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Definition of Derivatives

Germany • New Zealand

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Germany

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SUMMARY Germany defines derivatives in keeping with the requirements of European Union law while crafting a definition that aims at being more structured than that of the European Directive. Since 2007 the same definition is used in the German Banking Act and the German Securities Trading Act. The German courts have not contributed to the definition of derivatives. German scholars, on the other hand, have given the concept some thought.

I. Introduction

Germany defines derivatives in the Securities Trading Act[1] and in the Banking Act,[2] and since 2007 these definitions are identical. These are the only statutory definitions of derivatives in German law. The Banking Act defines derivatives because the selling and buying of derivatives on commission is a banking transaction in German law, so that anyone who has a full banking license can engage in such transactions. The Securities Trading Act defines derivatives because they are financial instruments the trade of which is subject to oversight by the financial markets authority.[3] The following remarks focus on the definition in the Securities Trading Act and its interpretation.

In the Securities Trading Act, the current definition of derivatives was enacted in 2007, to transpose European Union (EU) Directive 2004/39 on Markets in Financial Instruments (MiFID).[4] The German definition aims to include all the categories listed in the Directive's definition but groups the qualifying underlying values differently in a more structured and systematic manner, which is in keeping with German principles of legislative drafting that prefer abstract concepts to a mere listing of applicable events.[5]

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[1] Wertpapierhandelsgesetz [Securities Trading Act], *repromulgated* Sept. 9, 1998, BUNDESGESETZBLATT [BGBL.] I at 2708, *as amended*, § 2 (2), *current version at* http://www.gesetze-im-internet.de/wphg/index.html, *translation at* http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Gesetz/wphg_101119_en.html?nn=2821360#doc2684270bodyText6 (click on "Securities Trading Act" in right-hand column).

[2] Kreditwesengesetz [Banking Act], *repromulgated* Sept. 9, 1998, BGBL. I at 2776, *as amended*, § 1(11), http://www.gesetze-im-internet.de/kredwg/index.html.

[3] Securities Trading Act §§ 1, 4.

[4] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on Markets in Financial Instruments Amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and Repealing Council Directive 93/22/EEC, Annex I, § C(4)–(10), 2004 O.J. (L 145) 1, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:145:0001:0044:EN:PDF.

[5] Heinz-Dieter Assmann *in* HEINZ-DIETER ASSMANN & UWE SCHNEIDER, WERTPAPIERHANDELSGESETZ § 2(2) n.42 (6th ed. 2012).

The current German definition does not provide a general definition of derivatives, listing instead various groups of underlying transactions and events, the reference to which makes the financial instrument a derivative, yet according to expert commentary, the defining characteristic of a derivative is that valuation and price of the instrument depend on the future valuation of an underlying value.[6]

II. Definition of the Securities Trading Act

A. Translation

1. Section 2(2) of the Securities Trading Act

Section 2(2) of the German Securities Trading Act has been translated by the German Federal Financial Supervisory Authority (BaFin) as follows:[7]

> (2) Derivatives within the meaning of this Act are
>
> 1. firm contracts or option contracts in the form of acquisitions, swaps or in other forms which are to be settled at a future date and whose values are derived directly or indirectly from the price or value measure of an underlying instrument (futures and forward transactions) [*Termingeschäfte*][8] relating to the following underlying instruments:
>   (a) securities or money market instruments;
>   (b) foreign exchange or units of account;
>   (c) interest rates or other yields;
>   (d) indices of the underlying instruments specified in (a), (b) or (c), other financial indices or financial measures; or
>   (e) derivatives;
> 2. futures and forward transactions relating to commodities, freight rates, emission allowances, climatic or other physical variables, inflation rates or other economic variables or other assets, indices or measures as underlying instruments, provided
>   (a) they are cash-settled or grant the party to a contract the right to demand cash settlement without this right being contingent on default or another termination event;
>   (b) they are concluded on an organised market or a multilateral trading facility; or
>   (c) in accordance with Article 38 (1) of Commission Regulation (EC) No. 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive (OJ EU no. L 241 p. 1), they have the characteristics of other derivatives and are not for commercial

[6] *Id*. § 2(2) n.43.

[7] Securities Trading Act in translation, *supra* note 1.

[8] For an explanation of the term, *see infra* note 21 and accompanying text.

purposes and if the conditions set out in Article 38 (4) of this Regulation are not satisfied;

and if they are not spot contracts within the meaning of Article 38 (2) of Regulation (EC) No. 1287/2006;

3. financial contracts for differences;
4. firm contracts or option contracts in the form of acquisitions, swaps or in other forms which are to be settled at a future date and are intended for the transfer of credit risk (credit derivatives);
5. futures and forward transactions relating to the underlying instruments set out in Article 39 of Regulation (EC) No. 1287/2006 if they satisfy the conditions of no. 2.

2. *Section 37e of the Securities Trading Act*

Section 37e of the Securities Act is part of the Act's chapter on financial futures and forward transactions that was deemed necessary to protect the public against the risks of such transactions.[9] Section 37e translates as follows:

> Exclusion of the objection pursuant to section 762 of the Civil Code (BürgerlichesGesetzbuch) may not be made against claims arising from financial futures and forward transactions [*Finanztermingeschäfte*][10] involving at least one party which is an enterprise that concludes financial futures and forward transactions commercially or on a scale which requires commercially organised business operations or which purchases, sells or brokers financial futures and forward transactions. Financial futures and forward transactions [*Finanztermingeschäfte*] within the meaning of sentence 1 and sections 37g and 37h are derivatives within the meaning of section 2 (2) and warrants.[11]

B. Historic Development

When first enacted in 1994,[12] section 2(2) of the Securities Trading Act defined derivatives as follows:

> Derivatives within the meaning of this Act are rights that are traded on a domestic or foreign market within the meaning of paragraph 1 and whose exchange or market price depends directly or indirectly on the development of the exchange or market price of securities or foreign means of payment or the change in interest rates.[13]

From 2005 through 2007, section 2(2) of the Securities Trading Act[14] defined derivatives as follows:

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[9] O. Mühlbert & H. Assmann *in* ASSMANN & SCHNEIDER, *supra* note 5, n.1 before § 37e.

[10] For a discussion of this term, *see infra* note 34 and accompanying text.

[11] Securities Trading Act in translation, *supra* note 1.

[12] Wertpapierhandelsgesetz, July 27, 1994, BGBL. I at 1749.

[13] Translated by the author.

[14] Securities Trading Act § 2(2), as in effect from Jan 1, 2005, through July 16, 2007.

> Derivatives within the meaning of this Act are transactions for a future date [*Termingeschäfte*][15] that are firm contracts or options contracts the price of which depends directly or indirectly on
>
> (a) the exchange or market price of securities,
> (b) the exchange or market price of money market instruments,
> (c) interest rates or other yields,
> (d) the exchange or market price of goods or precious metals, or
> (e) currency exchange rates.[16]

C. Explanations

1. Section 2(2) of the Securities Trading Act

The following remarks are taken mainly from Heinz-Dieter Assmann's highly esteemed annotated version of the German Securities Trading Act.[17] Assmann precedes his explanations on the German definition of derivatives by listing the elements that are *not* required for making an instrument a derivative. According to Assmann, a derivative need not be securitized, standardized, or negotiable. Instead, a product crafted for an individual transaction may be a derivative.[18] Moreover, a derivative may be intended either for trading on an exchange or over the counter. On the other hand, derivatives are only the instrument listed in the legal definition. A product that does not fall within one of the listed categories is not a derivative.[19]

The current German definition of derivatives contained in section 2(2) of the Securities Trading Act does not provide a general definition of derivatives, listing instead various groups of underlying transactions and events, the reference to which makes the financial instrument a derivative, yet according to Assmann, the defining characteristic of a derivative is that valuation and price of the instrument depend on the future value of an underlying value.[20] For Assmann, the statutory definition brings out the salient points that

> the valuation (and therefore the price) of the right that can be claimed in the future or over a future period of time depends directly or indirectly, due to its content, on a **basic value** (also "underlying") that in itself is subject to fluctuations in price and valuation.
>
> The nature of the stipulated right is of secondary importance for the concept of the derivative as long as it shows the above described relationship to the basic value, yet different categories [of derivatives] can be distinguished, according to the content of the agreed upon right. The most important of these differences are those between firm contracts (Festgeschäfte), options contracts, and swaps.[21]

[15] *See infra* note 21 and accompanying text.

[16] Translated by the author.

[17] Assmann, *supra* note 5, § 2 (2) nn.38–56.

[18] *Id*. § 2(2) n.45.

[19] *Id.*

[20] *Id*. § 2(2) n.43.

[21] *Id.* (emphasis in original).

Assmann continues by explaining that a firm contract is one that obligates the parties to fulfill the contract on the delivery date, whereas an option gives the right, but not the obligation, to ask for performance. Thus, forwards and futures are firm contracts. The author then deals with a conceptual problem that occurs in German terminology because German experts use the word *Termingeschäft* (transaction for a date), a category that encompasses futures and forwards. Generally, this concept is translated as "futures and forwards." According to the author, this concept appears to have been misunderstood in section 2(2) number 1 of the Securities Act as also being the superior category for options and swaps.[22] There appears to be no term in English that is equivalent to *Termingeschäft*. The confusion about this term in German is also indicated by commentators to the Banking Law, who state that the concept is undefinable.[23] The term *Termingeschäft*, however, is firmly entrenched in German usage.[24]

Assmann explains that section 2(2) number 1 defines the concept of *Termingeschäft* with its forward-looking nature and thereby provides an important element of the definition of a derivative that is used also in numbers 2 and 5 of subsection (2).[25] According to Assmann, statutory definitions of firm contracts, options, and swaps (the three types of transactions by which a derivative can be forged) were not necessary because the concepts are well established in German legal thinking.[26] In addition, Assmann relates that the clause "deriving directly or indirectly" from an underlying value clarifies that *Termingeschäfte* (and thereby derivatives) can refer to an underlying value that in itself refers to other underlying values, such as an index or an option.[27]

Regarding the financial instruments that are grouped together in number 1, Assmann explains that the German listing includes money-market instruments, even though they are not mentioned in the EU's MiFID, because they were listed in the previous German definition of derivatives and their inclusion clarifies the intent of MiFID.[28] Also not included in MiFID but included for clarification in the German definitions (according to Assmann), are units of account.

Assmann does not list a currently used example for a unit of account, yet the question arises whether bitcoins could be the underlying value for a derivative. The German Federal Financial Supervisory Authority (BaFin, Bundesamt für Finanzdienstleistungen) issued a communication on bitcoins on December 19, 2013.[29] According to BaFin, bitcoins are legally binding financial instruments that fall into the category of units of account, according to the first sentence of section 1(11) of the German Banking Act.[30]

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[22] *Id*.

[23] Frank Schäfer, *in* KARL-HEINZ BOOS ET AL., KREDITWESENGESETZ § 1 n.223.

[24] This author wonders whether *Termingeschäft* is used as a synonym for "derivative."

[25] Assmann, *supra* note 5, § 2(2) n.46.

[26] *Id.* § 2(2) n. 47.

[27] *Id*.

[28] *Id*. § 2(2) n.48.

[29] Jens Münzer, *Bitcoins: Aufsichtliche Bewertung und Risiken für Nutzer*, BAFIN (Dec. 19, 2013), http://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Fachartikel/2014/fa_bj_1401_bitcoins.html.

[30] Banking Act, *supra* note 2.

On the underlying value of foreign exchange listed in number 1, Assmann describes some of the more common currency derivatives, among them, currency options and various types of currency swaps and undeliverable foreign exchange transactions.[31] With regard to indices as an underlying value, Assmann points out that only indices relating to securities, currencies, or interest rates qualify, and he names as examples various stock exchange indices, including the Dow Jones, the Nikkei, and the DAX. On the underlying value of derivatives, Assmann points out that all the derivatives listed in section 2(2) qualify and he mentions the swap option as being popular. In a swap option, the purchaser acquires the right from the seller of the option to execute a swap contract at a particular time.

The underlying values listed in section 2(2) number 2 are neither financial instruments nor related to them. Instead, they range from commodities futures to economic or climatic variables. For these to underlie a derivative, additional qualifications are needed. Thus, Assmann explains, they must either allow for a cash settlement; have been concluded on an organized market such as the Energy Exchange Austria (EXAA) in Vienna; or qualify as certain noncommercial transactions described in article 38(2) of EU Regulation No. 1287/2006 of August 10, 2006, which implements Directive 2004/39/EC.[32] For all of these underlying values, Assmann and the statutory definition clarify that spot deals do not qualify in that they call for the actual delivery of the stipulated goods.

As to the listing of financial contracts for differences (section 2(2) number 3 of the Act), Assmann explains the concept of a contract for differences; as to number 4 of the provision, dealing with credit derivatives, Assmann explains that they transfer the credit risk by isolating the risk of the creditor to obtain satisfaction from the debtor and transfer it totally or in part to the contractual partner of the credit derivate (the giver of security).[33]

The underlying values of the derivatives referred to in number 5 of section 2(2) are listed in article 39 of EU Regulation No. 1287/2006 as follows:

> (a) telecommunications bandwidth;
> (b) commodity storage capacity;
> (c) transmission or transportation capacity relating to commodities, whether cable, pipeline or other means;
> (d) an allowance, credit, permit, right or similar asset which is directly linked to the supply, distribution or consumption of energy derived from renewable resources;
> (e) a geological, environmental or other physical variable;
> (f) any other asset or right of a fungible nature, other than a right to receive a service that is capable of being transferred;

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[31] Assmann, *supra* note 5, § 2(2) n. 48.

[32] Commission Regulation (EC) No. 1287/2006 of 10 August 2006 Implementing Directive 2004/39/EC of the European Parliament and of the Council as Regards Recordkeeping Obligations for Investment Firms, Transaction Reporting, Market Transparency, Admission of Financial Instruments to Trading, and Defined Terms for the Purposes of that Directive, 2006 O.J. (L 241) 1, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:241:0001:0025:EN:PDF.

[33] Assmann, *supra* note 5, § 2(2) n.54.

> (g) an index or measure related to the price or value of, or volume of transactions in any asset, right, service or obligation.

2. Section 37e of the Securities Trading Act

Section 37e of the Securities Trading Act uses the term *Finanztermingeschäfte* (translated herein as "financial futures and forward transactions"). These instruments are regulated by section 37e, 37g, and 37h. Section 37e exempts these instruments from an otherwise prevailing prohibition of gambling contracts in German law.[34] Section 37g gives the authorities the power to prohibit individual issuances of such instruments when this is needed to protect investors, and section 37h limits arbitration agreements for such transactions to fully qualified merchants. Section 37e clarifies that these *Finanztermingeschäfte* consist of derivatives within the meaning of Securities Trading Act section 2(2) and warrants.[35]

According to Assmann,[36] the last sentence of section 37e indicates that all derivatives as defined by section 2(2) and all warrants are "financial futures and forward transactions" (*Finanztermingeschäfte*) within the meaning of section 37e.[37] It appears that the use of the term *Finanztermingeschäfte* instead of derivatives in this context may be somewhat confusing, yet it is wider than derivatives in that it includes warrants as well. According to Frank Schäfer, co-author of a leading commentary on banking law, the term *Finanztermingeschäfte* is used as a generic term to describe derivatives.[38]

III. Cases

German case law has neither expanded the definition of derivative financial instruments nor contributed to the development of the concept. The only recent case on derivatives adjudicates the issue of liability for imprudent investment advice. In a 2010 decision, the Regional Court of Cologne held that financial futures are derivatives within the meaning of section 2(2) of the Securities Trading Act.[39]

IV. Market-Based Definitions

Six Exchange, a Swiss Stock Exchange, defines derivatives as follows:

> In the derivative financial market, products (derivatives) are traded whose prices are derived from objects in the monetary markets (e.g. shares, bonds, indices, currencies). These so-called "underlying assets" are subject to changing market prices. Derivatives

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[34] Civil Code § 762.

[35] According to Assmann, warrants (*Optionsscheine*) fall under the Securities Trading Act's concept of miscellaneous securities that most often are issued with a debenture and give the added benefit of an option. Assman, *supra* note 5, § 2 n.31.

[36] *Id*. n.32 before § 37e.

[37] *Id*. § 37e n.10.

[38] Schäfer, *supra* note 21, § 1 n.223.

[39] Decision of Regional Court of Cologne (Landgericht Köln), Oct. 10, 2010, docket no. 3 O 608/09, available on the subscription database juris.

> make it possible to uncouple such market-price risks from the underlying asset and trade them separately.
>
> Derivative instruments enable risk transfer: investors can transfer unwanted risks to other, more risk-tolerant market participants. The actual investments are comparatively small when measured against the amounts that are involved. Large sums can be controlled with little capital. Price fluctuations in per cent of the invested capital are much greater than price fluctuations in the underlying asset. This is called "leverage". Trading in derivative instruments offers great potential returns, but it also entails a great potential for loss.[40]

Eurex, a European derivatives exchange describes its trade in derivatives as follows:

> The derivatives exchange Eurex® is one of the world's market leaders in the trading and settlement of futures and options on shares, share indices, exchange-traded funds as well as capital and money market products. It is a subsidiary of Deutsche Börse and the Swiss Exchange and emerged in 1998 from the merger of Deutsche Terminbörse (DTB) and the Swiss derivatives exchange Soffex.[41]

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[40] *Derivative Financial Market*, SIX SWISS EXCHANGE, http://www.six-swiss-exchange.com/knowhow/exchange/financial_market/derivative_market_en.html (last visited Mar. 18, 2014).

[41] *Product Description*, DEUTSCHE BÖRSE GROUP, http://deutsche-boerse.com/it/dispatch/en/listcontent/gdb_navigation/technology/20_Applications/10_Trading/20_Eurex_Trading_Platform/page0_TS_PS_EurexHandelsplattform.htm (last visited Mar. 18, 2014).

New Zealand

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SUMMARY New Zealand recently enacted significant reforms to the regulatory regime that governs matters related to financial products. The reforms include a new definition of derivatives, which will apply from April 2014. The broad definition is intended to provide for the treatment of derivatives based on their underlying economic substance, with the Financial Markets Authority also able to designate products as falling within the category.

The Income Tax Act 2007 does not contain its own definition of derivatives; rather, it refers to the definition contained in the New Zealand equivalent to the relevant international accounting standard.

I. Introduction

In August 2013, the New Zealand Parliament passed the Financial Markets Conduct Act 2013 (FMC Act).[1] This legislation replaces several statutes and regulations[2] and is intended to "promote the confident and informed participation of businesses, investors, and consumers in the financial markets" and "promote and facilitate the development of fair, efficient, and transparent financial markets."[3] It implements a number of the recommendations made by the industry-led Capital Market Development Taskforce in late 2009.[4] The Ministry for Economic Development (now the Ministry of Business, Innovation and Employment) subsequently conducted a review of securities law,[5] leading to introduction of the Financial Markets Conduct Bill in October 2011.[6]

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[1] Financial Markets Conduct Act 2013 (FMC Act), http://www.legislation.govt.nz/act/public/2013/0069/latest/DLM4090578.html. For an overview of the reforms and their implementation, *see* FINANCIAL MARKETS AUTHORITY (FMA), A GUIDE TO THE FINANCIAL MARKET CONDUCT ACT 2013 REFORMS (Nov. 2013), https://www.fma.govt.nz/media/1901900/a-guide-to-the-financial-markets-conduct-act-reforms-november-2013.pdf.

[2] *See* Financial Markets (Repeals and Amendments) Act 2013, http://www.legislation.govt.nz/act/public/2013/0070/latest/DLM5561104.html.

[3] FMC Act, s 3.

[4] (27 August 2013) 693 NZPD 12999, http://www.parliament.nz/en-nz/pb/debates/debates/50HansD_20130828_00000036/financial-markets-conduct-bill-financial-markets-repeals. For information on the Capital Market Development Taskforce and associated documents, *see Capital Market Development Taskforce*, MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT (MBIE), http://www.med.govt.nz/business/economic-development/capital-market-development-taskforce (last updated Feb. 2, 2012).

[5] For information and documents related to the Securities Law review, *see Securities Law Review*, MBIE, http://www.med.govt.nz/business/business-law/pdf-docs-library/current-business-law-work/securities-law-review (last updated Sept. 14, 2013). The reforms also stem from the earlier Review of Financial Products and Providers, which commenced in 2005. *Review of Financial Products and Providers*, MBIE, http://www.med.govt.nz/business/business-law/past-work-and-older-topics/review-of-financial-products-and-providers (last updated Dec. 7, 2011).

Specified provisions of the FMC Act, including the preliminary provisions that set out various definitions, will come into force on April 1, 2014, as part of the first implementation phase.[7]

Prior to the reforms, securities and derivatives were essentially regulated under separate legislation. With regard to derivatives, the Capital Market Development Taskforce and the securities law review identified that there was confusion about the definition of "futures contracts" in the Securities Markets Act 1988,[8] which caused uncertainty about how these products were to be regulated.[9] One of the major reforms in the new Act is that it "defines four types of financial product (debt, equity, managed investment products, and derivatives) in a manner intended to provide for treatment based on their underlying substance, while providing a degree of certainty around the treatment of common products, with powers for the Financial Markets Authority (FMA) to designate products as falling within the appropriate category."[10]

II. Definition of Derivatives in the FMC Act

A derivative is included in the definition of "financial product" in section 7 of the FMC Act. Section 8 provides definitions related to types of financial products. Under subsection (1), a derivative is specifically excluded from the definition of "debt security." The definition of derivative is set out in subsection (4), as follows:

> (4) In this Act, subject to subsection (5)(a) and (b) and section 10, **derivative**—
> (a) means an agreement in relation to which the following conditions are satisfied:
> (i) under the agreement, a party to the agreement must, or may be required to, provide at some future time consideration of a particular kind or kinds to another person; and
> (ii) that future time is not less than the time, prescribed for the purposes of this subparagraph, after the time at which the agreement is entered into; and
> (iii) the amount of the consideration, or the value of the agreement, is ultimately determined, is derived from, or varies by reference to (wholly or in part) the value or amount of something else (of any nature whatsoever and whether or not deliverable), including, for example, 1 or more of the following:
> (A) an asset:

[6] For information and documents related to the development of the bill, *see Financial Markets Conduct Act*, MBIE, http://www.med.govt.nz/business/business-law/current-business-law-work/financial-markets-conduct-act (last updated Feb. 12, 2014).

[7] Financial Markets Legislation (Phase 1) Commencement Order 2014, http://www.legislation.govt.nz/regulation/public/2014/0051/latest/DLM5945611.html.

[8] Securities Markets Act 1988, s 37, http://www.legislation.govt.nz/act/public/1988/0234/latest/DLM139727.html.

[9] *See* MINISTRY OF ECONOMIC DEVELOPMENT, REVIEW OF SECURITIES LAW: DISCUSSION PAPER 24–31 (June 2010), http://www.med.govt.nz/business/business-law/pdf-docs-library/current-business-law-work/securities-law-review/review-of-secuities-law-dicsussion-document-1625-kb-pdf.pdf.

[10] Parliamentary Library, Financial Markets Conduct Bill 2011 (Bills Digest No. 1963, 3 April 2012), http://www.parliament.nz/en-nz/pb/legislation/bills/digests/50PLLaw19631/financial-markets-conduct-bill-2011-bills-digest-no-1963.

(B) a rate (including an interest rate or exchange rate):
(C) an index:
(D) a commodity; and

(b) includes a transaction that is recurrently entered into in the financial markets in New Zealand or overseas and is commonly referred to in those markets as—
  (i) a futures contract or forward; or
  (ii) an option (other than an option to acquire by way of issue an equity security, a debt security, or a managed investment product); or
  (iii) a swap agreement; or
  (iv) a contract for difference, margin contract, or rolling spot contract; or
  (v) a cap, collar, floor, or spread; but
(c) does not include—
  (i) an agreement for the future provision of services; or
  (ii) a debt security, an equity security, or a managed investment product; and
(d) does not include an agreement in relation to which all of the following subparagraphs are satisfied:
  (i) a party has, or may have, an obligation to buy, and another party has, or may have, an obligation to sell, property (other than financial products or New Zealand or foreign currency) at a price and on a date in the future; and
  (ii) the agreement does not permit the seller's obligations to be wholly settled by cash, or by set-off between the parties, rather than by delivery of the property; and
  (iii) neither usual market practice nor the rules of a market permit the seller's obligations to be closed out by the matching up of the agreement with another agreement of the same kind under which the seller has offsetting obligations to buy.[11]

Under subsections (5)(a) and (b) of section 8, referred to in the above definition, a security that is declared by the Financial Markets Authority to be a derivative is taken to be included in the definition;[12] and a security that is declared to be a financial product of a different kind, or to not be a financial product, is excluded from the definition.[13] The definition of derivative is also taken to include "a right attaching to, or a legal or an equitable interest in, a financial product of that kind," or "an option to acquire, by way of issue, a financial product of that kind."[14]

Section 10, also referred to in the above definition, is headed "Miscellaneous matters related to definition of derivative" and states the following:

(1) Section 8(4)(d) applies only to the extent that the agreement deals with the purchase and sale referred to in that paragraph.
(2) An agreement under which one party has an obligation to buy, and the other has an obligation to sell, property is not a derivative merely because the agreement provides for the consideration to be varied by reference to a general inflation index

[11] FMC Act, s 8(4) (emphasis in original).

[12] *Id.* s 8(5)(a)(i).

[13] *Id.* s 8(5)(b).

[14] *Id.* s 8(5)(a)(ii) and (iii).

(for example, the Consumers Price Index (All Groups) published by Statistics New Zealand).

(3) Subsection (2) is subject to section 8(5)(a).[15]

The regulations for the first implementation phase of the new legislation include the prescribed times for the purposes of section 8(4)(a)(ii) of the Act, being three working days for a foreign exchange agreement, and one working day in any other case.[16]

III. Definition of Derivatives in the Income Tax Act 2007

Section YA 1 of the Income Tax Act 2007 states that, for the purposes of the legislation, "derivative instrument" means a derivative as defined in the New Zealand Equivalent to International Accounting Standard 39 (NZ IAS 39), which is titled "Financial Instruments: Recognition and Measurement."[17] A "derivative" is defined in NZ IAS 39 as follows:

> A derivative is a financial instrument or other contract within the scope of this Standard (see paragraphs 2–7) with all three of the following characteristics:
>
> (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');
>
> (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
>
> (c) it is settled at a future date.[18]

Accounting standards are issued under the Financial Reporting Act 1993 by the External Reporting Board (XRB). The XRB issued a new Accounting Standards Framework in April 2012.[19] Under the new framework, NZ IAS 39 is being replaced in stages by the New Zealand Equivalent to International Financial Reporting Standard 9: Financial Instruments (NZ IFRS 9).[20] However, this new standard contains the same definition of "derivative" as set out above.[21]

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[15] *Id.* s 10.

[16] Financial Market Conduct (Phase 1) Regulations 2014, reg 9, http://www.legislation.govt.nz/regulation/public/2014/0050/latest/DLM5956701.html.

[17] Income Tax Act 2007, YA 1, http://legislation.govt.nz/act/public/2007/0097/latest/DLM1520573.html.

[18] New Zealand Equivalent to International Account Standard 39, Financial Instruments: Recognition and Measurement, para. 9, http://www.xrb.govt.nz/includes/download.aspx?ID=132756.

[19] *Accounting Standards Framework*, EXTERNAL REPORTING BOARD, http://xrb.govt.nz/Site/Financial_Reporting_Strategy/Accounting_Standards_Framework.aspx (last visited Mar. 7, 2014).

[20] For a list of standards and their effective dates, *see Standards for For-Profit Entities*, EXTERNAL REPORTING BOARD, http://www.xrb.govt.nz/Site/Accounting_Standards/Current_Standards/Standards_for_For-Profit_Entities/Stds_for_For-Profit_Entities_T1-4.aspx (last visited Mar. 7, 2014).

[21] *See* New Zealand Equivalent to International Financial Reporting Standard 9, Financial Instruments (2013) (Hedge Accounting and amendments to NZ IFRS 9, NZ IFRS 7 and NZ IAS 39), Appendix A, http://www.xrb.govt.nz/includes/download.aspx?ID=131752.