

CENTRAL CLEARING HOUSE FACILITY PROPOSAL
Summary of Submissions Received & NZX
Response

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CONTENTS

	PAGE
1. INTRODUCTION	3
2. SUMMARY DESCRIPTION OF PROPOSED CCH FACILITY	5
A. GENERAL COMMENTS	5
B. REVISED REGISTRY REQUIREMENTS	6
C. FUTURE ENHANCEMENTS	7
3. STAKEHOLDER IMPACT	8
A. NZX FIRMS AND BROKERS	8
B. INVESTORS	8
C. GLOBAL CUSTODIANS AND NEW ZEALAND SUBCUSTODIANS	8
D. LISTED ISSUERS	8
4. SUBMISSIONS AND NZX RESPONSE	9
A. SYSTEM INTEGRITY	9
B. COSTS	12
C. AGENCY ISSUES	13
D. LEGAL ISSUES	14
E. CONFIDENTIALITY	16
F. IOSCO PRINCIPLES	17
G. COMPETITION ISSUES	17
5. WORKING GROUP PROCESS	18

I. INTRODUCTION

In March of this year New Zealand Exchange Limited (“NZX”) released a consultation paper on its proposal to establish a Central Clearing House (“CCH Facility”). The paper sought views from interested parties.

The consultation paper proposed that a CCH Facility should be introduced to better protect and bolster the robustness and integrity of New Zealand’s securities markets. The CCH Facility proposed was an infrastructure/technology improvement designed to ensure that New Zealand’s securities markets maintain their integrity, are further immunised from failures and outages in other parts of the securities landscape, and to protect New Zealand’s reputation as a destination for international capital. Core to this proposal is that the potential points of failure existing in the current securities system infrastructure are minimised.

The CCH Facility proposal was prepared on the assumption that system reliability is critical to the integrity of our securities market. This assumption is based on feedback from market participants following the market downtimes last year. In that regard the consultation paper noted that confidence in the market and its institutions is fundamental to maintaining investor interest and activity which in turn drives liquidity and provides opportunities for New Zealand businesses to source capital to grow.

The participants that have responded have indicated that they are aware that the existing structure is not ideal. The media response, supported by participant feedback indicated that this was also the case when we were forced to close the market last year. The CCH Facility is designed to address these issues.

Approximate system reliability

NZX’s starting point in making an assessment of the appropriate level of system reliability is an assumption that NZX should strive for a system that is operational during 99.99% of scheduled trading hours. To achieve this level of reliability, adjustments would need to be made to New Zealand’s securities market structure. The appropriateness of this assumption is something we wish to gain feedback on at the proposed working groups.

Proposed CCH Facility workshops

NZX received many thoughtful and useful submissions for which NZX thanks all submitters. In light of the comments and suggestions made, NZX has determined to hold development workshops with submitters to help define the best possible solution for the New Zealand market. This document summarises the written submissions received by NZX. It also sets out NZX’s response to the submissions received on the consultation document.

NZX will be inviting all those who submitted plus relevant interested parties to attend workshops to be held in August. In doing so, NZX wishes to emphasise that NZX's ultimate aim is to fix what it sees as market structure issues and wishes to work toward developing the best possible market structure for New Zealand. NZX considers that market participants and listed issuers are in a key position to contribute towards identifying the preferred market structure. This paper is intended to provide a basis for discussion at the workshops.

Possible Alternative

NZX has also been considering whether a compulsory or opt-in CCH Facility would be preferable. At this point, NZX has no clear view whether an opt-in model might be preferable or not. Some market participants have argued that it should be compulsory as they could continue to be able to trade all securities if an issue were to occur with the current on-register system. An alternative might be to allow those Issuers who wish to protect their registers to subscribe to the CCH Facility. This would mean that those companies opting in would have confidence that their security holders could continue to trade if registry systems or connections were to fail. Issuers not opting in would remain subject to the present procedures whereby trading of securities is halted where connections to the registry systems are compromised.

The possibility of an "opt in" approach could work well if acceptable to participants. That will give listed issuers the choice if they wish to improve reliability, and will allow listed issuers to assess the benefits of the proposals to them. This will also put an onus on market participants to express their views to listed issuers.

II. SUMMARY DESCRIPTION OF PROPOSED CCH FACILITY

A. GENERAL COMMENTS

In general, there seems to be some misunderstanding of what is proposed. NZX is proposing either:

- A "CCH" branch register where the CCH Facility holds a branch register and the Issuer's registry company holds the principal register. On market transactions are recorded on the CCH Facility, and all other transactions are recorded on the Issuer's register. NZX subsequently identified issues with this model, as it requires shareholders to elect which register they wished to be on, and shunt between registers if they wanted to trade on market or off market. This is essentially what happens with CHESS. ("Proposal 1")
- A single register that is transferred between the CCH Facility and the issuer's registry company on opening and closing of trading. While this solves the need for shareholders to elect which register to hold their shares, it does involve a considerable amount of data to be transferred, and (to a lesser extent) may have issues where CSNs have not been allocated. This is the model that NZX is currently proposing and has further expanded upon below under the heading "*Revised Registry Requirements*". ("Proposal 2")

In addition, as noted above, NZX is asking the question whether the CCH Facility should be mandatory or opt in. We would like to obtain views on these matters in the course of the proposed working group meetings.

There also seems to be little understanding as to the significance of the problem NZX is trying to address. In that regard we are taking this opportunity to note the following:

- We have made an assumption regarding the demand for system reliability. NZX is willing to reassess this if the users collaboratively indicate a willingness to accept a lower level of reliability. However our understanding is that a lower level of reliability is neither internationally acceptable nor acceptable to domestic market participants. In that regard we wish to facilitate listed company representatives and market participant representatives together in a workshop to discuss the preferred level of system reliability. Once the desired level of reliability has been settled, NZX plans to engage an independent technical expert to confirm that implementation of the proposals will improve reliability.

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- We are providing details of the two proposals and the advantages and disadvantages of each. In doing so, we will take the opportunity to address some of the most common issues raised by submitters against implementing a CCH Facility. Our comments are provided, in the NZX responses to the submissions section, which are set out below in part 4 of this paper.

B. REVISED REGISTRY REQUIREMENTS

Proposal 1

This proposal would involve the establishment of a branch register with the CCH Facility. Holders who wished to undertake on market transaction would need to arrange to shunt their holding from the principal register maintained by the Issuer to the branch maintained by the CCH Facility. On market transactions would then be recorded on the CCH Facility and all off market transactions would be recorded on the Issuer's register. Holders would need to ensure that their holding was recorded on the correct register before trading their securities. Corporate actions, such as calculation of dividend or voting entitlements would need to be done separately for each register. This structure reflects that adopted in Australia under the CHESS system.

Proposal 2

To address the inconvenience posed by the branch register proposal, NZX reconsidered the proposal and concluded that the CCH Facility does not need to be designated as a separate register under section 88 of the Companies Act 1993. Rather than having two registers, the CCH Facility and the commercial registry, the CCH Facility, taken together with the commercial registry, can be considered a single register. This single register is held in two places and maintained by 2 agents of the Issuer. Each agent is responsible for a specified set of tasks during a particular time period.

If one uses the analogy of a physical register book or journal into which entries are made, the commercial registrar hands that journal to the CCH Facility at 07:15 and the CCH Facility is responsible for making "on market" entries into that journal while the market is open, up until 18:15. At 18:15 the CCH Facility hands the journal back to the commercial registrar for it to make "off market" entries. During the day (07:15-18:15), whilst the CCH Facility has been making "on market" entries into the journal, the commercial registry has noted and queued up all entries it has received during the day. On receipt of the journal back from the CCH Facility it updates the journal with those entries. Another analogy is that an Issuer has "shift" workers updating its share register.

For the avoidance of doubt “off market” transactions lodged during the day would not be recorded, and thus not be effective until after the close of market. However, all transfers that take place during the trading day could be seen on inquiry of the commercial registrar, after the queued “off market” transactions have been entered at 18:15.

Maintaining a single register avoids the need for holders to elect the register on which they wish to hold their securities, avoids the need to complete shunts before trading and enables issuers to undertake corporate activities, such as calculation of dividend or voting entitlements against a single record.

NZX is not aware of any legal impediment to an Issuer having its share register maintained by two agents, each performing a certain function at distinct times.

NZX considers that having a single share register greatly simplifies the structure for Issuers and investors. No amendments to an Issuer’s constitution are required and the record of legal title is very clear as the CCH and commercial registry operate as a single share register. The point of inquiry (i.e., CCH Facility or commercial registry) to determine legal title will depend on the time of day that inquiry is made.

C. FUTURE ENHANCEMENTS

The CCH Facility would set the way for a number of possible future enhancements that could flow from its implementation. As an example of this, the CCH Facility proposal included NZX undertaking to develop and implement a true delivery vs. payment system so that payment for securities occurs instantly at the point that securities are transferred rather than there being the current netted accounting procedure undertaken by NZX’s FASTER system throughout the day with transfer of funds as between participants occurring at the end of the day.

The current system is not ideal as all counterparties in the market record a risk equal to their daily deposit into FASTER. In the current system settlement transactions may be unwound in the event of insolvency should a participant fail and notification not be made to NZX such that the participant continues to trade after it is insolvent.

True DvP is highlighted in the IOSCO principles that guide the development of good exchange behaviour. Although FASTER has a netted simile of this, FASTER does not provide true DvP. True DvP removes the potential of settlement risk through true irrevocability of security and cash transfer.

In addition, as part of the CCH Facility proposal, NZX expects to invest in ongoing future software and hardware upgrades.

III. STAKEHOLDER IMPACT

A. NZX MARKET PARTICIPANTS

Trading Participants' operations and back office requirements will be streamlined by the introduction of a CCH Facility. Trading Participants will have access to greater real-time 'consolidated view' information set that they will then be able to utilise to provide enhanced client service. Delivery and Settlement Participants' risk positions vis-à-vis other Delivery and Settlement Participants' capital adequacy and financial liabilities will also be improved as exposure to settlement risk, especially under any outage, will be reduced. Increased reliability will ensure that Trading Participants will be more likely to be able to trade uninterrupted throughout scheduled trading periods, minimising lost revenues from market outage.

B. INVESTORS

Investors' confidence in the New Zealand securities markets should be enhanced by a CCH Facility. This will be particularly true of international investors who rely on the global custodians for a view on the clearing, settlement, depository and registry risk profiles of each national market. It is also possible that the set of information available to institutional investors will be enhanced. Investors will have be able to trade on systems that meet international standards.

C. GLOBAL CUSTODIANS AND NEW ZEALAND SUB-CUSTODIANS

The custodian community recognises that the introduction of a CCH Facility will move the New Zealand securities markets more towards an overall market structure that they are comfortable with. In particular, a CCH Facility will conform more closely with the international standards that the custodians require national markets to adhere to. Custodians will be familiar and confident dealing with the CCH Facility model as similar systems are deployed internationally. They would also feel more comfortable about the system's flexibility for future development and its ability to achieve dynamic cost efficiencies over time.

D. LISTED ISSUERS

For Listed Issuers a CCH Facility should be positive. With no increase in cost structure anticipated, listed Issuers should not only have a better view and understanding of intra-day shareholder changes, but could legitimately expect positive second order effects in the overall market structure.

IV. SUBMISSIONS AND NZX RESPONSES

A. SYSTEM INTEGRITY

1. Present System

Submissions Received

- Some submitters suggested that the existing system is sound and performs well, but should be re-examined to determine where any weaknesses may exist and could be remedied before looking at the CCH proposal.
- Claims were made that no other market in the western world has been closed because real-time access to a registry has been interrupted.
- It was highlighted that the quality of infrastructure is constantly improving as technology advances and even higher levels of on-line availability are likely in the current year due to NZX's introduction of an improved telecommunications network and of computer hardware and software upgrades by registries.

NZX Response

The fact is failures have occurred. NZX cannot allow its markets to continue trading where failure occurs. To do so would put investors' funds at risk and ultimately the integrity of New Zealand's securities markets. Experience has shown that the existing system is vulnerable to failure. Users (particularly participants) have indicated to NZX that this is unacceptable. Whether the current level of reliability is acceptable is a policy issue to be determined by the users of the market. The CCH proposal is based on the assumption that users (particularly participants) find the current level of reliability unacceptable.

The CCH Facility proposal is intended to address flaws in the current system that have come to light in the recent past. The various market outages have highlighted areas where there could be potential improvement. NZX's stance on this matter is consistent with the increased global focus on market integrity and stability. A flawed system impacts more than the listed companies. In particular, a number of NZX Firms have highlighted their dependence on information availability, and with availability removed when registries are down, they are unable to operate correctly.

Comparisons with overseas exchanges halting markets are flawed as those exchanges operate systems more similar to the type proposed than the on-register system currently found in New Zealand, For example the CHES system in Australia closely resembles the system described as "Proposal 1" above. The current position in New Zealand is in fact the anomaly.

NZX is to strive to reach a market availability of 99.99% during market hours. This is similar to the Reserve Bank's stated availability targets of 100%, which we consider a good standard to measure ourselves against. Furthermore, NZX has stated, and stands by, a zero outage tolerance policy.

NZX is not proposing to guarantee total system integrity. This is not possible. What NZX proposes is to take the responsible action of reducing the potential for failure. This is totally in accord with good business practice, and the seriousness with which NZX takes its responsibilities to New Zealand capital markets.

In respect to improvements to the market infrastructure systems, the actions quoted are indeed part of the continual improvement activity NZX is undertaking. However, this activity can only be fully effective when it addresses all points of potential failure.

2. Proposed System

Submissions Received

- There were questions about the CCH Facility's ability to prevent fraud.
- Questions were raised as to whether a non-interested external party should be commissioned to provide an independent assessment in respect of the proposed CCH facility.
- Questions were asked about the contingency plans in the event that the CCH Facility was temporarily unavailable.
- Questions were asked whether the imposition of a further system interposed between the registries and the securities market creates another potential point of failure, since if, for any reason the registry was unable to transmit a copy of an Issuer's register to NZX in the morning, registration of transfers would not be possible.
- NZX is seeking to freeze the proprietary company registers, create a common "instance" of all holdings as a single integrated copy, trade on the common "instance" rather than the individual proprietary originals thereby reducing the communications cost (think gold shipment) and risk of real time update (think theft or loss) of the original. So at least in theory there is a long history of the model underpinning the proposal.
- The CCH model would reduce the points of failure inherent in the current model and provide an integrated execution and settlement platform.
- Having multiple registry providers and no CCH Facility makes improvements extremely hard to achieve. Future upgrades that are absolutely necessary in order to provide a low risk trade execution and settlement process include the ability to place holds on security balances (preventing multiple sale orders for the same holding), elimination of FINs and replacement of Austraclear.

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- The compelling proposition is with the CCH Facility being able to execute an irrevocable transfer of title on that instance of the register and NZX being able to settle in central bank funds (i.e., have an exchange settlement account), NZX can do something that none of the proprietary registries will ever be able to do – real time, irrevocable DvP. You have eliminated counter party risk and you have eliminated the float. How you do it is detail – dual listing, shunting, unjust enrichment, all can be dealt with as admin matters.

NZX Response

The proposal is not intended to address fraud. It is designed to address reliability and resistance to communications and interface failures with external systems. The issue exists that there is a potential for failure that has been evidenced over the previous 12 months with the system. NZX has identified that this is due to the current structural make-up of the on-register system. While the proposed system may not be risk free, it is designed to reduce the risk that the market is currently subject to.

An independent review would be able to confirm whether the CCH proposal would increase reliability over the existing system, and may be useful. NZX is happy for an independent assessor to validate the proposal and make recommendations. The consultative approach NZX has embarked on is specifically intended to facilitate this type of approach.

The duplicated failsafe nature of NZX's dual node system provides multiple points of resilience and robustness before a failure could occur. If unavailability were to occur, the impact would be no worse than the existing environment.

With Proposal 2, the data transfer occurs only twice a day, as opposed to continual availability at all times during the day. This would appear to reduce the points of vulnerability. Proposal 1 requires no data transfer (unless a shunt from one register to the other were to occur), and so would appear to eliminate the vulnerability completely. Alternative mechanisms for updating the CCH Facility will be made available. Furthermore, the book-end activities have been designed to allow a window of opportunity if a failure exists.

Should a registry be unable to provide the required data to NZX for any period or by the due time, trading would have to be halted in the affected securities as now occurs if communication between NZX and the registries is lost. However the transfer would occur only once per day rather than continuously as is now the case. This would mean less times when the market is susceptible to such a risk.

3. Multiple share sales

Submissions Received

- Question whether multiple share sales might be possible and wouldn't be picked up until reconciliation procedures occurred overnight.

NZX Response

Multiple transactions would not be possible as:

- In Proposal 1 holdings would only appear on one register at any time. Thus multiple transactions would not be possible.
- In Proposal 2 only one registrar would be able to record transactions at any time. If the Issuer registrar elected to maintain a copy of the register, and record transactions on it, they would be responsible for conforming those transactions against the "true" register (and any transactions that had occurred during the day) when it was returned at day end.

The proposal does not separate the streams of transaction reporting or holding balance movement. The proposal specifically proposes that critical off market transfers that occur during the business day will be notified to the true holder point on the CCH Facility immediately.

Multiple security trades are certainly a risk under the existing system if the connection to the registries was down and NZX were to allow trading to continue.

B. COSTS

Submissions Received

- End users shouldn't inevitably be required to bear the costs of the system without regard to the benefits it may provide.
- Uncertainty over what additional costs will result from the CCH proposal.
- What about the additional cost resulting from support staff accommodating the increased emphasis on start of day and end of day processes?
- There was some concern about the possibility of issuers having to re-negotiate their existing contracts with the registries if the proposals were implemented.
- The proposed new system would present an opportunity for monopoly pricing.
- Questions about costs of reconciliation.

NZX Response

The cost will need to be borne somewhere. NZX will cover the development costs for the CCH Facility. The benefit to listed companies is the ability to have liquidity in their shares at all times, and the wider benefit of improving confidence in the market. An opt-in model would address concern of ongoing cost because Issuers would only pay for the benefits they considered they were gaining.

The necessity to undertake reconciliations is overstated. Proposal 2 will require reconciliations only if the registry company elects to operate a copy of the register while the “true” register is in the CCH Facility’s control. While this may add to costs NZX would endeavor to ensure that costs are kept to a minimum. Proposal 2 should not have any additional audit costs, as there remains a single register with the same number of entries. The only change is the time of day and the person making those entries.

Proposal 1 requires no reconciliations, data transfer or additional staff time. The only additional cost would be whatever the CCH Facility charges (and is not matched by reduction in Registry company charges) and audit costs, if these are greater to audit the same number of entries on two branch registers rather than one principal register.

Only Proposal 2 requires work outside trading hours. This could be minimised by “loading and queuing” transactions in business hours and electronically processing them over night. Exception (i.e. transactions overtaken by FASTER transactions during the day), could be rejected and addressed the following day.

Some re-negotiation of contracts with registry companies may be necessary for Proposal 2. Proposal 1 shouldn’t require any change to existing contracts, as those contracts should provide flexibility for establishment of branch registers. It may reduce costs as the registries will no longer need to maintain communications with the FASTER system.

The situation that would result under a CCH Facility would be no different from other issues arising as a consequence of NZX being operator of the only registered exchange. There would be no issue of monopoly pricing with the opt-in model. The benefit to listed companies is the ability to have liquidity in their securities at all times and the wider benefit of improving investor’s confidence in the market.

C. AGENCY ISSUES

Submissions Received

- Concern that NZX has not addressed the issue of responsibility for the accuracy of the register and the associated commercial risk, which at present rests solely with registries.

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- Uncertainty as to where the duties and obligations of NZX would be set out and what they would be.
 - Concept of two agents could give rise to considerable complexities as regards the obligations and responsibilities of each agent.
 - There will be the potential to split accountability of the maintenance of the share register.
 - In circumstances where the legal obligation is on the company and its directors to ensure compliance with the share register commitment, companies are entitled to have a clear point of responsibility to the party delegated to maintaining the register.

NZX Response

NZX would be an agent of the Issuer to maintain the Issuer's security register. NZX will have the same responsibilities and obligations during its "custody" of the register (whether it's a single register or a branch register) as the existing registry companies. Each registry will be responsible for its own actions, and will be entitled to rely upon the accuracy of the others performance of their actions.

The duties and responsibilities in respect of the CCH Facility would (to the extent that the common law duties and responsibilities of an agent are insufficient) be set out in the service contract entered into between NZX and the Listed Issuer.

The legal aspects of having two registry agents (whether separated by time or location) are not complex. It is not unheard of to have more than one agent performing the same function at different times. There seems to be some confusion that the dual agency will be simultaneous. There will only be a single party with responsibility at any given time.

D. LEGAL ISSUES

1. Companies Act 1993 and Securities Act 1978

Submissions Received

- Question the view that a mirror register can be established under the Companies Act 1993.
- Information that is suggested to be held in the CCH system is not adequate to meet the requirements of a share register as set out in section 87(2) of the Companies Act 1993.
- Compliance with section 51 of the Securities Act 1978 is not clear under this proposal.
- How can directors be satisfied that their obligations to have an up to date register are complied with?

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- Holding paper based transactions would be inequitable and probably not legally supported.

NZX Response

NZX does not see difficulties in complying with the current legislation. The Companies Act authorises companies to hold branch registers (section 88) and section 87 has no prohibition on maintaining a register at different locations at different times of the day. With regards to ensuring companies' constitutions permit the register to be maintained at a second location, there may be a need to address the arrangement in their constitutions.

Section 87(2) of the Companies Act relates to content of the register. This should remain unchanged from the current content held by companies

Section 51 of the Securities Act only requires the company to maintain a register. It contains no restriction on the place at which the register is kept.

The agents will be responsible to the directors for accuracy of the entries they make in the same way that directors currently rely upon commercial registries.

The legislation (section 84 of the Companies Act) envisages delays of up to 30 working days. Holding "off market" transactions until the close of business on a working day will not be a problem. In any case time critical transactions requiring real time recording can be placed "on market" via the CCH Facility.

2. Legal Title

Submissions Received

- When does legal title vest?

NZX Response

The current proposals do not intend to change anything in this regard at this point in time. While this needs to be addressed, the preliminary step is to establish a reliable real time record of the current title, before dealing with the means of irreversibly transferring that title. NZX is working on separate initiatives in this respect.

3. Dual Registries

Submissions Received

- Will the CCH Facility or the registrar's register be regarded as the "principal register" in terms of the legislation?
- Which would be the correct version in the event of a discrepancy existing between the registers held by NZX and the registry?

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- The provisions of section 88 of the Companies Act 1993 do not permit duplication of registers and only permit registers to be split to facilitate off shore registers.
 - Unsure which copy of the register will be regarded as the ‘master’ copy at the point of transfer between the CCH Facility and each registry at the end of day?
 - It doesn’t make sense from an economic or system point of view that NZX duplicate the maintenance of some 2 million holdings for the sake of verifying the validity of some 2,000 sales.

NZX Response

If the branch register approach is taken the “Issuer” register will be the principal register. If the single register approach is taken there is no need for differentiation as there will only be one register in one location at any given time. Any copy of the register maintained by the registry company “intra day” will have no legal status and will be an administrative tool only.

The incoming register would be the correct register. The historic out going register from the previous transfer would be out of date as it would not reflect transactions undertaken during the trading period.

The register (or each branch) will need to comply with the full requirements of the Securities Act 1978 and the Companies Act 1993.

Each registrar will have responsibility for entries made on their branch register (or on the single register while it is in their control).

Use of branch registers is not limited by section 88 of the Companies act to overseas registers.

There is no “master copy” involved. The register as received will be the correct copy.

The aim is not to “verify validity” of sales, but to enable those sales to be achieved at all times during trading hours. The cost of storage for 2 million holdings is fractional from a database point of view, and is one of the least complex aspects of the overall development.

E. CONFIDENTIALITY

Submissions Received

- What steps will NZX have in place to protect the comprehensive amounts of confidential information the CCH Facility function will allow it access to?

NZX Response

The CCH Facility would have appropriate confidentiality and use arrangements in place.

F. IOSCO PRINCIPLES

Submissions Received

- The IOSCO principles say that central depositories or central registries provide a strong foundation for secure and efficient settlement. But they do not say that centralization provides the only strong foundation.
- Suggestion that the present system meets all of the requirements of IOSCO.

NZX Response

These comments demonstrate the need to review the reliability problem and ascertain the desired level of reliability. The NZX consultation paper set out how the creation of a CCH Facility will result in the NZX markets more closely adhering to the IOSCO principles, in particular by reducing market risk.

G. COMPETITION ISSUES

Submissions Received

- In addition some questions have been raised about competition issues.

NZX Response

This is a legal issue that NZX will need to consider.

V. WORKING GROUP PROCESS

To ensure an appropriate and workable solution is developed for all parties concerned, NZX is hosting a workshop in late August. The workshop is designed to help clarify points of contention and reach consensus on key concepts.

NZX's objectives in holding the workshop is threefold: (1) to hear in more detail from those who made submissions on key areas; (2) to endeavour to reach consensus on key issues, such as the acceptable level of 'uptime'; and (3) to outline the possibility of an 'opt-in' model.

The workshop will be held on Tuesday 31 August for all listed issuers and NZX Participants who made submissions. It will be held in the boardroom of NZX from 3:00 – 5:00pm.

Discussion and ideas arising from the workshop will be reviewed by NZX and incorporated into the final proposal where applicable. NZX may require further consultation prior to developing a final working proposal and will call on relevant parties where appropriate.

For further details, please contact Bridgit Vivian at bridgit.vivian@nzx.com.