ISDA Safe, Efficient Markets

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Consultation Document: A New Zealand Response to Foreign Margin Requirements for OTC Derivatives (July 2017)

The International Swaps and Derivatives Association, Inc. (**ISDA**)[1] is grateful for the opportunity to make a submission on this consultation document (the **Consultation Document**) published by the Reserve Bank and the Ministry of Business, Innovation & Employment (the **Agencies**).

As you are aware, since late 2016, ISDA has been considering the New Zealand law issues outlined in the Consultation Document – through discussions with the Agencies (in conjunction with the New Zealand Bankers' Association) and discussions with its members that have derivatives operations in New Zealand or with New Zealand counterparties. More broadly, since the publication in 2013 of global standards by the Basel Committee on Banking Supervision (BCBS) and the International Organisation of Securities Commissions (IOSCO), ISDA has been considering similar issues in many of the major jurisdictions in which its members are based or regulated. As a result, ISDA believes that it is well-placed not only to provide a view on the specific New Zealand law aspects of the Agencies' proposals but also to report on the experience of offshore counterparties and regulators who have already faced similar challenges.

We set out in the Schedule to this letter the questions asked by the Agencies in the Consultation Document and our submission on those questions. References in the submission to "paragraphs" are to paragraphs in the Consultation Document. We note that our members may choose to make their own individual submissions on the Consultation Document.

We would be happy to discuss our responses with the Agencies. Also, if the Agencies decide to proceed with legislative amendments, ISDA and its New Zealand law advisers, Bell Gully, would welcome the chance to comment on the draft legislation.

Yours sincerely

Keith Noyes
Regional Director, Asia-Pacific
ISDA

[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 875 member institutions from 68 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

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C: The impact of foreign margin requirements on New Zealand business	*1: Do you agree with this assessment of the likely impact of foreign margin rules on New Zealand entities? Are there risks to New Zealand entities that have been overlooked or mischaracterised?*	Yes, we agree with this assessment. We do not believe that there are material risks to New Zealand entities that have been overlooked or mischaracterised.
E: New Zealand response options to margin requirements	***Option A: Status Quo*** *2: Do you agree that current New Zealand law is a significant potential barrier to New Zealand entities' ability to effectively and efficiently provide margin?*	Yes, we agree. This is the consistent feedback ISDA has received from its members. In particular (and as the Consultation Document notes in paragraph 59), the various statutory moratoria in New Zealand have long been identified as a significant barrier to the enforceability of margin arrangements. The effect of those moratoria is discussed in detail in the collateral opinions ISDA has obtained for its members from its New Zealand counsel. ISDA members reviewing those opinions frequently identify that feature of New Zealand law as being the most problematic for their proposed collateral arrangements.
	Option B: Targeted legislative change *3: Does the proposed exception cover the enforcement of security interests in the right circumstances? Are there better ways of defining the scope of the exception?*	We agree that, *in respect of security interests over IM*, the proposed exception addresses the issues arising out of the three key impediments identified in paragraph 51. However, we also believe that the proposed exception is framed too narrowly. Given the size and systemic importance of the participants in the OTC derivatives markets, and the transactions they undertake, ISDA's view is that *all* margin arrangements are equally worthy of this statutory protection – regardless whether the protection is prompted by foreign margin rules. ISDA's view is that the protection should extend to, in particular (1) margin for cleared transactions, (2) margin for uncleared transactions not covered by a regulatory mandate, and (3) VM. With regards to VM, while the legal impediments to the effectiveness of those arrangements may not be as substantial as for other types of margin, there *are* impediments nonetheless. Creating a hierarchy of enforceability of margin arrangements with New Zealand entities would inevitably confuse offshore counterparties. It would

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		also continue to expose non-covered margin arrangements to the legal impediments identified by the Agencies, thereby passing up an opportunity to create comprehensive protection. The Agencies' rationale for *not* creating comprehensive protection is outlined in paragraph 94. The Agencies are concerned that doing so "could hinder the statutory manager's ability to effectively resolve the institution and may more broadly damage financial markets function and system stability". We do not share that concern. Quite the opposite. The purpose of margin is to enhance, not damage, financial markets function and system stability.
	(i) Statutory moratoria *4: Do you agree that New Zealand's moratorium provisions are a significant potential impediment to New Zealand entities' compliance with foreign margin requirements?*	Yes. See our submission on question 2 above.
	(i) Statutory moratoria *5: Do you agree that the proposed changes to moratorium provisions are necessary and sufficient to address this potential compliance barrier?*	Yes, subject to what we say in the following two paragraphs. One unique feature of the proposed changes is the extension of the moratorium in the Reserve Bank of New Zealand Act 1989 to cover the exercise of termination rights in the statutory management of a registered bank. That extended moratorium would apply for a two business day stay period. In all other respects, the proposed changes *ameliorate* the position with respect to margin arrangements. However, in this one respect, the position is *curtailed*, albeit for a short period. ISDA understands the reasons given by the Agencies for this curtailment. However, given that effective termination rights are a key requirement for close-out netting and collateral enforcement to operate, ISDA will be keen to ensure that any legislation implementing this change does not create unintended consequences. By way of example, if the new stay on termination extends to *all* margin arrangements, so too should the exclusion that lifts that stay after two business days. That must be the outcome for this specific change regardless whether, as a more general matter, the exclusion applies to security

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		interests over IM only (as to which, see our submission on question 3 above).
	(ii) Schedule 7 preferential creditors *6: Do you agree that Schedule 7 preferential claims are a significant potential impediment to New Zealand entities' compliance with foreign margin requirements?*	Yes.
	(ii) Schedule 7 preferential creditors *7: Do you agree that the proposed changes relating to preferential claims are necessary and sufficient to address this potential compliance barrier?*	Yes, subject to what we say in the following two paragraphs. In paragraph 69 and footnote 31, the Agencies contemplate that some preferential claims would continue to rank ahead of the claims of holders of cash margin. For example, liquidator's fees and (subject to discussion with the Inland Revenue Department) certain tax claims would continue to have priority. ISDA believes that would be an unfortunate outcome. This is because, in assessing the significance of this risk, overseas counterparties (and their regulators) will likely adopt an 'all or nothing' view. That is, they will either see *no* preferential claims, or they will see some. And, if there *are* some, the legal impediment identified by the Agencies will be regarded as continuing. The fact that there may be fewer preferential creditors than before is unlikely to be influential.
	(ii) Schedule 7 preferential creditors *8: Do you agree with the way we are proposing to protect secured derivative creditors from losing their priority interest to Schedule 7 preferential claims?*	Yes, subject to the comment in our submission on question 7 above.
	(iii) and (iv) Other PPSA priority rules & outright transfers under PPSA	

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	9: Do you agree that the proposed changes to priority rules in the PPSA are necessary and sufficient to address the potential compliance barriers identified?	Yes. In particular, we strongly support the proposed exemption operating in a manner similar to section 103A of the PPSA. We also welcome the proposed clarification in relation to the issue of whether an outright transfer of collateral (e.g., under an English law ISDA Credit Support Annex) creates a "security interest" for the purposes of the PPSA. As the Agencies have noted, this is an issue that has been the source of a significant difference of opinion within the New Zealand legal profession. The issue has been highlighted in ISDA's collateral opinions for New Zealand since the PPSA was enacted in 1999. It has led to considerable frustration, cost and delay for market participants, as they try to document and implement margin arrangements on the basis that either interpretation might be correct. ISDA's view, and that of its members, is that the legal position should reflect the intention of the parties when entering into arrangements providing for an outright transfer of collateral. In that regard, the parties do *not* intend to create a "security interest". Therefore, the proposed change should be to exclude such arrangements from the scope of the PPSA. One approach that would achieve that outcome would be to add outright transfers to the list of excluded arrangements in section 23 of the PPSA. That would have the benefit of being consistent with the approach taken in Australia: see section 8(1)(e) of the Personal Property Securities Act 2009 (Cwth). Our members may choose to make their own individual submissions in relation to this point.
	Sufficiency of legislative changes proposed in Option B *10: When implemented together, do you believe the changes set out under Option B will be sufficient to address impediments to creating and enforcing rights as a secured counterparty under New Zealand law?*	Yes. We agree with the Agencies' conclusion in paragraph 83 that there is limited rationale for statutory amendments to address the other potential impediments that have been suggested (i.e., impediments other than the three key ones identified). However, we do not agree that this is because, despite those impediments, "margin will be able to serve its purpose of protecting against a counterparty's default". That may not be the case.

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		For example, margin that has to be clawed back in the insolvency of a counterparty will certainly *not* have served its purpose. Rather, we believe the main reason a legislative fix is not necessary for these other impediments is because of a broad market acceptance (globally) of that type of legal risk. Paragraph 84 recognises that market acceptance.
	Sufficiency of legislative changes proposed in Option B *11: If you believe the changes set out under Option B are not sufficient, please describe additional legislative changes necessary for compliance. Please provide a rationale for any proposed changes.*	Not applicable.
	Consequences of legislative changes proposed in Option B *12: Do you believe there may be knock-on implications stemming from Option B (legislative change) that have been overlooked or mischaracterised?*	No.
	Consequences of legislative changes proposed in Option B *13: If the proposed legislative changes in Option B are adopted, are there any additional safeguards they should be subject to?*	No.
	The right approach for New Zealand *14: Do you share the Agencies' preliminary view that, on balance, targeted amendments to existing legislation may*	Yes. We accept the Agencies' position that a standalone Netting Act, even if identical in substance to discrete amendments to several Acts, could delay this reform.

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	be preferable to a standalone Netting Act for New Zealand?	We are also mindful of the Agencies' specific goals in introducing this consultation, in particular to address the urgent need for legislative reform to support internationally-compliant margin arrangements, and the Agencies' desire to address impediments in a targeted way, keeping deviations from existing insolvency and personal property securities laws to a minimum. While we are supportive of the efforts of the Agencies to address these impediments in a targeted way for this particular consultation, we urge that, going forward, the Agencies continue to engage the industry in discussions relating to, among other issues, an over-arching Netting Act for New Zealand. Our members believe that, post the present consultation, a discussion on a possible Netting Act in New Zealand will be an important one to address other possible concerns that may be beyond the scope of the present consultation (such as the provisions relating to voidable preferences). We would like to highlight that there are also certain advantages to a Netting Act (for example, as these exist in Australia and other jurisdictions), in particular, making the law as clear as possible. We would also support and encourage such a discussion as to a possible Netting Act, post the present consultation, only insofar as this would be beneficial to and help to further develop the New Zealand market as well as further improve the access of New Zealand counterparties to global markets. As noted, our members may choose to make their own individual submissions in relation to this point.