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Dear Caroline

Re: Draft Emissions Units, Settlement Systems and Future Bill Submission

With respect to the Draft Emissions Units, Settlement Systems and Future Bill we provide the following submission for your consideration.

As part of the policy process two papers were presented to cabinet in late 2007

- Reform of the Law relating to Future Exchanges and Clearing and Settlement System (POL (07) 382)
- Designated Settlement Systems and the Primacy of Clearing Houses' Interest in Collateral (CAB (07) 632).

The drafted bill is also supported by a discussion document as to the intent of the legislation and how it fits within the legal framework and intended regulatory outcomes of the legislation.

We note the extensive discussions in the support documents pertaining to a clearing house, utilization of a central counterparty (CCP) the risks faced by such entities and the mitigation measures, referenced as below:

Discussion Document Section 3.2:

"All clearing houses and settlement system designs are concerned to a varying degree with the level of assurance they provide to 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"

Reform of the Law relating to Future Exchanges and Clearing and Settlement System (POL (07) 382), Item 20

There are also certain practical or commercial problems in relation to attracting international and other participants to participate in a regional emissions trading platform, especially in relation to futures contracts. Many of these relate to the fact that New Zealand law relating to clearing and settlement systems and futures exchanges does not currently meet the

standards set by the Bank for International Settlements and International Organisation of Securities Commissions (BIS-IOSCO).

Reform of the Law relating to Future Exchanges and Clearing and Settlement System (POL (07) 382), Item 28

In order to make it commercially viable to implement the CCP infrastructure adequate capital backing is required in the form of cash and synthetic capital (used to manage participants risk positions). The supply of synthetic capital is dependent on NZX receiving a satisfactory rating from an international capital market risk rating agency. The rating agency will judge the proposed system on the robustness of the clearing house and the regulatory environment in which it operates.

Designated Settlement Systems and the Primacy of Clearing Houses' Interest in Collateral (CAB (07) 632), Item 4

The financial failure of a clearing house has the potential to disrupt the market it serves, as well as spilling over into other markets and payment systems. The potential for systemic risks means that central banks and securities regulators have a strong interest in the risk mitigation of the clearing house, including its access to collateral in the event of a default by a participant.

Designated Settlement Systems and the Primacy of Clearing Houses' Interest in Collateral (CAB (07) 632), Item 26

Because the CCP serves to concentrate risk (acting as the counterparty for all trades, with all market participants), the robustness of the risk management and adequacy of the CCP's claim on financial resources are critical considerations for the confidence that market participants will have in the market the CCP supports. Moreover, a risk management failure by the CCP has the potential to disrupt the market it serves, as well as spilling over into other markets and payment systems. The potential for systemic risks means that central banks and securities regulators have a strong interest in the integrity of the CCP

Designated Settlement Systems and the Primacy of Clearing Houses' Interest in Collateral (CAB (07) 632), Item 32

Finally, the clearing house can ensure that there are adequate financial resources to cover resulting losses (i.e., capital adequacy of the clearing house) and meet payment and product obligations on time (e.g., resources structured in a liquid manner to ensure timely access). It is generally the case that the assets of defaulting counterparties are accessed in the first instance. In the event that the assets the CCP has claim to on defaulting parties are insufficient, the capital and guarantees (e.g., synthetic capital²) of the CCP are accessed.

Reserve Bank of Australia Regulatory Impact Statement (CCP)

"Central counterparties interpose themselves between the two parties to a trade and become the buyer to every seller and the seller to every buyer. As such, they become parties to trades and take on the same risks as any other market participant. This role means that central counterparties have exposures to, or claims on, every other participant in their facility. As a result, their ability to meet all their obligations is critical to the stability of the financial system.

IOSCO Recommendation 5

A CCP should maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions. This requirement detail then sets out the requirement for stress testing to be conducted for various scenarios at least monthly, and oversight review of the model/s being used for stress tests at least annually.

The draft bill as currently drafted appears to be deficient in the legal framework with respect to the Designated Settlement Systems obligations to the industry as a whole, in particular a requirement to maintain adequate financial resources in order to provide transparency, and certainty for its sound operation.

The bill also appears to be silent on procedures in the event of CCP default or compensation mechanisms available, (other than the provisions in the RBNZ Act for statutory management).

The bill as currently drafted relies on the joint regulator review of the above matters in accordance with international best practice. We believe the market infrastructure is important enough to warrant explicit inclusion.

If we look Trans Tasman, the way Australia implemented these requirements into the legislative framework was through the Corporation Act.

Australian Government, Corporations Act 2001, Section 7, Sub Section 827D.

Requires: "The Reserve Bank of Australia (the Reserve Bank) may in writing determine standards for the purposes of enduring the Clearing and Settlement Facilities licensees construct their affairs in a way that causes or promotes overall stability in the Australian financial System."

The Reserve Bank of Australia publishes a guidance note on how this criteria will be measured which almost mirror the IOSCO standards.

Furthermore Corporations Act 2001, Section 8 Sub Section 821, Sub Section 821A – General Obligations of a Clearing and Settlement Facility Licensee Must

Requires to the extent that it is reasonably practicable to do so: (Subset published below)

- *comply with standards determined under section 827D; and*
- *do all other things necessary to reduce systemic risk; and*
- *do all things necessary to ensure that the facility's services are provided in a fair and effective way;*
- *comply with the conditions on the licence; and*
- *Adequate arrangements of an independent person or entity for supervising the facility including*
 - *handling conflicts of commercial interest,*
 - *enforcing compliance with operating rules*
 - *sufficient resources (including financial, technological and human resources) to operate properly*

We doubt that the right balance has been achieved between certainty required by participants and public interest in the robustness and integrity of the designated settlement systems unless there is explicit inclusion.

With respect to regulatory approval of amendments to rules of a designated settlement system, we are of the opinion that the right balance has not been struck between certainty

required by commercial parties and the ongoing public interest as there is no requirement for communication of a minimum set of information (reason for change, test of change, effect of change), or for public comment on critical rule changes.

The discussion document Section 4.4 states:

"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".

In addition to providing certainty as to the legal effect of entry onto a register of emissions units, it is necessary to provide comfort to persons acquiring securities or emissions units cleared and settled through a registered clearing and settlement system that they will be registered as the holder of the product. This is currently provided for in respect of securities under the Securities Transfer Act that are transferred in accordance with prescribed procedures (including in respect of securities transferred electronically through the FASTER system).

Reform of the Law relating to Future Exchanges and Clearing and Settlement System (POL (07) 382) Publicity Items 89 & 90

It is important to ensure that there is a clear conceptual separation between the Emissions Trading Scheme (which provides a register of ownership of interests in emissions units) and the proposals in this paper (which relate to improvements to the regulatory environment for futures exchanges and clearing and settlement systems more generally).

Therefore, I do not intend to issue a general media release; however I will communicate Cabinet's decisions to NZX in order to provide them with the assurance they require to continue development of the TZ1 emissions trading platform

Computershare New Zealand would like to meet with MED to ensure we fully understand the full implications of proposed legislation, before providing a final comment on the 'no requirement for registries to be part of a designated settlement system'.

Finally, given the significance and depth of changes to the industry we believe a longer consultation period would be in the best interests of the industry as a whole, together with, direct involvement from key stakeholders.

Yours faithfully

Barbara Baker
Director Business Development Asia Pacific