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Securities Law Review
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Dear Sirs

Review of Securities Law – Discussion Paper (June 2010)

1. Introduction

The International Swaps and Derivatives Association, Inc. (**ISDA**) welcomes the release of the Ministry of Economic Development's (**MED**'s) discussion paper entitled *Review of Securities Law* (the **Discussion Paper**). As a general comment, ISDA believes that the reforms proposed in the Discussion Paper and, in particular, the improved regulatory certainty that should accompany those reforms, represent a major step forward for New Zealand securities law.

ISDA broadly supports the proposed reforms and is grateful for the opportunity to comment on a number of the questions raised in the Discussion Paper. Not surprisingly, the focus of ISDA's submissions is on those aspects of the proposed reforms that most closely affect the operation of the over-the-counter (**OTC**) derivatives markets and the participants in those markets. Specifically, ISDA's comments in section 3 below principally focus on:

- the proposed definition of "derivatives" (Chapter 1, question 8);
- the categories of exempt investors and the consequences of exemption insofar as derivative transactions are concerned (Chapter 2, questions 3 to 7);
- the disclosure obligations in respect of non-exempt derivative transactions (Chapter 3, questions 15, 19 and 25); and
- the Hague Convention on indirectly held securities (the **Convention**) (Chapter 5, questions 10 to 13).

2. **About ISDA**

ISDA, which represents participants in the privately negotiated derivatives industry, is among the world's largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985, and today has over 820 member institutions from 57 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end-users that rely on OTC derivatives to manage efficiently the financial market risks inherent in their core economic activities.

Since its inception, 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 and collateral arrangements;
- securing recognition of the risk-reducing effects of netting and collateral 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.

3. **ISDA's submissions**

(i) ***<u>Chapter 1 – Defining regulated financial products</u>***

Securities Markets Act

In Chapter 1, section 3.5 of the Discussion Paper, the MED notes the confusion in the market place surrounding the definition of "futures contract" in the Securities Markets Act 1988. The resulting uncertainty has adverse implications for market participants and product development - in large part because it is unclear whether a particular derivative is regulated under the Securities Markets Act, the Securities Act 1978, or neither Act.

This has certainly been the experience of ISDA members that operate in New Zealand, and ISDA's New Zealand legal counsel. The "futures contract" definition, being primarily based around the concept of an exchange-traded product, is regrettably imprecise in its application to OTC products.

Securities Act

Similarly, but to an even greater degree, there is considerable legal uncertainty surrounding the application of the Securities Act to OTC derivatives. This uncertainty is not surprising as the Securities Act pre-dates the emergence of the OTC derivatives markets and there have been no serious attempts to update the definitions of key terms to keep track with product development. The practical effect of this uncertainty for ISDA members has been that they are typically required to assume that products offered by them *could* be "securities". Therefore, they are required to rely on an existing exemption, or seek a new one, in order to avoid the Securities Act's onerous disclosure requirements.

Inconsistencies between securities and derivatives regimes

ISDA agrees with the MED[1] that the inconsistency of treatment of OTC derivatives under the Securities Markets Act (regulation of dealers) and the Securities Act (regulation of offerings) does not make sense. In particular, the absence of a broadly applicable wholesale client exemption under the Securities Markets Act merely increases the cost of doing business in New Zealand without providing any corresponding benefit to local counterparties. With the form of the Financial Advisers Act 2008 (the **FA Act**) now finally settled, the justification for a wholesale client exemption in New Zealand financial services legislation seems to be broadly accepted.

General principles

ISDA agrees with the general principles enunciated by the MED[2] that:

- securities law aims to facilitate efficient capital markets by seeking to provide assurance to (a) investors (particularly retail investors) that they can confidently participate in capital markets and make financial decisions that are appropriate to their financial goals, and (b) businesses that they can efficiently and effectively raise funds from capital markets and hedge financial risks;
- securities law should be targeted at financial products where there is potential for market failure, and should avoid regulating other products;
- product categories are used to apply different types of disclosure and governance requirements to different types of products, thus products with similar disclosure and governance requirements should be assigned to the same category;
- the current categorization of "securities" and "futures contracts" is inappropriate;
- economic substance, rather than the legal form of the product, is paramount to its categorization;
- the definition of "derivatives" should require that they are either investments or used for hedging financial risk.

Comments on the proposed definition of "derivatives"

In Chapter 1, paragraph 58, the MED sets out a proposed definition of "derivatives". The MED's definition is based on the accounting definition of "derivative" in IAS39 and would specifically exclude collective investment schemes, equity and debt.

ISDA notes that the proposed definition represents a marked departure from what seems to have become a standard approach in recent legislation that defines "derivatives transactions".[3] In

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1 Chapter 1, section 3.6 of the Discussion Paper.

2 Introduction, paragraph 11 and Chapter 1, sections 1.2 and 4.1.

3 For example, section 136(1) of the Crown Entities Act 2004 and section 2(1) of the Public Finance Act 1989 (inserted by the Public Finance Amendment Act 2004) each defines "derivative transaction" as follows:

particular, the proposed definition represents a shift away from a predominantly *form-based* approach (under which there is a list of specified products and a catch-all category) to a predominantly *substance-based* approach (under which products are, regardless of their form, deemed to be derivatives if they have certain specified features).

ISDA appreciates that one of the stated goals of the reforms outlined in the Discussion Paper is to regulate on the basis of economic substance rather than legal form.[4] However, ISDA submits that, in this particular case, because of the vagaries of the specified criteria, the diversity in product types, and the need for certainty of categorisation, the definition must include an element of the form-based approach. To be clear, ISDA is *not* suggesting that the substance-based approach should be abandoned.[5] It is merely suggesting that it should be supplemented by a form-based approach.

For example, the proposed definition could be supplemented by a list of transaction-types, introduced by words such as "and includes, without limitation". That approach would make the definition more consistent with the definitions in the existing New Zealand legislation referenced above. It would also be consistent with the legislation in other jurisdictions in which ISDA members have a major presence. In this regard, the Appendix to this letter sets out equivalent definitions in United States and Canadian legislation, as well as in ISDA's Model Netting Act. The Model Netting Act definition is set out principally to provide a more comprehensive list of the types of specific products that could be included in a revised definition. However, given that the focus of the Model Netting Act is to ensure the enforceability of cross-product netting agreements, rather than the regulation of the products themselves, ISDA acknowledges that it may not be appropriate to include all of the listed products in the securities legislation definition.

ISDA would be happy to work with the MED towards drafting an amended definition that would achieve the dual objectives of having a substance-based approach but still providing regulatory certainty.

The MED is also proposing the following:

- as the accounting definition of a "derivative" requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be

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(a) a transaction that is a rate swap transaction, swap option, basis swap, forward rate transaction, interest rate option, foreign exchange transaction, cap transaction, floor transaction, collar transaction, currency swap transaction, cross-currency rate swap transaction, currency option, commodity swap, commodity option, equity or equity index swap, equity or equity index option, bond option, credit protection transaction, credit swap, credit default swap, credit default option, total return swap, credit spread transaction, forward purchase or sale of a security, or commodity or other financial instrument or interest (including an agreement or option that relates to any of these transactions); or

(b) a transaction that is similar to any transaction referred to in paragraph (a) that –

(i) is currently, or in the future becomes, recurrently entered into in the financial markets; and

(ii) is a forward, swap, future, option, or other derivative on 1 or more rates, currencies, commodities, equity securities or other equity instruments, debt securities or other debt instruments, economic indices or measures of economic risk or value, environmental or climatic variable, or other benchmarks against which payments or deliveries are to be made.

[4] See, for example, Chapter 1, paragraph 5.

[5] Although some ISDA members may not agree with this view.

expected to have a similar response to changes in market factors, derivatives that have 100% initial margin requirements or fully prepaid derivatives would be excluded;[6]

- derivatives be sub-categorized into exchange-traded and OTC derivatives. An exchange-traded derivative would be a derivative made on or effected through a derivatives exchange in New Zealand or overseas. An OTC derivative would be all other derivatives;[7]

- where an issuer issues derivatives over its own regulated financial products (e.g., equity warrants and options), then the derivative should generally be treated the same as the underlying, i.e., an equity warrant should have the same disclosure as the underlying equity security, with an additional explanation of the conversion process (strike price, strike date, etc).[8]

ISDA's position on each of the above proposals is as follows:

- a product that would otherwise be included as a derivative should not be excluded simply because it has 100% initial margin requirements or is fully prepaid. The drivers for requiring 100% initial margin or prepayment are typically related to counterparty credit risk, accounting or regulatory considerations impacting the issuer and/or the counterparty. From the standpoint of disclosure and governance requirements, they should not be treated differently from other derivatives. It should also be clarified that such products would not be classified as a debt security;

- whether the sub-categorization into exchange-traded and OTC derivatives is appropriate depends on the nature of the different treatment that is proposed for each sub-category. ISDA would be interested to know the specific differences that the MED has in mind in this regard. In addition, we believe that further attention needs to be paid to the definition of an "exchange", given global developments in regard to alternative swap execution facilities and the like. As the MED may be aware, under recent legislation in the Unites States, the concept of an "exchange" has been given a broader meaning than was traditionally the case. In the light of developments such as this, the MED may wish to consider the scope of the definition of "exchange";

- the MED suggests that the circumstances in which a distinction between OTC and exchange-traded derivatives might be made includes disclosure and governance. We are of the view that client type should be the principal driver behind the principles that would apply to disclosure in respect of derivatives. In practice, the application of sound disclosure principles based on client type to derivatives would still result in different disclosure statements for different types of derivatives in order to properly reflect the specific characteristics, risks and benefits of each product, irrespective of whether it is OTC or exchange-traded. However, the difference between OTC and exchange-traded may be relevant to the point in time when the client's classification is determined - for exchange-traded products, it will likely be practicable to make a one-time determination at the point of account-opening rather than on an on-going basis. This approach would deliver the type of consumer protection and market efficiency outcomes sought through the reforms, as a different but appropriate level of disclosure for each product would be made to retail and wholesale clients, respectively. Moreover, given the evolving concept of 'exchange' in international regulation, we believe an approach that bases

[6] Chapter 1, paragraphs 58 and 60.

[7] Chapter 1, paragraph 61.

[8] Chapter 1, paragraph 62.

disclosure policy and regulation on the difference between retail and wholesale clients will provide a more certain outcome than one that relies on whether the product is OTC or exchange-traded.

- we disagree with the different treatment proposed for derivatives over an issuer's own regulated financial products. Such an approach raises unnecessary complications, e.g., (a) would it make a difference that the derivative is cash-settled and not physically-settled, (b) what if there is optionality as to whether settlement should be cash or physical, (c) what if the issuer's own product comprises less than 100% of the underlying, (d) what does "own" mean, e.g., what if the issuer is an affiliate or a special purpose vehicle?

New products and designation powers

The Discussion Paper raises the possibility that there may be products which either (a) completely fall outside the definitions of the four categories, or (b) with respect to which it is unclear which of the four categories it falls within. It thus proposes that the Financial Markets Authority (the **Authority**) be given the power to "call in" a product, i.e., designate that the product falls within one of the four categories notwithstanding that it is technically not within the applicable definition, or into a new category. It further proposes that the Authority be given the power to re-classify products from one category to another. The Discussion Paper provides that such "calling in" or re-classification will not have retrospective effect, but proposes that the Authority be given the power to prohibit any further allotment pending a decision.[9]

Given the shift in the definitional approach from a *form-based* to a *substance-based* approach, ISDA believes that there is only a low risk of a product falling completely outside all of the four categories. If the MED considers it to be essential to guard against this low risk, ISDA submits that the preferred approach would be to create a fifth "catch-all" category into which all other financial products would fall. This approach would discourage issuers from attempting to structure the transaction to fall outside the four categories and thus avoid regulation under the new Act.

With regard to uncertainty as to which category a product falls within, ISDA submits that this will not be the case insofar as derivatives are concerned if its above proposal (that the *substance-based* definitional approach be supplemented by a *form-based* approach) is adopted.

ISDA does not agree that the Authority should be given the power to designate a product or to re-classify a product from one category to another, at least not without affording a reasonable period of time before such designation or re-classification takes effect. The viability of a product launch is very much dependent upon its classification (which the issuer would have determined based on legal advice) as this impacts both expected revenues (the targeted investor group) and costs (disclosure and governance requirements). Any product development would require significant expenditure of time and money - it would not be fair to the issuer if, shortly after the product is developed, it is told by the Authority that it can no longer offer the product. The focus should be on ensuring clarity and certainty in the definitions of the product categories, which ISDA believes can be achieved through supplementing the *substance-based* definitional approach with a *form-based* approach. To the extent that this is considered essential, a fifth "catch-all" category should be created.

[9] Chapter 1, section 4.2.

Financial products that do not earn a return or allow for risk hedging

The Discussion Paper proposes that there be a general exemption for financial products where the possibility of generating a return or hedging financial risk is "immaterial" to the investor's decision and also asks if such an exemption would be too broad.[10]

ISDA supports a general exemption for financial products where the possibility of generating a return or hedging financial risk is "immaterial" to the investor's decision.

ISDA does not agree with narrowing the exemption by restricting it to investments in not-for-profit or mutual organizations. ISDA believes that it would be difficult to define with precision the investee vehicles (especially given the diverse global forms they could take) that would qualify under such an exemption and that any definition would be susceptible to avoidance.

Bearing in mind the fundamental purpose of securities law, ISDA submits that the most appropriate way of implementing the exemption is to require the investor to declare that its decision to enter into the transaction was not influenced by the possibility of generating a return or hedging financial risk, and that it acknowledges that the transaction is an exempt transaction, and that it is not entitled to any of the protections, under the new Act.

New regime for investment brokers

The Discussion Paper proposes a new licensing regime for "investment brokers".[11] This would replace, among other things, the futures dealers authorisation regime in the Securities Markets Act. As we note above, the futures dealers regime can apply to dealers in OTC derivatives as well as dealers in exchange-traded derivatives.

The Discussion Paper provides few details of this new regime. However, one aspect of the current regime that ISDA would welcome clarification on is the key definition of "deals". In particular, the extremely broad definition currently set out in section 37(5) of the Securities Markets Act, which includes persons who advise or assist a client in connection with a futures contract trade, has caused a great deal of confusion in the market. Read literally, this definition (in particular, the "assists" wording) could catch many unintended parties. ISDA would welcome a sensible refinement of this concept in the new regime.

(ii) ***Chapter 2 – Offers to exempt investors***

This topic is of particular interest to ISDA as ISDA's expectation is that many OTC derivative transactions would be entered into between counterparties who should be exempt from compliance with securities laws. This is essentially a continuation of the position under current New Zealand law.

Principles for exemptions

ISDA agrees with the position[12] expressed by the MED that:

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[10] Chapter 1, section 4.3.

[11] Chapter 1, section 4.6.

[12] Chapter 2, sections 1.2 and 4.

- the approach should be to include all investors and then make selective exemptions from some or all of the securities law requirements for certain classes of investors;

- the distinction between a "public offer" and a "private offer" should be removed;

- the important principles to bear in mind in setting up the exemptions are:

    - certainty;

    - simplicity; and

    - low cost.

Problems with the current regime

ISDA agrees with the MED's comments[13] relating to the problems with the current regime. In the context of the OTC derivatives markets, the two Securities Act exemptions relied on most frequently are the "habitual investor" exemption and the "selected otherwise than as a member of the public" exemption. There is considerable legal uncertainty surrounding the scope of both of these exemptions. Often that uncertainty results in ISDA members needing to seek costly, and often inconclusive, legal advice on transactions that, from a policy perspective, should not be subject to securities laws.

Categories of exempt investors

In terms of the categories of exempt investors proposed in the Discussion Paper,[14] ISDA comments as follows:

- The starting point for an exempt investor definition should be the "wholesale client" definition in the Financial Advisers Act 2008 (the **FA Act**). This would mean that, for example, the monetary thresholds for determining what is a "large entity" should be aligned between the two pieces of legislation (currently, the thresholds for the proposed securities laws[15] are considerably higher than those under the FA Act).[16] Conceptually, it is difficult to see the justification for having different standards under the FA Act, on the one hand, and securities laws, on the other hand.

- The proposed investment business definition includes persons whose principal business is entering into derivatives transactions.[17] ISDA has two comments on this proposal.

  First, for most ISDA members (and most non end-user OTC market participants), the entry into derivative transactions is *part of* their principal business but not *the* principal business. That

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13 Chapter 2, Section 3.

14 Chapter 2, paragraph 18.

15 Chapter 2, paragraph 47.

16 Section 5C(1)(d).

17 Chapter 2, paragraph 35.

is, the majority of participants in these markets are diversified global financial services firms whose business includes, but is not limited to, derivatives trading. Accordingly, ISDA believes the test should be re-phrased to refer to persons whose principal business “includes” (rather than “is”) one or more of the enumerated activities.

ISDA does not support the restriction of this exemption to investment businesses above a certain size. As pointed out by the MED, size is only an approximate proxy for sophistication. It would also lead to overlap and possible confusion with the large entity exemption.

Secondly, in paragraph (b) of the proposed investment business definition, the MED has omitted the final words “on behalf of another person”, which are found in the underlying provision of the Financial Service Providers (Registration and Dispute Resolution) Act 2008 (the **FSP Act**) from which this part of the definition derives.[18] . We expect that the intent is that “investment business” would include the operations of a person who deals on a principal-to-principal basis as well as on an agency basis as, logically, both scenarios should be included. Perhaps this could be made explicit by including the words “whether as principal or agent” at the end of that part of the investment business definition.

- The thresholds in the proposed large entities exemption should be lowered to align with the equivalent exemption in the FA Act.
- The proposed minimum subscription price exemption[19] does not fit well in the context of derivatives. Derivative transactions do not typically have a subscription price. Rather, they have a notional principal amount. Accordingly, ISDA suggests that this exemption should be two-limbed. The first limb would apply to non-derivative financial products, and would specify an NZ$500,000 subscription price as the threshold. The second limb would apply to derivatives, and would most likely specify a higher amount as the threshold – say, NZ$1 million notional principal amount – to address the fact that the “investor” is not required to pay the full notional amount.
- ISDA supports the creation of a new exemption for investors advised by an independent financial adviser and believes that the criteria[20] proposed by the MED constitute a reasonable starting point.
- ISDA also supports the creation of a new exemption for investors who “opt out”[21] of the protections afforded by the new Act. ISDA believes that it would be sufficient for the investor to have obtained independent legal advice and to have signed a prescribed statement witnessed by a lawyer before being able to “opt out”.

Consequences of exemption

- ISDA agrees that offers made solely to investment businesses, sophisticated investors, large entities, and those making large investments should be exempt from all substantive parts of the new Act apart from civil liability for false and misleading statements, and that offers to

18 Section 5(k).

19 Chapter 2, section 4.10.

20 Chapter 2, paragraph 78.

21 Chapter 2, section 4.15.

other exempt investors should be exempt from everything apart from civil and criminal liability for false and misleading statements.[22] As pointed out by the MED in the Discussion Paper,[23] investment businesses, sophisticated investors, large entities, and those making large investments are assumed to be able to enforce civil claims through the courts. ISDA does not support the proposal that such investors be allowed to "opt in", with the agreement of the issuer, to the imposition of criminal liability.[24] It would be commercially difficult for the issuer to refuse its agreement with the result that "opting in" would practically become automatic. If the MED feels strongly about this, ISDA believes that it would be simpler and less contentious to apply civil and criminal liability across-the-board to all exempt investors.

- The MED asks whether offers to any category of exempt investors should be required to be registered on the new Register of Securities, and whether issuers to exempt investors should be required to register under the FSP Act or the Financial Reporting Act 1993.[25] ISDA's view, in all three cases, is that they should not.

  Almost by definition, exempt investor transactions are private transactions involving very few parties, all of whom are either sophisticated experienced investors or persons who, for other reasons, do not need securities law protection. Moreover, the terms of these exempt transactions are often commercially sensitive. Finally, certainly in the case of trading entities, there may be a very large number of these transactions entered into every day. In those circumstances, the additional costs associated with these registration and reporting requirements would far outweigh the negligible public benefit.

Certification and registration of exempt investors

- The MED asks whether self-certification should be allowed and also asks about the creation of a public register of exempt investors.[26] ISDA supports self-certification given the reluctance of many investors to provide sufficient private information to the issuer or a third party to enable the issuer/third party to make a determination. Further, ISDA is of the view that the costs and additional complications raised by third party verification would outstrip any potential benefits.

- ISDA does not support the creation of a new offence to discourage an issuer from encouraging or assisting a potential investor to falsely self-certify.[27] Instead, current provisions imposing criminal liability for false or misleading conduct should be appropriately enhanced (if necessary) to cover such conduct.

- To discourage an investor from falsely self-certifying,[28] perhaps a requirement should be imposed that self-certification must be in the form of a statutory declaration. This would emphasize to the investor the seriousness of the self-certification that he is making. The

22 Chapter 2, sections 4.3 and 4.4.

23 Chapter 2, paragraph 27.

24 Chapter 2, paragraph 28.

25 Chapter 2, questions 5, 6 and 7.

26 Chapter 2, questions 22 to 26.

27 Chapter 2, paragraph 114.

28 Chapter 2, paragraph 114.

penalties for a false declaration should, of course, include disqualifying the investor from impugning the validity of the transaction.

- ISDA is not convinced that the cost involved in setting up and maintaining a public register would be justified. A public register would need to incorporate a mechanism for updating changes. However, it would be difficult to incentivize investors to keep their status updated.

(iii) ***<u>Chapter 3 - Disclosure</u>***

Upfront disclosure

ISDA has relatively few comments on this section of the Discussion Paper, on the basis that ISDA believes that the exempt investor definition should exclude the typical parties to an OTC derivative transaction.

However, given that it might be possible in limited circumstances for a derivative transaction to be non-exempt, and given that the MED has invited submissions on the level of disclosure appropriate for derivatives,[29] ISDA comments as follows:

- ISDA favours the MED's preferred option of having a single disclosure document (a product disclosure statement or PDS), with further disclosures available on a register.

- ISDA also agrees that the risk disclosure section in the PDS's key information summary should be a self-assessment of risks by the issuer (rather than a third party assessment or an issuer assessment based on pre-determined risk ratings).

- The other proposed components of the PDS's key information summary for derivatives[30] seem appropriate.

- The proposed components for the remainder of the PDS for derivatives[31] are consistent with the approach typically required in disclosure documents provided by futures dealers under the terms of their Securities Markets Act authorisation. Where transactions are entered into pursuant to an underlying market agreement (which is normal), it should be possible to standardise much of that disclosure. In that case, for an individual transaction, the only additional disclosure that should be required (perhaps in a PDS addendum) is the details of the unique commercial terms of that transaction.

- ISDA is not in favour of empowering the Authority to impose sophistication warnings on derivatives products that the Authority deems "complex".[32] It may be beneficial for the market to standardize the language of the sophistication warning, but the discretion should be left with the issuer to determine if it would be appropriate to include the warning for a specific derivatives product.

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[29] Chapter 3, questions 15 and 19.

[30] See Chapter 3, paragraph 92.

[31] See Chapter 3, section 3.4.2.4.

[32] Chapter 3, section 3.4.4.

- Part 5 of the Securities Act currently provides the legislative framework through which mutual recognition regimes can be put in place to significantly reduce disclosure and other requirements for offshore issuers from comparably regulated jurisdictions[33]. The rationalisation of securities law into one Act provides the opportunity to review the relevance of the current legislative provisions around mutual recognition to derivative products under the Securities Markets Act. Arrangements that recognise equivalent overseas regulatory regimes are an important feature of today's international markets that facilitate cross border business by avoiding duplicative regulation and the attendant unnecessary compliance costs.

Ongoing disclosure

The MED acknowledges there are currently no ongoing disclosure obligations for an entity that offers derivatives. Given the short term of most derivatives, the MED does not consider that there is any need for such ongoing disclosure.[34] ISDA agrees.

Disclosure and liability

The MED asks what disclosure failures should result in voidability of the transaction.[35] ISDA is not in favour of this approach. First, it is difficult, if not impossible, to define what disclosure failures would be relevant for this purpose. Secondly, the principle should be to compensate an investor for any loss suffered as a result of any disclosure failure – this can be achieved without needing to provide for the transaction to be avoided and for consequential restitution.

(iv) ***Chapter 5 – Other Matters***

Hague Securities Convention[36]

The issues addressed by the Convention are pivotal to the business of ISDA's members, who deliver and receive extremely large amounts of cash and securities collateral on a daily basis.[37] Much of that collateral has a cross-border element to it.[38] Therefore, the operation of

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33 For example, the mutual recognition regime between New Zealand and Australia, applying to certain securities offers and interests in managed investment schemes, enables Australian and New Zealand issuers offering securities in either market to be able to use disclosure documents issued in the home jurisdiction in the host jurisdiction.

34 Chapter 3, paragraph 129.

35 Chapter 3, question 36.

36 ISDA notes that the Hague Securities Convention has , under the auspices of UNIDROIT, been recently followed by the Geneva Securities Convention. This latter Convention, which addresses substantive law issues as opposed to conflict of laws issues, was adopted in October 2009 and is available at http://www.unidroit.org/english/conventions/2009intermediatedsecurities/main.htm.

37 According to ISDA's most recent margin survey (dated 22 April 2010), the estimated amount of collateral in circulation in the OTC derivatives market at the end of 2009 was US$3.2 trillion.

38 Whether because of:

- the counterparties, their financial intermediaries, or the collateral issuer being located in more than one jurisdiction; or
- a foreign governing law; or
- some other reason.

the relevant conflict of laws rules is critical to determining whether secured party rights are adequately protected.

For that reason, ISDA has commissioned legal opinions in 45 jurisdictions addressing, among other things, the conflict of laws rules relating to collateral. The New Zealand law opinion, provided by Bell Gully, focuses on the conflict of laws rules contained in the Personal Property Securities Act 1999 (the **PPSA**). That opinion notes, as does the MED,[39] that there are gaps in the PPSA's rules and that the PPSA's rule for dematerialised securities conflicts with the equivalent rule in the Convention.

ISDA strongly supports the proposal that, ultimately, New Zealand should adopt the Convention rather than merely aligning local law to be consistent with the Convention. However, ISDA appreciates that signing and ratifying the Convention may take considerable time. In the interim, given the importance of having the relevant issues addressed as soon as possible, ISDA believes that New Zealand should align local law with the Convention. Such alignment would reduce the legal due diligence required in order for a counterparty to be able to accept collateral with a New Zealand connection. This should result in lower transaction costs and, therefore, greater readiness to transact with New Zealand counterparties. It should also result in a greater proportion of transactions being collateralised, leading to a corresponding reduction in credit risk.

Finally, the MED asks for some quantitative indicators of the effect of the current position.[40] ISDA does not collect such information from its members. However, by way of a single example, ISDA's New Zealand counsel (Bell Gully) estimates that it is instructed to address these conflict of laws issues approximately 10-20 times per year. The cost for this advice varies significantly, but typically ranges from NZ$5-20,000.

Once again, ISDA appreciates the opportunity to comment on the proposed structure of this significant impending law reform. For the purposes of the Official Information Act 1982, ISDA has no objection to the public release of this submission.

Yours sincerely

For the International Swaps and Derivatives Association, Inc.

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[39] Chapter 5, paragraphs 43 and 44.

[40] Chapter 5, questions 12 and 13.

Appendix

United States Bankruptcy Code

Section 101 (53B) of the Code defines "swap agreement" as:

(i) any agreement, including the terms and conditions incorporated by reference in such agreement, which is – (I) an interest rate swap, option, future, or forward agreement, including a rate floor, rate cap, rate collar, cross-currency rate swap, and basis swap; (II) a spot, same day-tomorrow, tomorrow-next, forward, or other foreign exchange, precious metals, or other commodity agreement; (III) a currency swap, option future, or forward agreement; (IV) an equity index or equity swap, option, future, or forward agreement; (V) a debt index or debt swap, option, future or forward agreement; (VI) a total return, credit spread or credit swap, option, future, or forward agreement; (VII) a commodity index or a commodity swap, option, future, or forward agreement; (VIII) a weather swap, option, future, or forward agreement; (IX) an emissions swap, option, future, or forward agreement; or (X) an inflation swap, option, future, or forward agreement;

(ii) any agreement or transaction that is similar to any other agreement or transaction referred to in this paragraph and that – (I) is a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap or other derivatives markets (including terms and conditions incorporated by reference therein); and (II) is a forward, swap, future, option, or spot transaction on one or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial, or economic consequence, or economic or financial indices or measures of economic or financial risk or value;

(iii) any combination of agreements or transactions referred to in this subparagraph;

....

Canadian Bankruptcy and Insolvency Act

A "derivatives agreement" is:

a financial agreement whose obligations are derived from, referenced to, or based on, one or more underlying reference items such as interest rates, indices, currencies, commodities, securities or other ownership interests, credit or guarantee obligations, debt securities, climatic variables, bandwidth, freight rates, emission rights, real property indices and inflation or other macroeconomic data and includes:

(a) a contract for differences or a swap, including a total return swap, price return swap, default swap or basis swap;

(b) a futures agreement;

(c) a cap, collar, floor or spread;

(d) an option; and

(e) a spot or forward.

ISDA's Model Netting Act

A "qualified financial contract" is:

any financial agreement, contract or transaction, including any terms and conditions incorporated by reference in any such financial agreement, contract or transaction, pursuant to which payment or delivery obligations are due to be performed at a certain time or within a certain period of time and whether or not subject to any condition or contingency. Qualified financial contracts include (without limitation):

(a) a currency, cross-currency or interest rate swap;

(b) a basis swap;

(c) a spot, future, forward or other foreign exchange transaction;

(d) a cap, collar or floor transaction;

(e) a commodity swap;

(f) a forward rate agreement;

(g) a currency or interest rate future;

(h) a currency or interest rate option;

(i) an equity derivative, such as an equity or equity index swap, equity forward, equity option or equity index option;

(j) a derivative relating to bonds or other debt securities or to a bond or debt security index, such as a total return swap, index swap, forward, option or index option;

(k) a credit derivative, such as a credit default swap, credit default basket swap, total return swap or credit default option;

(l) an energy derivative, such as an electricity derivative, oil derivative, coal derivative or gas derivative;

(m) a weather derivative, such as a weather swap or weather option;

(n) a bandwith derivative;

(o) a freight derivative;

(p) an emissions derivative, such as an emissions allowance or emissions reduction transaction;

(q) an economic statistics derivative, such as an inflation derivative;

(r) a property index derivative;

(s) a spot, future, forward or other securities or commodities transaction;

(t) a securities contract, including a margin loan and an agreement to buy, sell, borrow or lend securities, such as a securities repurchase or reverse repurchase agreement, a securities lending agreement or a securities buy/sell-back agreement, including any such contract or agreement relating to mortgage loans, interests in mortgage loans or mortgage-related securities;

(u) a commodities contract, including an agreement to buy, sell, borrow or lend commodities, such as a commodities repurchase or reverse repurchase agreement, a commodities lending agreement or a commodities buy/sell-back agreement;

(v) a collateral arrangement;

(w) an agreement to clear or settle securities transactions or to act as a depository for securities;

(x) any other agreement, contract or transaction similar to any agreement, contract or transaction referred to in paragraphs (a) to (w) with respect to one or more reference items or indices relating to (without limitation) interest rates, currencies, commodities, energy products, electricity, equities, weather, bonds and other debt instrument, precious metals, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial or economic consequence, or economic or financial indices or measures of economic or financial risk or value;

(y) any swap, forward, option, contract for differences or other derivative in respect of, or combination of, one or more agreements or contracts referred to in paragraphs (a) to (x); and

(z) any agreement, contract or transaction designated as such by [regulator] under this Act.