

21 April 2017

Mr James Mason
Financial System Division
The Treasury
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Dear Mr Mason

**National Innovation and Science Agenda – Improving Corporate Insolvency Law
Ipso Facto Reforms**

The International Swaps and Derivatives Association, Inc. (**ISDA**)¹ is grateful for the opportunity to comment on the Exposure Draft of the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017 (**Bill**), which proposes to reform Australia's insolvency laws. In this submission, ISDA limits its comments to the elements of the Reform related to ipso facto clauses (**Reforms**) and does not comment on the other aspects of the Bill (including those related to safe harbours for company directors). Our members may choose to make their own individual submissions on these Reforms and the Bill.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business through documentation that is the recognized standard throughout the global market, legal opinions that facilitate enforceability of agreements and collateral arrangements, the development of sound risk management practices, and advancing the

¹ **About ISDA:** Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 68 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org.

understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

ISDA acknowledges and supports the policy intention evidenced in the Explanatory Document accompanying the Reforms to exclude contracts, agreements and arrangements related to financial market transactions and financial market infrastructure from the scope of the stay on ipso facto clauses.²

However, there are a number of issues with the current approach taken in the Reforms on these matters which we consider important to raise at this stage. We do not consider these issues to be matters of policy, but rather technical drafting matters. In any case, we submit that it is critically important to clarify these technical matters before the Bill is enacted.

Submissions

For the reasons set out in this submission, ISDA strongly submits that each of the following should occur:

- (a) the Bill should include an express statement in the part of the Bill which relates to the amendments to the *Corporations Act 2001* (Cth) (***Corporations Act***) to clarify the interaction between the *Netting Act* and the ipso facto stays.

ISDA submits that the effect that the express statement should be to the effect of:

If there is any inconsistency between this Act and the Payment Systems and Netting Act 1998, the Payment Systems and Netting Act 1998 prevails to the extent of the inconsistency.

It is critically important for a number of reasons that the interaction of the Bill with the protections of the *Payment Systems and Netting Act 1998* (Cth) (***Netting Act***) is clarified. The approach outlined in this submission is consistent with that taken in other relevant Commonwealth legislation, including for example the *Personal Properties and Securities Act 2009* (Cth) (***PPSA***)³ and the *Netting Act* itself.

² In this regard, we note that the Explanatory Document referred to agreements under the *Netting Act* and arrangements entered into under an ISDA Master Agreement, as well as “rights of set off”, “flawed asset arrangements”, “repurchase agreements, forward contracts, commodity contracts, swaps, rated securitisations and structured financings that include ‘flip clauses’”, “master netting agreements”, “securitisation arrangements involving special purpose vehicles”, “securities settlement facilities”, “covered bond transactions” and “Real Time Gross Settlement arrangements”.

³ PPSA, section 256 provides:

If there is any inconsistency between this Act and one of the following Acts (the other Act), the other Act prevails to the extent of the inconsistency: (a) the Payment Systems and Netting Act 1998;...

- (b) the definition of “specified provisions”⁴ in the *Netting Act* be amended to expressly include the new sections of *Corporations Act* which provide for the stays on ipso facto clauses (currently sections 415D and 451E).

The *Netting Act* already specifically provides that the *Netting Act* protections apply “*despite any other law (including the specified provisions)*.” As noted in the 2016 Explanatory Memorandum,⁵ the “*specified provisions definition is an inclusive list of the provisions of other laws over which the PSN Act prevails and is inserted for transparency and ease of reference*”.⁶ We consider that an efficient and effective way to ensure the primacy of the *Netting Act* protections is to include the statement described in paragraph (a) above and include a reference to each new section of the *Corporations Act* which provides for the ipso facto stays in the definition of “specified provisions” in the *Netting Act*.⁷

- (c) the regulations made in connection with the Bill should properly and thoroughly describe the types of contracts, agreements and arrangements (including related security) which are protected under the *Netting Act* to ensure that, for example, the operators of approved RTGS⁸ systems are still able to exercise rights under ipso facto clauses.

ISDA submits that the contracts, agreements and arrangements which should be excluded from the operation of the stay on ipso facto clauses proposed in the Reforms should at least include *contracts, agreements and arrangements related to:*

- a. approved RTGS systems;⁹
- b. approved netting arrangements;
- c. close-out netting contracts; and

⁴ It is very important to make the distinction that the reference here is to the *Netting Act* concept of “specified provisions”, *not* “specified stay provisions”.

⁵ In this submission, the term **Collateral Protection Bill** is used to refer to the recent *Financial System Legislation Amendment (Resilience and Collateral Protection) Bill 2016* (Cth) and the term **2016 Explanatory Memorandum** is used to refer to the Explanatory Memorandum to the Collateral Protection Bill.

⁶ 2016 Explanatory Memorandum, [1.165].

⁷ See for example, 2016 Explanatory Memorandum, [1.201] and [1.271]. Importantly, the references to the sections imposing the ipso facto stays should be included in the “specified provisions” definition, and *not* the “specified stay provisions” definition. The “specified stay provisions” refer to the sections imposed stays related to the resolution regimes specifically developed for systematically important financial institutions (such as Australian banks and insurers) and are not relevant, or analogous, to the current Reforms.

⁸ RTGS in this context means real time gross settlement.

⁹ We note that the protection provided to approved RTGS systems under the *Netting Act* does not itself protect the termination of contracts related to the approved RTGS system (also note that it is important to refer to the contracts related to the system, rather than the system itself).

d. market netting contracts,

each of which are protected under the *Netting Act* (including the transactions and security related to these contracts, agreements and arrangements). Importantly, we note that the protections under the *Netting Act* are not limited solely to the systems, arrangements and contracts defined in the *Netting Act* themselves (eg close-out netting contracts, market netting contracts, etc). The *Netting Act* also protects, for example, the security granted in respect of close-out netting contracts and market netting contracts (the enforcement of which is protected in the circumstances described in the *Netting Act*). We consider that it is critical that these systems, arrangements and contracts, and the associated transactions and security agreements and arrangements be excluded from the scope of the stay.

- (d) it would assist market participants and improve certainty if the Government clarified in the Explanatory Memorandum to the Bill that the stay on ipso facto clauses only applies to the specific event referred to in the stay and does not prohibit the exercise of a right for any other reason. For example, a counterparty may still terminate the contract, agreement or arrangement, or exercise another right under the contract, agreement or arrangement, because the entity subject to the event described in the stay (eg the voluntary administration or scheme application etc) fails to perform an obligation, including a payment obligation. This approach of using an Explanatory Memorandum to clarify the scope of the stay has been taken in other Explanatory Memoranda, including the 2016 Explanatory Memorandum.¹⁰

Further detail on, and an explanation of, our submission is outlined below.

We hope that our comments in this submission will assist Treasury with the finalization of the legislative changes described in the Reforms. ISDA hopes to continue the constructive ongoing dialogue between Treasury, Australian regulators and derivatives market participants to consider, for instance, the practical concerns and risks surrounding the implementation of the matters set out in the Reforms.

Protections of the Netting Act are significant and should prevail despite any other law

The *Netting Act* came into force in Australia on 2 July 1998. As noted in the Explanatory Memorandum to the original *Netting Act*, it was considered that:

[the Netting Act] would make the financial position of Australian financial institutions more secure. Clarifying the law of netting will minimise risks associated with participating in multilateral netting in the payment system and the performance of certain large financial transactions involving netting systems

¹⁰ 2016 Explanatory Memorandum, [1.202], [1.203] and [1.204].

Similarly, in the 2016 Explanatory Memorandum, it was noted that:¹¹

[t]he objective underlying the framing of the [Netting Act] was to provide the utmost legal clarity and certainty that the netting arrangements established in relation to payment systems, transactions and facilities were legally valid and protected, including in situations where one of the participants or parties entered external administration.

...

Legal certainty is of the utmost importance in relation to these systems, arrangements and markets, and any uncertainty could cause significant systemic disruption.

To achieve this:

- (a) Part 2 of the *Netting Act* protects “**approved real-time gross settlement (RTGS) systems**”.

These systems include Australia’s high-value payments system, the Reserve Bank Information and Transfer System (**RITS**), Austraclear and CHESSTGS.

- (b) Part 3 of the *Netting Act* protects “**approved netting arrangements**”.

These arrangements include the settlement system operated by ASX Settlement, Austraclear (in Fallback mode) and the important payment systems operated by Australian Payments Network Limited (formerly known as Australian Payments Clearing Association Limited) (including the High-value Clearing System (in Bypass mode), the Bulk Electronic Clearing System and the Issuers and Acquirers Community Framework).

- (c) Part 4 of the *Netting Act* protects “**close-out netting contracts**”.

Contracts which fall within the definition of a “close-out netting contract” under the *Netting Act*, including the ISDA Master Agreement and other industry standard master agreements, are widely used in financial markets transactions such as currency (foreign exchange) derivatives, interest rate swaps and other interest rate derivatives, credit derivatives, equity derivatives, securities lending arrangements, repurchase agreements and other types of derivatives. As a result of amendments made to the *Netting Act* as a result of the enactment of the Collateral Protection Bill, Part 4 of the *Netting Act* also protects the enforcement of security under security-based collateral arrangements, subject to the safeguards set out in the *Netting Act*.¹²

¹¹ 2016 Explanatory Memorandum, [1.14].

¹² These amendments were introduced as part of an international reform agenda originated at the G20 level, and ensure that entities subject to Australian law can enforce rights in margin provided by way of security in the manner contemplated by the revised margin requirements for non-centrally cleared derivatives published by the

(d) Part 5 protects “**market netting contracts**”.

These contracts include contracts used by certain approved stock exchanges, derivatives exchanges and clearing facilities, including central counterparties (CCP). CCPs are highly important financial market infrastructure, particularly in modern markets as domestic and international regulation is mandating that certain transactions which were previously entered into on a bilateral basis be cleared through a CCP.

These *Netting Act* protections have been based on the sound policy that it is critically important for financial market participants and financial market infrastructure providers to be able to move swiftly and with confidence to manage their risks and close-out transactions should an event of default occur under particular contracts, agreements or arrangements (and associated transactions and security).

Accordingly, the protection of close-out netting contracts under the *Netting Act* applies “*despite any other law (including the specified provisions)*”.¹³ Similar protections apply to approved RTGS systems, approved netting arrangements and market netting contracts, the protection of which under the *Netting Act* applies “*despite any other law (including the specified provisions and the specified stay provisions)*”.¹⁴

We are concerned that any attempt to exclude the application of the stay merely by regulations without clarifying that the protections of the *Netting Act* prevail to the extent of any inconsistency could significantly undermine the fundamental principle that the *Netting Act* is to prevail despite any other law. This principle has been relied on by market participants and infrastructure providers to ensure their arrangements and systems have the required level of protection and certainty. Not stating that the *Netting Act* prevails will introduce uncertainty as to what contracts, agreements and arrangements are actually subject to, or excluded from, the stay and the way in which the *Netting Act* would actually apply to these contracts, agreements and arrangements.¹⁵

Accordingly, we submit that the Bill should include an express statement in the part of the Bill which relates to the amendments to the *Corporations Act* to clarify the interaction between the *Netting Act* and the ipso facto stays and include a reference in the definition of “specified provisions” in the *Netting Act* to the new sections of the *Corporations Act* which impose those stays. These are discussed in our submissions in paragraphs (a) and (b) at the start of this submission.

Basel Committee on Banking Supervision and the International Organization of Securities Commissions in March 2015.

¹³ *Netting Act*, section 14(3), albeit “*subject to a specified stay provision that applies to the contract*”. Importantly, the specified stay provisions only apply in respect of resolutions of certain significant regulated entities, such as Australian banks, life companies and general insurers.

¹⁴ *Netting Act*, sections 6A(2), 10(3) and 16(3).

¹⁵ Exposure Draft, Schedule 1 Part 2, proposed section 415D(4).

Existing methods of exclusion are not sufficient

Whilst we note that the Explanatory Document released as part of the Reforms indicates an intention to exclude, by way of regulation, certain types of arrangements (including agreements under the *Netting Act*), we are concerned that the references in the Explanatory Document to “agreements under the *Netting Act*” and other agreements:

- (a) do not necessarily correspond with the terms of the *Netting Act* (including the sections of the *Netting Act* which protect security structures associated with close-out netting contracts and market netting contracts¹⁶); and
- (b) do not necessarily align with, or cover all of, the types of systems, arrangements, contracts and related contracts, transactions and security agreements which are actually protected by the *Netting Act*.

For example, it is not clear whether the regulation would extend to:

- (a) protect the enforcement of the security granted over variation margin or initial margin exchanged by way of security in connection with an ISDA Master Agreement (eg under an NY law Credit Support Annex or Credit Support Deed). Margin requirements imposed by regulators internationally (including by the Australian Prudential Regulation Authority) require counterparties exchange margin (and at least initial margin will need to be provided by way of security). Protection of these arrangements was a key purpose of the 2016 reforms to the *Netting Act* which resulted from the enactment of the Collateral Protection Bill; and
- (b) protect the enforcement of the security granted by a clearing member to a CCP if the security was granted under a document separate to the market netting contract itself.

The *Netting Act* protects the enforcement of security in respect of these types of arrangements, if certain safeguards are met. However, these documents may not themselves be “close-out netting contracts” or “market netting contracts”. In our view, it is critical that these arrangements are excluded from the stay. We consider that the clarification that the *Netting Act* prevails to the extent of any inconsistency would ensure that these security arrangements continue to be protected in the manner contemplated by the *Netting Act*. However, given the breadth of the stay (that any “right” is “not enforceable”), potential uncertainty as to what “rights” it applies to and for the reasons discussed above, we submit that the range of contracts, agreements and arrangements (including any transactions and security) related to the systems, arrangements and contracts protected under the *Netting Act* also be expressly excluded by the regulations in a clear and comprehensive manner.

¹⁶ See, for example, sections 14(1)(ca), 14(2)(fa), 16(1)(ca) and 16(2)(fa) in relation to the protection of the enforcement of rights under security arrangements (which may not be documented as “close-out netting contracts” or “market netting contracts”).

We note that the proposed sections 415D(4)(c) and 451E(4)(c) of the *Corporations Act* provide that the stays do not apply to a right that:

- (i) *manages financial risk (within the meaning of Chapter 7) associated with a financial product (within the meaning of that Chapter); and*
- (ii) *is commercially necessary for the provision of financial products of that kind...*

We are deeply concerned that the terms “commercially necessary” and “manages financial risk” lack sufficient certainty to exclude all close-out netting contracts from the application of the stay. We acknowledge the reference in the Explanatory Memorandum to the Exposure Draft is intended to clarify that, by way of example, “swaps, where the party is entitled to close out their position in order to manage counterparty risks”¹⁷ would fall within this exclusion. Despite this, we consider that this would be very difficult, if not impossible, to apply with any certainty in practice. We do not expect market participants and their advisers would be able to confirm that all close-out netting contracts (including the derivatives master agreements and transactions documented which would fall within the definition of “close-out netting contract”) meet this requirement due to its inherent vagueness. Accordingly, we would submit that this exclusion may not achieve its desired effect as currently drafted.

For the reasons stated above, we consider that it is critically important to clarify that the *Netting Act*, including the protection given to close-out netting contracts and the security provided in connection with these contracts, prevails over the *Corporations Act* in relation to these stays to the extent of any inconsistency and to properly describe the related contracts, agreements and arrangements to be excluded from the stay.

Conclusion

We thank you for the opportunity to respond to the consultation on the Reforms. We would be very happy to discuss this matter further at your convenience. Please do not hesitate to contact Keith Noyes, Regional Director, Asia Pacific (knoyes@isda.org, +852 2200 5900), Erryan Abdul Samad, Assistant General Counsel (eabdulsamad@isda.org, +65 6653 4170), Jing Gu, Senior Counsel (jgu@isda.org, +65 6653 4170) or Rishi Kapoor, Director, Public Policy, Asia-Pacific (rkapoor@isda.org, +852 2200 5900) if we may be of further assistance.

¹⁷ Explanatory Memorandum to the Exposure Draft, [2.26].

Yours sincerely,

For the **International Swaps and Derivatives Association, Inc.**



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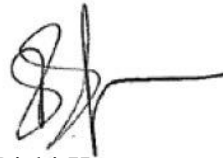
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