NEW ZEALAND BUSINESS ROUNDTABLE

Submission on the Financial Markets (Regulators and KiwiSaver) Bill

November 2010

1. Introduction

1.1 This submission on the Financial Markets (Regulators and KiwiSaver) Bill (Bill) is made by the New Zealand Business Roundtable, an organisation comprising primarily chief executives of major New Zealand business firms. The purpose of the Business Roundtable is to contribute to the development of sound public policies that reflect New Zealand's overall interests.

1.2 The Business Roundtable wishes to be heard by the Select Committee in relation to this submission.

1.3 In summary, the Business Roundtable submits that:

(a) The Financial Markets Authority (FMA) has the potential to play a positive role in relation to New Zealand's financial markets provided that its approach to the exercise of its significant regulatory powers is measured and responsible. We suggest some modest changes to its stated statutory purposes. We do not consider that the new financial levies have been properly justified.

(b) The proposed new power for the FMA to take over a person's right of action is unjustified, misguided, and unfair. Furthermore, the inclusion of the proposal in this Bill unwisely pre-empts the outcome of the Ministry of Economic Development's (MED) review of the securities laws. There has been inadequate consultation or regulatory impact analysis in relation to this proposal. The matter should be referred back to the MED for further consideration in the context of the substantive reforms that will emerge from its review.

(c) The Bill further expands on existing intrusions on NZX's ability to determine its own affairs. We oppose measures which reduce the independence of stock exchanges from outside interference by regulators and politicians. Private rule-making is not only a practical alternative to state regulation but in most cases it is also demonstrably superior.

2. Financial Markets Authority Bill

Preliminary comments

2.1 The Business Roundtable is, in principle, receptive to the establishment of the FMA to consolidate the market regulation functions currently performed by the Securities Commission, Ministry of Economic Development, the Government Actuary and some of the functions of NZX Limited. This institutional model has the potential to achieve the goal of more efficient and cost-effective regulation.

2.2 The success or otherwise of the FMA will be influenced as much by the approach of its board and senior personnel as its institutional design. The securities law review and aspects of this Bill contemplate a shift away from compliance-focused regulation toward risk-focused regulation. The successful transition towards this new approach to regulation will require the FMA to engage with the market in order to facilitate capital raising and commerce.

2.3 However, we note that some of the recent commentary about the expected approach and role of the FMA has a regrettably populist tone. For example, recent public suggestions by the new Commissioner for Financial Advisers that the global financial crisis had discredited the free market system and undermined the efficient market hypothesis were disquieting.[1] Yet to blame the global financial crisis on markets rather than on the regulatory environment governing those markers is gratuitous. In particular, in the absence of any evidence linking the financial company failures in New Zealand to the global crisis, such a statement indicates an ideological bias in favour of intrusive regulation. Yet, as the latest 2025 Taskforce report has found, expanding

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[1] *New Zealand Herald*, 'David Mayhew - Cleaning up the Markets', 4 October 2010.

rather than further shrinking the domain for voluntary exchange is fundamental to achieving the productivity gains necessary to close the income gap with Australia by 2025.[2]

2.4 It is therefore important to think clearly about the functions and the limits of intrusive government regulation. Such regulation was inextricably associated with the tremendous loss of value associated with the global financial crisis and, in conjunction with government-directed lending into housing, arguably did much to cause the asset bubble and market distortions which led to the crisis.[3] Simply put, private and political markets both fail against the unattainable perfect ideal.[4] The only sensible approach for the designers of quality regulation is to ascertain the best of the available options. (This is sometimes called the comparative institutional approach.) As much is clear from the government's policy statement on regulation, *Better Regulation, Less Regulation*, dated 17 August 2009. Moreover, the absence of state regulation is not synonymous with the absence of regulation. In the absence of detailed state regulation, regulation of dishonest and fraudulent practices would occur through competition and common law judges. The Business Roundtable notes with approval the measured approach of the Capital Market Development Taskforce to this issue:[5]

> 'Market discipline', where bad practices are driven out by competition or transparency, or 'self discipline', where participants have their own capital or reputation at risk, are the front-line and most powerful tools for a sound capital market.

2.5 The Business Roundtable believes that the FMA should focus its energies on preserving and enhancing the domain for voluntary exchange while ensuring that laws against dishonest and fraudulent practices in the financial markets are appropriate and are enforced in an effective, predictable and timely manner. The FMA should inspire confidence in New Zealand markets by leading by example in this respect. All too often in the past we have seen regulators and senior law makers leading the attack on the reputation of New Zealand markets as "the last frontier of the Wild West" rather than defending its sound historic base in the common law, uncorrupt courts, and English institutions more generally. The FMA should recognise its limitations. It is absolutely essential for New Zealand's future prosperity that caveat emptor applies – that those who invest for higher returns than those available from government stock accept that the risks of doing so fall on themselves. The FMA must seek to minimise moral hazard rather than exacerbate it. The recent bailout of finance company investors is a serious slap in the face for more prudent investors and is a troubling moral hazard-raising precedent. The FMA must frequently explain that state regulation cannot eliminate fraud, folly, greed and imprudence from human affairs. Investors have to take responsibility for their own decisions. We are confident that a properly focused FMA can take material steps towards improving the quality of New Zealand's regulatory environment.

Objective

2.6 The FMA's main objective is stipulated as follows by clause 8:

> The FMA's main objective is to promote fair, efficient, and transparent financial markets.

2.7 Clause 9(1)(c) of the Bill implicitly expands the FMA's objectives by stating that one of its functions is "to promote the confident and informed participation of businesses, investors, and consumers in the financial markets" by performing the various tasks specified in sub-clause 9(1)(c)(i)-(iii).

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2 http://www.2025taskforce.govt.nz/pdfs/2025tf-2ndreport-nov10.pdf

3 See, e.g., Mark Calabria, 'Did Deregulation Cause the Financial Crisis?' *Cato Policy Report* (July / August 2009).

4 See, e.g., David Friedman, *Private and Political Markets Both Fail*, Occasional Paper, New Zealand Business Business Roundtable (December 2004).

5 Capital Market Development Taskforce, *Capital Markets Matter*, page 81.

2.8 As a preliminary point, we note that this statement of the FMA's objective does not identify what the deficiency is with private arrangements that the pursuit of this objective will overcome. Moreover, it neither recognises that there are trade-offs between these three potentially conflicting objectives nor gives guidance as to the appropriate trade-offs (e.g., how much fairness is enough, and why is transparency preferable to privacy of commercially sensitive information?).

2.9 The Business Roundtable prefers the approach of the Capital Market Development Taskforce that the FMA's primary objective should be to facilitate participation in capital markets and that "the primary role of regulation in capital markets is to facilitate participation in markets by both investors and businesses".[6] This formulation would have the virtue of providing a clear sense of direction for the FMA and preserving the distinction between the FMA's objective under clause 8 and its functions under clause 9.

Financial levies

2.10 The provisions of Part 4, Subpart 1 of the Bill authorise the imposition of a levy on financial market participants to cover a portion of the FMA's costs in performing its functions. We question the appropriateness of this provision.

2.11 The concept of a user charge based on the benefit principle is that it is efficient to confront a user with the cost to the community of providing the payee with the requested service. This is because the user won't request the service unless the benefit to the user exceeds the charge. Provided that the charge reflects the (marginal or incremental) cost to the community, it is reasonable to presume, other things being equal, that the benefit to the individual and therefore to the community overall exceeds the cost.

2.12 However, the benefit principle does not apply to a situation where (as here):

(a) The "purchase" of the "service" is mandatory. Obviously in such circumstances there is no basis for presuming that the benefit exceeds the cost. Commonly "purchase" is made mandatory by tying the service to the ability to stay in one's chosen business. In that situation, the benefit to the payee has nothing to do with the quality or quantity of the service because the service is necessary to stay in business. Even if the private benefit from the service was highly negative the payee may still pay the charge in order to stay in business.

(b) The cost of the service is not competitively determined. A monopoly regulator does not face any competive pressures to minimise the cost of supply because the "user" must pay any charge that the political process will support.

2.13 The Treasury's user charge guidelines acknowledge these issues and state explicitly that the "beneficiary pays" principle is not necessarily efficient as a charging rule.[7] The Treasury's guidelines note the Auditor-General's report on the important issue of when a user charge crosses the boundary between an efficiency measure and a discriminatory tax. They acknowledge the likelihood of excessive costs with monopoly supply and mandatory purchase.

2.14 The Regulatory Responsibility Taskforce also recognised these problems and proposed in 2009 that taxes and charges should:[8]

(d) not impose, or authorise the imposition of, a tax except by or under an Act:

(e) not impose, or authorise the imposition of, a charge for goods or services (including the exercise of a function or power) unless the amount of the charge is reasonable in relation to both:

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6 *Ibid*, pages 81 and 87.

7 See http://www.treasury.govt.nz/publications/guidance/planning/charges, section 4.

8 Report of the Regulatory Responsibility Taskforce (30 September 2009), page 47, http://www.treasury.govt.nz/economy/regulation/rrb/taskforcereport/rrt-report-sep09.pdf

(i) the benefits that payers are likely to obtain from the goods or services; and

(ii) the costs of efficiently providing the goods or services:

2.15 The Business Roundtable considers that the levies on financial market participants have not been properly justified in terms of these provisions.

3. New enforcement powers

The new powers are very significant

3.1 We support the credible and efficient enforcement of the law's justified prescriptions and prohibitions. However, the proposed new powers of the FMA to take over private causes of action pursuant to Part 3, Subpart 3 have not been subject to adequate consultation or analysis and the Business Roundtable has serious reservations about them.

3.2 Clause 34 creates a new power for the FMA to take over, and control the exercise of, another person's right of action against registered financial service providers and public issuers (including their owners, directors, senior managers, promoters, managers, statutory supervisors, auditors, and experts whose statements are included in the prospectus).

3.3 The types of proceedings which the FMA will be empowered to take over are very wide-ranging, including civil proceedings under financial markets legislation or civil proceedings seeking damages for fraud, negligence, default, breach of duty or other misconduct in connection with the financial markets.[9]

Interference with private property

3.4 The FMA's power to take over private causes of action infringes on the property rights of the holders to control the exercise of that cause of action. The Business Roundtable has a number of concerns about the inconsistency of the proposal with private property rights:

(a) It is inappropriate to provide that a person's right to control their property can be overridden by a short notice period. Clause 35 of the Bill provides that the FMA may commence proceedings to exercise a person's right of action unless the person holding the right of action responds within 10 working days of receiving the FMA's notice by either commencing proceedings or giving written notice objecting to the FMA commencing proceedings.

(b) It is inappropriate and contrary to principle that the Bill will permit a Court to override a person's objection to the FMA exercising its right of action under clause 36. In effect, the FMA can potentially exercise a person's right of action against their will.

(c) Worse, clause 39 permits the Court to order the person who holds the right of action to pay the FMA's costs in relation to the proceeding. We regard it as extraordinary that someone could potentially be prevented from opting out of the FMA's proceeding but nevertheless required to pay the FMA's costs if the proceeding fails or turns out to be uneconomic.

(d) The FMA is not required to follow the wishes of the persons who hold the right of action being exercised. Indeed, the FMA is not even obliged to consult with those persons.

(e) There may be a number of reasons why a person decides not to take legal action that may be available to it. This could include a desire to avoid the administration and management costs or the public exposure that will inevitably result from initiating legal action or it could

[9] See, e.g., *Taking up arms for the investor – FMA's power to litigate* (Chapman Tripp, 21 September 2010); *Increased regulatory risk profile for financial markets participants and auditors* (Bell Gully, 24 September 2010).

arise from the fact that the person may initially prefer to attempt to constructively settle the matter with the other party, rather than pursuing the matter through the Courts. Indeed the FMA action may provoke counter claims against the persons.

(f) Clause 41 of the Bill allows the FMA to settle cases without seeking the consent of the affected parties. This is a further erosion of the rights of an individual, as it is likely that any settlement is likely to prevent the affected party from taking further action in the future. The Business Roundtable is particularly concerned about this given the "public interest" requirement in the Bill, which allows the FMA to use the powers as a further regulatory tool (i.e. as another method of raising awareness of security law issues and compliance), rather than simply acting in the best interests of the relevant plaintiffs (who are likely to be more concerned with obtaining the maximum financial settlement, as opposed to furthering the FMA's objectives).

3.5 These measures constitute serious intrusions into the rights of companies and investors to control the exercise of their causes of action. Compelling justifications should be required for such measures. The concern is aggravated by the rule of law problem identified above: that FMA decisions must involve fundamentally arbitrary judgments about trade-offs between competing objectives. As we discuss further below, the case for such reforms is patently uncompelling.

Legal experts are sceptical of the proposal

3.6 The Business Roundtable notes that the leading New Zealand law firms expressed scepticism about the proposal when it was raised by the MED in its discussion paper on the review of the securities laws.

3.7 Bell Gully submitted:[10]

> (a) Shareholders of public companies are able to bring class or representative actions and obtain litigation funding to meet the costs of doing so. We therefore question the need for the Authority to assume this role.
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> (b) As noted in the Discussion Paper, serious cases of breach of directors' duties generally come to light in the context of companies in receivership or liquidation. In those circumstances, receivers and liquidators (and in some cases statutory managers) have sufficient powers and incentives to take action in respect of any breach of directors' duties. There is no evidence to suggest any reluctance or inability on the part of receivers and liquidators to pursue such claims in appropriate cases.
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> (c) We question whether public regulators have sufficient resources and expertise to undertake the substantial responsibility of enforcing directors' duties generally. If the Financial Markets Authority assumes this role, it may require a substantial increase to its investigative and enforcement capacity. This must be funded by taxpayers, rather than the beneficiaries of such actions. The Authority's resources might be better focused on its core responsibilities, such as the oversight and enforcement of securities laws.
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> (d) It would be undesirable if the Financial Markets Authority's ability to bring a civil claim for breach of directors' duties excluded the ability of shareholders to control and settle their own claims. For example, a shareholder might prefer to settle his or her claim quickly in order to avoid litigation risk.
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> (e) We disagree with the reasoning in paragraph 123 of the Discussion Paper. If regulators are currently "using inapt offence provisions as an indirect way of obtaining an enforcement result against what the regulators may regard as breaches of directors' duties", that indicates poor practice and/or misconduct on the part of regulators and should cease. That is not a reason to give greater

[10] http://www.med.govt.nz/upload/74807/Securities%20Law%20Review%20053%20Bell%20Gully%20Web.PDF

> powers to regulators who are (the Discussion Paper implies) currently using their existing powers for improper purposes.

3.8 Chapman Tripp submitted:[11]

> Our issue with conferring such a power on the FMA is that the regulator's interest and the interests of investors are not always perfectly aligned, or even compatible. The investor may want a quick result but legal proceedings will frustrate the ability of the affected parties to pursue recovery claims. Further, the regulator may be more interested in demonstrating the efficacy of statutory protections and enforcement than in securing satisfactory compensation.

3.9 Harmos Horton Lusk submitted:[12]

> We can see no reason for establishing a system whereby the State is entitled to enforce directors' duties. A company represents a commercial arrangement amongst its shareholders and directors, which the State has no direct interest in. There is so far as we know, no evidence of any problem which public enforcement would correct. As the paper notes, there are already provisions in the Companies Act for derivative actions. Those provisions are aimed expressly at giving shareholders a realistic way to enforce directors' duties.

3.10 In a client publication, Russell McVeagh noted:[13]

> However, it is likely that questions will be asked regarding the need for the FMA to be provided with additional powers to those of the Securities Commission under current legislation, most pertinently the power to commence or take control of civil actions. Many saw the perceived failures of the Securities Commission as stemming not from inadequacies in the powers with which it is endowed, which are extensive, but instead from a lack of the necessary resources, willingness or mandate to effectively utilise those powers.

3.11 The Business Roundtable also notes the submission by Cathy Quinn, a lawyer and member of the Securities Commission:

> I am particularly concerned about the proposal to give the Financial Markets Authority (FMA) the power to enforce director's duties. I think this unnecessary – the FMA will have extensive powers under existing securities laws (assuming they are replicated, eg powers in relation to misleading and deceptive conduct in respect of securities, the power to bring a declaration of a civil liability event etc). Further, if shareholders see no point in bringing action against directors, then why should a statutory body with no financial interest have a right to do so? The response has been "because it is in the public interest". It is also in the public interest to encourage skilled, intelligent and experienced people to take on directorships in New Zealand. In my view, giving a regulator this power is yet another disincentive for quality people to enter the director community. The concern is that judgments of directors (often those made in testing circumstances) will be reviewed from a hindsight perspective from a regulator under pressure to be seen to do something and hold someone to account. Further, I do not believe it is appropriate to be making such a fundamental change to corporate law in New Zealand outside a comprehensive review of corporate law. It strikes me as an "ad-hoc" change which strikes at the heart of our corporate law.

3.12 Although most of the above commentary relates to actions against directors, similar concerns arise in relation to other private actions covered by the proposed provision. We submit that the scepticism of legal experts in relation to this proposal counsels caution. However, far from proceeding cautiously, this proposal has been fast-tracked by being inserted directly into this Bill.

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11 http://www.chapmantripp.com/Pages/Publication.aspx?ItemID=812

12 http://www.med.govt.nz/upload/74807/Securities%20Law%20Review%20016%20Harmos%20Horton%20Lusk%20Web.PDF

13 http://www.russellmcveagh.com/_docs/6128.SeptCorporateNewsletter_v3_336.pdf

Rushed analysis

3.13 Since these new powers have substantial implications for New Zealand's financial markets, they ought to be subject to correspondingly robust analysis. Regrettably, the proposal for these new powers was removed from the securities law review and inserted in the Bill, thereby preventing it from being fully considered in the context of the suite of reform measures under consideration by the MED. It is also important to note that the securities law review sought submissions on the pros and cons of a power similar to that in Section 50 of the Australian Securities and Investment Commission Act 2001 (ASIC Act). Part 3, Subpart 3 of the Bill goes significantly further than the ASIC Act in that it allows the FMA to take action on behalf of an individual, even where that individual has objected. Under Section 50 of the ASIC Act, where action is proposed to be taken on behalf of an individual, the prior written consent of that individual is required.

3.14 The Business Roundtable is very unhappy about the inadequate analysis contained in the regulatory impact statement in relation to the decision to include the measure in this Bill. The MED noted:[14]

> The limited time available has not allowed for a full analysis of the costs and benefits of the preferred option nor for the development of alternative regulatory and non-regulatory options. There may be other approaches that could achieve the objectives of the proposal. For example, the FMA could be given specific powers to enforce new civil liabilities and criminal offences associated with breaches of directors' duties and other misconduct that the proposal is targeted towards. Another alternative would be to facilitate private enforcement, for example through reform of the law and court procedures around class actions and through greater funding of courts and legal aid.

3.15 The regulatory impact statement seeks to justify the decision to include the proposal in the Bill as follows:

> The FMA Establishment Board has identified a material risk of a mismatch between expectations and powers if the FMA does not have the ability to take cases on behalf of investors at its establishment. During the period before new legislation is passed, a number of cases may arise in which the FMA finds itself unable to act effectively. This would tend to reduce investor confidence in the regulator and financial markets more generally. There is a risk that this would undermine the credibility of the FMA during the critical establishment period.

3.16 The Business Roundtable is not aware of any evidence of the level of investor confidence in the regulator, moral hazard issues aside, but it would be surprising if it were high given the failure of regulators internationally to prevent the global financial crisis and of regulators domestically to stop investors from losing money in finance companies when they chased higher returns. While it is likely to be attacked at the first opportunity by someone who has lost money and wants to free ride on the regulator's resources in the hope of retrieving it, there is also a risk, given information costs, that early action by the FMA will be misguided and discredited. Perhaps the best way to protect the credibility of the FMA in the early stages would be to not give it the power to take early actions. The Business Roundtable also submits that it is regrettable and short-sighted that such far-reaching legislation should be subject to such short-term considerations. This is a tangible illustration of some of the unfortunate consequences that follow from overblown rhetoric and mismanaged expectations about the capabilities of a "super-regulator".

Weak empirical basis

3.17 The Business Roundtable is concerned by the evident weaknesses of the justifications for the inclusion of this proposal.

3.18 In the first instance, there is an inadequate explanation of the current regulatory problems which the proposal seeks to address. As the submissions from Bell Gully and Harmos Horton Lusk note:

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[14] http://www.med.govt.nz/templates/MultipageDocumentTOC____44738.aspx

(a) There are already criminal penalties and pecuniary penalties in respect of corporate malfeasance;

(b) There are already private law remedies for shareholders and creditors (including derivative actions or actions by a liquidator or receiver); and

(c) The regulators already have the ability to assist private parties in bringing claims under the securities laws by seeking declarations of civil contravention.

3.19 Second, it is far from clear that there is substantial empirical evidence that public enforcement of civil duties promotes efficient financial markets. For example:

(a) The World Bank has published a short paper, entitled *Institutional Foundations for Financial Markets*, which concludes: "In banking and securities markets, characteristics related to private monitoring and enforcement drive development more than public enforcement measures".[15]

(b) A paper prepared for the National Bureau of Economic Research by Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, entitled *What Works in Securities Law*, states:[16]

> At the more general level, these results illustrate the theory of optimal institutions in Djankov et al. (2003), which maintains that optimal intervention is shaped by the tradeoff between the costs of market and government failure. For the case of securities markets, our evidence suggests that the efficient institutional choice takes the form of private enforcement of public rules, which encourages private recovery of damages by investors harmed by promoters.

(c) The powers in Part 3, Subpart 3 have clearly been based on Section 50 of the ASIC Act. Practice has shown that the use of Section 50 of the ASIC Act has been extremely limited, and when the power has been exercised, the subsequent legal proceedings have been costly and drawn out. Since 2000, it appears that the Australian Securities and Investment Commission largely relied instead on its civil and criminal penalty powers, as a more efficient and effective way to increase investor confidence and market credibility.

3.20 Clearly, the issues involved are far from clear-cut and sufficiently complex to warrant careful consideration. The Business Roundtable therefore submits that the appropriate approach would be to remove the proposal from the Bill and permit the MED to carry out proper consultation and analysis of the merits of the policy as part of the review of securities law.

4. Securities Markets Act

4.1 The provisions of Part 6 of the Bill, which will ultimately form part of the Securities Markets Amendment Bill, further tighten governmental control over registered exchanges. As such, they are part of a decades-long regulatory trend towards more intrusive government regulation of the stock market and the diminishing autonomy of that institution.[17] Specifically:

(a) The Minister will be able to prescribe "market integrity regulations" to take the place of market rules (currently the listing rules and participant rules of NZX) or parts of market rules.

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15 http://www.google.co.nz/url?sa=t&source=web&cd=1&ved=0CBoQFjAA&url=http%3A%2F%2Fsiteresources.worldbank.org%2FINTTOPACCFINSER%2FResources%2FInstitutional.pdf&ei=I_fNTMbqCI6isAPchsDcDg&usg=AFQjCNGf9TQAZvuPe-7MNXYie4eR3Hcvjg

16 http://www.nber.org/papers/w9882

17 See, e.g., Bryce Wilkinson, *Reform of Securities Trading Law – Evolution and Risks* (LexisNexis Conference, Securities Markets and Institutions, 28 March 2003).

(b) The regulatory model will change from allowing the exchanges to oversee their own rules (subject to a discretion by the Minister to intervene and disallow a change within a short window) to requiring exchanges to have all rule changes approved by the FMA.

(c) The proposed new section 36ZK of the Securities Markets Act 1988 requires a registered exchange to provide extraordinary levels of access to the exchange's facilities. The Bill clearly envisages (and provides the powers for) very intensive regulation of registered exchanges.

4.2 In short, the Bill proposes to place stock exchanges on a tight leash held by the FMA and the Minister. We are concerned that:

(a) These new interventions do not appear to be justified by any specifically identified problems with New Zealand's only registered exchange, NZX Limited. While the regulatory impact statement raises a number of potential problems, such as the potential for conflicts of interest, it also acknowledges that:[18]

> NZX operates a comprehensive conflict of interest policy designed to address other conflicts. Furthermore, NZX has shown a strong commitment to effective regulation (a well regulated market is more likely to attract issuers and participants over the long term), no actual conflicts of interest have been identified in the Securities Commission's annual oversight reviews of NZX, and there is limited evidence of direct regulatory failures in this context.

(b) The Bill appears simply to assume that the Minister and the FMA will be better placed to determine the appropriate balance of rules than NZX. As much is clear from the statement in the regulatory impact statement that:[19]

> Although there is a disallowance process for exchange rules, exchanges have sole responsibility for formulating rules, including those that aim to achieve regulatory outcomes. Conflicts of interest may cause exchanges to ignore emerging issues that require rule changes. Exchanges can also introduce rules that are detrimental to regulatory objectives, but where the evidence that this is the case is not sufficiently compelling to meet the high test for disallowance ("not in the public interest").

We believe that assumption is not only unjustified but it is also misguided.

(c) There appears to be inadequate recognition of the potential competitive disadvantages for NZX being subject to more intensive regulation. We consider that increasing NZX's regulatory compliance costs and regulatory uncertainty is likely to prejudice rather than promote the interests of New Zealand's capital markets.

4.3 More generally, the Business Roundtable is also concerned about outside interference with the ability of exchanges to determine their own rules and conduct their own affairs, particularly when that interference involves fundamentally arbitrary trade-offs. In our view, it is necessary to re-evaluate this regulatory path in the light of experience and evidence.

4.4 A recent monograph published by the Institute for Economic Affairs, entitled *Does Britain Need a Financial Regulator*?, explains the historical development of the London Stock Exchange as a private institution.[20] The international success of the London Stock Exchange (and its substantial role in developing the global economy) was based on private rule-making. The subsequent regulatory incursions on its independence and eventual subjection to the Financial Services

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18 'Financial Sector Regulatory Agencies', http://www.med.govt.nz/upload/Financial%20Markets/RIS-Financial%20Sector%20Regulatory%20Agencies.pdf, page 12.

19 *Ibid*, page 13.

20 Terry Arthur and Philip Booth, *Does Britain Need a Financial Regulator*?, Institute of Economic Affairs, 2010.

Authority coincided with the London Stock Exchange losing ground from the international heights occupied during the pre-War period. As the authors note:[21]

> So, from the end of World War I onwards, we have an elegant private regulatory institution gradually becoming a set of cartels and corporatist institutions.

4.5 Arthur and Booth reach the following conclusions:[22]

> Around the world, governments have tended to 'nationalise' the regulatory functions of investment exchanges. Rarely has there been any strong case made for this action. Early exchanges proved able to develop their own regulatory systems, and the most significant nationalisation (in the USA) arose as a result of an erroneous understanding of the causes of the Great Depression. Where exchanges still provide regulatory functions, they do so extremely successfully.

4.6 The Business Roundtable agrees that private regulation and rule-making is not only a practical alternative to state regulation but in most cases it is also demonstrably superior. This reflects a number of serious problems with state-mandated rules:

(a) Regulators and politicians lack detailed knowledge and expertise and so do not know the best mix of rules for any particular market and have poor incentives when designing rules.

(b) Improvements in rule-making require experimentation and diversity. This is best achieved through regulatory competition. As the Nobel laureate economist Friedrich Hayek explained, "Competition is thus, like experimentation in science, first and foremost a discovery procedure".[23]

(c) State-mandated rules inhibit regulatory competition via private rule-making.

4.7 Moreover, regulatory competition also exists between states. As such, capital shifts from states with poor quality rules and inefficient policy settings to jurisdictions with superior rules. Misguided and unjustified restrictions on New Zealand's capital markets are therefore seriously prejudicial to the national interest. In the Business Roundtable's view, it is appropriate to take stock of the consequences of previous legislative incursions against New Zealand's capital markets before creating further restrictions. We submit that a careful analysis would suggest that New Zealand should reconsider the road not taken: namely, to free up private markets and permit private institutions to control their own affairs subject to the general legal framework within which all commercial activity takes place.

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21 *Ibid*, page 41.

22 *Ibid*, pages 53-54.

23 Friedrich Hayek, *Law, Legislation and Liberty*, Vol. 3, University of Chicago Press, 1979.