Credit derivatives, Netting and ISDA Documentation: Recent Developments in New Zealand

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Introduction

(a) Outline of paper

This paper is in four parts:

- the first part looks at the new 2002 ISDA Master Agreement and considers what amendments to the standard form might be desirable from a New Zealand law perspective;
- the second part looks at the use (or rather lack of use) of credit derivatives in New Zealand and considers whether they raise particular New Zealand law issues;
- the third part looks at the various netting regimes in New Zealand; and
- the fourth part looks at the applicability of the PPSA to netting, credit support and repo documentation.

(b) Defined terms

In this paper, the following defined terms are used:

AFMA - Australian Financial Markets Association;
CIM Act - Corporations (Investigation and Management) Act 1989;
CSA - ISDA Credit Support Annex (English law - transfer);
CSD - ISDA Credit Support Deed (English law - security interest);
ICSD - international central securities depository;
NZBA - New Zealand Bankers' Association;
PPSA - Personal Property Securities Act 1999;
RBNZ - Reserve Bank of New Zealand; and

RBNZ Act - Reserve Bank of New Zealand Act 1989.

1. 2002 ISDA Master Agreement

(a) General

The project to revamp the 1992 ISDA Master Agreement began in 1999 with ISDA's Strategic Documentation Review. The project was completed in January this year when ISDA published the 2002 ISDA Master Agreement.

The main changes brought about by the new Master Agreement have been well canvassed.[177] In summary, the main changes are:

- the introduction of "Close-out Amount" as the single valuation measure;
- the addition of a Force Majeure Termination Event;
- the reduction in the grace periods used in certain Events of Default; and
- the inclusion of a set-off provision.

A number of drafts of a User's Guide to the 2002 ISDA Master Agreement have been circulated. ISDA published a User's Guide in July.

(b) Use in New Zealand

In 1993, the NZBA developed a standard form schedule to the 1992 ISDA Master Agreement. That schedule became the template for bank and

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177 See, for example:

- Tredgett and Berry, *A New Master Agreement for the New Millennium: the Development of the 2002 ISDA Master Agreement*, JIBFL May 2002;
- Berry, *ISDA Sets New Standard for Derivatives*, IFLR February 2003; and
- Henderson, *ISDA 2002 Master Agreement*, JIBFL March 2003.

non-bank counterparties in New Zealand. It was revised in 2000 following the enactment of New Zealand's netting legislation.

Unlike AFMA, the NZBA has not yet produced a standard form schedule to the 2002 ISDA Master Agreement. That said, in producing such a schedule, there are unlikely to be many changes required to the current NZBA schedule *due to matters of New Zealand law.*[178] There may, however, be a number of changes required to reflect changes in market practice (e.g., the deletion of the NZBA addenda).

Given that there is no NZBA standard form schedule to the 2002 ISDA Master Agreement, it is not surprising that the vast majority of New Zealand counterparties seem to be still using the 1992 ISDA Master Agreement.

2. Credit derivatives

For a number of years, growth in the global credit derivatives markets has far outstripped that for any other OTC derivative. Be that as it may, this growth has not filtered down to New Zealand. The New Zealand market for credit derivatives is extremely limited, despite their increasing use across the Tasman by the parents of our Australian-owned banks. While there is little publicly available information on the New Zealand market, anecdotal evidence suggests that activity is limited to a few issues of credit-linked notes.[179] Credit default swaps referencing New Zealand companies are rare.

Whatever the reason for the lack of credit derivatives activity in New Zealand, it is not because of legal impediments. Credit derivatives raise no additional issues over and above those raised by more vanilla derivatives. The only possible exception to this is that credit derivatives (more so than other products) are akin to insurance contracts and, therefore, are arguably subject to insurance legislation.

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178 One likely change is the replacement of the set-off provision in Section 6(f) of the 2002 Master Agreement with the so-called "extended set-off" provision in the current version of the NZBA schedule. While the former provision should operate in accordance with its terms in the insolvency of a New Zealand counterparty, the latter provision is more closely aligned with the requirements of New Zealand's netting legislation and is, therefore, preferable.

179 For example, the offer of "Generator Bonds" currently being promoted by Macquarie Equities New Zealand Limited and the offer of "HY-FIs" currently being promoted by ABN AMRO are, in essence, retail CLN issues.

(a) Consequences of credit derivatives being insurance contracts

If credit derivatives constitute insurance contracts, a number of consequences follow. For example:

- The protection seller would likely be regarded as carrying on "insurance business" in New Zealand and would be required, under the Insurance Companies' Deposits Act 1953, to lodge a NZ$500,000 deposit with the Public Trust. If it failed to do so, both it and its officers would be liable to a fine of up to NZ$100/day while the default continued. Also, if the default continued for three months, the protection seller could be prohibited from carrying on that business in New Zealand.

- The protection seller would be required to obtain, and register, a current credit rating from an "approved agency" pursuant to the Insurance Companies (Ratings and Inspections) Act 1994. If it failed to do so, both it and its directors would be liable to a fine of up to NZ$100,000 (for failure to obtain a rating) or NZ$50,000 (for failure to register the rating). The protection seller would also be required to disclose its rating to each counterparty prior to entry into a credit derivative. If it failed to do so, the counterparty would be entitled to cancel the contract within 20 working days of its execution.

- The protection seller and its counterparty would be subject to the common law rule requiring an insurer and an insured to act in utmost good faith towards each other.

(b) Definition of contract of insurance

All of this raises the obvious question of whether credit derivatives are, in fact, insurance contracts.

The New Zealand courts have adopted the widely accepted definition of a contract of insurance expressed by Channell J in *Prudential Insurance Co*

v Inland Revenue Commissioners [1904] 2 KB 658.[180] In particular, an insurance contract requires the insured to have an "insurable interest" in the subject matter of the contract.

An important qualification to this requirement is set out in section 7(1)(a) of the Insurance Law Reform Act 1985. That provision states that:

> no person for whose use or benefit or on whose account a policy of insurance is made is required to have any interest in any event for the purposes of –
>
> (a) Any contract of indemnity against loss;

This is a confusing provision.[181] It removes the requirement for the beneficiary of a contract of indemnity against loss to have an "insurable interest" in the subject matter. However, by its very nature, such a contract will only pay out where the insured can prove a loss (which inevitably requires an interest in the subject matter). Perhaps the best way to reconcile the provision is to conclude that, if there is no requirement for the insured under a contract of indemnity against loss to have an "insurable interest", there can still be an insurance contract. However, in the absence of such an interest, there may be no right to payment under that contract.

Consequently, in order for a credit derivative to avoid classification as an insurance contract, it must not be drafted as a contract of indemnity against loss. In practice, this means that there cannot be an obligation on the counterparty to hold the underlying reference obligation. Provided that this is the case, a credit derivative should not constitute an insurance contract under New Zealand law. This is similar to the conclusion that is widely accepted in most other common law jurisdictions.[182]

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180 See, for example, *The Motorcycle Specialists Limited v The Attorney-General* (1988) 5 ANZ Insurance Cases ¶ 60-882.

181 It was described as "a somewhat puzzling section" in *Wijeyaratne* v *Medical Assurance Society NZ Ltd* [1991] 2 NZLR 332, 339 (HC).

182 See, for example:

- Ciro, *Functional Regulation and Financial Products: Regulatory Interplay between Financial Derivatives and Contracts of Insurance*, JBFLP March 2002;
- PricewaterhouseCoopers, *The Financial Jungle – A Guide to Credit Derivatives* (2001) pp.15-16;
- Henderson, *Credit Derivatives – Part 3*: *Selected Legal Issues*, JIBFL May 1999; and

3. Netting

(a) *Terminology*

The terms "netting" and "set-off" are often used interchangeably. Technically, however, they are not the same thing. "Netting" is the process by which two or more reciprocal debts are extinguished and replaced by a single net debt. By contrast, "set-off" is the process in which parties agree that two or more debts may be satisfied by payment of the net amount – however, the gross debts remain in existence. This paper adopts the terminology used by the relevant statutory regime being considered, which is not necessarily consistent with the distinction drawn above.

(b) *The netting regimes*

Prior to 1999, the netting landscape in New Zealand was fairly simple. The only two statutory regimes applicable to companies that affected netting rights were the liquidation and statutory management regimes. Broadly speaking, the liquidation regime allowed netting, whereas the statutory management regime did not.

Since the enactment of netting legislation in April 1999, the landscape has become more cluttered (as it is also in Australia). It will become even more so once the Reserve Bank of New Zealand Amendment Bill is enacted. The table below summarises the principle features of each regime once that Bill comes into force (which is expected to be in the next few months).

- Benton, Devine and Jarvis, *Credit Derivatives are not Insurance Products*, IFLR November 1997.

Netting regime	Circumstances in which it applies	Example of transaction or entity covered	Mutuality required?	Written netting agreement required?	RBNZ designation required?	Overrides statutory management moratorium?	Payments protected from clawback
Solvent netting	Outside insolvency	Cash pooling arrangements	No	No	No	N/A	N/A
Section 310 of Companies Act	Liquidation	Loan vs deposit (no written netting agreement)	Yes	No	No	No	No
"Bilateral netting agreements" under sections 310A-O of Companies Act	Liquidation and statutory management	ISDA master agreement	Yes	Yes	No	Yes	No
"Recognised multilateral netting agreements" under sections 310A-O of Companies Act	Liquidation and statutory management	Austraclear NZ	No	Yes	Yes	Yes	No
"Designated payment system" under Part VC of RBNZ Act	At all times	CLS Bank	No	Yes	Yes	Yes	Yes

(c) The remaining legal issues in the context of close-out netting

By and large, the 1999 netting legislation has removed the legal uncertainty that previously surrounded the enforceability of close-out netting. In particular, it is now clear that close-out netting is enforceable against a company made subject to statutory management.

However, a number of peripheral issues are raised from time to time. For example:

- Some people have questioned whether the exception to the statutory management moratorium on exercising set-off rights[183] extends to protect non-companies. The argument is that the exception only extends to protect "a netting agreement to which sections 310A to

[183] Section 42(7)(a) of the CIM Act and section 122(7)(a) of the RBNZ Act.

3100 of the Companies Act" applies, and those provisions only apply to a netting agreement to which *a company* is party.[184]

- Whatever the correct interpretation for the issue above, it is clear that non-company corporates (in particular, local authorities and other statutory corporations) are not protected by the netting legislation except to the extent they can be made subject to statutory management.

- The netting legislation provides that the "netted balance" is the amount that is payable by, or to, the insolvent counterparty. The "netted balance" is defined to mean the amount calculated under a netting agreement "in respect of all or any transactions to which the netting agreement applies". In the case of a bridge,[185] it is arguable that any non-master agreement indebtedness (e.g., a loan) does not arise under a transaction "to which the netting agreement applies". If that were correct, the bridge provision would not have the benefit of the netting legislation. It should, however, be possible to draft such a provision in a manner that achieves this protection.

  The same issue applies to master masters.[186]

- While a liquidator or statutory manager cannot cherry pick individual transactions,[187] those transactions are still subject to the voidance preference provisions in the Companies Act. The practical consequence of this for the solvent counterparty is that, while the net settlement amount will be calculated on the basis of *all* transactions, that amount may subsequently have to be adjusted if a transaction were set aside under, say, section 292 (transactions having preferential effect).

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184 The writer's view is that this interpretation is inconsistent with both the wording in the Companies Act and the broad policy behind the netting legislation.

185 A "bridge" is a provision in a master agreement that purports to take into account, in the calculation of the close-out amount, amounts owing under *another* agreement. An example of a bridge is the set-off clause in Section 6(f) of the 2002 ISDA Master Agreement.

186 A "master master" is a master agreement that purports to net the close-out amounts payable under two or more underlying master agreements. An example is the Cross Product Master Agreement published by The Bond Market Association.

187 Section 269(2)(b)(ii) of the Companies Act, section 44(4) of the CIM Act and section 127(4) of the RBNZ Act.

- How close-out netting applies in relation to trusts is still a matter that is surrounded by uncertainty. The matter is further complicated in New Zealand by the fact that there is no regime that deals with the insolvency of trusts (and that, therefore, prescribes whether mutuality is required for insolvent set-off).

- The RBNZ (who sponsored the 1999 netting legislation) does not recognise, for capital adequacy purposes, any form of netting other than netting by novation.[188] Furthermore, this recognition extends only to foreign exchange contracts and not to other types of derivatives.

4. PPSA

In most respects, the PPSA has been welcomed as a significant step forward in reforming New Zealand's laws on security interests in personal property. In respect of financial markets documentation, the reception has been more mixed. At best, the PPSA is a step sideways. It poses as many issues as it resolves. A number of these new issues are discussed below in the context of netting, credit support and repo documentation. The discussion assumes a general understanding of how the PPSA operates.

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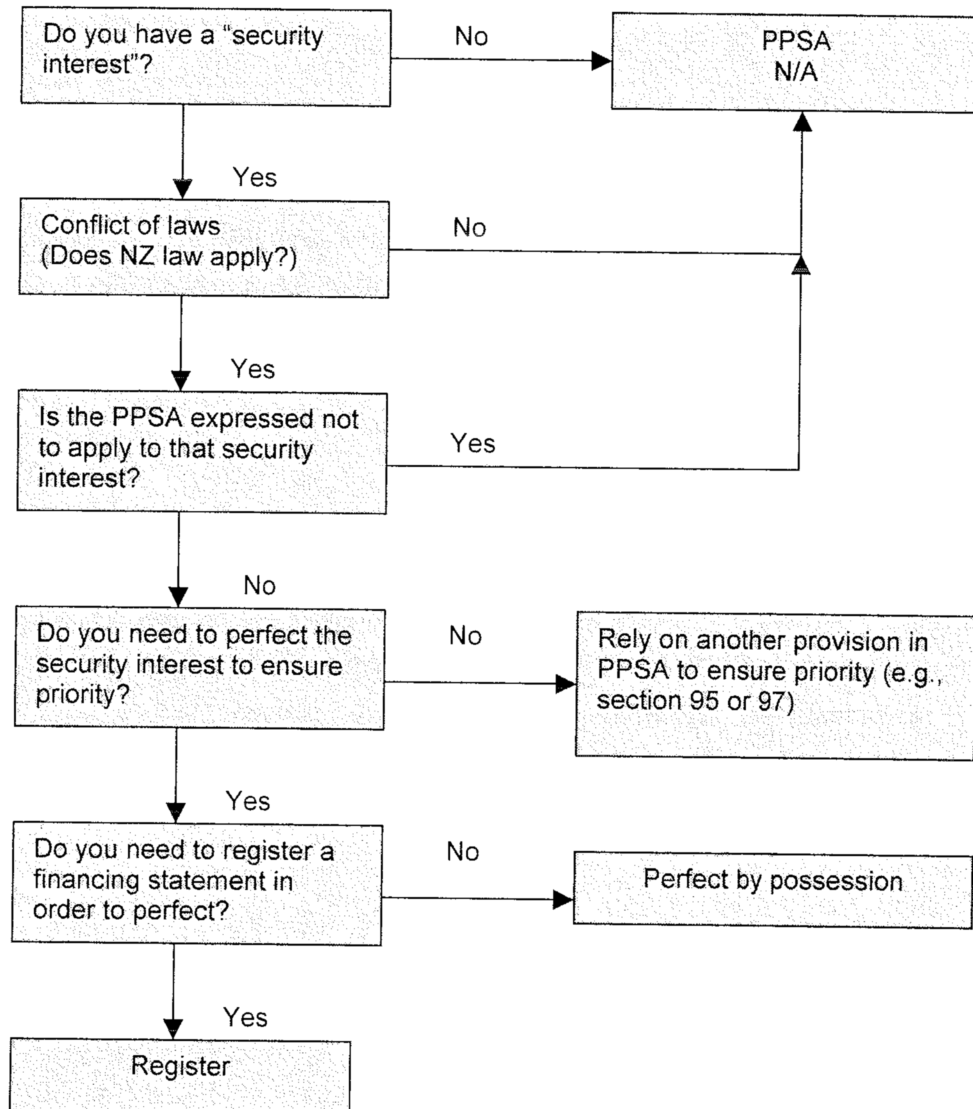
188 *Document BS2: Capital Adequacy Framework* (July 2003) para. 47.

The three key questions

The scheme of the PPSA can be broadly summarised by the series of questions set out in the diagram below.



In the context of financial markets documentation, three of these questions are key. These are:

- do you have a "security interest"?
- does New Zealand law apply?

- do you need to perfect the security interest in order to ensure priority?

Each of these key questions is considered below.

(a) Do you have a "security interest"?

"Security interest" is defined in section 17(1)(a) of the PPSA to mean:

> an interest in personal property created or provided for by a transaction that in substance secures payment or performance of an obligation, without regard to –
>
> (i) The form of the transaction; and
>
> (ii) The identity of the person who has title to the collateral;

In addition, and for the avoidance of doubt, section 17(3) lists a number of types of transactions to which the PPSA applies. The list includes "a fixed charge,...pledge,...[or] an assignment...that secures payment or performance of an obligation". This reinforces the central concept in the section 17(1)(a) definition that it is the *substance* of the transaction that is critical. It is immaterial that the form of a transaction is, say, an absolute assignment if, in substance, it secures payment or performance of an obligation.[189]

The table on the following two pages considers whether certain netting, credit support and repo documentation creates a "security interest".

Agreement	Does agreement create a "security interest"?
Netting agreement	- No, because: • the "secured party" has no *proprietary* interest in the claim of the "debtor" (as required by section 17(1)(a)) – it merely has a *contractual* right to apply that claim towards satisfaction of

[189] Section 24 restates this principle by providing that the application of the PPSA is not affected by the fact that title to collateral may be in the secured party rather than the debtor (which will be the case in an absolute assignment).

Agreement	Does agreement create a "security interest"?
	an amount owed to it by the debtor;[190] and • section 23(c) of the PPSA provides that the Act does not apply to any right of set-off, netting or combination of accounts.[191]
Netting agreement coupled with a flawed asset arrangement (e.g., 2002 ISDA Master Agreement[192])	- No. Same analysis as above. The flawed asset arrangement is not a "security interest" for the same reason the netting arrangement is not – the "secured party" has no proprietary interest in the underlying asset that is "flawed".[193] It merely has the right to withhold payment until the relevant condition is satisfied. But there is a contrary view,[194] which places reliance on the inclusion of "a flawed asset arrangement" in section 17(3). This contrary view inherently involves reading down the fundamental requirement in section 17(1) that a security interest must create a proprietary interest in the collateral. A flawed asset arrangement accompanied by, say, a right to sell the asset (e.g., as part of a "triple cocktail") *would* be a security interest. But it would be the charge created by the right to sell, rather than the flawed asset arrangement itself, that is the security interest.
CSD	- Yes.

190 It has been suggested by some that a non-mutual set-off may give rise to a proprietary interest in the claim (effectively, a charge). However, the authority for this proposition is weak (see, for example, *Re Tudor Glass Holdings Limited* [1984] 1 BCC 98,982). The better view is that this is not the case: Wood, *English and International Set-off* (1989), para. 5-185 and Derham, *The Law of Set-off* (3rd ed., 2003) para. 1680.

191 The exception to this rule is section 102 of the PPSA, which covers (among other things) the competing interests of a person entitled to a charge over a deposit and the bank at which the deposit is held.

192 The "flaw" in this case is the contractual restrictions in Section 2(a)(iii).

193 See *Re Bank of Credit and Commerce International SA (No 8)* [1998] AC 214, 225-227 (HL).

194 Gedye, Cuming & Wood, *Personal Property Securities in New Zealand* (2002) para. 17.4.8. Cf. Widdup & Mayne, *Personal Property Securities Act, A Conceptual Approach* (Revised edition, 2002) para. 2.36.

Agreement	**Does agreement create a "security interest"?**
CSA	- Yes. It is irrelevant whether the outright transfer method (i.e., the CSA) or the security interest method (i.e., the CSD) is chosen. The PPSA applies in either case. However, there is a contrary view that says the PPSA *does not* apply to a CSA because a feature of a "security interest" is that the debtor retains some proprietary interest in the collateral (akin to an equity of redemption). But: • While this retention of an interest is one of the hallmarks of a mortgage or charge at common law, there is nothing in the PPSA that suggests this is required under the new statutory regime. • This view confuses the classic recharacterisation cases[195] (which consider whether the *form* of an agreement and its *legal substance* are the same) with the test under the PPSA (which considers *economic substance*). Merely because, say, a CSA would not be recharacterised as creating security under common law does not mean it cannot be a "security interest" for the purposes of the (separate) PPSA test. • Section 17(3) of the PPSA states that the Act applies to "an assignment" that secures payment. • This contrary view is completely inconsistent with the PPSA's substance over form approach. Specifically, this view asserts that form *does* matter under the PPSA because, while the CSA and the CSD have the same economic substance, the Act applies to one but not the other.

[195] The leading New Zealand case is *Automobile Association (Canterbury) Incorporated* v *Australasian Secured Deposits Ltd (In Liquidation)* [1973] 1 NZLR 417 (CA).

Agreement	Does agreement create a "security interest"?
Repo agreement (e.g., TBMA/ISMA GMRA)	- Yes. Same analysis as for the CSA. The economic substance of the repo itself, and any margin transfer, is the same as a transfer of securities under a CSA.

(b) Conflict of laws (does NZ law apply?)

The PPSA has its own set of conflict of laws rules. These are set out in sections 26 to 33. The rules differ depending on the collateral type and the security interest type. In the context of financial markets documentation, the most common scenario (and the one that raises the most difficult legal issues) is a possessory security interest in investment securities.[196] In that case, the relevant conflict of laws rule is that New Zealand law (and, therefore, the PPSA) applies in determining issues of validity and perfection if:

- the security agreement is governed by New Zealand law; or
- the collateral is situated in New Zealand at the time of attachment.

The first possibility is self-explanatory. The second is less so. As with many other common law jurisdictions, there is little authority in New Zealand on the *lex situs* of securities held through an ICSD.[197] The prevailing view seems to be that, as in Australia, the "place of the relevant intermediary approach" (or **PRIMA**) would be adopted. There is overwhelming academic support for PRIMA.[198] It has also been accepted in private international law.[199]

This approach has the logical appeal of determining that proprietary issues in relation to interests in immobilised or dematerialised securities

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196 The terms "possessory security interest" and "investment securities" are discussed in section (c) below.

197 Although, in the case of dematerialised securities, section 26(2) of the PPSA provides that they are situated where the records of the ICSD are kept.

198 Dicey and Morris, *The Conflict of* Laws (13th ed., 2000) para. 22-043. See also *Oxford Colloquium on Collateral and Conflict of Laws*, Special Supplement to Butterworths Journal of International Banking and Financial Law (September 1998); Benjamin, *Interests in Securities* (2000); Austen-Peters, *Custody of Investments: Law and Practice* (2000).

199 *The Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary*, adopted on 13 December 2002.

should be governed by the law of the place where the record of title is maintained and where, therefore, orders in respect of those securities can be enforced. PRIMA overcomes the practical difficulty, commercial inefficiency and uncertainty surrounding the alternative "look through approach" (under which the *lex situs* of immobilised or dematerialised securities is the jurisdiction where the underlying securities are located).

(c) ***Do you need to perfect the security interest to ensure priority?***

In certain circumstances, the PPSA provides for methods other than perfection that allow a secured party to obtain priority over all other secured parties. These methods differ depending on the type of collateral involved. The method most likely to be relied on in the context of credit support or repo documentation is that set out in section 97. Section 97 gives priority to a "purchaser" (which includes a secured party) who takes "possession" of "investment securities" for value and without notice. The two central issues, which are related, are whether the collateral is an "investment security" and whether the purchaser has taken "possession". Each of these matters is considered in turn below.

"Investment securities"

The definition

The PPSA states that "investment security":

> Means a writing (whether or not in the form of a security certificate) –
>
> (i) That is recognised in the place in which it is issued or dealt with as evidencing a...share, right to participate, or other interest in property...or that evidences an obligation of the issuer; and
>
> (ii) That, in the ordinary course of business, is transferred or withdrawn –
>
> (A) By delivery with any necessary endorsement, assignment, or registration in the records of the issuer or agent of the issuer...; or

(B) By an entry in the records of a clearing house or securities depository; or

(C) By an entry in the records maintained for that purpose by or behalf of the issuer; or

(D) By an entry in the records maintained for that purpose by or behalf of the nominee;...

The terms "issuer", "clearing house", "securities depository" and "nominee" are not defined in the PPSA. The term "writing" includes the electronic recording or display of words.

The principal difficulty with this definition is its application to systems of multi-tiered holdings through intermediaries such as ICSDs. While paragraph (ii) of the definition clearly contemplates multi-tiered holdings, it is unclear whether a lower-tier holder has an interest in an "investment security" or merely an "intangible".

An example

Consider the following example:

- the Crown issues government stock and the register records the holder as New Zealand Central Securities Depository Limited (**NZCSD**), the nominee for Austraclear New Zealand;

- Domestic Bank X has a securities account with Austraclear that shows a credit of $50m of government stock of that issue; and

- Foreign Bank Y, in turn, has a securities account with Domestic Bank X that shows a credit of $20m of that government stock.

What is the nature of each party's interest for the purposes of the PPSA?

- Without doubt, NZCSD, as the first-tier (or direct) holder, has an "investment security". Its interest satisfies paragraphs (i) and (ii)(C) of the definition.

- Domestic Bank X, as the second-tier holder, also has an "investment security". While it is an indirect holder, paragraph (ii) of the definition of "investment security" includes the interest of a person holding

directly through the first-tier holder.[200] Its interest satisfies paragraphs (i) and (ii)(B) of the definition.

An interesting question is whether Domestic Bank X's "investment security" is the same as NZCSD's *for the purposes of the PPSA*.[201] If it were, difficult priority issues could arise if both parties (and, perhaps, others further down the chain) have "possession" and otherwise satisfy the requirements of section 97.

- The position of Foreign Bank Y, as the third-tier holder, is much less clear.

  On the one hand, there is the robust interpretation. This emphasises the definition's recognition of the widespread commercial practice of using systems of multi-tiered holdings and suggests that it cannot have been Parliament's intention to distinguish between second- and third- (or lower-) tier holders.

  On the other hand, there is the literal interpretation. This suggests that the definition's inclusion of indirect interests is limited to those deriving their interest directly through the first-tier holder. Paragraph (ii)(B) only applies where the records of the clearing house or securities depository relate to the property in paragraph (i) (i.e., the underlying security itself). Paragraph (ii)(B) does not apply where those records relate to an indirect interest.

  This issue is not new. Both Canada[202] and the United States have struggled with it. In the United States, the issue has been resolved in Revised Article 8 of the Uniform Commercial Code (the **UCC**).[203] Under Revised Article 8, a person in Foreign Bank Y's position would

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[200] There is an argument, which is a more extreme extension of the literal interpretation considered below for Foreign Bank Y, that says that only the *direct* holder (such as NZCSD) has an interest in an "investment security". Any *indirect* holder merely has an "intangible", the nature of which is determined by the contractual arrangement it has entered into with the holder immediately above it. The basis of this argument is that the *underlying security* (i.e., paragraph (i)) must, in the ordinary course of business, be transferred or withdrawn in the manner specified in paragraph (ii) in order to be an "investment security". But that is not to say that the *product of the transfer or withdrawal* is, itself, an "investment security" (unless it also satisfies the requirements of the definition).

[201] The "for the purposes of the PPSA" qualification is necessary because, clearly, under general principles, the asset that each party has is not the same thing.

[202] See Uniform Law Conference of Canada, *Tiered Holding System – Uniform Legislation Project, Report of the Production Committee* (30 April 1997).

[203] For a summary of Revised Article 8, see Potok, *Cross Border Collateral: Legal Risk and the Conflict of Laws* (2002), para.s 2.60-2.62.

have an interest in a "security entitlement" and a "securities account", both of which are categories of "investment property" under the UCC. This is a more conceptually correct analysis of the position of lower-tier holders.

Until the position is clarified by case law or legislation in New Zealand, it may be advisable for secured parties at this lower-tier level to analyse their position under the PPSA on the basis that *either* interpretation could be correct. The most likely practical consequence of this approach is that the secured party would both register a financing statement in respect of the collateral and take "possession" of it.

"Possession"

The definition

Section 18(1) of the PPSA states that:

> For the purposes of this Act, a person takes possession of an investment security if,-
>
> (a) In the case of an investment security that is evidenced by a security certificate, the person takes physical possession of that certificate; or
>
> (b) In the case of an investment security that is traded or settled through a clearing house or securities depository, the clearing house or securities depository, as the case may be, records the interest of the person in the investment security; or
>
> (c) In the case of an investment security that is not evidenced by a security certificate and that is not traded or settled through a clearing house or securities depository, the records maintained by the issuer, or on behalf of the issuer, record the interest of the person in the investment security; or
>
> (d) In the case of an investment security that is held by a nominee, the records of the nominee record the interest of the person in the investment security.

The example

- NZCSD has "possession" by virtue of paragraph (c).

- Domestic Bank X has "possession" by virtue of paragraph (b).

- Foreign Bank Y has possession of the "investment securities" (assuming that is what they are) if, in terms of paragraph (b), the clearing house or securities depository "records the interest of *[that] person*" (emphasis added) in that investment security.

  But who is the "clearing house" or "securities depository" here? If it is Austraclear, Foreign Bank Y cannot have "possession" as Austraclear's records only reflect the interest of Domestic Bank X. It is only if Domestic Bank X could, itself, be regarded as a "securities depository" (it is unlikely to be a "clearing house") that Foreign Bank Y could have "possession". But this runs contrary to the literal interpretation outlined above, which suggests that the only clearing house or securities depository that is being referred to is the first one (i.e., Austraclear).

  Statutory or case law clarification of this definition would also be welcome.

(d) In a nutshell

The table below summarises the legal position applying what the writer suggests is the better view in respect of each of the issues outlined above.

<table>
<tr><th>Transaction</th><th>“Security interest” created?</th><th>Does PPSA apply?</th><th>Need to perfect to ensure priority?</th></tr>
<tr><td>Netting agreement</td><td>No</td><td>N/A</td><td>N/A</td></tr>
<tr><td>Netting agreement coupled with flawed asset arrangement</td><td>No</td><td>N/A</td><td>N/A</td></tr>
<tr><td>CSD</td><td rowspan="3">Yes</td><td rowspan="3">Yes, if (very broadly):
• secured party’s intermediary is located in New Zealand; or
• New Zealand is the governing law</td><td rowspan="3">No, if collateral is “investment securities” (but ignores proceeds)</td></tr>
<tr><td>CSA</td></tr>
<tr><td>Repo agreement</td></tr>
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