FINANCIAL MARKETS CONDUCT BILL

SUBMISSION ON EXPOSURE DRAFT

International Swaps and Derivatives Association, Inc.

Clause Number	Clause heading	Submission
Part 1	**Preliminary provisions**	
Clause 6	Interpretation	• "Derivatives issuer" is defined to mean "a person that is in the business of *offering* derivatives" (emphasis added). In turn: – "offer" is defined (also in clause 6) to include inviting applications for the "issue" of, or to purchase, financial products; and – a derivative is regarded as "issued" to a person when the person enters into the legal relationship that constitutes the derivative (clause 10(2)(b)). While the extended definition of "issued" addresses the confusion that would otherwise arise in using that term in the context of derivatives, the reference in the "offer" definition to "inviting applications" remains problematic. That terminology, while appropriate for more traditional securities, does not reflect the reality of the derivatives markets. While the "offer" definition is inclusive (and, therefore, the Ministry could fall back on the ordinary meaning of the word, combined with the extended meaning of "issued"), ISDA believes that the better approach would be to clarify the position beyond doubt. Therefore, the "offer" definition should include a new paragraph (c) to read "offering to enter into [financial products/derivatives]". • While the "investor" definition is appropriate for financial products that are essentially *unilateral* in nature, it does not work well with *bilateral* products such as derivatives. In the context of a derivative, the "investor" is, presumably, intended to be the party that is not the "derivatives issuer". There are at least two issues here. First, in the case of reverse enquiries, the "offer of financial products" may in fact be made *by*, rather than *to*, the person that should properly be regarded as the investor. Secondly, in dealer-to-dealer trades, it might be possible for one of the parties to be both a "derivatives issuer" (because they are in the relevant business) and an "investor" (because an offer of financial products has been made to them). The appropriate drafting response to these two issues depends on the Ministry's policy intention. Assuming that its intention in the first scenario is to refer to the "true" investor, and its intention in the second scenario is to refer to the offeree, ISDA suggests the "investor" definition be reworded as follows: **investor** includes – (a) where a derivative is offered to a derivatives issuer – (i) by another derivatives issuer, the person to whom the offer is made; or (ii) by a person who is not a derivatives issuer, the person making the offer; (b) in any other case – (i) a person to whom an offer of financial products is made; and (ii) a person who acquires, or may acquire, a financial product

Clause Number	Clause heading	Submission
		ISDA believes that this approach, coupled with the corresponding change to the "issuer" definition suggested below, is preferable to the Ministry's approach set out in clause 17 of Schedule 1. The Ministry's approach seems to be to not require disclosure where the offeror of a derivative is not a derivatives issuer. By contrast, ISDA suggests that the identity of the party that makes the "offer" should not determine whether disclosure is required. Rather, the availability of one of the other Schedule 1 exemptions should be the determining factor. Regardless of the identity of the offeror, it is still appropriate for the two parties to be treated as "derivatives issuer" and "investor". • The "market services" definition generally reflects the wording of clause 370, which sets out the circumstances in which a market services licence is required. However, in the case of the service of acting as a derivatives issuer, the wording differs between the two provisions. Specifically, paragraph (e) of the "market services" definition excludes the words "in respect of a regulated offer of derivatives" (which are used in clause 370(1)(d)). ISDA submits that those words should be added to the "market services" definition. In making this submission, ISDA assumes (as seems to be the case) that there is no reason why a person acting as a derivatives issuer *in respect of a non-regulated offer* would need to be caught as a "market services" provider (albeit one not requiring a licence). This same comment would apply to clause 411(b), which relates to the requirement for licensees to use client agreements.
Clause 7	Meaning of financial product	• Paragraphs 45-52 of the explanatory material accompanying the draft Bill (the **Explanatory Material**) invite submissions on the proposal to exempt derivatives from the provisions of the Gambling Act 2003. As a preliminary comment, ISDA strongly supports this proposal. It addresses an important issue that existed, but that has now been statutorily clarified, in most other developed common law jurisdictions. In terms of the three options proposed by the Ministry, ISDA submits that option C is the best. While this option would not cover circumstances where neither counterparty is a "derivatives issuer", those circumstances should not arise often. Moreover, as the Ministry points out, removing this requirement for there to be a derivatives issuer (which is essentially option A) would open up the scope for abuse.
Clause 8	Definitions relating to kinds of financial products	• The definition of "derivative" is based very closely on the equivalent definition in section 761D of the Corporations Act 2001 (Australia). However, the Corporations Act definition, coupled with the Corporations Regulations 2001, expressly contemplate a carve-out for spot transactions. That carve-out was not carried over into the draft Bill although, ISDA understands, the Ministry's policy objective *is* to exempt spot transactions. ISDA further understands that the Ministry's reluctance to carry over this carve-out into the draft Bill is primarily because of the difficulties that have been experienced in Australia in considering the appropriate scope of, and in expressing, the spot exemption. ISDA is aware that the Corporations and Markets Advisory Committee (**CAMAC**)

Clause Number	Clause heading	Submission
		in Australia has been asked to consider this matter – in the slightly broader context of physically-settled forwards. CAMAC has been asked to report back to the Federal Government by 30 September 2011. That being the case, given the similarity between the two definitions, and the fact that the draft Bill's timetable should allow the Ministry to adopt (or at least consider) the Australian response, ISDA believes the best approach for now is simply to acknowledge the need for the carve-out but to wait until after the Bill's introduction for the carve-out to be drafted. • A subtle difference between the Australian and draft Bill definitions is that the former refers to "an arrangement", whereas the latter refers to "an agreement". Given that much of the rest of the definition duplicates the Australian wording *verbatim*, ISDA assumes that this change was intentionally made to convey a different meaning. ISDA would be interested in knowing what that different meaning is. • The reference in paragraph (b) of the "derivative" definition to ", or in the future becomes," is confusing. While the wording is borrowed from existing legislation (e.g., the "derivative transaction" definition in section 136(1) of the Crown Entities 2004), it makes little sense in the context of determining the appropriate classification of a product. That is, in determining the classification of a new product on day 1, it is of no help to say that it will be a paragraph (b) "derivative" if it becomes regularly traded – because that will obviously be unknown on day 1. The main effect of the ", or in the future becomes," wording is to allow some sort of retrospective classification to occur if, some time after day 1, the product does indeed become regularly traded. ISDA does not believe that is desirable. ISDA submits that this wording should be deleted, with the result being that a *new* product would need to satisfy the general wording in paragraph (a) in order to be a "derivative". • In paragraph (b)(i) of the definition of "derivative", "futures agreement" should be "futures contract". While the term "futures agreement" is used in the legislation in certain overseas jurisdictions (such as Canada), "futures contract" is the more commonly-used term in New Zealand. • In paragraph (b)(iv) of the definition of "derivative", "contract for difference" should be "contract for difference<u>s</u>". • In the context of paragraph (d)(i) of the definition of "derivative", ISDA does not consider it is appropriate to classify as a "derivative" a contract to sell an intangible that is not a financial product. For example, a contract for the forward sale of intellectual property should not be caught. ISDA therefore submits that the words "or intangible property that is not a financial product" should be added after the words in parentheses. • The financial product most likely to overlap with a "derivative" is a "debt security". The mechanism for resolving the overlap, and classifying such a product, is as follows: - if the product is covered by paragraph (b) of the definition of "derivative", it will be classified as a "derivative" (see paragraph (c)(ii) of the definition of

Clause Number	Clause heading	Submission
		"debt security"); but - if, for whatever reason (e.g, because it is a new product), the product is covered by paragraph (a) of the definition of "derivative" but not paragraph (b) also, it will be classified as a "debt security" (see paragraph (c)(ii) of the definition of "derivative"). ISDA's view is that there is no justification for such differential treatment. Consequently, the carve-out in paragraph (c)(ii) of the definition of "debt security" should exclude products covered by *either* paragraph (a) *or* (b) of the "derivative" definition. Similarly, and while recognising that an overlap between a "derivative" and an "equity security" may be less likely, ISDA believes that paragraph (b) of the definition of "equity security" should be amended by adding, at the end, the words "or a derivative of the kind referred to in paragraph (a) or paragraph (b) of the definition of that term".
Clause 10	Definitions of issued and issuer	• Clause 10(1)(b)(iv) provides that the issuer of a derivative is the derivatives issuer that offered to issue the derivative. However, as noted above, in the case of a reverse enquiry, it could be argued that the person who offers to issue the derivative is in fact the person who would ordinarily be regarded as the "investor". Therefore, in keeping with its suggested change to the "investor" definition above, ISDA submits that clause 10(1)(b)(iv) should be reworded as follows: (iv) a derivative, where the derivative is offered: (A) by a derivatives issuer, that person; or (B) to a derivatives issuer by a person who is not a derivatives issuer, the derivatives issuer. • In paragraphs 68-73 of the Explanatory Material, the Ministry invites submissions on the definitions of "issued" and "issuer" where there is intermediation. While the type of intermediation the Ministry refers to may be more common in the case of exchange-traded products, it also occurs with OTC products. In the circumstances described in paragraph 71, ISDA does not see the potential ambiguity suggested by the Ministry. Where A is acting as principal in both transactions, there is no transaction between C and B. To conclude otherwise would be to ignore the strict legal relationships between the three parties. In terms of how the draft Bill would apply to that scenario, ISDA's interpretation is that there would be two distinct transactions (between C and A on the one hand, and A and B on the other hand), with A being the derivatives issuer in each case. The wholesale exemption would apply to the second transaction, and perhaps to the first also.
Part 2	**Misleading or deceptive conduct or false or misleading representations**	
Part 3 and schedules 1	**Disclosure offers of financial products**	

Clause Number	Clause heading	Submission
and 2		
Clause 38	Right to withdraw and have money returned	• Clause 38(1) enables an offeree of financial products to return the products and have the relevant money repaid if the offer contravenes the draft Bill's disclosure rules. Both remedies (i.e., the "return" of the product and the repayment of the "relevant money") need to be clarified in the context of OTC derivatives. ISDA's submission is that, in the OTC derivatives context: - the equivalent of the "return" concept is the right to terminate all outstanding rights and obligations in relation to the terminated transaction; and - "relevant money" should refer to the net amount paid between the parties in relation to the terminated transaction (which may, from the perspective of the offeree, be a negative amount and, therefore, an amount payable *by* that party). It should also include the net collateral (if any), and any other related property, delivered between the parties. The combined effect of these two steps should be to restore the two parties to the financial position they were in prior to entry into the terminated transactions. That is akin to the position that clause 38(1) seems to be aimed at achieving. (Strictly speaking, under ISDA's submission, the financial position of the parties would not be *completely* restored – due to the time value of money not being recognised (other than in the limited circumstance set out in clause 38(3)(b)). However, that is also the case under the current wording of the draft Bill.) To achieve the effect of this submission, clause 38(1) could be reworded as follows: If, in contravention of section 34, a person makes an offer to another person (**A**) of: (a) a non-quoted derivative, A has: (i) the right to terminate all outstanding rights and obligations; and (ii) if it exercises its right in subparagraph (i), the right to receive or the obligation to pay, as the case may be, the net amount of the value as at the termination date of all money paid and property delivered between the parties, under or in respect of that derivative; or (b) any other type of financial product, A has the right to return the financial product and to have the relevant money repaid.
Part 4 and schedule 3	**Governance of financial products**	
Part 5	**Dealing in financial products on markets**	
Clause 218	Prohibition on insider conduct	• In paragraph 101 of the Explanatory Material, the Ministry seeks comments on whether this prohibition should be extended to trading in non-quoted derivatives in which the underlying is a quoted financial product of a listed issuer. ISDA is firmly of the view that it should not. Trading in OTC derivatives occurs almost exclusively among counterparties

Clause Number	Clause heading	Submission
		who would be considered “wholesale” (both in the general sense of the word and under the definition set out in the draft Bill). While there may not be equality of information (or even equality of *access to* information) between those counterparties, that is a matter those counterparties routinely face and accept in their business. If the matter is of particular concern to a counterparty in a specific circumstance, it will generally have the capability to take steps to address or mitigate the inequality. In those limited circumstances where an OTC counterparty is *not* a wholesale investor, the provisions in the draft Bill regulating the “offer” (in particular, the conduct prohibitions in Part 2 and the disclosure provisions in Part 3) provide appropriate protection for the investor.
Clause 293	Exemptions	• Clause 293(a) exempts financial products markets from subpart 7 of Part 5 if *both* the size threshold and the number of transactions threshold are satisfied. By contrast, paragraph 121 of the Explanatory Material states that: [f]acilities will be automatically exempt unless they breach both the size and number of transactions thresholds. This is to prevent a licence or exemption being required as a result of a single large transaction, or for facilities that are used for only very small transactions. ISDA assumes that the position outlined in the Explanatory Material represents the intended policy objective. Clause 293(a) should be amended accordingly. • ISDA also suggests that wording for the two thresholds be amended to clarify that they refer to *global* activity on the relevant market, not just *local* (i.e., New Zealand) activity. • Clause 293(b) exempt “prescribed wholesale markets” from subpart 7. These are markets designated as such in regulations made under clause 502(1)(k). Paragraph 122 of the Explanatory Material notes, in this context, that Cabinet has proposed “that markets that were not accessible to retail investors might be automatically exempt”. However, the Explanatory Material continues, there are concerns about extending the exemption to *all* wholesale markets: [f]urther, the bright-line tests in Schedule 1 could make it relatively easy to structure a market that is only be [*sic*] available to non-retail investors but that would not normally be considered to be ‘wholesale’. ISDA does not agree with that suggestion. However, more significantly, if that *were* the case, this would not be an issue confined solely to financial products markets. That is, the same issue would exist under, say, Part 3 (in relation to offers of financial products). In other words, having made the decision that a particular set of investors are “wholesale” for the purposes of one part of the Bill, the Ministry should not declare that those same investors cease to be “wholesale” for other purposes, unless compelling reasons require otherwise. ISDA does not believe such compelling reasons for differential treatment exist. Accordingly, ISDA believes that wholesale markets should be automatically exempt, subject to a power for the FMA to declare that a particular market *should* be subject to subpart 7.
Part 6	**Licensing and other**	

Clause Number	Clause heading	Submission
	regulation of market services	
Clause 413	Changes to client agreement	• This provision should be amended to permit the common practice of deeming a client to have accepted modified terms notified to them in writing, *but only in respect of new transactions*, by continuing to transact with the licensee.
Part 7	**Enforcement and liability**	
Part 8	**Regulations and exemptions**	
Clause 512	FMA may designate financial products and offers	Clause 512(1) allows the FMA to make certain declarations concerning the classification of a financial product. While ISDA appreciates the need for the FMA to have this power, ISDA is concerned at the relatively unfettered nature of this power. The procedural requirements set out in clause 513(1) are unlikely, in practice, to limit the FMA's exercise of this power. ISDA submits that it would be appropriate to add to clause 513: (1) a prohibition on any declaration having retrospective effect, and (2) a more extensive list of principles or factors (over and above the economic substance of the relevant financial product) that the FMA will apply or have regard to in making a declaration.
Part 9 and schedules 1- 4	**Miscellaneous provisions**	
Schedule 1, clause 3	Offer to wholesale investor	• Section 761G(7)(b) of the Australian Corporations Act provides that a financial product is provided to a wholesale client if it is provided for use in connection with a business that is not a "small business". A "small business" is a business employing less than 100 people (if the business is or includes the manufacture of goods) or 20 people (in any other case). The intention behind this category of wholesale investor is different to the "large" category described in clause 35 (which focuses on assets and turnover). ISDA submits that it would be appropriate to include this further category within the "wholesale investor" definition. However, given the relative sizes of the Australian and New Zealand economies, ISDA suggests that the appropriate number of employees should be 10 (for *all* industries), rather than 100/20. This suggestion is based on the latest available Statistics New Zealand information (for February 2010) showing that only 2.8% of New Zealand businesses employ 20 or more persons and only 6.1% employ 10 or more persons. • Clause 3(3)(b) contains the minimum subscription amount exemption. This exemption does not fit well with the structure of OTC derivatives, which typically have a notional principal amount rather than a subscription amount. ISDA submits that this exemption should have a separate limb for derivatives, with the threshold amount being NZ$500,000 of the notional principal amount (which, ISDA understands, reflects the analogous exemption in Australia).

Clause Number	Clause heading	Submission
Schedule 1, clause 29	Sale where issuer advises, encourages, or knowingly assists	• The draft Bill distinguishes between "issues" and "sales" of financial products. That distinction, while logical and understandable in the context of most other financial products, is considerably less clear in the context of OTC derivatives. While OTC derivatives can be "issued" (in terms of the extended definition in clause 10(2)(b)), there is not a separate concept of them being "sold" (in this regard, ISDA notes that "sale" is an undefined term in the draft Bill). Rather, the rights and obligations under an OTC derivative can be transferred to a replacement counterparty. If this were carried out by novation, which is usually the case, a new contract would arise between the transferee and the continuing party. Put another way, there is not a "sale" of the original financial product – there is a termination of that original product and the replacement of it with a new product. That new product would, under the draft Bill, be regarded as being "issued". And so the sale provisions seem redundant in the context of OTC derivatives. Nevertheless, ISDA sees a risk that, if "sale" remains undefined, the novation of an OTC derivative (or even the entry into the original transaction itself) could be regarded as an offer of a financial product for "sale". ISDA submits that the best way to address this risk would be to define "sale" (either generally, or at least in the context of derivatives). The definition should ensure there is no overlap with "issue", so that a financial product could not be regarded as being offered for both issue and sale at the same time.
Other matters	Hague Convention	• Paragraphs 42 and 43 of the Explanatory Material refer to Cabinet agreement to align New Zealand law with the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary. ISDA welcomes this reform, which it had proposed in its 20 August 2010 submission on the Ministry's *Review of Securities Law – Discussion Paper*. In addition, again as mentioned in its 2010 submission, ISDA strongly supports any proposal for New Zealand to adopt the Hague Convention (once it has aligned local law to be consistent with that Convention). • In paragraph 43 of the Explanatory Material, the Ministry notes that this alignment process will require technical amendments to the Personal Property Securities Act 1999 (the **PPSA**). In addition to those conflict of laws amendments, ISDA submits that it would be timely and appropriate to also make two other technical amendments that have caused concern and uncertainty for ISDA, its members and, more broadly, other participants in the global financial markets that routinely hold investment securities and cash as collateral in New Zealand. The two amendments are: (i) Clarification as to whether the outright transfer method of providing security (such as under the widely-used ISDA Credit Support Annex – English law) gives rise to a "security interest" for the purposes of the PPSA. This is an issue about which there is a divergence of views among the major New Zealand law firms. Given the significance of the issue, the potential consequences of

Clause Number	Clause heading	Submission
		an incorrect view being taken, and the relative ease of making the clarification, ISDA submits that this issue should be resolved when the Hague Convention amendments are incorporated. The same issue has recently been addressed in Australia, in the context of its personal property securities legislation (see section 8(1)(e) of the Personal Property Securities Act 2009 (Cth) (the **Australian PPSA**)). ISDA submits that a similar approach should be adopted in New Zealand. This could be achieved by inserting the following as section 23(d) of the PPSA: (d) any right or interest held by a person, or any interest provided for by any transaction, under a netting agreement (as defined in section 310A of the Companies Act 1993): (ii) Clarification that the definition of "investment security" includes indirectly-held securities held at the third- (or lower-) tiers. ISDA's legal counsel in New Zealand has expressed concern that it is unclear from this definition whether securities held more than one tier removed from the issuer are "investment securities". The analysis underlying this concern is complex, and ISDA would be happy to separately share that analysis with the Ministry. This issue is addressed in other jurisdictions with PPSA-like legislation (e.g., the US, Canada and Australia) through more conceptually-correct ('second generation') terminology. Typically, those jurisdictions recognise that the nature of the property of a holder of indirectly-held securities is in fact a bundle of rights in respect of a securities account held with an intermediary. That bundle of rights is then given a separate classification and treated as distinct from the underlying securities to which it relates. A secured party can perfect its security interest in that bundle of rights through taking "control". (See, for example, sections 15, 26 and 27 of the Australian PPSA.) ISDA submits that, in the light of this uncertainty, and the proliferation of systems of multi-tiered holdings of securities, the position under the PPSA should be clarified. If the approach outlined above, as taken by overseas jurisdictions, would require more extensive amendments to the PPSA than the Ministry believes would be acceptable at this time, ISDA suggests that the next best alternative would be to amend the "investment securities" definition by deleting "but" in paragraph (a)(ii) and inserting the following as paragraph (b) (and, therefore, renumbering the current paragraph (b)): (b) Includes the rights of a person who maintains an account with a clearing house or securities depository to which interests in property described in paragraph (a) may be credited or debited; but A consequential change should then be made to section 18(1)(b), which deals with "possession" of investment securities. That provision should be

Clause Number	Clause heading	Submission
		reworded to read as follows: (b) In the case of an investment security that is traded or settled through, or that represents the rights of a person who maintains an account with, a clearing house or securities depository, the clearing house or securities depository, as the case may be, records the interest of the person in the investment security; or This ('first generation') approach of grouping together both the underlying securities and the securities account rights linked to those securities is not ideal. However, ISDA submits that this would be an improvement of the existing position and would do no more than confirm what seems to have been Parliament's intention at the outset.