MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

COVERSHEET

Minister	Hon Kris Faafoi	**Portfolio**	Commerce and Consumer Affairs
Name of package	Financial Markets (Derivatives Margin and Benchmarking) Reform Amendment Bill Proactive Release	**Date of issue**	27 March 2019

List of documents that have been proactively released		
Date	**Title**	**Author**
27 March 2019	Financial Markets (Derivatives Margin and Benchmarking) Reform Amendment Bill – Approval for Introduction	*Office of Hon Kris Faafoi, Minister of Commerce and Consumer Affairs*
27 March 2019	*Cabinet Economic Development Committee Minute of Decision:* Financial Markets (Derivatives Margin and Benchmarking) Reform Amendment Bill: Policy Approval and Approval for Introduction	*Cabinet Office*

Information withheld **YES**

Some parts of this information are not appropriate to be released, and if requested would be withheld under the Official Information Act 1982 (the Act). Where this is the case, the relevant sections of the Act that would apply have been identified and are listed below. Where information has been withheld, no public interest has been identified that would outweigh reasons for withholding it.

Section of the Act	**Reason for withholding**
9(2)(f)(ii)	to protect collective and individual ministerial responsibility
9(2)(f)(iv)	to protect the confidentiality of advice tendered by Ministers of the Crown and officials

In Confidence

Office of the Minister of Commerce and Consumer Affairs

Chair, Cabinet Economic Development Committee

Financial Markets (Derivatives Margin and Benchmarking) Reform Amendment Bill: Approval for Introduction

Proposal

1. This paper recommends that the Financial Markets (Derivatives Margin and Benchmarking) Reform Amendment Bill (the Bill) be introduced into the House. It also seeks policy decisions on one outstanding matter relating to the Bill.

Policy

2. The purpose of the Bill is to enable New Zealand financial market participants to comply with international rules and thereby continue to enter into derivatives and certain other types of financial instruments with important overseas financial entities. This ability is important to New Zealand financial market participants as it means they can hedge certain financial risks and raise funds from a broader range of sources. The Bill is an omnibus bill which amends a number of Acts to achieve this purpose.

3. The Bill provides for:

    3.1. amendments to a number of Acts that will remove impediments to compliance with foreign margin requirements for Over-The-Counter (OTC) derivatives; and

    3.2. the establishment of a new licensing regime for administrators of financial benchmarks under the Financial Markets Conduct Act 2013.

Enabling compliance with foreign margin requirements for OTC derivatives

4. Large New Zealand banks fund their activities in part by raising money offshore. To protect against the exchange rate risk associated with this, they enter into financial contracts known as derivatives with international banks and other financial institutions. Large public sector fund managers (for example, the New Zealand Superannuation Fund (NZ Super Fund) and the Accident Compensation Corporation (ACC)) also rely on derivatives when carrying out their activities, as do various other private sector entities.

5. New rules being implemented across Group of Twenty (G20) countries require parties to certain types of derivatives to exchange collateral. This collateral is also referred to as "margin". If one party defaults or becomes insolvent, the non-defaulting party can call on, or "enforce", the margin agreement, and is therefore protected to some extent from the defaulting party's financial distress. In certain circumstances,

these rules have extraterritorial scope, meaning that large New Zealand banks need to be able to comply with them (as do large public sector fund managers such as ACC and the NZ Super Fund[1]).

6. Certain features of New Zealand law impede the ability of these entities to comply with foreign margin rules. If these entities are unable to comply, they may lose access to derivative and offshore funding markets. For banks in particular, alternative, costlier sources of funding may have to be sought. This could place upward pressure on domestic interest rates, meaning New Zealand consumers and businesses would face higher costs of borrowing. Ultimately, reduced integration with global financial markets could also damage the soundness and efficiency of New Zealand's financial system.

7. In March and April 2018, Cabinet agreed to number of legislative amendments that will remove the impediments to compliance with foreign margin rules [DEV-18-MIN-0031 and CAB-18-MIN-0122 refer]. The amendments will involve technical changes to the Reserve Bank of New Zealand Act 1989 (RBNZ Act), the Corporations (Investigation and Management) Act 1989 (CIMA), the Companies Act 1993, and the Personal Property Securities Act 1999 (PPSA).

8. More specifically, the amendments will:

   8.1. Provide narrow exceptions to otherwise automatic moratoria on exercising secured creditor rights in statutory management under the RBNZ Act or CIMA, and in voluntary administration under the Companies Act 1993. These amendments will enable posted margin to be "immediately" available to the non-defaulting party in the event of a default (which is a requirement of the foreign margin rules). In the case of statutory management under the RBNZ Act, these amendments will allow the non-defaulting party to access posted margin subject to a "stay" of no more than two days (which may be further extended by the Reserve Bank in limited circumstances);[2]

   8.2. Amend the order of preference given to certain creditors in a liquidation as set out in Schedule 7 of the Companies Act 1993. This will mean that the claims of derivative counterparties have priority over the claims of Schedule 7 preferential creditors, including employees and the Commissioner of Inland Revenue. This change to priority will be limited to claims on margin comprised of accounts receivable to allow accounts receivable to be posted as margin. Claims on margin comprised of other assets already have de facto priority over the claims of preferential creditors;

   8.3. Amend the PPSA so that the claims of derivatives counterparties have priority over the claims of any other person with a security interest in the posted margin;

1 Despite public sector entities generally being legally exempt from the rules, important foreign counterparties increasingly expect compliance with the rules regardless (as the rules are becoming standard market practice internationally).
2 Statutory management under the RBNZ Act applies only to registered banks. A short delay (i.e. the "stay" of up to two days that may be extended in limited circumstances) on the enforcement of these security interests against a failed bank may be necessary to facilitate the orderly winding up of the failed bank and avoid significant damage to the financial system.

8.4. Amend the PPSA to clarify that in certain circumstances the transfer of title in margin does not create a security interest for the purposes of that Act.

9. Importantly, in order to minimise any impacts on non-derivative creditors, these amendments will only apply in tightly defined circumstances. Specifically, the amendments will only apply where:

9.1. a counterparty to the derivative transaction is one of the following prescribed entities or class of entities:

9.1.1. a registered bank;

9.1.2. a central counterparty that is a designated settlement system;

9.1.3. the ACC;

9.1.4. the NZ Super Fund;

9.1.5. another entity or class of entities prescribed by regulations (this could include financial institutions that rely on derivatives and that might be caught by the margin requirements over time e.g. managed investment schemes or insurers);

9.2. the derivative meets certain requirements (such as being subject to a legally robust netting agreement); and

9.3. margin posted in relation to the derivative meets certain requirements, such as taking the form of a prescribed financial product (including certain investment securities or cash).

10. The impediments to compliance with foreign margin requirements arise from existing legislation, so can only be addressed through amendments to legislation.

11. It is possible that the fact that the Bill effectively subordinates the claims of preferential creditors (e.g. employees, Inland Revenue) to some of the claims of derivative creditors may be controversial. However, it is very unlikely that preferential creditors will be made worse off by the amendments. Only the entities noted in paragraph 9.1 can make use of the amendments, and the insolvency processes would be unchanged for other entities. Any impact on the preferential creditors of the entities able to make use of these amendments is likely to be very small and would only arise in the event that one of these entities suffered a particularly severe insolvency (which is very unlikely). This risk is also outweighed by the costs of inaction to the financial sector, consumers and businesses.

12. There are no outstanding policy issues relating to this part of the Bill.

Introduction of a licensing regime for administrators of financial benchmarks

13. In June 2016, the European Union (EU) responded to concerns about conflicts of interest and the manipulation of financial benchmarks by publishing new benchmark

regulations.[3] The new EU regulations set standards around the processes by which financial benchmarks are set, and will apply from 1 January 2020. The regulations have effect outside the EU as third party countries and benchmark administrators in those countries must meet the new standards if the benchmarks they administer can be used in financial contracts with parties located in the EU.

14. New Zealand banks and other large private and public sector organisations (e.g. the Reserve Bank, ACC, NZ Super Fund, NZ Debt Management Office) rely on contracts with EU counterparties that reference New Zealand benchmarks and access to EU financial markets for risk management, investment and capital raising purposes.

15. To ensure that New Zealand benchmarks (e.g. the Bank Bill Benchmark Rate which is administered by the New Zealand Financial Markets Association (the NZFMA)) meet those standards, and can continue to be used in critical financial contracts with EU counterparties, Cabinet agreed to establish a new licensing regime for administrators of financial benchmarks [DEV-18-MIN-0157 and CAB-18-MIN-0379 refer].

16. The new licensing regime will be implemented under the Financial Markets Conduct Act 2013 (FMC Act). It has been designed on an opt-in basis so that it only captures the financial benchmarks that are intended to be regulated. Licensing, monitoring and enforcement of the regime will be carried out by New Zealand's financial markets regulator, the Financial Markets Authority (the FMA). Subsequent regulations will prescribe the detail of the licensing standards and conditions, consistent with and as required by EU regulations.

17. The European Commission will then make a formal assessment of our regulatory framework to ensure it complies with binding requirements equivalent to the EU regulations.

Outstanding policy issue – new compulsion powers for the Financial Markets Authority

18. There is one outstanding policy matter in relation to the benchmarking aspects of the Bill which was not anticipated when earlier policy decisions were sought and for which I am now seeking approval.

19. The Bill includes new powers for the FMA to compel:

    19.1. a licensed administrator of a financial benchmark to continue administering that benchmark for a specified period and in accordance with specified requirements.

    19.2. a contributor to a benchmark (i.e. a non-licensed market participant which provides data or information to the benchmark administrator necessary for the generation or administration of the benchmark – e.g. a bank) to continue providing data or information to the administrator of the benchmark for a specified period and in accordance with specified requirements.

3 Financial benchmarks are figures, rates or indexes (e.g. interest rates) that are referenced in financial products to set or determine the value of those financial products, or to measure the performance of investment funds.

20. The purpose of these powers is to ensure the continuity and reliability of benchmarks to the market, and avoid instability that might occur if a benchmark were to be disrupted. This might occur where an administrator intends to cease administering a benchmark or is otherwise unwilling or unable to perform its responsibilities as administrator, or a contributor is unwilling to voluntarily contribute data necessary for the administration of the benchmark.

21. Requiring an administrator to continue to perform its functions can help to achieve:

    21.1. an orderly transition to another benchmark administrator, without disrupting the operation of the benchmark

    21.2. an orderly cessation of the benchmark, including giving reasonable time for users to amend financial contracts that reference the benchmark.

22. Instability in the market might also occur if critical contributors to a benchmark (such as large banks) ceased providing information or data to a benchmark. This could undermine the integrity of the benchmark as the benchmark may no longer reflect underlying market or economic reality. In these circumstances, requiring the contributors to continue to contribute data or information for a period of time can help to achieve:

    22.1. an orderly transition to another method for calculating the benchmark

    22.2. an orderly transition to another benchmark

    22.3. an orderly cessation of the benchmark, including giving reasonable time for users to amend or phase out financial contracts that reference the benchmark.

23. We anticipate that this type of disruption will be rare and exceptional but emergency-type powers that can be exercised quickly are necessary to avoid disruption to the benchmark and ensure market stability. The powers are also mandatory requirements in order for New Zealand to achieve formal "equivalence" status under the EU regulations that are driving the reforms. Officials became aware of the need to include these powers in the legislation during further discussions with the European Commission after initial policy decisions were sought.

24. The FMA will exercise these new powers by giving written directions to the relevant administrator or contributor if it is satisfied that it necessary or desirable, having regard to the purposes of the Act and the purposes of licensing within the Act.

25. An administrator or contributor who receives a direction from the FMA will be required to comply with it and civil liability will attach for non-compliance, including a maximum pecuniary penalty of $200,000 in the case of an individual or $600,000 in any other case. These penalties are based on existing penalty provisions for comparable conduct in the FMC Act, such as non-compliance with a general FMA direction.

26. I consider that these liability provisions will be adequate to incentivise compliance with a direction. There will generally be an interest from all parties to avoid market disruption and, particularly in the case of a benchmark administrator, a potential $600,000 penalty will likely represent a significant sum.

Impact analysis

27. Regulatory Impact Summaries (RIS) were prepared in accordance with the necessary requirements, and were submitted with the two respective papers for the Cabinet Economic Development Committee seeking approval of the policies relating to the Bill [DEV-18-MIN-0031 and CAB-18-MIN-0122 refer in respect of amendments relating to foreign margin requirements for OTC derivatives; DEV-18-MIN-0157 and CAB-18-MIN-0379 refer in respect of the amendments relating to administrators of financial benchmarks].

28. The Ministry of Business, Innovation and Employment (MBIE) has prepared an amended RIS in respect of the proposal to include new FMA new compulsion powers in the benchmark licensing regime. MBIE's Regulatory Impact Analysis Review Panel has reviewed the changes made to the attached RIS. The Panel considers that the changes do not impact on the previous quality assurance approval rating for this RIS and that it still meets the criteria necessary for Ministers to take informed decisions on the proposals in this paper.

Compliance

29. The Bill complies with:

    29.1. the principles of the Treaty of Waitangi;

    29.2. the rights and freedoms contained in the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993;

    29.3. the disclosure statement requirements (a disclosure statement has been prepared and is attached to the Bill);

    29.4. the principles and guidelines set out in the Privacy Act 1993;

    29.5. relevant international standards and obligations;

    29.6. the *Legislation Guidelines (2018 edition)*, which are maintained by the Legislation Design and Advisory Committee.

Consultation

30. In relation to the amendments to enable compliance with foreign margin rules:

    30.1. The Reserve Bank and MBIE consulted with the Treasury, Inland Revenue, and Department of Prime Minister and Cabinet (Policy Advice Group).

    30.2. The Reserve Bank and MBIE also published a public consultation document in 2017. Six submissions were received. Bilateral discussions were also undertaken with the New Zealand Bankers Association and technical legal experts. Views were also sought from the Council of Trade Unions. No significant concerns were raised (although some stakeholders suggested that broader law reform around derivatives and netting would also be appropriate).

31. In relation to the new licensing regime for administrators of financial benchmarks:

31.1. MBIE consulted with the Treasury, Reserve Bank, FMA, and the Department of Prime Minister and Cabinet (Policy Advisory Group).

31.2. MBIE and the FMA also discussed the policy proposals with the NZFMA and relevant industry participants (primarily the banks), including in relation to the compulsion powers for contributors and benchmark administrators. Consulted stakeholders agreed with the need to take prompt action in relation to the EU regulations, and supported the proposals.

32. The Ministry of Justice has been consulted on the proposal to extend certain penalties in the FMC Act to administrators of financial benchmarks. In light of the limited scope of these changes, Justice considers the proposed penalties are justified.

Binding on the Crown

33. The Bill amends Acts that already bind the Crown.

Law relating to existing agencies

34. The Bill amends the law relating to the FMA by providing it with a new power to compel administrators and contributors to administer benchmarks and contribute data respectively, as noted above in paragraphs 18-26.

35. The Bill does not amend the existing coverage of the Ombudsmen Act 1975, the Official Information Act 1982, or the Local Government Official Information and Meetings Act 1987.

Allocation of decision-making powers

36. The Bill does not involve the allocation of decision making powers between the executive, the courts, and tribunals.

Associated regulations

37. Regulations will be required to implement the Bill.

38. In respect of the amendments relating to margin requirements, regulations will be required in order to specify a small amount of technical detail about the nature of the OTC derivatives covered by the amendments. Specifically, to ensure that all forward foreign exchange contracts are covered by the definition, regulations are required to set out how quickly the forward delivery or payment of the relevant amount of currency under a forward foreign exchange contract must be made after the contract is entered into. These regulations will be small and of low complexity. We expect they will be gazetted shortly after the Bill receives the Royal assent and come into force around October 2019.

39. In respect of the new licensing regime for benchmark administrators, extensive regulations will be needed to fill out the detail of the regime in line with the requirements of the EU regulations.

40. Officials are still working through the policy of what needs to be included in regulations in light of the EU requirements. Regulations are likely to be of medium complexity and of medium to large size. At this stage, we anticipate that the regulations will include requirements such as governance and oversight, conflict of interest management, benchmark design and methodology, input data, business continuity and risk management, procedures around cessation of a benchmark and transition arrangements, codes of conduct for contributors, transparency and access to benchmarks, record-keeping and complaints processes, and reporting to the FMA.

41. Regulations will also be included to support the basic framework of licensing, including in relation to:

 41.1. eligibility criteria for benchmark administrator licences and requirements relating to directors and senior managers of the administrator

 41.2. matters that the FMA must have regard to before deciding to issue a benchmark administrator licence, persons or class of persons that must be consulted, and the manner of making a decision

 41.3. information the FMA must send to the Registrar

 41.4. conditions of benchmark administrator licences.

Other instruments

42. The Bill does not include any provision empowering the making of other instruments that are deemed to be legislative instruments or disallowable instruments (or both).

Definition of Minister/department

43. The Bill does not contain a definition of Minister, department (or equivalent government agency), or chief executive of a department (or equivalent position).

Commencement of legislation

44. It is necessary for the Bill to be passed by 1 September 2019 in order to:

 44.1. ensure that compliance with foreign margin requirements is possible under New Zealand law before the final group of affected entities is brought within the scope of these rules in September 2019; and

 44.2. allow the European Commission to start their assessment of New Zealand's benchmarking regime for "equivalence" in mid-2019 (which is expected to take several months), in advance of the EU regulations taking effect on 1 January 2020. Many other countries are applying for "equivalence" and officials have been informed that the longer New Zealand takes to enact its legislation, the more risk there is of not meeting the 1 January 2020 deadline as the European Commission will become busy processing other countries' applications for equivalence.

45. In order to meet the 1 September 2019 date for enactment, I am proposing that the Bill be referred to select committee for a shortened period of 4 months.

46. The amendments will come into force on a date or dates specified by one or more Orders in Council. This is likely to be by the end of September 2019, but no later than six months after the date of Royal assent.

47. The Bill is expected to be fully in force by the end of 2019, but the commencement date or dates are to be appointed by Order in Council to provide some flexibility for development of associated regulations which are needed for implementation of the Bill.

Parliamentary stages

48. The Bill should be introduced in late February or early March and passed by 1 September 2019.

49. I propose that the Bill be referred to the Finance and Expenditure Committee for consideration. I also propose a shortened select committee period of four months in order to enable compliance with relevant international reforms relating to financial markets before those reforms fully come into effect (see the discussion in paragraph 43).

Proactive Release

50. I will release this paper proactively in whole, subject to redactions as appropriate under the Official Information Act 1982.

Recommendations

The Minister Commerce and Consumer Affairs recommends that the Committee:

1. S9(2)(f)(iv)

2. **note** that the Bill:

    2.1. amends a number of existing Acts to remove impediments to compliance with foreign margin requirements for Over-The-Counter (OTC) derivatives; and

    2.2. establishes a new licensing regime for administrators of financial benchmarks under the Financial Markets Conduct Act 2013.

3. **agree** that:

    3.1. the Financial Markets Authority be given the power to compel:

        3.1.1. a licensed administrator of a financial benchmark to continue administering that benchmark for a specified period and in accordance with specified requirements;

3.1.2. a contributor to a benchmark to continue providing data or information to the administrator of the financial benchmark for a specified period and in accordance with specified requirements;

3.2. civil liability, including a maximum pecuniary penalty of $200,000 in the case of an individual or $600,000 in any other case, should attach for non-compliance with the powers described in recommendation 3.1.

4. if the Committee agrees to the policy proposal in paragraph 3, **approve** the Financial Markets (Derivatives Margin and Benchmarking) Reform Amendment Bill for introduction, subject to the final approval of the Government caucus and sufficient support in the House of Representatives;

5. **agree** that the Bill be introduced in late February or early March 2019;

6. **agree** that the Government propose that the Bill be:

6.1. referred to the Finance and Expenditure Committee for consideration;

6.2. enacted by 1 September 2019.

Authorised for lodgement

Hon Kris Faafoi
Minister of Commerce and Consumer Affairs