ISDA®

International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY, 10017
United States of America
Telephone: (212) 901-6000
Facsimile: (212) 901-6001
email: isda@isda.org
website: www.isda.org

30 November 2006

Review of Financial Products and Providers
Ministry of Economic Development
PO Box 1473
Wellington

Attention: Financial Sector Team
Regulatory and Competition Policy Branch

Dear Sirs –

Review of Securities Offerings Discussion Document - September 2006

We are writing to you on behalf of the International Swaps and Derivatives Association, Inc. (**ISDA**) to address particular issues raised in the Discussion Document entitled *Review of Securities Offerings* (September 2006) (the **Discussion Document**) released by the Ministry as part of the Review of Financial Products and Providers (**RFPP**). Specifically, this submission addresses the issues surrounding section 3.1.10.2 of the Discussion Document - headed *Definition of* "*Derivative*".

1. About ISDA

As you may be aware, ISDA represents participants in the privately-negotiated, or over-the-counter (**OTC**), derivatives industry. It is the largest global financial trade association by number of member firms. ISDA was chartered in 1985 and today has as members over 750 institutions from 52 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; and other 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 in determining capital requirements;
- promoting sound risk management practices;
- advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives; and
- encouraging the prudent and efficient development of the privately negotiated derivatives business.

2. Submission

This submission is in two parts.

In the first part (section 3 below), we respond to the principal issue raised in section 3.1.10.2 of the Discussion Document, namely whether OTC derivatives are more properly regulated as "securities" under the Securities Act 1978 or as "futures contracts" under Part 3 of the Securities Markets Act 1988.

In the second part (section 4 below), we raise a related issue previously raised with the Department of Internal Affairs (the **DIA**), namely the risk that the entry into derivatives could constitute "gambling" for the purposes of the Gambling Act 2004.

In relation to each of these two parts, we attach, by way of background, correspondence that should help to clarify ISDA's position on these matters.

3. Regulation of OTC derivatives

Section 3.1.10.2 of the Discussion Document discusses the regulation of OTC derivatives both as "securities" under the Securities Act and as "futures contracts" under Part 3 of the Securities Markets Act. Given that these are very distinct regulatory regimes, with quite separate policy objectives underpinning them, ISDA believes that each regime must be considered separately.

Securities Act

Introduction

The Discussion Document rightly recognises that certain types of OTC derivatives may be "securities" for the purposes of the Securities Act. Given the myriad types of OTC derivatives, and the rapid evolution of new products, ISDA sees little point in considering in this submission:

- which OTC derivatives fall within the "securities" definition; or

- whether the derivatives so caught constitute "equity securities", "debt securities" or "participatory securities" for the purposes of that Act.

Rather, ISDA prefers to focus on what the legal position should be for those OTC derivatives that *are* properly classified as "securities". In short, ISDA believes that they should be subject to the same rules as any other "security".[1] In other words, if an OTC derivative *is* a "security", and if it *is* offered to the public, there is no question that the disclosure requirements in the Securities Act should apply.

That said, almost by definition, it is very unlikely that OTC derivatives would be offered to the public. These are privately-negotiated bilateral contracts that are invariably entered into by either sophisticated and experienced counterparties or those who at least have access to suitably qualified advisers. In terms of the Securities Act, these counterparties should be exempt from constituting "the public" pursuant to either section 3(2)(a)(ii) (the professional or habitual investor exemption) or section 3(2)(a)(iii) (the "selected otherwise" exemption).

ISDA's submission

On the basis outlined above, ISDA's view is that the Securities Act does not require amendment to deal with OTC derivatives.

Securities Markets Act

Introduction

In certain respects, it is difficult to reconcile the "securities" regime under the Securities Act and the "futures contract" regime under the Securities Markets Act, especially given the similarity (and potential overlap) in the products these regimes regulate. On the one hand, there is a regime (i.e., for "securities") that applies only to retail activity. On the other hand, there is a regime (i.e., for "futures contracts") that generally applies to *both* retail *and* wholesale activity.

We say "generally" in the previous sentence because there are at least two exceptions to the application of the Securities Markets Act to wholesale activity. Specifically:

- pursuant to section 37(2) of that Act, the regime does not apply to certain interest rate or currency derivatives to which a registered bank is a party; and
- the recent practice of the Securities Commission, when considering applications for authorisation from a participant in the OTC derivatives markets, is to grant authorisation on the condition that the participant only deal with wholesale

[1] In saying this, ISDA acknowledges that the issuer disclosure framework around which the Securities Act is built may not be entirely appropriate for certain derivative products, particularly physically-settled ones. This is a point made in paragraph 155 of the Discussion Document.

clients.[2] The reason for this exception is a recognition by the Securities Commission that it is inappropriate to apply Part 3 to purely wholesale activity.[3]

The combined effect of these two exceptions is, ISDA submits, consistent with the principal policy behind this legislation – the protection of retail investors using intermediaries to deal in exchange-traded products. However, an unfortunate outcome of casting such a wide regulatory net and providing relatively limited and capricious exceptions is that it creates gaps and inconsistencies. For example, a registered bank is exempt from Part 3 if it "deals" in currency swaps, but not if it "deals" in currency options.

ISDA's submission

ISDA submits that, rather than requiring OTC derivative participants to go through the time-consuming and costly process of obtaining a "wholesale client" authorisation, the better approach is simply to exempt wholesale activity. The Securities Markets Act was not intended to regulate this activity when it was passed in 1988. And the Securities Commission acknowledges that there is little to be gained by applying this legislation to wholesale activity.

ISDA recommended this same approach to the Securities Commission late last year, following a request from the Commission for comment on the application of Part 3 to derivatives. By way of background, both the Commission's request and our response on behalf of ISDA are attached as Appendix I.

This approach would principally require two things - a definition of "derivative transaction" and a definition of "wholesale client". Both of these terms already exist in forms that could be used in this legislation. Specifically, amending legislation could use or adapt:

3. the "derivative transaction" definition in the Crown Entities Act 2004 (as referred to in our letter to the Securities Commission dated 23 December 2005, attached as Appendix I);[4] and
4. the "wholesale client" definition in recent Authorised Futures Dealers Notices.[5]

---

[2] See, for example, the Authorised Futures Dealers Notice 2005 (made in respect of Rabobank), the Authorised Futures Dealers Notice (No 2) 2005 (made in respect of Overlay Asset Management) and the Authorised Futures Dealers Notice 2006 (made in respect of JP Morgan).

[3] 4.7 However, we consider that people who deal exclusively for *wholesale* clients, such as large institutions, should be subject to a lower level of regulation on the basis that the need for public investor protection is lower when only wholesale clients are involved.

4.8 Generally the conditions of wholesale authorisation aim to ensure that any counterparty to a futures contract is a person that might be assumed to have either a sufficient level of assets or a sufficient knowledge of the futures industry to be excluded from general concerns about futures trading with retail investors. We would usually consider that such a person can be presumed to be 'sophisticated' and more able to look after their own interests.

Proposal to declare certain foreign exchange contracts to be futures contracts under the Securities Markets Act 1988 – A discussion paper, Securities Commission (21 April 2006).

[4] This definition is, in turn, based on the "Specified Transaction" definition contained in the 2002 ISDA Master Agreement.

4. Potential application of Gambling Act to OTC derivatives

Introduction

By way of background to this issue, we attach as Appendix II copies of:

- a letter from Bell Gully to the DIA dated 30 April 2001, together with a supporting letter from ISDA dated the same date; and
- correspondence between Bell Gully (acting on behalf of the New Zealand Bankers' Association)[6] and the DIA in September and October 2004.

To summarise the attached correspondence, as a result of the enactment of the Gambling Act and some unfortunate comments made by the Select Committee considering the legislation, there is a risk that derivatives could constitute illegal gambling under that Act. This risk is, in our view, a very real and significant one. Furthermore, the potential consequences if this risk were to eventuate could be disastrous for the industry given the sheer size and volume of outstanding transactions governed by New Zealand law.

ISDA's submission

Both the Select Committee and the DIA concluded that, if derivatives are to be excluded from the application of the Gambling Act, the exclusion should be contained in "a financial statute" rather than in the Gambling Act itself. ISDA submits that, for the reasons outlined in the attached correspondence:

- this *is* an issue that requires legislative rectification; and
- the legislation that results from the RFPP process is the ideal place for that rectification.

From a drafting perspective, there are a number of ways in which this rectification could be achieved. The key concept around which the exclusion would be based is the definition of "derivative transaction". Once again, there seems to be no reason why the existing definition contained in the Crown Entities Act could not be used.

---

5 The "wholesale client" definition varies slightly from one Notice to another. However, the standard definition is along the following lines:

(i) a person who controls at least $10 million; or
(ii) a trustee of a trust or a funds manager, acting in that capacity, who has under that person's control, as trustee or funds manager, net assets of at least $10 million; or
(iii) a person who is authorised to carry on the business of dealing in futures contracts under the Act; or
(iv) a person authorised in another jurisdiction by the competent authority of that jurisdiction to deal in futures contracts; or
(v) Her Majesty the Queen in right of New Zealand, a Crown entity named in the Crown Entities Act 2004, or a State enterprise named in the First or Second Schedule to the State-Owned Enterprises Act 1986 (each as amended from time to time); or
(vi) a person who is a statutory corporation or a registered bank; or
(vii) a person whose principal business is the investment of money or who, in the course of and for the purposes of their business, habitually invests money; or
(viii) a person who is a related body corporate of any of the persons mentioned in subparagraphs (i) to (vii) above.

6 The NZBA has kindly agreed to ISDA using this correspondence in this submission.

ISDA would be happy to work with the Ministry in formulating amending legislation that would both achieve the legal certainty sought by market participants and prevent abuse by those looking to validate clearly illegitimate activity.

ISDA very much appreciates the opportunity to contribute to the Discussion Document and would be most happy to elaborate on any of the points outlined above if that was deemed helpful.

We encourage you to contact either Mr David Craig of Bell Gully in Wellington (+64 4 915 6839; david.craig@bellgully.com), Ms Kimberly Summe in New York (+1 212 901 6000; ksumme@isda.org) or Ms Angela Papesch in Singapore (+65 6538 3879; apapesch@isda.org) with any questions you may have in the context of your review related to the abovementioned issues.

Yours sincerely,

Kimberly Summe
General Counsel