

2 September 2010

**NZ Markets Disciplinary Tribunal Special Division Decision  
Smartshares Limited  
Application for Rulings and Waivers from NZSX Listing Rules 9.1 and 9.2.1**

**Background**

1. Smartshares Limited ("Smartshares") is the manager of five exchange traded funds listed on the NZSX market: the NZX Australian 20 Leaders Index Fund, the NZX MidCap Index Fund, the NZX 50 Portfolio Index Fund, the NZX Australian MidCap Index Fund and the NZX 10 Fund ("the Funds"). Fund investors hold units in the Funds ("Unitholders").
2. Each Fund is required to track the performance of its associated index by holding securities ("Fund Securities") on the index in the appropriate weightings.
3. NZX Limited ("NZX") is launching a central counterparty clearing and settlement system ("CSS"). The clearing house operator, New Zealand Clearing Limited ("CHO"), will become the central counterparty for the settlement of trades of financial products on NZX's markets. Transactions will be settled onto the depository, operated by New Zealand Depository Limited ("CDO"). The entities which will operate the CSS are ultimately wholly owned by NZX.
4. CSS is a "designated settlement system" under section 156N of the Reserve Bank of New Zealand Act 1989. As part of that designation process, the rules of CSS ("CSS Rules") have been specified. The Reserve Bank and Securities Commission (as joint regulators) have the power under section 156ZC of this Act to disallow any amendment to the CSS Rules.
5. Following the launch of the CSS, Smartshares intends to:
  - a) use the depository to hold Fund Securities;
  - b) lend Fund Securities through the depository; and
  - c) continue to buy and sell Fund Securities on market through an NZX Market Participant.

The transactions noted in sub-paragraphs b) and c) above will be cleared and settled through the CSS.

6. Smartshares is a wholly-owned subsidiary of NZX. Smartshares and the entities which will operate the CSS are Related Parties for the purposes of the NZSX Listing Rules ("Rules").

*Fund Securities Transfer to Depository*

7. The legal title to the Fund Securities is currently held by the Fund custodian ("the Custodian"). The Custodian is an independent third party that provides a number of custodial services to the Funds. The beneficial interest in the Fund Securities is held by the Fund Trustees on behalf of Unitholders.
8. Once the CSS is established, Smartshares intends to procure the transfer of the legal title to all Fund Securities from the Custodian to the depository nominee ("Fund Securities Transfer"). The depository nominee, New Zealand Depository Nominee Ltd ("NZDN"), is a wholly owned subsidiary of CDO.

9. Smartshares proposes to undertake the Fund Securities Transfer so that the Custodian can use the custodial services of the depository and to allow Smartshares to instruct the Custodian to lend Fund Securities to other depository participants through the depository (this is discussed further below).

*Lending of Fund Securities*

10. In 2008, Smartshares notified Unitholders that it intended to amend the Fund trust deeds to allow Fund Securities to be lent ("Lending Transactions"). Copies of these notices can be found at [www.smartshares.co.nz](http://www.smartshares.co.nz). Smartshares has confirmed that the terms and conditions of the Lending Transactions are consistent with the terms and conditions of securities lending outlined in the notices to Unitholders sent in 2008.
11. Smartshares may only lend Fund Securities through the new CSS. Under the proposed rules of the CSS, depository participants can identify securities in a depository account as available for lending to other depository participants. At the beginning of each day CDO creates a lending pool out of identified securities. Borrowers can enter borrowing requests into the CSS. If there is sufficient product in the lending pool, and the borrower has provided sufficient collateral to cover its margin requirements, CDO will randomly allocate the borrowing request amongst lenders with securities in the lending pool on an anonymous basis, and a lending transaction will be created. Immediately after creation, lending transactions are novated and replaced with separate contracts between the lender and CHO, and the borrower and CHO, and then beneficial title in the securities passes from the lender to the borrower. The net effect of a Lending Transaction for the Funds is that the Custodian obtains a contractual right against CHO for the repayment or redelivery of the Fund Securities on loan. CHO will have a matching right against the borrowing counterparty.
12. Securities lending may occur at the initiative of a borrower (for commercial reasons of the borrower) or at the initiative of CHO to enable it to honour its obligations to ensure that all transactions through the clearing house are settled (for example where a clearing house participant fails to deliver securities under a trade). Smartshares may be the lender in either circumstance.
13. The Fund Trustees have approved the terms of the Lending Transactions through the depository and the required amendments to the Fund trust deeds. Lending Transactions are subject to the conditions prescribed in the Fund trust deeds and Offer Documents, including limits on the value of Fund Securities that can be lent and the amount of collateral that CHO will require from borrowers.

*On market transactions*

14. Smartshares instructs the Custodian to buy and sell Fund Securities on market in order to track the relevant indices and to buy additional Fund Securities on receipt of subscriptions for units in the Funds.
15. All on market trades must be cleared and settled through the CSS once established.

**Application 1 – Rule 9.2.1**

16. Smartshares has applied to the Special Division for:
  - a) a Ruling that the Fund Securities Transfer will not constitute a disposition of assets under Rule 9.2.2(a); or
  - b) if the Special Division determines that Rule 9.2.1 applies to the Fund Securities Transfer, a waiver from Rule 9.2.1 in respect of the Fund Securities Transfer; and
  - c) a waiver from Rule 9.2.1 for Lending Transactions through the depository; and

- d) a waiver from Rule 9.2.1 for the acquisition or disposition of Fund Securities on market and the clearing and settlement of those trades in the CSS.

*Rule 9.2.1*

17. The policy of Rule 9.2.1 is to regulate transactions whereby a Related Party to the transaction may gain favourable consideration due to their relationship with the Issuer.
18. However, the requirement to obtain the approval of a resolution for the purposes of Rule 9.2.1 may be waived if the involvement of a Related Party to the transaction was unlikely to have influenced the promotion to enter the transaction or its terms.
19. Rules 9.2.1, 9.2.2 and 9.2.3 provide:

**9.2 Transactions with Related Parties**

9.2.1 *An Issuer shall not enter into a Material Transaction if a Related Party is, or is likely to become:*

- (a) *a direct or indirect party to the Material Transaction, or to at least one of a related series of transactions of which the Material Transaction forms part; or*
- (b) *in the case of a guarantee or other transaction of the nature referred to in paragraph (d) of the definition of Material Transaction, a direct or indirect beneficiary of such guarantee or other transaction, unless that Material Transaction is approved by an Ordinary Resolution of the Issuer.*

...

9.2.2 *For the purposes of Rule 9.2.1, "Material Transaction" means a transaction or a related series of transactions whereby an Issuer:*

- (a) *purchases or otherwise acquires, gains, leases (as lessor or lessee) or sells or otherwise disposes of, assets having an Aggregate Net Value in excess of 10% of the Average Market Capitalisation of the Issuer; or*

...

- (e) *provides or obtains any services (including without limitation obtaining underwriting of Securities or services as an employee) in respect of which the actual gross cost to the Issuer in any financial year (ignoring any returns or benefits in connection with such services) is likely to exceed an amount equal to 1% of the Average Market Capitalisation of the Issuer; or*

...

*For the purposes of Rule 9.2.2(a), "Aggregate Net Value" means the net value of those assets calculated as the greater of the net tangible asset backing value (from the most recently published financial statements) or market value.*

...

9.2.3 *For the purposes of Rule 9.2.1, "Related Party" means a person who is at the time of a Material Transaction, or was at any time within six months before a Material Transaction:*

- (a) *a Director or executive officer of the Issuer or any of its Subsidiaries; or*
- (b) *the holder of a Relevant Interest in 10% or more of a Class of Equity Securities of the Issuer carrying Votes; or*
- (c) *an Associated Person of the Issuer or any of the persons referred to in (a)*

*or (b), other than a person who becomes an Associated Person as a consequence of the Material Transaction itself (or an intention or proposal to enter into the Material Transaction itself); or ...*

*Fund Securities Transfer*

20. Smartshares is seeking a ruling from the Special Division that Rule 9.2.1 will not apply to the Fund Securities Transfer as Smartshares does not “dispose” of assets for the purposes of Rule 9.2.2(a) because:
- a) the Fund Securities Transfer does not result in the disposition of the beneficial interest in the Fund Securities;
  - b) the Rule is intended to apply to the economic substance of a transaction, that is, the permanent disposal of rights in and interest to securities, rather than the bare transfer of legal title to allow the provision of custodial services; and
  - c) funds commonly change custodians and nominees in order to benefit from different service providers. Transfers of assets for the purpose of receiving services should not be considered Material Transactions under Rule 9.2.2, and therefore Rule 9.2.1 should not apply.
21. If a Ruling that Rule 9.2.1 does not apply is not made by the Special Division, Smartshares submits that a waiver from Rule 9.2.1 should be granted because:
- a) the substance of the transaction with NZDN as a Related Party is a transaction for the provision of services to which Rule 9.2.2(e) applies, as NZDN will be providing depository services to the Funds. These services if evaluated under Rule 9.2.2(e) would have an actual gross cost to Smartshares, in the form of depository fees, in any financial year that is much lower than 1% of the average market capitalisation of any of the Funds;
  - b) the Fund Securities Transfer is analogous to the transfer of assets to a custodian, and will be beneficial for the Funds as holding the Fund Securities in the depository will assist with the efficient management of the assets of the Funds, as well as allowing securities lending through the depository to take place; and
  - c) Unitholders are not affected by the Fund Securities Transfer to NZDN for any related fees as, under the provisions of the trust deeds, Smartshares must pay all depository and custodian fees for the Funds out of its set management fee.

*Lending of Fund Securities*

22. Smartshares submits that a waiver from Rule 9.2.1 for Lending Transactions is appropriate because:
- a) Lending Transactions are essentially transactions between the Custodian (acting as agent of Smartshares) and other non-related depository participants. The Related Party (CHO) is only involved in Lending Transactions because it acts as the central counterparty to every Lending Transaction. This role is essential in order to properly manage risk and assure clearing and settlement through the CSS for the benefit of all participants;
  - b) Rule 9.2.1 is intended to regulate the transfer of value between Related Parties to a Material Transaction. CHO’s sole economic interest in Lending Transactions is the fees it will receive from settling the transactions. These fees will be standardised in relation to all securities lending and are to be calculated on the same basis for every depository participant. The proposed level of fees is well below the 10% threshold in Rule 9.2.2(a) and the 1% threshold in Rule 9.2.2(e);
  - c) Smartshares has notified Unitholders of the proposed Lending Transactions and the Fund Trustees have approved the terms of the Lending Transactions. It would serve no

useful purpose to require Smartshares to hold meetings of Unitholders to provide Rule 9.2.1 approval, just because CHO is the central counterparty in the CSS;

- d) the policy underlying Rule 9.2.1 is to regulate material Related Party transactions in which a person may gain favourable consideration or influence the terms of the transaction because of their relationship with the Issuer. CHO's actions in clearing and settling transactions through the CSS will be constrained by the rules that govern the CSS, which will apply to all transactions through the CSS. Smartshares will make Fund Securities available for lending in accordance with the terms of the trust deeds. No discretion is available for Smartshares to change the terms, including the fees payable, of any Lending Transaction, and CHO cannot influence Smartshares' decision on these matters. Granting a waiver in these circumstances accords with the guidance set out in Footnote 1 to Rule 9.2.1, as the personal interest of CHO is both immaterial and plainly unlikely to influence the promotion of the proposal for Smartshares to enter into a Lending Transaction, or the terms and conditions of a Lending Transaction; and
  - e) Lending Transactions through the depository will provide benefits to Unitholders including additional income and potentially greater liquidity in Fund units.
23. The Special Division notes that while CHO's involvement in Lending Transactions is because it acts as a central counterparty between lenders and borrowers, it does not consider the role of CHO to be incidental. As noted above, Lending Transactions are novated and replaced with separate contracts between the lender (the Custodian acting on instruction from Smartshares) and CHO, and the borrower and CHO. By this, CHO assumes counterparty risk on all Lending Transactions. CHO manages the risk of default by a borrower by valuing outstanding loans on a daily basis and ensuring that borrowers maintain sufficient collateral. CHO is to have extensive powers under the CSS rules that may be exercised on default of a borrower. However, if CHO fails to redeliver equivalent Fund Securities or make a substitute payment to the Custodian (acting as agent of Smartshares), the Custodian's only right is to make a claim for compensation to CHO.

*On market transactions*

24. Smartshares submits that a waiver from Rule 9.2.1 for the acquisition or disposition of Fund Securities on market and the clearing and settlement of those trades in the CSS is appropriate because:
- a) Smartshares is required under the Fund Trust Deeds to acquire and dispose of Fund Securities to ensure the Funds track the relevant indices. Smartshares has no discretion to limit the size of these transactions or to conduct them off market. If the waiver is not granted, Smartshares will be restricted from complying with the issue terms of the Funds;
  - b) as with Lending Transactions, CHO's involvement in the transactions is incidental as a result of its role as the central counterparty for the CSS. The economic substance of on market transactions is that Smartshares enters into these transactions with unrelated third parties;
  - c) in the event that a series of on market transactions may breach the 10% threshold set out in Rule 9.2.2, Smartshares is bound by its issue terms to conduct the transactions. Smartshares considers it more pragmatic to obtain a pre-emptive waiver from Rule 9.2.1 in relation to all on market transactions, rather than seek an urgent waiver in the event that this threshold may be breached; and
  - d) the policy underlying Rule 9.2.1 is to regulate material Related Party transactions in which a person may improperly gain favourable consideration or influence the terms of the transaction because of their relationship with the Issuer. CHO's actions in clearing and settling transactions through the CSS will be constrained by the rules that govern the CSS, which will apply to all on market transactions through the CSS. Smartshares will instruct the Custodian to give effect to on market transactions in accordance with the terms of the Trust Deeds. No discretion is available for Smartshares to change the terms, including the fees payable, on

which CHO settles any on market transaction, and CHO cannot influence Smartshares' decision on these matters. Granting a waiver in these circumstances accords with the guidance set out in Footnote 1 to Rule 9.2.1, as the personal interest of CHO is both immaterial and plainly unlikely to influence the promotion of the proposal for Smartshares to enter into an on market transaction, or the terms and conditions of an on market transaction.

25. The Special Division notes that under the CSS, CHO will act as an intermediary between market participants in respect of on market transactions whereby each market transaction is cancelled and replaced by two separate transactions: one between the seller's clearing participant and CHO, and the other between the buyer's clearing participant and CHO. By this, CHO assumes counterparty risk on all trades. Accordingly, the Special Division considers the role of CHO to be more than incidental.

#### **Application 1 - Decision**

26. On the basis that the information provided to the Special Division is full and accurate in all material respects, the Special Division grants Smartshares as manager of the Funds a waiver from Rule 9.2.1 in respect of the Fund Securities Transfer, the Lending Transactions and on market transactions of Fund Securities through the CSS.
27. The waivers are granted on the conditions that:
- a. Smartshares notifies the Special Division no less than 10 Business Days before any material change occurs to the CSS Rules as they relate to securities lending or to any of the arrangements for the lending of Fund Securities through the CSS; and
  - b. Smartshares notifies the Special Division of any matter material to the lending of Fund Securities through the CSS as soon as reasonably practicable after Smartshares becomes aware of the same.

#### **Application 1 - Reasons**

28. In coming to the decision to grant Smartshares a waiver from Rule 9.2.1 in respect of the Fund Securities Transfer, the Special Division considered that:
- a. the transfer of legal title to NZDN is fundamentally a formal transaction to facilitate the operation of the CSS. It does not affect the beneficial title to the Fund Securities, and in itself should have no practical consequences for Unitholders;
  - b. there is legal precedent to support the submission that the Fund Securities Transfer is not a disposition of assets to which Rule 9.2.2(a) should apply. In *Ord v Calan Healthcare* [2004] 2 NZLR 122 (CA) and *Parkinson v James Products Ltd* (2009) 10 NZCLC 264,438 the court declined to treat a transfer of bare legal title as bringing about a change in ownership of shares sufficient to trigger pre-emptive clauses. In both cases, the court relied on the context as an important indicator as to the proper interpretation; and
  - c. Rule 9.2.1 is aimed at a change in full ownership of securities, that is the transfer of both legal and beneficial title. On that basis, the Special Division accepts that in the context of the Fund Securities Transfer the transfer of the bare legal title in the Fund Securities to NZDN should not be regarded as a "disposition" triggering Rule 9.2.1.
29. The Special Division considered it appropriate to grant a waiver, and not a ruling, because it is necessary to consider the circumstances of a particular case when determining whether a disposition of assets has occurred for the purposes of Rule 9.2.1. The Special

Division was concerned that if a ruling was granted then it could be used as a precedent in further decisions without the need to have regard to the circumstances of the particular transaction.

30. In coming to the decision to grant Smartshares waivers from Rule 9.2.1 in respect of the Fund Securities Transfer, Lending Transactions and on market transactions of Fund Securities through the CSS, the Special Division considered that:
- a) Footnote 1 to Rule 9.2.1 notes that in situations where NZXR is satisfied that the involvement of a Related Party was unlikely to have influenced the promotion to enter the transaction or its terms, NZXR will consider waiving Rule 9.2.1;
  - b) the Related Party relationship between Smartshares and the entities that will operate the CSS is unlikely to have influenced the decision by Smartshares to enter into the Fund Securities Transfer, Lending Transactions or to conduct on market trades through the CSS. The establishment of the CSS is part of a comprehensive overhaul of how securities are traded and settled through NZX's securities markets and has equivalent application to all market participants;
  - c) the CSS rules, and terms and conditions of trading, have been developed on an arm's length basis and will apply equally to all participants in the CSS. The Special Division notes that any amount of fees or costs payable in respect of the CSS will not impact on Unitholders of the Funds because Smartshares must pay all such expenses out of its set management fee and Smartshares has advised the Division that its management fees will not change as a result of the CSS coming into place or the implementation of securities lending by the Funds;
  - d) with respect to on market transactions of Fund Securities through the CSS, there is precedent for the granting of a waiver where an Issuer has no choice but to enter into arrangements with a sole service provider (who is a Related Party) in order to undertake its principal business where the terms of the service are the same for all participants (see NZXR decision in respect of SAT dated 12 March 2010), albeit that the precedent in question related to a waiver granted under Rule 9.1; and
  - e) it is satisfied that the policy contained in footnote 1 to Rule 9.2.1 has been met, and that waivers are appropriate.

#### **Application 2 – Rule 9.1**

31. Smartshares has applied to the Special Division for a ruling that the Fund Securities Transfer is not a disposition of assets for the purposes of Rule 9.1.
32. Smartshares submits that such a ruling is appropriate because:
- a) in the context of the Funds, where legal title to Fund Securities is never held by Unitholders, it is beneficial title that is of most significance for Unitholders. Although legal title is transferred, the beneficial interest to the Fund Securities is still held by the Trustee, for the benefit of Unitholders. Neither NZDN, nor CDO, has the right to share in the income or benefits of the Fund Securities it holds on behalf of Smartshares. If the beneficial interest to securities remains with the Issuer, a disposition of the securities has not occurred for the purpose of Rule 9.1;
  - b) the Fund Securities Transfer is not an alienation of the property rights of Unitholders, but merely an incidental result of changes to allow NZDN to provide depository services which will be of benefit to the Funds; and
  - c) it is commonplace for funds to change custodians, nominees and trustees. It is not the policy of Rule 9.1 to regulate transactions which are in substance a change from one service provider to another.

*Rule 9.1*

33. Rule 9.1.1 provides that:

*"An Issuer shall not (subject to Rule 9.1.3) enter into any transaction or series of linked or related transactions to acquire, sell, lease, exchange, or otherwise dispose of (otherwise than by way of charge) assets of the Issuer or assets to be held by the Issuer:*

*(a) which would change the essential nature of the business of the Issuer; or*

*(b) in respect of which the gross value is in excess of 50% of the Average Market Capitalisation of the Issuer;*

*except with the prior approval of an Ordinary Resolution of the Issuer..."*

**Application 2 – Decision**

34. On the basis that the information provided to the Special Division is full and accurate in all material aspects the Special Division grants Smartshares as manager of the Funds a waiver from Rule 9.1.1 in respect of the Securities Fund Transfer.

**Application 2 - Reasons**

35. In coming to the decision to grant Smartshares a waiver from Rule 9.1.1 in respect of the Fund Securities Transfer, the Special Division considered that:
- a) the policy behind Rule 9.1.1, as noted in the footnote to that Rule and described in waiver decisions of NZXR (including to AIR on 3 November 2009), is to regulate those transactions which are major decisions for an Issuer, or which may change the essential nature of the business of the Issuer;
  - b) the Fund Securities Transfer is not a transaction that will change the essential nature of the Fund's business either by acquiring new assets pursuant to a new business direction or by a large disposal of existing assets. The underlying beneficial interest in the Fund Securities remains with the Fund Trustees;
  - c) the Fund Securities Transfer itself will not result in any dilution of value of the Funds units. There is precedent for the granting of a ruling in circumstances where there is no dilution of value in the assets in the decision granted by NZXR to VCT dated 29 April 2008; and
  - d) Rule 9.1.1 is aimed at a change in full ownership of securities through the transfer of both legal and beneficial title. On that basis, the Special Division accepts that in the context of the Funds Securities Transfer the transfer of the bare legal title in the Fund Securities to NZDN should not be regarded as a "disposition" triggering Rule 9.1.1.
36. The Special Division considered it appropriate to grant a waiver, and not a ruling, because it is necessary to consider the circumstances of a particular case when determining whether a disposition of assets has occurred for the purposes of Rule 9.1.1. The Special Division was concerned that if a ruling was granted then it could be used as a precedent in further decisions without the need to have regard to the circumstances of the particular transaction.

ENDS