NEW ZEALAND BANKERS ASSOCIATION

Submission

to the

Finance and Expenditure Committee

on the

Financial Markets (Derivatives Margin and Benchmarking) Reform Amendment Bill

4 April 2019

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About NZBA

1. NZBA works on behalf of the New Zealand banking industry in conjunction with its member banks. NZBA develops and promotes policy outcomes that contribute to a strong and stable banking system that benefits New Zealanders and the New Zealand economy.

2. The following seventeen registered banks in New Zealand are members of NZBA:
    - ANZ Bank New Zealand Limited
    - ASB Bank Limited
    - Bank of China (NZ) Limited
    - Bank of New Zealand
    - China Construction Bank (New Zealand) Limited
    - Citibank, N.A.
    - The Co-operative Bank Limited
    - Heartland Bank Limited
    - The Hongkong and Shanghai Banking Corporation Limited
    - Industrial and Commercial Bank of China (New Zealand) Limited
    - JPMorgan Chase Bank, N.A.
    - Kiwibank Limited
    - MUFG Bank, Ltd
    - Rabobank New Zealand Limited
    - SBS Bank
    - TSB Bank Limited
    - Westpac New Zealand Limited

Background

3. NZBA welcomes the opportunity to provide feedback to the Finance and Expenditure Committee (**Committee**) on the Financial Markets (Derivatives Margin and Benchmarking) Reform Amendment Bill (**Bill**) and commends the work that has gone into developing the Bill.

4. If you would like to discuss any aspect of the submission further, please contact:

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Part one: Amendments relating to derivatives margin

Introduction

5. NZBA fully supports the purpose of the Bill and is grateful for the priority which has been shown, particularly given the potential impact on the viability of foreign funding programmes which rely on swaps to hedge currency risks.

6. NZBA has no comments on many aspects of the Bill and agrees with the overall drafting approach taken.

7. However, there are a number of aspects of the Bill which NZBA believes should be better addressed. Accordingly, we set out below proposed substantive and technical amendments to Part 1 of the Bill for consideration by the Committee.

8. In a number of instances, reference has been made to Australian and other international practice, both to take advantage of work that has already been undertaken in those jurisdictions, and (in the case of Australia) to ensure a degree of consistency and future-proofing – given the close linkage between our financial markets.

9. Within our different legal framework, we believe it is important that New Zealand adopts an approach which delivers consistent outcomes with Australia, in particular:

   (a) the type of collateral that can be provided as initial margin;

   (b) the eligible obligations that are secured; and

   (c) the counterparties and markets that have the benefit of the protection.

10. It is also important that the Bill does not go further than is necessary and create unexpected outcomes in our general insolvency law.

11. NZBA does not wish to delay the progression of this Bill. However, we believe that a broader review of the underlying legal framework that deals with derivatives under New Zealand law is long overdue. This is required to ensure that New Zealand's financial market participants are not materially disadvantaged when dealing in these types of instruments with financial market participants in other jurisdictions (such as with other G20 countries, in particular, Australia) and incur more costs (both in terms of the pricing of transactions and third party costs such as legal costs) than they should, due to an overly complex New Zealand legislative framework – which could be simplified by standalone netting legislation. We comment further on this point (and other suggested areas for further reform) in paragraphs 52 to 54 below.

Existing Derivatives

12. The transitional provisions set out in the Schedules to the Bill provide that the amendments made by Part 1 of the Bill apply only to qualifying derivatives entered into on or after commencement of the legislation. NZBA's view is that the amendments under Part 1 should apply to all qualifying derivatives, irrespective of when those derivatives were entered into. Failing this, qualifying derivatives should include transactions having a lifecycle or economic event that renders it in scope, notwithstanding that it was entered into prior to the legislation.

13. If the transitional provisions remain as currently drafted, this may have a significant impact on the ability of New Zealand banks to continue to transact or maintain positions under existing derivatives, and impose unnecessary costs on New Zealand banks. As matter of practice, it is unlikely that the New Zealand banks (and their offshore counterparties) will even be able to calculate the margin required under the set of qualifying derivatives between each New Zealand bank and its counterparty using the models in use internationally if the transitional provisions remain as drafted.

14. In addition, to distinguish existing derivatives from derivatives entered into after the commencement of the legislation would place New Zealand at odds with the rest of the international derivatives market.

15. There does not appear to be clear policy justification for excluding existing derivatives from the scope of the amendments, and the issue has not been a matter on which consultation has been undertaken previously.

16. NZBA considers that the transitional provisions in the Schedules should therefore be removed and that the Bill should make clear that the amendments apply to all qualifying derivatives, whether entered into before or after commencement of the legislation.

Collateral for Qualifying Derivatives

17. The definition of "qualifying derivative" proposed in clause 5 of the Bill refers to a derivative with posted collateral that consists of:

    (a) a financial product (within the meaning of s 7 of the Financial Markets Conduct Act 2013); or

    (b) an investment security, a negotiable instrument, or an intangible (within the meaning of s 16 of the Personal Property Securities Act 1999 (**PPSA**)).

18. NZBA considers that the scope of collateral which should have the benefit of the new protections under the Bill should cover property which is commonly provided as collateral in financial markets transactions. This is important from a policy perspective to:

    (a) on the one hand, ensure that there is certainty amongst market participants as to what types of collateral will have the benefit of the reforms proposed in the Bill; and

    (b) on the other hand, ensure that the "super-priority" given to collateral for qualifying derivatives does not unnecessarily interfere with the usual operation of the PPSA. The effect of the amendments in Part 1 is that security for qualifying derivatives will not need to be registered on the Personal Property Securities Register (**Register**) in order to have priority, and accordingly will not be disclosed to persons searching the Register. Competing secured creditors and preferential creditors will therefore have a legitimate expectation that the super-priority given to secured counterparties under qualifying derivatives will be limited to collateral of the type usually provided in financial markets transactions.

19. Accordingly, it is suggested that to cover property which is commonly provided in financial market transactions:

(a) the scope of collateral referred to in paragraph (b) to the definition of qualifying derivative should also include money (eg, bank notes) and documents of title, each as defined in the PPSA. We also query whether other types of "financial property" referred to in the Australian legislation should also be specifically referenced. For example, gold, silver, platinum; and

(b) given that collateral (eg, shares) is often held by intermediaries, a further subparagraph (iii) should be inserted in paragraph (b) of the definition of qualifying derivative to ensure such intermediated collateral is included. A suggested clause, based on the equivalent Australian provision, would be as follows:

> (iii) if a person (an intermediary) maintains an account to which interests in property or rights to payment or delivery of property of a kind mentioned in any of subparagraphs (i) or (ii) may be credited or debited, the rights of a person in whose name the intermediary maintains the account, to the extent that those rights relate to the interests in that property or the rights to payment or delivery of that property; and

20. NZBA also questions whether the proposed inclusion of "intangibles" within paragraph (b)(ii) of the definition of qualifying derivative is overly broad. An "intangible" will extend to a wide range of intangible property outside of that which is typically provided as collateral for derivatives, such as (for example) intellectual property rights. It would also include any "account receivable" of the debtor (as defined in the PPSA), being any enforceable monetary obligation of the debtor, not only book debts or funds held in a bank account.

21. For completeness, we recognise that indirect holders of financial products (eg, shares) may only have a security interest in an "intangible" (rather than an "investment security"). We also recognise that cash paid (eg, credited to the account of a collateral taker) under a credit support document is also considered to be an "intangible" and an "account receivable" under the PPSA. However, it is suggested that these forms of "intangible" that are commonly provided as collateral in derivatives markets transactions could be captured with more targeted (narrow) drafting in paragraph (b) of the definition of qualifying derivative. Again, reference could be made to the Australian legislation on how best to define these categories of collateral.

22. The changes proposed in paragraphs 18 to 20 above would ensure that the scope of collateral to which the protections in Part 1 attach would be generally consistent with the position taken in the equivalent Australian legislation and be consistent with the collateral that is usually referred to in legal opinions on derivatives.

Qualifying Derivative Security Interest

23. Clauses 4, 9, 11, and 14 each refer to enforcement of a "security interest over collateral that was posted for a qualifying derivative".

24. It is not clear what is intended by the reference to collateral having been "posted" for a qualifying derivative. There is a risk that, without further clarification, the reference may be interpreted as meaning any form of collateral the collateral taker has taken that secures a qualifying counterparty's obligations under a qualifying derivative. Furthermore, the above references in clauses 4, 9, 11 and 14 refer to collateral in its broadest sense, and not explicitly in the narrower sense provided for in paragraph (b) of the definition of "qualifying derivative".

25. NZBA considers that security interests in "posted collateral" having the benefit of the protections under Part 1 should:

(a) be more confined than broad security which may typically be taken over a debtor's working capital and assets (for example, under a general security agreement). In particular, "posted collateral" should be appropriated to the security and the collateral should be in the secured party's effective possession and control. This will give other third party creditors a degree of comfort that collateral which the debtor continues to possess and control is not subject to an unregistered, prior ranking security in favour of a derivative counterparty. It would also be consistent with:

(i) equivalent legislation in the EU, UK and Australia, each of which require possession and control as a necessary element of security arrangements qualifying for protection; and

(ii) comparable existing provisions in the PPSA (specifically, ss 96 and 97) which give priority to purchasers (including secured parties) of chattel paper and investment securities ahead of other perfected secured creditors, where the purchaser/secured creditor is in possession of the relevant collateral;

(b) only have priority over other security interests and preferential creditors to the extent that the obligations secured are obligations under the relevant qualifying derivative contract, and not broader obligations owed to the secured counterparty (including in respect of general credit facilities and other indebtedness). This is generally consistent with the requirements of the equivalent Australian legislation.

26. This could be achieved by replacing the references in Clauses 4, 9, 11, and 14 of the Bill to "security interest over collateral that was posted for a qualifying derivative" with references to a new defined term (for example, a "qualifying derivative security interest") in the proposed s122A of the Reserve Bank of New Zealand Act 1989:

> **qualifying derivative security interest** means a security interest taken in collateral (as referred to in paragraph (b) of the definition of qualifying derivative) by a counterparty to a qualifying derivative:
>
> (a) to the extent that it secures payment or performance of an obligation under or in relation to the qualifying derivative; and
>
> (b) the secured party (or a person acting on its behalf) has taken possession of that collateral (except where possession is a result of seizure or repossession).

"Possession" for the purposes of that definition could be defined by reference to the equivalent definition in s18 of the PPSA, but also specifically include additional provisions to deal with possession of financial products and intermediated collateral, based on the equivalent Australian legislation.

27. The above definition could then be incorporated in an amended s103B(1) to the PPSA, as provided for in clause 19 of the Bill:

> (1) A qualifying derivative security interest in collateral (as referred to in paragraph (b) of the definition of qualifying derivative) or its proceeds has

priority over any security interest (including a purchase money security interest) in the same collateral.

28. Importantly, by using a defined term (rather than a general reference to property posted as collateral) the priority afforded by the amended s103B(1) should apply only in respect of possessory security interests (as referred to in paragraph 25 above) in specific types of financial collateral (as referred to in paragraph 17 above), to the extent that it secures payment or performance of an obligation under a qualifying derivative. It also makes it clear, consistent with other provisions under the PPSA, that the priority extends to proceeds received in relation to that collateral (which, in the context of credit support documents for qualifying derivatives, will most likely involve distributions on the collateral and, in the case of cash collateral, interest amounts).

Knowledge of Inability to Pay Debts

29. Clauses 4, 9, 11, 14 and 19 of the Bill each disapply the protections from statutory moratoria and the priority ahead of secured and preferential creditors for security interests relating to qualifying derivatives in circumstances where the counterparty seeking to rely on those provisions knew that the defaulting counterparty was unable to pay its due debts at the time that the relevant security interest was entered into.

30. NZBA considers that the provisions which would disapply those protections where the counterparty knew of the insolvency of the defaulting counterparty should be deleted from the Bill. Those provisions were first identified in principle by the Reserve Bank in its Consultation Document of July 2017. The provisions are similar to comparable provisions in Australia in relation to close-out netting contracts under the Payment Systems and Netting Act 1998. However, those provisions were included because the Payment Systems and Netting Act 1998 displaces the ordinary voidable preference provisions in the Corporations Act 2001. The same position does not apply in New Zealand.

31. The policy behind the provisions is to ensure that the rights of ordinary creditors (to share pari passu in the defaulting counterparty's insolvent estate) are not adversely affected by the ability of a counterparty to seek an advantage in taking and enforcing security, in the knowledge of the defaulting counterparty's insolvency.

32. NZBA believes that the rights of ordinary creditors in those circumstances are adequately protected by the existing powers available to liquidators and statutory managers to challenge transactions and security entered into in the period prior to commencement of liquidation or statutory management, and to clawback payments and assets as a consequence. Those powers are available in respect of transactions under netting agreements. The amendments proposed in Part 1 would not prevent those powers from continuing to apply in respect of security interests for qualifying derivatives, whether as an insolvent transaction, a voidable charge, or as a transaction at an undervalue, entered into in the specified period prior to liquidation or statutory management at a time when the defaulting counterparty was unable to pay its debts.

33. Furthermore, the provisions identified in paragraph 29 above:

    (a) are inconsistent with the existing powers available to liquidators and statutory managers to avoid security interests for qualifying derivatives. In order to ensure equality of treatment amongst creditors, the focus of the existing voidable transaction provisions (as part of a deliberate legislative change under the reforms enacted by the Companies Act 1993) is on whether a

transaction has a preferential effect, rather than the subjective knowledge or intention of the relevant creditor. The focus of the provisions identified in paragraph 29 is solely on what the relevant creditor knew at the time the security agreement was entered into. This is likely to lead to an inconsistent treatment of security interests for qualifying derivatives, which may be excluded from the protections provided for by the amendments to Part 1 even where there is no preferential effect; and

(b) operate at the point of enforcement of security (rather than at the subsequent election of a liquidator or statutory manager) and thereby undermine the certainty that parties holding security for qualifying derivatives will be able to immediately enforce and realise their security in the event of a counterparty's insolvency, in line with the Basel Committee on Banking Supervision / International Organisation of Securities Commissions margin requirements. Counterparties holding security can be expected to be large and complex financial institutions, and determining whether a relevant person within the organisation had, or should have had, knowledge (within the meaning of s19 of the PPSA) of the defaulting counterparty's inability to pay debts at the time a security agreement was entered into (which may be months or years in advance of the defaulting counterparty's insolvency) can be expected to significantly delay their ability to enforce their security.

34. Clause 19 of the Bill would similarly disapply the priority otherwise provided to holders of security interests in relation to qualified derivatives where they knew that the counterparty was unable to pay its debts at the time the security agreement was entered into. For the reasons noted above, this is a matter best addressed by the existing powers available to liquidators and statutory managers to avoid security and clawback payments. The PPSA regulates the priority of claims of competing secured creditors to collateral, which are determined independently of any insolvency process the debtor may be subject to. It would be novel, under the PPSA, and inconsistent with other comparable provisions under the PPSA (notably ss 94 to 99), for the respective priority of competing interests between secured creditors in relation to collateral to depend on whether a secured creditor knew of the debtor's inability to pay its debts.

Clause 18 of the Bill

35. Clause 18 of the Bill contains a proposed amendment to the PPSA (through the inclusion of a new s 23(e)(xiv)) to clarify that, in certain circumstances, the transfer of title in collateral does not create a "security interest" for the purposes of the PPSA. Generally speaking, this technical amendment is to confirm the widely held view in the market that an outright transfer of collateral does not constitute a "security interest".

36. NZBA has advocated for several years for this point to be definitively dealt with in legislation, as the status quo means that legal opinions on the underlying transactions are qualified to an extent not otherwise seen in other jurisdictions. Very briefly, this adds cost and an unnecessary degree of complexity for New Zealand counterparties when entering into these types of transactions. For this reason, NZBA very strongly supports the policy intent behind the inclusion of Clause 18 in the Bill, but submits that it could, as drafted, result in a degree of uncertainty under New Zealand law as to whether other types of outright transfer of collateral would fall within the PPSA (which would then potentially contradict long-established common law principles).

37. To deal with this uncertainty, clause 18 could be amended so that the new s 23(e)(xiv) of the PPSA applies to all outright transfers of collateral (rather than outright transfers of collateral posted for a qualifying derivative). However, this approach could give rise to a reasonably significant change to the PPSA that is beyond the scope of the derivatives margin reforms contemplated by Part 1 of the Bill. Other parties in the broader lending/secured credit community may be caught unaware (as the Bill is a reasonably obscure piece of derivatives markets legislation). Given the complexity of the PPSA, the consequences of any such broader change will need to be carefully tested. It is also noted that this broader approach has not been taken in the other key PPSA jurisdictions (namely, Australia and Canada) – although in neither of those jurisdictions do the ISDA legal opinions appear to differ from those of the local industry association or the market more generally (which has, at least in part, created the uncertainty in New Zealand).

38. For these reasons, NZBA submits that clause 18 should be removed from the Bill and a separate work programme implemented to put in place an appropriately targeted legislative solution (perhaps involving both Government officials and industry experts in derivatives, secured lending and insolvency). Reference should also be made to how this issue has been dealt with in Australia. In the meantime, the status quo (as briefly described in paragraph 35 above) would remain in place. The status quo is not ideal (for the reasons outlined in paragraph 36 above). However, equally, it is not ideal to replace the status quo with clause 18 as currently drafted.

39. NZBA also believes that it would be best to deal with this issue (as it relates to derivatives margin) in standalone netting legislation. The case for standalone netting legislation is discussed further in paragraphs 52 to 54 below.

40. For completeness, if clause 18 is removed from the Bill this may lead to other consequential drafting changes to Part 1 that will need to be considered. For example, see paragraph (b) of the definition of "security interest" in clause 5 of the Bill.

Insolvency Practitioners Bill

41. A further matter for consideration in Part 1 of the Bill arises from a proposed amendment to the Companies Act 1993 under the Insolvency Practitioners Bill. Clause 6A of that Bill provides that a new voidable transaction provision – s 296A – is to be added to the Companies Act 1993, under which any disposition of a company's property is voidable by a liquidator if, in summary, it is made:

    (a) in the period beginning on the date on which an application is made to Court to appoint a liquidator and ending when the liquidator is appointed (or the application disposed of); and

    (b) other than in the ordinary course of business of the company.

    Importantly, the section will allow a liquidator to invalidate a "disposition" (which would include the grant of a security interest, as well as margin transfers and payments under a netting agreement) even where it is made for value and does not have a preferential effect.

42. NZBA is of the view that s 296A should not apply to entering into a netting agreement or a security interest for qualifying derivatives, or to any transaction, payment or transfer under a netting agreement or a security interest for qualifying derivatives, for the following reasons:

(a) Section 296A has been introduced to address the risk of "a rapid transfer of assets, often at undervalue or at no value, by shareholders and directors prior to the appointment of a liquidator. This is the harm identified in the misuse of phoenix arrangements." It is highly unlikely that insider transactions of this nature would involve netting agreements or qualifying derivatives, and so there is no need for the section to apply to those arrangements or payments, transfers or other transactions under those arrangements (which would in any event, as noted above, be subject to other existing avoidance powers available to liquidators and statutory managers); and

(b) The imposition of s 296A would create uncertainty for derivatives counterparties relying on security arrangements over margin collateral. It is not practical to suggest that those counterparties, particularly offshore financial institutions, can protect themselves in respect of any and each such transaction by searching the High Court register (to determine whether a liquidation application has been filed) or enquiring into whether entry into such transaction is within the ordinary course of business of the other counterparty.

43. A comparable provision to s 296A exists under the relevant UK insolvency legislation, as referred to by the Insolvency Working Group in their report. However, that provision does not apply to any property or security interest subject to a disposition (or created or otherwise arising under a "financial collateral arrangement" – effectively, a qualifying derivative security interest or an outright transfer of collateral) or to prevent close-out netting provisions from taking effect in accordance with their terms. Accordingly, similar exclusions should be provided for in relation to the proposed s 296A.

Preferential Creditor Claims

44. Clause 11 of the Bill provides that Clause 2(1)(b) of the 7th Schedule to the Companies Act 1993 should not apply to accounts receivable posted as collateral for a qualifying derivative.

45. NZBA's view is that Clause 2(1)(b) of the 7th Schedule should apply to such accounts receivable, but that any security interest over that collateral for a qualifying derivative should take priority ahead of the claims of all preferential creditors. If Clause 2(1)(b) does not apply at all to such accounts receivable, then any surplus available (after amounts secured in respect of a qualifying derivative are paid) would not be available to meet the claims of preferential creditors. That would be to the detriment of the interests of preferential creditors, and of other secured creditors whose collateral is available to meet the claims of preferential creditors.

46. Consistent with how other interests ranking ahead of preferential creditors (for perfected purchase money security interests and transfers of accounts receivable for new value) are dealt with, Clause 11 of the Bill should therefore be amended (using the definition referred to in paragraph 26 above) so as to operate instead as an additional subclause 2(1)(b)(i)(D) to the 7th Schedule to the Companies Act:

> (D) is not a qualifying derivative security interest (as defined in section 122A of the Reserve Bank of New Zealand Act 1989); and

47. Similar amendments will also be required in relation to other Acts which also provide for the payment of preferential creditor claims, so as to ensure consistent treatment

for security interests for qualifying derivatives across different insolvency processes. The relevant provisions to be amended would include:

(a) section 30(2) of the Receiverships Act 1993;

(b) section 153 of the Property Law Act 2007;

(c) section 275 of the Insolvency Act 2006; and

(d) section 13 of the Industrial and Provident Societies Amendment Act 1952.

Qualifying Counterparties

48. NZBA recognises that the approach taken in Part 1 to exclude from the relevant statutory moratoria, and to give priority to, security for qualifying derivatives entered into between "qualifying counterparties" is strongly preferable, in terms of certainty and efficiency, to the previous proposal consulted on (which would have only applied where counterparties were required to take initial margin by an international regulator).

49. However, there are other large corporates, local government and public sector entities that regularly enter into derivatives with domestic and offshore counterparties who will not automatically fall within the category of a qualifying counterparty. While it may be possible to include those entities over time as qualifying counterparties by regulation (eg, as a "prescribed entity" or "other entity of a prescribed class"), NZBA's view is that there is no clear rationale for limiting the protections provided by the amendments in Part 1 by reference to the type of counterparty.

50. Therefore, NZBA submits that the Committee may wish to consider whether the amendments provided for under Part 1 should apply in respect of all types of counterparties (not just "qualifying counterparties"). This approach would be consistent with:

(a) the treatment of netting agreements in insolvency (under s310A – 310O of the Companies Act 1993 and elsewhere), which provides for effective close-out netting without regard to the type of counterparty involved; and

(b) the approach taken in Australia (in relation to the equivalent reforms to the Payment Systems and Netting Act 1998), which allow for the enforcement of security of close-out netting contracts in an insolvency process, similarly without regard to the type of counterparty involved.

Cleared and uncleared derivatives

51. We also believe it would be helpful if the Explanatory Note to the Bill makes it clear that the Bill covers cleared and uncleared derivatives. It seems this is the intention because overseas clearing houses will be overseas persons and domestic clearing houses will be specified operators. Given the importance of cleared derivatives in the global markets, it would be helpful to clarify the intention that the Bill is not confined to the protection of uncleared OTC derivatives only.

New Zealand should be aligned with international best practice

52. NZBA believes that it is important for the law reform in Part 1 of the Bill to be put in place as soon as possible, so as to ensure that New Zealand law does not impede

the ability of New Zealand banks (and other qualifying counterparties) to post initial margin in accordance with the requirements of the international financial markets. NZBA agrees with the statement in the explanatory note to the Bill that "[i]nability to comply with these rules may impact affected New Zealand entities' integration with international financial markets and have significant implications for New Zealand's financial system".

53. That said, NZBA submits that further work is required in this area of New Zealand law that is crucial to the operation of New Zealand's derivatives markets. In this regard, we suggest that further work needs to be done in New Zealand to determine whether it is appropriate to deal with all laws concerning derivatives netting and posted collateral through separate standalone legislation. The legislation does not need to be complex but should recognise that, as a major participant in global derivatives markets, laws dealing with netting and collateral supporting derivatives should prevail over all other laws. This is the approach adopted in Australia, for example, and could be replicated in New Zealand without significant modification. Indeed we understand the World Bank has model netting legislation that has, for example, been adopted in a number of Pacific countries (eg, Samoa and Tonga). ISDA has also published a model netting act.

54. The key benefits of standalone legislation are:

(a) it would provide certainty and clarity for financial markets. Access to such markets is vital to New Zealand's financial system;

(b) it would be consistent with Australia, where the market participants and legal systems are very similar. New Zealand could benefit from the extensive work done by Australia's regulators, officials, banks and legal profession in getting the legislation right (and where the super priority prevails over depositor priority and the deposit insurance scheme – both significantly bigger policy decisions than anything required in New Zealand);

(c) it would minimise the risk for any further legislative change as other issues arise or are identified or as changes are required to follow to international practice;

(d) it would make the required legal opinions cleaner and simpler. To date, reform in relation to netting and derivatives related issues has been undertaken on a "piecemeal" basis, adding to its complexity at the expense of clarity and certainty; and

(e) it would enable Parliament to 'clean up' other longstanding technical points in legislation (that, we submit, have largely arisen due to the piecemeal approach taken to legislative developments in this area to date). For example:

(i) a technical change is required to the Companies Act to confirm that banks can take general security agreements over counterparties (eg, outside netting arrangements), without jeopardising the statutory priority for netting agreements entered into with the same counterparties (a change that we understand the Ministry of Business, Innovation and Employment has been consulting on for a number of years and which NZBA had suggested in its original submission to the Reserve Bank of New Zealand could usefully have been picked up with these changes);

(ii) it would also be helpful for legislation to enable clearing members to close out transactions which they had undertaken for "covered members" in global clearing houses immediately after those entities had gone into statutory management. Currently, clearing members may not be able to close out transactions that they have undertaken as agent for covered counterparties, such as New Zealand banks, because of the moratorium provisions in statutory management legislation or potentially "port" them to their own account for the same reason. This potentially leaves them unable to close out those banks' positions to determine their final exposure (something probably not in the interest of the bank in statutory management either).

Part two: Amendments relating to financial benchmarks

Introduction

55. NZBA supports the introduction of a licensing regime for administrators of financial benchmarks to respond to the regulations developed by the European Union (**EU**) in relation to the operation of financial benchmarks and the possible implementation of similar regimes by other jurisdictions. It is critical to NZBA's members that New Zealand financial benchmarks are recognised in the EU, given the importance of the markets within the EU to New Zealand banks and the need for NZBA's members to be able to enter into financial instruments with EU counterparties that reference New Zealand benchmarks.

56. Accordingly, NZBA is keen to progress the passage of the Bill as quickly as possible. This would provide as much time as possible for the Financial Markets Authority (**FMA**) to put in place the detailed licensing requirements for the New Zealand Financial Markets Association (as the administrator of the key New Zealand BKBM benchmark) that are needed for New Zealand's regulatory regime to meet the EU's formal "equivalence" status.

57. However, NZBA considers that there are several aspects of the Bill that need to be improved. In brief, these relate to:

    (a) clarifying that the FMA cannot compel a contributor to trade as part of the FMA's power under proposed s 448C;

    (b) clarifying the "contributor" definition in proposed s 448C(4) in order to limit the time period for which a contributor may be required to provide information or data to the FMA;

    (c) including a general requirement for the FMA to consult before it exercises its powers under proposed s 448C;

    (d) including a requirement for the FMA to consider the public interest before exercising its powers under proposed s 448C; and

    (e) clarifying that the contributor protections in proposed s 448J apply to both the contributor and its employees.

Clarifying that the FMA cannot compel a contributor to trade

58. NZBA submits that a specific provision should be included to make it clear that the FMA cannot compel benchmark contributors to trade under proposed s 448C, rather, contributors are required to provide information or data only.

59. NZBA understands that this is the intention of the proposed legislation. However, the key financial benchmark that the proposed regime will apply to (ie the BKBM benchmark) is primarily based on trading rather than data submission, and, given international concerns with submissions-based benchmarks, it is likely that this will also be the case for any new key financial benchmarks that are developed.

60. Therefore, it is possible that the powers given to the FMA under s 448C could be read as potentially requiring contributors to trade (or commit to trading) in order to produce the information that the FMA directs contributors to provide. Such a result would be unworkable. In particular, trading in connection with a financial benchmark needs to

reflect economic forces. This requirement may be difficult or impossible to reconcile where the contributor does not wish to trade, and is only doing so on the direction of the FMA

61. In this context NZBA notes that the EU Benchmark Regulation[1] that New Zealand's regulatory regime needs to comply with in order to meet the EU's formal "equivalence" status expressly excludes the requirement for contributors to trade. Article 23(5) provides as follows (emphasis added):

> 5. From the date on which the competent authority of the administrator is notified of the intention of a contributor to cease contributing input data and until such time as the assessment referred to in paragraph 4 is complete, it shall have the power to require the contributors which made the notification in accordance with paragraph 3 to continue contributing input data, in any event for a period of no more than four weeks, *without imposing an obligation on supervised entities to either trade or commit to trade*.

62. Accordingly, NZBA submits that s 448C should be amended by adding the following wording to the end of sub s 448C(2):

> (2) The FMA may, by written notice and otherwise in the prescribed manner, give a direction to a contributor requiring the contributor to provide information or data to a licensee, an authorised body, or another entity, where the provision of that information or data is necessary or desirable for the generation or operation of the financial benchmark specified in a licence, provided that the FMA may not give a direction that imposes an obligation on a contributor to either trade or commit to trade.

Clarifying the "contributor" definition

63. The definition of "contributor" in s 448C(4) refers to a person whose activities have previously resulted in the provision of information or data to a licensee, an authorised body or another entity, being in effect the administrator of a financial benchmark or a related party.

64. The exact scope of this definition is unclear, as there could be situations where a person has carried on activities which "result in the provision of information", but where that person has not itself provided the information and has no relationship with the relevant licensee or authorised body. The definition is relevant to s 448C(2), under which the FMA may compel the contributor to "provide information or data". Therefore, the drafting of the definition should be made consistent with the operative provision, and refer to persons who have previously provided the information or data.

65. Further, the definition does not have an end date to when a person who previously provided information is no longer a "contributor". Combined with the FMA's powers in s 448C(2), as currently drafted, a previous contributor could be compelled to provide information to the FMA even though the contributor may not have been providing information to the administrator of the financial benchmark for a material period of time. This could even require previous contributors to restart administrative operations that have been terminated in order to generate the information required by the FMA (or even to restructure its business to meet all the requirements of the rules and procedures of the financial benchmark, such as any requirements regarding size of operations).

[1] See EU Regulation 2016/1011 of 8 June 2016

66. NZBA submits that there should be a reasonable end date to when a person who previously provided information is no longer a "contributor" for the purposes of providing information to the FMA. NZBA suggests that this end date is 1 year after the contributor ceases contributing information.

67. NZBA considers that a 1 year period would strike a reasonable balance between providing certainty to contributors that have stopped contributing to the financial benchmark for a period of time that they will no longer be impacted by the FMA's direction powers, and providing the FMA with sufficient flexibility to obtain information from contributors that have recently left the market. In this context, NZBA notes that Article 23(5) of the EU Benchmark Regulation (see above) provides for a 4 week period only.

68. In light of the above, NZBA submits that the definition of "contributor" in s 448C(4) should be amended as follows:

> (4) In this subpart, **contributor** means a person whose activities have previously resulted in the provision by that person of information or data to a licensee or an authorised body for the generation or operation of the financial benchmark specified in a licence (in accordance with rules of that financial benchmark to which that person was subject), provided that a person shall no longer be a contributor at any time after the end of one year immediately following the date upon which a person ceased providing information or data to such a licensee or authorised body.

Extending the requirement for the FMA to consult before it exercises it powers

69. Sections 448G(4)(b) and 448H effectively require the FMA to consult with relevant contributors after the FMA makes an interim direction. However, these consultation provisions do not apply in respect of the exercise by the FMA of its powers under ss 448C and 448D where the FMA does not issue an interim direction. NZBA notes that currently there is no obligation on the FMA to issue an interim direction before exercising its powers under ss 448C and 448D.

70. Given the potentially broad application of the FMA's powers (including amending the rules and requirements of the benchmark), NZBA submits that the FMA should provide contributors with an adequate opportunity to make submissions and be heard on directions before they are issued under ss 448C and 448D, even if interim directions are not being issued.

71. Accordingly NZBA submits that either:

    (a) sections 448G and 448H are modified so as to require the FMA to issue an interim direction before it issues *any* direction under ss 448C and 448D; or

    (b) if the ability to issue directions under ss 448C and 448D without an interim direction is to be retained, then a mechanism analogous to that set out in ss 448G(4)(b) and 448H is included in ss 448C and 448D.

Requirement for the FMA to consider the public interest before exercising its powers

72. On a related point to the submission above, NZBA notes that under s 448G(1)(b), the FMA is required to act in the public interest when making an interim direction.

However, this requirement does not expressly apply to the FMA's general powers under ss 448C and 448D where the FMA does not issue an interim direction.

73. NZBA submits that there should be no difference on this point between interim directions and the directions under ss 448C and 448D where no interim direction has been issued.

74. NZBA notes in this context that the corresponding provisions in the Australian legislation dealing with the licensing of administrators of financial benchmarks on this issue include a specific reference to public interest as a requirement for the exercise of any powers by ASIC. Attached are extracts of s 908CE(2) of the Corporations Act and Regulatory Guide rule RG268.128 of the ASIC Regulatory Guide 268 (Licensing regime for financial benchmark administrators) which highlight the requirement for ASIC to consider public interest before exercising its powers.

75. Accordingly NZBA submits that language analogous to s 448G(1)(b) be included in s 448C(1) as an additional ground that the FMA needs to satisfy before exercising its powers under s 448C.

Clarifying that contributor protections apply to both the contributor and its employees

76. Lastly, NZBA submits that s 448J be amended to make it clear that any employee of a contributor that makes a good faith submission to a benchmark in response to an FMA direction (or interim direction) should be protected. While NZBA understands that the intention is that both the contributor and their employees are covered by the protections, NZBA considers that this should be clarified to avoid any uncertainty and encourage prompt compliance with any such direction.

77. Accordingly NZBA submits that s 448J be amended as follows:

> No civil or criminal proceedings may be brought against a person (or any other person acting on its behalf) by reason of the person having provided material, information, or data in good faith and in accordance with a direction (including an interim direction) under this subpart.

Extracts

See paragraph 74 above (Emphasis added).

Australian Corporations Act 2001

908CE Permitted powers and matters that may be dealt with in the rules

(1) The permitted powers and matters are the following:

(a) the power for ASIC to require, by written notice, an entity referred to in paragraph 908CB(h):

(i) to provide data or information to a benchmark administrator licensee, or to another entity, for the generation or administration of a significant financial benchmark specified in that licence; and
(ii) to provide ASIC with some or all of that data or information for purposes relating to the generation or administration of that significant financial benchmark;

(b) the power for ASIC to require, by written notice, a benchmark administrator licensee:

(i) to continue to generate or administer a significant financial benchmark specified in that licence; or
(ii) to generate or administer in a particular way a significant financial benchmark specified in that licence;

(c) powers or matters incidental or related to:

(i) one or more of the above powers; or
(ii) the compulsory generation or administration of a significant financial benchmark specified in a benchmark administrator licence;

including a power or matter prescribed by the regulations for the purposes of this paragraph.

(2) However, ASIC may only require something under a power referred to in subsection (1) if:

(a) ASIC reasonably believes it is in the public interest to do so; and

(b) in the case of paragraph (1)(a)—the activities of the entity concerned have previously resulted in the provision of data or information to that licensee for the generation or administration of that significant financial benchmark.

ASIC Regulatory Guide 268 Licensing regime for financial benchmark administrators

RG 268.128 The public interest test for giving a notice under the compelled benchmark rules in relation to the BBSW may be satisfied if we believe the BBSW will not be able to be determined. Specifically, the public interest test may be satisfied if:

(a) ASIC and the RBA consider it is likely the BBSW will not be able to be determined using the calculation mechanisms set out in the BBSW method (other than the final stage method); or

(b) the administrator of the BBSW informs ASIC or the RBA that it is likely to be unable to continue to administer the BBSW (this could be the case where the administrator is using a calculation method that can only be used for two days); or

(c) ASIC and the RBA consider that it is likely the BBSW will not be able to be generated and published without ASIC issuing a written notice.