



8 August 2011

Mr John Lonsdale
General Manager
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: closeoutnetting@treasury.gov.au

Dear Mr Lonsdale

Financial Sector Legislation Amendment (Close-out Netting Contracts) Bill 2011

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the Financial Sector Legislation Amendment (Close-out Netting Contracts) Bill 2011 (Bill).

AFMA represents the interests of participants in Australia's wholesale banking and financial markets. Our members include banks, stockbrokers, treasury corporations, fund managers, traders in specialised products (including energy markets) and industry service providers. Their businesses place them at the centre of the financial market: brokering transactions, arranging and underwriting capital raisings, structuring products, trading and investing. As part of our role, we offer practical support to over-the-counter (OTC) markets through standard documentation and market conventions.

1. General Observations

In general, AFMA welcomes the efforts made in clarifying the conflict between the provisions of the Payment Systems and Netting Act (PS&N Act) and the Banking Act, Life Insurance Act and the Insurance Act.

AFMA and the International Swaps and Derivatives Association (ISDA) regularly liaise in relation to issues affecting Australian OTC market documentation. Our members have been closely involved in the preparation of the ISDA submission to you on this matter. AFMA endorses the ISDA submission and incorporates it by reference into this submission. In particular, we draw Treasury's attention to the points made in the final

paragraph of section A1 of the ISDA submission regarding bringing aspects of the Transfer Act into line with FSB recommendations and the conclusions relating to voidable preferences in A2.

The following comments are supplemental to those provided by ISDA.

2. Grounds for Termination

Do you agree with the proposed grounds on which a statutory manager or judicial manager may issue a notice to terminate the default period earlier than 48 hours or to issue a notice to continue the default period beyond the 48 hours? If not, what alternative formulations would you recommend?

AFMA does not support the ability of a statutory manager to extend the stay period beyond 48 hours.

The only circumstances where a statutory manager should have the ability to do this is if a reputable entity (for example APRA acting with the financial support of the Australian Government) agrees to stand behind the obligations of the bank or insurance company if the period is extended.

The issue here is that the counterparty may be required to pay away amounts owing to the bank or insurance company during an extended stay period, which it would otherwise have set off against the mark-to-market value of future amounts owing to the counterparty by the bank or insurance company if the transactions were closed out. If the bank or insurance company defaults after the counterparty has made payment but before the bank or insurance company has satisfied its obligations to the counterparty, the counterparty will be in a worse position than it would have been in if it were able to close out after the 48 hours.

We recognise that a longer period would increase the likelihood that a statutory manager could find a willing transferee for the derivatives positions. This could be beneficial to the market, given that the forced closeout of a large book of derivatives in an illiquid market would generate losses for the insolvency estate (from wide bid-ask spreads), as was the case in Lehman Bros. Deleveraging would also create pressure on asset prices generally (which would adversely impact even healthy financial institutions, given mark to market accounting rules).

That however is outweighed by the uncertainty too long a stay would create with consequent sharp slowdown in activity in capital markets, as participants will be unsure as to whether their positions will be transferred or liquidated (and therefore uncertain on how to hedge their risk).

The unfettered discretion of the statutory manager to extend the period leaves too much uncertainty in the outcome which may well make it less desirable to do business with Australian banks and insurance companies. Other key jurisdictions do not leave this degree of uncertainty in their bank failure resolution schemes.

It is important that a statutory manager must give a notice in respect of **all** close-out netting contracts. Allowing the statutory manager to choose which contracts are to be closed out flies in the face of the fundamental concept of close-out netting.

More circumscribed analogous arrangements apply under United States and United Kingdom law.

United States

In relation to the United States you are referred to section 1821 (e) (10) (B) of title 12 of the United States Code (USC). This provision sets out that a counterparty to a “qualified financial contract” (this term including master agreements on certain financial instruments) may not exercise any right to terminate, liquidate, or net such contract solely by reason of, or incidental to, the appointment of a receiver for the relevant institution until the next following business day. However, this provision should be read in connection with 12 USC 1821 (e) (9) (A) pursuant to which the receiver may choose to transfer either all or none (but not only some of the) existing “qualified financial contracts” between the defaulting institution and a particular counterparty to another institution.

In this context, a narrow temporary suspension of contractual termination rights is reasonable since the exercise of such termination rights might possibly interfere with the transfer of the relevant transactions to the receiving institution. However, it should be noted that the temporary suspension only extends to termination rights which purport to be triggered specifically by the appointment of a receiver for the defaulting institution. In contrast, the right of the counterparty to exercise other contractual termination rights (including termination rights based on non-performance of contractual obligations) remains unaffected by the suspension provision.

United Kingdom

The special resolution regime under the UK Banking Act 2009 provides, inter alia, for the option of the UK banking supervisory authorities to transfer all or part of a defaulting bank's business to a private sector purchaser or a bridge bank (i.e. a company wholly owned by the Bank of England) on the basis of a (partial) property transfer order.

The UK Banking Act 2009 provides that a property transfer may override termination and change of control clauses (“default event provisions”) if so specified in the relevant transfer order. However, the potential negative consequences of these powers on UK banks in respect of netting agreements – including increased cost of capital and higher regulatory capital requirements – were identified early in the consultation process and were thoroughly discussed between the UK authorities and market participants. As a result, the UK Government enacted specific legislation that protects any kind of set-off or netting agreements (including bespoke agreements as well as those made under industry standards), with specific “carve-outs” for necessary exceptions.

Pursuant to the relevant Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (Safeguards Order), a partial property transfer (i) may not provide for the

transfer of some, but not all, of the protected rights and liabilities between a counterparty and the institution under a set-off arrangement, netting arrangement or financial collateral arrangement, (ii) may not terminate or modify the rights and liabilities which either the counterparty or the institution is entitled to set-off or net under a set-off arrangement, netting arrangement or financial collateral arrangement, and (iii) may not restrict the ability to terminate a set-off arrangement, netting arrangement or financial collateral arrangement on the basis that a partial property transfer is ordered.

3. Other Issues - Sub-section 14(3) of the PS&N Act Drafting Problem

Are there any other matters related to the initiatives contained in the Bill that need to be addressed?

In reviewing amendments to the PS&N Act it is opportune to reiterate a matter which has been the subject of previous submissions to the Treasury.

In the view of senior derivatives lawyers who opine on the validity of derivatives transactions conducted by AFMA members there is a long standing view that there is an error in the drafting of the Netting Act.

Currently section 14(3) provides:

(3) A person may not rely on the application of subsection (2) to a right or obligation under a close-out netting contract if the person acquired the right or obligation from another person with notice that that other person was at that time unable to pay their debts as and when they became due and payable.

We suggest the following changes highlighted in **bold italics** would more accurately reflect what is intended.

*(3) A person may not rely on the application of subsection (2) to a right or obligation under a close-out netting contract if the person acquired the right or obligation from another person **with notice that the counterparty to the close-out netting contract** was at that time unable to pay their debts as and when they became due and payable.*

The background is found in paragraph 73 of the Notes on clauses (of the PS&N Bill) at the end of the Explanatory Memorandum. It provides:

The exclusion of an obligation acquired from another person with notice that the other person was insolvent is intended to prevent a party to a close-out netting contract from buying in debts with a view to setting them off against its obligations under the netting contract where the counterparty is insolvent (clause 14(3)).

Further explanation is found in the Final Report of the Netting Sub-Committee of the Companies and Securities Advisory Committee on 'Netting in Financial Markets Transactions' - June 1997.

The genesis of section 14(3) is found in section 4.4 of the 'Proposed Close-Out and Market Netting Act' provided in Part 2 of the report. It provided at page 7 of the report:

s4.4 'Covered Obligation' means an obligation to which the close-out netting provisions of a close-out netting contract apply, and includes:

- (a) an obligation to pay money in Australian or foreign currency; and*
- (b) an obligation which does not relate to payment, to which the contract applies, but excludes an obligation acquired from a third party with notice that the obligor is Insolvent.*

In Part 3 of the report 'Explanatory Notes to the Proposed Act', when referring to proposed section 4.4, it provided - at page 14 as follows:

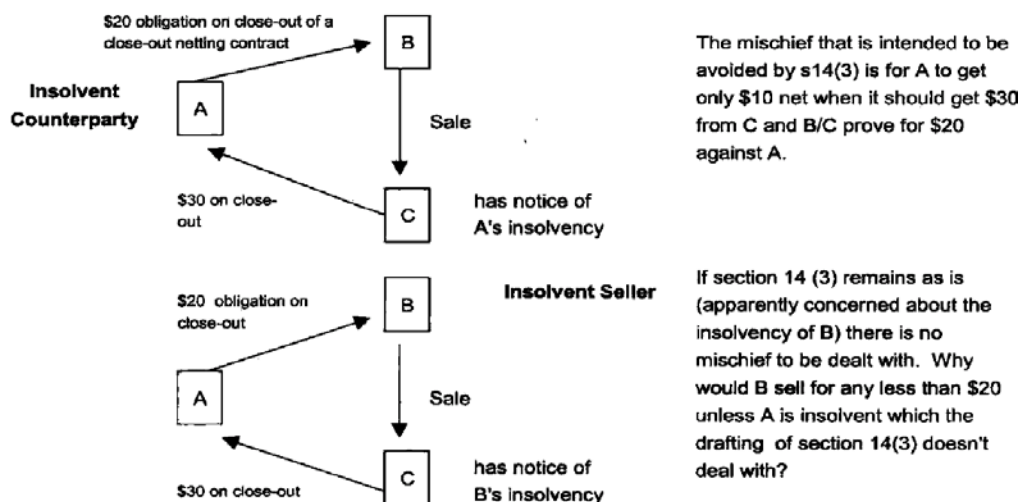
The exclusion of an obligation 'acquired from a third party with notice that the obligor is insolvent is intended to prevent a party to a close-out netting contract from buying in debts with a view to setting them off against its obligation under the netting contract, in circumstances where the counterparty is or is newly insolvent.

It should be noted that the reference in particular is to buying in debts of the insolvent counterparty to set off under the close-out netting contract, also reflected in paragraph 73 of the Notes on clauses (of the PS&N Bill as drafted) referred to above.

We note that the simple buying in of outstanding debts, in contrast to buying in outstanding transactions available for termination (close-out) under a close-out netting contract, to set off against amounts due under a close-out netting contract would in any event be affected by section 553C(2) of the Corporations Act.

We suggest that the mischief at which section 14(3) should be directed is the buying in of outstanding transactions under close-out netting contracts. This may have been obscured by references to the mere 'set-off' etc of 'debts' in the various explanatory materials, although these were, for various reasons, probably intended as references to buying in outstanding transactions. In any event the current drafting of section 14(3) seems in error.

The following diagram illustrates the basic issues:



Finally, we note that it would be anomalous for section 14(3) to remain as it is as it may have the effect that a party may not rely on section 14(2) of the subject Act in circumstances where it is intended it should be able to do so.

Please contact me at dlove@afma.com.au or (02) 9776 7995 if further clarification or elaboration is required.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'D Love', with a long horizontal stroke extending to the left.

David Love
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