

Consultation on the Draft Emissions Units, Settlement Systems and Futures Bill

February 2008

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1. INTRODUCTION

Emissions Trading Scheme

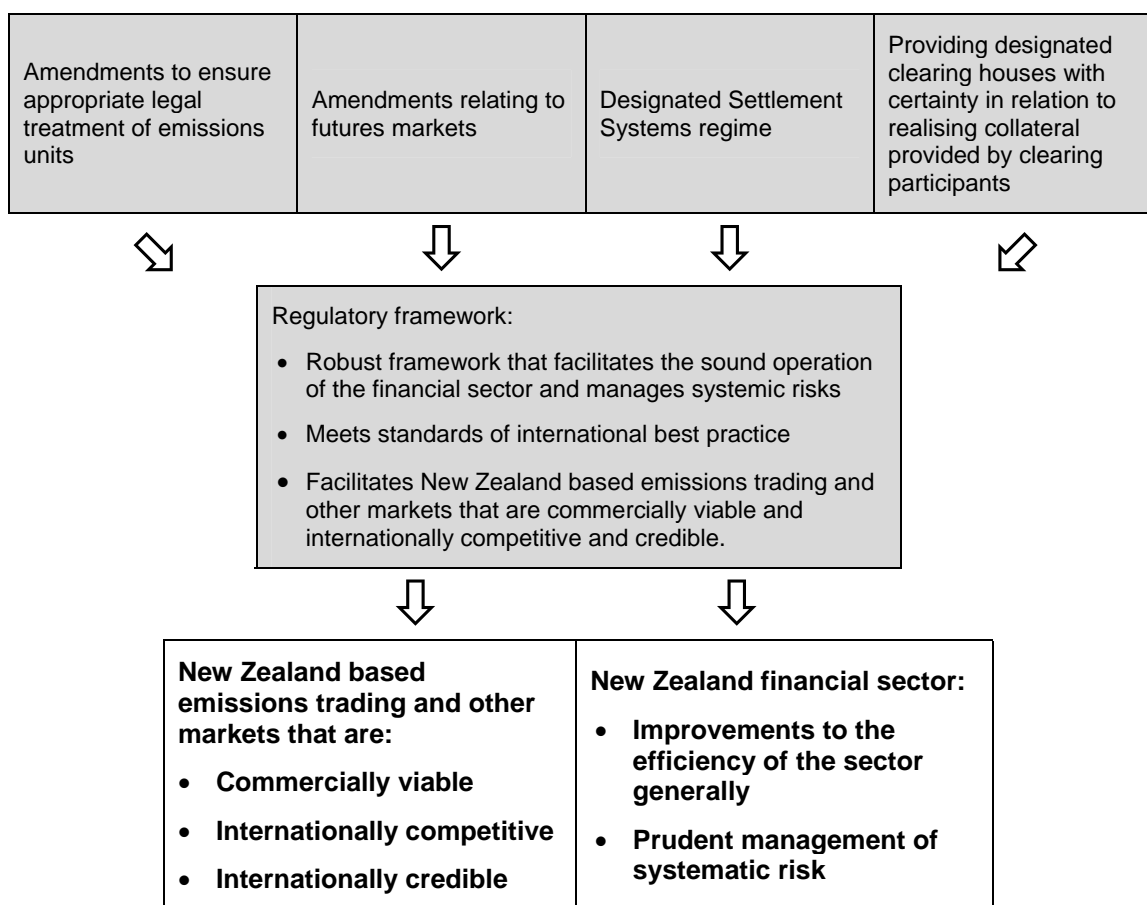
- 1.1 To meet New Zealand's obligations under the Kyoto Protocol, the Government has recently introduced the Climate Change (Emissions Trading and Renewable Preference) Bill into Parliament ("**ETS Bill**"). The ETS Bill's principal purpose is to amend the Climate Change Response Act 2002 to introduce a greenhouse gas Emissions Trading Scheme in New Zealand ("**NZ ETS**"). More information on the ETS Bill and other useful background material on the NZ ETS is available at www.parliament.nz and www.climatechange.govt.nz.

Amendments to financial regulation required

- 1.2 The trading of emissions units (including those arising from the mandatory/regulatory and voluntary markets) is expected to grow rapidly as the international actions to combat climate change increase. The trading of emissions units is an important aspect of the proper functioning of the NZ ETS, as it is the mechanism through which markets will allocate responsibility for reducing greenhouse gas emissions to those for whom the cost of reducing greenhouse gas emissions is least. To ensure that New Zealand's trading of emissions units (both mandatory and voluntary) is properly integrated with international carbon markets, it is also important that New Zealand's emissions trading platforms are able to have credibility in international markets.
- 1.3 For these reasons, it has become timely to undertake policy development to ensure that New Zealand's regulatory environment will enable the development of robust trading and clearing and settlement infrastructure in relation to emissions units, which meet standards of international best practice.
- 1.4 That said, although the original impetus for the changes in this Bill were with respect to emissions units, the proposed changes are intended to improve the operation of financial markets generally, not just in the emissions trading sphere. A number of the changes are designed to facilitate trade in a wider range of commodities than emissions units (and derivative products relating to emissions units). For example, the changes that improve the regulatory regime for clearing and settling financial products will benefit trading in equities, debt instruments, currencies and other commodities.
- 1.5 The diagram below illustrates the relationship between the reforms, outcomes sought in this policy process, and relevant players.

Figure 1: Relationship between reforms and outcomes sought in this policy process

The top row comprises the main amendments set out in the Draft Bill. The next row describes the type of regulatory framework that is likely to result from the amendments. The bottom row describes the ultimate objectives of the amendments.



Policy process thus far

- 1.6 The Ministry of Economic Development ("**Ministry**"), in consultation with other agencies, including the Reserve Bank and the Securities Commission, has led the policy development that has resulted in the drafting of the Draft **Emissions Units, Settlement Systems and Futures Bill** ("Draft Bill"), which is attached to this consultation document.
- 1.7 As part of this policy process, two papers were presented to Cabinet in late 2007:
- (a) The first paper, *Reform of the Law Relating to Futures Exchanges and Clearing and Settlement Systems* (POL (07) 382), made a number of proposals for amendments to the law regulating futures exchanges and clearing and settlement systems so as to facilitate a more robust legislative framework that meets the expectations of potential international participants.
 - (b) The second paper, *Designated Settlement Systems and the Primacy of Clearing Houses' Interest in Collateral* (CAB (07) 632), reported back to Cabinet on the policy tradeoffs resulting from providing clearing houses, which are to be part of a designated settlement system, with certainty of their interest in collateral provided in the settlement system. It also sought Cabinet agreement to a number of changes, including rescission of decisions previously taken by Cabinet, to the regulation of clearing and settlement systems.

- 1.8 The Draft Bill is intended to implement the recommendations in these Cabinet papers, which Cabinet has agreed to. To view the Cabinet papers, and the attached Regulatory Impact Statements, which include a list of the recommendations that were made to Cabinet, see http://www.med.govt.nz/templates/ContentTopicSummary_32791.aspx.

Consultation details

- 1.9 The purpose of this consultation is to test with stakeholders and other interested parties how well the Draft Bill implements the recommendations agreed to by Cabinet, including whether there are better ways of implementing these proposals in legislation.
- 1.10 Submissions should primarily relate to the text of the Draft Bill. However, to facilitate the writing of submissions, we have set out in this covering note the main changes in the Draft Bill. We have also included a number of guiding questions. These highlight the sorts of information we have identified as being crucial in evaluating policy options to facilitate efficient and effective financial markets, including the trading of emissions units.
- 1.11 This policy process has operated within the guidelines required for legislative design and regulatory impact assessments. In keeping with this approach the Ministry seeks comments from submitters on how affectively the Bill achieves the policy objectives and how well the Bill takes account of the costs and benefits of these proposed amendments (see questions in paragraph 1.14). The responses to all of the questions will assist in concluding a Regulatory Impact Statement that will be included with the Bill.
- 1.12 Please send submissions to:
- Caroline Ramsey
 Manager Financial Sector
 Competition, Trade & Investment Branch
 Ministry of Economic Development
 33 Bowen St, PO Box 1473,
 Wellington 6011, New Zealand
 (04) 474 2887
Caroline.Ramsey@med.govt.nz
- 1.13 The closing date for submissions is **Monday 10 March 2008**.

Questions

- 1.14 As set out above, we welcome comments on the Draft Bill. However, to provide an indication of the sort of information we are seeking, it may be useful to focus your response, in relation to each area covered in the Draft Bill, on the following questions:
- (a) Does the Draft Bill reflect the intent of the Cabinet decisions in the most cost-effective way. Are there any changes that would improve the cost-benefit ratio?
- (b) Do you agree with the impacts identified in this consultation paper? Do you think there are any other impacts, including the risk of unintended consequences?
- 1.15 In addition to these questions (which apply to all areas covered in the Draft Bill), we have included, where appropriate, further specific questions.
- 1.16 Please provide as much detail as possible in your response.

Official Information Act 1982

- 1.17 In providing your submission, please advise us if you have any objection to your submission being released. If you object to your submission (or a part of your submission) being released, please indicate which parts of your submission you would like to be withheld, and the grounds for withholding. The Ministry will carefully review any representations you make in this regard in preparing and releasing any summary of submissions, and in considering any formal Official Information Act requests that may be received in the future. Because the Ministry is subject to the Official Information Act, we must base any decisions about whether to withhold any submissions (or parts of submissions) on the grounds for withholding under the Official Information Act. This means that any requests for information to be withheld will not be determinative.

2. SUMMARY OF DRAFT BILL

- 2.1 As noted above, the Draft Bill reflects Cabinet's policy decisions after consideration of the *Reform of the Law Relating to Futures Exchanges and Clearing and Settlement Systems and Designated Settlement Systems and the Primacy of Clearing Houses' Interest in Collateral* Cabinet papers. These decisions are reflected in CBC Min (07) 22/11 and CAB Min (07) 44/4B.
- 2.2 The Draft Bill makes amendments to the following legislation:
- (a) the Personal Property Securities Act 1999 ("**PPSA**");
 - (b) the Reserve Bank of New Zealand Act 1989;
 - (c) the Securities Act 1978;
 - (d) the Securities Markets Act 1988; and
 - (e) the Securities Transfer Act 1991.
- 2.3 In summary, the Draft Bill amends:
- (a) certain aspects of the regulatory framework for trading in emissions units;
 - (b) the law relating to the authorisation of futures exchanges and dealers, and the role of the Securities Commission in this area;
 - (c) the law relating to the designation of payment systems, extending it to settlement systems, introducing a dual-regulatory regime comprising the Reserve Bank of New Zealand and the Securities Commission, and making more transparent the requirement to consider relevant international standards when recommending designation; and
 - (d) the rules governing priority as it relates to collateral provided in a designated settlement system, so that if the operator of a designated settlement system requires collateral to be transferred into the system for the purpose of giving greater assurance of settlement, the operator has certainty of priority in relation to that collateral in the event of default by that participant and is able to realise the collateral immediately if necessary.

- 2.4 The scope of the Draft Bill is narrower than it might initially appear in relation to the following:
- (a) **Registration of futures:** These amendments do not create an entirely new system for the registration of futures exchanges. Rather, they extend the current registration and supervisory procedures in relation to securities exchanges to futures exchanges; simplify the authorisation process for futures dealers that are authorised under the rules of an authorised futures exchange; and expressly provide for the trading of futures contracts in emissions units.
 - (b) **Designated settlement systems:** The designated settlement scheme (currently the designated payment scheme) is an opt-in scheme. It does not impose obligations on parties unless they wish to obtain and maintain designation. Further, these amendments do not affect the designations declared under the Reserve Bank of New Zealand (Designated Payment Systems) Order 2004 or any variations made to those designations before the date on which the Designated Settlement Systems Act 2008 comes into force.
 - (c) **Change to the PPSA:** The statutory priority provided to operators of designated settlement systems, is only relevant to designated settlement systems in which the posting of collateral (or another similar arrangement) is used to provide greater assurance as to settlement of transactions. In those circumstances, the interest of the operator in the collateral transferred to it will have priority over the interests of any other person in that collateral, in the event of a default by the participant that posted the collateral. Currently there are two designated payments systems ESAS and CLS, neither of which use collateral for this purpose. This amendment is only likely to have a practical effect if new clearing arrangements develop where there is extensive netting and collateral provided by clearing participants is required to mitigate counterparty settlement risk (e.g., futures and other derivatives).

3. BACKGROUND CONCEPTS

- 3.1 This section includes a description of some of the concepts that are referred to in this consultation document and the Draft Bill. The aim of this section is to better enable respondents who do not have the requisite background knowledge to understand the basic concepts behind certain aspects of the Draft Bill.

Clearing houses and settlement systems

- 3.2 A clearing house is the entity in a settlement system that acts on settlement instructions to settle transactions, clear trades, and collect and maintain collateral in relation to the settlement of trades. All clearing house and settlement system designs are concerned to varying degrees with the level of assurance they provide the clearing participants around completion of settlement. Generally the greater the materiality of exposures and associated risks of a transaction, the more assurance clearing participants will require from the clearing and settlement system before they choose to settle through that system.

Clearing Participants

Clearing participants are entities approved to clear and settle through a settlement system, in accordance with the rules of the settlement system. There are typically participation requirements on clearing participants including capital adequacy, and capability and capacity requirements (e.g., risk management processes). Clearing participants may clear and settle on their own account or on behalf of their customers.

Designated Settlement System

- 3.3 A designated settlement system is a clearing house and settlement arrangement that is declared to be a designated settlement system under the proposed regime. There are currently two designated payment systems in New Zealand, which have been approved by the Reserve Bank of New Zealand.
- 3.4 Designated settlement systems enjoy the benefit of legislative provisions designed to improve the confidence clearing participants have in the likelihood of successful settlement. These include, for both designated payment and designated settlement systems, certainty of netting and the protection for clearing participants against a liquidator from clawback of transactions settled through a designated system.

In addition, it is proposed that the operators of certain designated settlement systems have a statutory priority in collateral transferred to them. The designation approval, variation and revocation processes are concerned with ensuring these legislative provisions are only provided when they are in the public interest. Many of the provisions resulting from designation, intended to provide a greater likelihood of final and full settlement, will be prerequisites for major institutions and international participants considering transacting in New Zealand financial markets.

Posting collateral

- 3.5 Where a clearing house provides its participants with a level of assurance of settlement of trades entered on its system, posting collateral is one way of assisting the clearing house to meet those obligations and manage credit and liquidity risks in the event of the default of a clearing participant. Collateral provided in a settlement system is intended to cover losses at the time the collateral is posted and the “maximum probable future loss” for the period until the next margin call is required (typically one trading day).

Futures Contract

- 3.6 'Futures contract' is defined in section 37(1) of the Securities Markets Act 1988.

4. LEGAL TREATMENT OF EMISSIONS UNITS

Legal effect of registration

- 4.1 Under current law relating to title to shares in a company, entry onto a register is prima facie evidence of title. The terms of other types of securities commonly provide for the relevant register to be prima facie evidence of title too. This provides certainty for persons buying or selling securities or shares in a company by ensuring that the person registered as the holder of the securities or shares has legal title.
- 4.2 The Draft Bill provides that the statutory provisions relating to title and registration of emissions units be amended to provide that registration of an emissions unit on a register is prima facie evidence of title (see **clause 33 of the Draft Bill**). This will give owners of emissions units certainty of title, further supporting certainty and integrity of the system. Note that owners of New Zealand units will receive certainty of title through the legislation establishing the ETS.

Registrability of electronic transfers of securities and emissions units

- 4.3 The Draft Bill provides that the Securities Transfer Act 1991 be amended to confirm the registrability of the transfer of securities settled through a designated settlement system, (see **clause 11 of the Draft Bill**). The Draft Bill also confirms the registrability of emissions units transferred in accordance with the rules of a designated settlement system (see **clause 34 of the Draft Bill**).

- 4.4 There is no requirement for registries to be part of a designated settlement system to enable electronic transfer in this way. Such a requirement is potentially undesirable to the extent it might be used to force all settlements in that product through that particular settlement system, rather than giving buyers and sellers of that product choices on how they settle any trades in that product.

Exclusion of emissions units from definition of 'security'

- 4.5 The Draft Bill expressly excludes an emissions unit from the definition of 'security' (see **clauses 40 and 41 of the Draft Bill**). This provides certainty as to the legal treatment of an emissions unit. Trading in emissions units will not attract the provisions of the Securities Act 1978 and Securities Markets Act 1988 applicable to a security (e.g. prospectus, insider trading, market manipulation, and so on).

Emissions units to be investment securities under the PPSA

- 4.6 The Draft Bill amends the PPSA by extending the definition of "investment security" to include an emissions unit. This will provide purchasers of emissions units, through the operation of section 97 of the PPSA, with a priority over third party perfected security interests in those emissions units in specific circumstances (see **clause 37 of the Draft Bill**).
- 4.7 This change has been introduced under the ETS Bill in relation to NZ ETS emissions units. During the legislative process a decision will be made as to whether the change should be effected by the ETS Bill or the Draft Bill.

Specific questions

In addition to the questions set out in paragraph 1.13, please consider the following questions:

- The definition of 'emissions unit' (see **clause 22 of Draft Bill**) is intended to include voluntary units as well as regulatory units. Is the definition appropriate? Should voluntary and compulsory emissions units be treated the same under the Securities Act 1978, Securities Market Act 1988, Securities Transfer Act 1991, and the PPSA?
- Is prima facie evidence of title through registration appropriate for all forms of emission units, both of a compulsory and voluntary nature?
- Are there any risks associated with excluding emissions units from the definition of 'security' for the purposes of the Securities Act 1978 and the Securities Markets Act 1988 that should be further considered? Do these risks differ with respect to voluntary and compulsory units, or on some other basis?

5. CHANGES RELATING TO FUTURES MARKETS

- 5.1 Overseas experience has shown that a large proportion of trading in equities, bonds, currencies, emissions units and other commodities has occurred in the form of futures contracts, and that it is important therefore to ensure that New Zealand's regulatory environment for futures exchanges allows for emissions trading.
- 5.2 The changes in this section are based on the premise that the conduct rules, market infrastructure, and regulatory oversight role of the Securities Commission are sufficiently similar for both securities markets and futures markets to justify greater integration and streamlining.

Futures exchanges

- 5.3 Currently a person who describes themselves as a 'stock exchange' or 'securities exchange', or who wishes to hold themselves out as a regulated securities market, must apply to the Minister of Commerce to be a registered exchange under Part 2B of the Securities Markets Act 1988. If the same exchange wishes to hold itself out as a regulated exchange for trading in futures contracts in New Zealand, the exchange must apply separately to the Securities Commission for authorisation under Part III of the Securities Markets Act. This results in unnecessary compliance costs.
- 5.4 The Draft Bill amends the Securities Markets Act so that a registered securities exchange under Part 2B of the Securities Markets Act may be registered either for trading securities only or for trading securities and futures contracts (see **clause 15 of the Draft Bill**). An exchange registered for operating securities markets and futures markets will be deemed to be an authorised futures exchange under Part III of the Securities Markets Act (see **clause 26 of the Draft Bill**).
- 5.5 Subsequent changes to the existing (or introduction of new) conduct rules of a registered futures exchange that relate to futures markets are to be made on the basis of provisions similar to the current disallowance and approval provisions for the conduct rules of registered exchanges under the Securities Market Act (see **Part 3 of the Draft Bill**).

Futures Dealers

- 5.6 Currently futures dealers are required to apply to the Securities Commission to obtain authorisation to deal in futures contracts.
- 5.7 The Draft Bill codifies the effect of a number of class authorisations that have previously been granted for persons who are participants under a specified futures exchange. For example, there is an existing authorisation for NZX participants under the Authorised Futures Dealers Notice (No 3) 2004. Accordingly, all dealers in futures contracts who have been approved by a registered exchange to deal in the futures contracts will be deemed to be authorised to carry on the business of dealing in futures contracts for the purposes of Part III of the Securities Markets Act (see **clause 27 of the Draft Bill**).
- 5.8 This removes the need for futures dealers, who have already been subjected by the registered exchange to a substantially similar application process for admission as a participant in its futures market, from the need to separately seek authorisation from the Securities Commission.

Futures contracts

- 5.9 The Draft Bill clarifies the definition of 'futures contract' so that it extends to a futures contract for emissions units (see **clause 44 of the Draft Bill**). It is unlikely that the current definition in the Securities Markets Act 1988 is broad enough to include an emissions unit. Clarifying this definition provides certainty as to the application of the futures contract regime in the Securities Markets Act to futures contracts for emissions units. Officials consider it desirable to extend the definition to both NZ ETS units and non-NZ ETS units. This will enable authorised futures exchanges to trade in voluntary market units as well as NZ ETS units.

Clarification of the general powers and functions of the Securities Commission

- 5.10 The Draft Bill makes amendments to the Securities Markets Act 1988 to clarify that the Securities Commission has the power to review and comment on the law relating to, and activities on, futures markets and registered clearing and settlement systems, including advising the Minister in relation to conduct rules (see **Part 3 of the Draft Bill**).

- 5.11 This will give clear guidance to the market and potential participants as to the Commission's statutory functions and powers as regulator.

Specific questions

In addition to the questions set out in paragraph 1.13, please consider the following question:

- Are securities and futures markets of a sufficiently similar nature to warrant these changes?

6. DESIGNATED SETTLEMENT SYSTEMS

- 6.1 The Draft Bill provides that Part 5C of the Reserve Bank of New Zealand Act 1989 should be amended to provide a regulatory regime for the approval and oversight of designated settlement systems (see *Part 1 of the Draft Bill*). This will remain an 'opt-in' regime, but will be extended to cover systems that settle both payments and products, including securities.
- 6.2 The new regime will involve the Securities Commission and the Reserve Bank of New Zealand having a joint role in recommending designation of a settlement system to both the Ministers of Finance and Commerce. The two Ministers will have a role in recommending to the Governor General that a system be designated. The joint regulators will have powers to seek changes to designated settlement systems' rules and other matters, through the powers of variation and revocation. This approval and oversight framework will be consistent with the 2004 recommendations made in the report of the Financial Sector Assessment Programme ("**FSAP**") with respect to ongoing oversight once system rules are approved.
- 6.3 Specifically, the Draft Bill provides that Part 5C of the Reserve Bank of New Zealand Act should be amended to:
- Extend its scope to systems that settle the delivery of personal property as well as payments:** The extension from payments to settlements more generally provides a level of certainty to settlements systems that is only currently extended to payments systems.
 - Provide a role for the Securities Commission:** The Draft Bill provides that Part 5C will be extended to reflect that the Securities Commission and the Reserve Bank will have responsibilities for the designation, variation, and revocation of designations.
 - Encompass the different objectives of the two agencies:** While both agencies are concerned with the health and functioning of the financial system, they each view the problem from different but complementary perspectives. The Reserve Bank is primarily concerned with the avoidance of significant damage to the system resulting from the failure of a participant in the system. The Securities Commission is concerned with market conduct and integrity, including any risks the settlement system might have for participation more generally in New Zealand's securities markets. Reliance on a dual regulator regime in the approval of settlement and clearing systems has precedent in other jurisdictions, including Australia.

- (d) **Recognise both perspectives in the decision making process that determines whether a settlement system will become 'designated':** The Draft Bill provides that Part 5C be amended to provide that the Reserve Bank and Securities Commission will make a joint recommendation to both the Minister of Finance and the Minister of Commerce for a settlement system to be declared to be a designated settlement system. It is considered that involving both Ministers is appropriate given the policy objective of having both systemic risk and market integrity perspectives considered during this process.
- (e) **Improve the transparency of the approval process in a manner which is consistent with international standards:** Under the Draft Bill, it will become a requirement that relevant international standards pertaining to clearing and settlement systems be considered during the application and variation processes.
- (f) **For the purposes of avoiding doubt, include a provision in Part 5C which has the same effect as section 44 of the Securities Market Act 1988:** This provision would provide that the Commission may exercise any of its powers under the Securities Act 1978 in performing its functions under Part 5C for the purposes of Part 5C.
- (g) **Enable the Securities Commission to charge fees:** The RBNZ has authority to charge fees for applications under Part 5C. The Draft Bill extends Part 5C to enable the Securities Commission to charge fees also, subject to the approval of Ministers.

6.4 Further details are included in Part 1 of the Draft Bill.

6.5 It should be noted that **clause 7** of the Draft Bill provides that these amendments do not affect:

- (a) the designations declared under the Reserve Bank of New Zealand (Designated Payment Systems) Order 2004; or
- (b) any variations made to those designations before the date on which the Designated Settlement Systems Act 2008 comes into force.

6.6 The Reserve Bank and Securities Commission have agreed to develop a memorandum of understanding, including the development of procedures setting out their respective roles, responsibilities, and processes. This will ensure both agencies are clear as to their accountabilities and can perform their respective obligations under Part 5C.

Specific questions

In addition to the questions set out in paragraph 1.13, please consider the following questions:

- When considering an application for designation or a variation to an existing designation or to the rules of a designated settlement system, the Draft Bill provides that the Securities Commission and Reserve Bank must have regard to relevant international standards concerning clearing and settlement systems. Is this requirement sufficiently certain?
- Do the decision making processes in the Bill, with respect to approvals, variations and revocations, strike the right balance between certainty required by commercial parties and the ongoing public interest in the robustness and integrity of designated settlement systems? Is it appropriate for both regulators to have to agree to a variation or revocation decision?

- Do the provisions relating to the changing of a designated settlement system's rules, including critical rules, provide clearing participants with sufficient certainty with respect to whether the system is designated at a point in time, and therefore the settlement protections afforded by designation apply?

7. PROVIDING CERTAINTY THAT COLLATERAL PROVIDED BY CLEARING PARTICIPANTS CAN BE REALISED WITHOUT DELAY

- 7.1 The risk management practices within settlement systems are an integral component of an efficient and robust financial system. There is a range of risk management mechanisms available to clearing houses and settlement systems to mitigate the fulfilment risk facing participants in that system, which generally arises because of non-performance by other clearing participants (i.e., their counterparty to the transaction). These include the participation requirements (e.g., capital adequacy) on clearing participants, requiring margin to be posted by participants to underwrite their obligations, and access to and adequacy of the clearing house's capital reserves.
- 7.2 There are a number of models under which the clearing house may operate, some of which involve the clearing house bearing some degree of the risk of non-performance by the participants in the system. In the case of the central clearing party model¹, the clearing house assumes the settlement risks through the process of novation, thereby becoming the seller to all clearing participant buyers and the buyer to all clearing participant sellers.
- 7.3 In situations where the clearing house is directly bearing the risk, to a significant degree, of a default by a clearing participant it is typical for the clearing house to require participants to post collateral in the form of margin to mitigate this exposure. In the event of default this margin plays a very important role in meeting the central clearing house's obligations to other participants who were pre-novation counterparties to the defaulting clearing participant. The effectiveness of this collateral to address risks in the event of default will be a function of, among other things, the ability for the designated settlement system to have a timely claim to the defaulting party's collateral. If the clearing house cannot secure the collateral in a timely manner then the entire settlement system may be put at risk.
- 7.4 Any uncertainty over the designated clearing house's ability to realise collateral in a timely manner, in the event of a default, will increase the operating costs and capital requirements for the designated clearing house, thereby weakening the designated clearing house's international competitiveness. International participants will in some cases refuse to rely on settlement systems which cannot provide credible assurances that access to that collateral is assured to a very high degree. Finally, the failure of the operator of a designated settlement system has the potential to have a contagion effect, thereby threatening New Zealand's wider financial system.

Problem definition

Uncertain legal position of designated clearing houses' interests in collateral

- 7.5 Under the current law a designated settlement system could conceivably require clearing participants to provide them with a first-ranking priority for their interest in collateral. This would require the clearing participants to negotiate subordinations from (multiple) secured parties, in favour of the security interest of the designated clearing house.

¹ Currently there are no central clearing parties based in New Zealand, though they might be expected to develop in response to a significant growth in futures trading.

- 7.6 The difficulties with this approach, beyond the practicalities of identifying existing security interest holders and negotiating effective subordinations with them, are largely concerned with the certainty and speed with which the designated clearing house will be in a position to deploy the collateral to mitigate liquidity risks in the event of a default. Potential delays arise due to:
- (a) requirements to comply with the provisions in the Personal Property Securities Act 1999 (PPSA), pertaining to notification periods prior to disposal of the collateral and other procedural issues; and
 - (b) the risk that a receiver appointed to represent other creditors' interests challenges, and delays or frustrates the operator of the designated system's claim.

- 7.7 There may be further problems in that many large international participants, such as global investment banks, would have to breach the terms of their financing agreements (e.g., due to the existence of negative pledge clauses) if they were to grant a first ranking priority to a clearing house. This, coupled with different legal requirements that differ from those that are typically found in major international markets, would be sufficient to deter their involvement in New Zealand markets both as clearing participants and more generally.

Uncertainty as to effect of sections 95 and 97 of the PPSA

- 7.8 An alternative approach under the existing law might be for the designated clearing house to rely upon the provisions in the PPSA which effectively provide an overriding priority in specific circumstances. However, there is uncertainty as to whether the PPSA currently provides clearing houses with sufficient certainty that they will be able to realise, in a timely manner, collateral provided in a settlement system by defaulting clearing participants.
- 7.9 Sections 95 and 97 of the PPSA² provide persons receiving money or purchasing investment securities with a priority over third party security interests for cash and investment securities, provided certain conditions are met. As these are far and away the two most common forms of collateral that are provided in settlement systems, it is conceivable that a clearing house could be expected to rely on these provisions for securing its interest in collateral.
- 7.10 However, there is debate and a degree of doubt within the legal profession concerning the extent to which a clearing house can rely on these provisions to provide assurance that the clearing house will be able to realise collateral. This legal uncertainty arises because:
- (a) the interpretation of these provisions of the PPSA has yet to be tested in the courts with respect to collateral used to assure settlement. For example there is debate as to whether a clearing house that received "cash" collateral posted as margin is a "creditor", and to whether it has received payment of "a debt owing", under section 95. Therefore the PPSA provisions do not provide clearing houses and international participants the assurances they require;
 - (b) there is a risk that a clearing house's claim to investment securities under section 97 could be frustrated if the clearing house is found to have knowledge of prior security interests; and

² See Appendix A.

- (c) the right of a clearing house to collateral under sections 95 and 97 could be challenged by a third party, requiring the clearing house to establish that the sections apply under the specific circumstances of the case, thereby at a minimum delaying the clearing house's ability to realise the collateral in the required timeframe to meet liquidity pressures.

- 7.11 Some of these concerns may be able to be dealt with by designing the rules and procedures of the designated settlement system specifically to ensure the requirements of sections 95 and 97 are met. However, we believe there are real benefits in removing any residual doubt and specifically providing for the priority in legislation.
- 7.12 Further, it is critical that the affected clearing house is able to realise the collateral quickly enough to address liquidity concerns. Even if the right of the clearing house to the collateral were not challenged, there is a concern that the process in Part 9 of the PPSA would not permit the timely realisation of the collateral.

IOSCO recommendations

- 7.13 The current situation falls short of the International Organisation of Securities Commissions ("**IOSCO**") recommendations (a current, relevant international standard) with respect to a clearing house's priority in collateral, which call for a "high degree of assurance" that collateral can be accessed quickly.
- 7.14 Where the clearing house bears some of the risk in the event of a clearing participant defaulting, there is a requirement for a high degree of assurance to:
- (a) **ensure the efficiency and robustness of the clearing system:** lack of certainty increases the costs of operating a clearing house (e.g., by requiring additional capital) and reduces the confidence that potential clearing participants and their customers have in the settlement system; and
 - (b) **mitigate systemic risk to the wider financial system:** failure of a clearing house which is bearing risks during the settlement process has potentially wider impacts on the financial system (for example, where the clearing house novates during the settlement process).

Approach to the issue abroad

- 7.15 The European Union, the UK, the USA, and Canada have all provided statutory priority to clearing houses over collateral posted as margin. International participants will therefore be looking for a clear, unambiguous priority in relation to a clearing house's interest in posted collateral when deciding whether or not to participate in the New Zealand market.

Conclusion on problem definition

- 7.16 For these reasons, the current law does not provide the necessary degree of assurance that clearing houses, which use participants' collateral to give greater assurance of settlement, can in the event of a default by a clearing party rely on this collateral to satisfy obligations to its participants or to satisfy the level of assurance recommended under the IOSCO principles and required by many international participants. While there may be a high degree of certainty in the ability of the clearing house to secure a priority in the collateral under the current law, it is doubtful that the clearing house will be able to realise that claim quickly enough to address liquidity concerns. Liquidity is paramount in mitigating credit and systemic risks in the event of a significant default, particularly when a default occurs in volatile markets, where in a matter of minutes prices can move significantly against the clearing house's open position due to the default.

Change proposed in Draft Bill

- 7.17 The Draft Bill provides that the PPSA be amended so that certain operators of designated settlement systems have priority in relation to any collateral provided in the settlement system by a clearing participant in the event of default by that participant and the process for realising that collateral will be simplified to enable immediate realisation of the collateral (see **clause 12 of the Draft Bill**, which inserts a new section 103A into the PPSA). The designation will provide for this and it is intended that only collateral used by designated clearing houses for the purposes of effecting the settlement will have the benefit of these protections.
- 7.18 Although the discussion of this issue above considers the position where the collateral provided to the clearing house is either investment securities or money, this is because these are the forms of collateral that are most commonly provided to clearing houses as they are highly liquid with observable market prices. Notwithstanding this, the amendment to the PPSA will apply the statutory priority to all types of collateral. The Ministry is interested in submitters' views on whether it is necessary or desirable to limit this provision to collateral in the form of investment securities and money.

Impacts of change proposed in Draft Bill

- 7.19 The impacts of this change are anticipated as being as follows:
- (a) **Wider financial system:** Confidence in settlement systems is a foundation of an efficient and robust financial system, and the statutory priority has the potential to strengthen this confidence. The likelihood of settlement failures, or default by a designated clearing house, due to inability to access collateral, will be reduced by improving the certainty and timeliness with which the clearing house can access this collateral in the event of a clearing participant default. The amendment may assist in attracting international market participants, clearing participants, and providers of capital. This provision might also encourage the use of central counterparty structures which could serve to concentrate risks within our financial systems. However, this risk is mitigated by the approval and ongoing regulation of designated settlement systems, a process involving dual regulators and subject to international best practice.
 - (b) **Designated clearing houses:** Whilst the designated clearing house is an obvious beneficiary of the statutory priority, the policy rationales for the priority are to strengthen clearing participants' and their customers' confidence in our financial systems, and mitigate financial system systematic risk which might otherwise arise. Any financial benefit to the clearing house arises as a consequence of the realisation of these policy objectives. Clearing houses will benefit from the creation of the statutory priority in their favour through increased certainty in their ability to realise collateral posted by a clearing participant in the event of default by that participant. This will be financially beneficial to clearing houses in a number of ways, including lower expected costs and greater certainty of outcome than is currently the case under the PPSA. The reduced risk profile and greater transparency, in keeping with international best practice, will result in New Zealand clearing houses being more attractive to third parties to rely on for their clearing and settlement activities. In these ways, the amendment will contribute to New Zealand clearing houses being commercially viable and being able to leverage off their investments in clearing house technology.
 - (c) **Clearing participants:** Clearing participants in designated settlement systems, which enjoy the statutory priority, will have greater certainty of settlement as a consequence of the statutory priority. In the event that another participant defaults, the clearing house will have certainty of priority over collateral and the ability to liquidate the collateral immediately if required.

- (d) **Parties with security interests in the collateral of clearing participants:** Parties with security interests in the collateral of clearing participants are generally sophisticated institutions (such as major banks) with expertise in financial markets and personal property securities law. It is expected that these institutions will be able to provide for the new risk profile of their debtors by re-pricing and/or restructuring the relevant debt. We understand that these changes may happen over time and are not likely to occur immediately. Assuming sections 95 and 97 of the PPSA would apply to collateral posted with a designated clearing house in any event, it is unlikely that the statutory priority granted in favour of a designated clearing house will impact on the secured party's ability to access collateral in the absence of this amendment. However, as referred to above, the statutory priority in favour of designated clearing houses applies in respect of all types of collateral. Accordingly, if collateral other than investment securities or money was posted as collateral with the designed clearing house (which the Ministry understands would be unlikely in practice), the secured party would not have priority to that collateral in circumstances where they may otherwise have expected to have priority. These possible impacts would also arise where a customer of a clearing participant delivers collateral in a form other than cash or investment securities to the participant for the participant to post as collateral with the designated clearing house.

Specific questions

In addition to the questions set out in paragraph 1.13, please consider the following questions:

- Are the provisions relating to the statutory priority sufficiently restrictive to ensure this provision is only available to the operators of designated clearing systems and with respect to collateral received from clearing participants for the purposes of assuring settlement?
- Should the statutory-priority for operators of designated settlement systems apply only in relation to certain collateral (for example money and investment securities are common forms of collateral in these circumstances as they are highly liquid)?
- Is reliance on a section in the PPSA sufficient for the purposes of making the existence of the statutory priority transparent to creditors? Could the PPSR be amended to improve the awareness of creditors?

APPENDIX A: PERSONAL PROPERTY SECURITIES ACT 1999, SECTIONS 95 AND 97

95 Priority of creditor who receives payment of debt

- (1) A creditor who receives payment of a debt owing by a debtor through a debtor-initiated payment has priority over a security interest in—
 - (a) The funds paid;
 - (b) The intangible that was the source of the payment;
 - (c) A negotiable instrument used to effect the payment.
- (2) Subsection (1) applies whether or not the creditor had knowledge of the security interest at the time of the payment.
- (3) In subsection (1), debtor-initiated payment means a payment made by the debtor through the use of—
 - (a) A negotiable instrument; or
 - (b) An electronic funds transfer; or
 - (c) A debit, a transfer order, an authorisation, or a similar written payment mechanism executed by the debtor when the payment was made.

Example

Person A has a perfected security interest in person B's (a car dealer's) inventory (cars).
 Person B sells some of the cars and deposits the cash proceeds into a cheque account.
 Person B draws a cheque and pays person C (an unsecured creditor).
 Person C's interest in the cheque has priority over person A's security interest in the cheque.

97 Priority of purchaser of investment security

- (1) The interest of a purchaser of an investment security has priority over a perfected security interest in the investment security if the purchaser—
 - (a) Gave value for the investment security; and
 - (b) Acquired the investment security without knowledge of the security interest; and
 - (c) Took possession of the investment security.
- (2) For the purposes of subsection (1), the purchaser of an investment security who acquired it under a transaction entered into in the ordinary course of the transferor's business has knowledge only if the purchaser acquired the interest with knowledge that the transaction is a breach of the security agreement to which the security interest relates.

Example

Person A has registered a financing statement in respect of all of person B's shares.
 Person C also takes a security interest in all of person B's shares, but does not know about person A's security interest.
 Person C perfects its security interest by taking possession of person B's share certificates.
 Person C's security interest in person B's shares has priority over person A's security interest in the same shares.