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BY POST AND BY E-MAIL

15 August 2008

Mr Robert Patch
Attorney-General's Department
Central Office
Robert Garran Offices
National Circuit
BARTON ACT 2600
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Dear Mr Patch,

Personal Property Securities Bill 2008 - Consultation Draft

The International Swaps and Derivatives Association, Inc. ("**ISDA**") is grateful for the opportunity to respond to the request by the Attorney-General's Department ("**Department**") for submissions in relation to the consultation draft of the Personal Property Securities Bill 2008 released for public comment on 16 May 2008 ("**Bill**").

ISDA's submission is set out below. This submission is limited to certain high-level and international aspects and consequences of implementing legislation of the nature set out in the Bill, by reference to ISDA's experience and observations of international markets. It is not intended to be a submission on each detailed aspect of the relevant Australian law, as we understand that the Department has already received submissions of this nature.

Exclusion of close-out netting contracts

ISDA supports the exclusion of rights held under close-out netting contracts (as defined in the Australian *Payment Systems and Netting Act*, ("**Netting Act**")) contained in Section 22(d) the Bill. As the effectiveness of close-out netting which takes place under close-out netting contracts (such as the master agreements published by ISDA) is already protected under the Netting Act, ISDA agrees that is not necessary to include such contracts within the ambit of the Bill and their inclusion in such wide ranging legislation could have unexpected effects on documentation which is integral to the Australian and international derivatives markets.

In keeping with this approach, ISDA is keen to ensure that the protection of the Netting Act is not impaired by the Bill. Accordingly, ISDA is concerned that Section 13 of the Bill may purport to override the Netting Act, as it states in general terms that:

> "This Act prevails over the following to the extent of any inconsistency:
>
> (a) a law of a State or Territory;

(b) a rule of law or equity."

It is not clear how this sits with the wording of the Netting Act, for example Section 14(4) which states that:

> "Subsections (1) and (2) [being the provisions giving efficacy to close-out netting] have effect despite any other law (including the specified provisions)."[1]

ISDA understands that the Netting Act is an Act of the Australian Commonwealth parliament, and not an Act of the parliament of any of the Australian States or Territories. Also, given the importance of the provisions contained in the Netting Act for the stability and confidence in the financial markets and payment systems generally, ISDA expects that the Bill was not intended to override the Netting Act's provisions. However, from the perspective of ensuring certainty in dealing with the Australian financial markets and clearing systems, ISDA believes that it is important that the next draft of the Bill expressly clarifies that its provisions do not prevail over those of the Netting Act.

As a further point in relation to the preliminary wording of the exclusion of close-out netting contracts from security interests in section 22(d), ISDA suggests that it would be preferable to refer to:

> "any right *or interest* held by a person, *or any transaction*, under any of the following:"

rather than:

> "any right held by a person under any of the following:"

as the definition of security interest in section 21(1) refers to "interests" and "transactions".

Absolute transfers of investment instruments

ISDA notes the commentary released with the Bill ("**Commentary**") states that it is likely that the regulations would exclude lending arrangements in relation to investment instruments from the definition of security arrangements (section 3.10 of the Commentary). ISDA understands the policy behind this exclusion is that it is not intended that the arrangements under the Bill interfere with the ability to transact efficiently in the financial markets. ISDA supports such a policy.

In order to properly achieve this policy objective, ISDA believes that such an exclusion should refer to the nature of the transaction which is put into place in such arrangements, rather than referring to commercial descriptions such as "lending". This would minimise the risk of inadvertently disadvantaging parts of the financial markets that effect similar transactions to securities lending but do so under different commercial descriptions (such as reciprocal purchase or "repo" transactions). A similar "title-transfer" approach is also taken in some of ISDA's own credit support documents, which form part of ISDA's master agreements.

These arrangements usually take the form of an absolute transfer of the financial instruments from one party to the other together with a contractual obligation on the transferee of the financial instruments to transfer *equivalent* financial instruments to the original transferor. Absolute transfers of cash can occur in the same way. In securities loans and repos, transfers of cash can occur at the same time as, but in the opposite direction to, each of the two transfers of financial instruments.

ISDA believes that the exclusion to be contained in the regulations should be drafted on a general basis, referring to arrangements involving the transfer of investment instruments by a tranferor to a transferee together with an obligation on the transferee to transfer equivalent investment instruments to the original

[1] Similar provisions are contained in section 10(3) (dealing with approved multilateral netting arrangements) and section 16(3) (dealing with market netting contracts) of the Netting Act.

transferor. It should also be broad enough to include the cash which could be transferred as part of these arrangements.

Meaning of investment instruments

The exclusion of lending arrangements relating to investment instruments is just one demonstration of the importance of the definition of investment instruments. Another is the fact that the Bill provides that something which is an investment instrument is excluded from the definition of *account*. As absolute transfers of accounts are taken to be security interests for the purpose of the Bill, but absolute transfers of investment instruments are not, it is therefore critical to the smooth operation of the financial markets that all financial market instruments are included in the definition of investment instruments and not inadvertently caught by the definition of accounts. The relevance of something being treated as an account and not an investment instrument is also demonstrated by section 117 of the Bill, which applies to accounts but not investment instruments. This is a wide ranging provision, covering rights of set-off between parties in connection with a transfer of accounts and overriding contractual provisions prohibiting transfers of rights to accounts.

Due to the importance of the distinction between accounts and investment instruments, ISDA is concerned that the definition of investment instrument is sufficient and clear.

ISDA notes that the definition of *investment instrument* in section 19 of the Bill is broadly drafted. However, there seem to be some financial market instruments which remain excluded from the definition:

- derivatives which are not traded on a financial market, such as those traded on the over-the-counter market;
- interests in any of the investment instruments which are in the list, for example those arising because the actual investment instrument is being held by a custodian, clearing system or other intermediary;
- investment entitlements, as used in section 50 of the Bill;
- foreign exchange contracts which are not derivatives;
- units in a trust which is not a registered managed investment scheme;
- debentures which are not quoted securities; and
- Australian Emissions Units and other carbon emissions permits recognised under the emissions trading scheme announced by the Australian government.

ISDA regards the inclusion of over-the-counter derivatives themselves as critical. If transfers of these transactions (which occur commonly by way of novation) need to be registered to be effective, and dealings with them are regulated in the manner provided for by section 117 of the Bill, significant disruption could be caused. For example, settlement by novation of transactions is common in some international derivatives markets. Also, in many transactions it is regarded as fundamental that the contractual prohibition on assignment contained in the documentation used (such as the master agreements published by ISDA) is effective.

The additional financial market instruments listed above are either commonly involved in the settlement of over-the-counter derivatives, or closely linked to the over-the-counter derivatives market. The treatment of these as accounts and not investment instruments under the Bill would lead to distortions and anomalies which would have a significant impact on the efficiency of financial market transactions.

Control of investment instruments

A related point to the description of investment instruments is the reference to the methods by which they can be controlled as described in section 34 of the Bill. This is relevant to ISDA's membership as some market participants will take collateral for obligations of a counterparty by a traditional security interest over what is described as investment instruments, as opposed to the absolute transfer method described above. ISDA supports the ability to perfect security interests in investment instruments by control rather than registration.

ISDA notes that section 34(2) sets out methods of control for uncertificated instruments which are similar to those contained in 262(1)(g) of the current Australian *Corporations Act* in relation to registration of charges over marketable securities and we support the consistency of the treatment. However, ISDA makes two additional comments in this regard:

- the ability to control uncertificated investment instruments should not be limited to those held in Australian clearing systems, and it should be permissible to control instruments held in overseas clearing systems for this purpose; and

- the methods of control should also be able to be exercised in respect of investment instruments not held in clearing systems, such as contracts. For example, this could be achieved in a manner similar to controlling ADI Accounts under the Bill.

Hague Securities Convention

ISDA notes that the Department has requested (in Section 11.74 of the Commentary) submissions as to the extent that the Bill should implement rules consistent with the Hague Conference on Private International Law Convention of 5 July 2006 on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary ("**Hague Securities Convention**").

ISDA supports the Hague Securities Convention and considers that it is of great importance to the international financial markets that the Hague Securities Convention be adopted as widely as possible. ISDA believes the conflict of laws rules set out in the Hague Securities Convention are critical for reducing legal uncertainty and legal costs regarding the law applicable to indirectly held securities.

ISDA believes that the final text of the Hague Securities Convention represents a careful balance of the fundamental objectives of:

- *ex ante* certainty for financial market participants achieved by clearly defining and simplifying the conflict of laws rules for disposition of securities held in book-entry form by financial intermediaries;

- compatibility with global technological advancements and the realities of modern systems for holding and transferring book-entry securities; and

- compatibility with a broad range of legal traditions.

ISDA actively participated in the public consultations leading to the adoption of the Hague Securities Convention by the Hague Conference on Private International Law. Since then, ISDA has, among other efforts, written to the European Commission and the US Department of State to express its strong support for the Hague Securities Convention and its adoption by EU member states and the US. For more background, please visit our website at http://www.isda.org/c_and_a/collateral-Financial.html

Accordingly, ISDA strongly supports the incorporation of rules consistent with the Hague Securities Convention into the Bill.

Conclusion

ISDA would be happy to speak with the Department in relation to any further developments in relation to the Bill, to elaborate on or clarify any issues raised in this submission or generally to discuss any future developments in the derivatives market in Australia.

Therefore, if you or your colleagues have any questions regarding our comments, please do not hesitate to contact Ms Angela Papesch (apapesch@isda.org; +65 6538 3879) and Ms Jacqueline Low (jlow@isda.org; +65 6538 3879) or Mr Scott Farrell (scott.farrell@mallesons.com; +612 9296 2142) of Mallesons Stephen Jaques.

Yours faithfully,
For the International Swaps and Derivatives Association, Inc.

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