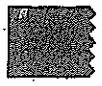
# Appendix I

## Securities Commission Correspondence



SECURITIES COMMISSION

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Ref: 200-020 / #76253

24 November 2005

International Swaps and Derivatives Association, Inc.
360 Madison Avenue
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United States of America

By facsimile: 001 212 901 6001

Attention: Kimberly Summe, General Counsel

Dear Ms Summe,

**ISDA MASTER AGREEMENT**

1. The New Zealand Securities Commission is a statutory body responsible for the regulation of futures contracts in New Zealand under the Securities Markets Act 1988.

2. The Securities Markets Act requires people who carry on the business of dealing in futures contracts to be authorised by the Securities Commission.

3. We have received several requests from market participants for clarification of whether certain types of financial instruments are "futures contracts" under the Securities Markets Act. The definition of "futures contract" in the Securities Markets Act is broad, by comparison to that in some other jurisdictions, but is not entirely clear in its application to certain products. Please find the definition **attached** as an Appendix.

4. The Commission considers it is important for there to be certainty in the futures industry as to what constitutes a futures contract for the purposes of the Securities Markets Act.

5. Under section 37(7) of the Securities Markets Act the Commission may declare:

   (a) an agreement, option, or right; or

   (b) a class of agreements, options, or rights,

   to be agreements to which the Securities Markets Act applies; i.e. futures contracts.

6. The Commission has been asked to consider whether it will declare that certain classes of agreements are futures contracts. It has been suggested that the Commission could clarify the existing definition of futures contract by reference to the agreements listed in the term "specified transaction" in the current Master Agreement published by the International Swaps and Derivatives Association, Inc. ("ISDA").

7. We understand the term "specified transaction" means:

> "*(a) any transaction (including an agreement with respect to any such transaction) now existing or hereafter entered into between one party to this Agreement (or any Credit Support Provider of such party or any applicable Specified Entity of such party) and the other party to this Agreement (or any Credit Support Provider of such other party or any applicable Specified Entity of such other party) which is not a Transaction under this Agreement but:*
>
> *(i) which is a rate swap transaction, swap option, basis swap, forward rate transaction, commodity swap, commodity option, equity or equity index swap, equity or equity index option, bond option, interest rate option, foreign exchange transaction, cap transaction, floor transaction, collar transaction, currency swap transaction, cross-currency rate swap transaction, currency option, credit protection transaction, credit swap, credit default swap, credit default option, total return swap, credit spread transaction, repurchase transaction, reverse repurchase transaction, buy/sell-back transaction, securities lending transaction, weather index transaction or forward purchase or sale of a security, commodity or other financial instrument or interest (including any option with respect to any of these transactions); or*
>
> *(ii) which is a type of transaction that is similar to any transaction referred to in clause (i) above that is currently, or in the future becomes, recurrently entered into in the financial markets (including terms and conditions incorporated by reference in such agreement) and which is a forward, swap, future, option or other derivative on one 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, or other benchmarks against which payments or deliveries are to be made;*
>
> *(b) any combination of these transactions; and*
>
> *(c) any other transaction identified as a Specified Transaction in this Agreement or the relevant confirmation.*"

8. It has been suggested that the Commission could declare the agreements included within the term "specified transaction" to be futures contracts for the purposes of the Securities Markets Act. It has been put to us that it would be appropriate to refer to these transactions because of the view that ISDA documentation is used globally and was apparently intended to apply to all derivative products commonly used at present, as well as those that may be developed in the future.

9. We are considering a declaration along these lines as one option for clarification of the futures regime under the Securities Markets Act. However, we are also considering how best to further define the agreements included within the term "specified transaction".

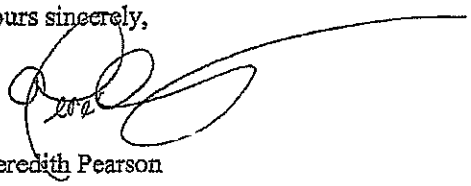
10. We are interested to find out whether there is sufficient certainty and acceptance within the futures industry about the meaning of the agreements included within the term "specified transaction". We also wish to know more about the extent to which the ISDA Master Agreement is actually used by market participants.

11. We would be grateful for the view of ISDA on these points, or more generally on the proposal outlined above.

12. We intend to publish a discussion paper on the proposal to clarify aspects of the futures regime under the Securities Markets Act. We will send ISDA a copy of this paper once it is published. Any comment made by ISDA at this stage would not limit the ability of ISDA to submit further comments in response to the discussion paper.

13. Thank you for your assistance. We look forward to hearing from you.

Yours sincerely,



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## APPENDIX

Section 37(1) of the Securities Markets Act defines the term "futures contract", as follows:

*"futures contract" means-*

*(a) an agreement under which one party agrees to deliver to another party at a specified future time a specified commodity or a quantity of a specified commodity at a price which is fixed when the agreement is made but under which it is contemplated or understood that the obligations of the parties may be satisfied by means other than actual delivery:*

*(b) an agreement under which each party has either:*

*(i) an obligation to pay a sum of money to the other or to credit the account of the other with payment of a sum of money; or*

*(ii) a right to receive payment, or a credit, of a sum of money from the other,*

*depending on whether at a future date the value or price of a specified commodity calculated in a manner specified by, or in accordance with, the agreement is greater or less than the value or price agreed upon by the parties when the agreement was made:*

*(c) an agreement under which each party has either:*

*(i) an obligation to pay a sum of money to the other or to credit the account of the other with payment of a sum of money; or*

*(ii) a right to receive payment, or a credit, of a sum of money from the other,*

*depending on whether at a future date the value or level of a specified index calculated in a manner specified by, or in accordance with, the agreement is greater or less than the value or level agreed upon by the parties when the agreement was made:*

*(d) an option or right to assume, at a specified price or value, or within a specified period, or by a specified date, rights and obligations under an agreement of a kind described in a preceding paragraph:*

*(e) an agreement, option or right which is declared by the Commission, in accordance with this section, to be an agreement, option or right to which this Part of this Act applies:*

*(f) an agreement, option or right which is of a class of agreements, options or rights declared by the Commission, in accordance with this section, to be a class to which this Part of this Act applies.*

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Matter no. 01-310-2383

23 December 2005

Dear Meredith

**"Futures contracts" under the Securities Markets Act 1988**

We refer to your letter dated 24 November 2005 to Kimberly Summe, General Counsel of the International Swaps and Derivatives Association, Inc. (**ISDA**). As you know, we are ISDA's New Zealand counsel and have been instructed by ISDA to respond on its behalf to the issues raised in your letter

***ISDA's view on the proposed "clarification"***

As a preliminary point, ISDA would like to express its view on the Commission's proposed "clarification". ISDA regards this proposed declaration not as a clarification, but as an (unnecessary) extension of the current regulatory regime. Specifically, whereas the current definition of "futures contract" in the Securities Markets Act (the **Act**) covers *some* OTC derivatives, the declaration would effectively mean they are *all* covered.[1] By way of example, it is clear that the current definition of "futures contract" does not cover physically-settled OTC derivatives. But the effect of the declaration would be that such transactions become "futures contracts". ISDA believes this extension is unjustified in the context of legislation that was enacted to protect participants in the futures markets, not the OTC derivatives markets.

Furthermore, given the policy behind the Act, ISDA cannot see the rationale for applying this regime to OTC derivatives *of any type*. OTC derivatives are transactions that are typically entered into on a principal-to-principal basis between sophisticated counterparties. In our experience, the Act generally only applies to participants in the OTC derivatives market because of the extremely broad definition of "deals" in section 37(5) (in particular, the "advises or assists" wording). However, in the OTC derivatives market, unlike the futures market, there is limited scope for the potential abuse that the Act is intended to prevent (principally, dealers misappropriating client funds). On that basis, ISDA suggests that it may be more appropriate for the declaration to *exclude* OTC derivatives from the definition of "futures contract" than to *include* them. Perhaps this could be achieved by way of a class authorisation under section 38(2)(b) if, as seems to be the case, the Commission does not have the power to do this by way of a declaration under section 37(7).

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1 One unusual consequence that would result from the declaration is that a currency or interest rate swap entered into with a registered bank would *not* be a "futures contract" (because of section 37(2)), but another type of OTC derivative entered into with a registered bank (say, an equity swap) *would* be a "futures contract".

ISDA acknowledges that the more appropriate place to express these views is in a submission once the Commission's discussion paper is published. However, ISDA wishes to make its views known from the outset.

***The proposed definition***

As you know, the "Specified Transaction" definition in the 2002 ISDA Master Agreement is in two broad parts. The first part, paragraph (a)(i), contains a list of the derivative transactions that were most common at the time the Master Agreement was published. The second part, paragraph (a)(ii), attempts to "future proof" the definition by referring generically to new types of transactions that are subsequently developed.

ISDA believes (as do we) that any definition of "derivatives" (or a similar term) must be expressed in this two-part manner if it is to avoid obsolescence. In fact, this is the approach adopted in the definition of "derivative transaction" currently set out in section 136(1) of the Crown Entities Act 2004 (and replicated in section 2 of the Public Finance Act 1989). Part A of the schedule to this letter sets out that definition. Part B of the schedule sets out a marked version of that definition that shows the differences from the "Specified Transaction" definition (although mere changes in word order are not marked and the introductory words of the "Specified Transaction" definition are ignored). As you can see, the definitions are very similar.

Perhaps the Commission could look at adopting the "derivative transaction" definition, which has the benefit of already being enshrined in New Zealand legislation, rather than seek to develop a similar, but subtly different, definition for this purpose.

***The Commission's questions***

The Commission's questions in paragraph 10 of its letter, and ISDA's response to those questions, are set out below.

***We are interested to find out whether there is sufficient certainty and acceptance within the futures industry about the meaning of the agreements included within the term "specified transaction".***

We assume that, when you refer to "the meaning of the *agreements*", you mean the specific *transactions* rather than the master agreements under which those transactions are entered into. There should be no need to refer to the master agreements (as evidenced by the "derivative transaction" definition in the schedule).

ISDA's view is that there *is* a large degree of certainty and acceptance within the industry as to the meaning of these terms. The documentation that ISDA publishes, in particular its product-specific confirmations and definition booklets, help identify and standardise the features of these transactions. That said, in an industry that is constantly developing, it is inevitable that not every transaction will fall neatly under one, and only one, label. However, given that the objective is not that every transaction should be able to be labelled under one of the listed terms, but merely that "derivative transactions" as a group should be identifiable, hybrid or innovative products should not be a problem.

***We also wish to know more about the extent to which the ISDA Master Agreement is actually used by market participants.***

The ISDA Master Agreement is the document of choice worldwide by participants in the OTC derivatives industry. ISDA has over 670 member institutions from 47 countries. These members include most of the major dealers, and many of the major end-users, in

the OTC derivatives industry. Almost all of these members would use the ISDA Master Agreement to document their privately negotiated derivative transactions.

Please feel free to call us if you wish to discuss this matter further.

Yours sincerely

[*Sgd: D J Craig*]

**David Craig**
Partner

# Schedule

## Part A

"derivative transaction" means –

(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.

## Part B

~~"Specified Transaction" means, subject to the Schedule,~~ ("derivative transaction" means =

(a) a~~) any~~ transaction ~~which~~that is a rate swap transaction, swap option, basis swap, forward rate transaction, commodity swap, commodity option, equity or equity index swap, equity or equity index option, bond option, interest rate option, foreign exchange transaction, cap transaction, floor transaction, collar transaction, currency swap transaction, cross-currency rate swap transaction, currency option, credit protection transaction, credit swap, credit default swap, credit default option, total return swap, credit spread transaction, ~~repurchase transaction, reverse repurchase transaction, buy/sell back transaction, securities lending transaction, weather index transaction or~~ forward purchase or sale of a security, or commodity or other financial instrument or interest (including ~~any~~ an agreement or option ~~with respect~~that relates to any of these transactions~~)~~); or ~~(ii) which is~~

(b) a ~~type of~~ transaction that is similar to any transaction referred to in ~~clause (i) above that~~ paragraph (a) that –

(i) is currently, or in the future becomes, recurrently entered into in the financial markets ~~(including terms~~; and ~~conditions incorporated by reference in such agreement) and which~~

(ii) is a forward, swap, future, option, or other derivative on ~~one~~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~~, (b) any combination of these transactions and (c) any other transaction identified as a Specified Transaction in this Agreement or the relevant confirmation.~~.

# Appendix II

## Department of Internal Affairs Correspondence

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30 April 2001

## 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.



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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 Thirty[3] 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]

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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.

# ISDA

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**Department of Internal Affairs**
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**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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Matter no. 01-296-7107

15 September 2004

Dear Jane

**Application of the Gambling Act to derivatives**

We act for the New Zealand Bankers' Association (**NZBA**). On behalf of the NZBA, we have been asked to contact the DIA and raise again an issue that we (Bell Gully) initially raised at the time the gaming legislation was in Bill form. The issue is the potential application of the Gambling Act to derivative transactions.

Rather than restating the issue, I thought it might be simpler to forward you a copy of the submission that we made on the Bill, together with the supporting submission made by the International Swaps and Derivatives Association, Inc. I attach a PDF version of these two submissions.

Since we made that submission, the legal position has, in our view, worsened considerably. There are two principal reasons for this.

First, the Gambling Act has now been enacted, adopting a statutory definition of "gambling" that is wider than the common law concept of a "wagering contract". In the process, we have rendered irrelevant those few (mainly English) cases that reassuringly have held that OTC derivatives are not "wagering contracts" and, therefore, are not illegal under gaming legislation.

Secondly, and more disturbingly, the Select Committee considering the legislation acknowledged in its report (at page 4) that the broad definition of "gambling" *can* capture transactions that are not generally considered to be gambling. However, the Committee's view was that, if financial transactions are to be excluded:

> "we consider this should occur in financial statutes, which would deal with new financial products as they are introduced into the market."

This is of little help in relation to *existing* derivative products, which do not have the benefit of any exemption (except, in limited cases, under the Securities Markets Act 1988).

This is an issue of concern not just to the NZBA member banks, but also to offshore financial institutions that transact with New Zealand counterparties. A number of these institutions have approached us in relation to this issue and are surprised to find that there is no statutory exemption for OTC derivatives (as is the case in the major markets in which they operate, such as the US, the UK and Australia).

The purpose of this letter is to see whether the DIA would consider supporting a regulation under section 368(a) of the Gambling Act in relation to OTC derivatives. If the DIA



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accepts the general basis for this exemption, we would be happy to work together in the preparation of an exemption order.

Please feel free to call me to discuss this.

Yours sincerely

*[Sgd: David Craig]*

**David Craig**
Partner

Enc.

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20 October 2004

David Craig
Partner
Bell Gully
PO Box 1291
WELLINGTON

Dear David

**Application of the Gambling Act 2004 (the "Act") to derivative transactions**

I refer to your email of 15 September 2004 and to our subsequent telephone conversation in relation to the above. I apologise for the delay in responding to you.

As you note, the above issue was addressed by the Select Committee when considering the Gambling Bill. The Committee formed the view that while some forms of derivative transactions may fall within the scope of the definition of "gambling", it was not appropriate to alter the definition in the Bill for the purpose of excluding derivatives. It was of the view that if any such exclusion were to be made, it should be made in a financial statute. Given this consideration, we do not consider that it is appropriate to seek to amend the Act to exclude derivatives from the definition of "gambling".

You have asked whether we would support a regulation under section 368(a) to exclude OTC derivatives (as defined in your letter) from the application of the Act. Firstly, we are not convinced that the wording of section 368(a) is wide enough to allow a regulation to be made which applies to a class of transaction. We do not consider this type of exemption is contemplated by section 368(a). In this respect, the language of the section is quite different from, for example section 5(5) of the Securities Act 1978 or section 45 of the Takeovers Act, which both make reference to the ability to grant exemptions for a "class of transactions".

Secondly, and as you will also be aware, the Committee considered the fact that the uncertainty around gaming and derivatives exists internationally, and is not fully addressed in most overseas gambling related legislation. The Committee was not convinced that this uncertainty warranted amendment to the definition as, in its opinion, the "courts and the common law have proved adequate to the task of differentiating between the kinds of transaction that should be covered by gambling statutes and those that are financial transactions". We consider that the same reasoning militates against a "class exemption" even if that were possible.

In sum, there are no plans in the short to medium term to amend the Act or to support a regulation under section 368(a). However, we note your concerns and will bear them in mind should an opportunity for amendment arise.

Lastly, as you no doubt know, I will be leaving the Department at the end of the month. Accordingly, if you have any further queries or comments in relation to this matter, please could you contact Stefania Esposito, a solicitor in the Legal Services team, in the first instance. Her email address is stefania.esposito@dia.govt.nz.

Yours sincerely

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27 October 2004

Dear Stefania

**Application of the Gambling Act 2003 to derivatives**

I refer to Jane Meares's letter to me dated 20 October 2004. Jane suggested that I contact you in the first instance if I had further queries or comments in relation to this matter.

While I appreciate that the DIA appears to have finalised its views on this matter, I nonetheless would like to make a couple of comments on Jane's response.

First, in relation to the regulation-making power in section 368(a) of the Act, I suppose we can simply agree to disagree on the scope of that power.

Secondly, and more importantly, I disagree strongly with the comment that "the uncertainty around gaming and derivatives exists internationally". That is simply not the case. We have discussed this issue at length with representatives of the International Swaps and Derivatives Association, Inc. (ISDA) - by far the largest global association in this industry. We have also discussed this issue with members of the legal team of some of the world's largest investment banks, who have derivatives operations in many jurisdictions. Their shared view is that New Zealand is one of relatively few countries amongst the leading developed economies that has not clarified this issue by amending legislation. Specifically, this issue has been addressed in the UK, the US and, more recently, Australia.

Thirdly, while the Courts and the common law may historically "have proved adequate to the task of differentiating between the kinds of transaction that should be covered by gambling statutes and those that are financial transactions", that position was changed radically once the Act came into force. The relevant common law decisions, none of which were given in New Zealand, related to the concept of a "wagering contract". In New Zealand, "wagering contracts" were covered by the (now repealed) Gaming and Lotteries Act 1977. Whatever comfort a New Zealand entity may have taken from those (mainly English) decisions is no longer of any relevance as the *common law* concept of a "wagering contract" has been replaced in New Zealand by the *statutory* definition of "gambling" in the Act. It would be an extremely optimistic (and ill-advised) institution that contends that that line of English cases still has application in New Zealand following the Act coming into force.

Globally and in New Zealand, the derivatives markets are among the largest financial markets. Very few of the participants in these markets are prepared to rely, for the purpose of ensuring the enforceability of their contracts, on a court providing a favourable

interpretation to (what is at best) ambiguous legislation. They require legal certainty, and have it in most major jurisdictions.

I would appreciate it if you would bear these comments in mind if, indeed, there is an opportunity to amend the Act in the future.

Yours sincerely

*[Sgd: David Craig]*

**David Craig**
Partner