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**Gaming Review Team
Policy Group
Department of Internal Affairs
Level 6, State Insurance Building
Corner Waring Taylor Street and Lambton Quay
Wellington**

30 April 2001

Dear Sir or Madam:

Re.: Submission on Gaming Reform in New Zealand

We have been advised by our members that the department of Internal Affairs is reviewing the Gaming and Lotteries Act 1977 and that submissions on the regulations of gaming are invited following a consultation paper entitled "Gaming Reform in New Zealand: Towards a New Legislative Framework".

The International Swaps and Derivatives Association is the global trade association representing leading participants in the privately negotiated derivatives industry, a business which includes interest rate, currency, commodity, credit and equity swaps, as well as related products such as caps, collars, floors and swaptions. ISDA was chartered in 1985, and today numbers over 500 member institutions from 37 countries on five continents. These members include most of the world's major institutions who deal in and leading end-users of privately negotiated derivatives, as well as associated service providers and consultants.

Since its inception, the ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business. Among its most notable accomplishments are: developing the ISDA Master Agreement; publishing a wide range of related documentation materials and instruments covering a variety of transaction types; producing legal opinions on the enforceability of netting; securing recognition of the risk-reducing effects of netting in determining capital requirements; promoting sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

With this letter we would like to support the enclosed submission by Bell Gully, which highlights the need to remove the existing uncertainty relating to the applicability of the above Act to derivative transactions. We understand that there may be further opportunity to discuss these matters in more depth and would like to offer our assistance with respect to any related queries that may arise.

Yours sincerely,



**Angela Papesch
Head of Asia-Pacific Office**

Encl.



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SUBMISSION ON GAMING REFORM IN NEW ZEALAND

Introduction

The Department's consultation paper entitled "Gaming Reform in New Zealand: Towards a New Legislative Framework" calls for submissions on the regulation of gaming.

Our submission deals with a very specific, but very important, aspect of the existing regulatory regime: the potential application of gaming legislation to derivative transactions.

Background

The derivatives markets

Very broadly, a derivative transaction is a transaction whose value depends on (or "derives" from) the value of some underlying asset or the level of some underlying rate or index. A simple example is an option to buy shares. However, by far the most common types of derivatives instruments are those involving interest and exchange rates. Interest rate and currency swaps and options are widely used to hedge underlying exposures to interest or exchange rate volatility.

Derivative transactions are of two types: exchange-traded or over-the-counter (or **OTC**). Exchange-traded derivatives (such as futures) are standard form contracts that are, as the name suggests, traded on an exchange (such as the New Zealand Futures and Options Exchange). By contrast, OTC derivatives are individually negotiated contracts entered into between two organisations.

In the relatively short period since the first use of these products for financial assets (some 20-30 years ago), they have been overwhelmingly accepted as an indispensable financial tool for allocating risk. As a result, the derivatives markets have become the world's largest financial markets. The size of the OTC market was estimated by Swaps Monitor to be U.S.\$103.9 trillion (notional amount outstanding) as at 30 June 2000.

Gaming legislation

Section 128(1)(a) of the Gaming and Lotteries Act 1977 provides that wagering contracts are unenforceable. The Gaming and Lotteries Act does not define "wagering contract". However, there has been a fair amount of case law on this issue.

In New Zealand, as in other Commonwealth jurisdictions, there has been concern for some time that OTC derivative transactions could fall within the common law definition of "wagering contracts" and, therefore, be unenforceable. This concern has been aggravated by a number of developments. In particular:

- The English courts have, on occasion, shown a large degree of ignorance of derivative transactions (no New Zealand court has considered the issue). As a result, there have been some unfortunate statements made by those courts. For example, the following statements come from judgments of the House of Lords, England's highest court:
 - "A swap contract...is more akin to gambling than insurance.": *Hazel v Hammersmith and Fulham London Borough Council* [1991] 1 All ER 545, 559 (HL).
 - "Interest rate swaps...are in law wagers.": *Westdeutsche Landesbank Girozentrale v Islington borough Council* [1996] 2 WLR 802, 805 (HL).
- Section 40 of the Securities Amendment Act 1988 exempts certain (very limited) types of OTC derivatives from the Gaming and Lotteries Act. That exemption was introduced, presumably, because of a risk that those contracts would otherwise be subject to that Act. This creates an inference that those types of OTC derivatives not expressly exempted remain subject to the Gaming and Lotteries Act.

Despite these developments, the prevailing view in New Zealand is that, *on balance*, a New Zealand court would adopt the approach taken in *Morgan Grenfell & Co. Limited v Welwyn Hatfield District Council* [1995] 1 All ER 1 (QBD). The court in that case held that OTC derivatives should not be wagering contracts where there is a legitimate commercial interest or purpose to the contract.

We stress that this is the prevailing view "on balance". There is no question that uncertainty remains. That uncertainty is significant and, in our view, given the importance and size of the derivatives markets should be statutorily removed. Our experience is that it is an impediment to (domestic and offshore) organisations wanting to carry on this type of business in New Zealand.

Previous statutory amendments to facilitate derivatives activity

Parliament has, in the past, shown its willingness to amend legislation that was originally enacted in a pre-derivatives era and that, post-derivatives, raises technical issues. For example:

- Following the *Hammersmith* decision referred to above, there was concern that statutory corporations may not have the power to enter into derivative transactions. As a result, the legislation establishing a number of statutory corporations was amended to expressly confer this power.
- Netting legislation was passed in 1999 (principally in the Companies Amendment Act 1999) in response to a concern that the netting provisions that are an integral part of derivative transactions might not be enforceable in an insolvency.

Examples such as these demonstrate the broad recognition that legal uncertainty in the derivatives markets is highly undesirable and should, where possible, be rectified. We

submit that the gaming laws give rise to similar technical issues and should receive similar rectification.

Experience overseas

This issue is not unique to New Zealand. It also arises in other jurisdictions, particularly other Commonwealth jurisdictions. From New Zealand's perspective, the two most relevant jurisdictions are England and Australia. We briefly outline below what has been done in those jurisdictions.¹

England

This issue has been overcome in England by the enactment of section 63 of the Financial Services Act 1986 (the **FSA**). Section 63 provides that the UK gaming legislation does not apply to any dealings in "investments". The list of "investments" in Part 1 of Schedule 1 to the FSA is extensive and includes most OTC derivatives.

Australia

As in New Zealand, in Australia there is a specific exemption from gaming laws for exchange-traded derivatives (see section 1141 of the Corporations Law) but not for most OTC derivatives. In Australia, this problem was recognised by the Companies and Securities Advisory Committee (**CASAC**). In delivering its final report, CASAC recommended that:

All on-exchange and OTC derivatives transactions should be expressly excluded from gaming and wagering legislation.²

So far, this recommendation has not been implemented. However, this appears to be principally due to the fact that the Commonwealth Parliament lacks the constitutional power to make the legislative change (the individual States must take action). The need for a change in Australia is well recognised though.

Submission

In its Global Derivatives Study, the Group of Thirty³ concluded that:

In those jurisdictions where derivative transactions may be considered gambling contracts or off-exchange futures contracts, participants should seek legislative action to ensure that such transactions will not be deemed illegal and unenforceable.⁴

¹ This issue has also been addressed in the United States. The Futures Trading Practices Act of 1992 exempts "swap agreements" (which is very broadly defined) from State gaming laws.

² *Regulation of On-exchange and OTC Derivatives Markets, Final Report* (June 1997), Recommendation 50.

³ The Group of Thirty is a private independent organisation made up of representatives from central banks, international banks and securities houses. It is based in Washington, DC.

In line with this conclusion, and with the experience in England and Australia, we submit that there should be an express exemption for all OTC derivatives from the application of the statutory and common law gaming and wagering laws. In making this submission, we recognise the inherent difficulty in defining the scope of transactions that such an exemption would cover. However, this is an issue that others have dealt with satisfactorily (as in England). We would be happy to work with the Department to consider the scope of such a legislative change.

We also acknowledge that there will be some people who will claim that such an exemption would encourage abuse by those who would seek to take advantage of it for a purpose other than that for which it was intended. Claims such as this are inevitable whenever an exemption or preference is granted. In response to any such claim, we make two points. First, anecdotal evidence (in particular, from England) suggests this concern is unwarranted. In practice, people have not re-arranged their (illegitimate) affairs to obtain the benefit of such an exemption. Secondly, the scope for abuse can be minimised through a carefully worded definition of the transactions to which the exemption would apply.

Ultimately, the definition difficulty and the scope for abuse must be balanced against the risks of allowing the current uncertain and distorted position to continue.

Yours sincerely



D J Craig
Partner

⁴ *Derivatives: Practices and Principles, Appendix I: working papers (July 1993), p.54.*