven risks in the NZU market*

- 21 In 2018, the government consulted on improving the NZ ETS to ensure it is a credible and well-functioning scheme that helps New Zealand meet its climate change targets. This consultation helped identify seven market governance risks facing the NZ ETS and NZU market, set out in three risk themes.

*Developing policy options to address the seven risks*

- 22 The government also consulted on options to design and introduce a market governance framework in both 2021 and 2022. Both these consultations assisted towards the development of policy options for the market governance framework. The consultations considered regulatory options and tools to address the seven risks outlined in Table 1 below.

**Table 1: Summary of risk themes and market risks**

| Risk Theme                                      | Risk                                                                                                 |
|-------------------------------------------------|------------------------------------------------------------------------------------------------------|
| <b>Theme A:</b><br>Governance of Advice         | <b>Risk 1:</b> Inadequate, false or misleading financial advice relating to NZUs                     |
|                                                 | <b>Risk 2:</b> Conflicts of interest while providing financial advice relating to NZUs               |
| <b>Theme B:</b><br>Governance of Trading        | <b>Risk 3:</b> Potential lack of transparency, oversight, and monitoring of trades in the NZU market |
|                                                 | <b>Risk 4:</b> Credit and counter-party risks                                                        |
| <b>Theme C:</b><br>Governance of Market Conduct | <b>Risk 5:</b> Insider trading and information asymmetry                                             |
|                                                 | <b>Risk 6:</b> Manipulation of NZU prices                                                            |
|                                                 | <b>Risk 7:</b> Money laundering/financing of terrorism in the NZ ETS                                 |

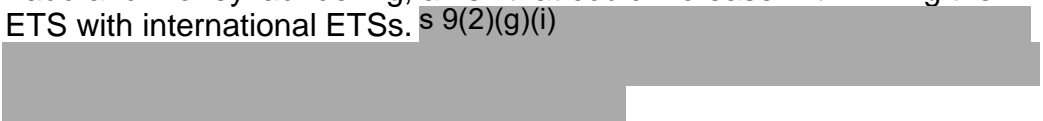
*Cabinet previously agreed in principle to two proposals in this Cabinet paper*

- 23 In 2022, Cabinet agreed in principle, subject to further analysis, funding, and Cabinet decisions on the comprehensive package [CAB-22-MIN-0344 refers], to progress two tools:
- 23.1 *an optional centralised exchange.* MfE, in consultation with MBIE and MPI, undertake further analysis and the Minister of Climate Change returning to Cabinet with technical requirements and funding considerations in order to address governance of trading risks with an exchange; and
- 23.2 *an education campaign.* The education campaign is to be targeted for all people interacting with the NZU market, informing them of market risks in the NZ ETS and the benefits and implications of upcoming market changes.

*The NZ ETS market governance work programme has been allocated funding under the Climate Emergency Response Fund*

- 24 Under budget 2023/24, I note the market governance proposals have been allocated \$38 million under the Climate Emergency Response Fund (CERF).
- 25 I have been invited by Cabinet to include options to draw down the \$38 million as part of this Cabinet paper, tagged to the operational proposals in this paper.
- 26 The fundings in this initiative, will be subject to the financial and outcome-based monitoring and reporting associated with the CERF.

*External reviews of the NZ ETS*

- 27 External reports from Covec and Catalyst (2017)<sup>3</sup> and Ernst and Young (2019)<sup>4</sup> considered whether NZUs should be defined as a financial product with regulation under existing financial markets frameworks.<sup>5</sup>
- 28 The 2017 Covec and Catalyst report noted the NZ ETS is exposed to potential fraud and money laundering, a risk that could increase with linking the NZ ETS with international ETSs. s 9(2)(g)(i)  

- 29 Consequently, NZU-related financial advice would be regulated, NZU trading would fall under the AML/CFT Act, and all carbon trading, whether on exchange or OTC, would be automatically regulated.
- 30 Further, the 2019 Ernst and Young report highlighted the need for financial market-style regulations in the NZU market to address market governance risks. While it did not provide a specific recommendation for regulatory oversight, it presented three options:
  - 30.1 extending the FMA's regulatory functions to the NZ ETS;
  - 30.2 extending the EPA to regulate the NZ ETS's financial aspects; or
  - 30.3 adopting a combined approach:
    - 30.3.1 incorporating Fair Dealing and prohibitions against unfair behaviour into the CCRA; and

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<sup>3</sup> Covec and Catalyst Advisory Partners (2017) Market governance of the Emissions Trading Scheme: Options and analysis. Available at: <https://environment.govt.nz/publications/market-governance-of-the-emissions-trading-scheme-options-and-analysis/>

<sup>4</sup> Ernst and Young (2019) Managing the ETS Market as it evolves. Available at: [ETS Group - EY\\_Report\\_ManagingETSMarket\\_Final\\_6-19\\_Final.pdf - All Documents \(sharepoint.com\)](#)

<sup>5</sup> Note that agencies have raised concerns with the application of these reports to the specific circumstances that exist in the NZ ETS.

### 30.3.2 including the NZ ETS within the market regulation and licensing regime of the FMC Act.

#### *External reports commissioned by international carbon markets and organisations*

- 31 The Board of the International Organization of Securities Commissions (IOSCO) has published a consultation report<sup>6</sup> with the aim of outlining recommendations for integrity and orderly functioning carbon markets.
- 32 IOSCO consulted on its views for clarifying the legal status of carbon allowances, setting up strong frameworks for market surveillance, trader behaviour oversight, and enforcement in carbon markets. This includes robust regulation of market infrastructures like trading venues and unit registries, and public disclosures about aggregate positions and periodic reporting from regulatory data.

#### *Relevant experience from international carbon markets*

- 33 Internationally, carbon units are mostly defined as financial instruments or securities and fall within financial market regulations for supra- and national-emission trading schemes comparable to the NZ ETS.

Table 2: Supra- and national schemes

|                                      | <b>NZ ETS</b>               | <b>EU ETS</b>               | <b>UK ETS</b>               | <b>Australia</b>            | <b>South Korea</b>          |
|--------------------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
| <i>Primary and secondary markets</i> | <b>Allowances</b>           | <b>Financial instrument</b> | <b>Financial instrument</b> | <b>Financial instrument</b> | <b>Financial Instrument</b> |
| <i>Derivative market</i>             | <b>Financial Instrument</b> | <b>Financial instrument</b> | <b>Financial instrument</b> | <b>Financial instrument</b> | <b>Not allowed</b>          |

- 34 The European Union Emissions Trading System (EU ETS), United Kingdom Emissions Trading System (UK ETS), Australian Government's Emissions Reduction Fund and South Korean ETS are all market-based mechanisms that regulate their carbon units as financial instruments, and deal with many of the same risks we are addressing in the NZU market.
- 35 By treating their carbon allowances as financial products and regulating the scheme under an existing financial market framework, each scheme has a comprehensive, well-functioning governance framework which promotes fairness, integrity, and efficiency of operation.
- 36 Each scheme also:
- 36.1 has robust systems for monitoring, reporting, and verification to ensure the integrity of the carbon units being traded;

<sup>6</sup> IOSCO (2022). Compliance Carbon Markets. Available at: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD719.pdf>

36.2 is supervised by its equivalent financial market regulator and regulates its participants under financial market legislation; and

36.3 penalties that can be imposed for non-compliance with the regulations.

## Analysis

37 The below analysis proposes a package of reforms to mitigate present risks in the NZU market. As the finer details of the package are developed, it may be appropriate to consider exemptions for some NZU market users; for example, certain NZ ETS participants with compliance obligations.

### *Progressing an education campaign*

38 I note that Cabinet has previously agreed in principle, subject to funding, that MfE begin work on an education campaign for all people interacting with the NZU market [CAB-22-MIN-0344 refers]. Given funding has now been allocated to the market governance work under the CERF, I recommend that we progress this education campaign.

39 I propose that MfE work with MBIE, MPI, FMA and the EPA to establish this education campaign. An education campaign would serve as a foundational, preliminary component to aid knowledge of the NZU market. The education campaign could be delivered in stages over four years and update all people interacting with the NZU market on the market governance reforms as they are developed.

### *Beginning the procurement process for an exchange to facilitate the trading of NZUs*

40 I propose officials initiate an RFP process, led by MfE, to begin the procurement for an exchange and associated market infrastructure, such as clearing systems, separately from the wider policy proposals.

41 s 9(2)(f)(iv)

[REDACTED]

42 s 9(2)(f)(iv)

[REDACTED]



[REDACTED]

43 As the procurement progresses, I intend to report back to Cabinet alongside the Minister of Commerce and Consumer Affairs in March 2024, and seek a decision on whether centralised clearing should be mandatory, considering:

43.1 MfE's preferred supplier(s);

43.2 the estimated costs for establishing the exchange;

43.3 the estimated costs of making the centralised clearing system compulsory;

43.4 the rationale and estimated costs to establish and operate centralised clearing for all NZ market users;

43.5 any disproportionate impacts of the optional exchange and centralised clearing for ETS participants with compliance obligations; and

43.6 implications for Treaty partners.

44 s 9(2)(f)(iv) [REDACTED]

45 I intend to report back with the Minister of Commerce and Consumer Affairs on a comprehensive market governance package, which will consider these market wide protections.

46 Note, I intend to report back to Cabinet by March 2024 on the outcomes of the RFP process and their preferred supplier. s 9(2)(f)(iv) [REDACTED]

*Implementing the exchange – including improved information collection and sharing provisions*

47 I consider amendments will need to be made to the CCRA and other relevant legislation to allow a clearing system and exchange to be fully implemented. For example, a clearing system and exchange would need connections to the New Zealand Emissions Trading Register (Register) to operate efficiently.

48 Work is ongoing to ascertain the Register's ability to interface with a clearing system and exchange s 9(2)(g)(i) [REDACTED]

- 49 Further, the EPA and FMA need the ability to share and receive information in relation to a clearing system and exchange as necessary to fulfil their respective functions.
- 50 Therefore, I propose that the necessary amendments be made to the CCRA and any other relevant legislation (such as the Financial Markets Authority Act 2011) to allow the clearing system and exchange to be fully implemented. These amendments would include:
- 50.1 improving the information collection and sharing provisions for both the EPA and FMA;
- 50.2 enabling the Register, Registrar and EPA (as applicable) to have the ability to publish or share all information collected with a future procured supplier(s) and a market regulator.

*Improved regulation of Over the Counter trades*

- 51 I propose the CCRA and other relevant legislation be amended to improve the EPA and Registrar's ability to collect, store, publish and share information related that would improve transparency, monitoring and oversight of NZU trades.
- 52 The EPA and Registrar (as applicable), through the Register, currently does not collect certain transaction information that could improve transparency, oversight and monitoring of the NZU market. Specifically, price of transacted NZUs or whether trades are being made between related or non-related accounts (post-trade information).
- 53 This means the government must rely on third-party sources to obtain the secondary market price of NZUs. Noting this, the information is not market-wide, because no single market platform has complete oversight of the market. Further, this market data is not always publicly accessible to market participants; some platforms require the user to open an account with the platform provider before accessing the data.
- 54 Further, the EPA and Registrar, via the Register, already collect some useful market information which would improve transparency in the marketplace but such information is unable to be reported or published. For example, by knowing the types of NZU market users involved in buying and selling NZUs, other market users can gauge the intentions and motivations behind the trades, which can provide valuable insights into market sentiment and future price movements.
- 55 Improving access to market-wide post-trade information is useful for transparency, monitoring, and oversight of the NZU market as it provides visibility into executed transactions, prices, volumes, and market user's

activities. All the above help market users make more informed investment decisions.

- 56 Therefore, I propose that the necessary amendments be made to the CCRA and other relevant legislation to require account holders to provide the information listed below and allow the EPA/Registrar/Register (as applicable) to collect, store, publish and share the following:

56.1 the price of NZUs in the transaction;

56.2 whether trades are being made between non-related accounts; and

56.3 the transactor's primary reason for holding an account.

*Increasing regulatory oversight by applying Financial Markets Conduct Act "fair dealing" provisions*

- 57 I also propose to increase regulatory oversight of the NZU market, by making NZUs financial products only for the purpose of the 'fair dealing' provisions of Part 2 of the FMC Act.
- 58 Broadly, Part 2 prohibits conduct that is misleading or deceptive in relation to any dealing in Part 2 financial products or financial services, the making of false or misleading representations, and the making of unsubstantiated representations. These provisions are based on the equivalent provisions in the Fair Trading Act, but customised for the financial markets context.
- 59 The proposal does not involve applying new substantive obligations to those who buy or sell or give advice about NZUs, although maximum penalties would increase from \$200,000 for individuals and \$600,000 for non-individuals, to the higher of three times the gain or \$1 million for individuals or \$5 million for non-individuals. These penalties apply to misleading and deceptive conduct only. Note, there is discretion in setting the penalty and that these are maximum amounts only. The regulator and court have discretion in the level of penalties sought and imposed.
- 60 Part 2 also prohibits offers of financial products in the course of unsolicited meetings,<sup>7</sup> which, like the uninvited direct sales provisions of the Fair Trading Act, is directed at preventing pressure selling.
- 61 The FMA oversees and enforces the fair dealing settings, and this change would allow the FMA, as the specialist regulator of financial products and services, to use its extensive regulatory toolkit in response to misconduct relating to NZUs. This toolkit includes:

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<sup>7</sup> A person must not, in the course of an unsolicited meeting, offer financial products for sale to a person who is not acting in trade. The penalties for unsolicited meetings in the FMC Act include \$200,000 for individuals and \$600,000 for non-individuals.

- 61.1 using compulsory information request powers to investigate and aid the detection of misconduct;
  - 61.2 using tools like direction orders and stop orders to act where conduct contravenes, or is likely to contravene fair dealing standards;
  - 61.3 issuing guidance about expectations for market conduct and advice; and
  - 61.4 monitoring compliance, investigating conduct and bringing civil prosecutions (including seeking pecuniary penalties and options for seeking compensatory orders on behalf of affected persons).
- 62 Combined with the proposed education campaign, improved transparency, and procured clearing system and exchange, I consider applying the 'fair dealing' provisions an appropriate response to address the risks of poor, misleading, or conflicted advice.
- 62.1 Such advice may be in breach of the prohibitions against misleading or deceptive conduct or false or misleading representations, which the FMA could use its regulatory toolkit to respond to.<sup>8</sup>
  - 62.2 I consider that this fair dealing proposal is more appropriate towards responding to the types of examples of poor advice identified so far (to the extent they are not already addressed by the introduction of regulation of forestry advisers).
- 63 I also consider Fair Dealing an appropriate initial response, at this time, for addressing the remaining market governance risks because:
- 63.1 the proposal would also allow the FMA to intervene in relation to insider trading and market manipulation, but only to the extent it involves using false or misleading representations to induce a transaction;<sup>9</sup>
  - 63.2 fair dealing alongside the procured clearing system and exchange is the more appropriate response now, given the current fragmented/OTC nature of the market; and
  - 63.3 giving oversight responsibility to a reputable regulator such as the FMA can increase regulatory standards in the shorter term. It also provides evidence which may assist with informing appropriate future regulatory settings, and allows FMA to build capability in NZU markets.
  - 63.4 Fair Dealing is an appropriate regulatory response at this stage because the current NZU market structure is predominantly OTC, which is a fundamental point of difference from overseas emissions

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<sup>8</sup> For example, while not relating to advice as such, the FMA recently issued direction orders based on the fair dealing provisions preventing a property developer offering investments from publishing misleading information about the nature and potential returns on the investments it was offering.

<sup>9</sup> For example, the FMA is also using fair dealing as part of a current case involving alleged manipulation of share prices via online channels, because of the potentially broader reach of fair dealing over specific market manipulation rules.

trading schemes (such as the EU) which trade nearly exclusively via authorised platforms.

64 I also propose that:

64.1 a regulation-making power is added to the FMC Act to enable other types of emissions units to be called into regulation under Part 2 of the FMC Act via regulations; and

64.2 Any necessary legislative change be made to enable FMA, MfE, MPI and the EPA to be able to share and receive information to the extent necessary for those agencies to give effect to their regulatory responsibilities.

*Establishing a work programme for the trading and market misconduct risks*

65 While I consider the fair dealing provisions to be the appropriate regulatory response for now, I consider that further regulation may be warranted as the NZU market develops.

66 I propose that I report back to Cabinet alongside the Minister of Commerce and Consumer Affairs by June 2024. This report back would include final decisions to progress comprehensive regulatory solutions (if considered appropriate) for the following risks:

66.1 Potential lack of transparency, oversight, and monitoring of trades in the NZU market;

66.2 Credit and counter-party risks;

66.3 Insider trading and information asymmetry; and

66.4 Manipulation of NZU prices.

67 I note the report back to Cabinet should consider whether the way in which the above risks are regulated, as financial products, under the FMC Act would be practical and appropriate for regulating the NZU market.

68 I note that an effective insider trading framework for the NZU market requires ongoing public disclosure of material market moving information. This allows everyone in the market to know what is and is not insider information. As part of that package, I therefore propose to direct officials to consider an effective disclosure mechanism, which will likely require consultation with those affected.

69 I do not expect smaller NZU market users to hold material market moving information so do not expect them to be affected by disclosure obligations. I expect officials to consider the impact on smaller NZU market users.

70 Any report back to Cabinet on market governance proposals should consider the ongoing work on the NZ ETS review.

*Implementation and timeframes*

71 After the report back to Cabinet, I intend for the:

71.1 Fair Dealing proposals to be introduced by mid-2024; and

71.2 changes to come into force soon after the Amendment Bill is passed.

72 I also intend that the:

72.1 comprehensive Market Governance package be introduced by the end of 2024, depending on the legislative priorities of the government; and

72.2 changes to come into force within 24 months of the Bill being passed.

**Financial implications**

73 I note that as part of Budget 2023, the tagged contingency New Zealand Emissions Trading Scheme Market Governance was created with the following profile:

|                              | \$m – increase/(decrease) |         |         |         |         | 2027/28<br>&<br>Outyears |
|------------------------------|---------------------------|---------|---------|---------|---------|--------------------------|
|                              | 2022/23                   | 2023/24 | 2024/25 | 2025/26 | 2026/27 |                          |
| Tagged Operating Contingency | -                         | 9.500   | 9.500   | 9.500   | 9.500   | 6.000                    |
| Tagged Capital Contingency   | -                         | -       | -       | -       | -       | -                        |

74 I note that Cabinet invited me to include options to draw down the tagged operating contingency established above when reporting back to Cabinet, with an expiry date of this contingency being 1 February 2024.

75 s 9(2)(f)(iv)

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

- 76 I note that further work is required to finalise these costs and how they will be split across agencies.
- 77 I seek agreement to delegate authority to draw down the tagged contingency referred to above (as well as establishing any new appropriations as necessary), once these costs have been finalised, to me alongside the Minister of Commerce and Consumer Affairs, and the Minister of Finance. Further, I propose to extend the expiry date of the tagged contingency to 30 June 2024.

78 s 9(2)(f)(iv)

s 9(2)(f)(iv), s  
9(2)(g)(i)

*Additional funding is required for the comprehensive package*

- 79 I note that more funding will be required for the comprehensive package contained in the report back to Cabinet. This is because the roles and responsibilities of regulators may be expanded under the comprehensive package, and there may be additional capital expense costs for government compliance infrastructure to be upgraded.

**Legislative implications**

- 80 The market governance proposals will require amendments to the Financial Markets Conduct Act 2013, Climate Change Response Act 2002 and other relevant legislation and regulations.
- 81 I note that the introduction of an amendment Bill for the market governance proposals will require a legislative bid for the 2024 legislative programme.

**Impact Analysis**

*Regulatory Impact Statement*

- 82 A Regulatory Impact Analysis Panel from the MfE, MBIE and MPI has reviewed the Regulatory Impact Statement (RIS) "A Market Governance Framework for the New Zealand Emissions Trading Scheme" produced by MfE, dated June 2023. The review team considers that it partially meets the Quality Assurance criteria.
- 83 The RIS is consulted, and relatively clear and concise given the nature of the proposals.
- 84 The RIS indicates the limits and constraints under which the proposals have been developed, such as the lack of empirical evidence available due to the nature of the issues being addressed, and previous Cabinet decisions driving the formulation of the proposals. However, these limitations are not clearly reflected in the development of the proposals in the rest of the document, and the alignment is not clear between the problem definition, the different sets of

objectives and the options considered. Finally, there is little detail on the likely costs and benefits of the proposals. Therefore, the Panel considers the RIS does not provide Ministers with sufficient evidence that the benefits of the proposals outweigh the costs.

- 85 Despite these issues, the RIS serves to inform Ministers on the likely consequences of the favoured option.

#### *Climate Implications of Policy Assessment*

- 86 The Climate Implications of Policy Assessment (CIPA) team has been consulted and confirms that the CIPA requirements do not apply as there is no direct emissions impact.
- 87 While these specific proposals do not have an explicit objective to reduce emissions, they are intended to support the effective functioning of the NZ ETS which is a key driver of emissions reductions.

#### **Population impacts**

- 88 There are no population implications of the proposed policy changes. We considered the impacts on the various population groups, such as: children, seniors, disabled people, women, people who are gender diverse, Pacific peoples, veterans, rural communities, and ethnic communities.

#### **Implications for Māori**

- 89 The proposal contained in this Cabinet paper is not expected to have a disproportionate effect to Māori.

#### *The exchange should reduce risks of financial harm and transaction costs*

- 90 Introducing optional exchange-based trading could reduce the risk of financial harm from price manipulation, insider trading, and credit and counter party risk. In designing the exchange, agencies will be mindful of the costs to ensure smaller NZU market users, including iwi and Māori who can currently trade bilaterally with minimal administrative cost, are not disproportionately impacted.
- 91 The intent of the exchange is to encourage liquidity and participation on the platform, so any considerations to reduce barriers to trading will be essential and considered as part of the procurement process.
- 92 I note the clearing system and exchange do not remove any existing channels or platforms from the market that iwi and Māori currently access and utilise. This means any current arrangements that iwi and Māori use are expected to remain accessible regardless of the establishment of the exchange.

#### *Fair Dealing has comparable obligations to the status quo*

- 93 Regarding Fair Dealing, the approach is expected to have limited impact because the Fair Dealing obligations are comparable with obligations that



already apply under the Fair Trading Act 1986. The only differences being the FMA becomes responsible for oversight of the NZU market, in place of the Commerce Commission.

## **Human rights**

- 94 There are no inconsistencies between these proposals and the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993.

## **Consultation**

### *General public*

- 95 In 2022, MfE consulted on the impacts of treating NZUs as a financial product. The targeted engagement period was from 17 November 2022 to 27 February 2023.
- 96 MfE hosted:
- 96.1 one online general webinar about the NZU market governance proposals;
  - 96.2 four targeted online workshops for Iwi/Māori, forestry, and financial sectors;
  - 96.3 a further two online hui with Iwi/Māori; and
  - 96.4 five one-on-one meetings with stakeholders, at their request.
- 97 We received 63 submissions from various sectors including energy, forestry, financial, platform operators, agriculture/ farming, Māori representatives, environmental groups, construction, wood processors and individuals.

### *Legislation Design and Advisory Committee feedback*

- 98 MfE sought feedback from the Legislation Design and Advisory committee (LDAC) during the development of the Market Governance Framework. In their letter dated 11 December 2022, the LDAC advised MfE focus efforts on the:
- 98.1 detail of the policy problems they are seeking to address,
  - 98.2 design of the regulatory interventions required to address those identified problems, and
  - 98.3 role of regulators in supporting the regulatory system to achieve its objectives.
- 99 LDAC's feedback has been considered and will be incorporated into the design of the comprehensive market governance proposal for the report back to Cabinet.

### *Departmental consultation*

- 100 The agencies consulted in the development of this Cabinet Paper were: MBIE, the FMA, the EPA, MPI, Ministry of Justice, Ministry of Foreign Affairs and Trade, the Department of the Prime Minister and Cabinet, Te Arawhiti, Te Puni Kokiri, Climate Change Commission, Parliamentary Counsel Office (PCO) and Treasury.

### **Communications**

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

### **Proactive release**

- 102 This paper will be proactively released and is subject to redactions as appropriate equivalent to those under the Official Information Act 1982.

### **Next steps**

- 103 I propose that drafting instructions be issued PCO to draft the decisions set out in this paper in a Bill.
- 104 I also propose to share this Cabinet paper, drafts of further Cabinet papers on related issues, drafting instructions to the PCO, subsequent draft legislation or regulations, and related documents, with the FMA and the EPA.

### **Recommendations**

The Minister of Climate Change recommends that the Committee:

- 1 **Note** that in 2015, the review of the NZ ETS found that the New Zealand Emissions Trading Scheme (NZ ETS) could be improved, and identified that the market governance framework is not fit for purpose as it does not ensure market integrity, efficiency and confidence, nor addresses potential misconduct;
- 2 **Note** that in 2018 and 2022, the Government consulted on improving the NZ ETS and identified seven market governance risks;

### *Prior Cabinet decisions regarding market governance*

- 3 **Note** that in 2022, Cabinet agreed in principle, subject to further analysis, funding, and Cabinet decisions on the comprehensive package, [CAB-22-MIN-0344 refers] to progress:
  - 3.1 *an exchange*. Ministry for the Environment, in consultation with Ministry of Business, Innovation and Employment, and Ministry of Primary Industries, undertake further analysis and the Minister of Climate Change return to Cabinet with technical requirements and funding

considerations in order to address governance of trading risks with an exchange; and

- 3.2 *an education campaign.* The education campaign is to be targeted for all people interacting with the NZU market, informing them of market risks in the NZ ETS and the benefits and implications of upcoming market changes;

*Progressing an education campaign*

- 4 **Agree** that the Ministry for Environment (MfE) will work with the Ministry of Business, Innovation and Employment (MBIE), the Ministry of Primary Industries (MPI), the Financial Markets Authority (FMA), and the Environmental Protection Authority (EPA) to establish an education campaign for all people interacting with the NZU market;

*Progressing the procurement of an optional centralised exchange*

- 5 **Direct** officials to begin a Request for Proposal process, with a report back, to procure a centrally cleared, optional to use exchange and associated market infrastructure;

- 6 s 9(2)(f)(iv)

- 7 **Invite** the Minister of Climate Change and Minister of Commerce and Consumer Affairs to report back to Cabinet in March 2024, and seek a decision on whether centralised clearing should be mandatory, considering:

- 7.1 MfE's preferred supplier(s);
- 7.2 the estimated costs for establishing the exchange;
- 7.3 the estimated costs of making the centralised clearing system compulsory;
- 7.4 the rationale and estimated costs to establish and operate centralised clearing for all NZ market users;
- 7.5 any disproportionate impacts of the optional exchange and centralised clearing for ETS participants with compliance obligations; and
- 7.6 implications for Treaty partners;

- 8 s 9(2)(f)(iv)

- 9 **Note** that implementing the exchange package is intended to assist transparency, monitoring and oversight of trades in the secondary market and publication of market information will assist with transparency and information asymmetry.

- 10 **Note** the EPA is currently exploring the impact of the proposed market governance approach on the Register and the ability to connect to and support the exchange;
- 11 s 9(2)(f)(iv) [REDACTED]  
[REDACTED]  
[REDACTED]  
[REDACTED]
- 12 **Note** that information will need to be shared between the Register)/Registrar/EPA (as applicable), the exchange/market operator of the exchange and the agency monitoring the exchange, which will require amendments to Climate Change Response Act 2002 (CCRA) and other relevant legislation;
- 13 **Note** that legislative changes may also be required to enable the clearing system and/or exchange to interface with the Register and connect into the existing arrangements in place for NZU trading;
- 14 **Agree** the necessary amendments be made to the CCRA and other legislation (such as the Financial Markets Authority Act 2011), to ensure that the clearing system and/or exchange can operate effectively and efficiently and the EPA and the FMA have the ability to share and receive information in relation to the clearing system and/or exchange as necessary to fulfil their functions;
- 15 **Note** that the regulatory oversight of the clearing system and/or exchange needs to be considered, prior to the launch of the clearing system and/or exchange;
- 16 **Agree** to amend the CCRA and other relevant legislation to enable the Register/Registrar/EPA (as applicable) to have the ability to publish or share all information it collects with a future procured supplier(s) and the agency monitoring the clearing system and/or exchange, and that this information may be made available to market and/or the public;

*Improved regulation of Over the Counter trades*

- 17 **Note** the EPA/Registrar (as applicable), through the Register, currently does not collect certain information regarding the price of transacted NZUs or whether trades are being made between related or non-related accounts;
- 18 **Note** there are limitations on the EPA's ability to report and publish some useful market information that would improve transparency for NZU market users;

- 19 **Note** these restrictions on information limit transparency, monitoring and oversight of trades in the NZU market;
- 20 **Agree** that the necessary amendments be made to the CCRA and other relevant legislation to:
- 20.1 enable the Register, Registrar and EPA (as applicable) to publish or share certain market information already collected; and
  - 20.2 require account holders to provide the information listed below and allow the EPA/Registrar/Register (as applicable) to collect, store, publish and share the following:
    - 20.2.1 the price of NZUs in the transaction;
    - 20.2.2 whether trades are being made between non-related accounts; and
    - 20.2.3 the transactor's primary reason for holding an account;

*Applying Fair Dealing provisions under the Financial Markets Conduct Act 2013*

- 21 **Note** that the appropriate regulatory response to the seven market governance risks at this stage is to increase regulatory oversight in NZU markets;
- 22 **Note** that the FMA is responsible for monitoring and enforcement of the "Fair Dealing" provisions in Part 2 of the FMC Act, which prohibits:
- 22.1 Misleading or deceptive conduct, false or misleading representations, and unsubstantiated representations in relation to financial products and services; and
  - 22.2 Offers of financial products in course of unsolicited meetings;
- 23 **Agree** to treat NZUs as a financial product for the purposes of Part 2 in the FMC Act;
- 24 **Note** that recommendation 27 means FMA will be responsible for overseeing the Fair Dealing provisions in relation to NZUs;
- 25 **Agree** that a regulation-making power is added to the FMC Act to enable other interests, such as other types of Emissions Units (certain types or classes) that are not NZUs, to be called in to regulation under Part 2 of the FMC Act via regulations;
- 26 **Agree** that the offences, penalties and regulatory tools arising from Part 2 of the FMC Act will apply to NZUs in the same manner as financial products and financial services under Part 2, with any necessary modifications;
- 27 **Note** the offences and penalties for a contravention of this Part are:

- 27.1 a civil liability of which penalties include \$200,000 for individuals and \$600,000 for non-individuals; and
- 27.2 a pecuniary penalty not exceeding:
  - 27.2.1 three times the amount of the gain made or the loss avoided; and
  - 27.2.2 \$1 million in the case of an individual; or
  - 27.2.3 \$5 million in any other case;
- 28 **Note** the pecuniary penalty in Recommendation 27.2 only applies to the offences of misleading or deceptive conduct, false or misleading representations, and unsubstantiated representations, and is not applicable to the offence of offers of unsolicited meetings;
- 29 **Agree** that the FMA, MfE, MPI, MBIE and EPA may share and receive information to the extent that is necessary for those agencies to give effect to their regulatory responsibilities and to make any necessary legislative changes to give this effect;

*Establishing a market governance work programme for the trading and market misconduct risks*

- 30 **Note** that further regulation may be warranted as NZU markets develop;
- 31 **Agree** that the Minister of Climate Change and Minister of Commerce and Consumer Affairs report back to Cabinet by June 2024 on final decisions to introduce comprehensive regulatory solutions for the following risks:
  - 31.1 Potential lack of transparency, oversight, and monitoring of trades in the NZU market;
  - 31.2 Credit and counter-party risks;
  - 31.3 Insider trading and information asymmetry;
  - 31.4 Manipulation of NZU prices;
- 32 **Note** the report back to Cabinet should consider whether the way in which the above risks are regulated, as financial products, under the FMC Act would be practical and appropriate for regulating NZU markets;
- 33 **Note** an effective insider trading framework for the NZU market requires ongoing disclosure of material market moving information;
- 34 **Direct** officials to design a disclosure mechanism for ETS participants, including both emissions and removal activities, and persons that hold NZUs, for the purpose of insider trading prohibitions;

- 35 **Note** as part of the report back to Cabinet, officials will consider the impact on smaller NZU market users in NZU markets when developing the regime;
- 36 **Note** the report back should consider the wider ongoing work regarding the NZ ETS review;

#### *Legislative implications*

- 37 **Note** that the market governance proposals to impose the fair dealings proposals will require amendments to the CCRA and Financial Market Conduct Act 2013 and other relevant legislation;
- 38 **Note** that the introduction of an amendment Bill for the market governance proposals will require a legislative bid in the 2024 legislative programme;

#### *Implementation and timeframes*

- 39 **Note** the Minister of Climate Change intends for:
- 39.1 work on the education campaign to begin immediately after funding is drawn down;
- 39.2 s 9(2)(b)(ii), s 9(2)(f)(iv)
- 39.3 the Fair Dealing proposals to be introduced by mid-2024; and
- 39.4 the changes to come into force soon after the Amendment Bill is passed;
- 40 **Note** the Minister of Climate Change intends for:
- 40.1 the comprehensive Market Governance package to be introduced by the end of 2024 depending on the legislative priorities of the government; and
- 40.2 the changes to come into force within 24 months of the Bill being passed;


#### *Financial implications*

- 41 **Note** that as part of Budget 2023 the tagged contingency New Zealand Emissions Trading Scheme Market Governance was created with the following profile;

|                              | \$m – increase/(decrease) |         |         |         |         | 2027/28<br>&<br>Outyears |
|------------------------------|---------------------------|---------|---------|---------|---------|--------------------------|
|                              | 2022/23                   | 2023/24 | 2024/25 | 2025/26 | 2026/27 |                          |
| Tagged Operating Contingency | -                         | 9.500   | 9.500   | 9.500   | 9.500   | 6.000                    |
| Tagged Capital Contingency   | -                         | -       | -       | -       | -       | -                        |


- 42 **Note** that as part of Budget 2023, Cabinet invited the Minister of Climate Change to include options to draw down the tagged operating contingency established above when reporting back to Cabinet on Emissions Trading Scheme market governance;
- 43 **Note** that the proposals in this Cabinet paper will have financial implications on the FMA, EPA, MBIE and MfE;
- 44 **Note** that the Minister of Climate Change intends to cover these costs through the tagged contingency established as part of Budget 2023

45 s 9(2)(f)(iv)


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- 46 **Note** that further work is required to finalise these costs and how they will be split across agencies;
- 47 **Agree** that the Minister of Climate Change, the Minister of Commerce and Consumer Affairs, and the Minister of Finance, can draw down the tagged contingency referred to above (establishing any new appropriations as necessary) once these costs have been finalised;
- 48 **Agree** to extend the expiry date of the tagged contingency to 30 June 2024;

49 s 9(2)(b)(ii), s 9(2)(f)(iv)

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50 s 9(2)(f)(iv), s 9(2)(g)(i)

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*Next steps*

- 51 **Authorise** the Minister of Climate Change and Minister of Commerce and Consumer Affairs to issue drafting instructions to the Parliamentary Counsel Office to implement the decisions set out above through a Bill;
- 52 **Agree** that the Minister of Climate Change and Minister Commerce and Consumer Affairs may share this Cabinet paper, drafts of further Cabinet papers on related issues, drafting instructions to the PCO, subsequent draft legislation or regulations, and related documents, with the FMA and the EPA;
- 53 **Agree** that the Minister of Climate Change and Minister of Commerce and Consumer Affairs are authorised to further clarify and develop policy matters relating to the proposals in this Cabinet paper in a manner not inconsistent with the policy recommendations contained in the paper;

*Proactive release*

- 54 **Agree** to proactively release this Cabinet paper subject to redactions as appropriate equivalent to those under the Official Information Act 1982;

Authorised for lodgement

Hon James Shaw

Minister of Climate Change

| Appendix 1: Initial Market Governance package                                                        |                                                                                                                                |                                                                                                                                                                    |                                                                                                                                     |                                                                                                                             |                                                                                                                                              |
|------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------|
| Market Governance Risks                                                                              | Centralised clearing and exchange                                                                                              | Fair Dealing (Part 2 of FMC Act)                                                                                                                                   | Improved Transaction reporting                                                                                                      | Education Campaign                                                                                                          | Overall coverage                                                                                                                             |
| <b>Risk 1:</b> Inadequate, false, or misleading advice to NZ ETS participants                        | None                                                                                                                           | <b>Good</b><br>Allows FMA to intervene where conduct misleads in relation to dealings about NZUs, and where false, misleading, or unsubstantiated representations  | None                                                                                                                                | <b>Good</b><br>Equips market participants with the knowledge needed to make informed decisions and avoid potential pitfalls | <b>Good</b><br>Provides a light-touch response to poor advice, which is proportional at this stage                                           |
| <b>Risk 2:</b> Conflicts of interest involving the New Zealand Emissions Trading register            | None                                                                                                                           | <b>Good</b><br>As above, where conflicts of interest are involved in misleading or deceptive conduct                                                               | None                                                                                                                                | <b>Good</b><br>Improves knowledge about potential conflicts                                                                 | <b>Good</b><br>Provides a light-touch response to deceptive conduct, which is proportional at this stage                                     |
| <b>Risk 3:</b> Potential lack of transparency, oversight, and monitoring of trades in the NZU market | <b>Good</b><br>Frontline regulator has transparency and oversight of trades                                                    | <b>Good</b><br>Allows the regulator to receive and review market surveillance information from the exchange                                                        | <b>Good</b><br>Provides regulator with detailed transaction data for monitoring and oversight of the market                         | None                                                                                                                        | <b>Good</b><br>Provides transparency, monitoring and oversight of trades                                                                     |
| <b>Risk 4:</b> Credit and counter-party risks                                                        | <b>Good</b><br>Centralised clearing and platform market rules fully address credit and counter party risks                     | None                                                                                                                                                               | None                                                                                                                                | None                                                                                                                        | <b>Good</b><br>Provides clearing mechanisms, market rules and regulatory response to credit and counterparty risks                           |
| <b>Risk 5:</b> Insider trading and information asymmetry                                             | <b>Partial</b><br>Frontline regulator can monitor trades but cannot distinguish if the trade was based on inside information.  | <b>Partial</b><br>Allows the regulator respond to deceptive conduct where false or misleading representations or conduct induce a transaction                      | <b>Partial</b><br>Enables a regulator to detect suspicious trading. Cannot distinguish if the trade was based on inside information | None                                                                                                                        | <b>Partial</b><br>Provides a light-touch response to deceptive conduct. But does not have a disclosure regime for detecting insider trading. |
| <b>Risk 6:</b> Manipulation of NZU prices                                                            | <b>Partial</b><br>Frontline regulator has transparency and oversight of trades to detect anomalous trading behaviour on market | <b>Good</b><br>Allows FMA to intervene where false or misleading representations are made to induce a transaction or suspected misconduct appears to affect prices | <b>Good</b><br>Provides regulators with better data on trades, enabling detection of abnormal trading patters                       | None                                                                                                                        | <b>Good</b><br>Provides a light-touch response which allows the regulator to respond to misleading or deceptive practices                    |
| <b>Risk 7:</b> Money laundering/financing of terrorism in the NZ ETS                                 | Not applicable<br>Existing Anti-Money Laundering and Counter-Financing of Terrorism Act to be considered during report back.   |                                                                                                                                                                    |                                                                                                                                     |                                                                                                                             |                                                                                                                                              |