ISDA Safe, Efficient Markets

5 February 2016

Division Head
Financial System Division
The Treasury
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Dear Sir/Madam

**Resilience and Collateral Protection and Client Money Reforms**

The International Swaps and Derivatives Association (**ISDA**)[1] is grateful for the opportunity to comment on the Resilience and Collateral Protection and Client Money Reforms (**Reforms**).

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

The release of the Reforms is a significant step made by Australia in facilitating the enforcement of security-based collateral arrangements for financial market transactions, clarifying Australian law to implement a stay framework which aligns with the principles set out in the Financial Stability Board's (**FSB**) *Key Attributes of Effective Resolution Regimes* (the **Key Attributes**) and the ISDA 2015 Universal Resolution Stay Protocol (**Stay Protocol**) and ensuring legal certainty for the operation of key financial market infrastructure. As such, ISDA appreciates the Commonwealth Treasury's (**Treasury**) efforts in this area and in particular, supports Treasury's considered approach in developing a strong legislative regime for the enforcement of security-based arrangements in line with other national and regional regimes (eg the European Parliament

[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 67 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.

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and Council Directive 2002/47/EC on financial collateral arrangements (**Financial Collateral Directive**)) and clarifying the Australian law relating to resolution-based stays.

We are strongly supportive of:

a) reforming Australian law to remove the existing impediments to efficient creation, perfection and enforcement of security-based financial collateral arrangements;

b) ensuring a strong, internationally consistent resolution regime for financial institutions and one that is aligned with the FSB's Key Attributes and the Stay Protocol; and

c) ensuring that key components of the financial market infrastructure are robustly protected by Australian legislation and can operate in a certain and efficient manner in all market conditions.

However, there are a number of issues we consider it important to raise at this stage. In this submission, we also set out certain general observations and comments which we hope would be useful in providing the necessary context to our more specific responses.

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 to 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.

***Scope of Submission***

In this submission, we primarily focus on the matters set out in the following components of the Reforms to the extent they relate to financial market transactions and derivatives markets:

a) the *Financial System Legislation Amendment (Resilience and Collateral Protection) Bill 2016* (**Bill**) and the associated explanatory memorandum (**Explanatory Memorandum**); and

b) the *Financial System Legislation Amendment (Resilience and Collateral Protection) Regulation 2016* (**Regulation**), the associated explanatory statement (**Explanatory Statement**) and the updated list of approved bodies (**Approved Bodies List**).

While we agree that the issues dealt with throughout the Reforms are closely interrelated, we believe, given our focus on the over-the-counter (**OTC**) derivatives markets, that other respondents, in particular, other international financial trade associations with a broader and less sector-specific focus and mission than ours, may be better placed to comment in detail on

specific parts of the Reforms (eg in relation to the enhanced protection of the client money of retail clients).

Consistent with our mission, we are primarily concerned in this submission with the effect of the proposed Reforms on the safety and efficiency of the derivatives markets in Australia, by considering the direct impact of the proposals on the rights of a market counterparty under its derivatives transactions with a failing financial institution (**FI**, more specifically, being Australian Authorised Deposit-taking Institutions (**ADI**), general insurers (**GIs**), life insurance companies (**life companies**) and private health insurers (**PHIs**)) and under related netting and collateral arrangements. For example, it is necessary to balance the need for a stay on counterparty's close-out rights in order to allow the Australian resolution authority (the Australian Prudential Regulation Authority (**APRA**) or other statutory manager or judicial manager) to resolve distressed FIs and preserve the stability and efficiency of the Australian market, while ensuring that such powers do not adversely impact market participants, which impacts on counterparties' ability to manage their own risks and counterparties' inclination to trade with Australian regulated entities.

In particular, we are concerned with the risks associated with any inconsistency between the Australian resolution stay regime and the approach adopted under the Key Attributes, Stay Protocol and other jurisdictions. Any inconsistency could impact on the relative footing of Australian FIs as against FIs in other jurisdictions.

Our membership includes the leading global, regional and national financial institutions as well as leading end-users and many other important financial market participants. Our leading financial institution members are members of the other international financial trade associations to which we refer above, and their views on those other issues may be represented to you through those associations. Our members may also choose to make their own individual submissions to Treasury.

***Overview***

ISDA is grateful for your consideration of a number of our previous submissions[2] in respect of the implementation of derivatives reform and impediments to international integration in derivatives markets. We are pleased to see that the Bill and Regulation address many of our concerns expressed in our previous submissions.

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[2] For example, ISDA's submission dated 23 June 2014 in respect of the *Financial Sector Legislation Amendment (Netting Contracts) Bill 2013*, ISDA's submission dated 28 March 2014 in respect of the Financial System Inquiry, ISDA's submission dated 19 April 2013 in respect of the *Corporations and Financial Sector Legislation Amendment Bill 2013*, ISDA's submission with respect to the amendments proposed to the *Netting Act* in 2011.

ISDA acknowledges the efforts which have been made by the Australian Government and the Australian financial regulators in facilitating compliance by Australian participants with multiple international regulatory regimes as a result of the G20 derivative reforms. A focus on pro-active regulation which facilitates international business is critical for the integration of the Australian financial markets with the rest of the world and ISDA welcomes Treasury's, and the Australian regulators', efforts to promote cross-border consistency and implement regulation consistent with international standards.

We submit it is critical that these efforts at maintaining harmony between Australian and international derivative regulatory reform (including, relevantly, in respect of the protection of security-based collateral arrangements and the application of resolution-based stays) continue as regulation, and international frameworks and models of best practice, are developed. Most importantly from an Australian market perspective, this international consistency mitigates against market fragmentation and facilitates the efficient entry into risk management transactions by Australian entities overseas, as well as international entities in Australia.

Accordingly, we submit that it is vitally important that the regime for enforcing rights in respect of security-based collateral arrangements and exercising close-out rights in resolution scenarios aligns, to the extent possible, with the approach taken in key jurisdictions internationally, such as in the United Kingdom, Europe and the United States of America.

We have set out our submission below on the following topics:

a) in respect of the Bill:

    a. resolution period and potential declaration by APRA under the proposed section 15C;

    b. termination for other grounds;

    c. no cherry-picking;

    d. application of Division 2 of Part 4 of the *Payment Systems and Netting Act 1998* (Cth) ("***Netting Act***");

    e. approved RTGS systems, approved netting arrangements and market netting contracts;

    f. protection from insolvency law;

    g. expansion of definition of external administration;

    h. "eligible obligation" concept;

i. possession and control;

j. “financial property”;

k. other amendments set out in the Bill; and

l. priority of reforms in the Bill; and

b) in respect of the Regulation:

a. requirement that the performance of obligations in relation to the derivatives contract to be secured;

b. updated list of approved bodies;

c. enforcing security; and

d. timing of commencement of reforms.

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**Financial System Legislation Amendment (Resilience and Collateral Protection) Bill 2016**

***Overview***

As discussed above, we strongly support the policy intention evinced in the Bill. The amendments to the *Netting Act* in respect of enforcing security and clarifying the operation of close-out stays are of great importance to the safety, efficiency and stability of the financial markets, including the OTC derivatives markets. Legal certainty around the enforceability of netting and security-based credit support arrangements is critical to the stability of the market, particularly in light of the imminent margin requirements to be imposed by regulators across the world.

We understand that the Australian Government and its regulators share this view and consider that the Reforms go some way to improving the consistency of the legal protection of derivatives arrangements in Australia with other important jurisdictions.

***Stays on close-out rights - Resolution period and potential declaration by APRA under the proposed section 15C***

In many cases, the market counterparty to the regulated entity is a regulated financial institution itself. We submit that it should be clarified, by the Australian Government and APRA, that the application of any stay provision (1) does not mean that APRA will require that the sound institution cannot treat its exposures as net; and (2) in the interests of the stability of the system, during the period in which rights of a counterparty to close-out transactions entered into with a failing FI, APRA does not require the sound counterparty to treat the obligations owing under the affected close-out netting contract as gross for the purposes of calculating its exposure. This is fundamental to systemic stability and the ability of counterparties to conduct their business in an effective manner.

The principal concern of market participants in this regard is to ensure that there is sufficient clarity and certainty as to the rules that will apply and as to the full legal, tax and regulatory capital effects, so that market participants can analyse the market and other risks of the transaction, structure and document it properly, price it accurately (including by pricing the regulatory capital implications of the transaction) and hedge it effectively and reliably. Certainty under the *Netting Act* is of great importance to the safety efficiency and stability of Australia's financial markets. Any difference between the approach taken in Australia and the approach taken in other jurisdictions (including in Europe under the EU Banking Recovery and Resolution Directive (**BRRD**)) in respect of a European or US bank could mean that potential counterparties to these Australian institutions will perceive there to be greater risks in dealing with Australian institutions. To the extent that the proposed solution does not result in potential financial institution counterparties to these Australian FIs treating close-out netting as being enforceable, such potential counterparties will not be entitled under the Basel rules to net exposures or offset

the value of collateral, leading to higher regulatory capital charges and thus, higher transaction pricing for Australian institutions.

Accordingly, we suggest that care is taken in clarifying the existing inconsistency between the *Netting Act* and other Australian Acts and ensuring that the framework sets out for the application of stays to close-out rights reflects the approach taken in the Stay Protocol.

We support the length of the resolution period not exceeding two business days. Just to note, for example, this seems to be broadly compliant with the definition of Protocol-eligible Regime in the Stay Protocol and similar to the US approach under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act titled "Orderly Liquidation Authority".

We submit that the Bill should clarify that section 15C of the *Banking Act 1959* (Cth) (***Banking Act***) and the equivalent stay provisions in other industry Acts still require that all payment and delivery obligations of the regulated body be satisfied for the duration of the stay. Whilst we note that these stay provisions provide that the fact that the relevant resolution event (eg the fact that an ADI statutory manager is in control of the ADI's business) does not allow the contract, or a party to the contract, to, among other things, deny any obligations under that contract, we submit that it is important that the Australian resolution stay regime explicitly complies with the requirements of the Stay Protocol and that this issue be expressly addressed in the Bill.[3] Possible methods of addressing this issue could be to:

a) confirm that the reference to "deny any obligations" in each stay provision includes a requirement that the regulated body meet payment and delivery obligations (and that the relevant resolution event does not allow a regulated body to cease to meet delivery or payment obligations); or

b) expressly provide that each stay ceases to apply if a payment or delivery obligation of the regulated body is not satisfied.

Based on ISDA's previous experiences in respect of the Stay Protocol, this is an issue that may attract the attention of the Stay Protocol's drafting group and working group.

We note that there are a number of other issues which could give rise to arguments that the extension of a specified stay provision by APRA under the proposed section 15C does not meet the required conditions for a "Close-out Stay" under (e)(ii) of the definition of Protocol-eligible Regime of the Stay Protocol. For example, the requirement that the regulated body or transferee

[3] This includes, for example, the requirement in paragraph (i)(B) of the definition of "Protocol-eligible Regime" that "*During the pendency of any such temporary Close-out Stay, such laws include either or both of the following requirements:— (I) All payment and delivery obligations of the Failed Financial Company under such Covered Agreements and Covered Credit Enhancements are required to be satisfied; or (II) All payment and delivery obligations of both parties under such Covered Agreements and Covered Credit Enhancements are deferred until the expiration of such Close-out Stay*".

is "at least as creditworthy as the Failed Financial Company was immediately prior to the start of resolution proceedings" under (e)(ii)(4) of the definition of Protocol-eligible Regime is not explicitly covered in the Bill. However, we note that the requirement under Section 15C(3)(d) that either (i) the party's level of capital meets capital requirements applicable to it or (ii) arrangements are in place to ensure that the party performs its obligations under close-out-netting contracts may be interpreted to satisfy this condition.

Additionally, section 15C allows APRA to declare that a specified stay provision is to continue if the "APRA is satisfied that all matters in subsection (3) will be satisfied in relation to the party in respect of which the declaration under subsection (2) will be made." Under the definition of Protocol-eligible Regime, the conditions for a Close-out Stay are stated as a factual matter and would be decided by a court, not the applicable regulator. Therefore, arguments could be made that the requirement that APRA is "satisfied" that the conditions under Section 15C(3) "will be satisfied" in relation to a party is not sufficient to meet the definition of Protocol-eligible Regime, which requires that these conditions are in fact true.

We note that, even if the Australian resolution stay regime does not clearly meet the conditions (or even if it does), it may be possible (or necessary) to create an annex with some sort of waiver or conditions attached to bring it clearly in scope of the Stay Protocol. This process will likely be more difficult the more the Australian resolution regime deviates from the definition of "Protocol-eligible Regime" in the Stay Protocol and there is no certainty that the relevant interested parties (both regulators and market participants) would agree to an Australian Annex being added if the conditions are less clearly met.

***Stays on close-out rights - Termination on other grounds***

We understand the amendments are intended to relate to the period during which section 15C of the *Banking Act* (and the equivalent insurance legislation) prevails over the *Netting Act*, and not as a general prohibition on termination or close-out netting for other reasons during that period.

As discussed in our Previous Submissions, we agree that counterparties should be allowed to rely on any event other than the relevant resolution event (ie the appointment of a statutory manager or judicial manager) to terminate transactions entered into under the close-out netting contract and that close-out netting is not generally suspended. Thus, for example, if the ADI fails to make a payment or delivery that is due under a close-out netting contract (for whatever reason, including due to compliance with a direction from APRA), the counterparty should be allowed to exercise its termination, and close-out netting, rights. Similarly, if the ADI subsequently becomes subject to any other form of external administration (including winding up), the counterparty should be allowed to exercise its close-out netting rights. Of course, it should not be limited to these examples.

As this is a critical point for market participants, we strongly support the inclusion of the statements confirming this in the Explanatory Memorandum to the Bill.[4]

***No cherry-picking***

We support the implementation of section 36AB of the *Financial Sector (Business Transfer and Group Restructure) Act 1999* (Cth) (***Business Transfer Act***), which provides that a partial transfer that covers some (but not all) of the assets and liabilities the FI has under a close out netting contract, market netting contract or approved netting arrangement is void to the extent of the assets or liabilities the transferring body has, just before the partial transfer, under the contract or arrangement, with respect to the counterparty.

However, we would also submit that it be clarified that the stay provision in section 36AA does not apply in respect of such partial transfers (ie where the transfer covers some (but not all) of the assets and liabilities of the body under a close out netting contract, market netting contract or approved netting arrangement (as applicable)). We note that this approach was taken in the proposed amendment to the *Netting Act* in 2014. Accordingly, we submit that, in addition to the currently-proposed section 36AB, the amendments in respect of section 36AA of the *Business Transfer Act* set out in the 2014 amendment (in the proposed subsection 36AA(3)) should be included in the Bill. We strongly support the existence of a netting safeguard, which should ensure that netting is enforceable notwithstanding the transfer by the resolution authority of some but not all of the rights or obligations under a master netting agreement.

We would emphasize that it is critical that there be no "cherry-picking" by the statutory or judicial manager or as part of a transfer of business under the *Business Transfer Act* and that the U.S. approach where close-out netting contracts not only with the counterparty but also with its affiliates are treated as a whole together with associated collateral is to be recommended (as was discussed in our Previous Submissions).

We also note in relation to our submission that no cherry picking be allowed that under the US regime the US resolution authority, the Federal Deposit Insurance Corporation (**FDIC**), must transfer all "qualified financial contracts" (**QFCs**) to a transferee or none, regardless of whether the QFCs are linked by a common master agreement. In addition, it must transfer all QFCs not only of the counterparty but also all QFCs of all of that counterparty's affiliates with the failing firm. Although these requirements may restrict the flexibility of the authorities in relation to the restructuring of the failing firm's business, there are clearly risk management advantages to both

[4] For example, we support the statements in the second bullet point of paragraph 1.78 (page 24), paragraphs 1.183 to 1.185 (pages 62 to 63), paragraph 1.190 (page 65) and paragraph 1.204 (page 69) that "the stays in the Industry Acts only relate to the particular action described in the relevant stay provision and do not prohibit a party closing out for any other reason (e.g. a counterparty may still terminate because the regulated body, e.g. an ADI, fails to make a payment or perform an obligation, irrespective of whether that failure to pay or perform was in compliance of a direction by the resolution authority)".

of these additional features, which maximise available set-off rights (subject to some legal uncertainty about the full enforceability of cross-affiliate set-off).

In relation to security, we consider that the safeguard in section 36AB should provide that a transfer of secured obligations is legally ineffective unless the related security arrangement together with the secured assets are also transferred to the transferee (being the new obligee). For these reasons, we submit that, in relation to security, the reference to "assets and liabilities the body has, under the contract or arrangement" in section 36AB of the *Business Transfer Act* should also include any assets and liabilities which are subject to security given in respect of the contract or arrangement (ie secured assets are treated in the same way as the assets and liabilities under the contract or arrangement, noting some difficulties that would need to be worked through in respect of all-assets security arrangements) or that it be clarified that any transfer under the *Business Transfer Act* remain subject to security given in relation to assets and liabilities the regulated body has under the close-out netting contract, market netting contract or approved netting arrangement. These comments apply generally to all contracts not just close-out netting contracts, market netting contracts and approved netting arrangements.

Additionally, we would submit that there should be express provision that APRA cannot modify transferred contracts (or at least that this be clarified in the explanatory materials).

***Application of Division 2 of Part 4 of the Netting Act***

Section 15A of the Bill provides that the section (which relates to certain specified stay provisions ceasing to apply) "*applies in relation to a close out netting contract to which a regulated body is a party if:*

*(a)* *an obligation under the contract of a party to the contract is an eligible obligation in relation to the contract; and*

*(b)* *a specified stay provision (other than a direction stay provision) applies to a trigger event that happens in relation to the contract.*"

Accordingly, it appears to be anticipated that there may be close-out netting contracts to which Division 2 of Part 4 of the *Netting Act* may not apply and therefore to which the specified stay provisions may apply generally. Similarly, the specified stay provisions will continue to apply generally in respect of contracts which are not close-out netting contracts.

The Stay Protocol now contains a Securities Financing Transaction Annex (**SFT Annex**) which provides that a range of commonly used securities financing and repurchase agreements are covered by the Stay Protocol. These agreements include master agreements widely understood to be close-out netting contracts, but also includes master agreements in respect of which the

"close-out netting contract" analysis may not be so clear.[5] Further, an Other Agreements Annex to the Stay Protocol is expected to be published that, for adhering parties that adhere to it, will expand the definition of "Covered Agreement" to include all agreements subject to the applicable resolution stay regulations in a jurisdiction.

As currently drafted, the Bill will not change the result that the Australian special resolution regime will not satisfy the definition of Protocol-eligible Regime with respect to any Adhering Parties that have adhered to the SFT Annex or Other Agreements Annex for certain agreements which are not close-out netting contracts or which do not contain an "eligible obligation". This is because the Australian resolution stays would apply generally to close-out netting contracts which do not contain an "eligible obligation" and contracts which are not close-out netting contracts rather than being subject to specific criteria as required under the Stay Protocol. We assume this is the Government's, and regulators', policy intention but you may wish to reconsider the application of the stay provisions and Division 2 of Part 4 of the *Netting Act* if this is not the policy intention.

We also note that sections 15B and 15C deal with the circumstances in which APRA may declare that non-direction stays cease or declare that non-direction stays continue and, generally, allow APRA to make the relevant declarations in relation to all close out netting contracts of the party.[6] The difference in application of sections 15B and 15C as against section 15A could potentially lead to uncertainty as to the application of the mechanisms set out in sections 15B and 15C.

We also submit that any security-based collateral arrangements in support of obligations pursuant to a close-out netting contract (including any pledge, charge, mortgage or other security interest in collateral or title transfer arrangements) and other credit enhancements (including any guarantee, collateral arrangement, trust or similar arrangement, letter of credit, transfer of margin or any similar arrangement) entered into in respect of the close-out netting contract should be treated in the same way as the close-out netting contract. This is important for compliance with the requirements of a Protocol-eligible Regime under the Stay Protocol as both "Covered Agreements" and "Covered Credit Enhancements" are provided the same protections under the definition of Protocol-eligible Regime. For example, in subsection 15A(2), in our view, it should be clarified that the specified stay provision (other than a direction stay provision) ceases to apply to a close-out netting contract and security given in respect of that close-out netting contract. Similar amendments would also be relevant in sections 15B and 15C.

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5 For example, the SFT Annex provides that the following, among others, are Covered Agreements: the 1996 Master Repurchase Agreement, published by the Securities Industry and Financial Markets Association and the 1987 Master Repurchase Agreement, published by the Public Securities Association, the 2000 Master Securities Loan Agreement and the 1993 Master Securities Loan Agreement, in each case published by the Securities Industry and Financial Markets Association.

6 Bill, subsection 15B(2) and paragraph 15C(2)(a).

***Stays on close-out rights – Approved RTGS systems, approved netting arrangements and market netting contracts***

In order to maintain the safe and orderly operation of a central counterparty (**CCP**), members have expressed a view that an express exemption should be provided for CCPs from the stay in order to allow for the porting of financial contracts from a distressed FI to a substitute FI pursuant to the usual default rules of the relevant CCP. It is worth noting that Article 71(3) of the BRRD also provides for such an exemption. Article 71(3) provides

> *that "[a]ny suspension under paragraph 1 or 2 (of Article 71) shall not apply to systems or operators of systems designated for the purposes of Directive 98/26/EC, central counterparties, or central banks".*

Accordingly, we strongly support the amendment to the *Netting Act* to clarify that the protections provided to approved RTGS systems, approved netting arrangements and market netting contracts under the *Netting Act* have effect despite any other law, including the specified provisions and the specified stay provisions.

It is imperative that certainty with respect to netting and collateral enforceability exists in respect of the clearing houses and settlement and payment systems which are fundamental to the stability of the Australian financial system. We note that ensuring the certainty and effectiveness of netting and collateral arrangements and the clarity and transparency of client asset segregation arrangements is, if anything, likely to reinforce the effectiveness of a resolution regime by inspiring confidence in market participants that they are being dealt with fairly and in a predictable manner consistent with their expectations. Segregation of client assets should be clear, transparent and enforceable. The regime should provide for rapid identification and return to each client and/or a solvent custodian for the client of its assets.

***Protection from insolvency law***

ISDA supports the broad protection of payments, transfers of property, creation of rights, giving of security and the entry into close-out netting contracts set out in the proposed subsection 14(5) of the *Netting Act*. We submit that Treasury consider expanding this to clarify that:

a) in respect of paragraph 14(5)(d) of the *Netting Act*, the entry into *one or more transactions under* close-out netting contracts also be protected (as the close-out netting contract is often the derivatives master agreement and it will be important to ensure that the entry into specific transactions under that framework agreement is also protected to allow entities to continue to trade during a statutory management etc); and

b) this broad protection be extended to approved netting arrangements and market netting contracts. Paragraphs 10(2)(e) and (f) of the *Netting Act*, as amended, provide that certain netting payments and transfer of property in respect of approved netting

arrangements are protected and paragraph 16(2)(g) provides broad protections to market netting contracts. However, these protections do not currently extend to the creation of (new) rights or obligations under arrangement or contract, the giving of security (noting the giving of security is only relevant to market netting contracts) and entering into new approved netting arrangements, market netting contracts or incurring obligations and entering into transactions under those arrangements and contracts during a statutory management or judicial management. We would expect that there is be a similar public policy rationale for protecting these things in respect of approved netting arrangements and market netting contracts as there is in respect of close-out netting contracts.

***Netting and enforcement of security - definition of "external administration" in the Netting Act***

We strongly support the amendment to the definition of "external administration" in section 5 of the *Netting Act* to explicitly include the appointment of a statutory manager or judicial manager under the relevant provisions of the *Banking Act*, *Insurance Act 1973* (Cth) and *Life Insurance Act 1995* (Cth).

***Enforcing security – "eligible obligation" concept***

We note that, in order for the enforcement of security to be protected under subsections 14(1) and (2) of the *Netting Act*, the obligations secured by the financial property, and discharged through the enforcement must be "eligible obligations" in relation to the contract (or certain related obligations to pay interest or costs and expenses incurred in connection with the enforcement of security).

We understand that this change is intended to facilitate the enforcement of rights in respect of the security-based credit support arrangements to be used to comply with margin requirements. As a general matter, the Margin Requirements for Non-Centrally Cleared Derivatives (**BCBS-IOSCO Margin Requirements**) published by Basel Committee on Banking Supervision (**BCBS**) and the Board of the International Organization of Securities Commissions (**IOSCO**) requires that "appropriate margining practices should be in place with respect to all derivatives transactions that are not cleared by CCPs".[7] Accordingly, it is important that the protections under the *Netting Act* apply to allow for all obligations with respect to all derivatives transactions to which the BCBS-IOSCO Margin Requirements (and the margin requirements imposed by international regulators) to be secured and discharged through the enforcement.

The equivalent to the concept of "eligible obligation" in the *Financial Collateral Arrangements (No. 2) Regulations 2003* (**FCARs**) and in the Financial Collateral Directive itself is "relevant financial obligations". There has been some controversy in a number of European countries about this concept being broad enough to cover commercial loans, retail deposits and other

[7] BCBS-IOSCO Margin Requirements, Key Principle 1.

transactions that are arguably not obligations arising from financial market trading operations of the type at which the Financial Collateral Directive is aimed. The definition of "relevant financial obligations" also appears to be circular. We presume that anything that parties would customarily transact under an ISDA Master Agreement in the ordinary course of business should be within the scope of the protection. Accordingly, it may be helpful to ensure that anything, for example, that would fall within the scope of Appendix A to ISDA's netting and collateral opinions is covered in the definition of "eligible obligation".

We submit that limiting the concept to the *Corporations Act 2001* (Cth) definitions of "derivatives" and "foreign exchange contracts" may be too narrow and does not capture some transactions ordinarily understood to be derivatives in financial markets (for example, physically settled derivatives in relation to tangible property, such as certain commodity derivatives including grain forwards). We submit that it be clarified, whether in the Explanatory Memorandum or otherwise, that the obligations related to the transactions described in Appendix A of ISDA's netting and collateral opinions and in the definition of "Specified Transaction" in the ISDA 2002 Master Agreement (re-written, of course, to make it suitable for insertion in an Australian statute) fall within the definition of "eligible obligation". Cross-referencing the BCBS-IOSCO Margin Requirements could also be workable, if viable from the Government's perspective, but is narrower than Appendix A and may not be sufficiently flexible to adapt to any changes in margin requirements or the implementation of the BCBS-IOSCO Margin Requirements by national regulators.

***Enforcing security – possession and control***

As a general matter, we support the use of the possession or control concept in subsection 15A(1)(b) and the clarification of circumstances in which the requirement for a secured party or third party to have possession or control would be, or would not be, satisfied. We acknowledge Treasury's efforts to develop a regime which is consistent with the approach taken under the FCARs and the Financial Collateral Directive and also purporting to address the shortcomings of those regimes. The proposed provisions in paragraph 14A(1)(b) and subsections 14A(2), (3), (4) and (5) seem to cover the necessary issues and do appear to address most, if not all, of the uncertainties of the current English approach and, subject to the resolution of the matters discussed below, could perhaps even form the basis of a legislative proposal in the United Kingdom.

In the table in subsection 14A(5), we submit that the reference to "*right (however described) to consent to*" in the drafting of "*The secured party (or a person who has agreed to act on the instructions of the secured party) must have the right (however described) to consent to the exercise of that right by the grantor*" be amended to instead refer to "*right (however described) to withhold consent to, or to impose conditions on,*". This is because we expect that it is more important, from assessing whether a secured party has "control", that the secured party has the ability to prevent the grantor exercising a particular right (ie withhold consent so as to prevent

the right being exercised) rather than the secured party being able to positively consent to the exercise of a right (ie give consent).

In relation to the equivalent legislation in the United Kingdom (ie the FCARs), there is case law that interprets "control" in a fairly narrow way. We understand from past experience that security arrangements for derivatives exposures may fail the "control" test on the basis that the arrangements contain flexible substitution rights (for example, grantor has right to substitute without consent until a default has occurred). It is unclear at this stage whether this type of security structure with flexible substitution rights will arise more often due to the implementation of margin requirements.

Accordingly, the Government may wish to consider whether there is any policy rationale for stating in subsection 14A(5) that the secured party's consent is required in order for the grantor to exercise any right to substitute financial property (particularly if the substitution mechanisms set out in the agreement satisfy the margin requirements). We submit that the Explanatory Memorandum clarify the operation of item 4 of the table in subsection 14A(5) (right to substitute financial property) (and the other items referring to consent) to confirm that the control analysis could still be satisfied where a security agreement or triparty arrangement provides that the secured party is deemed to consent to a substitution unless they object. We submit that it should also be made clear that it is not necessary for the secured party to expressly consent to a substitution or withdrawal of excess collateral on each occasion (or at all), as long as it has the *ability* to do so (or, more specifically, to withhold its consent on a particular occasion). This appears to be an extension to the matters already discussed in paragraph 1.139 of the Explanatory Memorandum. We expect that the clarification of the consent requirement would make it easier to provide clean legal opinions as will be required under the margin rules.

In relation to the right to withdraw excess financial property, as long as the right to withdraw excess relates to the excess over the agreed collateral requirement (rather than the excess over the secured obligation amount, which might be higher), it is not clear to us why the exercise of that right needs to be subject to a right of veto by the secured party or its agent. We consider that the key point is that the secured party must, directly or through its agent, have possession or control over the amount it has agreed with the grantor that it will be entitled to hold until discharge of the secured obligations or enforcement of the security arrangement. It is up to the secured party to ensure that the agreed collateral requirement is sufficient to satisfy the BCBS-IOSCO Margin Requirements. Accordingly, we submit that the table in subsection 14A(5) be amended to provide that a grantor's right to withdraw "excess" financial property does not affect the control analysis under subsection 14A(1)(b), irrespective of whether the exercise of the right is subject to the secured party's consent. In other words, we submit that the condition listed in the table in Column 2 in respect of the right to withdraw excess financial property should be "None".

***Enforcing security – "financial property"***

Generally, we support the use of the definition of "financial property", although we recognize that you may receive specific submissions in its coverage.

***Other amendments set out in the Bill***

We strongly support the other amendments set out in the Bill which:

a) enhance legal certainty around the enforceability of netting and the transfers of property through securities settlement systems; and

b) protect payment and settlement transactions executed through approved RTGS systems, the netting of obligations incurred under approved netting arrangements, and payments and transfers of property to meet obligations under market netting contracts from being void or voidable in an external administration. ISDA submits that it is important that these protections apply when the thing is done during the external administration of the participant (particularly during the statutory management or judicial management of the participant).

However, we note that other international financial trade associations and certain of our members may be better placed to comment in detail on these specific parts of the Reforms.

***Priority of reforms in the Bill***

We strongly support the use of the *Netting Act* to ensure that the legislative protections provided to netting and security-based collateral arrangements have effect despite any other law (subject to the issues we discuss regarding resolution stays). Given that it is critical that market participants have certainty that the protections have this effect, we submit that this should be clarified in the explanatory materials.

**Financial System Legislation Amendment (Resilience and Collateral Protection) Regulation 2016**

We strongly support the apparent policy intention set out in the Regulation to remove the impediments to trustees of superannuation funds regulated under the *Superannuation Industry (Supervision) Act 1993* (Cth) (***SIS Act***) and life companies regulated under the *Life Insurance Act 1995* (Cth) (***Life Insurance Act***). We consider that this promotes international integration without compromising the original policy objective sought to be achieved under the *SIS Act*, *Life Insurance Act* and associated regulations. Until this is addressed, these entities face restrictions in dealing in an international marketplace in a manner consistent with the G20 reforms designed to make that marketplace safer.

***Requirement that the performance of obligations in relation to the derivatives contract to be secured***

We note that, to satisfy sub regulation 13.15A(1A) of the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (***SIS Regulations***) and sub regulation 4.00A(1A) of the *Life Insurance Regulations 1995* (Cth) (***Life Insurance Regulations***), the charge must be given in order to comply with a requirement in the rules governing the operation of an approved body or an Australian or foreign law "*that the performance of obligations in relation to the derivatives contract be secured*".

We are concerned that a strict interpretation of the phrase "*that the performance of obligations in relation to the derivatives contract be secured*" may result in certain charges not falling within the scope of the sub regulations, even though the charges are given to comply with the requirements of certain clearing members of important liquid markets This is because the market practice of a clearing member taking security over a client's assets may arise due to a requirement that client funds be segregated rather than necessarily because of a direct legislative requirement to take security from clients in respect of derivatives contracts. We note that this circumstance is expressly referred to in the Explanatory Statement as the rationale for amending the existing *SIS Regulations* and *Life Insurance Regulations* and we support the clarification set out in the Explanatory Statement.

Accordingly, we submit that the reference to a requirement in the rules governing the operation of an approved body or an Australian or foreign law be broadened to include circumstances where the consequences of a regulatory regime necessitate the taking of security to ensure compliance with regulations (and remove the reference to "*that the performance of obligations in relation to the derivatives contract be secured*"). This appears to be consistent with the policy position explained in the Explanatory Statement.

We submit that it will also be important that the reference to "law" is given a broad interpretation, to include regulations made under Acts and prudential standards made by

financial markets regulators. We support the clarification of this matter in the Explanatory Statement.

***Updated list of approved bodies***

We note that the updated list of approved bodies has now been published. We strongly submit that the current list of approved bodies is significantly outdated and needs to be updated to refer to the range of exchanges and CCPs used in the international derivatives markets. We recognize that you may receive specific submissions in the coverage of the list and note that it will be important to ensure that the names of the approved bodies set out in the list reflect the proper legal names of the relevant entities.

***Enforcing security***

We note that our submissions in respect of possession and control and financial property apply equally to the references to these concepts in the Regulation and any changes made in respect of the Bill should be made to the Regulation.

***Timing***

We note that the Regulation is to commence the "*later of:*

> *(a) the start of the day after this instrument is registered; and*
>
> *(b) immediately after the commencement of the Financial System Legislation Amendment (Resilience and Collateral Protection) Act 2016.*"

We also note that the Regulation does not commence at all if the *Financial System Legislation Amendment (Resilience and Collateral Protection) Act 2016* does not commence.

Given the urgent need for Australian regulated trustees of superannuation funds and life companies to be able to access liquid international markets in order to obtain optimal pricing and efficiently manage their risks, we submit that, to the extent possible, the Regulation take effect as early as possible (at least in respect of the new sub regulation 13.15A(1A) of the *SIS Regulations* and sub regulation 4.00A(1A) of the *Life Insurance Regulations*).

We thank you for the opportunity to respond to the Consultation. 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) and Erryan Abdul Samad, Assistant General Counsel (eabdulsamad@isda.org, +65 6653 4170) if we may be of further assistance.

ISDA®

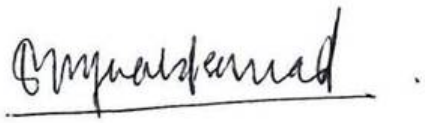
Yours sincerely,

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

Keith Noyes

Regional Director, Asia-Pacific

Erryan Abdul Samad



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