

To
Ministry of Economic Development

For
Investment Law Team

By
Email: investment@med.govt.nz

Date
6 September 2011

Dear Sir/Madam

Financial Markets Conduct Bill

1. Introduction

1.1 Thank you for the opportunity to review and provide comments on the Financial Markets Conduct Bill (the "**Bill**"). This Bill is a highly ambitious project and we commend the Ministry of Economic Development's (the "**Ministry's**") efforts in producing the Bill. We also strongly endorse the use of pre-introduction exposure drafts of proposed legislation, particularly when the proposed legislation is the length and complexity of the Bill.

1.2 Buddle Findlay is one of New Zealand's leading commercial and public law firms with offices in Auckland, Wellington and Christchurch. Buddle Findlay acts for a number of clients affected by the proposals in Bill, including banks and financial institutions, equity, debt and derivatives issuers, listed companies, trustees and trustee companies, managed investment schemes and fund managers, and other licensed intermediaries. While this submission builds on our experiences with these clients, this submission reflects our own views and not that of any particular client or group of clients.

1.3 We would be happy to discuss any aspect of this submission with you if that would be helpful. In particular, we would be happy to review any revisions to the drafting of the Bill, whether arising out of our submissions or those of others. If you have any queries or would like to discuss, please contact either:

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1.4 We would also find it very helpful if the Ministry were able to provide a debrief once it has a chance to consider all submissions. It would be very useful for us to better understand why particular submissions were or were not incorporated. This will

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enable us to better prepare and target our and our clients' comments at the Select Committee stage of the Bill.

2. Confidentiality

- 2.1 We confirm that we have no objection to the Ministry publishing this submission on the Ministry's website.

3. Structure of this submission

- 3.1 Our detailed comments are set out in your suggested template **attached** as an Annex to this letter. We do however set out some observations on the Hague Convention, the Personal Property Securities Act 1999 (the "**PPSA**") and related issues below.

4. Possible PPSA amendments

Amendments to PPSA to facilitate cross-border transactions

- 4.1 We support the view that the PPSA should be amended to align New Zealand law with the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary (the "**Convention**"). This will eliminate a significant source of uncertainty faced by New Zealand businesses participating in cross-border transactions involving securities.
- 4.2 We also believe that this is a good opportunity to make another amendment to the PPSA to resolve an issue which arises in New Zealand in relation to derivatives. This issue is the issue of whether or not a "security interest" under the PPSA is created when collateral is posted under an ISDA Credit Support Annex (Bilateral Form Transfer English Law) ("**Credit Support Annex**").

Credit Support Annexes and their significance

- 4.3 As you are probably aware, the Credit Support Annex is a document which has been published by the International Swaps and Derivatives Association ("**ISDA**"), and is widely used to reduce the credit risk exposure that one party to an ISDA Master Agreement has to the other party.
- 4.4 When two parties enter into a derivative, the value of that derivative to each party will vary depending on fluctuations in the value of underlying assets referenced by it. For example, if Party A has agreed to swap NZ\$100,000 for US\$80,000 with Party B on a future date, the value of that swap to Party A will increase (and the value to Party B will decrease by the same amount) if the New Zealand dollar weakens against the US dollar. This is because Party A will be able to acquire US dollars on that date under the swap for less New Zealand dollars than it would be need to pay in the spot market to acquire them.
- 4.5 Under an ISDA Master Agreement there may be many derivatives in place between the two parties, and the aggregate value of those derivatives to one party or the other can be very significant. However, to realise that value, the party to whom the

agreement is valuable relies on the other party being able to make the relevant payments. In other words, it has a credit risk on the other party.

- 4.6 A Credit Support Annex provides a mechanism for credit risk under an ISDA Master Agreement to be minimised. It does this by requiring the party to whom the ISDA Master Agreement has negative value (the “**transferor**”) to transfer property (usually cash or high credit quality liquid instruments such as US Treasury Bills) to the other party (the “**transferee**”). The transferor retains no interest in this property. However, in certain circumstances (which will arise when further fluctuations in the value of assets referenced by the derivatives reduce the value of the ISDA Master Agreement to the transferor) the transferee may be obliged to transfer equivalent property back to the transferor. This mechanism minimises the amount each party owes to the other at any time because the party to whom the agreement has positive value will have effectively been pre-paid that value.

Uncertainty under PPSA

- 4.7 There is considerable uncertainty in the market about whether the transferee under a Credit Support Annex is the absolute owner, or merely has a security interest, in the transferred property, for the purposes of the PPSA.
- 4.8 A number of firms (including Buddle Findlay) believe this situation does not give rise to a security interest, because the transferor does not retain any interest in the property. This means that the first test in the definition of "security interest" in section 17(1)(a) of the PPSA that there be "an *interest* in personal property" is not met. However, we are aware that other firms, including ISDA's New Zealand law advisers, hold a different view. That view is that the arrangement is, in substance, a security agreement, and will be characterised as such where New Zealand law applies.
- 4.9 The uncertainty around this point means that parties are unclear about their rights in relation to property transferred to them. It is also leading many to incur additional legal fees to obtain advice about the potential risks, and make complex amendments to the standard form of the Credit Support Annex to mitigate those potential risks. In some cases, parties are registering financing statements, which potentially send false signals to the market that their counterparties (often banks) need to raise secured debt. A finding that a security interest was, in fact, created may also place many transferors in breach of undertakings to third parties not to give security over their assets. For these reasons we believe there would be a real benefit in clarifying the law, and that this is an opportune time to do it.
- 4.10 We suggest that section 17 of the PPSA be amended by inserting a new sub section "(4)" at the end of the definition as follows:

"(4) To avoid doubt, a person (A) who transfers property to another person (B) does not have an interest in that property for the purposes of subsection (1)(a) merely because B has an obligation to transfer equivalent property to A at a future date."

5. Concluding remarks

- 5.1 Thank you again for the opportunity to review the Bill at the exposure draft stage. We look forward to working with you further over the coming months to finalise and implement the securities law reforms.

BUDDLE FINDLAY

A handwritten signature in black ink, appearing to read 'S Judd', written in a cursive style.

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