

BELL GULLY



# Derivatives

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JUNE 2008

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## FOREWORD

Lawyers providing legal services to financial market participants must be aware of the concerns commonly raised by those who are unfamiliar with the domestic legal system. We have prepared this publication primarily to address the issues that, in our experience, are typically raised by overseas entities seeking to carry out derivatives-related activities in New Zealand or with a New Zealand counterparty. This publication should also assist those who already have some experience with the New Zealand derivatives industry.

This publication is prepared on the basis of the law in force in New Zealand as at 1 June 2008. Bell Gully may update this publication from time to time when significant changes are made to the relevant law.

If you would like further information on issues addressed in this publication, Bell Gully or the Bell Gully Derivatives Group, please do not hesitate to contact any of the Derivatives Group members profiled below.

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## THE BELL GULLY DERIVATIVES GROUP

Bell Gully has the leading derivatives law practice in New Zealand. Bell Gully has a team of partners and solicitors in both the Wellington and the Auckland offices who specialise in derivatives law. A brief profile of the partners who are members of this team is set out on page V.

### Areas of expertise

The Bell Gully Derivatives Group advises on a full range of derivatives issues including:

- documentation for OTC transactions;
- regulation of OTC and exchange-traded transactions;
- netting;
- collateralisation;
- litigation;
- general enforceability;
- structured products;
- dealing with fund managers;
- conflict of laws;
- payment and clearing systems for derivative transactions;
- the use of the Internet and Internet-based platforms to enter into and advise on derivative transactions; and
- taxation.

### Experience

The Bell Gully Derivatives Group has an established track record in advising on derivatives matters that is unrivalled by any other New Zealand firm. For example, Bell Gully:

- is a member of the International Swaps and Derivatives Association, Inc. (ISDA);
- acts as New Zealand counsel to ISDA, including providing:
  - the New Zealand law netting opinion on the ISDA master agreements; and
  - the New Zealand law collateral opinion on the ISDA credit support documents;
- provides the New Zealand law netting opinions to a number of other international industry and sponsor organisations, such as:
  - The Futures and Options Association (UK), on the FOA master netting agreement;
  - the International Capital Market Association, on the global master repurchase agreement;
  - the British Bankers' Association, the Members of the Foreign Exchange Committee (US) and the Canadian Foreign Exchange Committee, on the IFEMA, ICOM and FEOMA master agreements; and
  - the Securities Lending and Repo Committee (UK), on the overseas securities lender's agreement;
- acts for the New Zealand Bankers' Association (NZBA) in preparing standard form documents widely used in the New Zealand derivatives market;

- acts for the NZBA in relation to the restructuring of New Zealand's payment systems, and related documentation, rules and procedures;
- acts for the New Zealand Financial Markets Association (NZFMA), including assisting in the NZFMA's dealer accreditation process;
- acts for a group consisting of the major electricity generators/retailers in preparing standard form documents used in the electricity derivatives market;
- acts for CLS Bank International in connection with the settlement within the CLS System of NZ\$ FX transactions;
- has advised various Government departments on issues relating to the trading of carbon credits;
- has acted for a financial institution made subject to statutory management (including advising on proceedings brought against an overseas counterparty in relation to currency swaps);
- has acted for the NZBA and, as special counsel, for the Reserve Bank of New Zealand, New Zealand's central bank, in connection with New Zealand's netting legislation; and
- routinely advises domestic and international financial institutions and end-users on documentation and other derivatives issues.

Members of the Bell Gully Derivatives Group regularly publish articles and lead seminars on derivatives-related issues.

## **DERIVATIVES GROUP MEMBERS**

### **Wellington Office**



#### **David Craig**

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**QUALIFICATIONS**

LLB(Hons), BCA, Victoria University of Wellington

**ADMITTED**

1990 New Zealand

David Craig is a partner in the firm's financial services department. He has practised both in New Zealand and with Cravath, Swaine & Moore in New York. He specialises in banking, finance and derivative transactions.

### **Auckland Office**



#### **Jonathan Ross**

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LLB(Hons), Victoria University of Wellington

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1980 New Zealand

1982 New York

Jonathan Ross is a partner in the firm's commercial department. He has practised in New York, London and New Zealand. He regularly advises domestic and international financial institutions on netting and derivatives issues.

## 1 REGULATION

New Zealand has one of the world's most deregulated economies. The regulation of New Zealand's financial sector is, by comparison to that of, say, the United States, the United Kingdom or Australia, light-handed.

There are nevertheless a number of regulatory issues of which an entity proposing to carry out derivatives-related activities in New Zealand or with a New Zealand counterparty must be aware. These regulatory issues are outlined below. Some of the issues may only be applicable in exceptional circumstances, if at all. We refer to them because it is our experience that they have an equivalent in many overseas jurisdictions. These equivalent regulatory issues are frequently encountered by overseas entities in their home jurisdiction. When seeking New Zealand legal advice, overseas entities expect a commentary on the extent to which the same issues arise in New Zealand.

### 1.1 Securities Act

The Securities Act 1978 regulates certain securities offerings in New Zealand by requiring disclosure to potential investors of specified information relating to the securities and their issuer. The Securities Act applies to an offer of securities to the public for subscription. The two main issues are whether a derivative transaction involves the offer of a "security" and, if so, whether the offer is to "the public".

#### "Security"

It is unclear which derivative transactions involve the offer of "securities" for the purposes of the Securities Act. There is no directly applicable New Zealand case law that considers this issue.

The Securities Act defines a "security" as an "interest or right to participate in any capital, assets, earnings, royalties, or other property of any person". This definition is wide. New Zealand courts are reluctant to read down the term. Broadly, if a derivative transaction is a security, it will be one of three types:

- a *debt security*, which is defined to mean "any interest in or right to be paid money that is, or is to be, deposited with, lent to, or otherwise owing by, any person"; or
- an *equity security*, which is defined to mean "any interest in or right to a share in, or in the share capital of, a company"; or
- as a residual category, a *participatory security*, which is defined to mean all securities that are not debt securities, equity securities or one of the other types of security specified in the Securities Act.

Generally, the risk that a derivative transaction is classified as a security is greater if the transaction is physically-settled rather than cash-settled. This is particularly so where the underlying asset is a share. For example, a cash-settled share option should not be a security but a physically-settled share option is an equity security.

Given the broad definition of "security" and the reluctance of the New Zealand courts to read down the term, the prudent approach is that some derivative transactions (such as repos, physically-settled options and, perhaps, currency swaps) entered into with New

Zealand counterparties are “securities” in terms of the Securities Act. The specific issues are complex and are beyond the scope of this publication.

Under draft legislation recently circulated but not yet introduced into Parliament, “emissions units” will be excluded from the definition of “security”. However, the legislation is silent on the classification of emissions units *derivatives*. They would, therefore, be subject to the same analysis that applies to derivatives generally.

#### “The public”

If a derivative transaction involves the offer of a “security”, the Securities Act applies if that offer is made to “the public”. This term is not defined, but the Securities Act contains guidelines on its construction.

The Securities Act contains a private placement safe harbour, which excludes from the definition of “the public” persons whose principal business is the investment of money or who, in the course of and for the purposes of their business, habitually invest money. This safe harbour (for what is, in effect, institutional investors) should apply to most OTC derivative transactions that are entered into with New Zealand wholesale counterparties.

Nevertheless, care must be taken to ensure that New Zealand counterparties are in practice institutional investors of this kind. Also, it is unlikely that natural persons (such as high net-worth individuals) qualify under this safe harbour. Therefore, entities entering into derivative transactions with individuals in New Zealand should seek advice on the applicability of *other* Securities Act exceptions. For example, there are separate exceptions applicable where the investors are “wealthy” or “experienced in investing money” within the meaning set out in the Securities Act.

#### Registered banks exemption

Under the Securities Act (Registered Banks Futures Contracts) Exemption Notice 2007, a registered bank can avoid the Securities Act’s disclosure rules in relation to OTC “futures contracts” (which would likely cover most cash-settled derivatives). A condition of this exemption is that the bank must prepare a disclosure document for the relevant products containing certain prescribed information.

## 1.2 Securities Markets Act (investment advisers)

Part 4 of the Securities Markets Act 1988 requires the formal disclosure of certain matters by those who provide investment services to the public. It also regulates advertising by those persons. Generally, this regime should not be applicable to an entity that merely enters into derivative transactions with a New Zealand counterparty at arm’s length. However, where an entity takes on an advisory role, this regime could apply.

The Securities Markets Act applies when an investment adviser or an investment broker gives investment advice or receives investment money or investment property. These issues are considered in the following paragraphs.

#### “Investment adviser”

An investment adviser is a person who, in the course of business, gives a recommendation, opinion or guidance to a member of the public in relation to buying or selling securities.

Investment advice does not include guidance about the procedure for buying or selling securities.

#### **“Investment broker”**

An investment broker is a person who, in the course of business, receives investment money or investment property.

Investment money is money received from, or on account of, a member of the public in relation to buying or selling securities. Investment property is security certificates or other valuable property received from, or on account of, a member of the public for the same purpose.

#### **“The public”**

The definition of “the public” is central to the investment advisers disclosure regime.

The meaning of “the public” for the purposes of both the Securities Act and the Securities Markets Act is similar (but not identical). In particular, the institutional investor safe harbour in the Securities Act applies correspondingly to the term “the public” in the Securities Markets Act.

However, even if certain derivative transactions are “securities” and are offered to “the public”, the Securities Markets Act will not apply to a counterparty to the extent it is regarded as the issuer of those securities.

#### **Territorial scope**

Part 4 of the Securities Markets Act applies regardless of where the investment adviser or investment broker carries on business. It is sufficient that the advice or service is offered to a person in New Zealand, unless the investment adviser or investment broker can show it took all reasonable steps to prevent this.

### **1.3 Gaming**

The new Gambling Act 2003 came into force on 1 July 2004. Unlike the old Gaming and Lotteries Act 1977, which adopted the common law concept of a wagering contract, the Gambling Act defines and governs “gambling”. Broadly, unauthorised gambling is prohibited and is illegal. In the context of derivative transactions, “gambling” (under the Gambling Act) is at least as troublesome as “wagering contract” (at common law).

Unfortunately, the Parliamentary Select Committee that considered the Gambling Act chose to ignore submissions recommending that derivatives be expressly excluded from the application of the Gambling Act. However, what is worse is that, in doing so, the Committee acknowledged that the broad definition of gambling can catch financial transactions that are not generally considered to be gambling. The Committee considered that any exemption for these transactions should be contained in separate legislation that deals with new products as they are introduced. This is little comfort for existing products. Furthermore, new products are unlikely to be accompanied by legislation in which such an exemption could be included.

Therefore, until the matter is clarified by further legislation or by case law, the issue remains that derivative transactions could be challenged as being unauthorised and illegal gambling.

## 1.4 Carrying on business in New Zealand

The Companies Act 1993 requires an overseas company that carries on business in New Zealand to register under Part 18 of that Act. The term “carrying on business in New Zealand” is not defined in the Companies Act. The Companies Act nevertheless gives guidelines as to the meaning of this term by specifying a non-exhaustive list of circumstances that do, and circumstances that do not, constitute carrying on business in New Zealand.

It is unlikely that an overseas company would be carrying on business in New Zealand merely by entering into, or settling, derivative transactions with a small number of New Zealand counterparties. However, if an overseas company proposes to expand its activities in New Zealand by establishing a place of business in New Zealand or by appointing agents to conduct its business in New Zealand, it should seek advice on the application of Part 18 of the Companies Act.

## 1.5 Overseas Investment Act

The Overseas Investment Act 2005 regulates overseas investment in New Zealand. The Act requires overseas persons to obtain consents in specified circumstances. The term “overseas person” includes:

- a company incorporated outside New Zealand; and
- a New Zealand company at least 25% owned or controlled by a company incorporated outside New Zealand.

Under the Overseas Investment Act, an overseas person must obtain consent from the Overseas Investment Office if:

- the overseas person acquires a 25% or more ownership or control interest in a New Zealand company and the value of those securities or the consideration provided by the overseas person, or the value of the assets of the New Zealand company, exceeds NZ\$100 million; or
- the overseas person establishes a business in New Zealand for a period exceeding 90 days in any year and the total expenditure expected to be incurred, prior to the commencement of the business, in establishing that business exceeds NZ\$100 million; or
- the overseas person acquires any property in New Zealand used in carrying on business in New Zealand where the total value of the consideration provided exceeds NZ\$100 million.

The entry by an overseas person into derivative transactions with New Zealand counterparties should not, by itself, result in that overseas person requiring consent under the Overseas Investment Act. However, as with Part 18 of the Companies Act (see 1.4), any overseas person expanding its New Zealand activities should seek advice on the application of the Overseas Investment Act.

## 1.6 Securities Markets Act (futures dealing)

Part 3 of the Securities Markets Act regulates dealings in futures contracts and the operation of a futures market or futures exchange.

### Dealing in futures contracts

This regime is intended primarily to regulate dealers in *exchange-traded derivatives*. However, Part 3 is regrettably obscure in its application to OTC derivatives. That said, some of the authorisations granted, and discussion documents issued, by the Securities Commission indicate the Commission's view that the regime *does* apply to dealers in OTC derivatives.

Section 38(1) of the Securities Markets Act provides that:

No person shall carry on the business of dealing in futures contracts unless that person is, or is a member of a class of persons that is, authorised by the [Securities] Commission by notice in the *Gazette* to carry on the business of dealing in futures contracts.

The two central concepts in section 38(1) are “futures contracts” and “dealing”.

#### “Futures contracts”

Section 37(1) of the Securities Markets Act defines “futures contract”. This term includes cash-settled forward transactions, contracts for differences and certain types of options. Section 37(2) excludes from the definition of “futures contract” currency and interest rate swaps and forward interest rate and forward exchange rate agreements to which a New Zealand registered bank is a party.

Under draft legislation not yet before Parliament, it is proposed to extend the definition of “commodity” (a key component of the “futures contracts” definition) to expressly include “emissions units”. Consequently, most cash-settled carbon credit derivatives will be “futures contracts” for the purposes of the Securities Markets Act.

#### “Dealing”

Section 37(5) of the Securities Markets Act provides that a person “deals in a futures contract” if that person:

- (a) Acquires or disposes of the futures contract on behalf of another person; or Offers to acquire or dispose of the futures contract on behalf of another person; or
- (b) On behalf of another person induces, or attempts to induce, a person to acquire or dispose of the futures contract; or
- (c) Advises or assists a person in connection with the acquisition or disposition of the futures contract; or
- (d) Does any other act or engages in conduct declared by the [Securities] Commission by notice in the *Gazette* to constitute dealing in a futures contract for the purposes of this Part of...[the Securities Markets] Act.

It is clear from this definition that “dealing” extends beyond its normal meaning. That said, entities that enter into futures contracts with New Zealand counterparties solely as principal and without assuming any advisory capacity should not be subject to this regime.

#### Authorisation for registered banks

Under the Authorised Futures Dealers Notice (No 3) 2007, registered banks are authorised to deal in OTC “futures contracts” (which, as stated in 1.1, would likely cover most cash-settled derivatives). This authorisation is the Securities Markets Act equivalent of the Securities Act exemption outlined in 1.1. Like that exemption, this authorisation requires

the preparation of a disclosure document for the relevant products. Certain other conditions also apply.

### Operating a futures market or futures exchange

Part 3 of the Securities Markets Act also prohibits:

- any person (other than an authorised futures exchange) carrying on business in New Zealand:
  - using a style or title including the words “futures exchange” or “futures market”;
  - or
  - stating or implying that the person is an authorised futures exchange or operates a futures market or futures exchange that is regulated under New Zealand law; and
- designated persons conducting a futures market or futures exchange in New Zealand.

## 1.7 Credit contracts

The Credit Contracts and Consumer Finance Act 2003 (the CCCFA) regulates the provision of credit under “credit contracts”. The definition of “credit contract” may include certain types of derivative transactions (in particular, those that involve an upfront payment by one party and subsequent payments by the other party totalling more than that upfront payment).

The CCCFA contains provisions relating to, for example, the conduct of the parties to a credit contract. It also requires the creditor to disclose certain contractual terms to the debtor (although this disclosure regime is unlikely to apply in these circumstances).

The application of the CCCFA cannot be excluded merely by selecting a foreign (i.e., non-New Zealand) governing law. If a “credit contract” has a substantial connection with New Zealand (such as, perhaps, a New Zealand counterparty), the CCCFA potentially applies.

## 1.8 Insurance

The Insurance Companies’ Deposits Act 1953 requires every company (whether domestic or overseas) carrying on any class of insurance business in New Zealand to lodge a NZ\$500,000 deposit with the Public Trust. If a person fails to comply with the requirements of that Act, and that failure continues for a period of three months, that person may be prohibited from carrying on insurance business in New Zealand (either indefinitely or for a fixed period).

In addition, the Insurance Companies (Ratings and Inspections) Act 1994 requires those carrying on insurance business in New Zealand to obtain, and register, a current credit rating from an approved agency. The insurer is required to disclose its rating to each customer prior to entry into a contract of insurance. If it fails to do so, the customer is entitled to cancel the contract within 20 working days of its execution.

All of this raises the obvious question of whether derivative transactions are insurance contracts. While certain products (notably, credit derivatives and longevity/mortality and catastrophe products) are more at risk than others, it should be possible to structure any derivative transaction in a manner that minimises this risk to an acceptable level.

## 1.9 Exchange control

There are no foreign exchange controls in force in New Zealand.

## 1.10 Regulation of equity investments

In the case of physically-settled equity derivatives or derivatives collateralised with equities, the following regimes may be applicable if the equities are issued by a New Zealand issuer:

- restrictions on foreign ownership in the constitution of the New Zealand issuer (which are rare);
- Part 2 of the Securities Markets Act (which requires substantial security holders in a listed company to publicly disclose certain information). This regime has recently been discussed in detail, in the context of equity swaps, in *Perry Corporation v Ithaca (Custodians) Limited*;
- the Overseas Investment Act (see 1.5);
- the Takeovers Code;
- the New Zealand Stock Exchange Listing Rules (if the equities are listed on the NZSX);
- the Commerce Act 1986 (which regulates certain business acquisitions having anti-competitive consequences); and
- the insider trading regime in Part 1 of the Securities Markets Act (the application of this regime to futures contracts is outlined in 1.11).

Generally, these regimes only apply where the underlying equities to which the transaction relates are a certain proportion of the total number of those equities on issue. For example, a substantial security holder under Part 2 of the Securities Markets Act is a person having a relevant interest in at least 5% of the shares of a listed company.

## 1.11 Securities Markets Act (insider trading)

Part 1 of the Securities Markets Act prohibits certain conduct by “information insiders” of NZX-listed companies. In particular, subject to certain exceptions, information insiders may not trade, tip, or advise or encourage trading in securities of such a company. The fact that the conduct may occur outside New Zealand is irrelevant, provided that it relates to dealings in securities that occur (at least in part) in New Zealand. There are criminal sanctions for contravening these rules.

The rules also cover insider conduct in relation to futures contracts listed on an authorised futures exchange. This is a significant change from the pre-2008 insider trading legislation, which focused solely on dealings in shares.

## 1.12 Use of the Internet

A growing number of entities are looking to the Internet as a cheap and effective way of promoting their derivatives capabilities, providing advice and, ultimately, entering into transactions. While we have given extensive advice on the issues raised in New Zealand where the Internet and Internet trading platforms are used, these issues are complex and beyond the scope of this publication.

### 1.13 Impending law reform

A substantial and wide-ranging review of financial services law is currently underway in New Zealand. The Ministry of Economic Development is leading this review and hopes to have legislation enacted in 2008, with the new regulatory infrastructure to be in place by 2010 and a two-year transition period to follow.

This reform will affect all entities (both local and overseas) that carry out derivatives-related activities in New Zealand.

#### Financial Service Providers (Registration and Dispute Resolution) Bill

The cornerstone of this reform is contained in the Financial Service Providers (Registration and Dispute Resolution) Bill (the **FSP Bill**).

The FSP Bill:

- sets up a registration system for financial service providers; and
- establishes a comprehensive, industry-based dispute resolution system.

#### *Registration*

Currently, the only financial service providers with registration requirements are banks, futures dealers, superannuation schemes, building societies, industrial and provident societies, friendly societies, credit unions and contributory mortgage brokers. There is no current registration regime for derivative counterparties. However, if the FSP Bill is enacted in its current form, anyone in the business of providing a “financial service” or a “financial adviser service” will need to register.

“Financial service” is defined widely to include, among other things:

- borrowing and lending money;
- managing money or securities on behalf of others;
- providing retail financial leases;
- operating money transfer or FX services;
- underwriting or placing insurance;
- issuing or underwriting securities or acting as a trustee or manager for an issue of securities;
- issuing means of payment (such as credit and debit cards); and
- *entering into derivatives.*

A financial service provider cannot provide a financial service unless that person is registered under the FSP Bill. The main requirements for registration are that the person or its controlling owners, directors and senior managers are not otherwise disqualified (e.g., by virtue of being bankrupt or the subject of certain banning orders or criminal convictions) and that the person is a member of an approved dispute resolution scheme (an **ADRS**).

The registration process will be overseen by the new Registrar of Financial Service Providers and Financial Advisers – initially the Registrar of Companies. The register will be kept in electronic form and will be searchable by the public.

*Dispute resolution*

The FSP Bill will establish a comprehensive, industry-based dispute resolution system, the key features of which are that:

- the relevant Minister may approve a dispute resolution scheme if it meets specified criteria; and
- membership of an approved dispute resolution scheme will be mandatory for financial service providers who transact with natural persons and small businesses (defined as those with no more than 19 employees).

It is expected that more than one scheme will be approved, and that financial service providers will be able to elect which scheme to join. The system is to be funded by industry participants. However, there will be a reserve scheme, for financial service providers who are not members of an approved scheme, which will be funded by a levy on members.

**Financial Advisers Bill**

A related piece of legislation is the Financial Advisers Bill (the **FA Bill**). This Bill does two main things:

- imposes statutory conduct obligations and statutory disclosure obligations on financial advisers; and
- establishes a co-regulatory regime for financial advisers, to be overseen by the Securities Commission and industry-based approved professional bodies (**APBs**) (although the Government has recently announced that it is considering a regime under which the Securities Commission would be the sole regulator).

The FA Bill prohibits a person from performing a “financial adviser service” for a member of the public unless that person is registered under the FSP Bill and is a member of an APB. The definition of “financial adviser service” is the key to the FA Bill’s application. Broadly, a “financial adviser service” is the giving of a recommendation, opinion or guidance to a member of the public on financial products or borrowing or investment decisions. The term also includes the handling of money in connection with a financial decision.

Owing to the broad definition of “financial adviser service”, the FA Bill will have considerably wider scope than the equivalent regime currently embodied in the Securities Markets Act (outlined in 1.2). That regime applies only to the provision of investment advice, or the receipt of investment money, in relation to securities. This broader scope under the FA Bill will lead to uncertainties about the point at which a financial service provider’s role crosses over into this new regime.

In part because of these uncertainties, the Government has recently announced that it is considering restricting the definition of “financial adviser” to persons whose primary business is the provision of financial advice or who regularly provide such advice in the course of their business.

*Statutory conduct obligations*

These include:

- the obligation to act with integrity;
- the obligation to exercise reasonable care, diligence and skill;
- a prohibition on engaging in misleading or deceptive conduct; and
- money handling and trust accounting requirements.

*Statutory disclosure obligations*

These include the requirement to disclose upfront in a disclosure statement:

- the adviser's experience, qualifications and professional standing;
- the name of the APB and ADRS of which the adviser is a member;
- whether the adviser has been convicted of certain criminal offences;
- fees; and
- potential conflicts of interest, including commissions.

## 2 NEW ZEALAND COUNTERPARTIES — CAPACITY AND AUTHORITY

### 2.1 Companies

#### Capacity

The principal constitutive document for a company incorporated under the Companies Act is its constitution. A company may, but is not required to, have a constitution. If a company does not have a constitution, its affairs are regulated wholly by the Companies Act. If a company does have a constitution, then that constitution may, to the extent permitted by the Companies Act, negate or modify the provisions of the Companies Act.

Section 16 of the Companies Act specifies the capacity of a company. Section 16(1) provides that a company has:

- (e) Full capacity to carry on or undertake any business or activity, do any act, or enter into any transaction; and
- (f) For the purposes of paragraph (a)...., full rights, powers and privileges.

Section 16(2) provides that a constitution may contain a provision relating to the capacity of the company but only if the provision restricts that capacity.

In addition, section 17(1) provides that:

No act of a company and no transfer of property to or by a company is invalid merely because the company did not have the capacity, the right, or the power to do the act or to transfer or take a transfer of the property.

It is generally agreed that the intention of this provision is to abolish the doctrine of *ultra vires* with respect to companies. However, it is not entirely clear whether it does so in all circumstances (e.g., where the company's counterparty is aware of the lack of capacity).

#### Authority

Under New Zealand law, a company acts through the persons who represent it. These persons act as the agents of the company. To bind the company, an agent must have authority to act on the company's behalf.

Authority is of three types: express, implied and ostensible. Express authority is typically set out in the company's constitution and conferred by board resolution and internally delegated authorities. Implied authority exists by virtue of the position occupied by the agent and the surrounding circumstances. Ostensible authority exists where the company represents that the agent has authority to perform a particular act.

In all three situations, the company is bound by the acts of its agent.

Section 18(1) of the Companies Act sets out certain rules dealing with authority. Third parties dealing with companies are entitled to assume that the company's internal requirements (for example, treasury authorities) have been complied with (the so-called indoor management rule). In broad terms, this rule prevents a company from asserting against a third party dealing with the company that one of the company's agents (e.g., the relevant officer authorising the entry into the derivative transaction) did not have authority

to bind the company. That protection does not apply where the third party dealing with the company knew, or ought to have known, of that lack of authority.

Notwithstanding this protection, most New Zealand and overseas entities, when dealing with New Zealand companies, require evidence of the authority of the person acting on behalf of the company, both in executing a master agreement and in entering into derivative transactions under it. Counterparties often seek written evidence in the form of a certificate from an appropriate company officer (often, a director) of the continued authority of the company's representatives with whom it deals to act on the company's behalf.

## **2.2 Banks, insurance companies and other financial institutions**

There are no specific laws or regulations regulating banks or insurance companies in New Zealand that apply in this derivatives context.

Most New Zealand banks, insurance companies and other financial institutions are companies incorporated under the Companies Act. Where this is the case, the discussion above in relation to the capacity and authority of companies incorporated under the Companies Act is relevant.

In the case of life insurance companies, the Life Insurance Act 1908, while not affecting capacity or authority in the strict sense, nevertheless gives rise to important considerations for any prospective counterparty.

## **2.3 Government- or state-owned corporations**

Most New Zealand government- or state-owned entities will be state-owned enterprises or statutory corporations.

### **State-owned enterprises**

State-owned enterprises are subject to the State-Owned Enterprises Act 1986. That Act requires state-owned enterprises to have what is known as a statement of corporate intent which, in broad terms, sets out the corporate purposes of the state-owned enterprise. Directions may also be provided to the state-owned enterprise by relevant Government ministers.

However, state-owned enterprises will in general also be companies under the Companies Act. Issues of capacity and authority will, therefore, be resolved in the same manner as for any other company.

### **Statutory corporations**

By contrast, statutory corporations derive their corporate existence from specific New Zealand statutes.

When dealing with a statutory corporation, the legislation under which the statutory corporation is established must be considered in each case. A statutory corporation's contractual capacity is generally limited to the exercise of those powers that are expressly conferred by, or may reasonably be implied from, the language of the relevant empowering or constitutive statute. If the statute limits the powers of the statutory corporation, then a contract made outside the scope of those powers is void. In addition, those powers must in

general be exercised in furtherance of the specific statutory functions of the statutory corporation.

In *Hazell v Hammersmith and Fulham London Borough Council* [1991] 1 All ER 545 (HL), the UK House of Lords held that the council in that case, which was a body corporate under English local government legislation, had no power to enter into swap contracts and other hedging contracts and that those that it had entered into were unlawful. That decision cast considerable doubt under New Zealand law at the time on the ability of statutory corporations to enter into derivative transactions.

The *Hammersmith* issue has, to some extent, been addressed now that the Crown Entities Act 2004 is in force. That Act is an umbrella statute that provides generic rules for all Crown entities (which includes statutory corporations). In particular, the Act contains a comprehensive definition of derivative transaction and, subject to a number of exceptions (including those set out in the Crown Entities (Financial Powers) Regulations 2005), a general prohibition on Crown entities entering into derivative transactions.

## 2.4 Partnerships

### Ordinary partnerships

Under New Zealand law, an ordinary partnership is not a separate legal entity. Accordingly, any derivative transaction entered into by an ordinary partnership is entered into by the individual partners (or a nominee of the partnership). The capacity issue is, therefore, twofold. First, each partner must have the *capacity* to enter into derivative transactions. Secondly, the agreement constituting the partnership should authorise entry into these derivative transactions.

In principle, the issue of the *authority* of an individual person to enter into a trade on behalf of an ordinary partnership should be dealt with in the same manner as for a company.

### Limited partnerships

By contrast, a limited partnership established under the new Limited Partnerships Act 2008 is a separate legal entity. Issues of capacity and authority are dealt with in the same manner as for a company.

## 2.5 Mutual funds, hedge funds and other trusts

Like a partnership, a trust is not a separate legal entity. In effect, a trust relies on an agent (the trustee) to enter into derivative transactions on its behalf. If derivative transactions are authorised under the trust's constituting documents (usually a trust deed), the trustee has recourse to the trust fund for obligations arising out of the derivative transactions.

Accordingly, if an entity enters into derivative transactions with a trustee on behalf of a trust, the trust deed must be reviewed to determine capacity. Also, Part 2 of the Trustee Act 1956, which sets out the general investment powers of trustees, may be relevant. Moreover, depending on the type of trust fund or the type of trustee involved, the Superannuation Schemes Act 1989, the Unit Trusts Act 1960 or the Trustee Companies Act 1967 may also be relevant.

Complex legal issues arise when derivative transactions are entered into with trustees (in particular, trustees who appoint fund managers as agents to enter into derivative

transactions in relation to the underlying trust funds). These issues are beyond the scope of this publication.

## **2.6 Local authorities**

The ability of local authorities to enter into derivative transactions is not straightforward. The reasons are similar to those outlined above in relation to statutory corporations.

Section 12 of the Local Government Act 2002 confers on local authorities broad powers to enter into any transaction for the purposes of performing its role. However, there are restrictions on the capacity of local authorities to enter into incidental arrangements (which are defined to include certain derivative transactions). Most importantly, no local authority may enter into incidental arrangements, within or outside New Zealand, in currency other than New Zealand currency. This restriction appears to apply whether the local authority is paying or receiving the foreign currency under the incidental arrangement.

## 3 CONTRACTUAL FORMALITIES

### 3.1 Formation

Under New Zealand's conflict of laws rules, whether a contract is validly formed should be governed by the putative proper law of the contract (i.e., the law that would be the proper law if the contract came into effect). As a New Zealand court should, in the absence of exceptional circumstances, recognise the express choice of law of a master agreement, the putative proper law of a derivative contract with a New Zealand counterparty should be the governing law of the relevant master agreement.

### 3.2 Form of contract

Under New Zealand law, contracts may be written or oral, or partly written and partly oral. Certain kinds of contracts are required to be in writing (e.g., a guarantee). A derivative transaction entered into under a master agreement is not required to be in writing.

Oral agreements are valid and binding under New Zealand law unless they constitute an agreement that is required to be in writing. There may, however, be evidential difficulties in proving both the fact of an oral agreement and its terms. In practice, this evidential difficulty is overcome by the recording of telephone conversations between dealers or by other confirmations. If telephone conversations are to be recorded, we recommend that the prior consent of the counterparty be obtained (typically, in the master agreement).

### 3.3 Execution

The appropriate form of execution by a New Zealand counterparty depends on the nature of the entity.

#### Companies

Section 180(1) of the Companies Act sets out the manner in which companies may enter into contracts. Section 180(1) applies whether or not the contract is entered into in New Zealand and whether or not it is governed by New Zealand law.

No particular form of execution is required for a New Zealand company:

- to execute a master agreement; or
- to confirm a derivative transaction in writing.

However, it is common in New Zealand to require that:

- a New Zealand company execute a master agreement under the name of the company by two of its directors; and
- a confirmation of a derivative transaction should be signed under the name of the company by a person on a list of authorised signatories.

#### Other counterparties

In the case of other kinds of counterparty, such as statutory corporations, trusts or partnerships, this issue must be considered in the context of the relevant empowering or constitutive documents for each counterparty. Those documents may include an Act of Parliament (in the case of a statutory corporation), a trust deed (in the case of a trust) or a

partnership deed (in the case of a partnership). Also, section 13 of the Property Law Act 2007 (which applies broadly to contracts or other obligations entered into by a “body corporate”) may be relevant.

## 4 NETTING

New Zealand is a netting-friendly jurisdiction. New Zealand's insolvency laws, and in particular its insolvency set-off provisions, are creditor- rather than debtor-friendly. Those laws and provisions permit the termination of contractual obligations and, in the case of a corporate insolvency, favour the orderly and efficient liquidation of the debtor's affairs.

New Zealand's insolvency laws are similar to other jurisdictions, most relevantly England and Australia, which are based on a similar creditor- rather than debtor-friendly philosophy.

### 4.1 Close-out netting

Our experience is that, of the various types of netting, the enforceability of bilateral close-out netting invariably most concerns counterparties. Close-out netting typically embodies three distinct concepts:

- first, the termination of all outstanding transactions as at the termination date;
- secondly, the valuation of those transactions as at that date; and
- thirdly, the aggregation of the (positive or negative) value of each transaction to produce a single net settlement amount payable to the in-the-money party.

The issue of the enforceability of close-out netting will most likely arise when a counterparty is, or is about to become, subject to an insolvency regime. In New Zealand, there are a number of insolvency regimes to which a counterparty may be made subject. These include:

- liquidation under the Companies Act;
- compromise under the Companies Act;
- voluntary administration under the Companies Act;
- statutory management under the Corporations (Investigation and Management) Act 1989;
- statutory management under the Reserve Bank of New Zealand Act 1989 (in the case of banks registered under that Act);
- judicial management under the Life Insurance Act 1908 (in the case of an entity that issues life insurance policies in New Zealand); and
- receivership under the Receiverships Act 1993.

Of these insolvency regimes, the most significant for the purposes of considering the enforceability of close-out netting are liquidation, administration and statutory management.

### 4.2 Liquidation

Sections 310A to 310O of the Companies Act provide that, notwithstanding certain provisions to the contrary in that Act, the net settlement amount calculated as being due under a netting agreement (referred to as the netted balance) is the amount that is due to or from the insolvent counterparty.

Netting agreements are of two types: bilateral netting agreements and recognised multilateral netting agreements.

## Bilateral netting agreement

A bilateral netting agreement is:

an agreement that provides, in respect of transactions between 2 persons to which the agreement applies, -

- (a) that on the occurrence of an event specified in the agreement, all or any of those transactions must (or may, at the option of a party) be terminated; and
  - (i) an account taken of all money due between the parties in respect of the terminated transactions; and
  - (ii) all obligations in respect of that money satisfied by payment of the net amount due from or on behalf of the party having the net debit to or on behalf of the party having a net credit; or
- (b) that each transaction is to be debited or credited to an account with the effect that the rights and obligations of each party that existed in respect of the relevant account prior to the transaction are extinguished and replaced by rights and obligations in respect of the net debit due on the relevant account after taking into account that transaction; or
- (c) that amounts payable by each party to the other party are to be paid or satisfied by payment of the net amount of those obligations by the party having a net debit to the party having a net credit;

but does not include any bilateral netting agreement that is part of a multilateral netting agreement.

Essentially, a bilateral netting agreement is a written agreement between two persons that provides for any of three different types of netting: close-out netting, netting by novation or payments netting. Most of the standard form master agreements commonly used in OTC derivatives markets should constitute a bilateral netting agreement. However, an important qualification is that there must be no walkaway provision in the agreement (such as the First Method in the 1992 ISDA master agreements).

## Recognised multilateral netting agreement

A recognised multilateral netting agreement is a multilateral netting agreement in respect of which the clearing house is declared by the Reserve Bank of New Zealand, New Zealand's central bank, to be a recognised clearing house. In turn, a multilateral netting agreement is:

an agreement that provides for the settlement, between more than 2 persons, of payment obligations arising under transactions that are subject to the agreement, and that provides, in respect of transactions to which it relates, that debits and credits arising between the parties are to be brought into account so that amounts payable by or to each party are satisfied by, -

- (a) Payment by or on behalf of each party having a net debit to or on behalf of a clearing house (whether as agent or as principal) or a party having a net credit; and

- (b) Receipt by or on behalf of each party having a net credit from or on behalf of a clearing house (whether as agent or as principal) or a party having a net debit.

In contrast to the equivalent legislation in a number of other jurisdictions, a netting agreement does not need to be entered into between particular types of counterparty or to relate to particular types of transactions in order to qualify for protection under the Companies Act.

### 4.3 Administration

The position in the case of the administration of a New Zealand counterparty is essentially the same as in a liquidation. In particular, the netting provisions outlined in 4.2 (which apply in a liquidation) are substantially duplicated in the administration regime.

### 4.4 Statutory management

New Zealand's two statutory management regimes are substantially similar. The discussion below focuses only on the regime set out in the Corporations (Investigation and Management) Act.

Statutory management under the Corporations (Investigation and Management) Act creates a moratorium in relation to the affairs of the New Zealand counterparty made subject to statutory management. This moratorium provides that no person may, among other things:

- take any action or other proceedings against the party made subject to statutory management; or
- apply or resolve to put that party into liquidation; or
- transfer, or remove from New Zealand, any property or assets of that party; or
- exercise any right of set-off against that party.

In addition, the statutory manager is, notwithstanding any single agreement provision in a master agreement, able to suspend the obligation of the New Zealand counterparty made subject to statutory management to pay any amount or deliver any property, notwithstanding the terms of the master agreement.

However, section 42(7) of the Corporations (Investigation and Management) Act provides that none of the moratorium provisions (in particular, the provision preventing the exercise of rights of set-off) prevent the exercise of the close-out netting provisions in a netting agreement as defined in the Companies Act.

### 4.5 Limitations of protection for netting agreements

It is perhaps as important for entities to appreciate the limitations of the protection for netting agreements as it is to appreciate the benefits. Some of these limitations are listed below:

- A liquidator or statutory manager of a New Zealand counterparty is still able to challenge the validity of transactions entered into under a netting agreement. For instance, these transactions continue to be vulnerable to the provisions in the Companies Act dealing with transactions having preferential effect and transactions at undervalue.

- New Zealand's netting legislation does not apply to statutory corporations, except to the extent they can be put into liquidation or made subject to statutory management.
- The statutory management moratorium on exercising security rights continues to apply to entities (other than a recognised clearing house or a designated payment system) that have entered into collateral arrangements securing a bilateral netting agreement with a New Zealand counterparty that is made subject to statutory management.
- There is no clarification of the enforceability of multi-branch netting in the liquidation, administration or statutory management of a New Zealand branch of an overseas corporation or a New Zealand company that has offshore branches. The position will be no clearer once the Insolvency (Cross-border) Act 2006 comes into force.
- The effect of the statutory protection is not that netting agreements will (capacity and other similar issues aside) be enforceable in accordance with their terms in the liquidation, administration or statutory management of a New Zealand counterparty. For example, there may still be certain clawback (and other) provisions in the Companies Act that have not, in effect, been overridden by the netting agreement provisions. Those clawback (and other) provisions, therefore, continue to apply despite the terms of a netting agreement to the contrary. However, in practice, the effect of those provisions is likely to be minor in the context of the netting agreement taken as a whole.
- The netting legislation provides that the netted balance is the amount that is payable by, or to, the insolvent counterparty. The netted balance is defined to mean the amount calculated under a netting agreement in respect of all or any transactions to which the netting agreement applies. In the case of a bridge (such as Section 6(f) of the 2002 ISDA Master Agreement), it is arguable that any non-master agreement indebtedness (e.g., a loan) does not arise under a transaction to which the netting agreement applies. If that were correct, the bridge provision would not have the benefit of the netting legislation. It should, however, be possible to draft such a provision in a manner that achieves this protection.  
The same issue applies to master masters.
- How close-out netting applies in relation to trusts is uncertain. New Zealand has no regime that deals with the insolvency of trusts (and that, therefore, prescribes whether mutuality is required for insolvent set-off).

#### 4.6 Netting regimes – summary

The table below summarises key aspects of the various netting regimes that are in effect in New Zealand.

Netting regime	Circumstances in which it applies	Example of transaction or entity covered	Mutuality required?	Written netting agreement required?	Reserve Bank of New Zealand designation required?	Overrides statutory management moratorium?	Payments protected from clawback?
Solvent netting	Outside insolvency	Cash pooling arrangements	No	No	No	N/A	N/A
Section 310 of Companies Act	Liquidation	Loan vs deposit (no written netting agreement)	Yes	No	No	No	No
Bilateral netting agreements — under sections 310A-O of Companies Act	Liquidation, administration and statutory management	ISDA master agreement	Yes	Yes	No	Yes	No
Recognised multilateral netting agreements — under sections 310A-O of Companies Act	Liquidation, administration and statutory management	Recognised clearing house transactions	No	Yes	Yes	Yes	No
Designated payment system under Part VC of RBNZ Act (currently proposed to be extended to <i>securities</i> systems as well)	At all times	CLS Bank	No	Yes	Yes	Yes	Yes

## 5 COLLATERALISATION

With the worldwide growth in derivatives activity, it has become increasingly common for counterparties to look to collateralisation as a method of reducing their credit exposure to other market participants. While, until recently, collateralisation of derivative transactions was comparatively rare in New Zealand, it is becoming more common.

It is beyond the scope of this publication to consider the issues that collateralisation raises. However, our experience is that entities typically require advice on matters such as:

- capacity;
- contractual restrictions on the grantor of security;
- credit support documentation;
- legal characterisation of transfers under credit support documentation and repo/stock lending documentation;
- appropriate types of collateral;
- valuation of collateral;
- registrability of credit support documentation;
- perfection and priority of credit support;
- taxation;
- conflict of laws principles; and
- payment, securities and settlement system services.

The Bell Gully Derivatives Group has advised clients on all these matters. In particular, we have advised extensively on the application of the Personal Property Securities Act 1999 (the **PPSA**) to derivative transactions. The PPSA, which came into force on 1 May 2002, represents a significant change to the law in New Zealand governing security interests in personal property. The PPSA is modelled on equivalent legislation in North America (such as Article 9 of the US Uniform Commercial Code). Similar legislation has recently been proposed in Australia.

## 6 DOCUMENTATION

ISDA documentation is the preferred method for documenting derivative transactions in New Zealand. However, to cater for certain aspects of the New Zealand market, the New Zealand Bankers' Association (**NZBA**), advised by Bell Gully, has published a number of documents amending the standard ISDA terms. These documents include a standard form master agreement schedule. The product-specific addenda that were published by the NZBA previously, except for the repo addendum, were withdrawn in 2007 (in line with the approach earlier taken in Australia).

The master agreement schedule, in our experience, is of most interest to entities that are offered standard NZBA documentation by a prospective New Zealand counterparty. Generally, the NZBA master agreement schedule will modify the ISDA standard for three reasons:

- to obtain the full benefit of New Zealand's netting legislation;
- to incorporate appropriate New Zealand tax representations; and
- to conform certain parts of the NZBA schedule to those recommended by the Australian Financial Markets Association (**AFMA**). (This is largely a consequence of the fact that all four of New Zealand's main trading banks are Australian-owned.)

Despite the predominance of ISDA documentation, other master agreements are used by New Zealand counterparties. The degree to which these other master agreements have penetrated the New Zealand market is discussed below.

### **TBMA/ISMA Global Master Repurchase Agreement**

It is not yet common for two New Zealand counterparties to transact repos under the TBMA/ISMA global master repurchase agreement. This is because the NZBA in 1997 published its own stand-alone master agreement dealing with repos and securities lending transactions. At that time, the NZBA also published an addendum to the ISDA master agreement that covers both repos and securities lending transactions. Both documents were updated in 2000, and the repo addendum again in 2007. As these two NZBA documents are drafted specifically for use by New Zealand counterparties, they (in particular, the ISDA addendum) are the preferred document for use in the New Zealand repo market. However, when a New Zealand counterparty wishes to enter into repos with an overseas entity, it is relatively common for that overseas entity to insist on the use of the TBMA/ISMA global master repurchase agreement.

Under New Zealand law, a repo entered into under a well-drafted master agreement should be characterised as two outright sales of the underlying securities. However, for the purposes of the PPSA (which focuses on the economic substance, not the legal form, of a transaction), a repo gives rise to a security interest. The consequences of that classification are beyond the scope of this publication.

### **ICOM/IFEMA/FEOMA**

The ICOM/IFEMA/FEOMA master agreements are not the documents of choice among New Zealand counterparties. In 1993, the NZBA published addenda to the ISDA master agreement covering a variety of derivative products, including FX transactions and currency options. However, these addenda were withdrawn in 2007. Today, New Zealand

counterparties are more likely to use the ISDA master agreement and, perhaps, to borrow certain provisions from these other documents (e.g., the netting by novation provisions). The gradual harmonisation of these product-specific master agreements with the ISDA documentation, as evidenced by the 1998 FX and Currency Option Definitions published jointly by ISDA, EMTA and The Foreign Exchange Committee, suggests this practice will continue.

#### **Australian Securities Lending Agreement**

Securities lending transactions in New Zealand that are not documented under the NZBA addendum referred to above are typically documented under a modified version of the Australian Securities Lending Agreement (**ASLA**) published by the Australian Securities Lending Association Limited. The principal modifications usually made to the ASLA for use in New Zealand address tax and netting issues.

#### **Short-form Foreign Exchange Master Agreement**

In 2000, the NZBA updated its short-form foreign exchange master agreement. This document is similar to that published by AFMA in Australia. It is most frequently used to document short- to medium-term foreign exchange transactions between New Zealand counterparties that, prior to the publication of that agreement, were not subject to a master agreement.

#### **Credit support documentation**

Both the Credit Support Annex and the Credit Support Deed published by ISDA for use with English law-governed master agreements are, with minor amendments, appropriate for use with New Zealand counterparties. However, the Credit Support Annex, which provides for an outright transfer of collateral rather than the creation of a security interest, is more effective in a number of respects in protecting the interests of the secured party.

The ISDA Credit Support Annex (New York law) may also be used with New Zealand counterparties, although it is uncommon to do so.

## 7 TAX

### 7.1 Income tax

The Income Tax Act 2007 imposes income tax on income derived by residents and certain income derived by non-residents. New Zealand resident taxpayers are taxed on income from all sources and non-resident taxpayers are taxed on their income sourced in New Zealand. However, New Zealand's right to tax the income of non-residents sourced in New Zealand is limited by any relevant Double Tax Agreement (DTA) that New Zealand enters into. Whether the source or residence rules, or the rules contained in the relevant DTA, apply to derivative transactions entered into with a New Zealand counterparty are questions of fact that must be determined in the light of the relevant circumstances.

#### Residence

Entering into a variety of derivative transactions does not, of itself, mean that an overseas entity becomes a New Zealand resident for tax purposes. An overseas entity is generally only deemed to be a New Zealand resident where its centre of management is in New Zealand. Residency can also be gained in other circumstances, but these are unlikely to apply in this context.

#### Source

The source rules, contained in section YD4 of the Income Tax Act, impose income tax on various kinds of income derived from New Zealand. The types of income that are potentially derived from New Zealand by an overseas entity entering into derivative transactions with a New Zealand counterparty are the following:

- interest income derived from or in respect of money lent in New Zealand;
- interest income derived from or in respect of money lent outside New Zealand:
  - to a resident of New Zealand, except where the money lent is used by the resident for the purposes of a business carried on outside New Zealand through a fixed establishment outside New Zealand; or
  - to a non-resident of New Zealand, if the money is used for the purposes of a business carried on in New Zealand through a fixed establishment in New Zealand;
- income derived from contracts made or wholly or partly performed in New Zealand;
- income derived from any business wholly or partly carried on in New Zealand; and
- income of any form derived directly or indirectly from any other source in New Zealand.

#### Interest

Interest is deemed to be derived from New Zealand in the first two circumstances listed in the paragraph immediately above. Payments received by an overseas entity from a New Zealand counterparty pursuant to a derivative transaction will normally be derived from New Zealand to the extent to which they are interest.

The term "interest" is defined in the Income Tax Act to include any payment made in respect of money lent, not being a repayment of the money lent. The term "money lent" is itself defined in section YA1 of the Income Tax Act to include:

- (a) Any amount of money advanced, deposited, or otherwise let out, whether on current account or otherwise...;
- (b) Any amount of credit given...whether on current account or otherwise...;
- (c) Any amount advanced, deposited, or let out, or for which credit is given,...under any obligation or arrangement that is similar to any advancing, depositing, letting out or giving of credit, of any of the kinds referred to in [the preceding paragraphs];
- (d) Any amount paid to, or for the benefit of, or on behalf of, or dealt with in the interest of or on behalf of, any...person in consideration for an agreement to pay or a promise to pay by [that] person, where [the amount originally paid] is exceeded by the amount payable [by that person receiving the original amount] in accordance with the agreement or the promise.

Therefore, whether the payments received by an overseas entity from a New Zealand counterparty pursuant to a derivative transaction are interest income derived from New Zealand depends on whether there is any advance of principal between the parties on entry into the derivative transaction that falls within the definition of “money lent”. Where no advance of principal of this kind occurs, the money lent definition will not be met.

The scope of the definition of “money lent” is not certain. The meaning of “money lent” has not been considered in detail by a New Zealand court, either generally or in relation to derivative transactions entered into by a New Zealand counterparty. Similarly, the Inland Revenue Department (the New Zealand revenue authority) has not issued any public statement that analyses how this definition applies to derivative transactions.

As a matter of standard New Zealand tax practice, conventional currency and interest rate swap transactions are not regarded as involving money lent. Further, so far as we are aware, Inland Revenue has not sought to impose New Zealand tax on payments made to non-resident entities under those derivative transactions. (Further, NZBA members have sought and obtained binding Inland Revenue rulings (applicable to NZBA members) confirming that standard repo and securities lending transactions do not involve money lent (except to a minor extent).)

However, it is conceivable that a derivative transaction between a New Zealand counterparty and an overseas entity may involve money lent. In that case, the New Zealand counterparty is potentially liable to deduct non-resident withholding tax (NRWT). The possible imposition of NRWT is considered below.

### Contracts made or performed in New Zealand

It is also possible that any payment received by an overseas counterparty will be income derived from contracts made or wholly or partly performed in New Zealand. Whether the Inland Revenue Department takes this view will depend on the circumstances and the nature of the derivative transaction entered into. The payments are more likely to be sourced from New Zealand where:

- the New Zealand counterparty has executed any documentation relating to the derivative transaction in New Zealand; or
- any payments are made in New Zealand.

In circumstances where Inland Revenue can establish that an overseas counterparty derives income from a contract entered into or wholly or partly performed in New Zealand, the provisions of the DTA (if any) between New Zealand and the jurisdiction in which the overseas counterparty is resident for tax purposes should be considered.

#### **Business carried on in New Zealand**

An overseas entity is unlikely to be carrying on business in New Zealand merely because it enters into derivative transactions with New Zealand counterparties.

### **7.2 Withholding tax**

Interest payments made to non-residents that are sourced from New Zealand are subject to NRWT. Whether a payment amounts to interest for the purpose of the NRWT rules is determined by the definition of interest contained in the Income Tax Act (outlined above). The Income Tax Act imposes NRWT at a rate of 15% of the gross amount of the interest payment. This rate is reduced to 10% of the gross amount under certain DTAs.

A borrower may pay a 2% levy (known as approved issuer levy) as a voluntary alternative to NRWT provided that the borrower and the lender are not associated, and the debt instrument is a registered security.

NRWT is not payable on non-interest income from derivative transactions.

### **7.3 Goods and services tax (GST)**

Section 8(1) of the Goods and Services Tax Act 1985 imposes an indirect value added-type goods and services tax (GST) at a rate of 12.5% on supplies by a registered person of goods and services made in New Zealand in the course of the furtherance of a taxable activity by reference to the value of that supply. GST is not, however, imposed on exempt supplies.

#### **No supply in New Zealand**

Entering into derivative transactions with New Zealand counterparties should not mean that the overseas counterparty supplies a service in New Zealand for GST purposes. A non-resident is treated as supplying services in New Zealand only where the services are physically performed in New Zealand. The physical performance of the contracts entered into by an overseas entity pursuant to a master agreement is not likely to occur in New Zealand unless the derivative transactions are entered into (in the sense of being executed), or payment is made, by that overseas entity in New Zealand. It is, therefore, advisable for overseas entities not to execute documentation for derivative transactions in New Zealand.

#### **Supply of financial services**

Section 14 of the Goods and Services Tax Act provides that the supply of financial services is an exempt supply. The exchange of currency and issue, allotment or transfer of ownership of a debt, equity or participatory security are a supply of a financial service. Many of the supplies made by an overseas entity pursuant to derivative transactions are likely to involve the supply of a financial service, and will, therefore, be exempt from GST.

Accordingly, an overseas entity should not be liable to pay GST when it enters into derivative transactions with New Zealand counterparties.

#### **7.4 Stamp duty**

There are no stamp duties in New Zealand that an overseas entity needs to consider when entering into a master agreement or a derivative transaction with a New Zealand counterparty.

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