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DERIVATIVES MOVE INTO REGULATORY SPOTLIGHT UNDER PROPOSED LEGISLATION

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The most comprehensive reform of New Zealand's securities and financial markets law in a generation took a significant step forward on Tuesday with the release of a consultation draft of the Financial Markets Conduct Bill. The draft Bill, a 400 page behemoth, not only consolidates securities and financial markets legislation currently contained in a number of different Acts - it also re-writes much of that legislation.

This note focuses on the significance of the draft Bill for derivatives market participants: both those who operate through a presence in New Zealand and those who transact with New Zealand counterparties exclusively from offshore. For these organisations, the news is mostly good.

While OTC derivatives are set to shift from the regulatory shadows into the regulatory spotlight, the broader and clearer exemptions that will accompany that shift should give rise to a better regime overall. And certain unrelated statutory amendments that will be tacked on to the Bill (addressing the gaming issue in particular (see 5 below)) are also welcomed.

Here are the draft Bill's highlights for derivatives market participants.

1 Definition of "derivative"

The draft Bill applies to "financial products". "Financial products" are defined as debt securities, equity securities, managed investment products, or derivatives. From the perspective of derivatives market participants, the term "derivative" is the key to unlocking the draft Bill's scope. It is the basis for determining which products and which persons are to be regulated.

Thankfully, the draft Bill's definition bears little resemblance to what was initially proposed in the July 2010 discussion paper issued by the Ministry of Economic Development (**MED**). That definition, which was based on the relevant accounting definition of "derivatives", had a number of shortcomings – not the least being a departure from the more traditional, predominantly form-based, definition and a resulting lack of certainty of categorisation.

By contrast, the draft Bill provides a hybrid of a form-based definition and a substance-based definition. This is the approach recommended by ISDA and others in their submissions to the MED in 2010. The

definition follows very closely the equivalent definition set out in section 761D of the Corporations Act 2001 (Australia), with elements also borrowed from the definition set out in the Crown Entities Act 2004.

The proposed definition is as follows:

derivative

a) means an agreement in relation to which the following conditions are satisfied -

i) under the agreement, a party to the agreement must, or may be required to, provide at some future time consideration of a particular kind or kinds to another person; and

ii) the amount of the consideration, or the value of the agreement, is ultimately determined, derived from, or varies by reference to (wholly or in part) the value or amount of something else (of any nature whatsoever and whether or not deliverable), including, for example, 1 or more of the following:

(a) an asset:

(b) a rate (including an interest rate or exchange rate):

(c) an index:

(d) a commodity; and

b) includes a transaction that is currently, or in the future becomes, recurrently entered into in the financial markets and is commonly referred to in those markets as -

i) a futures agreement or forward; or

ii) an option (other than an option to acquire an equity security, a debt security, or a managed investment product by way of issue); or

iii) a swap agreement; or

iv) a contract for difference; or

v) a cap, collar, floor, or spread; but

c) does not include -

i) an agreement for the future provision of services;

ii) a debt security, an equity security, or a managed investment product; and

d) does not include an agreement in relation to which the following subparagraphs are satisfied -

i) a party has, or may have, an obligation to buy, and another party has, or may have, an obligation to sell, tangible property (other than New Zealand or foreign currency) at a price and on a date in the future; and

ii) the agreement does not permit the seller's obligations to be wholly settled by cash, or by set-off between the parties, rather than by delivery of the property; and

iii) neither usual market practice, nor the rules of a market, permits the seller's obligations to be closed out by the matching up of the agreement with another agreement of the same kind under which the seller has offsetting obligations to buy

Tempering the relative clarity of this proposed definition is the power given to the Financial Markets Authority (**FMA**):

- to declare that a security that would not otherwise be a financial product is to be treated as a derivative; and
- to declare that a derivative is to be treated as another type of financial product (or vice versa).

2 Disclosure required for regulated offers

Part 3 of the draft Bill requires those offering financial products to provide a product disclosure statement (PDS) to investors. An offer in respect of which disclosure is required to at least one person is known as a "regulated offer". In addition to this disclosure obligation, the issuer under a regulated offer must keep a register for its financial products and will become subject to accounting and audit requirements.

However, these obligations are subject to a number of exemptions. The most relevant of these exemptions for derivatives market participants will be the wholesale investor exemptions.

The scope and clarity of the various categories of "wholesale investor" mark a major improvement over those currently contained in the Securities Act 1978. A stated goal of the MED in preparing the draft Bill was to provide more 'bright lines' tests for the wholesale exemptions. They seem to have succeeded in large part.

By way of example, a wholesale investor will include persons who meet specified investment activity criteria within defined periods. Such persons will be able to self-certify as wholesale investors. A derivatives market participant will be able to rely on that certification unless it knows, or ought to know, that the certification is incorrect.

3 Licence required to operate financial product market

Part 5 of the draft Bill contains provisions requiring operators of "financial product markets" to be licensed.

The definition of a "financial product market" is sufficiently broad that it could catch, for example, internet trading platforms where the platform provider acts purely as an intermediary. For such persons, there will be a number of possible ways to avoid the requirement to seek a financial product market licence:

- It could seek a market services licence on terms that would cover this facility (see further 4 below). This is likely to

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be a less onerous regulatory regime than that applying to financial product markets.

- It could seek "prescribed wholesale market" status. It is not yet clear what this would involve.

4 Licence required to provide certain market services

Part 6 of the draft Bill contains provisions requiring providers of certain "market services" to be licensed. These "market services" include acting as a derivatives issuer in respect of a regulated offer of derivatives.

As with the product disclosure regime outlined in 2 above, the licensing regime will not apply if the derivatives market participant only deals with wholesale investors. However, for those persons whose dealings include one or more retail investors, a licence will be required from the FMA.

Futures dealers currently authorised under the Securities Markets Act 1988 will have their authorisation carried over to the new regime. They will be deemed to hold a market services licence on equivalent terms to their existing authorisation. However, a significant difference between these two regimes, which may limit the usefulness of this carry-over, is that the wholesale/retail distinction is not a feature of the current legislation (but *is*, as we say above, a feature of the new legislation). Therefore, it may well be that some authorised futures dealers will not require a market services licence (whether deemed or actual) once the draft Bill is in force.

5 Unrelated bonuses for derivatives users

According to the explanatory material that accompanied the draft Bill, the form of the Bill that will be introduced into Parliament before this year's election (26 November) will include two further items that should be welcomed by derivatives users.

The first item is a clarification that New Zealand's gaming rules do not apply to derivatives. While the exact scope of this exemption is a matter on which the MED has invited submissions, this will put to rest an annoying loose end that has been tied up in most other developed jurisdictions.

The second item is the alignment of New Zealand law with the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary. The Hague Convention proposes a set of uniform conflict of laws rules for determining the law applicable to issues concerning interests in intermediated securities. This is a matter dealt with, in part, in the Personal Property Securities Act 1999 (the **PPSA**). But the PPSA's rules are incomplete and not entirely consistent with the Hague Convention. So the proposed alignment of those rules with a more comprehensive and internationally-recognised standard will no doubt be seen in a positive light by offshore derivatives market participants.

The MED has called for comments on the draft Bill by 6 September. This is a tight timeframe given the significance, length and complexity of the legislation. However, the MED has emphasised that the relevant policy decisions have already been made. Therefore, comments should be solely in respect of technical issues. Interested parties will, however, have a further chance to comment on substantive issues once the Bill has been introduced into Parliament and referred to a Select Committee.

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