5 February 2016

Division Head
Financial System Division
The Treasury
Langton Crescent
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By email: resilienceandcollateral@treasury.gov.au

Dear Ms Quinn

Resilience and Collateral Protection Law Amendments

The Australian Financial Markets Association (AFMA) welcomes the release of the Financial System Legislation Amendment (Resilience and Collateral Protection) Bill 2016 (Bill) Financial System and Legislation Amendment (Resilience and Collateral Protection) Regulation 2016 (Regulation) for consultation. This letter contains comments on the Bill and Regulation.

AFMA generally supports the legislation and acknowledges the policy support it demonstrates for improving legal certainty and the effectiveness of contractual relationships between market participants. The following comments go to technical drafting matters aimed at fully achieving the objectives of the Bill and Regulation and do not detract from our overall support for these pieces of legislation.

Part A - Payment Systems and Netting Act 1998 Amendments

1. General

AFMA agrees with policy objectives set for the Bill to amend the *Payment System and Netting Act* (PSN Act) and certain other Acts to:

- Enable Australian entities to enforce rights in respect of margin provided by way of security in connection with certain derivatives in the manner required by international standards.
- Clarify domestic legislation to support globally coordinated policy efforts and provide certainty on the operation of Australian law in relation to the exercise of termination rights (also known as close-out rights) under derivatives arrangements.
- Enhance financial system stability by protecting the operation of approved financial market infrastructure.

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Given the impending introduction of non-cleared derivatives margining it is very important to our members and the market as a whole that this legislation is settled as soon as possible and introduced into Parliament with the desire that it will become law and provide the certainty needed for the market wide redocumentation of derivatives contract arrangements between counterparties that is needed to underpin the new margining rules.

The reforms for margining mean that some margin should be provided by way of security and not by the outright transfer of title. The desire to operate in this way will be driven by the need to post initial margin on a gross basis leading to a much greater value and demand for collateral being used by counterparties. The party providing the collateral enjoys greater benefits in the event of a counterparty's insolvency if it is provided by way of a security interest. The practice of pledging collateral has been common practice in the United States for many years because of an accommodating legal environment. However, the range of legal issues that need to be taken into account under Australian law has to date meant that providing collateral by way of granting of security interest is seen as more complex and less certain leading to the historic preference for outright transfer.

Legal certainty as to the enforceability of close-out netting and financial collateral arrangements is crucial for any derivatives transaction in over-the-counter derivatives. Close-out netting is an essential component of the hedging activities of financial institutions and other users of derivatives. For swap dealers, who specialise in bringing counterparties together for transferring risk, the need for netting stems from the dealer's central role in risk intermediation. Each time a dealer enters into a transaction with a counterparty, the dealer takes on exposure to the transferred risk. The dealer does not normally wish to retain the exposure however, so it enters into offsetting hedge transactions. By maintaining a matched book – or more accurately, a balanced book – of offsetting transactions, the dealer avoids unwanted exposure to movements in interest rates, currencies and other sources of market risk. The result of this hedging activity is that, over time, the aggregate of derivatives activity includes a large number of inter-dealer and other hedge transactions that function largely to adjust risk positions and limit exposure to market movements.

In Australia, the PSN Act has since 1998, amongst other, things generally provided through its close-out netting provision certainty as to the enforceability of close-out netting contracts in a situation where a party to such a contract is made subject to external administration. In the absence of such certainty, domestic and foreign counterparties may be reluctant to enter into financial market transactions that commonly operate under standard contractual agreements that include close-out netting provisions.

Globally, the objective has been set through the margin requirements for non-centrally cleared derivatives issued by the Basel Committee and IOSCO (BCBS-IOSCO) in revised form in March 2015[1] to greater reliance on margin to help market participants to better internalise the cost of their risk-taking, because they will have to post collateral when they enter into a derivatives contract. It is also intended to promote resilient markets in times of stress, when a market participant who has not received

[1] BCBS-IOSCO, Margin requirements for non-centrally cleared derivatives issued by the Basel Committee and IOSCO, March 2015

margin could be under pressure to withdraw from trading to preserve its capital. As part of this principles framework, the BCBS-IOSCO noted that:

> *The applicable netting agreements used by market participants will need to be effective under the laws of the relevant jurisdictions and supported by periodically updated legal opinions. Supervisory authorities and relevant market participants should consider how those requirements could best be complied with in practice.*[2]

2. *Definition of "financial property"*

AFMA's comment on the definition of "financial property" proposes a limited broadening to include silver and platinum alongside gold as precious metals.

It is important to the functioning of the market that eligible collateral covers a broad set of financial property that is held and is sufficiently diversified and not subject to wrong-way risk. Since 2008 central banks have been considering and adjusting their eligibility criteria for collateral, as have market developments, which have directed a shift from unsecured to secured funding and thereby greater use of collateral. At the same time financial regulators worldwide have cooperated on the topic of regulatory reform to address flaws in the financial sector, in particular as regards liquidity and risk management. In view of these developments, internationally active financial institutions are faced with complex and often diverging collateral requirements across borders and frameworks.

Amongst commonly used and accepted collateral used in the market are precious metals, including gold. For example, the major clearing houses such as LCH and CME accept precious metals as collateral. At present only gold among the precious metals is specified under the Bill in "financial property" definition.

Precious metals are commonly considered by the market to comprise of gold, silver and platinum. Support for this interpretation under Australian law can be found in the Australian Taxation Office ruling[3] on what it considers to be a 'precious metal' for the purposes of sections 38-385 and 40-100 of the *A New Tax System (Goods and Services Tax) Act 1999*. Precious metal is defined in section 195-1 as gold (in an investment form) of at least 99.5% fineness; silver (in an investment form) of at least 99.9% fineness; or platinum (in an investment form) of at least 99% fineness. This list can be extended by regulation but no additional metal has been added. For the purpose of the GST Act the precious metal needs to be in an investment form meaning the metal must be in a physical form that is capable of being traded on the international market for that metal by traders in that metal in that market. The relevant traders are therefore the banks, bullion dealers, commodity brokers and stockbrokers that generally deal in gold, silver or platinum in the bullion market. Paladium is the next most common metal that is treated by the market as precious when treated as an alternative to platinum. However, its growing importance comes from its use an industrial metal not as a store for value.

Investment trading in precious metal is commonly conducted through warrants on major exchange markets, in particular London Metal Exchange (LME). An LME warrant is a document of possession

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[2] Idem, Requirement 3 – Variation margin – section 3ii p 19.

[3] ATO Ruling: Goods and Services Tax: What is 'precious metal' for the purposes of GST? - GSTR 2003/10, http://law.ato.gov.au/atolaw/view.htm?docid=GST/GSTR200310/NAT/ATO/00001

issued by warehouses for metal held on the owner's behalf. In September 2015, LME Clear, the clearing house for the LME market, received approval from the Bank of England to accept LME metals warrants as collateral. For this reason it is desirable that warrants over precious metals also be acceptable.

AFMA considers that it is consistent with the policy intention underlying the definition of 'financial property' to slightly broaden it to include precious metals in the form of gold, silver and platinum and warrants over them. This would mean that gold, silver and platinum could be provided a collateral.

3. Definition of "Eligible Obligation"

AFMA considers that further consideration needs to be given to the definition of 'Eligible Obligation' to make it provide the intended coverage and protection. Sole reliance on the derivative definition in the Corporations Act, which was developed for different purposes is not sufficient to achieve the intended policy objective. At a minimum, physically settled commodity transactions should be included as eligible obligations (wherever used throughout the exposure draft) as they are often documented under an ISDA Master Agreement (and Credit Support Annex) and may be considered derivatives depending on their use.

The BCBS-IOSCO margin requirements apply to the range of non-cleared derivatives which are normally the subject of variation margin. Accordingly, it is important that the protections under the PSN Act apply to all obligations with respect to all derivatives transactions secured and discharged under margining agreements.

The definition of financial obligation is important because for the enforcement of security to be protected under subsections 14(1) and (2) of the PSN 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).

While the Corporations Act definition of 'derivative' is broad it does not encompass all derivatives traded under market documentation that need close-out netting protection, in particular ISDA Master Agreements, because of the 'tangible property' exclusion in subparagraph 761D(2)(a)(i) of the Corporations Act. For example, commodity swaps in the form of metals/grain spot and forward trades are not necessarily 'derivatives' for the purposes of section 761D of the *Corporations Act* although these products are commonly traded under ISDA Master Agreements (and the ISDA 2005 Commodity Definitions clearly contemplate that this will be the case). Similarly both spot and forward emissions trades are generally transacted under the ISDA Master Agreement. ISDA has developed a Part 7 for European Emissions Allowance transactions that includes spot transactions and a US Emissions Allowance Transaction Annex. For this purpose, spot emissions trades would appear not to be derivatives under section 761D and there is some uncertainly as to whether forward emissions trades are derivatives or not.

AFMA considers that forward tangible property commodity contracts are commonly traded in the market under derivatives documentation and that these contracts merit equal treatment with swap contracts traded under the same documentation, in particular ISDA Master Agreements. Accordingly, the definition of 'eligible obligation' should be extended to encompass derivatives contracts relating

to tangible property in the form of commodities. It would also be prudent to include a regulation making power with the respect to the definition to allow internationally recognised derivatives that may be omitted by the Australian definition to be expressly included.

4. S14A (5) Effectiveness of security given in respect of obligations under close-out netting contracts

AFMA is concerned that certain drafting is affecting the effectiveness of security given in respect of obligations under close-out netting contracts with regard to the reference to the right to consent in items 4 and 5. This is because sub-paragraph (5) of section 14A is expressed as not limiting paragraph 1(b), however it is difficult to see any other construction and so it could lead to confusion if the drafting intention is not made clear.

Sub-paragraph (5) states that paragraph 1(b) is taken not to be satisfied if column 2 of the table sets out a condition and the condition is not met. The conditions in items 4 and 5 state that the secured party must have the right to consent. However, a consent condition is not necessary or desirable and is contrary to market practice. In the ISDA Credit Support Annexes under New York law, consent to substitution is not typically required by market participants, and the secured party's consent is not part of the procedure by which excess collateral is withdrawn. We note that the secured party is protected in respect of substitutions as the substitute collateral must be received prior to release of the original collateral. Similarly, the secured party may dispute any calculations under the Credit Support Annex, including in respect of return amounts.

We understand the drafting is informed by the EU Financial Collateral Arrangements Directive, which states (Article 2 (2)) that "[A]ny right of substitution or to withdraw excess financial collateral in favour of the collateral provider shall not prejudice the financial collateral having been provided to the collateral taker", however the Directive has no consent requirement. Item 7 requires effectively that the secured party (or its insolvency official) has a right to stop the security being released when the secured party goes insolvent. This seems to conflict with BCBS-IOSCO Key Principle 5. This requires that the "collected margin must be subject to arrangements that protect the posting party to the extent possible under applicable law in the event that the collecting party enters bankruptcy".

We suggest that conditions in items 4, 5 and 7 be deleted.

5. Cross reference correction

In section 14(A) in 14(A)(1), the reference in the first line to "14(1)(fa)" should be to "14(2)(fa)".

6. Secured Party possession or control - 14(A)(1)(b)(ii) - Contract language alignment

The BCBS-IOSCO principles effectively mandate that the world's derivatives contracts be supplemented by one or two custody agreements (also referred to as "triparty agreements" or "account control agreements"). The form of these agreements is not yet settled or standardised. Even when or if they are:

- It could very well be the case that the relevant document is interpreted as not containing an acknowledgement in this form, albeit that, as a matter of fact and law, such possession or

control may exist. So there may be a problem with the words: ", who acknowledges in writing that he, she or it".

- The custodian could not say that it has possession / control of the property, in circumstances where the grantor has possession / control of the property – by virtue of 14A(2). Section 14A(3) says that the property is in the possession of the grantor where it is the registered owner or account holder of the property. The grantor appears deemed to be the registered owner / account holder under the ISDA Account Control Agreement (see Part 1 of the Annex – Nature of Account).

The BCBS-IOSCO principles may only work on the basis that both the grantor and the secured party have some rights to possession / control in certain circumstances. For example, each party has control when the other party becomes insolvent. In such a case, the concept of the custodian having possession and control of the property "on behalf of the secured party" could be problematic.

AFMA recommends that further consideration be given to how emerging contractual language is developing and flexibly accommodate how possession / control may be characterised.

Part B - Financial System Legislation Amendment (Resilience and Collateral Protection) Regulation 2016

7. Independent commencement

The Regulation's commencement is subject to the condition precedent of the commencement of the Financial System Legislation Amendment (Resilience and Collateral Protection) [Act]. The policy objective behind the Regulation to legally clarify the ability of life insurers and trustees of superannuation funds to provide margin by way of security in relation to derivatives and foreign exchange contracts to allow access to international capital markets and liquidity is a standalone objective of great merit. It is highly desirable that this clarification to the law proceed as soon as possible.

While there is drafting language commonality between the Regulation and the Bill they are not interdependent. The Bill will be subject to the vagaries of the Parliamentary process and its highly desired timely passage cannot be presumed. The Regulation stands on its own merit for the reasons set out in its Explanatory Statement with which we agree and should commence at the earliest opportunity.

AFMA recommends that the Regulation should be allowed to commence on the day after its registration as a legislative instrument.

8. Secured derivatives with the requirement of law

The proposed subregulation 1A for both the Life Insurance Regulation and SIS Regulation requires "that the performance of obligations in relation to the derivatives contract be secured" where 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.

There are two difficulties with using this formulation with respect to the mandatory margining requirements:

1. The Australian life company / trustee may not be personally subject to any requirement. Rather, its counterparty might be the complying party.
2. There is a question whether under different jurisdiction's regimes the charge itself is actually given in order to comply. For example, the CFTC requirement is that Initial Margin is to be collected / posted and held with a custodian under an agreement that meets the relevant requirements. There is no formal requirement for security to be given.

AFMA suggests that further consideration be given to the use of the words "given" and "requirement" in the subregulation to overcome these two limitations.

9. Definitions comments also apply to Regulation

The comments made in respect of the PSN Act definitions of "financial property" (Comment 2), "eligible obligation" (Comment 3) and possession / control (Comment 6) also apply to their use in the Regulation.

Part C - Client Monies

The consultation paper on Client Monies released in conjunction with the Bill includes a separate second part dealing with Wholesale Clients. The Government proposes to implement its commitment announced in response to the Financial System Inquiry to "ensure participation in international derivatives markets" by implementing certain reforms in respect of wholesale clients.

AFMA supports the amendment or clarification of the client money regime as proposed in the consultation paper to provide that:

1) the existing section 981D of the Corporations Act is to continue to apply; and

2) the AFS licensee and that wholesale client may agree the way in which client money, and client property, of that wholesale client will be held and dealt with in respect of dealings in derivatives. Of course, this would not, of itself, allow such a wholesale client to deal with the client money or client property of its own which are not those of wholesale clients in this way.

Part D - ISDA comments commended

AFMA has had the opportunity to review the comments of the International Swaps and Derivatives Association (ISDA) on the Bill and Regulation. Their comments are informed by an intimate understanding of the relationship of these reforms to the predominant international documentation governing derivatives transactions maintained by ISDA. AFMA commends the ISDA comments to you.

Thank you for your attention to our comments. Please contact me at dlove@afma.com.au or on +61 (02) 9776 7995 if further clarification or elaboration is desired.

Yours sincerely

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