BUDDLE FINDLAY

Derivatives margin reform – Good progress...but

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The proposed reforms for derivatives margin contained in the Financial Markets (Derivatives Margin and Benchmarking) Reform Amendment Bill represent good progress in this technical yet very important area of New Zealand law. However, we believe there is still more to be done to ensure that 'NZ Inc' is not adversely affected because it hasn't put in place a regulatory regime consistent with global best practice.

Introduction

In this article, we provide a recap on why the derivatives margin proposals in the Bill are currently before Parliament, what the proposed new laws will achieve and our views on what still needs to be done in this area.

The Bill is currently at Select Committee and submissions close on 4 April 2019. If you are interested in making a submission on the Bill, we would be pleased to assist.

Why the proposals are being made

Rules are currently being implemented across the G20 countries that require parties to certain types of derivatives to exchange collateral (also referred to as 'margin'). While it has been common to exchange collateral during the life of a derivative (variation margin), the new rules will also now potentially require both parties to exchange collateral at the commencement of the contract by way of security (initial margin).

New Zealand is not a G20 country, and New Zealand law does not require parties to exchange collateral. However, circumstances will arise where the new rules will affect New Zealand parties (eg where they enter into a derivative with a counterparty from G20 country). New Zealand law (as it currently stands) potentially affects the ability of New Zealand entities to exchange collateral in accordance with the terms required by the new rules. In particular, the new rules generally require collateral posted as security to be immediately available in an event of default - and this may not be the case in all circumstances under New Zealand's current laws. This is the principal mischief that the derivatives margin proposals in the Bill are intended to fix. If this is not fixed then, as stated in the Explanatory Note to the Bill, this may "…have significant implications for New Zealand's financial system". The Bill also makes some other 'fixes' for other long-standing technical issues relating to derivatives margin.

What the derivatives margin rules under the Bill will do

The Bill represents good progress in this area. If enacted in its current form, it will put 'qualifying counterparties' in a much stronger position to be able to comply with foreign margin requirements. The key things the Bill does are, it:

- Removes stays/moratoria under certain New Zealand's insolvency laws that would otherwise prevent a non-defaulting derivative counterparty from accessing posted collateral immediately in an event of default. If the defaulting derivative counterparty is made subject to statutory management under the Reserve Bank of New Zealand Act 1989, a stay of generally no longer than two days will still apply
- Gives priority under the Companies Act 1993 to the claims of derivative counterparties over those of preferential creditors of the defaulting derivative counterparty
- Gives priority under the Personal Property Securities Act 1999 (PPSA) to the claims of derivative counterparties to posted collateral over the claims of any other person with a security interest in the collateral
- Excludes interests in collateral for derivatives that is transferred outright to a counterparty from the scope of the PPSA.

Each of the above rules will only apply where:

- The derivative is a 'qualifying derivative' (eg it must be subject to a legally robust netting agreement)
- The parties are qualifying counterparties' (namely, the New Zealand banks, the ACC, the New Zealand Superannuation Fund, designated clearing and settlement systems (like NZClear and NZX) or another entity to be prescribed by regulations)
- The collateral meets certain requirements (eg the collateral is cash or certain types of investment securities).

What still needs to be done

In our view, before the Bill is passed, the following points should be considered further:

- Will the new laws apply to qualifying derivatives entered into before the commencement of the legislation? The Explanatory Note to the Bill indicates that this will not be the case. However, we cannot see a policy reason why the new laws should not apply to all 'qualifying derivatives' (no matter when they were entered into). We suggest that this point should be clarified in the Bill itself.
- Is the 'qualifying counterparty' definition broad enough? The definition picks up the New Zealand entities that commonly enter into derivatives. However, there are other large corporates and public sector entities that regularly enter into these types of financial products. Is the intention for these other types of counterparties to be prescribed in regulation? Moreover, the policy reason for restricting the application to 'qualifying counterparties' seems weak. The banking industry had suggested the changes should apply to all counterparties. The 'qualifying counterparty' formulation in the Bill was not consulted on, and appears to be a compromise position given the initial proposal that it would only apply to parties required to take initial margin by an international regulator, which was criticised as unworkable. The position advocated and consistent with international practice is that the law should apply to all cleared and uncleared derivatives. We believe this is the better position. Further, this would be more consistent with the approach taken in other New Zealand legislation dealing with netting (which does not impose 'counterparty type' requirements).
- Are the proposed PPSA amendments the best way to deal with the underlying policy points? The scope of these amendments appear to be overly broad, both in the class of assets which may qualify (potentially extending beyond the range of collateral traditionally posted for derivatives) and the obligations which may be 'secured', which are not necessarily limited to the obligations under the qualifying derivative contract. In particular, we suggest that the concept of 'posted' collateral needs to be elaborated, so that it identifies only collateral which is within the effective possession or control of the secured counterparty to secure the payment or performance of obligations under a qualifying derivative. Furthermore, it is unclear why, as a matter of policy and for consistency with other provisions in the PPSA, the priority (as opposed to the validity or voidability) of a security interest for qualifying derivatives should depend on whether the secured creditor had knowledge of the debtor's insolvency (see clause 19 of the Bill).
- Will security taken over collateral for qualifying derivatives be susceptible to challenge by a liquidator or statutory manager? While the protection afforded for netting agreements (in section 310G of the Companies Act) from challenge as insolvent transactions or transactions at an undervalue remains, the ability to avoid security under section 293 of the Companies Act will continue to apply. The disapplication of an anticipated new voidable disposition provision (under section 296A of the Insolvency Practitioners Bill) to netting agreements and security should also be addressed in the Bill.

More broadly, we suggest that it is time for New Zealand to undertake a broader stocktake of its derivative related legislation and the rules surrounding the posting of collateral for derivative contracts. While the Bill does address the key issue for derivative counterparties at the moment (to facilitate compliance with the new international requirements for posted collateral) and one long-standing issue has been dealt with (namely, the treatment of an outright transfer of collateral under the PPSA), there are other issues that could do with being clarified in legislation (for example, the treatment of general security agreements under section 310B(2) of the Companies Act, the treatment of 'dematerialised' securities under the PPSA, the impact of voidable transactions on netting and margin requirements and the effect of New Zealand insolvency stays/moratoria on the ability of clearing members to close-out transactions undertaken for covered members in global clearing houses).

As part of a broader stocktake, we believe that the current laws that deal with this technical area of the law should be collated and put into the one Act and the industry should continue to advocate this position. If the laws were in the one Act, this would make it more straightforward for counterparties to obtain 'clean' legal opinions on the entry into these types of transactions. Further, if the laws were all contained in the one Act (as is the case in Australia), the application of the Interpretation Act and other principles of statutory interpretation would likely be more straightforward, especially if the application of the netting Acts (and associated derivatives margin rules) were to be tested in a New Zealand court.

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